Pension increase policy, the Notional Pensioner Account and when the pension increase policy can be changed; an actuary's perspective.

1. In terms of section 14B of the Act, every Fund must establish a pension increase policy that targets some percentage of inflation. The pension increase policy will often have two components:
   (a) A "basic" increase –
      e.g. 75% of the year on year change in the Headline Consumer Price Index as measured 4 months before the effective date of the increase, subject to affordability.
   (b) A "catch up" increase
      e.g. Increase pensions to at least 75% of the change in Headline Consumer Price Index from date of retirement to a date 4 months before the effective date of the increase, subject to affordability.

2. The minimum pension increase provisions in the Act require the fund's actuary to do four separate calculations:
   (a) Determine the increase required by the pension increase policy.
   (b) Determine the increase required to raise pensions by the full Headline Consumer Price Index from date of retirement to the effective date of the increase.
   (c) Quantify the Notional Pensioner Account.
   Determine the maximum increase that can be afforded from the balance in the Notional Pensioner Account.
   (d) Determine the maximum increase required by the Act, which will be the lower of (b) and (c).
   (e) The members are then entitled to the higher of (a) and (d) BUT not so much as to put the fund into a deficit.

3. The Notional Pensioner Account is quantified as follows:

   For each pensioner still alive at the valuation date, determine the capital available when the pensioner retired (which will be the initial annual pension payable multiplied by the value the actuary places on R1 of pension per annum). This value will incorporate the actuary's view of "reasonable benefit expectations" of the pensioners: it will depend upon the pension increase policy, current market conditions, and the actuary's view of the likely longevity of the pensioners. The capital then grows with investment returns earned and is reduced by pension payments and expenses. This is summed across all the pensioners.

   Where a surviving spouse is in receipt of a pension, the capital calculation should, I believe in terms of the Act, be done at the date of death of the pensioner. However, most funds continue to include the capital available when the member died.

   Although the Act requires the Notional Pensioner Account to be quantified only for the pensioners still alive at the valuation date, in practice, most funds add in the capital on retirement for a retiree, and leave the account to enjoy any mortality profits or losses. i.e. when a pensioner dies, the remaining balance is left in the Notional Pensioner Account and when the actuary changes longevity assumptions, the cost of the change is born by the balance in the Account.

In the 2007 amendments to the Act, if the full statutory minimum pension could not be afforded, the actuary was allowed to proportion down the Notional Pensioner Account to be equal to the pensioner liabilities at the surplus apportionment date (after any share of surplus applied to increase pensions in course of payment). This permanently reduces the Notional Pensioner Account at that date. Any investment return thereafter and pension payments apply to this reduced balance at the surplus apportionment date.

If increases are granted in excess of what can be afforded by the Notional Pensioner Account, with the consent of the employer (and with the requisite funding either from other sources of surplus or the employer), the Notional Pensioner Account is increased by the present value of these increases.

4. To put this into "English":

- You must target a percentage of inflation as a pension increase, subject to affordability.
- You don't have to give pensioners more than inflationary increases.
- You don't have to pay more than the lower of
  - what the Fund can afford to provide from the accumulation of pensioner assets with fund return less pension payments and expenses, and
  - the amount that would put the fund into a deficit (aka a "financially unsound condition").
- You can release surplus from the pensioner assets if you feel that you have more than enough to provide for full inflation increases in future.

There are two important qualifications:

- The Notional Pensioner Account could have been (permanently) reduced at the surplus apportionment date if you could only grant a portion of the statutory minimum increase (with the reduced total equal to the pensioner liabilities at the surplus apportionment date, after that increase); and
- Trustees are not obliged to give a minimum pension increase that will put the Fund into a deficit.

BUT

Neither the pensioners nor the active members are protected from deficits that arise on the other side of the balance sheet (i.e. pensioners being protected from deficits affecting active members, or active members being protected from deficits affecting the pensioners). In particular, there is nothing preventing a deficit in respect of active members to be funded, in part, by good investment returns earned on the pensioner assets.

5. There is essentially a presumption that a pension will be fully funded by the time a member retires, and the trustees will manage the pension increases and pension assets thereafter from the balance in the Notional Pensioner Account.

6. Because the capital injected into the Notional Pensioner Account on retirement of a member incorporates the actuary's view of how the pensioners' reasonable benefit expectations will be satisfied, and the investment return earned will reflect an investment strategy which must also take account of expectations and the pension increase policy, the Notional Pensioner Account puts a limit on the pensioners' reasonable expectations. i.e. The pensioners cannot expect more in the way of increases than the Notional Pensioner Account can satisfy.

7. If you change the pension increase policy, you don't change the balance in the Notional Pensioner Account. e.g. A fund develops a surplus in the Notional Pensioner Account and the trustees decide to increase the provision for pension increases from 75% of Headline CPI to 85% of Headline CPI which would require pensions to be capitalised at a rate of 4,5%, say, rather than 5%. Pensioner liabilities would rise by something of the order of 4%. This must be accommodated within the Notional Pensioner Account as previously quantified.

8. The actuary will look to cover both the pensioner liabilities and any solvency reserve that he or she deems desirable for pensioners out of the balance in the Notional Pensioner Account before considering pension increases.

9. I'd like to contrast three situations in which the trustees may have to reconsider their pension increase policy or consider reduction in the pension increase granted because of an adverse impact on "affordability":

   (a) The actuary makes additional provision for the future longevity of pensioners. (Pensioners are expected to live longer.)

   (b) A large investment transaction goes sour and the assets backing pensions achieve a much lower than expected investment return.

   (c) Active members enjoyed much larger than expected increases in pensionable remuneration as a result of a change to their packages, and this caused a significant deficit on the active member side of the fund's balance sheet.

10. I consider these separately:

(a) The additional provision for future longevity increases the pensioner liabilities. The Notional Pensioner Account is not affected. Any excess of value of assets in the Notional Pensioner Account over the pensioner liabilities would be reduced. This would reduce the capacity for current and future pension increases. "Affordability" of pension increases would be negatively impacted. If lower increases look likely in future (in relation to inflation), the trustees must reduce the pension increase target relative to inflation.

(b) Investment losses or poor investment performance causes the Notional Pensioner Account to grow by less than expected. If the loss is big enough, it could deny the trustees the ability to grant a pension increase, as these would not be "affordable" from within the resources of the Notional Pensioner Account. If the trustees were reckless or negligent in making the investment, the pensioners may well have an action against the trustees or their investment consultants. If such action is insufficient to recover the loss, the "affordability" of pension increases may be permanently, negatively, impacted and trustees may have to reduce the pension increase target relative to inflation.

(c) The development of a deficit on the active member side of the balance sheet is more of a challenge. Most actuaries will advise trustees that a generic term such as "subject to affordability" in the pension increase policy will be breached if the fund will go into deficit as a result of the pension increase. (The proviso in section 14B that an increase need not be given if it will put the fund into a "financially unsound" condition is generally interpreted as putting the fund, as a whole, into a deficit.) A deficit on the active member side of the balance sheet will therefore be interpreted as reducing "affordability".

Note, however, that the Notional Pensioner Account balance is not affected by a deficit on the active member side and it will continue growing. Any future surplus on the active member side will then go first towards satisfying pensioners' expectations because, as soon as the fund is not in deficit, the pensioners could get increases right the way up to what the Notional Pensioner Account can support.

This can give rise to acrimonious discussion in the board of management, if there are pensioner representatives, particularly when the Notional Pensioner Account balance is larger than the amount required to fund pension increases at the desired level, but these increases are cut back because the fund as a whole would go into deficit.

11. A Fund can grant increases that are higher than inflation. For example, a fund could have a pension increase policy as follows:

(a) The Fund will target a basic increase of 75% of Headline CPI subject to affordability.

(b) The Fund will grant a "catch up" increase to at least 75% of the change in Headline CPI from date of retirement, subject to affordability.

(c) The Fund may grant a further supplementary increase subject to affordability.

Say the Notional Pensioner Account will support a "catch up" increase to full inflation, and there is still a surplus which is equivalent to an increase of, say, 3%, leaving a solvency reserve that the trustees deem reasonable. Assuming there is no deficit on the active member side of the Fund's balance sheet, the minimum increase will be the catch up increase to full inflation, but there is nothing stopping the trustees using the supplementary increase provision to grant more than that, up to the 3%.

12. Does a history of pension increases which are larger than the target stated in the pension increase policy create a "reasonable benefit expectation" that the target is higher than the amount stated in the policy?

"Reasonable benefit expectation" is a concept that actuaries must take into account when valuing liabilities, determining transfer values and determining the distribution of assets in a liquidation.

The actuary will take policy and practice into account when determining his assumptions for such calculations.

With regard to future pension increases, the primary determinant of reasonable benefit expectations will be the pension increase policy. If there is a history of granting pension increases that are higher than the target in the policy the actuary may question the trustees as to whether the policy needs revision. The actuary will not override the target in the policy without the trustees being aware of the consequences in terms of his valuation and the fund's investment strategy.

If the pension increase policy is vague (which will not be consistent with the Act as currently worded), then the actuary may be guided by practice. Even then, the actuary should discuss his interpretation with the trustees.

13. Can a board of trustees reduce the target relative to inflation in the pension increase policy?

Yes, if the Notional Pensioner Account will not support the future level of pension increase in the policy as it stands, a revised investment strategy cannot generate the additional returns that are needed, and the employer will not inject further assets into the Notional Pensioner Account, the trustees will have no alternative but to reduce the target relative to inflation in the pension increase policy.

However, if the Notional Pensioner Account does support the target relative to inflation in the pension increase policy, the trustees could reduce the target, but the minimum pension increase provisions will ensure that the pensioners get their expected increases up to full inflation. An example might help: a fund has historically had a pension increase target of 100% of inflation; the fund capitalised pensions (and therefore funded the Notional Pensioner Account) assuming that it would earn 3% more than full inflation in the Notional Pensioner Account; the Notional Pensioner Account continues to deliver 3% more than inflation (so pension increases of full inflation can be afforded), assuming no change in longevity assumptions, but the trustees are concerned that future expectations are that real returns will be much lower and full inflation may not be affordable – they therefore reduce the target to 80% of inflation in the pension increase policy. For as long as the Notional Pensioner Account continues to earn 3% more than inflation, full inflation increases will continue to be delivered.

14. Is the employer obliged to fund any shortfall in the Notional Pensioner Account relative to the pensioner liabilities?

Most funding plans are designed to ensure that a pension is fully funded on the retirement of a member. (This adheres to a principle that an employee's cost should be matched against the revenue that the employee produces. A retired employee will add nothing to the revenue-earning capacity of the enterprise so the full cost of that employee should be met by the time the employee retires.) This is one of the principles on which the Notional Pensioner Account operates.

The trustees are expected to manage pension increases within affordability as measured by the Notional Pensioner Account (with the added complication of possible deficits from the active member experience). The trustees are therefore expected to manage the pensioner liabilities so that the pensioner liabilities are less than or equal to the balance in the Notional Pensioner Account.

The employer will not expect to fund deficits between the Notional Pensioner Account balance and the pensioner liabilities.

On termination, in terms of section 30(3) of the Act, if the market value of the assets is less than the sum of

- Minimum individual reserves for the active members, plus
- The cost of annuity policies which will provide equivalent pensions for the existing pensioners,

the shortfall represents a debt payable by the employer to the fund.

I'm not aware of any cases covering this aspect, but pensioners would have an expectation that any excess of assets in the Notional Pensioner Account over the pensioner liabilities would be available to support pension increases in future. "Equivalent pensions" to be sourced from annuity policies need to include this margin.

If the trustees have constrained pension increases below what would be affordable if the Notional Pensioner Account were considered on its own, because of deficits on the active member side, and the fund terminates, can pensioners then claim from the employer the excess of assets in the Notional Pensioner Account despite the funding situation?

It might be prudent to split the pensioner assets from the active member assets and run the two as two separate "notional" funds from a funding point of view. It would need a legislative change to give full effect to this.

Jeremy Andrew