Pensions Management Institute
ACHIEVING PENSIONS EXCELLENCE

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Defined Benefit Arrangements

Mock Examination Notes

1. **You are an experienced administrator for a large defined benefit final salary scheme and you are about to start training a junior member of staff. Prepare some notes that you could use whilst training your colleague, and that you could give to them for future reference, to:**

    - **explain the differences between a final salary scheme and a career average revalued earnings scheme**

    - **distinguish between a buy in and a buy out**

20 marks

Differences between a final salary scheme and a career average revalued earnings scheme

A final salary scheme provides a pension benefit that is based on a member's pensionable service and their earnings close to retirement (known as their 'final pensionable salary'). For example:

1/60 x Final Pensionable Salary x Pensionable Service = Pension

This means that the only earnings that are taken into account when determining the member's pension are those earned across the last few years before retirement.

In contrast, under a career average revalued earnings (CARE) scheme, the member's pension is based on their earnings across the entire period of scheme membership, so that – for example – the member accrues 1/60th of pensionable earnings each year.

To combat the effects of inflation, the earnings for each year's CARE scheme membership 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.

Because the benefits under a CARE scheme are based on a member's earnings across their entire pensionable service, the costs of funding this type of scheme are generally more stable than for final salary schemes.

Distinguish between a buy in and a buy out

Both buy ins and buy outs can be used by schemes to transfer their liability for the payment of future pension instalments to pensioners, and possibly the liability for deferred members' benefits too, to an insurance company. For a fixed cost now, the scheme transfers to the insurer the risk of the unknown future cost of paying the pensions.

Under a buy in, the trustees insure their liability for future pension payments, so that the financial risk of providing those pensions is transferred to the insurer. The members concerned still remain members of the scheme and the scheme still retains liability for the actual payment of their benefits and for meeting any necessary disclosure requirements.

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Under a buy out, however, the members whose benefits are bought out become policyholders of the insurer and their connection with the scheme ceases.

The decision to buy in benefits is simply an investment decision for the trustees and so a buy in does not require the extensive member communication exercise that would be required if the trustees wished to buy out the benefits instead.

(The relevant sections of the Study Manual are Part 1, Chapter 1.1.3 and Part 4, Chapter 6.8.3.)

2. Prepare some notes explaining how the ending of contracting out in April 2016 affected a member's and employer's National Insurance contributions and the benefits a member receives from a former contracted out defined benefit scheme.

10 marks

Until 6 April 2016 the State pension consisted of two tiers, the basic State pension and the additional State pension, known as the State Second Pension or S2P. If a defined benefit scheme contracted out, it took over the responsibility for paying a pension to scheme members in place of the additional State pension.

In exchange for this, the member and the employer paid a lower rate of National Insurance (NI) contributions to the State, with the rebate on the NI contributions (the 'contracted out rebate') being used to fund benefits in the scheme.

From 6 April 2016, a new single tier State pension has replaced the basic State pension and the State Second Pension for individuals reaching State pension age on or after that date. As part of this change, contracting out was abolished.

The abolition of contracting out means that both the member and the employer pay higher NI contributions as there is no longer a contracted out rebate. As this would have resulted in higher costs for employers who sponsored a contracted out scheme, employers have been given the power (available until 5 April 2021) to reduce benefits for future service and / or increase member contributions, in order to offset the loss of the contracted out rebate. The value of any reduction in benefits and increase in member contributions cannot be greater than the increase in the employer's NI contributions.

Pension schemes which were contracted out still have to preserve members' entitlements to contracted out benefits accrued before 6 April 2016. There is no change to those previously accrued benefits as a result of the ending of contracting out.

(The relevant sections of the Study Manual are Part 1, Chapter 1.2.1 and Chapter 1.2.2.)

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3. You are a pension scheme administrator. A new colleague in your team has asked you to explain the general legislative / statutory minimum level of benefits that must be made available to current early leavers (ie on leaving before retirement) from registered pension schemes. They have also asked you to include the key related requirements.

Write a paper for your colleague explaining:

- **What happens if the member has been automatically enrolled and opts out within the one month opt out period**
- **Options if the member has less than 3 months' qualifying service**
- **Options if the member has between 3 months' and 2 years' qualifying service**
- **Options if the member has at least 2 years' qualifying service**

20 marks

The points that should be covered in your paper are:

What happens if the member has been automatically enrolled and opts out within the one month opt out period

The employer will refund any contributions the member has made and the member is treated as never having joined the pension scheme.

Options if the member has less than 3 months' qualifying service

Member is usually only entitled to a refund of their own contributions including any additional voluntary contributions (AVCs) they have paid.

The contributions (including AVCs) repaid are usually subject to a 20% tax deduction. If the refund exceeds £20,000, tax would be charged at 50% on any repaid contributions over this amount, although in practice this is very unlikely to arise for a member with short service.

Any investment return on AVCs or interest added to ordinary contributions must be paid gross. The member declares this amount to their local Inspector of Taxes and any tax due will be levied directly on the individual.

If the member has transferred in benefits from a personal pension, they have a right to a deferred pension on leaving whatever their period of qualifying service. A refund cannot be paid.

Options if the member has between 3 months' and 2 years' qualifying service

Member usually has a choice between:

- A refund of contributions (including any AVCs) paid as for a leaver with less than 3 months' qualifying service. If the scheme was contracted out before 6 April 2016, the member's share of reinstating them in the State Second Pension for contracted out service before 6 April 2016 (known as the certified amount) is usually deducted from the refund in addition to tax at 20%/50% as appropriate

- Transferring the value of their benefits, known as a cash transfer sum, to another arrangement such as a new employer's scheme or personal pension scheme

Trustees must inform the member of their right to a refund or cash transfer sum within 3 months of the member leaving pensionable service. Trustees can leave the option open indefinitely or may give the member a reasonable period (usually 3 months) to request their cash transfer sum. If the cash transfer sum option is not taken up within the reasonable period a refund will be paid. These timescales are recommended by the Pensions Regulator's Code of Practice on early leavers.

Some schemes may be more generous and offer a deferred pension after less than 2 years' qualifying service. Where a deferred pension is offered the member is not entitled to a cash transfer sum but they are entitled to a cash equivalent transfer value.

If the member has a transfer in from a personal pension a refund or cash transfer sum is not available.

Options if the member has at least 2 years' qualifying service

Under the Pension Schemes Act 1993, members are automatically entitled to preserved benefits as a deferred pension within the scheme.

Where preservation applies the member has a right to a preserved benefit payable on retirement or death at or after normal pension age. This is in respect of all benefits excluding lump sum death benefits earned up to the date of leaving. Scheme may also provide deferred death before retirement pensions although this is not required under the preservation requirements.

Under the preservation regulations such members must automatically be provided with details of their rights and options under the scheme within 2 months of the trustees being notified that the member has left pensionable service.

Members with deferred benefits can transfer their benefits to another pension scheme or to a suitable insurance policy, personal or stakeholder pension scheme.

(The relevant section of the Study Manual is Part 2, Chapter 4.1.)

4. You are a consultant for a defined benefit scheme. A new trustee has asked you to draft a paper explaining:

- **the issues that need to be taken into account when setting the basis for the calculation of individual transfer values, and**
- **the actions the scheme has to take when a member requests a statement of their transfer value**

20 marks

The issues that need to be taken into account when setting the basis for the calculation of individual transfer values

Include the following points:

- The trustees are responsible for setting the basis and assumptions used for calculating transfer values, after taking advice from the scheme actuary
- The cash equivalent transfer value should represent the value of the benefits that would otherwise be preserved for the member under the scheme
- The discount rate used must be based on market rates of return and should have regard to the scheme's investment strategy

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- The trustees must decide whether any discretionary benefits are included in the calculation and, if so, to what extent. When considering this, they should take into account any established practice or policy on granting discretionary benefits and whether or not the employer's consent is needed for these benefits to be granted

- If the scheme rules allow deferred members to exercise any options that would increase the value of their benefits, the transfer value basis must be based on the assumption that the member would exercise that option

- An allowance can be made for expenses, including the costs to the scheme of paying the transfer value and also any savings that the scheme would make if the transfer went ahead

- The trustees can reduce transfer values if the scheme is underfunded and they have received an insufficiency report from the scheme actuary

The actions the scheme has to take when a member requests a statement of their transfer value

Include the following points:

- When a member requests a transfer value statement, the member's cash equivalent must be calculated with an effective date no later than three months after the date of the member's request

- If, for reasons beyond their control, the trustees are not able to calculate the transfer value within this three month period, the time limit can be extended by up to a further three months

- The effective date of the calculation is known as the guarantee date and a written statement of entitlement must be issued to the member within ten working days of the guarantee date

- The statement of entitlement must include a statement of the guaranteed cash equivalent transfer value and the guarantee date

- If the full transfer value of the member's safeguarded benefits is over £30,000, the scheme must tell the member that he/she will need to take appropriate independent advice before a transfer can be made to an arrangement that provides flexible benefits

(The relevant sections of the Study Manual are Part 4, Chapter 5.3.1 and Chapter 5.3.2, Part 2, Chapter 4.2.3 and Chapter 4.2.5.)

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5. You are a consultant for a defined benefit scheme. A new trustee has asked you to prepare some notes explaining the options available to the scheme when a member asks to transfer in benefits from another scheme.
10 marks

Include the following points:

- Scheme members do not have a statutory right to transfer benefits into the scheme: the trustees can decide whether or not they wish to accept a transfer in
- If the scheme does accept a transfer in, the benefits granted must be determined using methods and assumptions that are consistent with those used to calculate outgoing transfer values
- There is generally no requirement for the scheme to provide transfer in benefits in any particular form. The scheme could offer a fixed benefit, added years of service or a money purchase benefit. If added years are awarded, the scheme will also need to make an assumption about the member's future salary increases to calculate the number of added years that should be provided

(The relevant sections of the Study Manual are Part 4, Chapter 5.3.3, and Part 2, Chapter 2.6.)

6. A member has written to the trustees to seek assurances that the scheme is adequately funded and in particular is asking for confirmation that in any event, the Pension Protection Fund (PPF) they have heard about will mean every member's benefits are completely protected. The trustees have asked for your assistance on answering the point about the PPF.

Draft a section of the letter which the trustees could insert in their letter.
20 marks

Assuming that the trustees have written an introduction and explained the scheme's funding position, your answer should look like an extract from a letter and include the following points:

- The PPF was set up to provide protection to members of defined benefit schemes if their employer becomes insolvent after 5 April 2005. Therefore the company would have to become insolvent before the scheme could enter the PPF
- Additional conditions exist: the scheme would have to go into wind up and the assets must be insufficient to buy out the members' benefits with an insurance company, before the PPF could take over the scheme and the liabilities. So the insolvency of the company alone would not qualify the scheme for protection from the PPF
- The protection afforded does not necessarily extend to the full benefits expected either. For those members over normal pension age, the protection is the provision of 100% of the pension currently in payment; for members under normal pension age, it is 90% of the accrued pension subject to an overall maximum amount. The contingent dependant's benefit would be 50% of the member's benefit and future pension increases are set at CPI up to a maximum of 2.5% pa – but only on pension accrued after 5 April 1997 for all members

(The relevant sections of the Study Manual are Part 5, Chapter 2.1, Chapter 2.2 and Chapter 2.5.)