R04 2020/2021
Final Salary Schemes
Part 2: Taking the benefits

Taking benefits for members of final salary schemes is a much simpler process than for money purchase members. At retirement the member will be told how much they will receive. The pension will increase in payment and include a spouse's pension. The only decision the member has to make is how much cash to take.

The milestones for this part are to understand:

- The concept of a scheme pension
- The calculation of a PCLS
- The legal requirements to increase benefits in payment and to provide a spouse's pension

Scheme pension

The trustees of a final salary scheme do not normally buy annuities to secure the member's pension. Instead they pay an income directly from the fund and this is termed a **scheme pension**.

HMRC requires that this:

- Must be payable for life.
- Must be payable at least annually.
- Cannot normally reduce in the amount paid unless the proportionate reduction applies to all scheme members.
- Can only be guaranteed for a maximum of ten years.
- May be transferred in payment to an insurance company. If a transfer takes place the income cannot be altered nor allow further tax free cash to be drawn.
- May incorporate pension protection.

Some schemes will deduct the member's state pension when it comes it starts to be paid. The additional amount between scheme and state pension age is called a **Bridging Pension**.

Hilary started to receive a scheme pension at 60. At 66 she is receiving £12,000 and starts to get her state pension. This is £8,000. Her scheme pension is reduced to £4,000

This is not common as it has a greater effect on those with low pensions compared to those with a high amount of scheme pension.

Hilary has lost 2/3rd of her scheme pension but a colleague who had the same state pension but a scheme pension of £24,000 would only lose 1/3rd

Early retirement

Every scheme will have a normal or scheme retirement date, usually between 60 and 65. HMRC allow the benefits to be taken from 55 but the scheme rules may only allow early retirement from 60

Requesting early retirement is normally a formality but the scheme will usually apply an actuarial reduction which reduces the size of the pension to take account that it will be paid for a longer period.

David is 58 and has 30 years' service. Based on 1/60th accrual and a salary of £40,000 his pension would be £20,000. However, the scheme retirement age is 60 so by taking it earlier he gets two years more income than if he had waited until reaching 60. The scheme will therefore reduce his pension.

Whilst there must be a scheme retirement date, there is no requirement to retire or leave employment to take the pension. Some schemes may increase the pension if it's taken later than scheme pension age.

PCLS calculation

The final salary member has only to make one decision which is how much cash to take. In the private sector the practice is for the member to give up part of the pension for cash. In principle the amount of PCLS is still 25% but as there is one fund for all members we need a method to calculate this.
The scheme will have a commutation factor (CF) stating how cash can be taken for a reduction of £1 in the pension. A commutation factor of 14 would mean that for every £14 cash taken the pension would be reduced by £1.

The scheme will inform the member of the annual pension if they take no cash. They will also give the member the maximum cash that can be taken together with the commutation factor and await the member's instructions. Any cash must be paid before the first pension payment. Once a payment has been made it is not possible to take any cash.

In calculating the maximum PCLS, the scheme must use this formula.

$$\frac{\text{Pension before commutation} \times \text{Commutation factor}}{1 + (0.15 \times \text{Commutation Factor})}$$

Tom has a pension of £15,000 and the CF is 14.

14 x £15,000 = £210,000
1 + (0.15 x 14) = 3.1
£210,000/3.1 = £67,741.94

The reduction in pension would be £67,741.94/14 = £4,838.71
Tom could therefore get a pension of £10,161.29 plus a cash sum of £67,741.94.

Tom could choose any sum between £0 and £67,741.94.

Schemes probably prefer members to take the maximum cash since this reduces their long term liabilities.

There is an alternative formula for calculating cash which is

$$\frac{\text{Pension before commutation x Commutation factor x20}}{20 + (3 \times CF)}$$

You get the same figure and either is acceptable.

Making the choice

Taking the maximum PCLS looks very attractive but if the member lives a long time, they will probably receive more in pension. The factors that need to be considered in making the decision are:

- Tax situation of the member. A tax free sum is more attractive to a higher rate tax payer.
- Health of them member. A large PCLS paid now may be more attractive to someone who feels they have a shorter life expectancy than normal.
- Need for PCLS. This may be attractive to someone who has a mortgage or other debts.
- Other sources of income. Someone with other income could probably take a reduction in the scheme pension.
- View on future inflation. The gap between a pension taking the maximum PCLS and taking non will widen as each is increased in line with inflation. The higher the inflation rate is in future, the wider the gap

If the scheme has an AVC facility the scheme rules may allow the member to fund the PCLS from the AVC fund.

In the previous example Tom could take a pension of £15,000 and no PCLS or a PCLS of £67,741 and a reduced pension of £10,161.

Tom has £40,000 in his AVC fund and the scheme rules allow him to use this to fund the PCLS. Tom decides to take the maximum PCLS but use the £40,000 from his AVC fund.

He then takes £27,741 by commutation and with a factor of 14 his pension is reduced by £1,981 to £13,019

Final salary pension increases

One of the great benefits of a final salary pension is that it is legally required to increase in payment each year giving retired members a certain degree of protection against inflation. The technical term for this is **escalation**.

The simplest situation is where all the pension rights were accrued after April 1997. The pension must increase in payment as follows:

- For benefits accrued from April 1997 but **before** April 6 2005, the scheme must increase the pension by CPI to a maximum of 5%
- For benefits accrued **after** April 6 2005, the scheme must increase the pension by CPI to a maximum of 2.5%

The position for rights accrued before April 1997 is more complicated because of the presence of a Guaranteed Minimum Pension (GMP).

If the scheme wasn't contracted out of SERPS/S2P there would be no GMP and the scheme does not need to increase pensions in payment for any benefits accrued before April 1997.

Faisal was a member of a **contracted in scheme** from April 1987 until March 2016 when he retired.

The legal minimum that the scheme must increase his pension by is:

April 87 to April 1997	Nil
April 1997 to April 2005	CPI capped at 5%
April 2005 to April 2016	CPI capped at 2.5%

A Guaranteed Minimum Pension always had an element of inflation protection. Between April 1978 and April 1988 the State took full responsibility for increasing the GMP which it did by increasing part of the member's State pension.

From April 1988 it required the scheme to increase any GMP built up after that date by CPI capped at 3%. If CPI was higher the State would pay the excess.

This means that someone who has benefits that started before April 1997 in a contracted out will have a pension split into 3 elements

- Guaranteed Minimum Pension (GMP)
- Pre 97 Excess Benefits (that is benefits built up in excess of the GMP)
- Post 97 Benefits

In summary:

GMP	• For benefits accrued **before** April 6 1988 the scheme does not have to increase the pension since the State provides full CPI protection • Benefits accrued **after** April 6 1988 the scheme pays the first 3%. If CPI is higher the DWP will pay the excess
Pre 97 Excess benefits	The scheme does not have to provide escalation
Post 97 Benefits	• For benefits accrued **before** April 6 2005, the scheme must increase the pension by CPI to a maximum of 5% • For benefits accrued **after** April 6 2005, the scheme must increase the pension by CPI to a maximum of 2.5%

The original rules linked increases to Retail Price Index (RPI) but the 2011 budget changed this to Consumer Price Index (CPI). However, if the scheme's own rules say that benefits must be increased in line with RPI then this overrides the legislation.

These are the legal minimum a final salary scheme must provide. Schemes can and often do pay increases at a higher rate than this. In particular, they will often provide escalation on pre 97 excess benefits.

Escalation post April 2016

The abolition of contracting out from the start of the 16/17 tax year had implications for the rules on the escalation of any GMP.

There will be no change for anyone who reached State Pension Age on or before April 5 2016.

Everyone who reaches State Pension Age on or after April 6 2016 with a GMP will be affected. Increases in the GMP element will no longer be provided by the State as part of the member's State pension. This means no increase in the pre April 1988 benefits. The scheme will still be responsible for increasing the post 1988 benefits by CPI capped at 3%.

In practice most schemes already offer escalation on pre 1997 non GMP benefits at CPI/5% and they may extend this to the old GMP benefits. This will be looked at in more detail in the section on State benefits.

Spouse's/dependant's pension

All final salary schemes must pay a pension to the member's spouse of at least 50% of the member's pension on all benefits accrued since April 6 1997. For same sex marriages and civil partnerships, the scheme is only obliged to pay benefits accrued since December 2005. Contracted out schemes must also provide a 50% spouse's pension from any GMP element.

Legally schemes can pay a "dependant's pension" to anyone but the scheme's rules may restrict this to a legal spouse or civil partner. In practice, many schemes will consider paying to an unmarried partner on a discretionary basis.

Whilst these are the minimum requirements many schemes will pay a spouse's pension on all benefits. They may also pay a higher amount than 50%.

There is no restriction on the size of a dependant's benefits provided the member dies under age 75. (The scheme may of course impose its own restrictions). If the member dies after 75 the aggregate of dependant's pensions cannot exceed the member's scheme pension.

A spouse's pension from a defined benefit scheme is always taxable regardless of the age of the age of the member on death.

Pension Protection

A scheme can guarantee that it will be paid for 10 years so that it can continue after the member's death.

The scheme can also offer Pension Protection which is similar to Lifetime Annuity Capital Protection. The formula is:

Pension at the start x 20 less gross payments made

Stan died 6 years after receiving his company pension. The initial pension was £15,000 and at the time of his death had received £100,000 in gross payments. The scheme offered pension protection so the amount paid would be:

£15,000 x 20 = £300,000 less £100,000 = £200,000

The payment is tax free if the member died under 75 and taxable as the recipient's non-savings income if death occurs after 75.

Triviality

If final scheme benefits have a capital value of less than £30,000 they may be commuted for a cash sum under triviality. A 25% of the PCLS can be taken and the rest is taxable.

That concludes this part so you should now understand

- The concept of a scheme pension
- The calculation of a PCLS
- The legal requirements to increase benefits in payment and to provide a spouse's pension