Company pensions:
What you need to ask

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FROM THE TUC

What should I ask a prospective employer about pensions?

A pension is a very important part of the pay package offered by an employer. A good pension can add as much as a quarter to the value of your salary. Particularly if you intend to work for an employer for more than a short time and have any choice about the job you do, you should ask some hard questions about the pension scheme on offer.

Of course pensions can be complex. Pension schemes can have important extra benefits or hidden catches, and you can find out more about occupational schemes in detail at: worksmart.org.uk/money/viewsubsection.php?sun=28

You can use this document when considering a job offer. We list the key questions you need to ask, and as it's always best to look as though you know what you're talking about, we'll give you an idea of some of the answers you might get, and what they mean. At the end you'll find a helpful question sheet, to record the answers you get.

The first question to ask is:

- **do you provide a pension to which the employer contributes?**

Every employer with more than five staff now has to offer a gateway to a stakeholder pension (though many don't). But employers do not have to make any contribution to the pensions of their staff.

So the first thing to do is to establish whether they make a contribution. Simply providing a stakeholder pension with no employer contribution does no more than provide an opportunity to staff to save their own money. While an employer provided stakeholder may be a convenient way to save, and may have lower charges than one you can set up on your own, you will have to put a great deal of your own money aside to get a reasonable pension.

The next question to ask is:

- **If so, is this a salary related pension or a money purchase scheme?**

There are basically two types of pension provided by, or through, employers, though some provide a choice or a scheme that mixes them up – usually known as a hybrid scheme. It is important to understand the difference.

Salary related pensions (also known as defined benefit or DB schemes) pay a pension based on how long you work for the employer that runs the scheme and the salary you are paid. Final salary schemes use the salary you are earning when you stop being paid by your employer to

calculate your pension. This is the commonest type of salary related scheme, but other schemes can use your average salary while you worked for the employer or some other formula.

Money purchase pensions (also known as defined contribution or DC schemes) are a kind of savings scheme. You build up your own savings (often called your pension pot) made up of your contributions, tax rebates and usually an employer's contribution. The pension you receive will depend on how much you and your employer contribute (the defined contribution), how well the pension fund's investments perform and annuity rates when you retire. An annuity is a financial product that you buy with your savings and provides a pension for you (and your partner, when you die, if you choose this kind of annuity) for life.

Employers can set up their own money-purchase occupational scheme or provide a gateway to another scheme. While there are differences between the two, the most important factor is how much the employer will contribute.

The basic difference between salary related pensions and money purchase schemes is that with a salary related scheme you can tell in advance what pension you will receive, while a money purchase scheme pension will depend on factors that can't be foretold in advance such as the performance of scheme investments and annuity rates.

Another way to look at this is that with salary related schemes the employer bears the risk. You have been made a pensions promise, and it is up to the employer to make good that promise by paying enough into the scheme.

With a money purchase scheme you bear the risk. If investments do badly or annuity rates fall, then you will end up with a lower pension.

This does not mean that a salary related scheme will always pay a better pension, or that salary related pension schemes are always better. For the same contribution rates over some periods a good money purchase scheme will provide a better pension than a typical final salary scheme.

There are good and bad examples of both types of pension (and many people who would be grateful to have access to either!).

One crude rule of thumb in comparing schemes is to find out how much the employer puts in. Many employers have replaced salary related schemes with money purchase schemes in recent years, but have also cut back the employer contribution at the same time.

In any case there are few jobs where you get the choice between the two types of scheme. If you do get a choice, which is best for you will depend on your circumstances and plans.

A good money purchase scheme may be better for younger people who are expecting to change their job, as over their working life their early contributions may well grow substantially, while a salary related pension built up from a short period of service early on in a career may not grow as much. On the other hand the guaranteed benefits from a salary related scheme are usually better for those approaching retirement or those expecting to remain in their job for any length of time.

Option 1: Salary related pensions

The questions you need to ask about salary related pensions are rather different to those to ask about money purchase schemes because they work in such different ways.

We assume here that you are being offered a final salary scheme. This is much the commonest and means that your pension is based on your pay rate when you leave the employer.

Hybrid schemes are explained at: worksmart.org.uk/money/viewquestion.php?eny=187 and other ways pensions can be related to salaries are at: worksmart.org.uk/money/viewquestion.php?eny=183

The first question to ask about a salary related pension is:

- **what is the accrual rate?**

The accrual rate is simply a bit of pensions jargon for how much pension you build up each year you work for your employer. It is usually expressed as the fraction of your final salary that you will get for each year you work. Using this bit of jargon will show that you know what you are talking about!

A final salary related pension depends on three things – your final salary, how long you work for the employer and the accrual rate. For example if your final salary was £50,000, and the accrual rate is a generous 1/50 you would get a pension of £1,000 a year for each year you had worked.

Accrual rates are often around 1/60th. Any better than this is very good in today's difficult pension climate. Anything below this – say 1/80th, which is another common rate – is less good. although still better than all those without salary related pensions are getting.

The next questions to ask are:

- **what pension is available for surviving dependents?**
- **can a survivor's pension be paid to an unmarried partner?**

Almost every salary related pensions scheme will provide what are generally called survivor's benefits. This is a pension paid to a dependent (such as a spouse, partner or young children) if you are receiving a pension but die.

But how generous these are, and who can claim, will vary from scheme to scheme.

How big will the pension be? A half pension is common and a two-thirds pension is generous for a surviving partner. On top of this, extra pension may be paid for dependent children, probably a quarter pension for up to two children.

Who can get the survivor's pension? Some schemes limit it to married spouses only. A good scheme will extend it to all genuine partners – both of the same and opposite sex.

The next key question is

- **what is the employee contribution?**

With a final salary scheme the employee's contribution is generally fixed, though may be varied from time to time. (With some pension funds facing difficulties in recent times, some employee contributions have increased.)

Some schemes are non-contributory – the employers bear the whole cost of the scheme. This may be generous – or may simply mean you are getting a smaller salary than people doing similar jobs without a non-contributory scheme.

All in all it is hard to say what are ideal contributions.

A rule of thumb is that five per cent is a reasonable employee contribution for a quality pension scheme. To justify a lot more than this a scheme would either need to be particularly generous or a situation exist where the workforce agree to increase contributions to preserve a scheme in difficulties (which may be well worth doing).

There are other questions you can ask about a salary related scheme. There's more about what makes a good salary related scheme at: worksmart.org.uk/money/viewquestion.php?eny=182

Option 2: Money purchase schemes

Money purchase schemes are much simpler, and therefore easier to understand. There are only two key questions to ask:

- **what contribution does the employer make?**
- **is this dependent on an employee contribution?**

A money purchase scheme is simply a savings scheme, which in return for getting some good tax breaks limits how you can spend your savings to pension provision. The main disadvantage is that you do not know what your pension will be, though you can use workSMART's pension calculator www.pensioncalculator.org/worksmart to get an estimate.

Most experts recommend that you should aim to save 15 per cent of your pay throughout your working life in order to retire at a reasonable age with a reasonable pension, and most people consider it fair if employers contribute at least twice as much as their employees.

A good employer contribution would therefore be around ten per cent, leaving you to contribute five per cent. On top of this the employer should pay the costs of other benefits in the scheme such as death in service or disability benefits. Some pay more. Many employers who offer a stakeholder pension as their only pension option make no contribution at all.

Sometimes how much the employer is prepared to put in will depend on how much you are willing to save, and may vary by age. For example they may be prepared to match your contribution or make a minimum contribution, but pay more if you are prepared to pay above a particular threshold. You should make sure you understand the rules and aim to maximise what your employer pays if you can afford it.

There are other issues to take into account with money purchase schemes, and you can find out more at: worksmart.org.uk/money/viewquestion.php?eny=186

Questions for both types of company pension

There are some other benefits that may be provided by a pension scheme. Although they will be provided in different ways by different schemes, what you need to know is how generous the benefits are. On the other hand, asking 'what happens if I die?' may not be a good question to ask at an interview! These include:

- **what are the death in service benefits?**

Most salary related schemes have some kind of death in service benefit which is made up of a lump sum and a reduced pension for a spouse or nominated beneficiary. A lump sum of three times earnings and a half pension for a surviving spouse (or beneficiary) is reasonable. Anything better is good.

- **what if I have to stop working because I am too ill?**

Many schemes will pay you the pension you would have got had you worked through to the normal retirement age if you have to retire early because of poor health. Other schemes may not be quite so generous, but still assume you have worked extra years.

How schemes judge whether you are too ill to continue working can vary, as can whether there is a length of time you must be a member of the scheme before you can claim.

With a money purchase scheme you are building up your own pension pot, with which you will buy an annuity and take, if you wish, a cash lump sum. There is little scope therefore for any extra benefits from a money purchase scheme. If you die then your pension pot will be available for your dependents, but nothing extra from the scheme.

However, many employers alongside their money purchase pension will take out insurance policies to cover staff, and these may provide life assurance if you die or an income if you become too ill to work.

Normally the employer bears the cost of these, but you should still watch the small print. Some will exclude some types of disability such as HIV- or AIDS-related illnesses, or sports injuries.

A good scheme should pay up to two-thirds of your earnings if you become unable to work, and four times your salary as a death in service benefit.

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Do you provide a pension to which the employer contributes?

a) Yes (continue)   b) No (stop here)

If so, is this a salary related pension or a money purchase scheme?

a) Salary related   b) Money Purchase   c) Hybrid

For salary related pensions:

what is the accrual rate?

what pension is available for surviving dependents?

can a survivor's pension be paid to an unmarried partner?

what is the employee contribution?

For money purchase schemes:

what contribution does the employer make?

Is this dependent on an employee contribution?

What are the death in service benefits?

What if I have to stop working because I am too ill?

For more free plain-English advice on your pension options, visit www.workSMART.org.uk/pensions