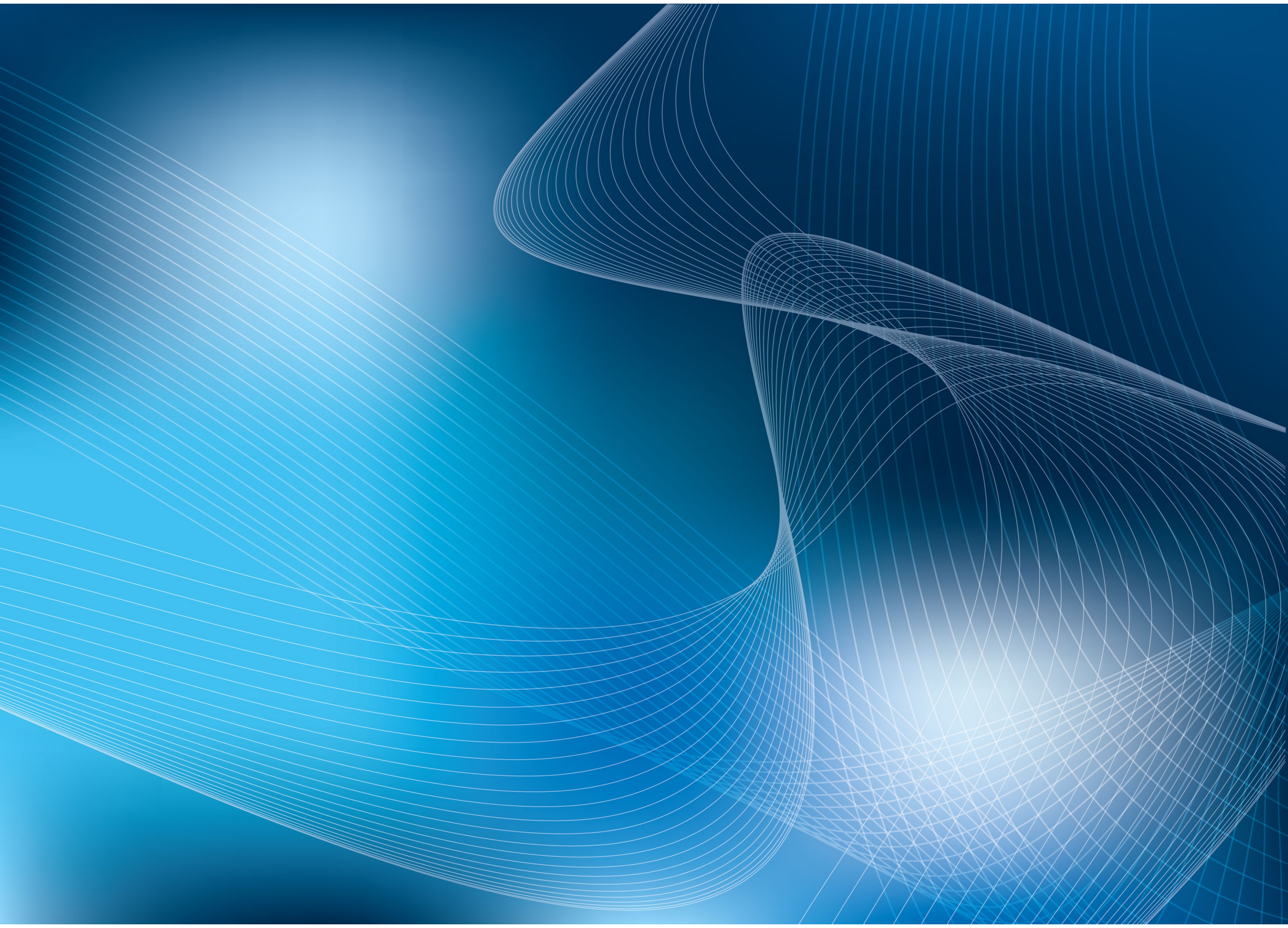
NeXtStep®

A-Z of pensions and actuarial terminology



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PensionsWatch
ACTUARIAL CONTROL SYSTEMS

Status of this information

This document is intended to be a general guide to some of the most frequently encountered pensions and actuarial terminology. It is not intended to be exhaustive and it is no substitute for professional advice.

Whilst every effort is made to provide up to date and accurate information, from time to time the information contained in this document may need updating.

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A

Accrual rate

The factor used to calculate benefits in a defined benefit pension scheme. For example, a scheme with an accrual rate of 1/60th, will provide 1/60th of pensionable salary for each year of pensionable service.

Accrued benefits

The benefits earned in respect of service already completed.

Active fund management

A style of management of assets (e.g. equities, gilts) in which the skill of the fund manager is used to select particular stocks at particular times, with the aim of achieving higher than average growth for the asset sector.

This may be contrasted with passive fund management whereby assets are usually automatically held in line with an index (e.g. the UK Equity 100 Index), with no judgement being applied by a fund manager.

Active member

A member of an occupational pension scheme who is currently accruing benefits in that scheme.

Actuary

A person qualified to calculate commercial risks and probabilities involving uncertain future events, often in the context of life assurance, general insurance or pensions.

In the LGPS, each fund must appoint a Fund Actuary who is responsible for assessing the financial position of the Fund every three years and for setting contribution rates for each participating employer.

In the private sector, defined benefit pensions schemes must appoint an actuary to perform a similar role – normally referred to as the Scheme Actuary.

Actuarial liability

This is the value, using actuarial methods and assumptions, placed on the obligations of a pension scheme for outgoings that are expected to fall on the scheme after the date to which the calculations relate. It includes the present value of future instalments of pensions in payment and related contingent benefits, and the present value of future payments expected in respect of active and deferred pensioners. The actuarial liability may or may not include a reserve for expenses.

Actuarial valuation

Commonly refers to an investigation by an actuary into the financial position of a pension scheme, usually carried out at least every three years. The primary aims of an actuarial valuation are to assess the funding level and to recommend an employer contribution rate.

Administering Authority

The local authority that administers the LGPS for its area.

Admission Agreement

This is a legally binding contract sets out the terms under which a private contractor may participate in the LGPS and which employees may become members of the LGPS.

Admission Body

An employer who has been admitted to the LGPS fund under the terms of an Admission Agreement.

Annualised return

The average return over a given period scaled up or down to a true annualised figure. Some quoted yields need to be annualised. For instance, as coupons on government bonds (gilts) are usually paid every 6 months, market yields are usually quoted as “semi-annual” rates. This is the actual return expected over 6 months, multiplied by 2. The annualised yield is slightly higher than the quoted rate due to the effects of compounding the interest.

Auditor

An individual or firm who reports on the financial statements of a company (or other entity). The financial statements will include an auditor's report, which will include the auditor’s view on whether the financial statements show a true and fair view of the entity’s true financial position at the reporting date.

Automatic enrolment
This refers to the requirement for employers to automatically enrol their workforce (who meet specific criteria) into a qualifying pension scheme.

AVCs (additional voluntary contributions)
These are contributions paid by individual pension scheme members above the minimum level, in order that additional benefits are provided. Often the additional pension is defined contribution in nature, or is in the form of added years of service.

B

Balance sheet
A financial statement, at a precise point in time, showing the assets and liabilities of a company (or other entity) and hence the net asset position.

Basic state pension
This is the first tier of state pension, payable from State Pension Age. The amount depends on the number of qualifying years that have been built up.

From 2016, simplification of the state pension system means that the Basis state pension and S2P will merge to form a single-tier system.

Bid price
The price at which an investor can sell an asset. This is usually lower than the offer price, which is the price at which an investor can buy an asset. The average of the two prices is known as the mid price.

Buy-out
This refers to the process of securing pension liabilities with an insurer, so that they take on the responsibility for the payment of pensions in exchange for a payment.

C

CARE (Career Average Revalued Earnings Scheme)
This is a type of defined benefit pension scheme that calculates retirement benefits using the average of revalued pensionable salaries over all of the member's pensionable service. This differs from a final salary scheme, whereby only the salary near to retirement is used to calculate benefits. From 1 April 2014 the LGPS is to become a CARE scheme.

Closed scheme
A pension scheme which does not admit new members. Contributions may or may not continue and benefits may or may not be provided for future service.

Commutation factors
These are factors that are use to determine what the reduction in pension should be when a cash lump sum is taken.

Contracted out
Commonly used to describe a UK pension scheme which provides benefits in place of the State Second Pension (S2P, previously SERPS). Currently these benefits from the scheme are paid for by means of a rebate of the relevant National Insurance (NI) contributions.

Corporate bonds
A bond with a fixed interest rate (or sometimes an index-linked rate) issued by a company for a fixed period of time. Bonds issued by the UK government are not known as corporate bonds but as “gilts” or “UK sovereign debt” and are generally considered “risk-free”.

CPI (Consumer Price Index)
This is used by some pension schemes (including the LGPS) to calculate pension increases. CPI measures the average changes month-to-month in prices of consumer goods and services purchased in the UK. In many instances, CPI has replaced RPI as the reference for indexation from 2011.

Credit rating
This is a measure of the credit worthiness of a debtor, usually a company or a government, that reflects the credit rating agency's view of the debtor's ability to pay back debt and the likelihood of default.

Current Service Cost
This is a term used in the context of accounting under IAS19 or FRS17. It represents the expected increase in liabilities in respect of benefits accruing over the accounting period, based on market conditions at the beginning of that period, net of any contributions from employees. In simple terms, it is the expected cost to the employer of benefits expected to accrue over the accounting period.

Curtailment
This is a term used in the context of accounting under IAS19 or FRS17. This is an event that significantly reduces the expected years of future service of present employees, or significantly reduces the accrual of defined benefits for some

or all the active scheme members. Examples might include a redundancy program as a result of closing a department, or the introduction of a defined contribution pension arrangement covering all employees for future service.

D

Defined benefit scheme
A pension scheme in which the benefits are defined in the scheme rules and accrue independently of the contributions payable and investment returns achieved. Most commonly, the benefits are related to members' earnings when leaving the scheme or retiring, and the length of pensionable service. Also known as "final salary" or "salary-related" schemes, or "DB" schemes if abbreviated. CARE schemes are also defined benefit schemes.

Defined contribution scheme
A scheme that provides retirement benefits based on the build up of a "pot" of money, accumulated through the investment of contributions paid by both the employee and the employer. At retirement, the accumulated fund may be used to purchase a pension (known as an annuity) based on market rates offered by insurance companies at that time.

Deferred member
A member entitled to a deferred pension (sometimes known as "preserved benefits") – i.e. a member who has stopped accruing benefits but whose pension has not started to be paid.

Demographic assumptions
These are assumptions, usually made by an actuary, used to assess the value of a pension liability that relate to estimating when payments will be made, and for how long. Examples are: mortality rates, rates of leaving service, and early retirement rates.

Dependant
A person who is financially dependent on a member or pensioner or who was so at the time of death or retirement of the member or pensioner. Scheme rules specify the definition of a dependant.

Designated Body
A Designated Body is listed in a schedule to the Regulations, and may state who, within the organisation, can join the LGPS.

Discontinuance valuation
This is an actuarial valuation of a pension scheme that assumes that the scheme starts to wind-up at the effective date of the valuation.

Discount rate
The discount rate is the assumed investment return used in a present value calculation of assets or liabilities.

Duration (Macaulay)
In finance, the (Macaulay) duration of a financial asset or series of cash-flows is the weighted average of the times until those fixed cash flows are received. It is used to measure the average time of payments made by a pension scheme. Technically, duration is the sum of the time weighted discounted payments of a bond or series of cash-flows.

Duration (modified)
This is similar to the Macaulay duration, but includes a small adjustment that means it is usually more reliable for use in estimating the effect that change in interest rates will have on the price of a bond (or the effect of a change in discount rate on the value placed on liabilities).

E

Employer Covenant
This refers to the ability of an employer to provide support to the pension scheme. A strong covenant reflects a high likelihood that the employer would be able to rectify a deficit that may emerge if, for example, pension investments perform badly.

Equalisation
Generally refers to the requirement that benefits earned in a pension schemes after 17 May 1990 cannot treat one sex more favourably than the other (e.g. retirement ages must be the same).

Equities
Shares in a company which are often bought and sold on a stock exchange. Owning shares makes shareholders part owners of the company in question and usually entitles them to a share of the profits (if any), which are paid as dividends.

Expected return on assets
This is a term used in the context of accounting under IAS 19 or FRS 17, and can refer to an assumption or a monetary amount. As an assumption, it represents the expected long-term rate of return of assets held (based on the actual assets held and market conditions at the start of

the accounting period). As a monetary amount, it is calculated by multiplying the asset return assumption by the fair value of the plan assets at the start of the accounting period (but allowing for expected changes in assets over the period, for example contributions paid into the scheme).

F

Financial assumptions
These are assumptions, usually made by an actuary, used to place a value on assumed future cash-flows. Examples are: the discount rate, inflation, and the rate of salary increases.

Fixed interest
A general term covering all investments which pay interest at a pre-agreed rate for a fixed term, including corporate bonds and gilts.

FRS17
This is the accounting standard that sets out the requirements and accounting treatment for retirement benefits for entities that report under UK Generally Accepted Accounting Principles (GAAP).

Frozen scheme
This generally refers to a scheme where the accrual of benefits has ceased, but the scheme has not entered into wind-up.

FTSE indices (Financial Times Stock Exchange indices)
These are published by the Financial Times. The FTSE100 index shows the movement in share prices of the top one hundred companies (by capital value) listed on the London Stock Exchange. Other FTSE indices include the FTSE all-share index (which includes all the shares listed on the London Stock Exchange). There is also a range of FTSE indices for UK Gilts.

Fund actuary
This is an actuary appointed by an LGPS Fund, who is responsible for assessing the financial position of the Fund every three years and for setting contribution rates for each participating employer.

Funding level
The relationship (normally expressed as a percentage) between the actuarial value of a scheme's assets and liabilities at a specified date (usually the valuation date).

Funding Strategy Statement (FSS)
The Funding Strategy Statement is a fund specific document which sets out the funding strategy adopted for the fund. The document is produced by the Administering Authority and maintained in consultation with employers and the Fund Actuary.

G

Gilts
Bonds issued by the UK Government. The payments, both the coupon payments and final redemption amount, can be fixed or index-linked. Currently, all index-linked gilts are indexed according to the RPI index.

GMP (Guaranteed minimum pension)
This is the minimum pension which an occupational pension scheme must provide as one of the conditions of contracting out of SERPS for service before 6 April 1997 (unless it was a defined contribution scheme contracted out through the provision of "protected rights"). GMP is payable from age 60 for females and 65 for males. The element of GMP earned after 5 April 1988 must increase in payment by the minimum of 3% or the increase in the CPI index if less.

Growth asset
Assets which can, broadly speaking, be expected to grow in value in line with the economy as a whole over the long term. Examples include equities, property and hedge funds. These assets differ from assets such as bonds or cash that are usually held with the objective of achieving a more stable return.

H

Hybrid scheme
This is a scheme that provides a mixture of both defined benefit and defined contribution benefits.

I

IAS19
This is the accounting standard that sets out the requirements and accounting treatment for employee benefits for entities that report under International Financial Reporting Standards (IFRS).

IAS19 R
This is the common abbreviation for the revised version of IAS19 than comes into effect for periods starting on or after 1 January 2013.

Index return
This generally refers to the return that would be achieved on investment had they been invested in line with a particular quoted index (for example, the UK All Share Equity Index).

Indices
Show the average movement of the value of a compilation of assets. Different indices apply to different assets, e.g. shares in smaller companies, shares in larger companies, property, gilts and corporate bonds. Overseas assets have their own indices, e.g. the Dow Jones and the Nasdaq in the US.

Interest cost
This is a term used in the context of accounting under IAS 19 or FRS 17. It represents the expected increase in liability over the accounting period due to the unwinding of the discount rate. It is based on the discount rate and present value of the scheme liabilities at the beginning of the period. It should reflect changes in those liabilities during the period (e.g. where benefits have been paid).

L

LGPS
The Local Government Pension Scheme, as defined in the Local Government Pension Scheme Regulations.

LGPS Regulations
The LGPS Regulations 1997, the LGPS (Administration) Regulations 2008, the LGPS (Transitional Provisions Regulations 2008, and, the LGPS (Benefits, Membership and Contributions) Regulations 2007, as amended.

Liabilities
Amounts which a pension scheme has an obligation to pay now or in the future. The value of liabilities payable in the future cannot be accurately determined, and will be dependent on the assumptions used.

Liability driven investment
This is a type of investment strategy that focuses on the timing, nature and risk of the pension payments that are expected to be made. Often, such strategies involve hedging the scheme's exposure to changes in interest rates and inflation.

LIBID
This is a benchmark for short term interest rates between banks world-wide, which is published daily. The London Interbank Bid Rate is the rate that banks are willing to pay for eurocurrency deposits in the London interbank market.

LIBOR (London Interbank Offered Rate)
This is a benchmark for short term interest rates between banks world-wide, which is published daily.

Life Expectancy
This is the average future lifetime for an individual under a specific actuarial assumption (called the mortality or longevity assumption). For example, if a figure of 25 is quoted for a 65 year old male then the average age at death under the assumptions used would be 90.

LPI (Limited price indexation)
This is usually a reference to the minimum annual rate of indexation which must be applied to pensions in payment or deferred pensions, where they relate to service after 5 April 1997. LPI is the lesser of the actual rate of inflation and either 5% or 2.5% depending upon the date when the service was accrued and whether the pension is in payment or deferred. GMP earned after 5 April 1988 must receive at least LPI, limited to 3% pa, in payment.

M

Mortality rates
Statistics regarding the likelihood of death at specified ages. In most cases actuaries will use standard tables produced by the actuarial profession, perhaps with an adjustment if felt needed to best represent the specific scheme population to be considered. In some cases actuarial firms produce their own proprietary tables which may not be publicly available.

Multi-employer scheme
This is a scheme where more than one employer participate. Such schemes can be group schemes, where all employers are related, or industry wide schemes where they are not. Often, the such schemes are sectionalised so that each section effectively acts like a separate pension scheme.

N

NEST (National Employment Savings Trust)
NEST is a workplace defined contribution pension scheme. It can be used by an employer to meet its

auto-enrolment duties.

NPA (normal pension age)
This is the earliest age at which a member can receive full pension benefits (i.e. the benefits are not reduced at this age.

O

Offer price
The price at which an investor can buy an asset. This is usually higher than the bid price, which is the price at which an investor can sell an asset. The average of the two prices is known as the mid price.

Ongoing valuation
This is an actuarial valuation that assumes that the pension scheme continues to operate without entering into wind-up.

P

Passive fund management
The management of assets, e.g. equities, gilts, by holding an exact replica of a given index, e.g. FTSE100, FTSE350, with the result that the assets in question move exactly in line with the chosen index. This is different to active fund management and is usually associated with lower annual charges.

Past service cost
This is a term used in the context of accounting under IAS 19 or FRS 17. It will arise as a result of past service benefit improvements over the accounting period – for example the award of pension increases above that required by the scheme documents or expected according to past practise.

Pensionable salary
Earnings used to calculate retirement benefits in a defined benefit scheme. In some schemes the benefits are calculated by averaging pensionable salary figures over a certain number of years. The averaged figure is often referred to as final pensionable salary.

Pension Protection Fund (PPF)
Established to pay compensation to members of eligible defined benefit pension schemes, whose sponsoring employers become insolvent. The PPF is funded by a levy on all eligible defined benefit schemes and became operational on 6 April 2005.

Pensions Regulator (TPR)
The Pensions Regulator is the UK regulator of work-based pension schemes.

Personal Pension
This is a contract-based pension scheme that an individual can set up with a pension provider.

Present value
A method used to calculate the current value of a series of future pension payments and future receipts, such as contributions and investment returns.

Preserved benefits
Benefits arising in respect of an individual who has ceased to be an active member of a pension scheme, but who has yet to start receiving pension benefits. Also known as deferred or paid-up (PUP) benefits.

Priority order
This specifies the way that assets of a pension scheme that winds-up are used to secure benefits. If there are insufficient assets in the scheme to cover all benefits, the benefits higher up the priority order will be covered first.

Projected unit method
A method for calculating the liability (often called “technical provisions” within the private sector) which takes account of future expected salary increases.

PPF levies
These are levies on PPF-eligible pension schemes that are collected in order to fund the PPF.

R

Rates and Adjustments Certificate
A certificate setting out the contributions payable by each employer in an LGPS fund, in accordance with the LGPS Regulations.

Real growth rate
In the context of pensions this refers to a rate of increase above that of inflation. For example, if inflation is assumed to be 2% pa then salary growth of 5% pa relates to a real growth rate of 3% pa (i.e. 5% less 2%). The 5% rate is referred to as the nominal rate.

Recovery Plan
The is a document that sets out how a pension scheme deficit will be removed.

Revaluation
This generally refers to indexation of pension in deferment, i.e. between the time when active membership ceases and the pension is taken. Generally, revaluation is in line with CPI (though some schemes still use RPI and GMP benefits revalue at a different rate).

Risk premium
The additional return from an investment (over the risk-free gilt yield) demanded by investors to compensate them for investing in higher risk assets. This is often used in the calculation of the expected investment return on equities.

RPI (Retail Prices Index)
This is an index of retail prices (for all items) published by the Office of National Statistics, which is used to determine the rate of inflation over the previous 12 months. Historically used to increase to state pensions and index-linked gilts are equal to the rate of change in the RPI. In many instances of use, RPI has been replaced with CPI with effect from 2011.

S

S2P
Refers to State Second Pension, which is the earnings related element of the state pension scheme which has replaced the State Earnings Related Pension Scheme (SERPS) to enhance the basic state pension.

Salary sacrifice
A written agreement between the employer and employee whereby the employee forgoes part of his or her future earnings in return for a corresponding contribution by the employer to a pension scheme.

Schedule of Contributions
The is a document that sets out the timing and amount of contributions that an employer has agreed to pay into a pension scheme.

Scheduled Body
A scheduled body is a statutorily defined body within the terms of the Regulations, and has an obligation to participate in the LPGS.

Scheme Actuary
An actuary appointed by a private sector defined benefit pension scheme.

SERPS (State Earnings Related Pension Scheme)
This was the State Second Pension that was replaced by S2P.

Settlement
This is a term used in the context of accounting under IAS19 or FRS17. It is an action that relieves the employer of the primary responsibility for a pension obligation and eliminates significant risks relating to the assets and liabilities in respect of that obligation. Examples would include purchasing annuities in respect of pensioner liabilities or making a bulk transfer payment to another arrangement.

SIP (Statement of investment principles)
This is a written statement of the principles governing decisions about investments for an occupational pension scheme, which trustees are required to prepare and maintain. When preparing the SIP, trustees must have regard to advice from a suitably qualified person, and consult with the employer.

SORP (Statement of recommended practice)
This is guidance on best accounting practice for the presentation of financial information prepared by the particular sector to which the SORP relates.

State pension age
This is the age at which individuals can claim their State Pension, though there is the option of deferral. Currently, this is age 65 but will rise to 66 by 2020.

Statement of funding principles
This is a document for a trust-based pension scheme that sets out the trustees' policy for ensuring that funding requirements are met.

Swaps
Arrangements by which one type of income stream is exchanged for another (e.g. an income stream at a variable rate of interest may be swapped for an income stream at a fixed rate of interest). Such an arrangement is often made through an investment bank.

Interest rate swaps are the most frequently used but there are other types of swaps available – for example those aimed at offsetting the risk of adverse fluctuations in inflation or longevity.

T

Tax-free lump sum
A sum of money available to pension scheme members at retirement in exchange for a reduction in pension payments. This is currently paid free of tax.

Technical provisions
A term used in the context of private sector pensions to describe the actuarial liability in relation to service that has already been completed.

The Pensions Advisory Service (TPAS)
This is an independent non-profit organisation that provides free information, advice and guidance on pension schemes and pensions-related issues

Transfer value
The amount of money which a scheme will pay to another pension arrangement in lieu of benefits which have accrued to a member. Sometimes referred to as a CETV (Cash Equivalent Transfer Value).

Trust Deed and Rules
These are legal documents that determine how trust-based pension schemes are run and what benefits are provided under the trust. Trustees will be appointed to run the trust on behalf of the beneficiaries.

Trustee
In the context of private sector pensions, an individual or company appointed to carry out the purposes of a trust in accordance with the provisions of the trust instrument and general principles of trust law.

TUPE
Refers to Transfer of Undertakings (Protection of Employment) Regulations which aim to protect employees who are transferred to a new employer. The objective is to ensure that specific employee terms and conditions are protected and maintained under the new employer.

U

Unapproved benefits
These are benefits that do not meet certain conditions imposed by HRMC so that they do not benefit from all of the tax advantages usually associated with pension schemes.

V

Volatility
This is a measure of the expected level of fluctuations in an asset's return or of other uncertain events. For example, if trying to determine the effect that a cap can have on pension increases the volatility is considered. In general, the higher the volatility the more effect that a cap will have (in that it is more likely to "bite" and reduce the increase rate).

W

Winding-up
This is the process that a Trust undergoes in order to terminate. The assets and liabilities will be fully discharged before the wind-up is complete.

Y

Yield
A measure of the annual income earned on an investment. For shares this is normally the annual value of the dividends expressed as a percentage of the market price of the share.

Questions?

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