The Trustee toolkit downloadable

DB recovery plans, contributions and funding principles

Tutorial four: Future service funding methods

By the end of this tutorial you will better understand:

- the difference between the main approaches trustees can take in valuing future service benefits
- the different types of other payments the employer needs to make
- what the PPF levy is
- how the PPF levy is made up

This tutorial is part of **Scenario two**.

Glossary

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

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The Forest Group scheme

The Forest Group scheme is a medium sized, ongoing scheme, open to new members and future accrual. The scheme's trustees need to work out the regular employer contributions that are added to the employee contributions in order to pay for current and future service. The trustees need to consult Forest Group about the level of employer regular contributions. Above all, it is an opportunity for the trustees to be updated on all the factors which contribute to the strength of the employer covenant. Of course, the trustees are already in regular communication with the employer about its covenant.

The trustees need to consult Greta, their scheme actuary, and to take all this information into account when deciding what the contribution rate for current and future service should be.

Three actuarial methods

Greta is focusing on the three main actuarial methods used for working out the contribution rates for current and future service. All of them aim to secure a stable contribution rate over the years. The objective of all the methods is to take account of the membership's current and future age profile. The trustees therefore need to be aware of the age profile of their own scheme.

A reminder

Greta reminds the trustees that it generally costs less to provide benefits for younger members than it does for older members.

This is because, in the case of younger members, there is a longer period over which the investments can grow. However, if expected salary increases are higher than the discount rate it costs more to provide benefits for younger members than it does for older members. This applies to individual members and to schemes as a whole.

So, as well as knowing about the current age profile, trustees need to be aware of the trends in the age profile of their scheme. For example, the membership might on average be getting older if the scheme was closed to new members.

Projected unit credit method

If the trustees consider that there are likely to be enough new young members for the age profile of the scheme to remain constant, then they might choose the projected unit credit method. If they prove to be wrong, and the age profile of the membership increases over time, then the average contribution will be higher in the future.

Greta points out to the trustees that this method is the same as the projected unit method which she described to them in relation to valuing past service liabilities.

Attained age method

If the trustees consider that the average age of the scheme members is likely to increase with time, then they might consider the attained age method.

This method is sometimes used for closed schemes, where the active membership is expected to age and the number of actives is expected to decline. In this case, average employer contributions per member or per £ of covered salary are likely to be higher, but they are likely to remain more stable than they would using other methods.

Entry age normal method

Trustees of schemes with members that tend to be the same age on entry and remain in service until retirement may consider the entry age normal method. This method can effectively reduce the employer contributions for older members, in recognition of the funding built up over previous years, and contributions should remain stable.

In Greta's experience, it is used more in the public sector than in the private. But it might also be used by the trustees of big organisations with a 'cradle to grave' culture. Again, if trustees prove to be wrong, the contribution rate could rise if age on entry increases over time.

Which method?

Greta asks the Forest Group trustees which method they should consider for their own scheme when setting their future service contribution rate.

Possible answers: Attained age method, Projected unit credit method, Entry age normal method

Answers are at the back

Additional payments

Greta reminds the trustees that as well as paying the set contributions, the employer also has to make some additional payments.

The scheme's expenses

For the Forest Group the employer pays for the scheme's expenses. These include:

- premiums for any insured benefits.
- any professional fees (they pay Greta, for example)
- administration costs
- the Pension Protection Fund (PPF) levy

The PPF

The PPF offers protection to members of schemes with deficits whose sponsoring employers become insolvent (although this compensation may not be as much as their accrued benefit entitlements). It can only do this at a cost which falls on all DB schemes charged through the PPF levy. In fairness to all schemes the PPF looks at two aspects of the riskiness of schemes when calculating the levy.

- How likely is it that this sponsoring employer might become insolvent (the insolvency risk)?
- If it did become insolvent, how big would the deficit be (the underfunding risk)?

The answers to these questions are reflected in the risk-based element of the levy.

The PPF levy

There are two elements to the levy: a risk-based element and a scheme-based element. Currently at least 80% of the levy is risk-based and is based on the likelihood of a scheme making a claim on the PPF (the insolvency risk) and the potential size of that claim (the underfunding risk). The remaining 20% is based on the scheme's liabilities on a prescribed basis (its section 179 liabilities).

The size of the risk-based levy

We have seen that the size of a scheme's risk-based levy is driven by both insolvency risk and underfunding risk. The insolvency risk is measured using an Experian assessment of the employer's insolvency risk. The higher the probability that an employer will become insolvent, the higher the risk-based levy. Similarly, the lower a scheme's funding level (ie the larger the deficit), the higher the risk-based levy.

Answers and feedback

Which method?

The right answer is projected unit credit method.

The Forest Group scheme is ongoing to both future accrual and new members. It is constantly replacing members who leave with new members, so it may be reasonable to assume that the age profile will remain constant. This is the main assumption used in the projected unit credit method, so it makes sense for the Forest Group trustees to select this method.

If the Forest Group scheme was closed to new members, the average age of members would increase. The trustees should then consider the method that allows for this: the attained age method.

If the scheme admitted new joiners all at a particular age, then the trustees might consider the entry age normal method to be appropriate.

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November 2017
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