Merchant Navy Officers Pension Fund

Report to the Trustees on the financial implications of including discretionary benefits in the calculation of Transfer Values from 6 April 1997

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1 Introduction

1.1 It has for some years been a requirement of the professional guidance for actuaries to include discretionary benefits in transfer value calculations unless the Trustees direct otherwise.

1.2 The position has been formalised somewhat by the Occupational Pension Schemes (Transfer Values) Regulations 1996. These now require that, from 6 April 1997, before the Trustees can direct the Scheme Actuary to exclude discretionary benefits, they must have a report from the Scheme Actuary setting out the financial implications for the Fund of not making such a direction.

1.3 If a direction to exclude discretionary benefits is given, this Report should be made available to Fund members within one month of a valid request. Any instruction to the Scheme Actuary to exclude discretionary benefits must also be disclosed in the Trustees' Annual Report and Accounts, and as part of the basic scheme information.

2 Discretionary Benefits

2.1 Deferred pensioners of the Fund have a right to the benefits guaranteed under the rules, and these will automatically be reflected in transfer value calculations. In addition, there is a practice of discretionary benefits being granted in the areas described below.

Old Section bonuses

2.2 No increases to members' accrued Old Section entitlements are guaranteed under the Rules. However, there is an established practice of annual bonuses being granted on these entitlements, both in deferment and in payment.

New Section pension increases

2.3 The Rules of the New Section provide for guaranteed increases to pensions in payment only in relation to post-April 1988 GMPs. However, again there has been a practice of granting discretionary increases each year on pensions in payment in excess of the GMP.

3 Approach to funding

3.1 The ongoing funding basis includes allowance for future Old Section bonuses at the rate of 2.5% per annum (in the context of the other assumptions). The assets of the Section would, if the valuation assumptions are borne out in practice, be sufficient to enable such bonuses to be granted indefinitely in the future. However, a new constraint is the introduction of the minimum funding requirement (MFR). By reference to the MFR basis, there would not currently be sufficient assets for such bonuses to be granted indefinitely. The extent to which such bonuses are in fact granted in the future will depend upon the actual experience of the Section, in particular future investment returns. There therefore cannot be any certainty as to what level of discretionary bonuses will be paid in future.

3.2 The ongoing valuation basis of the New Section includes no advance provision for discretionary pension increases. Therefore, any increases granted in future must arise out of the current excess of assets over past service liabilities or any further surplus generated in the future out of the actual experience of the Fund. As with the Old Section, the introduction of the MFR may act as a further constraint on the granting of pension increases in the absence of favourable investment experience.

3.3 The MFR basis assumes the assets held to cover pensions once they come into payment, and for a period prior to payment, will comprise Government fixed interest securities. This, in my view, is inconsistent with assuming that the Fund will generate significant investment surpluses in future out of which discretionary pension increases can be funded.

4 Implications of including discretionary benefits in transfer values

4.1 If allowance were to be made in transfer values for discretionary bonuses and pension increases, members transferring their entitlements to another scheme will crystallise extra benefit which may or may not actually emerge for those members remaining within the Fund. In effect any expectation of such discretionary benefits would, to the extent it is reflected in the transfer calculations, be treated as though they are guaranteed for transferring members. Moreover, the MFR basis, by assuming gilt returns for pensions just prior to and in payment implicitly incorporates a part of the potential investment surpluses out of which discretionary increases might be paid.

4.2 The payment of transfer values including allowance for discretionary benefits could, in some cases, lead to transferring out funds in excess of those reserved for on the funding basis, and certainly the transferring out of funds in excess of those needed to match the corresponding MFR liabilities. This could gradually weaken the financial security for the remaining members, and reduce the scope for discretionary benefits to be paid in practice.

J M Hill
Fellow of the Institute of Actuaries
Partner in the firm of Watson Wyatt Partners

Watson Wyatt Partners
Watson House
London Road
Reigate
Surrey
RH2 9PQ

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