The Actuarial Profession
making financial sense of the future

Pension Scheme Termination – PPF and Wind-Up

How to calculate PPF Compensation

Stephen Rice – Chief Actuary, PPF

Agenda

- Admissible Rules
- What is Compensation?
- Compensation Levels
- Compensation Cap
- Worked examples

The Actuarial Profession
making financial sense of the future

Agenda
Worked examples

1. Compensation Cap
2. Tranches
3. Determining the deferred pension to value as part of a s143 valuation
4. Compensation where a pension is already in payment
5. Compensation where a pension (not yet in payment) is subject to multiple tranches

The Actuarial Profession
making financial sense of the future

Admissible Rules

- Admissible Rules are the scheme rules disregarding:
  - recent rule changes that would increase the protected liabilities at the relevant time, and
  - any scheme rules that come into operation on or operates by reference to the winding up of the scheme or any associated event

The Actuarial Profession
making financial sense of the future

Admissible Rules
Recent rule changes

Recent rule changes means:

- Changes to the scheme rules which took effect or were made in the period of three years prior to the assessment date, and
- Any scheme rules that operate by reference to an insolvency event in relation to the employer or any prescribed event relating to the future of the employer as a going concern

The Actuarial Profession
making financial sense of the future

Admissible Rules

- Further guidance and examples are provided on the PPF website
- http://www.pensionprotectionfund.org.uk/financial_management_-_appendix.pdf

The Actuarial Profession
making financial sense of the future

What is Compensation?

Relevant legislation

- Schedule 7 of Pensions Act 2004
- The Pension Protection Fund (Compensation) Regulations (2005 No. 670)
- Amending regulations as appropriate

The Actuarial Profession
making financial sense of the future

What is Compensation?

Compensation can be reduced:

- Revaluation and indexation can be reduced by the Board.
- Levels of compensation can be reduced by the Secretary of State on the recommendation of the Pension Protection Fund.

The Actuarial Profession
making financial sense of the future

Compensation – Protected Pension Rate for pensioners

For pensioners, the protected pension rate is that calculated in accordance with the scheme's admissible rules

The Actuarial Profession
making financial sense of the future

Compensation – Protected Pension Rate for postponed pensioners

For postponed pension scheme members, the protected pension rate is that calculated in accordance with the scheme's admissible rules as though postponement had ceased immediately before the assessment date

The Actuarial Profession
making financial sense of the future

Compensation – Protected Pension Rate for deferred pensioners

For deferred pensioners, the Protected Pension Rate is the deferred pension at exit in accordance with the scheme's admissible rules; plus revaluations

- from exit to the assessment date, and then
- from the assessment date to Normal Pension Age

The Actuarial Profession
making financial sense of the future

Compensation – Protected Notional Pension for active members under NPA

- Notional pension rate for all active members =

  Accrual rate * Pensionable Earnings * Pensionable service (excluding pension credit service);

  plus revaluations from the assessment date to Normal Pension Age

The Actuarial Profession
making financial sense of the future

Definition – Normal Pension Age

It is the earliest age from which members can retire from the scheme without consent or reduction (see paragraph 34 of Schedule 7).

The Actuarial Profession
making financial sense of the future

Definition – Indexation & Revaluation

- Indexation

  Compensation increases only apply to compensation accrued after 5 April 97 service entitlements. They take place on 1 January. The amount of the increase is the increase in the RPI to the preceding 31 May, capped at 2.5%.

- Revaluation

  Deferred member's benefits are revalued at the lower of the RPI increase between assessment date and date of retirement and 5% p.a. over the same period.

The Actuarial Profession
making financial sense of the future

Compensation Levels

- There are two levels of Compensation:
  - 100% level, applied to compensation not subject to the Compensation Cap
  - 90% level, applied to compensation which is subject to the Compensation Cap

The Actuarial Profession
making financial sense of the future

Compensation Levels – 100% payment level

- Who are eligible to receive Compensation equivalent to 100% of their pension as at the assessment date?
  - Those who are over their scheme's normal pension age as at the assessment date.
  - Those who are under the scheme normal pension age and in receipt of an ill-health pension as at the assessment date.
  - Those who are in receipt of a survivor's pension.

The Actuarial Profession
making financial sense of the future

Compensation Levels – 90% Payment Level

- Who are eligible to receive Compensation equivalent to 90% of their pension as at the assessment date?
  - Those who are under their scheme's normal pension age as at the assessment date; and not in receipt of an ill-health pension or survivor's pension as at the assessment date.
- Compensation for these members is subject to the compensation cap before the application of the 90% factor.

The Actuarial Profession
making financial sense of the future

Definition - Compensation Cap

- What is it?
  - The Compensation Cap is an upper limit to the amount of Compensation that can be paid to a member before the application of the 90% compensation payment level.
  - The Compensation Cap is age-related and subject to actuarial adjustment factors if the pension scheme member is above/below age 65.
  - The Compensation Cap at age 65 is set annually by order of the Secretary of State.

The Actuarial Profession
making financial sense of the future

Compensation Cap

- When does it apply?
  - At the point at which the Compensation comes into payment; or
  - If the Compensation was already in payment – at the assessment date.

The Actuarial Profession
making financial sense of the future

Compensation Cap – Example 1

- Scenario
  - Assessment date is 1 October 2007
  - Member is age 58 and took early retirement
  - The current value of the annual rate of pension before commutation as at the assessment date = £28,500
  - The current value of the annual rate of pension after commutation as at the assessment date = £21,500

The Actuarial Profession
making financial sense of the future

Compensation Cap – Example 1

- Step 1 – Does the current value exceed the appropriate compensation cap?
  - Identify the correct compensation cap
    http://www.pensionprotectionfund.org.uk/index/other_guidance/compensation_cap_factors.htm
  - Identify the correct current value of the pension as at the assessment date.
- In this case
  - Member is age 58 – compensation cap is £26,198.32
  - Member's current annual value of pre-commutation pension is £28,500

The Actuarial Profession
making financial sense of the future

Compensation Cap – Example 1

- Step 2 – Calculate the appropriate cap fraction
  - Where the current value of the pension exceeds the compensation cap; a cap fraction needs to be calculated.
  - The cap fraction is calculated as:

$$\frac{\textbf{Appropriate Compensation Cap}}{\textbf{Current value of annual pension before commutation}}$$

- In this case
  - £26,198.32 / £28,500 = 0.919239

The Actuarial Profession
making financial sense of the future

Compensation Cap – Example 1

Step 3 – Apply the cap fraction

The cap fraction should be applied to the annual rate of pension that is in payment

In this case

0.919239 * £21,500 = £19,763.64

Step 4 – Apply the 90% Compensation Payment Level %

The benefit after the application of the compensation cap should be reduced to 90%.

In this case

0.9 * £19,763.64 = £17,787.28

The Actuarial Profession
making financial sense of the future

Tranche

What is a tranche?

A tranche is an element of compensation which is payable from a specific Normal Pension Age.

A tranche in respect of benefit accrued on both 5 and 6 April 1997 will have a pre-1997 component and a post-1997 component.

The Actuarial Profession
making financial sense of the future

Tranches – Example 2

Scenario:

- Member is age 62 as at the assessment date with the following:
  - One tranche where the NPA is 60
  - One tranche where the NPA is 65
- As the member is over the age of 60 as at the assessment date, the first tranche will have a compensation level % of 100% and it will not be subject to the compensation cap.
- As the member is under the age of 65 as at the assessment date, the second tranche will have a compensation level % of 90% and will be subject to the compensation cap.

The Actuarial Profession
making financial sense of the future

Example 3 – deferred pensioner calculation for a s143 valuation

Note that this example is taken from PPF website – 'Section 143 FAQs'
http://www.pensionprotectionfund.org.uk/index/faqs/section_143_faqs.htm

Scenario

- The member is aged 50 at assessment date (with 2 tranches of benefit).
- Suppose the revalued scheme benefit at assessment date is (shown on next slide)

The Actuarial Profession
making financial sense of the future

Example 3 – deferred pensioner calculation for a s143 valuation

Benefits at assessment date			
Tranche	Pre or post 97	NPA	Benefit (£ p.a.)
Tranche A	Pre97	60	20,000
Tranche B	Pre97	65	8,000
Tranche B	Post 97	65	15,000

The Actuarial Profession
making financial sense of the future

Example 3 – deferred pensioner calculation for a s143 valuation

- Step 1: Projection of compensation cap to NPA
- Project the compensation cap in force at assessment date to 60 or 65 (using the assumptions in the guidance)
- Note that the example uses sample values for the compensation cap
- 60: 25,000 * 1.015^{10} = 29,013.52
- 65: 29,000 * 1.015^{15} = 36,256.73

The Actuarial Profession
making financial sense of the future

Example 3 – deferred pensioner calculation for s143 valuation

- Step 2: Calculate the % of cap used at each NPA
- % cap used at 60 = 20,000 / 29,013.52 = 68.93%
- % cap used at 65 = 68.93% + (8,000 + 15,000) / 36,256.73 = 132.37%

The Actuarial Profession
making financial sense of the future

Example 3 – deferred pensioner calculation for s143 valuation

- Step 3: Now use the Cap percentages and the 90% factor to determine the benefits to value
- Tranche A
  - From 60 to 65 = £20,000 * 90% = £18,000
  - At 65 = 20,000 * 90% / 132.37% = £13,598.25
- Tranche B (pre-1997 element)
  - From 65 = 8,000 * 90% / 132.37% = £5,439.30
- Tranche B (post-1997 element)
  - From 65 = 15,000 * 90% / 132.37% = £10,198.69

The Actuarial Profession
making financial sense of the future

Example 4 – pensioner calculation for compensation

- Scheme Scenario

- XYZ Plc has entered the assessment period. The assessment date is 1/5/07. The scheme has a normal retirement age of 63.
- The scheme equalised on 1/1/94.
- Prior to 1/1/94 men could retire at 65 and women at 60.
- Members can retire unreduced from 60 with trustees and employer consent.
- Scheme's normal pension age for PPF purposes is 65, 63 or 60
- The NPA 63 tranche is actually split into two elements (pre97 and post97 – not considered here)

The Actuarial Profession
making financial sense of the future

Example 4 – pensioner calculation for compensation

- Member Scenario

- Mr Smith early retired on 31/8/04 taking cash and a reduced pension.
- His date of birth is 31/3/46
- His pension is currently £33,500 pa
- His full pension (i.e. pre-commutation) is currently £42,500 p.a.
- The tranches are shown in the next slide
- What is his initial level of compensation at assessment date?

The Actuarial Profession
making financial sense of the future

Example 4 – pensioner calculation for compensation

Split of benefit into tranches		
NPA	Pension of £33,500	Pension of £42,500
65	£3,500	£6,250
60	£3,000	£6,000
63	£27,000	£30,000

The Actuarial Profession
making financial sense of the future

Example 4 – pensioner calculation for compensation

- At assessment date member's age last birthday is 61
- Compensation cap for age 61 last birthday is £27,601.62
- Benefits subject to cap = £6,250 + £30,000
- Cap fraction = 27,601.62 / 36,250 = 76.14%
- Apply cap fraction and 90% limit to appropriate tranches (of actual benefit)
  - Tranche 65: 3,500 * 76.14% * 90% = £2,398.41
  - Tranche 60: £3,000
  - Tranche 63: 27,000 * 76.14% * 90% = £18,502.02
  - Total: £23,900.43

The Actuarial Profession
making financial sense of the future

Example 5 – Multiple tranches

- Pension scheme member entitled to tranches of pension and lump sum at ages 60 and 65
- At age 60
  - Periodic pension = £12,000
  - Lump sum = £36,000
  - Actuarial commutation factor, say = 18
  - Compensation cap, say £20,800

The Actuarial Profession
making financial sense of the future

Example 5 – Multiple tranches

- At age 65
  - Periodic pension = £15,000
  - Lump sum = £45,000
  - Actuarial commutation factor, say = 15
  - Compensation cap, say £30,000

The Actuarial Profession
making financial sense of the future

Example 5 – Multiple tranches

- At age 60
  - Step 1: Divide lump sum by actuarial factor
    - In this case = 36,000 / 18 = 2,000
  - Step 2: Add the actual periodic pension to Step 1
    - In this case = 12,000 + 2,000 = 14,000

The Actuarial Profession
making financial sense of the future

Example 5 – Multiple tranches

- Step 3: Compare to compensation cap
  - In this case 14,000 is less than compensation cap of £20,800
  - Lump sum at age 60 = 90% * £36,000 = £32,400
  - Periodic compensation starting from age 60 = 90% * £12,000 p.a. = £10,800 p.a.
- Step 4: Calculate the cap % for use in assessing later tranches
  - In this case = 14,000 / 20,800 = 67.308%

The Actuarial Profession
making financial sense of the future

Example 5 – Multiple tranches

- At age 65
  - Step 1: Divide lump sum by actuarial factor
    - In this case = 45,000 / 15 = 3,000
  - Step 2: Add the actual periodic pension to Step 1
    - In this case = 15,000 + 3,000 = 18,000

The Actuarial Profession
making financial sense of the future

Example 5 – Multiple tranches

- Step 3: Compare to compensation cap (using the cap % methodology)
  - In this case 18,000 / 30000 = 60%
  - Add this to the retained cap % i.e. 67.308% + 60% = 127.308% (> 100%)
  - All future payments are capped i.e. benefits at 65 and benefits in respect of retirement at 60
- Step 4: Calculate the final cap %
  - In this case = 100 / 127.308 = 78.55%

The Actuarial Profession
making financial sense of the future

Example 5 – Multiple tranches

- Step 5: Periodic pension
  - In this case
  - Periodic pension (65) = 15,000 * 78.55% = £11,782.50
  - Periodic pension (60) = 13,000 * 78.55% = £10,211.50

  [suppose £12,000 p.a. at age 60 has increased with indexation to £13,000 p.a. at age 65]
- Step 6: Lump sum (65)
  - In this case = 45,000 * 78.55% = £35,347.50

The Actuarial Profession
making financial sense of the future

Example 5 – Multiple tranches

- Step 7: Apply 90% compensation level
  - In this case
  - Periodic payment = (11,782.50 + 10,211.50) * 90% = £19,794.60
  - Lump sum = 35,347.50 * 90% = £31,812.75

The Actuarial Profession
making financial sense of the future

Commutation

- For members reaching NPA once their scheme has transferred to the PPF
  - Calculated after the application of the compensation cap and the 90% compensation level
  - All retiring members are entitled to commutation
  - Amount commuted is restricted to a maximum of 25% of pension entitlement

The Actuarial Profession
making financial sense of the future

Commutation

- Trivial commutation
  - Governed by the Finance Act 2004
  - Value of PPF compensation and pension rights on the nominated date do not exceed 1% of Lifetime Allowance
  - No trivial commutation has previously been paid
  - Extinguishes the member's entitlement to PPF compensation

The Actuarial Profession
making financial sense of the future

Compensation for survivor's benefits

- Compensation is payable to spouses and financially dependent unmarried partners where there is a provision under the admissible rules
- Entitlement for surviving spouse and unmarried partners is 50% of member's period compensation at date of death
- Compensation is payable to member's surviving children until they reach age 18 (25 in specific circumstances)
- Entitlement of 25% of member's period compensation at date of death for first child, rising to 50% for two or more children

The Actuarial Profession
making financial sense of the future