

Glossary

Accrual rate

The accrual rate is the rate at which pension builds up in a defined benefit scheme. A typical accrual rate in the UK for a final salary scheme is 1/60th. This means after a full 40 year career, the member would have built up a total pension of 40/60ths, i.e. two-thirds, of their final salary.

Defined Benefit ('DB') pension scheme

A defined benefit pension scheme is one where the retirement benefit is specified in advance to the members. The most common type of defined benefit pension scheme in the UK is the Final Salary scheme where the pension at normal retirement is calculated as a fraction (quite commonly 1/60th) of final salary (often salary averaged over a period, say three years, before retirement) for each year of scheme membership.

Another type of defined benefit scheme is the career revalued average earnings plan where the pension is a fraction of the member's career earnings, with earlier years' earnings increased to retirement in line with some index, perhaps RPI or NAE. Cash balance plans are also defined benefit arrangements; here a fund accumulates as a fraction of salary (may be final salary or career averaged) and this is converted into pension using market annuity or scheme-specific rates.

A feature common to the various types of defined benefit pension scheme is that the cost of the benefit is not known in advance. The ultimate cost depends on various features, eg rate of salary growth, length of service before leaving, longevity in retirement and, most importantly, the investment returns earned on money put aside to fund the benefit. Most usually, the employee pays a fixed contribution towards his benefit with the employer paying the 'balance of cost' – assessed by actuarial valuation every three years.

Defined Contribution (DC) pension scheme

A defined contribution pension scheme (sometimes called a “money purchase” scheme) is one where the contributions are defined, usually as a percentage of salary/earnings, from both the employer and employee. There is no guarantee on the size of pension. The pension will depend on the rate of investment return earned and the annuity rates available at retirement to convert the accumulated fund into pension.

A defined contribution pension scheme is set up under Trust and is sponsored by an employer. Employers must contribute. This is different from a Group Personal Pension or Stakeholder scheme, which is usually a series of contracts between a provider (life insurance company or investment house) and the individual member.

There are also some company schemes that are a hybrid of defined benefit and defined contribution arrangements.

FRS17

FRS17 is the new UK accounting standard for pension costs in company accounts. It will replace SSAP24. Full implementation was delayed to tie in with new EU accounting rules which are expected to apply for company years starting on or after 1st January 2005, and which will require a listed UK company to report under international accounting standards instead. The international accounting standard on pension costs is being redesigned and is expected to look like FRS17 from 2005, although there will be some changes.

At present, FR17 disclosures are made in the notes to the accounts of UK companies and are not compulsory on the primary statements themselves.

The biggest change from SSAP24 for a defined benefit scheme is that the difference between the assets and liabilities is placed directly on the balance sheet. Liabilities are measured by reference to corporate bond yields and assets at market value. Where a pension scheme holds a lot of equities, this means that the figures disclosed are likely to be very volatile. SSAP24 used smoothed values in the main and spread surpluses/deficits forward; there was, therefore, usually little balance sheet effect.

This volatility on the balance sheet may constrain a company's ability to distribute dividends and may impact on banking or other debt covenants.

Minimum Funding Requirement (MFR)

The MFR was introduced in 1997 as a protection against the under-funding of defined benefit pension schemes. In essence, the original aim of Government was to have a test that allowed pensions in payment to be covered in full and gave non-retired members a 50:50 chance of receiving their leaving service deferred pension if they transferred their MFR "value" to a personal pension.

Unfortunately, this aim has been thwarted by a combination of lower expected inflation, lower expected future investment returns and pensioners living longer in retirement. Despite being modified, MFR is now very unlikely to meet the original objective. Further, although it was not designed to ensure this, the MFR level of required assets is well short of providing full benefits on an annuity and deferred annuity buy-out on discontinuance.

The Government has announced that MFR will be removed and replaced by a scheme-specific funding requirement.

Personal Pension (PP) and Group Personal Pension (GPP)

A GPP is just a number of personal pension contracts packaged together, possibly with some employer branding of literature etc, to appeal to employees. A personal pension is a contract between the provider (life insurance company or investment house) and the individual member. Employers may contribute to a personal pension. They operate on a defined contribution basis and the pension at retirement will depend on the rate of investment return earned and the annuity rates available to convert the accumulated fund into pension.

Stakeholder legislation

The Government made it compulsory for employers to designate and offer access to a Stakeholder scheme, with certain exceptions, from October 2001. However there is no requirement for an employer to make contributions.

The principal exemptions from the requirement to offer access to a designated Stakeholder scheme are if the Employer:

- has less than five employees; or
- offers a GPP (to all employees aged 18 or over) to which it contributes at least 3% of employees' basic pay; or
- runs an occupational DB or DC scheme open to all employees other than:
 - those aged 18 or less, or within five years of retirement;
 - with less than one year's service; or
 - has no employees earning more than the Lower Earnings Limit.

Stakeholder scheme

A Stakeholder scheme is very similar to a GPP but with certain controlled features. The only charge that may be taken from a member's contributions or fund is an annual charge of up to one per cent of the accumulated fund. Any with-profits funds offered under a Stakeholder arrangement must not cross-subsidise other with-profits contracts.

TUPE requirements

TUPE is an acronym for ‘Transfer of Undertakings (Protection of Employment) Regulations 1981’.

The Regulations preserve employees’ terms and conditions when a business or undertaking, or part of one, is transferred to a new employer. The Regulations have the effect that employees employed by the previous employer when the undertaking changes hands automatically become employees of the new employer on the same terms and conditions. It is as if their contracts of employment had originally been made with the new employer. Thus employees’ continuity of employment is preserved, as are their terms and conditions of employment (**including pension rights**) under their contracts of employment.

The Regulations apply when an undertaking or part of an undertaking is transferred from one employer to another. Some examples of transfers are:

- where all or part of a sole trader’s business or partnership is sold or otherwise transferred;
- where a company, or part of it, is bought or acquired by another;
- where two companies cease to exist and merge to form a third;
- where a contract to provide goods or services is transferred in circumstances which amount to the transfer of a business or undertaking to a new employer.

Vesting periods

A vesting period is the period of membership after which a member has a right to a pension benefit. Under current pension legislation, an occupational defined benefit or defined contribution pension scheme does not have to offer a vested deferred pension benefit to a leaver if they have not completed two years’ membership. The employee would simply get a refund of their own contributions if any, less tax, and less the cost of buying back into the State scheme for a contracted-out arrangement. The employer contributions can be re-directed for the benefit of other members.

GPPs and Stakeholder schemes, on the other hand, must offer immediate vesting. That means that all employer contributions remain for the benefit of the employee even if they leave very shortly after joining.

