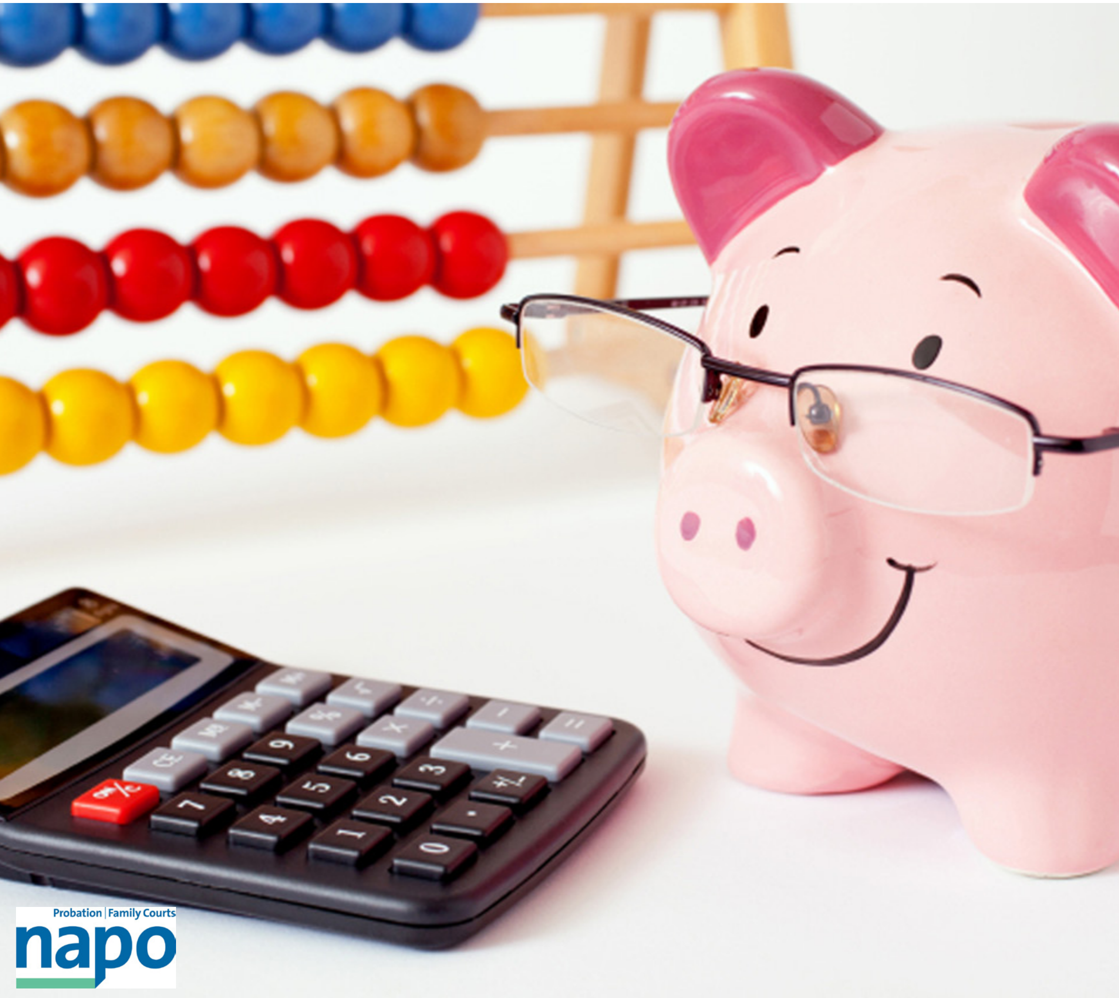
A Beginner's Guide to... Pensions



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Pensions matter

Pensions are very important for all workers. Workplace pensions should bring peace of mind for when you retire, affording security and some degree of choice.

However, pensions can seem complicated. They have acquired a language of their own that is not easily accessible. As governments constantly review and tinker with workplace pensions, it is important people know how they work and are able to understand the choices they are asked to make.

Pensions are also under attack. Although unions fought off government attempts in 2012 to undermine and reduce public sector pensions, financial pressures mean many are tempted to consider whether paying into a pension is worth it. Years of low pay rises, the rise of student debts, the enormous costs of securing a home and the likelihood and costs of supporting dependants for longer can all make saving for a rainy day during your career seem less urgent. But without a workplace pension, security in retirement will be beyond most people.

That is why Napo is publishing this **Beginner's Guide to Pensions**. The aims are simple:

- Demystify pensions – they really do not need to be complicated.
- Help you have a better understanding of the choices you can make about pensions.
- Signpost you to independent financial advice and support – available to you via our comprehensive members' benefits package.

If after using the guide you have any questions or require further direction, please contact your local Napo Reps or Napo HQ using info@napo.org.uk. Napo membership affords you pension support and guidance. For pensions and other financial advice, you can access this via our members' benefits package.

Dean Rogers
Assistant General Secretary

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What is a pension?

A pension is when some of your earnings are put aside (or deferred) and invested so you can use them when you retire. The amount set aside is known as a **pension contribution**.

In most cases, your employer will also make contributions partly funded by government tax incentives to encourage saving for retirement.

Since 1908, the government has paid most people a **state pension** funded from general taxation and from **National Insurance contributions** from 1946. This has always been intended as a minimum safety net with incentives for employers and workers to save for an additional work-based pension.

Pension funds have themselves become an important driver in post-war financial markets and are a major source of investment capital across the globe.

What is the Local Government Pension Scheme and how does it work?

Prior to the **CARE scheme** being introduced in 2014, those paying into the **Local Government Pension Scheme (LGPS)** would have seen their pension calculated as follows:

> Number of *full* years in the LGPS x 1/60 (1.67%) of your final salary paid to you until you die, or access to a lump sum worth 3 ½ times your final pension.

However, the CARE scheme offers **guaranteed returns** (defined benefits) based on **fixed contributions** (defined contributions) and is calculated as follows:

> 1/49 (2.04%) of each year's salary allocated to your pension fund and the total paid to you until you die after which a portion of it will continue to be paid to your next of kin. You could also opt to receive a lump sum where you will get £12 for every £1 of your pension you trade in.

If you were paying into the LGPS before the CARE scheme was introduced, your pension will be calculated using both models.

What are the main differences between the new CARE scheme and the old LGPS?

The pre-2014 LGPS was known as a **final salary scheme** meaning only your final salary (or the best salary in your last three years of service) was used to calculate the value of your pension and lump sum. Members paying into the scheme could expect to receive 1/60 of their final salary for each *full* year of service.

The value of 1/60 was based on people contributing for 30 years and so their pension would be a maximum of ½ their final salary (i.e. 30/60's). Those working longer than 30 years had their pension capped at 30 years.

If you got promoted several times across your career or in the last few years you could do relatively well in this model as your contributions would have been relatively lower over the course of your career than someone who did not have as many promotions.

Indeed, some senior executives in local government and other parts of the public sector were retiring with six-figure pensions based on huge salary hikes in the last few years of service. On the other hand, if you earned less at the end of your career than at other times (for example working part-time or dropping down a grade as many women did in local government after returning from career breaks) you did comparatively less well. Therefore, the new CARE system offering a higher 1/49 annual return (the **accrual rate**) was seen as both fairer and more equitable.

What is accrual rate and why is it important?

In schemes that guarantee a fixed return like the LGPS, the accrual rate is how much your pension is *guaranteed* to grow. In the current CARE model the rate is 1/49 of your earnings each year. In the old model it was 1/60 of your final salary for each *full* year of service.

How much does my pension cost me?

If you are in the LGPS your pension contributions are as follows:

Pay Bands	Contribution Rates
Up to £13,600	5.5%
£13,601 - £21,200	5.8%
£21,201 - £34,400	6.5%
£34,401 - £43,500	6.8%
£43,501 - £60,700	8.5%
£60,701 - £86,000	9.9%
£86,001 - £101,200	10.5%
£101,201 - £151,800	11.4%
Over £151,800	12.5%

How much does my pension cost my employer?

Your employer will contribute about three times your contribution.

> i.e. An employee earning £30,00 will make annual pension contributions of £1,950. Their employer's contribution for that year will be £5,850

The contributions made by you and your employer are not subject to tax making them worth more.

How long do I need to pay into the LGPS before I qualify for a pension?

You only qualify to draw an LGPS pension if you have made more than two year's contributions to the LGPS. If you leave voluntarily before completing two years in the scheme, your contributions should be re-paid to you. If you are a Napo member and are dismissed then Napo would aim to negotiate with the employer to recover pension contributions.

Can I move my LGPS pension?

You can choose to transfer your pension into another fund but this may not always be possible (e.g. if the scheme is vastly different from the LGPS) or worthwhile.

You are advised to get independent financial advice before transferring a pension.

When can I access my pension?

Under the LGPS you can now access your pension anytime between 55 and 75-years-old.

However, you will have an anticipated **Normal Retirement Age** aligned to the **State Pension Age** (65 to 67-years-old depending on how old you are). Anyone retiring before their normal retirement age will usually see their pension reduced, although exceptions can include redundancy or ill-health early retirement.

Why do I lose some of my pension if I retire early?

In schemes that offer a guaranteed return you will almost always have to sacrifice some of the value of your pension if you draw it before your normal retirement age. The earlier you retire the higher the sacrifice expected.

This is because if you retire early, the amount of money you are paying into your fund is reduced but the length of time the scheme would expect to be paying the pension increases. To protect the value of the fund, the monthly sum you get is reduced accordingly.

What if I am not in the LGPS?

If you are not in the LGPS you can choose to join a pension scheme offered by your employer. These **private sector schemes** operate on broadly the same principle: part of your wages are set aside and your employer will also make a contribution which is invested for you to draw down when you retire.

However, there is unlikely to be a guaranteed return and the contribution you make is likely to be variable; i.e. you can probably pay more or less at different times. Your employer will pay less than they would pay into the LGPS.

! **TIP: Contact your HR department and/or your local Napo Rep for more information**

When you retire, you gain access to your pot and choose either to buy an annual pension (an **annuity**) based on how much you have saved and the value at that point of the investment, or choose to invest the money in other ways or a combination of the two.

Napo strongly advises anyone at this point to access our independent financial advice.

Do these schemes offer an accrual rate?

In private sector schemes there is no fixed accrual rate. The value of the pension is instead dependent on the success of investments at the point when you retire.

Do those in private pension schemes get less if they retire early?

Although your guaranteed sum will not be reduced, the value of the pension you buy will be less if you are buying one at 55-years-old than it would be if you were buying one at 65-years-old. This is based on the assumption that the annuity will be paid for longer so the fund will need to be stretched for longer.

You will also have paid less into your pension fund by retiring early.

How safe is my pension?

For LGPS members in probation all of the contributions are administered by the **Greater Manchester Pension Fund (GMPF)** who also invests the monies on scheme members' behalf – the aim being to make sure there is enough in the pot to meet the guarantees in the scheme when people retire. This is monitored independently by **actuaries**. They report on the size of funds and if there is a forecast shortfall or fund deficit, they recommend either higher contributions or changes to benefits.

The GMPF was chosen to administer all probation pensions when the National Probation Service and CRCs were created. They are one of the largest and most secure funds in the UK worth millions with no deficit. The secretary of state has further underwritten the arrangement so if a CRC owner fails to maintain contributions, the state will guarantee the defined benefits making them very safe.

This is the same for members in the Cafcass LGPS except the scheme is administered by **West Yorkshire Pension Fund.**

Those in private pensions have the security of knowing the industry is heavily regulated, including protection from illegal activity and is underwritten by the industry and the state.

What is an Added Value Contribution?

Some people want to save more for their retirement and top-up their pension, particularly if they have gaps in service. Government encourages this by offering tax breaks on additional pension payments taken from wages.

Additional Voluntary Contributions (or AVCs) are paid into separate funds which broadly work like a private scheme. When you retire the AVCs can be used to purchase added years in the LGPS, additional lump sums, an additional annuity or for wider investments.

Napo advises members to seek independent financial advice before purchasing an AVC.

What is a stakeholder pension?

By the 1990s many people were changing jobs regularly and so unlikely to work 30 years or more for the same employer or be paying into the same pension fund. With more people employed in small companies who did not offer a company pension scheme, or working for themselves, the number of people without a work-based pension was rising.

To encourage people to save for retirement government encouraged stakeholder schemes. These allowed people to save flexibly, supported by tax incentives for employers and employees and are more transferable i.e. if you change jobs you could take your pension with you.

What is auto-enrolment?

All employers are now required to offer workplace pensions to their workers and assume they want to contribute – known as auto-enrolment. If you choose to opt-out, your employer must ask you periodically if you wish to opt-in.

What does deferred benefit mean?

If you are a member of the pension scheme for two years or more and leave before your normal retirement age the benefits are protected so you can access them when you retire.

How are pension lump sums calculated?

Under the old LGPS final salary scheme you received a one off lump sum of roughly 3 ½ times your annual pension. You could also vary this by buying or selling some of your pension / lump sum. Accrued lump sum entitlements were protected when the new scheme started on 1 April 2014.

In the new CARE scheme, you can choose to buy a lump sum or not. Every £1 of your pension fund that you transfer to a lump sum is multiplied by 12.

Napo advises members to obtain independent financial advice before making decisions around buying or selling elements of their pension fund.

What is the 85 year rule and do I qualify?

If you were a member of the LGPS on 30 September 2006 you qualify for the **85 year rule**.

This gives added protections or benefits where someone's age and length of service combined comes to more than 85 years, allowing access their pension early.

Those covered no longer need their employer's permission to exercise this right even if they are under 60-years-old. However, the impact on benefits is complex and anyone thinking of exercising the 85 year rule should seek specific advice from their scheme provider and HR department.

Broadly speaking:

• If you qualify for the 85 year rule and are under 60 you can access early retirement but some or all of your benefits will be reduced.

• If you will be 60 or over by 31 March 2016 and choose to draw your pension between age 60 and your normal retirement age and you satisfy the 85 year rule when starting to draw your pension, the benefits built up until 31 March 2016 will not be reduced.

• If you are under 60 by 31 March 2016 and choose to draw your pension between aged 60 and your protected normal retirement age and you satisfy the 85 year rule when you start drawing your pension, benefits built up to 31 March 2008 will not be reduced.

• If you will be aged 60 between 1 April 2016 and 31 March 2020 and meet the 85 year rule by 31 March 2020, some or all of your benefits built up between 1 April 2008 and 31 March 2020 may not be subject to the full reduction.

The government sometimes refers to my career average. Is this accurate?

The term career average is misleading, especially when made in reference to the old final salary scheme. In the CARE model, sometimes referred to as a career average scheme, there is no link to someone's average salary either annually or over a career.

The pension will be based upon a guaranteed proportion of your total pensionable earnings during each year (in the LGPS this is 1/49), regardless of if this goes up or down. In principle, all contracted pay should be classed as pensionable (and subject to contributions) unlike the old model where occasional overtime tended not to be pensionable as it could not be guaranteed in any final salary calculations.

If your pay goes up or down the amount going into your fund will go up or down accordingly but will always be 1/49 of your salary in that year.

Is my pension affected by inflation?

The value of your pension fund is increased in line with inflation annually, using the **CPI measure**. This will also apply once you are drawing your pension.

Does striking affect my pension?

When you go on strike you lose a day's pay for each full day you are on strike.

This means that if you are in the LGPS, the value of 1/49 of your annual salary is very marginally reduced and in private sector schemes your contributions are also fractionally reduced.

However, the loss of one day's service is not as critical as it may have been in the old LGPS scheme where pension payments were based on the number of *full* years' service. The cost of making up the loss in the new scheme is greatly increased due to the higher employee and employer contributions and the higher accrual rate.

Members will therefore want to think carefully as to the value of making up such a loss and should contact Napo directly if in doubt.

What if I have periods of sick, maternity or paternity leave?

If you are in the CARE scheme and have been on reduced or no pay because of sickness or family leave (such as maternity and paternity leave) you will see no reduction in your pension.

This is because you only make contributions on pay received, but the amount transferred into your pension fund will be calculated to meet your normal pay for reduced periods.

In private sector schemes this is not guaranteed and advice should be sought from your HR department and Napo Reps.

How does ill-health retirement work with my pension?

Retiring early because of ill-health gives you immediate access to your pension. At this point the pension acts like an insurance scheme.

In the LGPS, if the pension fund's occupational health advisors recommend that you are unlikely to be able to work again before your normal retirement age, you and your employer's full contributions are made up and you can access your full pension as if you had worked until your normal retirement age. This is referred to as a **Tier 1 retirement**.

If the pension fund's occupational health advisors think you may not be able to recover well enough to do your job, but could be well enough to do a lesser paid job, you could be granted access to ill-health retirement at the value of your current pension or even have it reduced for drawing it early.

If you are not successful in getting a Tier 1 pension when you retire but your condition does not improve or gets worse, you can apply for a reassessment through your old employer and potentially have your pension made up from the point where the reassessment is successful.

In private sector schemes, you should also be able to access ill-health early retirement via an occupational health assessment. The benefits will depend on what is set out in the specific scheme, but can include compensation for loss of earnings. Some private pension schemes combine this with salary protection while ill.

If you think you may need to access ill-health early retirement, you are advised to contact Napo via your local Rep as soon as possible.

What happens if I am made redundant and I am near retirement?

If you are a member of the LGPS and are made redundant (either voluntarily or on a compulsory basis) and are over 55-years-old, you can try and access your pension early. The terms for doing so will depend on the circumstances of your redundancy but can include potentially having your full pension made up to any normal retirement age or protected normal retirement age (for some this is 60-years-old).

If you are in a private pension scheme you are also likely to have access to your pension with possible enhancements and insurance for loss of your job. However this will depend on the specific scheme you are in and the nature and circumstance of the redundancy.

Contact Napo if you think you may be made or offered redundancy. We will be able to give you specific advice and support during negotiations to protect your job, and/or try to maximise your redundancy package.

Case Study 1

A person joins the NPS on 1 January 2017 on a starting salary of £20,000.

1/49 of £20,000 = £408.16 into their pension fund.

They progess to £25,000 in 2018.

1/49 of £25,000 = £510.20 into their pension fund.

Their salary remains at £25,000 in 2019, 2020, 2021, 2022, and 2023. So their fund increases by £510.20 for each of these five years.

5 x 510.20 = £,2551 into their pension fund.

This person then goes part-time for five years, earning 50% of their salary meaning:

5 x £255.10 =£1,275.50 into their pension fund.

They then get a promotion and return to full-time working with a new new salary of £35,000.

1/49 of £35,000 = £714.29 into their pension fund.

Guaranteed pension so far = £5,459.15 per year.

This continues until they leave the service or retire. Each year the value of the pension fund is also increased by CPI for that year to protect against inflation.

Case Study 2

A person joined the service in 1984 and is now retiring on a salary of £35,723 at 65-years-old after accruing 30 years of membership in the LGPS.

Between 1984 and 2008, the LGPS was calculated as 1/80 of final salary plus a lump sum for each full year of service. The pension will be calculated on their final salary and not the salary when the scheme ended in 2008.

1/80 of £35,723 x 24 (number of years in old LGPS) = £10,716.90 annual pension
Lump sum is 3 x £10,716.90 = 32,150.70

This person also has six years in the 2008 LGPS scheme which saw 1/60 of their final salary for each full year of service added to their pension fund.

1/60 of £35,723 x 6 (number of years in 2008 LGPS) = £3,572.30

1/49 of all this person's pensionable earnings have been accrued since 2014 in the new CARE scheme

This equates to £1,550.79

This person considers cashing in some of their pension post 2008 which could give them £12 for each £1 they give up in pension. However, after accessing independent advice via Napo's members' benefits scheme decides to take their full pension which is now:

£16,089.00 annual pension
£32,150.70 one-off tax free lump sum

Useful contacts and Information

Napo Members' Services
www.napo.org.uk
020 7223 4887

Pension Glossary of Terms
www.thepensionsregulator.gov.uk/glossary.aspx

Local Government Pension Scheme
www.lgps.org.uk

State Pension
www.gov.uk/state-pension

Greater Manchester Pension Fund
www.gmpf.org.uk
0161 301 7000

West Yorkshire Pension Fund
www.wypf.org.uk
01274 434 999

Workplace Pensions
www.workplacepensions.gov.uk