

Final Salary Pension Schemes

(Should I stay or should I go?)

Introduction

These notes have been produced in response to **the growing concern** among some of our clients **about the security of the benefits** that they have in their employer provided 'defined benefit' pension schemes, which are commonly referred to as 'final salary' schemes.

Although such pension schemes are used in both the public and the private sector, **it is to members of final salary schemes in the private sector that these notes are addressed.**

Although final salary pension schemes in the public sector are also under pressure (note the recent proposals to change the NHS pension scheme from a defined benefit to a defined contribution basis), there is not the same level of concern over the security of benefits that have been earned to date.

Please note that it is not the purpose of this Fact Sheet to provide advice as to any particular course of action.

Arch Financial Planning Limited cannot be held responsible for any action you take as a result of anything that is stated here.

If as a result of reading this Fact Sheet you wish to investigate further the possibility of taking a transfer value in lieu of your deferred pension benefits in a final salary pension scheme, you will be put in touch with one of our pension specialist advisers.

Only those of our advisers who have passed the Chartered Insurance Institute's examination G60: *Pensions* are allowed to provide advice on such matters.

Even then, such advice cannot be generic but would be based on your particular circumstances having reviewed all of the facts and obtained an independent O&M Pension Transfer Analysis.

There are no circumstances in which we would be willing to give advice as to the suitability or otherwise of effecting a transfer from a final salary pension scheme where you are still in the employment of the employer concerned.

What this Fact Sheet will strive to do is to point out to you, in general terms, **the advantages and disadvantages of remaining in membership of a final salary pension scheme** against the alternative of taking a transfer value into a private pension arrangement.

Background information

Traditionally employers have provided pensions for employees that have **a known amount of pension and other benefits**. These are 'defined benefit' schemes. That is, what you as an employee can expect to receive is defined as a percentage of your 'final salary' for each year of membership in the scheme. The amount of pension you will receive from such a scheme is dependent upon:

- A** the **length of time served** in the scheme (known as pensionable service);
- A** **earnings** just prior to retirement (known as final pensionable salary); and
- A** the scheme's '**accrual rate**'. The accrual rate is the proportion of salary that is received for each year of service. So, if your scheme has an accrual rate of 60ths, you will receive 1/60th of your final pensionable salary for each year of service completed.

For example, if you are in a 60ths scheme and will complete 23 years service just before reaching your normal retirement age and your final pensionable salary is £70,000, you will receive a pension of:

$$(23 \times 70,000) / 60 = \text{£}26,833 \text{ pa}$$

If your scheme **provides one sixtieth of final salary** for each year of membership, this would result in a pension of half of your final salary after 30 years' of scheme membership (ie 30/60ths). If your scheme **provides one fiftieth of final salary** for each year of membership, this would result in a pension of half of your final salary after 25 years' of scheme membership (ie 25/50ths).

Other benefits, such as the ability to take a lump sum on retirement and pensions for your spouse or dependent children on your death, are also defined.

The current position

The latest information that we have (*Financial Times* Fund Management Supplement 31 January 2005) is that **about 60% of final salary pension schemes are now closed to new members.**

The great majority of employees in the private sector will not get pensions that will be linked to their salary. In 20 years there will be relatively few employees in the private sector retiring with pensions based on their final salary. In 40 years time there may be virtually none.

What has gone wrong?

For many years final salary schemes set up and funded by trusted employers **were regarded as a safe method of pension provision.**

The schemes are set up under trust, governed by actuarial rules on funding, monitored by the appropriate legislation and invested so that assets match liabilities. **Schemes were seen as solid and safe and would always pay out as promised.**

The popularity of these schemes among employers has **declined dramatically in recent years,** however, as employers become increasingly reluctant to bear the steeply rising costs and have to deal with complicated and onerous rules and regulations.

The situation has been made worse because employers have found that **the schemes have become heavily underfunded** so that large increases in employer contributions have become necessary to address this problem.

The main causes of such underfunding have been Government legislation preventing schemes from holding surplus and receiving dividend credit. Having removed the surplus, scheme values were then hit **by the dramatic and sustained falls in equity values** over the last few years.

To these factors can be added changes to taxation and accounting practices and, very importantly, **the ever increasing costs created by longer life expectancy** (referred to as increased 'mortality').

Having witnessed the demise of companies such as BCCI, WorldCom, Enron, Equitable Life and Arthur Anderson, we are right to ask the question, 'Is any company totally safe today?' to which we must answer 'Probably not'. That no doubt applies to your employer too. And if no company is entirely secure then no private sector pension fund can be either.

Underfunding

It is your company that promises you the pension and **it merely uses the pension fund as an efficient way to provide it.** If your company is trading soundly, it has an obligation to meet its promise and if there is underfunding, to make it good over a period of time.

While your company has the right to cancel the final salary pension scheme **it cannot get out of its promise relating to past benefits.**

The Pension Act 2004 **introduced the Pension Protection Fund.** This is designed to provide **further protection where companies fail** leaving an underfunded pension scheme with no hope of making up the deficit.

Pension Protection Fund

The Pension Protection Fund (PPF) **opens its doors on 6 April 2005** for all companies which become insolvent after that date and which provided final salary pension scheme benefits.

The PPF is expected to top-up the entitlement of its claimants to **90% of their promised benefits up to £25,000 per year** if the claimant had not reached normal retirement age. If the PPF claimant **had reached normal retirement age** at the time of the insolvency event **the benefit would be topped up to 100% with no cut-off.**

However, **the PPF benefits are not quite as generous as they seem** since inflation proofing (limited to the level of 'Limited Price Indexation') will only apply to post April 1997 benefits. Limited Price Indexation is currently the lower of the RPI or 3% pa.

Furthermore **ancillary benefits will be standardised.** For example, a spouse's pension under the PPF will be 50% of the member's pension, even if the original scheme had promised two thirds.

It has been estimated that for a typical final salary scheme being taken over by the PPF, **the total value of PPF benefits might be of the order of 70% of the scheme's own promised benefits.**

The PPF benefits may turn out to be less than this, **particularly if the PPF's resources are inadequate for the claims made on them.** There are three sources of revenue for the PPF, namely; levies on the final salary schemes of solvent employers, the assets of the schemes it takes over, and investment returns on the first two. **The Government does not underwrite the PPF.**

Any statement, therefore, which describes the PPF benefits as 'guaranteed' is demonstrably false.

Incidentally, the impact of the PPF may not be restricted to those of you unlucky enough to see your employer go bust. **If a solvent employer has to pay a high levy to the PPF** for having a final salary pension scheme, **the likelihood increases that your employer might close that scheme.**

Market risk and longevity risk

Where you do not have access to a final salary pension scheme, or you find that you have to leave such a scheme for future service because the scheme is closed by your employer, **you have to take on two main risks yourself - market risk and longevity risk.**

A Market Risk. Employers have been advised for many years by consulting actuaries to reduce market risk in their pension schemes **by matching their assets to their liabilities.**

Such schemes have particularly used **long term index linked gilts** to achieve this as these assets generate close to a known real return.

Where you find yourself having to invest in your own private pension arrangement you should be investing your own pension funds in the same way. That is, **by using an asset allocation strategy** which includes **index linked gilts** and **other bonds** as well as **commercial property** and **equities** to reflect your own attitude to risk.

A Longevity Risk. This risk **generates uncertainty over the cost of purchasing an annuity** in the future and is harder to avoid. This risk has been taken by companies running final salary schemes. However, companies had not realised how much of this risk they were taking on. Had they understood the nature of this risk many companies would never have set up final salary pension schemes in the first place.

To quote a phrase from Adair Turner, chairman of the Pensions Commission, 'We have been living in a fool's paradise.' **It is now clear that final salary pension schemes should never have been considered as being risk free.**

If you are forced by circumstances to build up your pension fund in a defined contribution or 'money purchase' scheme, then **you will at least have the benefit of being aware to a certain extent of the risks that you are taking.** For example, the dramatic and sustained falls in equity values over the last few years are difficult to ignore.

Whilst you cannot avoid such risks **your very awareness of them should encourage you to seek to build up other assets** for your future financial security and not rely entirely on your pension funding.

Conclusion

If you are working in the private sector and you are fortunate enough to have the opportunity to be a member of a final salary scheme **you should certainly make it your goal to get as much out of this system of pension provision as you can.**

At the same time you need to realise that there is also a risk in this particular mode of pension provision. **You also need to build up other assets for your future financial security** and not rely entirely on your employer's provision.

Winding-up priorities

A final salary pension scheme is simply the means used by your employer to fulfil the promise of future pension benefits. As such there **will be no identifiable pot of money held in your name alone.**

One of the big issues of which you need to be aware is **where you might be in the 'pecking order'** should your employer go into liquidation or otherwise close the final salary scheme.

The Pensions Act 1995 brought in a new order of priorities **to determine the order in which funds in a final salary pension scheme should be used to secure benefits for members** when it is wound up.

These are in order of priority:

- A** benefits from **AVCs** which have been funded by the member
- A** pensions **already in payment**, excluding future increases
- A** **guaranteed minimum pensions (GMP)** for service prior to 6 April 1997
- A** increases to **pensions in payment**
- A** **post retirement increases** to GMPs
- A** all **other entitlements**

Taking a transfer value now

In the light of the type of problems highlighted you may feel that it is best to 'be done with the worry' and **take a transfer value into your own private pension arrangement.**

There are **many employees who wished that they had done this in the past** but who have now seen their promised pension benefits disappear completely through the failure of their employer, leaving an underfunded pension scheme behind. The Pension Protection Fund should give some comfort to people who find themselves in this situation in the future.

You may well find that some of your colleagues have decided to take their transfer values. It will be particularly difficult for those who have most to lose, that is, those with a long pension scheme membership, as the transfer values on offer may appear to be substantial.

However, if you were to join them in taking a transfer value **you would miss out on the additional money that may be put into the scheme to make up for the underfunding in the future.** This is because the transfer values on offer will already have taken into account the level of underfunding.

If you take the transfer value **there will be no chance to change your mind later on.** However, if you decide to wait and see what happens and you regret not taking the transfer value **you will be able to apply for a further transfer value quotation in the future.** Please note that the scheme administrators can refuse to provide more than one transfer value quotation to you in any 12 month period.

An issue often overlooked by employees who are considering taking a transfer value, but intend to remain in the same employment, is **the other valuable potential benefits which they might also unwittingly be giving up**.

These might include:

- A death benefits before retirement.** Leaving a final salary pension scheme could also mean that your spouse loses a lump sum of **up to 4 times your salary in the event of your death**. The final salary scheme may also be providing a generous **spouse's pension benefit** which will also be lost in the event that the transfer value is taken.
- A disability benefits.** Leaving a final salary pension scheme could also mean that you are removed from the company's **group income protection scheme or group private medical insurance scheme**. There might also be generous **ill health early retirement provisions** under the final salary scheme which will certainly not be provided by any private pension plan into which you transfer.
- A redundancy benefits.** Whilst not normal practice, it is sometimes the case that **employers will enhance your benefits** from their final salary scheme (ie possibly by adding extra years of service or removing an early retirement penalty) if they have to make you redundant.

The health of your scheme

Your assessment as to whether you should 'stay or go' will be influenced by **any current problems**, either real or perceived, **with the funding of your employer's scheme** and whether these are most likely to improve or deteriorate. In this respect **it is in your interests to take notice of the reports produced** by the trustees of your final salary pension scheme and in particular to its funding position.

The trustees of an occupational pension scheme are legally bound to produce an annual report within seven months of the scheme year end. The annual report itself is made up of a number of documents, including, the **auditor's statement**, the **latest actuarial valuation certificate** and the **scheme's audited accounts**.

Where you have been told that your employer's scheme is underfunded, you can at least be sure that now the problem is out in the open the trustees will be working hard with your employer and the scheme's pensions consultants to arrange for the shortfall to be addressed.

It is important to be aware that **transfer values usually reflect the health or otherwise of a pension scheme**. If you decide to transfer away from an ailing scheme **you will usually receive a poor transfer value to reflect this**.

A final thought

You may be influenced to leave a perfectly good final salary pension scheme purely by the size of the transfer value on offer. However, **you need to be aware of just how much capital it takes to provide even quite modest pension benefits** now that we are all living much longer and investment returns are historically low.

For example, let us say that you are a 50 year old married man and **have been offered a transfer value by the trustees of your employer's final salary pension scheme of £150,000**, which may seem like a small fortune. You are planning to retire at age 60 or 65. If you were able to invest this sum for the next 10 or 15 years and achieve an investment return of 7% net of charges you will probably have done rather well.

Your fund at age 60 would have grown to around £295,000 or at age 65 to around £414,000. Assuming that you have now suddenly reached age 60 or 65 and have that amount of money available in your pension fund today, what would it buy you?

Well, let us assume that you are in good health and do not smoke cigarettes and that you want a joint life pension which would pay **two thirds of your pension to your wife** on your prior death and which would **escalate in value by just 3% a year**. Your pension would at best be:

£10,976 pa assuming you are age 60, or
£17,690 pa assuming you are age 65.

That may not look quite so much to you and especially in relation to the potential pension you would be giving up. Also, of course, **inflation over the next 10 or 15 years and any reduction in current annuity rates** would make serious inroads into the value of these pensions.

Any information given in this fact sheet relating to pensions legislation is based on our understanding of legislation and practice in force at the date of this fact sheet. Whilst we believe our interpretation of current law and practice to be correct in these areas, we cannot be responsible for the effects of any future legislation or any change in interpretation or treatment.

For Further Info

If you would like to receive advice on any pensions issue please ask your usual Arch adviser or contact us via one of the following:

Tel: **01483 204600**
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Online: **www.arch-fp.co.uk**

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