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The pension crisis

— what the future is for NHS employees

By **Peter Davies**

Want to go fishing? Will what you are saving now ensure a comfortable retirement?

In future NHS employees may have to work longer, for a lower pension, as a result of the government review of the NHS pension scheme. This article reviews the history of pensions, the current provisions, the causes of the pension crisis and the likely solutions

Comments are currently being invited on the reforms to the NHS pension scheme (see news story on page 85). The NHS confederation, which is reviewing the scheme on behalf of the Department of Health, is suggesting that the retirement age should be raised from 60 to 65 and the pension should be based on average rather than final salary. The result is likely to be lower costs to the employer (taxpayer) but fewer retirement benefits for the employee. This article reviews the history of pensions and tries to explain why the government is now taking action.

History of pensions

The first recognisable pension scheme in the UK is believed to be the Customs superannuation scheme in the seventeenth century. This is thought to have been non-contributory (ie, employees were not required to pay into the scheme themselves). Sir Edmund Halley, of comet fame, worked out the earliest annuity tables (calculations of the cost of providing a pension based on life expectancy) which were used for these schemes.

Retirement pension plans, as we know them today, started for civil servants at the beginning of the nineteenth century. Before this time, employees were allowed to continue to work as long as they were able. There was a gradual run down to retirement and old age. At that point, employees had some stark options: they were looked after by their previous employer, their family or, *in extremis*, the workhouse. An Act of Parliament in 1810 established the pension scheme for civil servants who could no longer work. This pension was non-contributory and related to final salary. An attempt was later made to compel workers to contribute to the scheme, but this was rescinded after protests.

In 1834 the Superannuation Act was passed and the more familiar two-thirds of final salary (after 45 years service) system arrived. From this point on, a whole raft of schemes appeared, some were funded by the employer, but others were not. The first private sector pension scheme was established for the benefit of employees in the East India Company towards the end of the nineteenth century.

There were murmurings of compulsory retirement in the nineteenth century but, even as late as the 1930s, this had not yet come to fruition and was still being called for by unions. I know this to be true as my father-in-law in his presidential speech to his union (Union of Shop, Distributive and Allied Workers) in 1935 called for such a thing.

As the popularity of employee pension schemes grew and large amounts of money and tax relief appeared, the issue of pensions became political.

For the current government, which is dealing with problems of the past, the ageing population and a lack of saving by employees today, the pension issue has turned into something of a political nightmare.

Peter Davies is an independent financial adviser and practice principal, Ashley Law Cathedral, Cardiff

Current pension problems

Both private and public sector workers in the second half of the 20th century were able to enjoy generous benefits on retirement. Pensioners have become used to receiving between half and two-thirds of their final salary in retirement. However, the situation has changed in recent years — the problems in the private sector are all too easy to see.

Instead of allowing funds to build up a surplus in good years to feed them in lean years, rules were devised by the Inland Revenue which made it compulsory to get rid of the surplus. Premium holidays were one way, payments back into the company were another. Together with the collapse in world stock markets, this has resulted in funds having shortfalls.

People are also living longer which means they receive their pension for longer. In 1981, a 65 year old male could expect to live, on average, to 79.8 years. In 2004, this increased to 84. The result of this change is that the pension is more expensive for the employer to provide.

In today's climate, a pension of £6,000 a year would cost about £100,000 to purchase (15 years ago it cost £50,000). This is as a result both of falls in the stock market and increased life expectancy.

When the Maxwell empire collapsed in the early 1990s, some pensioners found that their pensions stopped. Today, as a result of the 1995 Pension Act, when a firm goes into liquidation, receivership, administration or in any other way ceases trading, former employees who are in current receipt of pensions will be looked after first by the purchase of an expensive annuity from an insurance company. This may leave little or no money for those employees who have been contributing to the scheme but have not yet retired. The result is that the final salary or defined benefit schemes are no longer viable in the private sector.

Of course, this does not apply to government backed schemes such as those for the NHS, civil servants and teachers, as they do not have a fund accumulating. Tax today pays for the retirement benefits of the public servants of yesterday. The NHS pension scheme currently pays £3.2bn to its pensioners each year. However, the increasing life expectancy of retirees after they have finished working means that the cost of these schemes to the government and the taxpayer has risen. The government has decided therefore, that the minimum retirement age for public sector workers (to receive a full pension) will now be 65.

The NHS pension scheme

The NHS Pension Scheme, like the Civil Service Scheme, was set up by Act of Parliament and has no trustees and essentially no actual funds. In fact it has what are called notional imaginary funds (a calculation is done to work out what these funds might be). The key benefits of the scheme are listed in Panel 1.

The NHS pension is an eightieth scheme: the total number of years worked is divided by eighty and multiplied by the final salary to calculate the pension. This means that if an employee worked forty full years they would retire on half pay. The maximum number of years that can be put towards the scheme is 45 (giving a maximum pension of 56 per cent of final salary). Pensioners also receive a tax-free lump sum equivalent to three times their annual pension on retirement. There are additional rules for retirement because of ill health or for those retiring early for other reasons. Employees can retire from the age of 50, but a reduction in the benefits will be applied until the age of 60 (see Panel 2).

Most NHS employees between the ages of 16 and 70 can join. Broken service can also be catered for. It is a flexible and well thought out scheme.

The gross cost to employees is at the moment 5 per cent of pay for manual workers and 6 per cent for the rest. The net cost is less, about 3.5 per cent, because the contributions qualify for tax relief at the employees highest rate. The estimated value of the pension is equivalent to 20 per cent of salary.

Panel 1: Benefits of the current NHS pension scheme

- A pension equal to one-eightieth of an employee's final year's salary for each year worked in the NHS
- A tax-free lump sum equal to three times an employee's annual pension
- A pension for an employee's spouse after their death of half the rate they were receiving
- Life assurance to provide cover if an employee dies before retiring

Panel 2: Benefits available when retiring before the age of 60

Age	Pension	Lump sum
59	94%	97%
58	89%	94%
57	84%	92%
56	80%	89%
55	75%	86%
54	72%	84%
53	68%	82%
52	65%	79%
51	62%	77%
50	60%	75%

Hospital pharmacists are normally full members of the pension scheme. As with NHS staff in general, a large proportion are female. Quite often a career break is important. Not just a "children break" but there may be a need to look after a sick relative. These breaks are catered for in the NHS scheme by the simple means of totalling years of service. This also applies to part-time working and job sharing.

Because this is a defined benefit scheme the government pays the extra required to meet the total cost of the benefits. The NHS pension is index linked to the cost of living for anyone who retired after the age of 55.

Should a scheme member die before retiring a lump sum will be paid. If a member dies after retirement, a spouse's pension would be paid at an appropriate level. The full rules and details are in the 50 page book "A guide to the NHS Pension Scheme", which all members should read (other further reading is listed in Panel 3).

Some employees may have joined not at the beginning of their careers but late on and feel that they want to enhance their pension by extra payments. This can be done in a number of ways including paying into the NHS additional voluntary contribution (AVC) scheme with either Standard Life or Prudential. Alternatively, NHS staff can take out a free-standing AVC with any pension company of their choice. An additional option, only open to those earning less than £30,000 is to open an NHS Stakeholder pension. Added years can also be bought. Any employees interested in doing this should consult the booklet "Increasing your benefits" from the NHS Pension Scheme Office.

The future of pensions

As I mentioned earlier, the final salary or defined benefit scheme, for the private sector, is dead. By June 2004, 10,500 final salary schemes had been closed. Employees in the private sector will have to use funded investment pensions, where they additionally take on the risk of fluctuations in the stock market.

The result of the review of NHS pensions is likely to be less generous retirement benefits. The consultation on the NHS pension scheme lasts until 11 April. Pharmacists reaching retirement before 2013 can look forward to retiring with the benefits that they had always expected. Those who reach the age of 60 after 2013, or who start working for the NHS after 2006, however, will need to consider carefully the effects of the changes on their future financial plans. Female staff who had been anticipating receiving the state pension on reaching 60 should also be aware that this will not be available until the age of 65 after 2020. The increase in age will be phased in, starting in 2010.

Panel 3: Further reading

- NHS Pension Agency. A guide to the NHS Pension Scheme. Fleetwood: The Agency; 2004.
- NHS Pension Agency. Increasing Your Benefits. Fleetwood: The Agency; 2004.
- NHS Pension Agency website **www.nhspa.gov.uk**
- Sue Ward. Planning your pension: A TUC guide for everyone at work (TUC Guide). London: Kogan Page; 2002. (£8.99)

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