

Redundancy – how it affects your defined benefit pension benefits

Active Members



This Factsheet looks at the issues which affect YOU as a job holder where you are an **active member** of a **defined benefit pension** scheme and you are facing the prospect of redundancy.

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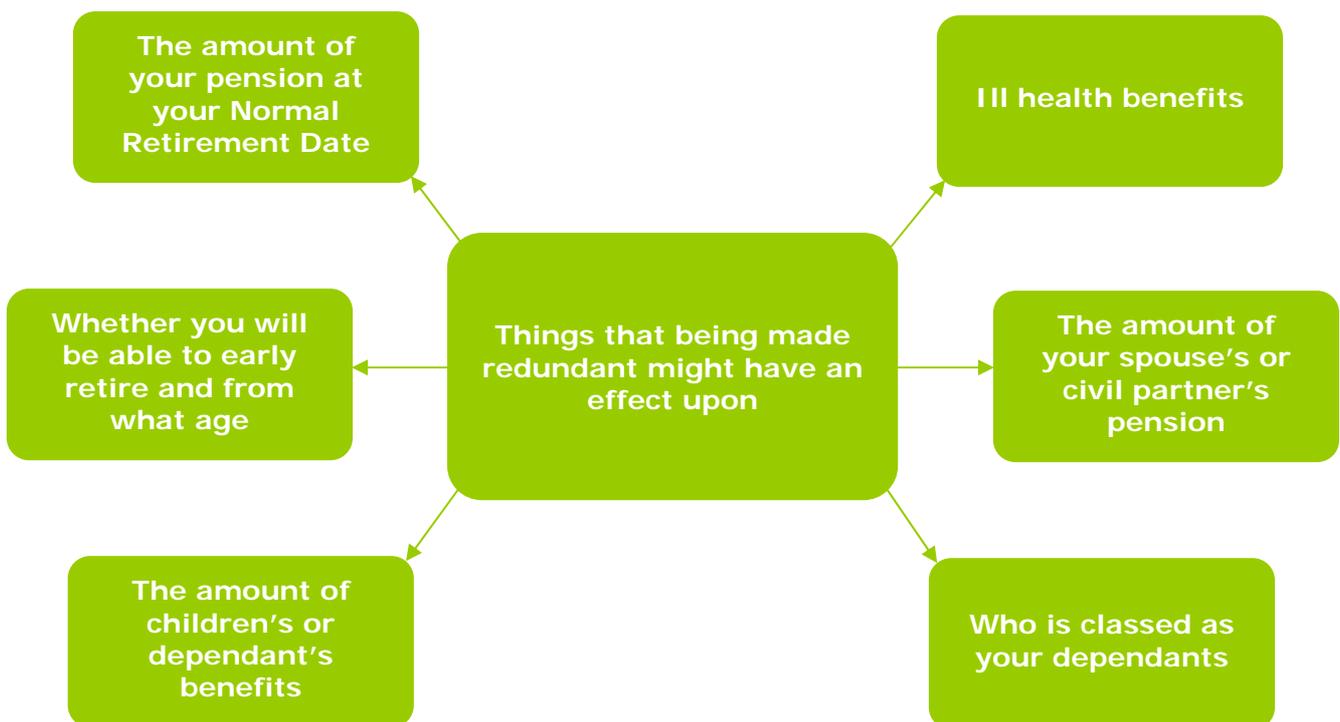
Introduction

Companies are in a constant state of change and occasionally this affects their workforce and leads to the redundancy of certain jobs. This Factsheet looks at the issues which affect YOU as a job holder where you are an active member of a defined benefit pension scheme and you are facing the prospect of redundancy.

We will look at:

- The effect upon you, the member
- The effect on your immediate pension benefits
- The loss of your future pension benefit rights
- Some potentially positive ways in which redundancy can help your pension planning
- The effect on the employer's covenant to support the scheme.

We will not consider issues which are governed by employment law.



The effect upon you, the member

Although many of us at some stage in our careers will be part of a redundancy program, the prospect or initial impact of redundancy can be traumatic in the short term.

Very few of us cope well with imposed change and yet most of us eventually come to terms with changes in our lives.

For a minority of people, however, redundancy can be a welcomed event for a variety of reasons.

Redundancy gives you the opportunity to develop a clear understanding of what your entitlements are, and what sort of action is required to meet any potential changes that may occur to your retirement and life insurance provision.

It is unlikely that you will give a lot of thought to this as you start the process of looking for new employment. However, the consequence of redundancy demands a review of what you can realistically do to plug the new gap in your pension planning. At the time of your redundancy, you may be getting counselling through your employer.

Whether redundancy is welcomed or not, it is essential that you have a clear understanding of what is happening to your pension benefit and of any offers which are being made to you which may affect your pension entitlement.



The effect on your immediate benefits

In relation to any employee benefits package provided by your employer - which will include the pension scheme - there are a number of key consequences to you being made redundant.

- You will cease to be an **active member** of your pension scheme and you will become a **preserved member** (unless you take your pension benefits in which case you will be a **pensioner member**). This may impose immediate changes to your pension benefits.
- Your pension benefits are '**preserved**' in real terms and you cannot make any further contributions to that scheme.
- Any '**death in service**' lump sum benefit that you may have been entitled to as an active member will cease. Any subsequent lump sum payable on your death is likely to reduce significantly.
- Any **spouse's** or **civil partner's pension** paid on your death before retirement might reduce.
- Any **children's** or **dependents' pensions** paid on your death before or after retirement might reduce or cease altogether.
- Whoever might be classed as your **dependants** to qualify for benefits on your death, may change.
- You may lose the ability to draw benefits on the grounds of **ill-health** if these were available for active members. Some schemes require a minimum period of scheme membership before a member is eligible for ill-health benefits.
- You may be offered **incentives to transfer** your pension benefits out of the scheme but this may be for a limited period, or the incentives may be offered on a first-come first-served basis.
- You may lose the ability to retire early. Alternatively, you may lose access to potentially generous **early retirement** provisions, although for those members close to Normal Retirement Date it is not uncommon to be offered an improved early retirement package as part of the redundancy settlement.
- Depending on how your **scheme service** is recorded, you may lose a significant part of your last year's contributions/service.
- Once the redundancy exercise is over you will probably no longer receive the steady flow of information about issues governing your pension from your employer and their advisers that you may have previously been used to.

The loss of future pension benefit rights

Ceasing to be an active member of the pension scheme **cuts the link** between your earnings and how your pension was accumulating.

Whilst you are an active member of a defined benefit scheme, your pension benefits are linked with your **pensionable earnings**. However, when you become a preserved member, part or all of your pension benefit is instead linked to **inflation**:

- **active member – pension benefits typically linked to earnings**
- **preserved member – pension benefits typically linked to inflation (part or all).**

This is important because earnings tend to increase at a **faster** rate than inflation.

Over a period of years, a pension linked to inflation is, more often than not, **worth less** than a pension linked to earnings.

Example:

- If **earnings** grew by an average of 4.0% p.a. over 15 years, each £1,000 would grow to £1,801.
- If over the same period **inflation** averaged 3.0% p.a, each £1,000 would grow to £1,558.

The difference between inflation and earnings growth



Using redundancy to your advantage

Some potentially positive ways in which redundancy can help your pension planning.

Employers do recognise that making people redundant can be life changing for their employees. Many employers make significant efforts and provide a variety of services to soften the blow of redundancy. Used sensibly and with the right advice, redundancy can be a very powerful way of building up your pension benefit.

A redundancy package may cover a number of special benefits which would not have been available to you if you were an active member who chooses to leave the scheme voluntarily.

These special benefits could include:

- Counselling - which helps you understand the value of the pension benefits you've earned so far, and the changes that may be introduced as a result of you ceasing to be an active member.
- Special early retirement benefits for those close to Normal Retirement Date.
- Significant cash settlements for those too young to retire early, (although these may have to be justified under Age Discrimination legislation).
- The options to transfer your benefits to a new employer's scheme on enhanced or more favourable terms.
- Options to transfer your benefits to another pension arrangement (such as a personal pension plan) on enhanced or more favourable terms.

You should receive a redundancy payment from your employer.

How much you receive will depend upon how long you were employed.

If you manage to find replacement employment quickly, you can choose to spend some of your redundancy payment on a new car or a holiday, for example.

However, you might consider investing at least some of your redundancy payment towards your overall retirement planning. Invested wisely and with the appropriate advice, the total benefits you may receive at retirement could become bigger than you might have expected to receive before the redundancy.

New rules available since A-Day, (6th April 2006), mean that you can take advantage of the generous annual contribution allowance into a registered pension scheme if you decide to use part of your redundancy payments to make further pension provision.



Your employer's pension promise

The effect on the employer's covenant to support the scheme.

There may be a number of reasons an employer makes redundancies. It may sometimes appear to be part of a profit-driven exercise. However, 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 financial situation and its continuing ability to support the pension scheme.

The ability to pay for scheme benefits is called the covenant – it reflects the company's commitment to the pension scheme and its ability to meet that commitment by coming up with the contributions when they are required - not just now - but many years into the future.

This is not a concern shared by members of public sector pension schemes whose pensions are 'protected' by government promises.

Pension benefits, currently, are very expensive to fund, and the value of the members' scheme benefits can represent a large proportion of the company's net assets (as pension liabilities now have to appear on their balance sheets). In these circumstances, the pension scheme can drive a weak company into receivership. Before that happens, you should take advice on the wisdom of leaving your pension benefits within the scheme.

Your employer may decide to close the

scheme at some point in the future.

If an employer that sponsors a defined benefit scheme goes into administration, scheme members may be eligible for compensation if the scheme is accepted by the **Pension Protection Fund (PPF)**.

The PPF is not the full safety net many people believe and you should make yourself familiar with what you might receive in the event that your employer fails and your scheme qualifies for compensation for its members.

As part of its overall financial considerations, even where the future stability of a company is not in question, it may look at the viability of continuing to fund a defined benefit scheme for those employees still in service.

It may decide to close the scheme at some point in the future.

This could still affect you once you become a preserved member.

Most pension scheme members would be surprised to learn just how much their employers pay into the pension scheme to fund retirement benefits.

Many employers are currently paying 20%-25% of payroll into the pension scheme (which is in addition to any contributions you pay whilst an active scheme member).

Furthermore, if the scheme is in deficit, the sponsoring employer will be paying extra contributions to fund the shortfall.

Summary & Key Points

When making enquiries about your pension benefit it is very important that you make it clear whether you are an **active member**, a **preserved member** or a **pensioner member**.

Active, preserved and pensioner are different classes of membership of a pension scheme. Any definitions and paragraphs contained within your Scheme Rules or scheme literature relating to any benefit may differ considerably between these categories.

If you cease to be an active member of your pension scheme and you become a preserved member:

- Check what **lump sum** benefit would be paid **on your death** as this may reduce significantly.
- Investigate what **spouse's** (or civil partner's) **pension** would be paid on your death before retirement as this might reduce.
- See whether any **children's** or **dependents' pensions** paid on your death before or after retirement might have reduced.
- Explore whether your **dependants** may continue to qualify for benefits on your death (e.g. what happens if you marry/remarry?).
- Are there any changes to **ill-health** provision or eligibility (if these were available for active members)?
- Are there **incentives to transfer** your pension benefits out of the scheme?
- Will you be able to **retire early**?
- Will your **pensionable service** (the period you are deemed to be a scheme member) reflect the whole of your service up to the date of redundancy?

Keep informed and seek advice

Keep informed. Your scheme may modify benefits and rules. Legislation may change. Your circumstances may alter.

Rules differ from scheme to scheme and are wide and varied in content. Don't assume that what applies to one of your pension schemes will necessarily apply to others that you may have.

HMRC impose rules which registered pension schemes must conform to.

This Factsheet forms part of our module **Redundancy** and should be read alongside the other Factsheets and Quicknotes in the series.

This is not an authoritative document.

This Factsheet contains general information on particular points of interest associated with pensions but is not intended to be a complete or authoritative guide.

This Factsheet does not constitute any form of advice or recommendation and should not be relied on in making (or refraining from making) any specific personal or business decision.

You should seek independent legal, financial and other professional advice from an appropriately experienced and qualified adviser before making any such decisions.

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