Defined Benefit/ Defined Contribution Pensions (A Primer)

There are two types of pension:

1) Defined Benefit (DB) schemes – examples include: TP, LGPS, Civil Service, NHS and other public-sector schemes. DB schemes are now vanishingly rare outside the public sector.

2) Defined Contribution (DC) schemes – examples include: NEST, People's Pension and investment companies like Aviva and Royal London.

Once you understand the general concepts behind these very different beasts, working with the figures on your statement and planning for your financial future becomes easier. Do have a look at the glossary on page 5. Cognitive Load and all that. 🙂

DEFINED BENEFIT (DB) SCHEMES:

Teachers' Pension Scheme (TP) is a Defined Benefit (DB) scheme. A DB scheme is a promise/pledge/ agreement – it is NOT a pot of money belonging to a member.

It is called 'Defined Benefit' scheme because you know the formula that will be used to calculate your annual pension when you are enrolled into TP. Your annual pension will be paid for the rest of your life.

Defined Benefit Schemes can also have extra benefits built in. For example, an automatic lump sum, Death Grant, Survivor's Pension, Ill-Health Retirement facility, favourable accrual rates during maternity leave. Each DB scheme will have different 'extra benefits' and each benefit will have conditions attached. It is in your interests to understand what your scheme (eg TP) and sub-scheme (eg Career Average) offers.

TEACHERS PENSION SCHEME (TP):

Vocabulary: 'accrue' *means to* ***'build up'. 'Accrual rates'*** *are the rate at which something, the pension in this case, builds up. Accrual rates are effectively 'fudge factors' that are not directly related to anything the member is or does. Accrual rates for each TP sub-scheme are set by very clever mathematicians called 'actuaries' who work for the government and eat numbers for a fun and leisurely Sunday brunch.*

TP has THREE sub-schemes. Check your TP statement to find out which one(s) you are in:

i) **FINAL SALARY 80th/ NORMAL PENSION AGE 60 SCHEME (FS80th/NPA60)**:

Members who joined TP before 1st January 2007 will have some of their pension in this scheme.

The accrual (build up) rate is 1/80 and the Normal Pension Age (NPA) is 60.

This scheme has an automatic lump sum payment of 3 x annual pension built into it as a sub-scheme benefit. The automatic lump sum does NOT reduce your annual pension.

In addition, when you claim your pension, you can choose to sell/ exchange some of your index-linked annual pension in return for a one-off optional lump sum:

£1 in reduced index-linked annual pension for £12 of one-off, upfront lump sum.

ii) **FINAL SALARY 60th / NORMAL PENSION AGE 65 (FS60th/ NPA 65)**:

Members who joined TP between 1st January 2007 and 31st March 2015 will have some of their pension in this scheme.

The accrual (build up) rate is 1/60 and the Normal Pension Age (NPA) is 65.

This scheme does NOT have an automatic lump sum.

At the point of claiming your pension, you can sell/ exchange some of your index-linked annual pension in return for a one-off 'optional lump sum':

£1 in reduced index-linked annual pension for £12 of one-off, upfront lump sum.

Notice that the accrual rate in this scheme is 1/60 which is better than the 1/80 in the FS80th/NPA60 scheme. However, the FS80th/NPA scheme has a NPA of 60 (ie you can access it earlier) and an automatic lump sum of 3 x annual pension.

A BIT MORE ABOUT THE FINAL SALARY SCHEMES:

In the Final Salary (FS) schemes, TP promises to pay you according to a pre-determined formula. This formula is based on your 'final average salary' AND your 'accrual rate' AND the amount of time you have contributed to the scheme. The amount of time you have contributed to the FS scheme(s) is called your 'reckonable service'.

The formula for the Final Salary schemes is:

Final Average Salary x (Reckonable Service/ Accrual Rate)

The FS schemes are also index-linked. The Final Salary schemes are generally straightforward to understand in principle but are made much more complex by the FS schemes having MANY quirks, twists and turns.

iii) **CAREER AVERAGE REVALUED EARNINGS (CA OR CARE)**:

This is the TP scheme that is currently open.

Members who joined TP on or after 10th March 2012 will be in this scheme from 1st April 2015.

All members who were in either of the two Final Salary schemes on 31st March 2022 will also be in the CA scheme for any service after 1st April, 2022. You may hear words like 'McCloud Judgement' or 'Rollback' or 'RSS' being used but that is for another day.

CA has an accrual rate of 1/57 of your gross salary and an NPA that is equivalent to your State Pension Age.

For example, if you earned £57k this year, you would accrue £1k in your CA account.

The amount you accrue (build up) in your CA account in any given month(s) and years is added to your annual pension entitlement. You will be able to see the value of your CA account rising on your TP statement each month.

The CA scheme is index-linked ie it is adjusted for inflation each year plus a little bit (1.6%) more if you are an active member of the scheme. That extra 1.6% doesn't sound like much but it can be really significant for members who remain in the CA scheme for long periods of time.

In the current Career Average (CA) scheme, as long as you contribute a fixed and pre-determined (by the government) percentage of your gross salary in any given month, TP promises to pay you a pre-determined, small fraction (1/57) of that salary + inflation every year from your Normal Pension Age.

The CA scheme does NOT have an automatic lump sum.

At the point of claiming your pension, you can sell/ exchange some of your index-linked annual pension in return for a one-off optional lump sum: £1 in reduced index-linked annual pension for £12 of one-off, upfront lump sum.

The Career Average Scheme is generally simple to understand and easier for TP to administrate. Especially in comparison to the Final Salary schemes.

Notice that the accrual rate in this scheme is 1/57 which is better than either of the Final Salary schemes. However, the NPA for the CA scheme is your State Pension Age.

MORE TP NUGGETS:

a) You (the employee) and your school/ LA/ trust (the employer) will pay a fixed amount to TP each month. The amounts you and your employer are required to pay are set by the government.
Your employer currently pays 28.68% into TP. This is more than double the amount you do but that is largely irrelevant because there is no ‘pot’ with your name on it (like there is in a Direct Contribution Scheme). That figure of 28.68% should give you an idea of how valuable the scheme is though.

b) The TP is an 'unfunded scheme' meaning the TP uses money from the UK government’s Treasury to pay retired members. Active members’ contributions go into the UK Treasury.

c) When you take your pension, the TP, and ultimately the government, has an obligation to pay you according to the terms and conditions it set out when you joined the scheme.

This means that TP (and all other DB pension schemes) assumes all risk - it is their responsibility/ obligation to make good on the arrangements that they made with you. Stockmarket bombing? - their problem. Economy crashing? - their problem. National crisis (like the pandemic)? - their problem.

d) You cannot pay into TP (or any other DB scheme) unless you are in a job with an employer that entitles you to be part of the scheme. For example, agency supply teachers work in schools but are not eligible to be in the TP whereas supply staff that are directly employed by the school are eligible to be in TP. Teaching Assistants aren't entitled to be in the TP but are entitled to be in LGPS, which is another DB scheme.

e) These DB schemes are generally NOT portable - ie if you leave after a certain number of qualifying years (two years) but aren't yet eligible to draw the pension, you just have to let it sit there (accruing inflation) until you come to draw it. This is called being a 'deferred member'.

If you change careers and get another public sector job, you are, for a short period of time, allowed to transfer your TP to your new public-sector DB pension scheme eg LGPS or NHS.

Major things that change the final outcome of your entitlement are:

✅ your Full-Time Equivalent salary (FS and CA for different reasons)
✅ how much reckonable service history you have (FS only)
✅ whether you work full-time or part-time (both FS and CA for different reasons)
✅ whether you take your pension early (ie before the scheme's Normal Pension Age) and the actuarial adjustment you will incur for doing so. (both FS and CA)
✅ inflation increases (both FS and CA and CA has an additional bump for active members)

Final Salary was, on balance, a better deal than Career Average but Career Average is still considered to be much better than anything you can get in a workplace pension or open market DC scheme.

When the member dies, there are strict rules that govern who (eg spouse, civil partner, partner, children) will get any entitlement to the member's annual pension, what amount they will get and under what conditions. Remember, there is no 'pot' with an owner's name that can be distributed in their will but the member does have some say on who their Death Grant (if they are eligible for it) goes to.

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DEFINED CONTRIBUTION (DC) SCHEMES:

Called 'Defined Contribution' because you know, and have control over, how much you contribute. You won't know the outcome until you come to draw your DC pension.

Your employer opens an account with an investment firm's pension scheme in your name. Both you and your employer pay into the scheme. The employer must pay in at least 3% of your gross salary, in line with minimum legal percentages. Some employers will pay their legal minimum contribution and not a penny more. Other employers – particularly independent schools that have left, or are withdrawing from, TP - will be far more generous with the percentage of your salary they will pay in. You also get tax relief from the government on contributions.

From Day 1 after your first contribution, there is a 'pot' with your name on it. The value of your account belongs to you, though it will fluctuate depending on a number of things but most obviously, the performance of the investments you hold.

There is much more flexibility about how much you can pay into a DC schemes compared to DB schemes like TP.

You assume all risk - if your investments do well, you will have a large pot at the end. If they don't, you won't. Once the employer has paid in what they have promised to, that is their obligation complete.

Major things that change the final outcome of your pot are:

✅ how much you have put into your pot
✅ how much your employer has put into your pot
✅ the returns on your chosen investments
✅ whether you have to pay any penalties eg for moving your pension between providers.
✅ your monthly fees to the pension provider.

It is worth noting that DC schemes are usually nowhere near as generous as DB schemes. Whilst there might be a very occasional stockmarket whizz-kid that knocks it out of the park with their investment choices during boom years, they are outliers. So are employers who will make generous contributions.

If you decide not to pay into your DC pension anymore, you can transfer it much more easily to another DC scheme or you can just stop paying into it and let it sit there until you are old enough to access it (this is called 'Normal Minimum Pension Age' and is ten years fewer than State Pension Age). You will still have to pay monthly account fees that will slowly erode the value of your pot, you won't get any inflation bumps but you may end up with a relatively decent-sized pot if your underlying investments fly (or a smaller pot if the underlying investments don't do so well).

On the owner's death, DC scheme can be passed on to heirs, subject to certain rules.

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CLOSING COMMENTS:

TP is considered to be a ‘gold-plated’ scheme although most people would agree that it isn’t as golden as it once was. It is also index-linked to preserve the purchasing power that inflation erodes. Index-linking is a valuable part of TPS.

There is nothing to stop anyone (apart from lack of spare cash) complementing their TPS with SIPPs, ISAs, LISAs (age-dependent) or general investment accounts. In fact, it would be good practice to do so if you are able to, especially as many teachers don't continue teaching until they reach NPA (Normal Pension Age).

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GLOSSARY:

accrue – build up

accrual rate – the rate at which pension builds up. Accrual rates are set for each TP sub-scheme.

CA/ CARE – Career Average Scheme (full name Career Average Revalued Earnings scheme. The scheme’s name is a bit of a misnomer as no ‘average’ is ever calculated)

DC scheme – Defined Contribution scheme (a type of pension where the value is reflected by the underlying assets. The DC scheme is a ‘pot’ of assets that belong to the owner)

DB scheme – Defined Benefit scheme (a type of pension where the member contributes to a pension in exchange for an annual pension determined by a pre-determined formula. The pension is paid for the rest of the member’s life after claiming the pension)

FS scheme – Final Salary scheme (the scheme’s name isn’t fully reflective of how it works)

Final Average Salary - the salary that TP use to calculate your pension entitlement. It is generally NOT the salary you finished on

NPA – Normal Pension Age (the age a pension can be taken without actuarial reduction)

TP – Teachers’ Pension scheme (a DB pension scheme for people who work in a teaching role in qualifying institutions like schools)