Pensions Management Institute
ACHIEVING PENSIONS EXCELLENCE

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Defined Benefit Arrangements

Assignment 1 Notes

(Part 1 – Scheme Design)
Recommended Time: 3 hours

1. **A member of a non contributory scheme asks you to explain why they should not assume the benefits from a DB scheme are guaranteed. How would you answer?**

10 marks

Include the following points:

- The fact that the employer pays the whole cost does not mean no risk
- The cost of benefits is determined by the actuary and can only be an estimate
- The estimated cost is met by contributions by the employer and investment returns
- Contributions are pooled in the pension fund with none earmarked for any individual
- The benefit formula is defined, but the final amount and payment of it cannot be guaranteed as it depends on the employer's ability to meet the costs
- The employer carries the risk of the unknown costs and the members also bear the risk in the event of underfunding or insolvency

(The relevant section of the Study Manual is Part 1, Chapter 1.1.2.)

2. **Describe the arrangements that could be used for individuals or small groups of members, such as an employer's senior executives.**

10 marks

Mention the following:

- Executive Pension Plans – registered pension schemes, which are almost always DC and often provided for high earning employees. They are subject to the Annual and Lifetime Allowances and are set up under trust, master trust or exchange of letters

- Small Self Administered schemes (SSASs) – typically operated for the directors of smaller limited companies where scheme members are also trustees. These schemes provide the trustees with freedom over the choice and methods of investment. Since 6 April 2006, the legislative distinction between SSASs and other occupational pension schemes has fallen away

- Employer Financed Retirement Benefits Schemes – unregistered (formerly 'unapproved') arrangements not subject to the Annual and Lifetime Allowances. Typically established for highly paid staff and directors

(The relevant section of the Study Manual is Part 1, Chapter 1.1.4.)

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3. **You are making notes before drafting a paper for a client who is initiating a review of their DB final salary scheme as the way to provide retirement benefits in the future.**

Draft an introduction then list and briefly describe the elements of a DB final salary scheme's design and their relevance that you expect to discuss with the client.

20 marks

Eligibility conditions – can affect membership levels and volume of small benefits, affecting costs. If the scheme is being used for automatic enrolment, the employer will either need to ensure that the scheme's eligibility conditions remain wide enough to allow automatic enrolment or provide an alternative automatic enrolment scheme for employees who cannot join the DB scheme.

Accrual rate and Pensionable Salary – how changing either or both can affect cost.

Contributions – structure and balance between employer and employee could be reviewed, and a tiered contribution structure could be introduced. Mention the possible restrictions on the contribution structure arising from the Equality Act 2010 and possible exemptions.

Benefits and Options – include the benefits and options applicable for normal and early retirement, in the event of death, early leaver benefits, increases to pensions and how those could be reviewed.

(The relevant section of the Study Manual is Part 1, Chapter 1.3.)

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4. **You work for a third party administrator and administer a range of schemes for various clients. Draft some notes that you could provide to a new colleague to outline the various benefit design variations that your clients' schemes might adopt.**

20 marks

Include the following:

- ***Final Salary*** - this is traditionally the most common form of DB pension scheme. A member's pension at retirement is calculated based on their pensionable service and their earnings close to retirement. For example:

  1/60 x Final Pensionable Salary (FPS) x Pensionable Service = Pension

  Pensionable Service is usually counted from the date of joining the scheme, but if a member transfers benefits from another scheme and is granted additional service, then that is taken into account too

- ***Career Average Revalued Earnings Schemes*** - benefits from these schemes are based on earnings over the member's entire pensionable service, matching fluctuations in earnings more closely. To combat the effects of inflation, the earnings for each year are increased between the year in which they were earned and retirement. The increase may be in line with average earnings but can be in relation to another factor, such as price inflation. At retirement the pension is the total of the pension earned over each of the preceding years, based on the increased (or 'revalued') earnings

- ***Hybrid Schemes*** - these are schemes where the benefits are neither pure DB nor pure DC and can be either:

  - A scheme which primarily provides benefits on one basis but will provide them on another basis if that would produce better benefits

  or

  - A scheme which provides both final salary and money purchase benefits

- ***Cash Balance Schemes*** - cash balance schemes provide a guaranteed rate of return on contributions paid in and the target benefit is a cash sum at retirement that may be used to purchase a pension. The method and terms of conversion from cash to pension may be defined or may depend on annuity rates available. Unlike true DC schemes, the contributions and funds are pooled and individual 'member accounts' are hypothetical

(The relevant section of the Study Manual is Part 1, Chapter 1.1.3.)

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5. **You are the consultant to an employer who has decided to restructure their DB scheme in order to reduce costs. Outline the restructuring options available to the employer and the extent to which these options could reduce the cost of the scheme to the employer.**

20 marks

The various options include the following:

- Continue running a DB scheme but reduce the benefit accrual for future service and/or increase members' contributions to share the cost of the scheme more equitably between the employer and members. This has the least impact in terms of reducing costs to the employer, as the scheme continues in existence and benefit accrual continues, albeit possibly at a lower rate

- Close the scheme to new members and set up a new DC arrangement for those members. This limits the risk of open ended costs for the employer to existing members only. The cost to the employer for new members will be limited to the contributions the employer is obliged to pay

- Close the scheme to both new entrants and to existing members for future accrual but allow benefits for existing members earned up to the date of closure to be linked to future pensionable salary and offer both types of member entry to a new DC scheme.

  Preventing future accrual has a greater impact on limiting costs to the employer than just closing the scheme to new entrants

- Close the scheme to all future accrual and wind up the scheme. This option has the greatest impact on reducing costs in the long term, but because benefits have to be secured in order to wind up the scheme, there is a large short term cost as any underfunding has to be addressed

Mention that if the employer has 50 or more employees, the employer will need to carry out consultations about the changes with members and relevant parties such as recognised trade unions, before making any changes.

(The relevant section of the Study Manual is Part 1, Chapter 1.5.)

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6. **Employer A is in the process of purchasing Employer B which currently operates an occupational pension scheme. You have been asked by Employer A to outline their responsibilities and the options available to them regarding the pension arrangements for the employees who are being transferred to Employer A.**

10 marks

Include the following points:

- Where individuals who have pension rights under an occupational pension scheme are transferred to a new employer under Transfer of Undertakings (Protection of Employment) Regulations 2006/246 (the TUPE Regulations) their new employer has responsibility under Transfer of Employment (Pension Protection) Regulations 2005/649

- The new employer must offer membership of an occupational pension scheme or stakeholder pension scheme.

- If the scheme is not a money purchase scheme it must meet minimum quality standards. It must either

- provide benefits worth the equivalent of at least 6% pensionable pay for each year of membership (excluding benefits arising from member contributions) and must not require members to contribute more than 6% pensionable pay, or

- require the employer to match employee contributions paid to the scheme up to a maximum of 6% of the employee's remuneration

(The relevant section of the Study Manual is Part 1, Chapter 1.2.)

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7. **Summarise the impact of the following key Acts:**

- **Finance Act 2013**
- **Taxation of Pensions Act 2014**
- **Pension Schemes Act 2015**
- **Finance (No 2) Act 2015**
- **Public Service Pensions Act 2013**

10 marks

Include the following points:

Finance Act 2013

- Annual Allowance reduced from £50,000 to £40,000
- Lifetime Allowance reduced from £1.5m to £1.25m
- Fixed Protection 2014

Taxation of Pensions Act 2014

- New pension flexibility options
- Money Purchase Annual Allowance

Pension Schemes Act 2015

- Requirement to take appropriate independent advice before transferring
- Changes to statutory right to transfer

Finance (No 2) Act 2015

- Pension Input Periods aligned with tax year
- Tapered Annual Allowance

Public Service Pensions Act 2013

- Public service scheme members moved to CARE scheme
- Normal Pension Age (including transitional protections)
- Employer cost cap

(The relevant sections of the Study Manual are Part 1, Chapter 1.2.3 and Chapter 1.6.)