My Personal Circumstances:

Security and Risk

For Preserved Members of Defined Benefit Schemes

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Security and Risk – Preserved Members

This Factsheet briefly discusses some of the main issues relating to security and risk and how these can have an effect upon your retirement planning.

It is written for people who are **preserved members** of a **defined benefit scheme**.

Introduction

There is a degree of risk in all aspects of life and everything we do, and this is especially true of your pension benefits. There is no such thing as 'no risk' and no such thing as an absolute guarantee.

It is essential that you understand the main issues associated with security and risk as they will affect upon YOU and your dependants, and your retirement planning. This Factsheet is designed to make you think about the various issues associated with security and risk, WHY these occur and HOW these could have a bearing upon your pension benefits. Some of the points are more obvious than others, but they are all important.

The Factsheet is written primarily for those members whose benefits are held within a scheme which actively manages its obligations. Where the scheme has been wound up or is in the process of being wound up, other considerations will apply which are outside the scope of this Factsheet.

If you are intending to get advice from a Financial Adviser these are some of the things you should be discussing with them.

Security of your employment (risk of tenure)

You will be a preserved member for one of several reasons, the main ones being:

- You ceased to be employed by your employer (e.g. you left of your own accord or were made redundant)
- You chose to opt out of active membership for your own personal reasons
- You continue to be working but your employer closed your pension scheme so that you cannot build up future pensionable service in that particular scheme (even though you may have been offered an alternative pension arrangement). This is often called a 'closed scheme' or more correctly a 'scheme closed to future service accrual'.

The concept of a 'job for life' seems to be an unrealistic ideal. Businesses are constantly changing and most employment sectors, from manufacturing to finance, retail to transport have suffered large scale redundancies. Even with the same employer, change is now the norm and unless we as individuals are able to respond to these changes, we can be affected adversely by the change.

Job security has an important impact upon your retirement provision as your current income may allow you to build upon the foundations of your preserved pension to fulfil your retirement financial planning objectives.

Your **pension benefit** will depend upon the length of your **pensionable service** – (which may have been counted in the number of years, months or days) that you were credited with whilst you were an active member of the scheme. The longer this service, the bigger your benefits and the more valuable they are to you.

Security of the scheme's sponsoring employer (covenant risk)

Even though you are no longer an active member of the scheme, you must appreciate that the benefits which are held in the scheme for your future, depend upon the continuing solvency of the pension scheme and the sponsoring employer. It is important that it can afford to pay its contribution to the cost of benefits - not just for the remaining active members but also for preserved members too. This financial commitment can last many years, to ensure all benefits are paid to all members and their dependents.

Many employers will be involved in redundancy exercises at some stage. These can happen for a number of reasons. It may be part of a profit-driven exercise. A redundancy program might be part of a steady downsizing of the business because of trading difficulties.

Where the employer only pays the minimum redundancy payment, this could be an indication about the company's deteriorating financial situation and its continuing ability to support the pension scheme. A failure to meet the required contributions could mean that the scheme cannot pay full benefits. For more information see our Quicknote The effect on the employer covenant.

So, whilst you are no longer an active member of the scheme, you still need to keep aware (as much as you realistically can) of the sponsoring employer's financial circumstances.

If you are a member of a Public Sector scheme (NHS, Local Government, Teachers, Civil Service etc.), your pension is funded by your contributions (if the scheme demands that you pay contributions) and by the taxpayer, so 'covenant risk' is not as big an issue as it is for private sector scheme members.

Increasing life expectancy (mortality risk)

We're living longer – and that's a fact. But it's not all good news. With longer life expectancy come greater costs for employers and the current active members:

- Pension schemes are facing paying pensions out for much longer than they had originally planned.
- Employers are being asked to pay extra contributions to fund these additional costs.

The longer this trend continues, the more expensive pensions will become in terms of providing the actual pension income at retirement. The implications of living longer are something employers, schemes, members, government and society must all face up to.

Greater life expectancy will also mean an increase in **State Pension Age** which has historically been 65 for males and 60 for females. From 6th April 2010 over a 10-year period, State Pension Age for women will gradually increase to age 65:

- Women born before 6th April 1950 are not affected by the change.
- Women born between 6th April 1950 and 5th April 1955 will have a State Pension Age which gradually rises from 60 to 65 (see Table of State Pension Age).
- Women born after 5th April 1955 now have a State Pension Age of 65.

So, from 6th April 2020 both men and women will have a State Pension Age of 65.

Under the Pensions Act 2007, the State Pension Age for men and women is to rise gradually over a period of 22 years between 2024 and 2046:

- The first rise from 65 to 66 will be phased in between 2024 and 2026,
- The second rise from 66 to 67 will be phased in between 2034 and 2036, and
- The third rise from 67 to 68 will be phased in between 2044 and 2046

From 6th April 2046 both men and women will have a State Pension Age of 68.

Life expectancy is still relevant to you as a preserved member as your pension scheme will continue to face the prospect of paying out pensions for longer than it had originally planned – and demand further contributions and funding from the sponsoring employer to cover this.

Find out how long your Life Expectancy is.

Legislation, Regulation and Governments (political risk)

The risk of current and future burdensome legislation and regulation will have an effect on your total pension provision even though are a preserved member. State Pensions will increase for many in the future but for others, particularly higher earners, they will reduce.

The increased costs and liabilities to schemes, sponsoring employers (and taxpayers) of this swathe of legislation and regulation - particularly over the last 20 years – has had some unintentionally negative effects including:

- The closing of significant numbers of pension schemes to new members.
- The winding up of thousands of occupational pension schemes.
- The 'levelling down' of member benefits to prevent discrimination (where one member is discriminated against another - it is less costly to 'level down' to the weakest factor rather than 'level up' to the strongest factor).

The irony is that most legislation was intended to improve and protect scheme members' benefits. This in practice means higher costs for both employees and employers. The impact of these changes has led to thousands of schemes closing or winding up – hardly what was intended.

The creation of **The Pensions Regulator** was welcomed in many quarters but the levies it imposes on occupational pension schemes are viewed by many as excessive and unfair. This presents still greater costs for employers and further reason for them to review the costs and risks associated with providing a defined benefit scheme.

Political change also includes the risk associated with a change in Government, as political parties have different agendas and priorities. Pensions and security in retirement continue to be a political 'hot potato'.

Inflation and interest rates (economic risk)

Inflation and interest rates play an important role and therefore there is a risk element involved with them both.

Low inflation and interest rates have increased the value of the pensions payable to members and tended to make schemes less well funded which reduces member security.

High inflation and interest rates will tend to have the opposite effect as the spending power of your pension during retirement reduces.

Most private sector pension schemes have a 'cap' on the pension increases they pay to pensioners so over the longer term, high inflation would erode the value of your pension. High interest rates reduce the value of members' benefits but the security to the benefit itself should improve. However in such situations in the past, politicians have intervened to make schemes provide better inflation protection on benefits.

Market and exchange rates (financial risk)

The security of your pension benefits will rely on market conditions. Private sector pension schemes (and some Public Sector schemes) invest in a wide variety of assets with more schemes investing significant amounts of money in overseas markets. Pension benefits are paid from the employee and employer contributions and the investment returns on these assets. The higher return on the assets, the better the security for members.

The value of assets will go up and down with the confidence investors have in the world investment markets. Consequently, the security of your future pension is influenced by market sentiment and exchange rates if some of your schemes assets are traded outside the United Kingdom.

In terms of your scheme's solvency, the skill of the investment manager in dealing with the state of the economy and markets is important. A weak economy or stock market can lead to greater deficits. A strong economy and buoyant investment returns can reduce deficits and increase surpluses. The investment manager can add value in any situation but can only buck the market trends by taking bigger risks.

If the value of the assets exceeds the value of the pensions due to members, the scheme has a surplus which means that contributions can be reduced or benefits increased. If, however, the value of pensions are greater than the value of its assets the scheme is said to be in deficit. The majority of pension schemes are currently in deficit.

Personal circumstances, age, health, income, assets (personal risk)

Your personal circumstances play an important part in your retirement planning:

Age Your age is important. The closer you are to retirement, the more secure you are likely to want your pension benefits to be. This means that you require less exposure to risk. Conversely, the younger you are, the more speculative you are likely to be, and so not be as concerned about taking a risk.
Health If you are in good health you will be able to work longer and therefore accumulate more pension benefits in future than if you were in poor health. The risk of deteriorating health is therefore very important.

Income and assets The greater your income and assets, the more you have available to plan for a comfortable retirement. The lower your income and assets, the more difficult it will be to secure the standard of living you would like to achieve for your retirement, and the greater the chance that you will need additional State assistance in retirement.

Dependants If you have dependants (e.g. spouse, civil partner, children) your *spendable* income will probably be lower than a single person on the same income. This may affect your ability to build an adequate retirement for yourself or to fund the dependency pensions on your eventual death.
These factors are important in a more subtle way. As a preserved member, you cannot influence what happens within the scheme, but you may decide to take actions in relation to your scheme benefits to help protect you from some of the risks involved with your scheme membership.

Before you take any action in relation to your scheme benefits (e.g. whether to stay in the scheme or to transfer-out to another arrangement), you should take independent financial advice as the benefits payable by your scheme can be very valuable. Your response to the advice will depend greatly on your attitude to risk, discussed in the following section.

Your attitude to risk (financial risk)

In dealing with any of your financial arrangements, you should consider your attitude to security, risk and reward. Each of them should be classed as a separate item (e.g. pensions, investments). Apart from any State Pension or Social Security benefits, your scheme pension may be the only income you receive when you retire.

As we have mentioned earlier, keeping your pension in your existing occupational pension scheme involves some degree of risk. Likewise transferring your pension rights to another scheme involves risk too.

Only a few years ago, being a member of a defined benefit scheme gave great comfort to scheme members. Unfortunately, tens of thousands of scheme members have lost considerable amounts of their retirement provision as a result of their employer ceasing trading, leading to the pension schemes being wound-up with a big deficit. Equally many others have lost considerable amounts by transferring benefits out and making inappropriate investment decisions.

If you seek financial advice you should be asked what your attitude is to security, risk and reward. Pension and Financial Advisers will usually have standard forms to gather information about you, so that they may advise you according to your personal circumstances.

It is important therefore, that you make certain when discussing your attitude to risk, that you are specific about what this relates to. Your attitude to risk will probably differ when focusing upon your pension provision compared to your risk profile when investing in different assets (e.g. stocks and shares, property). Make sure that the attitude to risk used in any advice process, relates to your retirement provision and planning.

You may be asked to select your 'risk profile' from a list. An example would be a scale of 1 to 5, 1 to 10 etc. or choosing a sentence such as "My attitude to risk is conservative" or "My attitude to risk is balanced/medium". When selecting a risk profile from a scale of 1 to 10 for example, make sure you know which is the low-risk end of the scale – obvious maybe – but important nevertheless.

Be sure to select the one that best fits you – not one you think will impress the adviser. If what you are presented with does not adequately reflect YOU – discuss this with the adviser – and make sure this is carefully noted in his records.

Your attitude to risk will probably change the closer you get to retirement age as you seek to protect the benefits you have built up. Re-assess your risk profile from time to time. You maintain your house and car. Take time to maintain your retirement provision. There is no such thing as 'no risk' – whatever pension benefit you have there will be a degree of risk attached to it. Regular careful management of those benefits will ensure that those risks are minimised.

Summary and Key Points

When making enquiries about your **pension benefit** it is very important that you make it clear whether you are a **preserved member** rather than an **active member** or a **pensioner member**. Active, preserved and pensioner are different classes of membership of a pension scheme and any definitions and paragraphs contained within your Scheme Rules or scheme literature relating to any benefit may differ considerably between these categories.

- Risk comes in many forms – you should consider what risks YOU face in terms of your retirement provision.
- Is your pension scheme secure?
- Do you keep abreast of changes – legislation and regulation may affect your pension benefits?
- Are you affected by the increase in **State Pension Age**?
- Have you considered how your personal circumstances may impact upon your retirement provision?
- Keep informed. Your scheme may modify benefits and Rules. Legislation may change. Your circumstances may alter.

This is not an authoritative document. Seek professional advice from an appropriately experienced and qualified adviser.

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