Glossary of Pension Terms

[This glossary brings together in one place an explanation of some terminology related to pensions]

Types of Pension

What are **pension schemes?** They are collective savings products designed to provide the scheme participants with an income in retirement. Usually there are tax privileges attached both to the contributions paid into the scheme and to the scheme income that accumulates through investment returns. Benefits are usually regarded as income and taxed accordingly. Pension schemes differ from other investments in that they are granted tax privileges, and that they can only be redeemed under pre-determined conditions, usually a minimum retirement age or earlier death or disability and that they are operated for the benefit of all participants on a parity basis. **Single employer schemes** are specially set up for employees within an enterprise. A **multi-employer pension scheme** is one where all relevant public sector agencies participate in one scheme for that sector. For example, there may be a scheme for all mine workers, another for transport workers, and another for all health sector workers. Alternatively there may only one scheme for all public sector workers, or all state owned enterprise workers.

The main types of scheme are:

- **Provident Fund (PF)** – provident funds are a particular form of retirement savings. They may be mandatory and are defined contribution schemes that pay out the contributions made and interest accumulated as a lump sum on retirement or other predetermined circumstances. Participants may be able to receive part in cash and part as an annuity. Typically, equal contributions are made by both the employer and the employee
- **Pay-as-you-go (PAYG or PAYGO)** – many national pension schemes are PAYG schemes, where the outgoings to pay pensions to today's pensioners are paid for by the contributions of today's workers and employers. PAYG schemes are essentially **unfunded pension schemes**, meaning that the scheme accepts the responsibility to provide retirement benefits to participants, but does not set aside moneys today to meet future obligations. Most public sector schemes have been unfunded, PAYG schemes. The PAYG system is based on a philosophy of "intergenerational solidarity" where today's workers support older workers. With pensioners living longer, current contribution rates are too low in many schemes, and the danger is that these schemes are already, or will become, financially unsustainable and collapse. The opposite of the PAYG approach is a funded scheme
- **Funded schemes**. In a funded scheme, there is an asset allocated today against some or all future obligations. These schemes do not therefore rely on intergenerational transfers like pay-as-you-go schemes, and should be financially sustainable. **A fully-funded scheme** would mean that there are enough assets to meet all obligations. Defined contribution schemes (see below) are fully funded; defined benefit schemes, however, may be less than fully funded (i.e. **partially-funded**) as they are never likely to have to meet all their obligations on any given day
- **Defined Contribution (DC) schemes** – these can also be called **accumulation or money purchase schemes**. Here the benefit provided at retirement, or earlier death or disability, is the sum of the actual contributions made plus the interest that has been earned on the investment of these contributions. Unlike a defined benefit scheme, the benefit is not pre-determined and is totally dependent upon the level of contributions, the rate of investment return and annuity rates at retirement. These schemes provide the contributor with a sum of money that the contributor then has to plan how to use to meet his or her financial needs in retirement. Defined contribution schemes are, by definition, fully funded. There has been a world-wide trend towards defined contribution schemes by employers for the basic reason that once an employer makes a particular month's contribution it has no future liability. The employer's pension costs for each and every employee are known in advance, unlike a defined benefit scheme where the total costs for an individual or an enterprise are unknown.

- **Defined benefit (DB) scheme** – also called **"final salary schemes", fixed or guaranteed benefit schemes**. In these schemes, the pension scheme promises to pay the contributor a benefit that can be pre-determined. It is usually a certain percentage of the contributor's actual salary at or close to retirement for each month or year that the contributor has contributed to the scheme. Most public sector schemes are of this type, and will pay long serving employees between 50% and 70% of their actual, or very close to actual, final pre-retirement salary. In addition many public schemes also allow a lump sum that is often subject to preferential tax treatment.

Other Pensions Terms:

- **Contribution rate** - The **actual contribution rate** is usually defined as a percentage of the employee's wage. A scheme could have a flat rate contributions for all participants. The definition of wage can vary from scheme to scheme. It will always be at least the employee's base wage (although it may only be adjusted once a year despite wage increases during the year) and in the more generous schemes it may include irregular payments such as overtime, bonuses etc. Many schemes require both the employee and the employer to contribute (contributory schemes) but some schemes, usually for executives and sometimes for civil servants only require the employer to contribute (non-contributory). **The actuarially required contribution rate** may be much higher, however, and is the rate required (all other things being equal) to meet the predicted future obligations calculated on the basis of reasonable assumptions of workforce and demographic trends. For example in one country, the rate paid was 15 per cent, but the rate that would be required to fully fund the scheme was 61 per cent. In practice, contribution rates of 5 – 15% can be considered "reasonable"; rates above 20 % are unlikely to be politically, financially or industrially viable.
- **Contributory pensions** – this is where the employee has to make a contribution. Some schemes (particularly where there are tax advantages for the employer) may be non-contributory.
- **Contribution holiday** – in a defined benefit scheme the actuary will estimate the rate of contribution needed to fund the benefits over the next few (usually three) years. If the required rate is at or less than the rate being contributed by employees, then there is no need for the employer to contribute.
- **Contribution arrears** – where either the employer has failed to transfer contributions into the scheme in accordance with either legislation or scheme rules.
- **Unfunded pension liabilities** – these refer to the liability of the scheme to meet al of its pension obligations and promises in future
- **Real rate of return** – this is the amount by which the actual investment return earned by the pension scheme exceeds the rate of inflation.
- **System dependency ratio** – this is the percentage of people of working age who are supporting those who are pensioners.
- **Pension scheme deficit** – in a defined benefit scheme this is calculated as the amount of shortfall in the assets of the scheme on a given day compared to the cost of meeting all scheme liabilities on that day.
- **Vesting scale**– this is defined as the portion of the employer's contributions which is paid to the contributor if the contributor ceases to be a scheme participant before having contributed for a given period or otherwise being eligible to receive a benefit. A scheme is said to be **"vested"** when there is a minimum service period to receive a refund of the employer contributions in full. **"Fully vested" or "immediate vesting"** means that there is no minimum period before the employer's contribution is refunded in full. **Partially vested** means the employee only receives part of the employer's contribution if the full service requirements have not been met.
- **Preserved benefit** – this is the amount that a former contributor is entitled to if they cease to be a scheme participant before reaching retirement age or other pre-determined circumstances.

Some schemes require benefits to be preserved in the scheme, and only paid out at retirement. Others will require the compulsory transfer of the preserved benefit out of the scheme as a lump sum on the day the employee ceases to be a contributor.. Where the preserved benefit remains in the scheme, it will be indexed until the benefit is paid out.

- **Indexation** – in the context of this Tool Kit it is the amount by which a preserved benefit is increased (it also applies to the pension paid to a pensioner in a defined benefit scheme). It is most common to use the rate of inflation as the measure of indexation although the most generous schemes use movements in wages, and others use a mixture of inflation and wage movements.
- **Trustees** – many pension schemes are managed on a day-to-day basis by trustees. The concept of trust is an Anglo-Saxon one whereby a group acts on behalf of all other (in a pension scheme's case) contributors and, in a defined benefit scheme, pensioners. The trustees must act without favor of any individual and take collective responsibility for the decisions they take. Anglo-Saxon schemes apply the prudent man philosophy i.e. the Trustees take decisions on applying the logic of the average person. Trustees can be sued if they do not take decisions in accordance with the scheme's rules (in Anglo-Saxon countries – the Trust Deed) or they take decisions that are imprudent. Trustees should usually take decisions on the basis of professional advice.
- **Supervisory Board"-** in non-Anglo-Saxon countries the provision of trust may not apply. Here the control of the scheme rests with a supervisory board. Different countries have different legal structures applying to the supervisory board but generally they are not dissimilar to the principles of trust law.