



CAREER AVERAGE PENSIONS

INTRODUCTION

This briefing looks at career average pension schemes and analyses the differences between these and the more common form of defined benefit arrangement: final salary schemes.

Career average pensions, are also known as CARE schemes (Career Average of Revalued Earnings) are an alternative type of defined benefit pension scheme to the traditional final salary model. As variations on a theme, CARE schemes and final salary schemes operate in a very similar way, providing an annual pension which is calculated by reference to the following formula:

$$Pension = AccrualRate \times Service \times Earnings$$

The only difference that necessarily exists between comparative CARE and final salary schemes is the definition of earnings that is used in the above formula. Whilst a final salary scheme would use the amount of pensionable salary in the run up to retirement, a CARE scheme would look at the pensionable salary over a member's whole period of service.

Final salary schemes offer a more beneficial level of pension to members whose pay might be significantly increased in the run up to retirement. This means that members who do not receive such large pay rises are in effect cross-subsidising those members who do, as their contributions are proportionately higher (when compared with the level of pension paid out).

REVALUED EARNINGS

One of the most important features of CARE schemes is the method of revaluation of earnings. This is important as there may be a period of 40 years or more between the first year's pensionable salary and the retirement date. Over this period of time the real value of the early years' pensionable salary will have been decreased by the effects of price or wage inflation.

To stop this decrease schemes will revalue (i.e. increase) each year's pensionable salary in line with a certain index between the year in which the earnings were received and the date of retirement.

The indexation may be in line with price changes as given by the Retail Prices Index (RPI) or Consumer Prices Index (CPI); or in line with the national average earnings (NAE) Index; alternatively it can be a fixed amount such as 2.5%.

An example of revalued earnings is shown below. It assumes that the index by which earnings are revalued is a consistent 2% per annum and the member is in the CARE pension scheme for 5 years immediately before retirement.

Year	Pensionable Earnings	Revaluation Percentage*	Revalued Pensionable Earnings
1	£20,000	8.24%	£21,649
2	£20,500	6.12%	£21,755
3	£21,000	4.04%	£21,848
4	£22,000	2.00%	£22,440
5	£23,000	0.00%	£23,000
AVERAGE	£21,300		£22,138

* the revaluation percentage for the first year is 2% compound interest over 4 years

The table shows that the average pensionable salary is £21,300, but the average revalued pensionable salary is significantly higher at £22,138.

CAREER AVERAGE VERSUS FINAL SALARY

In the example above we see average revalued earnings of £22,138. If this member was in a career average scheme with an accrual rate of 1/60, then this would result in a pension of:

$$\frac{5}{60} \times £22,138 = £1,845 \text{ pa}$$

The final salary in the example is £23,000. If the member was in a final salary scheme with an accrual rate of 1/60, the pension would be:

$$\frac{5}{60} \times £23,000 = £1,917 \text{ pa}$$

So for this member, a final salary scheme with the same accrual rate would yield a better pension.

However, to retain the same overall scheme value when a scheme is changed from final salary to CARE it is generally necessary to improve the accrual rate e.g. from 1/60 to 1/57, in this case the adjustment to the accrual rate in the CARE context would lead to a higher pension than in the final salary scheme:

$$\frac{5}{57} \times £22,138 = £1,942 \text{ pa}$$

Two further examples of the pensions members who are on significantly different career paths might get from the same pension schemes are highlighted below. Andy receives regular promotions throughout his 8 year career, whereas Diane's pay rises are gradual and reflect general pay rises.

EXAMPLE 1

Benefit

This example assumes general pay rises are 2% per year on average whereas price inflation is 2.5%. Two different accrual rates are considered for the CARE schemes.

Year	Earnings	Andy		Diane	
		Revalued Earnings	Earnings	Revalued Earnings	Earnings
1	£20,000	£23,774	£20,000	£23,774	£23,774
2	£20,400	£23,658	£20,400	£23,658	£23,658
3	£20,808	£23,542	£20,808	£23,542	£23,542
4	£25,000	£27,595	£21,224	£23,428	£23,428
5	£25,500	£27,461	£21,649	£23,313	£23,313
6	£36,000	£37,823	£22,082	£23,199	£23,199
7	£36,720	£37,638	£22,523	£23,086	£23,086
8	£48,000	£48,000	£22,974	£22,974	£22,974
Average		£31,186		£23,372	
CARE Pension (1/54)		£4,620		£3,462	
CARE Pension (1/60)		£4,158		£3,116	
Final Salary Pension (1/60)		£6,400		£3,063	

Contributions

In a flat rate contribution scheme (e.g. where all members pay in 6.5%) Diane will have paid in about three quarters of the amount paid in by Andy over the 8 years (£11,158 compared with £15,108 i.e. 74%) and would receive a career average pension equivalent to about three quarters of Andy's. However, on the final salary basis, Diane would receive a pension worth less than half of Andy's.

In a scheme with variable contribution rates this distortion is limited but still exists. Using the LGPS rates to illustrate, Andy would have paid in £15,662 over the 8 years while Diane would have paid in £11,158 (71% of Andy's) yet in the current final salary arrangement she would receive a pension that is only 48% of Andy's.

EXAMPLE 2

This example assumes general pay rises are 3% per annum on average whereas price inflation is 2.5%. As above, two different CARE accrual rates are considered. The differences in contributions would be similar to Example 1.

Year	Earnings	Andy		Diane	
		Revalued Earnings	Earnings	Revalued Earnings	Earnings
1	£20,000	£23,774	£20,000	£23,774	
2	£20,600	£23,890	£20,600	£23,890	
3	£21,218	£24,006	£21,218	£24,006	
4	£25,000	£27,595	£21,855	£24,123	
5	£25,750	£27,730	£22,510	£24,241	
6	£36,000	£37,823	£23,185	£24,359	
7	£37,080	£38,007	£23,881	£24,478	
8	£48,000	£48,000	£24,597	£24,597	
Average		£31,353		£24,184	
CARE Pension (1/54)		£4,645		£3,583	
CARE Pension (1/60)		£4,180		£3,224	
Final Salary Pension (1/60)		£6,400		£3,280	

The examples above show that there are instances when a career average pension can be more beneficial to members than a final salary pension with the same accrual rate.

The examples also show that career average has the effect of reducing the pensions payable to Andy who benefited from a number of promotions throughout his career. This can be mitigated by an improved accrual rate which GMB would expect if a scheme was changing from final salary to CARE without reducing a scheme's overall value.

EXAMPLE 3 - CAREER AVERAGE PENSION FOR A MEMBER WHO GOES FROM FULL TIME WORKING TO PART TIME WORKING

Just like in final salary schemes, the fairest way of treating part time service is to pro-rate a member's pensionable service according to the difference between their part time hours and the full time equivalent number of hours and to calculate pensions by reference to the full time equivalent level of pensionable earnings. This is shown in the example below.

The example assumes general pay rises are 2% per annum on average whereas price inflation is 2.5%. The member moves from working full time hours to reduced hours after four years – both part time and whole time equivalent (WTE) earnings are shown.

Year	Hours	Pensionable Service (years)	Actual Earnings	WTE Earnings	Revalued WTE Earnings
1	37.5	1	£20,000	£20,000	£23,774
2	37.5	1	£20,400	£20,400	£23,658
3	37.5	1	£20,808	£20,808	£23,542
4	37.5	1	£21,224	£21,224	£23,428
5	22.5	0.6	£12,989	£21,649	£23,313
6	22.5	0.6	£13,249	£22,082	£23,199
7	15	0.4	£9,009	£22,523	£23,086
8	15	0.4	£9,189	£22,974	£22,974
Total Service		6		Average	£23,372
CARE Pension (1/54)		[1/54 * 6 * 23372]			£2,597
CARE Pension (1/60)		[1/60 * 6 * 23372]			£2,337
Final Salary Pension (1/60)		[1/60 * 6 * 22974]			£2,297

EXAMPLE 4 - PENSION FOR A MEMBER WHOSE PAY IS REDUCED AT ONE POINT IN THEIR CAREER

This section looks at someone whose pensionable pay is reduced at some point in their career meaning that their highest level of pay is not experienced in the run up to retirement and may not count towards their pension in a final salary scheme. Examples of such a scenario could be as the result of a job evaluation exercise or a member stopping pensionable overtime or shift work.

The example below is similar to others used above in that it makes assumptions about price inflation and pay rises. In this example, price inflation is assumed to be 2.5% per annum. Pay is assumed to rise at a similar rate, except for the one off pay cut shown below after 7 years.

Year	Earnings	Revalued Earnings	
1	£25,000	£39,966	
2	£25,625	£39,966	
3	£26,266	£39,966	
4	£26,922	£39,966	
5	£27,595	£39,966	
6	£28,285	£39,966	
7	£28,992	£39,966	
8	£21,500	£28,915	
9	£22,038	£28,915	
10	£22,588	£28,915	
11	£23,153	£28,915	
12	£23,732	£28,915	
13	£24,325	£28,915	
14	£24,933	£28,915	
15	£25,557	£28,915	
16	£26,196	£28,915	
17	£26,851	£28,915	
18	£27,522	£28,915	
19	£28,210	£28,915	
20	£28,915	£28,915	
Final Year's Earnings	£28,915	Average Revalued Earnings	£32,783
CARE Pension (1/54)			£12,142
CARE Pension (1/60)			£10,928
Final Salary Pension (1/60)			£9,638

FACTORS THAT AFFECT THE CAREER AVERAGE PENSION

As illustrated in the examples the main factor in designing a career average scheme, that will impact on the amounts of pensions paid, is the accrual rate. As with final salary schemes, a variety of accrual rates exist which are typically in the region of 1/40 to 1/100.

The second feature is the rate at which earnings are revalued. The most common measure of revaluation is in line with price inflation, subject to an annual cap (e.g. 5%).

Otherwise the level of pension you receive is dictated by how much you earn, how long you are in the pension scheme and at what age you take your pension – just like in a final salary scheme.