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Part 1 – Effective date of guidance

1.1. This is version G3 of the guidance.

1.2. This version of the guidance is effective for valuations with an effective date on or after 11 September 2006 or for valuations with an effective date prior to 11 September 2006 to be signed on or after 1 November 2006.

1.3. This guidance should be read in conjunction with the most recent version of our *Guidance on assumptions to use when undertaking the valuation in accordance with Section 179 of the Pensions Act 2004.*

Part 2 – Overview

2.1 Introduction

2.1.1 To calculate the scheme based element of the pension protection levy for eligible schemes, the Board of the Pension Protection Fund is required to take account of scheme liabilities, and to calculate the risk based element of the pension protection levy the Board is required to take account of the degree to which a scheme is underfunded.

2.1.2 An eligible scheme is defined by **section 126** of the Pensions Act 2004 ("the Act") and associated regulations.

2.1.3 Section 179 of the Act requires trustees (or managers) to obtain valuations at prescribed intervals for this purpose. A section 179 valuation is based on the level of assets and liabilities for the scheme. The liabilities are based on the scheme benefits taking into account key features of the levels of compensation paid by the Board of the Pension Protection Fund.

2.1.4 The actuarial valuation must be prepared and signed by a person meeting the criteria specified in **section 179(2)** of the Act and **regulation 10** of the valuation regulations.

2.1.5 The **section 179** valuation is a simplified valuation (relative to a **section 143** valuation) based on the scheme's benefits but taking into account certain key elements of the Pension Protection Fund compensation. The full details of compensation are set out in **Schedule 7** to the Act.

2.1.6 Where a scheme submits a valid Pension Protection Fund valuation prior to the last working day of each financial year, the pension protection levy will be calculated taking account of the information provided in that valuation.

2.2 Purpose of this guidance

2.2.1. This guidance is intended to support actuaries who are undertaking valuations to determine the level of underfunding in accordance with section 179 of the Act. Such guidance was envisaged in paragraph (4) of section 179. The valuation results will be used to set and calculate the pension protection levy in accordance with section 175.

2.2.2. The legislation and associated regulations relating to these valuations came into force on 6 April 2005.

2.3 Legislative requirements

2.3.1. **Section 179** of the Act requires schemes to undertake a Pension Protection Fund valuation to establish the level of scheme assets and liabilities on a section 179 basis and so to determine the level of scheme underfunding that is used in the risk based levy calculation.

2.3.2. The associated regulations set out the high level principles for conducting a section 179 valuation. This guidance provides additional detail.

2.4 Why is this valuation necessary and when is it needed by?

2.4.1. The valuation will provide the Board of the Pension Protection Fund with information on the level of liabilities and underfunding within a scheme. This will inform the calculation of the pension protection levy.

2.4.2. Schemes have considerable discretion in choosing when to provide their first Pension Protection Fund valuation, **but**:

- the relevant time of the valuation ('relevant time' for the purposes of section 179 of the Act, means the date in relation to which the assets and liabilities of the eligible scheme are calculated) must be no earlier than 1 November 2004 and no later than 5 April 2008 (but see paragraph 3.4 below); and
- the valuation must be sent to the Board of the Pension Protection Fund or the Pensions Regulator within a year of the relevant time.

2.4.3. After the initial valuation, schemes must provide the Pension Protection Fund with further valuations at regular intervals. The relevant time of each subsequent valuation must be no later than three years after the relevant time of the previous valuation and, again, the valuation must be sent to Board of the Pension Protection Fund or the Pensions Regulator within a year of the relevant time.

2.4.4. This time scale allows for the valuation to be undertaken in line with a scheme's normal valuation cycle; however schemes wanting to provide a valuation on a more frequent basis may do so. The most recent valuation information provided by the last working day of each financial year will be used to calculate the pension protection levy.

2.4.5. If a scheme wishes a section 179 valuation to be taken into account within the pension protection levy calculation for a particular levy year, that scheme must submit that valuation to the Board of the Pension Protection Fund or the Pensions Regulator by the last working day of the relevant financial year.

2.5 Where to send valuation information

2.5.1. Valuation information should be provided to the Pensions Regulator within the annual scheme return form. If a valuation is completed following the submission of the annual scheme return, but prior to the last working day of the financial year, or the 12 month period between completion and required submission of a valuation expires before the scheme return is issued, the details of that valuation should be provided to the Board of the Pension Protection Fund using the electronic form available on the Pension Protection Fund website.

2.5.2. For further details about the valuation process please go to the Pension Protection Fund website at: www.pensionprotectionfund.org.uk

2.5.3. The contact address for the Pension Protection Fund is:
Pension Protection Fund
Knollys House
17 Addiscombe Road
CROYDON
CR0 6SR
Tel: 0845 600 2541

2.6 Legislation or authority for actuarial valuations

The Pensions Act 2004 (the Act)

The Pension Protection Fund (Valuation Regulations) 2005 SI 2005/672 ('the valuation regulations')

The Pension Protection Fund (Partially Guaranteed Schemes)(Modification) Regulations 2005 SI 2005/277

The Pension Protection Fund (Pension Compensation Cap) Order 2005. SI2005/825 ('the Cap regulations')

The Occupational Pension Schemes (Modification of Pension Protection Provisions) Regulations 2005 SI 2005/705

The Occupational Pension Schemes (Levies) Regulations 2005 SI 2005/842

The Pension Protection Fund (Compensation) Regulations 2005 SI 2005/670

The Pension Protection Fund (Entry Rules) Regulations 2005 SI 2005/590

The Pension Protection Fund (Multi-employer Schemes)(Modification) Regulations 2005 SI2005/441

The Pension Protection Fund (Hybrid Schemes)(Modification) Regulations 2005 SI2005/449

Part 3 – Protected liabilities

3.1. The scheme's protected liabilities are defined in **section 131** of the Act. The amount of the protected liabilities relating to benefits for or in respect of members and to wind-up shall be determined in accordance with **section 179** of the Act, the valuation regulations, this guidance note, and the most recent version of the "*Guidance on assumptions to use when undertaking a valuation in accordance with Section 179 of the Pensions Act 2004"* as published by the Board.

3.2. The definition of protected liabilities includes "liabilities of the scheme which are not liabilities to, or in respect of, its members". Such external liabilities might include items such as professional advisers' fees which have been incurred prior to the date of the **section 179** valuation but had not been paid from the pension scheme's assets by that date. External liabilities may be zero if there are no such items or if any such liabilities have already been deducted from the asset value.

3.3. Bulk transfers after the valuation date should be ignored, assuming the assets being transferred in are not incorporated into the asset value to be included on the section 179 valuation certificate. If there are concerns that the section 179 valuation no longer accurately reflects the scheme's position, the scheme actuary may undertake a subsequent section 179 valuation.

3.4. The scheme actuary may use prudent approximations in calculating the protected liabilities. For example liability data from a previous valuation, including one carried out prior to 1 November 2004, may be used and those liabilities may be rolled forward on a prudent basis to the relevant time i.e. the effective date of the valuation.

3.5. The scheme actuary is required to certify in his report that, in his opinion, the calculated value of the protected liabilities is unlikely to have been understated. The PPF will accept approximations, for instance approximations necessitated due to lack of data, if the actuary certifies the approach taken.

Part 4 – Benefits for and in respect of Members

4.1 General

The benefits for and in respect of members of the scheme should be valued as at the relevant time. For the purposes of this valuation the benefits to be valued are the scheme benefits, but taking into account the adjustments contained in the four bullet points below. This reflects the requirement of the PPF Valuation Regulations that scheme benefits, rather than the levels of Pension Protection Fund compensation, are used in a section 179 valuation.

- applying the appropriate cap (to the benefits for members under normal pension age). Please note the cap does not apply in the case of ill health and survivors' benefits in payment at the valuation date;
- reducing the benefits by 10% in respect of those members under normal pension age on a pro-rata basis (as above, this does not apply in the case of ill health and survivors' benefits in payment at the valuation date);
- disregarding any indexation applicable to pre 6 April 1997 service;
- allowing for indexation up to RPI but capped at 2.5% on service from 6 April 1997.

4.2 Liabilities to be included

4.2.1. In accordance with **section 179(5)** of the Act, the value of liabilities should not be limited to the value of the assets, even where the scheme rules may so provide.

4.2.2. For schemes with a partial crown guarantee the valuation must only be of that part of the scheme that is not covered by a Crown guarantee.

4.2.3. The liability in respect of money purchase benefits shall be disregarded for the purposes of determining the protected liabilities. The definition of what constitutes a money purchase benefit is a matter of some uncertainty. Please refer to the Pension Protection Fund website for further information.

4.2.4. Benefits secured under contracts of insurance should be valued for a **section 179** valuation, provided the insurance policies are held in the name of the trustees.

4.2.5. Where a scheme with more than one employer operates a sectionalised scheme, separate valuations will be required for each separate section of the scheme, setting out the assets and benefits attributable to each section.

4.3 Normal pension age

4.3.1. For **section 179** valuation purposes, Normal Pension Age for a scheme member should be assumed to be the same as what would have been their MFR Pension Age. This is the age at which, under the provisions of the scheme, the member will first become entitled to receive a full pension on retirement of an amount determined without a reduction to take account of its payment before a later age (but disregarding any entitlement to pension on retirement in the event of illness, incapacity or redundancy). This is further explained in Regulation 7(10) of the Occupational Pension Schemes (Minimum Funding Requirement and Actuarial Valuations) Regulations 1996.

4.3.2. Please note that paragraphs 34(1) and 34(2) of Schedule 7 to the Pensions Act 2004 should not be applied.

4.3.3. There will therefore be one Normal Pension Age for each scheme member for **section 179** valuation purposes. In practice PPF compensation may, of course, be payable in two or more tranches beginning at different ages, but this should be ignored for the purpose of a **section 179** valuation.

4.3.4. It should be assumed that a non-pensioner over normal pension age retired immediately before the valuation date.

4.4 Non-pensioner members

4.4.1. For **section 179** valuation purposes, benefits for an active member should be calculated as though the individual had become a deferred pensioner immediately before the valuation date. In practice PPF compensation may be calculated slightly differently.

4.4.2. A non-pensioner with less than 2 years service may not be entitled to a deferred pension under scheme rules. In such cases, the benefits to be valued are those which the member is entitled to under the rules of the scheme (subject to the adjustments detailed in paragraph 4.1).

4.4.3. The pre-retirement decrements to be used to value benefits for non-pensioners are retirement at Normal Pension Age and death before Normal Pension Age.

4.4.4. It should be assumed that there is no commutation of pension at retirement for non-pensioners. However, where a scheme provides for a defined separate lump sum to be paid at retirement, not as a result of commutation, these benefits should be valued.

4.4.5. All pensions (including any non-revaluing pension, GMP, fixed pension payable from normal pension age, unrevalued career average pensions, and pensions with fixed increases in deferment) should be treated for revaluation purposes in the same way as deferred compensation increases. Between the date of leaving and the date of valuation, deferred pension increases should be valued as per the scheme rules.

4.4.6. Where a post-retirement guarantee period is provided by a scheme, this should be included within the protected liabilities.

4.5 Pensioner members

4.5.1. Where a member is already in receipt of a pension and is entitled to an increase to that pension when they reach their GMP age, the value of that future increase in benefit should be included within the protected liabilities. This should only be valued for those pensioners who are under state pension age and whose current pension is made up of excess over GMP only.

4.5.2. GMP step-ups and anti-franking increases do not need to be valued for other pensioners and non-pensioners.

4.5.3. Where a pension will stop being paid prior to the pensioner's death, that pension should be included in the valuation of the liabilities, but should not be included when testing against the compensation cap (see below).

4.5.4. Where a post-retirement guarantee period is provided by a scheme this should be included within the protected liabilities.

4.6 Splitting benefits into pre and post 1997

4.6.1. For schemes with non-uniform accrual of benefits, an accurate split into pre 6 April 1997 and post 6 April 1997 pension should be made. This split should allow for different accrual rates and different pensionable earnings definitions; however, this is subject to paragraphs 3.4 and 3.5 of this guidance.

4.6.2. Where pensioners have previously commuted part of their pension for a lump sum and the scheme makes no distinction between pre and post 97 benefits, the member's pension should be pro-rated by service into pre and post 97 pension.

4.6.3. Fixed pensions and pensions based on notional service should be allocated between pre and post 97 benefits in accordance with normal scheme practice. Where there is no such practice, the whole benefit should be treated as post 1997.

4.7 Compensation cap

4.7.1. On grounds of prudence, the compensation cap can always be ignored. Please refer to paragraphs 3.4 and 3.5 for further details.

4.7.2. For non-pensioners under normal pension age, the compensation cap applicable at the scheme's normal pension age should be applied as at the valuation date. The compensation cap is assumed to increase at the same rate as deferred compensation increases i.e. the lesser of 5% per annum and the increase in the

Retail Prices Index. Please note that this is different from the rate of increase assumed for a section 143 valuation and in practice the compensation cap would only be applied when a member's compensation came into payment.

4.7.3. For a member in receipt of a normal health early retirement pension who is under their normal pension age, the cap should be applied for the appropriate age of the member as at the valuation date.

4.7.4. For pensioners below normal pension age, the actuary does not need to consider previously taken cash lump sums. This is in contrast with a section 143 valuation where the actuary would need to consider such lump sums.

4.7.5. In schemes where cash lump sum benefits based on service and salary accrue separately alongside pension benefits, the cash benefits for non-pensioners below normal pension age should be incorporated into the comparison of benefit levels with the compensation cap. This should be undertaken by converting the lump sum into an equivalent pension using the factors required to calculate the annualised value of a lump sum available from the Pension Protection Fund's website.

4.8 Death benefits

4.8.1. Spouses' benefits that are to be valued are the same as scheme benefits, except for the four adjustments detailed in paragraph 4.1 of this guidance. This may well be different from the compensation that would actually be paid from the Pension Protection Fund to the spouse of an existing pensioner.

4.8.2. The pre-retirement lump sum death benefits that are to be valued are those payable on death in deferment under the scheme rules, irrespective of whether the member is an active or deferred member at the valuation date. Benefits which do not accrue are ignored. Please note that a refund of contributions is regarded as an accruing benefit for these purposes. Lump sum death benefits should not be included when comparing benefit levels against the compensation cap.

4.8.3. The compensation cap applicable to a member's benefit on death prior to normal pension age would be that applicable to the member's last birthday at the date of the valuation.

4.8.4. Where the member's benefits would have been restricted by the compensation cap (i.e. if the member is under Normal Pension Age) and the spouse's benefit is a proportion of the member's pension, the spouse's benefit that should be valued is equal to the spouse's proportion multiplied by the member's pension as restricted by the cap and the 90% compensation level.

4.8.5. Where the spouse's pension to be paid on death is not based on the member's pension, the spouse's pension is not subject to the cap.

4.9 Hybrid schemes

4.9.1. For a hybrid "better of" scheme, where benefits may be either defined benefit (DB) or defined contribution (DC), the assets and benefits to be included within the protected liabilities should only be those that relate to members where the DB benefits exceed the DC benefits at the relevant time.

4.9.2. The calculation for each individual should consider whether the underpin bites as at the valuation date using the current scheme methodology. Only those members for whom the DB benefits exceed DC benefits should be included in the liability calculations. Members with purely DC benefits (i.e. the DB benefits do not exceed the DC benefits) should be excluded from both the assets and liabilities of a section 179 valuation.

4.9.3. The compensation cap and the 90% level should be applied to the DB members of the hybrid scheme (after the underpin test has taken place).

4.9.4. In a DC scheme with a DB underpin, for any period of service where the DB underpin would not apply, the corresponding assets and liabilities should be excluded from the valuation.

4.9.5. For a DC scheme with a DB underpin that only applies for a particular period of service, the member's fund in relation to that period of service alone should be compared to the underpin using current scheme methodology.

4.9.6. If a scheme does not currently have its own methodology in place then the actuary should adopt the methodology they would employ if conducting a funding valuation.

4.10 Cash balance schemes

4.10.1. For each individual under NPA aged x with a normal pension age of y and cash balance amount of (£A_1 + £A_2) at the valuation date (where £A_1 and £A_2 are the cash balance amounts accrued in relation to pre and post 97 service respectively), the scheme actuary should:

- Apply a cap to (£A_1 + £A_2) of the compensation cap at age y multiplied by the annuity at age y. The annuity at age y is derived from two annuities at age y, weighted by pre and post 97 service, using from the appropriate yield in payment as defined in "*Guidance on assumptions to use when undertaking a valuation in accordance with Section 179 of the Pensions Act 2004*". The annuity at age y should also contain an element in respect of a contingent spouse's pension unless the scheme does not provide such a benefit;

- Discount the capped cash balance amount payable at retirement at age y, after allowing for mortality, by a factor of $(1+i)^{x-y}$ where i is the yield in deferment defined in "*Guidance on assumptions to use when undertaking a valuation in accordance with Section 179 of the Pensions Act 2004*";

- Discount the capped cash balance amount payable on death before retirement, after allowing for the probability of death, in n years' time by a factor of $(1+i)^{-n}$;

- Sum all the discounted capped cash balance amounts over all the various contingencies;

- Apply a multiplier of 90%.

4.10.2. For each individual over NPA but not yet in receipt of a pension, the **section 179** liabilities should equal the cash balance amount in relation to that particular member.

Part 5 – Assets

5.1. Assets must be taken into account in a section 179 valuation in accordance with the valuation regulations. The valuation regulations specify that for the purposes of determining a **section 179** valuation the appropriate person shall adopt the value of the scheme assets stated in the relevant accounts, and that value shall be taken to be the value of those assets at the relevant time.

5.2. Relevant accounts must be audited accounts. The definition of relevant accounts can be found in Regulation 1 of the Pension Protection Fund (Valuation) Regulations 2005. The Board's preference is that relevant accounts be prepared in respect of a period ending on the **section 179** valuation date. However, options (b) and (c) of the definition of "relevant accounts" permit the accounting period to end on a different date in certain circumstances.

5.3. The assets in respect of money purchase benefits should not be included in the assets in accordance with **section 179(6)** of the Act.

5.4. Insurance polices held in the name of the trustees should be included in the assets for **section 179** purposes. Regulation 7 (2) of the Pension Protection Fund (Valuation) Regulations 2005 contains some detail on how this valuation should be carried out. The value of these assets might not be equal to the value of liabilities for section 179 purposes; however the Board would have concerns about any valuation that understated liabilities or understated underfunding.

Part 6 – Data

6.1. The Pension Protection Fund regards it as best practice for trustees or managers to take appropriate action to ensure that, as far as is practicable, all potential scheme beneficiaries have been identified and that the associated membership data is correct. To the extent that there are residual uncertainties about the membership data, prudent approximations by the scheme actuary will be acceptable. This is an aspect of the prudent estimation of protected liabilities described in Part 3.

Part 7 – Valuation method

7.1. Any reasonable age definition may be used for the purpose of the calculation provided consistency with the revaluation and increase periods can be demonstrated.

7.2. For each scheme member the protected liability must be calculated as the present value of the accrued benefits using the assumptions specified in the most recent version of *"Guidance on assumptions to use when undertaking a valuation in accordance with Section 179 of the Pensions Act 2004".*

Part 8 – Expenses

8.1 Expenses must be determined as specified in the most recent version of *"Guidance on assumptions to use when undertaking a valuation in accordance with Section 179 of the Pensions Act 2004"*.

Part 9 – Reporting

9.1. The scheme actuary's report on the **section 179** valuation should be addressed and sent to the trustees. The certificate on the Pension Protection Fund website should form part of the scheme actuary's report. The results of the **section 179** valuation should be included on the next annual scheme return form issued by the Pensions Regulator.

9.2. Regulation 2 of the Valuation Regulations requires the trustees or managers to provide the Board or the Pensions Regulator on the Board's behalf with the valuation within one year of the relevant time of the valuation. This requirement is satisfied if the results are sent to the Pensions Regulator on a scheme return sent to the Pensions Regulator within one year of the relevant time of the valuation. If the next opportunity for submitting a scheme return will not be until after a year has elapsed since the relevant date, then the results should be sent to the Board electronically, using the section 179 valuation certificate available on the Pension Protection Fund website.

9.3. The latest **section 179** valuation results received by the last working day of each financial year which immediately precedes the start of the relevant levy year will be used for the levy calculation in respect of the relevant levy year commencing on 1 April.

Part 10 – Review

10.1 This guidance note will be reviewed at regular intervals as the Board of the Pension Protection Fund deems appropriate.