



CARE pensions – and how they compare to Final Salary pensions

CARE stands for '**Career Average Revalued Earnings**', a name which gives a clear indication of what it entails.

CARE like Final Salary is a type of 'defined benefit' pension scheme i.e. scheme members are promised a defined level of pension when they retire or leave, on a formula generally related to their salary and years of service.

In calculating the pension the '**Earnings**' you have in each year of your employment, or '**Career**' are taken into account and an '**Average**' of all of them is calculated.

In order to maintain its value, the pension earned each year is '**Revalued**' up until the time that you retire or leave, before being averaged. Revaluation is usually set by reference to a measure of inflation.

In a Final Salary scheme, by contrast, all years of service are linked to a scheme-determined definition of each members 'final salary'. Generally it is only salary just before you retire that influences the pension.

CARE pensions have been introduced by a significant number of employers in the private sector in recent years, generally to replace Final Salary pensions. They have also been introduced in the main public service pension schemes.

An illustrative calculation of how a CARE pension is calculated is provided in an Appendix to this briefing.

Accrual rates and Revaluation rates

There are two critical things which determine the quality of a CARE scheme, which are:

- the accrual rate (the proportion of earnings earned as pension for each year of service) which might be 1/60 or 1/80 or an equivalent % figure.
- the revaluation rate.

A final salary scheme could be thought of as a CARE scheme where pension once earned increased, or was revalued, in line with each member's future pay rises. In practice the revaluation rate in CARE schemes is set at one rate for all members.

Revaluation rates have generally been set on a basis linked to inflation. Perhaps the most common rate, when schemes were first established was RPI (often with a cap of 5% in any year). In recent times revaluation rates have sometimes been worsened or established at lower levels e.g. CPI inflation, often capped at 2.5%, has become more common.

When valuing final salary schemes, actuaries generally assume that the earnings of members of a pension scheme will rise a little bit faster than RPI inflation. These assumptions are based on historic national trends though they are to an extent modified by factors specific to the particular organisation involved. A prudent view is usually taken, which means they are a bit higher than what is actually expected. The actuary may also allow separately for pay increases due to promotion.

This switch from a final salary to a CARE basis will be calculated as reducing the cost of pension if the CARE revaluation rate is less than the previously assumed rate of earnings increase. The other reason that CARE may be adopted is that the employer has wanted to remove the risk that future pay rises will increase the cost of pension earned before the salary increase was given. In a CARE scheme future pay rises increase future pensions but leave past service benefits unchanged.

A different approach to revaluation was taken for the public service schemes. Although the main schemes have revaluation linked to inflation, the expected detriment from this was offset by improving the accrual rate. This approach was designed not so much to make savings as to make schemes fairer to those members who do not have promotional careers.

In final salary schemes members whose salary rises fastest during their careers get a better return from the scheme, for their contributions, than those whose salary rises at a slower rate. This is because the pension is based only on the final salary but contributions reflect earnings over the member's whole career.

In a CARE scheme all members get a pension which is argued to be fairer as it better reflects the earnings and contributions throughout the members' careers.

A simplified ready reckoner of the potential loss a member might suffer from a CARE scheme, relative to a final salary scheme is that the loss would be:

Years of membership x difference between pay rises and the revaluation rate x ½

So, for example, if a member had twenty years membership during which their pay rose by 1% a year above the scheme revaluation rate then the loss of pension as compared to a final salary scheme would be around 10%.

Effect on past service

CARE schemes are often introduced to replace final salary schemes. In this event the value of past service benefits may or may not be affected.

In some cases past benefits remain linked to future final salary. This is what happened with the public service schemes.

In other cases past service benefits have been fixed by reference to 'final salary' at the point the scheme changed to CARE and then increased each year of future service in line with the revaluation rate in the CARE scheme.

This reduces benefits to the extent that pay rises exceed the revaluation rate and has proved attractive to companies as a means to reduce pension scheme deficits.

A simplified ready reckoner for the loss to members is that the loss would be:

Years of future membership x difference between future pay rises and the revaluation rate

Other considerations

In final salary schemes it is often the case that not all pay is pensionable. One reason for this is that variable items of pay, such as shift or overtime, are excluded as they may not still feature in a member's 'final salary'. In a CARE scheme this argument does not apply and an argument can be made for all pay being pensionable.

The amount of salary progression a person has during their career is the key determinant of whether they would be better served by a Final Salary or a CARE scheme, which delivered the same total value of pension to all members. Those with short or broken careers, many of whom may be women, may have as a result less career progression and therefore tend to benefit from CARE.

Also important is when during a career promotions are achieved. If promotion is achieved at the end of a career then a member's pension will increase a lot more if they are in a final salary scheme than if they are in a CARE. If the promotion happens at the beginning of a career then the increase in a CARE scheme pension will not be much less than it is in a final salary scheme.

In designing a CARE scheme within a budget the different levels set on the accrual rate, revaluation rate and the increase in benefits when deferred will affect how benefits are distributed between members of different ages, between those who obtain promotions at different points in their careers and between early leavers and those who stay to retirement.

A disadvantage of CARE is that it makes pensions more difficult to calculate and that the pension may not bear a predictable relationship to the level of pay before retirement. Individuals may or may not have a clear idea as to how their career and pay will progress. At a collective level the Union, faced with a CARE proposal, will need to form a view as to the likely career movement of all of its members.

Some employers have in recent times offered 'final salary' pensions but with a cap placed on the growth of pensionable pay. These will tend to be worse than a CARE scheme would be as with CARE all pay remains pensionable.

Appendix

Illustration of CARE and Final Salary pension calculations

This is a grossly simplified calculation to show how pensions are calculated under the two formats.

Consider the following individual who has a pension based on five years service.

In this final salary scheme pension is based on the final year's earnings

In the CARE Scheme pension is based on Career Revalued Earnings. The revaluation basis used in this case is inflation, which is assumed to rise by 2.5% p.a.

Year	Earnings	Career Revalued Earnings
1	£20,000	£22,075
2	£20,700	£22,290
3	£21,425	£22,510
4	£22,175	£22,730
5	£22,950	£22,950

The 'final salary' in the final salary pension calculation is the Year 5 salary of £22,950 (note however that some final salary schemes base pension on an average of salary in the years before retirement)

In the table above, Year 1 Earnings are revalued by 2.5% p.a. for four years in order to give the Career Revalued Earnings for that year. Year 2 Earnings are revalued for three years (etc) through to Year 5 Earnings which are not revalued at all.

The CARE salary used to calculate pension is the Average of the five 'Career Revalued Earnings' figures in the table – which is £22,510

This means that the pay figure used to calculate pension is 2% lower in the CARE scheme than in the final salary scheme, and that the pension would similarly be reduced if the accrual rate in the schemes was identical.

This result emerges because pay has risen by 3.5% each year which in every year is higher than the revaluation rate.

Other results are possible. If pay rises exactly matched the revaluation rate the pension would be the same, or if pay rises were less than revaluation the CARE pension would be higher. If in Year 3 the member had got a 10% promotion then the CARE pension for the five years would have been 5.5% less.