

Defined Benefits Schemes

In a Defined Benefit (DB) pension scheme the amount of annual pension that a member will receive in retirement is dictated by a predetermined formula.

Calculating your Entitlement

The most traditional form of Defined Benefit Scheme is the Final Salary Scheme.

To work out a member's entitlement to annual pension income under a Final Salary Scheme there are 3 values you will need to know, connected by the formula below.

Income = Accrual Rate × Number of Years Service × Final Salary

The accrual rate is a fraction, commonly 1/60 or 1/80.

So an employee earning £30,000 at retirement with 40 qualifying years of service, enrolled in a final salary pension scheme with an accrual rate of 1/60, could expect to receive a Pension income of:

Pension Income = 40/60 × 30,000 = £20,000 per annum

Along with the income there will also usually either be an accompanying pension commencement lump sum (PCLS) or if not then the facility to 'commute' some of your annual income for a PCLS, in this case you would expect to receive a reduced annual pension.

Funded or Unfunded?

In a 'funded' arrangement the employer (and member) will make contributions into an investment portfolio. It can be very hard to accurately predict what contribution levels are required to meet the pension fund's future liabilities, as assumptions have to be made about the performance of the investments. This can lead to schemes becoming either 'over-funded' or more commonly in the press in recent years 'under-funded'. Because the members have an entitlement

to a guaranteed level of pension income, it is the responsibility of the employer to make up any shortfall.

In an 'un-funded' scheme, such as those usually found in the public sector, there is no building up of pension assets throughout the members employment, instead pension income payments have to come directly from the pension sponsors sources of income which in the case of government will usually be taxes.

The Future

As the employer has to provide the pension income for the length of the members' retirement, over the years, the cost of running DB schemes has increased steadily, with increasing life expectancy. In response to this many employers have closed existing schemes, opting to switch to less generous Career Average Schemes or moving away from DB schemes in favour of Defined Contribution schemes, where members do not have a guaranteed level of income in retirement.

If you would like to discuss any of the above in more detail please do not hesitate to contact us.

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