The Trustee toolkit downloadable

DB recovery plans, contributions and funding principles

Tutorial two: Accrued benefits funding methods

By the end of this tutorial you will better understand:

- the difference between the main approaches trustees can take in valuing the scheme benefits (technical provisions)
- how choosing one approach over another will affect the valuation

This tutorial is part of Scenario one.

Glossary

A detailed glossary of technical terms can be downloaded from the Resources tab when you log in at www.trusteetoolkit.com

The Pensions Regulator

A tale of two members

The trustees of the Forest Group Hotels scheme are calculating their liabilities for past service (technical provisions). The trustees will need to decide which method to use to value past service benefits. That decision will depend on whether the scheme still has active members, as their liabilities will continue to increase in line with salary over the years until those members access their pension benefits. The pension age of the scheme is 65. Let's look at two example members.

Arlene

Arlene is 45, has been in the scheme ten years and is a deferred member. She has accrued benefits of £3,300 per annum to date.

Under the scheme rules, the £3,300 pa pension benefits she has already earned will increase with RPI inflation capped at 5% pa (ie Limited Price Indexation (LPI)) over the next 20 years until she reaches the scheme's pension age.

So, if LPI is assumed to be 2% pa, by 65 her pension will have grown to £4,903 pa. This figure is derived by increasing each year's pension by 2% for 20 years: £3,300 x (1.02 to the power of 20) = £4,903.

Boris

Boris is 45, has been in the scheme ten years and is an active member. He has accrued benefits of £3,300 per annum to date.

Because Boris is an active member and because it is a final salary scheme, the £3,300 pa benefits that he has already accrued will increase in line with his salary between now and his pension date. This is likely to be more than inflation and the trustees have already agreed to assume that the salary increase will be 4% pa.

On this basis his pension in relation to his first 10 years of service will have grown to £7,231 pa by the time her reaches pension age: £3,300 x (1.04 to the power of 20) = £7,231 pa.

To this will be added the pension benefits that he will accrue between now and his pension age, ie his future service benefits. In passing, Greta (the scheme actuary) mentions that this would work differently in a different type of DB scheme, eg career average. In this case, the benefits would be more likely to grow in line with inflation.

Outcome

The trustees can see that increases in past service benefits for active members are affected by future salary growth, whereas for deferred members and pensioners, the benefits are affected by inflation.

Inflation

The technical provisions relate only to the scheme's liabilities for past service but even those liabilities for past service will increase over time. The employer is bound by law to allow for minimum increases in past service liabilities which relate to inflation. This means that some increases must be included in the technical provisions in relation both to deferred members like Arlene and active members like Boris.

Future salary increases

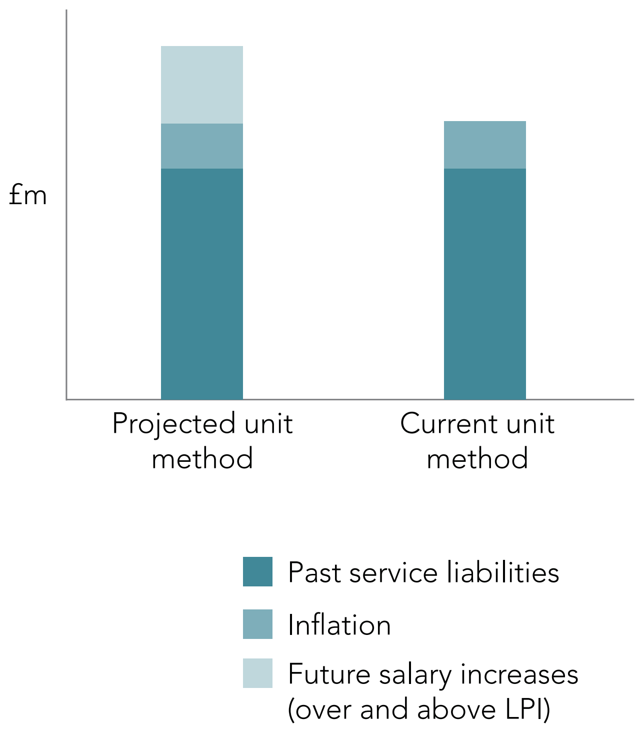
In addition, the legislation requires technical provisions to be set prudently. This means that increases for active members that are attributable to salary growth, that are expected to be over and above inflation should be taken into account in the calculations of technical provisions.

The decision

The trustees now need to decide what they want to propose to the employer about salary related increases for active members.

Two methods

The law requires technical provisions to be valued using an accrued benefit funding method. There are four such methods, however two are most commonly used: the projected unit method and the current unit method.



The projected unit method

This method fully accounts for increases within the calculations for the technical provisions.

The current unit method

This method treats active members the same as deferred pensioners, ie only allows for increases in past service benefits for active members in line with inflation (eg LPI in this scheme) in the technical provisions.

Specifically, it does not allow for increases relating to salary growth, over and above inflation, in the technical provisions.

Using the methods

Having explained about the two methods for calculating the technical provisions, Greta goes back to her example members, Arlene and Boris, to show how they work in practice.

Arlene

Arlene is a deferred member so there is no future salary growth over and above inflation to be taken into account. This means that the size of her past service liability will be the same whichever method is used.

Boris

The current unit method would show Boris's past service liability to be smaller than it would be if the projected unit method were to be used. The difference would consist only of expected increases due to salary growth which are over and above the expected rate of inflation.

Questions about funding methods

Greta has finished explaining the basics of the projected unit and the current unit methods, and she asks the trustees if they have any questions.

Are there any other methods?

Greta tells the trustees that there are two other accrued benefit funding methods for working out the technical provisions. She explains that she does not need to go into detail about these because, although they are acceptable methods, they are used only rarely:

- The partial projected unit method (often used for schemes which are due to be closed within a specified period)
- The defined accrued benefit method (often used where scheme is considering winding up)

Which method has the scheme used in the past?

The Forest Group scheme has always used the projected unit method for its scheme funding valuations because it still has a lot of active members. This is also the method that Greta has been using in all her recent calculations.

Greta advises them to continue using this method for setting their technical provisions as the scheme is still open and circumstances have not changed.

What would be the effect of using the current unit method instead of the projected unit method (using the same assumptions)?

Greta reminds the trustees that the current unit method calculations generally resulted in the liabilities for Boris's past service benefits being lower than with the projected unit method.

Like Boris, the majority of the Forest Group members are active, so the current unit method would similarly generally reduce the size of the technical provisions for most members. In turn this would reduce the contributions required from the employer. However, this approach may not be prudent as it would not reflect the true extent of the liabilities.

How does the choice between methods affect other schemes?

Only active members' past service liabilities are affected by future salary growth, so the difference between the outcomes of the two methods depends on the proportion of active members in a scheme.

If a scheme has very few active members, the difference between the two methods is barely noticeable. If the scheme has only deferred or pensioner members then there will be no difference at all.

Greta then points out that schemes considering winding up will often use the current unit method, as they would not then need to take into account any future salary increases.

Decision

The trustees are all satisfied that they know all they need to about the projected unit and current unit methods, and feel that they can now make an informed decision.

The Forest Group scheme still has a high proportion of active members and the trustees decide that they should continue to use the projected unit method so that future salary increases are fully accounted for.