The Trustee toolkit downloadable

Introducing pension schemes

Tutorial one: What is a pension scheme?

By the end of this tutorial you will better understand:

- the types of trust-based pension schemes
- how trust-based DC and DB schemes work in relation to providing benefits
- how a trust-based scheme operates

This tutorial is part of **Scenario one**.

Glossary

A detailed glossary of technical terms can be downloaded from the Resources tab when you log in at **www.trusteetoolkit.com**

The Pensions Regulator

Introduction

In the UK, if you have paid sufficient National Insurance contributions throughout your working life, you are entitled to a state pension from the government. For many, this will not be sufficient to give them the standard of living they hope for in their later years. There are lots of ways of overcoming this financial shortfall, one of which is saving via a pension. A pension is simply a tax efficient way of saving regularly.

Legal framework of work-based pension schemes

Pension schemes are primarily set up under one of two legal frameworks: trust-based and contract-based.

Trust-based schemes

Occupational pension schemes that are established under trust, and that have trustees, are called trust-based schemes.This toolkit has been designed to help the trustees of trust-based schemes to understand and fulfil their role.

However, there are other types of pension scheme, and it is helpful for trustees to have a general understanding of these.

Contract-based pension schemes

Pension schemes that are established by insurance companies or other specialist providers where there are direct payment arrangements are often called contract-based schemes.

Under these arrangements there is a contract between the provider and the member but the employer is not a party to the contract and there are no trustees. The scheme, if set up for a particular workplace, may be given the name of the employer or group, but this doesn't mean that the employer is a party to the scheme.

It simply reflects the fact that the employer has designated the scheme as one its employees may join, and in relation to which, it is prepared to facilitate payroll deductions.

The employer may set up a management committee to oversee the operation of a contract-based scheme on behalf of its own employees. But the powers and responsibilities of such a committee will not be as extensive as those of a trustee body.

Types of trust-based scheme: DB

In a DB scheme the provision of pension benefits involves a promise from an employer to provide an employee (the pension scheme member) with certain benefits at pension age.

The amount of pension the employee will receive (the benefit) is fixed by reference to a member's pensionable salary and length of service, but the level of employer, and sometimes employee, contributions required to meet the agreed pension is variable and dependent on a number of factors.

The amount paid by the employer will usually be the subject of negotiations between the trustees and the employer, based on the findings of the scheme's actuary. The amount of employer's contributions is liable to change from time to time, usually following each actuarial valuation of the scheme.

In a DB scheme the investment risk is carried by the employer, not the member. This is because a member's benefits are defined in the scheme rules and accrue independently of the contributions payable and investment returns. Scheme assets are used to pay for (or fund) those benefits so the better the investments perform, the lower the contributions that the employer will need to pay to fund the member's benefits and vice versa. Contributions paid by both the member and the employer attract tax relief.

Final salary

A final salary scheme is one version of a DB scheme. In a final salary scheme the pension paid to a member is calculated as the member's final pensionable salary (ie the member's pensionable salary on the date the member leaves service with the employer) multiplied by the period of membership multiplied by the accrual rate.

Example: Hassan

When Hassan reached his scheme's normal pension age he had been a member of his final salary pension scheme for 20 years.

His final pensionable salary (defined by the scheme's trust deed and rules as basic salary, excluding bonus) amounted to £48,000, and the scheme's accrual rate was 1/80th. His pension therefore amounted to 20 x £48,000 x 1/80, ie £12,000.

This means that for each year of his retirement, Hassan is entitled to receive an income from the scheme of £12,000 (gross). The amount accrued in each year of membership is then revalued every subsequent year in accordance with the schemes rules. The revaluation rate may be a prices or earnings index, or could be based on something else, for example the scheme's investment returns.

CARE scheme

A career average revalued earnings (CARE) scheme is a variation on the traditional DB scheme. In a simple CARE scheme, the member's pension is usually based on the average earning throughout the member's active membership.

The pension a member earns in any year is typically calculated as the member's pensionable salary in that year multiplied by the scheme's accrual rate. That amount is then revalued every subsequent year in accordance with the scheme rules. The revaluation rate may be a prices or earning index, or could be based on something else, for example the scheme's investment returns. It may also be subject to a minimum rate of increase.

When a member accesses their benefits the revalued pension amounts earned each year are added together to give the total pension.

Example: Louise

Louise is a member of her company's CARE scheme, and her pensionable earnings in her first year of membership are £20,000. The scheme's accrual rate is 1/80th, so she earns a pension of £20,000 x 1/80, ie £250. The following year her pensionable earnings are £22,000 so she earns a pension of £22,000 x 1/80, ie £275.

The pension that she earned the previous year is increased by the rate of increase in the Consumer Prices Index, which was 2.0%, so it now amounts to £255. Therefore, her total pension after two years amounts to £255 + £275, ie £530.

This process is carried out each year until her pension becomes payable.

Additional voluntary contributions

DB schemes may offer access to an additional voluntary contribution (AVC) scheme.

For many years there was a statutory requirement for schemes to permit members to pay AVCs. Usually these contributions would be made to the same scheme, but the type of benefits provided, and the organisation with which AVCs were invested, were often different.

In particular, AVCs in DB schemes were generally used to secure DC benefits although some DB schemes do allow for members to pay AVCs on an 'added years' basis (ie to purchase additional years of pensionable service which count towards the member's pension benefits).

The statutory requirement to offer AVCs no longer exists, but some schemes still provide for them, often as a top up to their existing pension.

Types of trust-based scheme: DC

In a trust-based DC pension scheme the amount of contributions payable by the members and the employer will be set out in the scheme rules. Each member will have their own pot of money identified within the scheme.

The amount of pension that will be paid to a member or, where relevant, a dependant, cannot be determined until the member accesses their benefits or dies. This will depend on the amount of contributions paid in, the way in which the investments have performed, any costs or charges taken from the member's pot, and the choices the member makes when choosing how a pension is paid.

Contributions paid by both the member and the employer attract tax relief.

Investment

The trustees usually make a range of investment options available to the members, and the contributions will be invested by the trustees in line with each member's individual wishes or, where the member does not express a preference, in a default arrangement.

Investment risk

In a DC scheme the investment risk is carried by the member, not the employer, because the value of a member's pot used to secure pension benefits increases or decreases in line with investment performance. The better the investments perform, the higher the pension that the member will usually be able to secure. However, charges will also have an effect on the eventual size of the pot available.

How does this compare to a DB scheme?

This is in contrast to a DB scheme, where a member's benefits are defined in the scheme rules and accrue independently of the contributions payable and investment returns. Investment risk around performance of assets used to fund DB benefits is carried by the employer.

You can learn more about the different options for accessing pension benefits in the Tutorial: 'Decisions at pension age' in the Module: 'How a DC scheme works (2014)'.

Other types of trust-based scheme

Schemes that offer mixed benefits

These schemes incorporate both DB and DC structures within one scheme. There are many different types of such schemes, of which the most common are:

- separate DB and DC sections in one scheme – where individuals may have benefits in either or both sections
- a DC scheme – which incorporates a guarantee of a minimum level of benefit, eg DC schemes which historically contracted out of the (state earnings related pension scheme (SERPS)/state second pension (S2P) using guaranteed minimum pensions (GMPs) or the reference scheme test. It's no longer possible to 'contract out' using a DC scheme.
- a DB scheme – which incorporates a minimum 'return' on the contributions paid, or where the pension will not be less than a specified proportion of the contributions paid

Master trusts

A master trust is a type of scheme that offers DC benefits and is used, or intended to be used, by different employers that are not connected with each other.

There has been significant growth in the numbers of employers and members that use master trusts following the introduction of automatic enrolment and, from October 2018, The Pensions Regulator will be responsible for authorising and supervising this type of pension scheme.

Small schemes (historically also referred to as small self-administered scheme or SSAS)

A small scheme is a trust-based pension scheme designed for a maximum of 11 members who are often directors of the sponsoring employer and who want more control over the investments of their pension scheme. In particular, such schemes allow for self investment of the pension scheme funds into the business.

Types of contract-based scheme (work-based)

These are pension schemes taken out by individuals with an insurance company where direct payment arrangements exist in respect of employees.

The individual may have considerable flexibility over the way in which the pension scheme is invested, and the way in which the benefits under the scheme are taken. There are three main types of work-based personal pension scheme.

Group personal pension schemes (GPP)

These are pension schemes set up and operated by insurance companies or specialist providers for multiple employers who have no other association with each other.

They are DC schemes, and may offer the members a wide range of investment choices from both the insurance company's own range of funds, or from funds operated by other investment providers.

Group self-invested personal pension (Group SIPP)

This is a type of group personal pension scheme under which there tends to be a wider choice of investments.

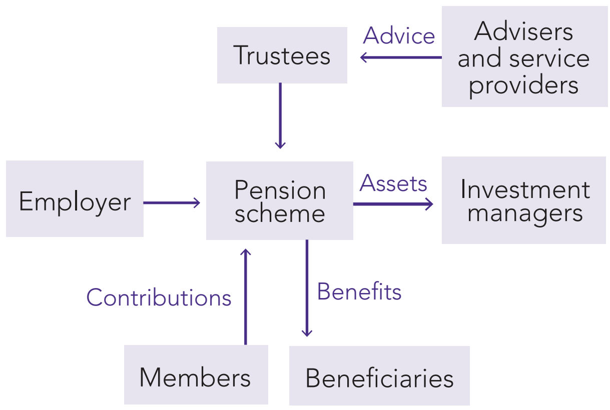
Stakeholder schemes

Stakeholder schemes were introduced by the Government in April 2001 in an attempt to increase pension coverage. They were set up by employers who were required to make such a scheme available to their employees, and were usually contract-based.

Members joining these schemes paid contributions to them, but there was no requirement for employers to contribute, and very few did so.

The requirement to offer a stakeholder scheme fell away with the introduction of automatic enrolment from April 2012.

Overview of a trust-based scheme



Employer

For an occupational scheme, the employer establishes the trust and may retain powers under the deed to make changes.

The employer will also nominate at least some of the scheme's trustees and is responsible for calculating and collecting contributions from members and passing these to the trustees, together with the corresponding employer's contributions, in a timely manner.

Trustees

Trust-based pension schemes are managed by trustees, who have the legal responsibility for ensuring that the scheme is properly run in accordance with the trust documents, usually the trust deed and rules.

You will learn more later in this module and then in the Module: 'The trustee's role'.

Scheme assets

One of the consequences of establishing a trust-based scheme is that the scheme's assets are kept separate from the assets of the employer.

Advisers and service providers

Trustees will rely on a number of specialists and experts to help them in the efficient running of their scheme.

You will learn more later in in the Tutorial: 'Introducing advisers and service providers' in the Module: 'Running a scheme'.

Bundled or unbundled

Trustees may decide to use a 'bundled' or an 'unbundled' approach to running their scheme.

In a 'bundled' arrangement all the main services are provided by the same organisation, usually a firm of benefit consultants or an insurance company.

In an 'unbundled' arrangement different organisations may be used to provide different services.