

## **J05 Pension Income options 2020/2021**

### **Part 2 Final Salary Schemes 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:

- Pre-retirement benefits
- 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
- Member protection under the Pension Protection Fund and Financial Assistance Scheme

#### **Pre-retirement benefits**

These are:

- Death in Service Benefit
- Spouse's/dependent's pension
- Ill health pension

#### **A lump sum death in service benefit.**

This is based on a multiple of salary at time of death. If the multiple is 4 and the member's salary was £40,000 then the amount paid would be £160,000. This is usually paid under a discretionary trust. The member cannot usually demand the benefit is paid to a specific person but can complete an expression of wish. This can be overruled by the trustees and whilst rare they may do this in the case of marital breakdown.

Peter died and left an expression of wish asking the trustees to pay the benefit to his partner Sandra. The scheme contacted Peter's manager and found out that he had left his wife Carol and children two years earlier. Based on that information the trustees may decide to pay all or part of the benefit to Carol

The benefit of having the payment under a discretionary trust is that the money will not be part of the deceased's estate and can be made quickly. Most schemes will usually try and get the money paid out within a matter of days of being notified of the member's death.

### Spouse's pension, pre-retirement

Schemes will pay a spouse or dependant a pension if the member dies before retirement. The best will base this on the member's prospective service.

Jim's scheme pays a spouse's pension of 50% of salary at date of death based on potential service. The accrual rate is 1/60<sup>th</sup>.

Jim died aged 45 having been a member for 10 years. The scheme retirement age is 65. His salary was £40,000.

His potential service was 30 years, so his pension is calculated as 30/60 of £40,000 which is £20,000. His widow gets 50% of this and would receive a pension of £10,000 a year. (This is an example and schemes may pay more than this)

### Ill health pension

Subject to HMRC requirements being met the scheme will usually pay an ill health pension.

In order to qualify for an ill health pension, the following conditions must be met:

- the member must have ceased work because of illness or accident
- the trustees must have medical evidence that the member will be unable to return to work.

This last point is a high threshold particularly for a younger member. The prognosis for a 30 year old who was involved in a car accident may be that he is unlikely to return to work for seven or eight years but a full recovery will be made. In those circumstances the member would not qualify for an ill health pension and if one were made it would be an unauthorised payment.

As the member gets closer to 55 it becomes easier to meet the requirements and once over 55 the ill health pension is no longer applicable as they would be able to crystallise the benefits under the normal rules.

In a DB scheme the pension may be based on potential service to retirement.

Let's say in the previous example that Jim did not die but qualified for an ill health pension. This would be calculated as follows:

Salary £40,000 x 30/60 = £20,000

If a member leaves the employer and becomes a deferred member some of these benefits may still be paid but at a reduced rate.

## 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  $\frac{2}{3}$ <sup>rd</sup> of her scheme pension but a colleague who had the same state pension but a scheme pension of £24,000 would only lose  $\frac{1}{3}$ <sup>rd</sup>

## 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  $\frac{1}{60}$ <sup>th</sup> 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.

$$14 \times £15,000 = £210,000$$

$$1 + (0.15 \times 14) = 3.1$$

$$£210,000 / 3.1 = £67,741.94$$

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

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

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 if the scheme was **contracted out** because it will have **Guaranteed Minimum Pension (GMP)**.

If the scheme wasn't contracted out of SERPS (abolished in 1997) 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	<ul style="list-style-type: none"> <li>• For benefits accrued <b>before</b> April 6 1988 the scheme does not have to increase the pension since the State provides full CPI protection</li> <li>• Benefits accrued <b>after</b> April 6 1988 the scheme pays the first 3%. If CPI is higher the DWP will pay the excess</li> </ul>
Pre 97 Excess benefits	The scheme does not have to provide escalation
Post 97 Benefits	<ul style="list-style-type: none"> <li>• For benefits accrued <b>before</b> April 6 2005, the scheme must increase the pension by CPI to a maximum of 5%</li> <li>• For benefits accrued <b>after</b> April 6 2005, the scheme must increase the pension by CPI to a maximum of 2.5%</li> </ul>

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 as 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.

Schemes can pay a "dependant's pension" to anyone but their 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 will 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:

$£15,000 \times 20 = £300,000$  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.

## Risks for DB members

Whilst a DB scheme offers the members many benefits, it is not without risk. The major risk is that the sponsoring employer goes into liquidation. This would not matter if the scheme had sufficient assets to cover all the promised benefits accrued at the date of liquidation. If the scheme is in deficit the members' pensions will be at risk.

The 1995 Pension Act made the first attempt at securing member's benefits but this proved inadequate. The Pensions Act 2004 introduced the **Pension Protection Fund (PPF)** to give protection to all members of final salary schemes that where the sponsoring employer failed **after 6 April 2005**

Schemes do not automatically enter the PPF once the employer becomes insolvent. It will only be accepted if the fund has insufficient assets to pay benefits at PPF level.

Once an insolvency event occurs the trustees must notify TPR and the scheme will enter a minimum 12 month assessment period. During this time:

- No new members can be admitted.
- No further benefits will accrue and no transfer values can be paid. The only exception is if the member requested a CETV, gave instructions in writing to transfer and designated a scheme to accept the transfer value **before the assessment period started**.
- Benefits can be paid out but only to the level of PPF compensation
- The PPF can intervene in the management of the scheme and give directions to trustees
- The PPF will review any moral hazard issues
- It will review any recent rule changes
- The PPF will instruct the scheme actuary to carry out an actuarial valuation at the date the assessment period started

The trustees and TPR will investigate possible rescues (by a take-over for example). They will also assess whether the assets of the scheme are sufficient **to pay the benefits at PPF levels** which will be lower than what the scheme was originally offering. If neither is possible the scheme can be admitted to the PPF which takes over the scheme's assets.

Pensions will be paid on the following basis

- Members who have retired over the scheme normal retirement age, or in receipt of an ill health pension or a dependent's pension will get 100% of benefits. In other words if they were being paid £45,000 a year pension, they will continue to receive that.
- Members who haven't reached the scheme's NRD including those who took early retirement, when the insolvency event occurred, will only get 90% of benefits subject to a maximum amount
- This cap is set each April 1 and for 2020/2021 is £41,461 if the Scheme retirement age is 65. The maximum compensation at 65 is 90% of this or **£37,315**. If the scheme retirement age is earlier the compensation cap is reduced.
- From April 6 2017 the cap can be increased by the **Long Service Cap**. This increases the cap for members who have 21 years or more service by 3% for each complete year of service over 20 years up to a maximum of double the annual cap. The PPF have applied this to all affected members but it wasn't backdated and only applies to benefits payable from April 6 2017.
- A further actuarial adjustment may be applied to those who take early retirement
- Spouse's pension of 50% of the member's PPF compensation
- Revaluation of deferred pensions will be CPI to a maximum of 5% for benefits accrued up to April 2009 and 2.5% for post April 2009 benefits. Escalation only applies to post April 1997 benefits and only at CPI subject to a maximum of 2.5%.

Jim and his daughter Kate both worked for the same employer and were members of its DB scheme. The scheme has been admitted into the PPF.

Jim had retired in 2014 having joined in 1974. Prior to the collapse of the business his pension was £28,000 a year. The scheme increased his pension by 4% a year and paid a spouse's pension of  $\frac{2}{3}$ <sup>rd</sup> of the member's pension.

Kate had been a member for 15 years when the employer collapsed. Her pension rights at that point were £8,000 a year.

In the PPF Jim will still receive £28,000 a year but only benefits accrued since April 1997 will be increased and these will be limited to CPI capped at 2.5%. If he dies before his wife, she will receive only 50% of his pension rather than  $\frac{2}{3}$ <sup>rd</sup>

Kate will not accrue any further benefits. Benefits accrued prior to April 2009 will be revalued by CPI capped at 5%. Post 2009 accruals will be revalued at CPI capped at 2.5%. At retirement she will receive 90% of the revalued pension.

Even if the sponsoring employer is still in business, members may be concerned if they are informed that the scheme is in deficit. When there is a deficit the scheme trustees must agree a recovery plan with the employer that aims to eliminate the deficit over a period of time.

The other risk members face is dying shortly after retirement. This is particularly severe if the member wasn't married or had no dependants since the pension would cease on death

That concludes this part so you should now understand:

- Pre-retirement benefits
- 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
- Member protection under the Pension Protection Fund and Financial Assistance Scheme