

Proposed Pension Reform - CARE Schemes compared to Final Salary Schemes

In his report on Pension Reform, published in March 2011, Lord Hutton recommended that public sector Schemes should change from a Final Salary Scheme to a CARE (Career Average Revalued Earnings) Scheme, but what is the difference?

CARE like Final Salary is a type of 'defined benefit' pension scheme, by this we mean that the Scheme member is promised a defined level of pension when they retire based on a formula generally related to their pay and the number of years they have been a Scheme member.

In a CARE Scheme the amount of pension build up is calculated each year as a proportion of the member's pay received for that year. The resulting pension is quite often referred to as the 'pension pot' or 'retirement pot'. Each year's 'pot' is added together to determine the final pension.

In order to maintain the value of the pension, each yearly component is revalued annually up until the time the member leaves the Scheme or retires. Increases will be aligned to earnings revaluation.

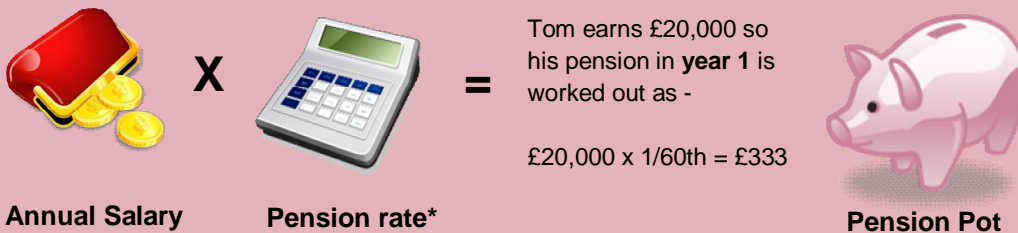
This sounds complicated, but we have provided an illustration of how this may look using some illustrations below.



How a CARE (Career Average Revalued Earnings) Scheme works

The illustration below uses Tom as an example. Tom works full-time and earns £20,000 a year. We have assumed he remains a scheme member for 20 years until he retires

This is what would happen in Tom's first year of membership under the CARE scheme. He would earn a percentage of his salary for his year of membership and this would start his 'Pension Pot'. This is illustrated as follows:



* This is often referred to as the pension 'Accrual Rate' and represents what proportion of annual salary is used in the pension calculation. It has yet to be decided what the rate will be for the proposed CARE Scheme. However, the new proposals issued by HM Treasury on the 2nd November 2011, in their document 'Public Service Pensions: good pensions that last' suggests that the rate could remain at 1/60th, so this is what we've used in the example.

Tom's pension pot from the first year would be revalued the following year and for each year thereafter up until his retirement. This can be illustrated as follows:

As shown above, Tom earns £20,000 so his pension in **year 1** is worked out as -
 $\text{£}20,000 \times 1/60\text{th} = \text{£}333$



\times

The pension will be revalued each year up until Tom's retirement date (we have used 3% each year as an example)#

$=$

Tom's pension for **year 1** is worth £343 by the end of year 2 (Over the full 20 years leading up to retirement, Tom's pot for **year 1** is worth £584)



It is proposed that the level of increase is linked to earning revaluations

Each year Tom earns further pension pots. These are added together (after they have been revalued) to work out Tom's pension.

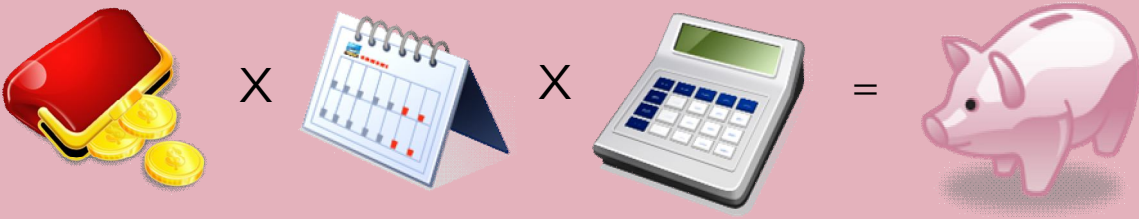
If Tom has a 3% pay rises each year, by adding every year's revalued pension pots together, he could expect a pension of £11,690 a year after 20 years service.



How a Final Salary Scheme works

The example below uses Tom again to illustrate how his same membership details (as used above for the CARE Scheme) would look if applied to the Final Salary Scheme

In the illustration above it assumes Tom's pay rises at the rate of 3% each year to revalue his pension pots. Using the same rate of increase, over 20 years this would achieve a final salary of £35,070. If we apply this to the calculation used to determine the pension under a Final Salary Scheme, it would look like this:



Tom's final salary which is £35,000

Tom's period of membership which is 20 years

The pension rate which is currently 1/60th

Tom could expect a pension of £11,690 a year

What the above illustrates is that if Tom's circumstances were that his pay increased using only earnings revaluation, there would be no significant difference in the final pension amount regardless of whether the calculation is performed under a CARE Scheme approach or that of a Final Salary Scheme.

However, the amount of pay progression a person achieves during their career (by this we mean progression through pay scales or promotion) is a determining factor, with the CARE Scheme favouring those members where progression is less frequent.

If pay progression is most prominent at the beginning of the member's career, then it is likely this will have a lesser impact on the pension calculated under the CARE Scheme when compared to the equivalent pension from a Final Salary Scheme. It is true, however, that a significant increase in the member's pay shortly before retirement would favour the Final Salary Scheme approach.

Under both the CARE Scheme or Final Salary Scheme approaches, the pension outcome will depend largely on the course of the member's personal circumstances throughout their working life.

The Government recommends that the new CARE Scheme is introduced by April 2015. Should the proposed change go ahead, members pensions could be calculated in two parts. The protection offered by the Government would ensure that the pension based on service before the introduction of the new CARE Scheme, would use the existing Final Salary Scheme approach. This pension would be added to the result of a further calculation using the new CARE Scheme approach, based on the member's service falling after the introduction date for the new Scheme.