General information on PPF factors

General principles

Types of PPF factor

There are six types of factor needed to administer the PPF, as well as for use in section 179 (levy) and section 143 (PPF entry) valuations:

- Compensation cap factors at each retirement age, to adjust the compensation cap at age 65, which is provided by DWP each year.
- Commutation factors to calculate the one-off cash lump sum that can be paid in return for giving up an amount of annual compensation.
- Factors to convert stand-alone lump sums into equivalent annual compensation amounts, for comparison against the compensation cap.
- Early retirement factors to reduce annual compensation and lump sum entitlements, if taken early.
- Late retirement factors to increase annual compensation and lump sum entitlements, if taken late.
- Step-down factors to convert temporary compensation into the equivalent lifetime compensation.

Actuarial basis and assumptions

The Pensions Act 2004 requires the Board of the PPF ('the Board') to set its commutation factors based on actuarial equivalence. We have extrapolated this to apply to the rest of the factors as well. Based on actuarial equivalence, our factors are intended to be broadly cost-neutral when derived from the assumptions used for the annual valuation of the PPF.

Full details of these assumptions are set out in the edition of the PPF's annual report and accounts published in the same calendar year as the factors, but the main principles behind them are:

1. The assumptions used should be best estimate so that they are as likely to overstate as understate the calculated liabilities.
2. A risk-free discount rate should be used to convert the estimated future cash flows into a current value of liabilities to compare with the market value of assets.

The most recent published edition of the annual report and accounts can be found here: https://www.ppf.co.uk/annual-report

Additional assumptions made for all of the factors include:

- Factors are calculated on a unisex basis, using a 50/50 male/female split
- Where factors allow for the situation where survivor compensation is payable, we have used the 'relevant partner' assumption that 85 per cent of men and 70 per cent of women have a relevant partner

- Where factors are not shown separately for pre 6 April and post 5 April 1997, i.e. compensation cap and early retirement factors, an assumption of the proportions of service in each of these categories has been made according to the proportions in relevant subsets of the PPF's deferred pensioner membership. For example, members not eligible for early retirement over the next year would be excluded from the analysis.

PPF compensation increases in payment

Compensation in respect of service in the pension scheme prior to 6 April 1997 does not increase in payment. Compensation from service after 5 April 1997 increases in payment in line with CPI inflation, subject to a maximum of 2.5 per cent a year.

Frequency of review

We carry out a full review of the factors annually, but we also monitor market movements on a monthly basis. If we believe that the impact of market movements is significant, we would carry out a full review part way through the year. We only update the factors if the review shows that the updated factors are materially different from those that are currently in force.

The factors

Compensation cap factors

The Board produces a single set of compensation cap factors i.e. not separate factors for each of pre 6 April and post 5 April 1997 compensation.

The compensation cap at age 65 is reviewed by DWP each year, and the new cap comes into effect on 1 April (having been published in the preceding February/March). The PPF produces factors to adjust that cap to be appropriate for other ages.

The compensation cap is used to determine the level of compensation payable by the PPF to individuals at each age. Paragraph 26 of Schedule 7 of the Pensions Act 2004 sets out the circumstances in which the compensation cap applies and Paragraph 27 of the same sets out how and when the compensation cap should be increased.

The factors in force will usually be based on the market conditions as at the 30 November prior to the most recent 1 April, and the assumptions used for the PPF's annual valuation in the same calendar year as that 30 November.

Factors other than the compensation cap factors

Unless otherwise stated, the factors come into force from 1 October, having been published in the preceding July, and calculated on the assumptions used for the PPF's most recent annual valuation using market conditions as at 31 March. This may not always be the case, e.g. if the factors were not materially different from the previous set and so were not updated, or if the factors were updated as part of a review outside of the usual annual process.

Commutation factors

The Board produces four sets of commutation factors.

Different factors are produced in respect of pre 6 April 1997 and post 5 April 1997 PPF compensation. In addition, separate factors are produced to reflect the different provisions for compensation payable to survivors after a member has passed away: no survivor's compensation payable, or 50 per cent survivor's compensation payable. To which category a member belongs depends on the rules of their pension scheme prior to it entering the PPF.

If a member elects to commute annual compensation for a one-off cash lump sum, they will commute both their own compensation and the 50 per cent attaching survivor's compensation, if applicable.

Annual equivalent of lump sum factors

Where schemes that provide a lump sum benefit, other than by way of commutation, this will need to be converted into an equivalent annual pension for comparison against the PPF compensation cap. The factors used for this are the inverse of the commutation factors.

The Board produces two sets of lump sum conversion factors, one each for pre 6 April 1997 and post 5 April 1997 PPF compensation, based on a 50 per cent survivor's compensation being payable.

Early retirement factors

The Board produces a single set of factors for reducing compensation upon early retirement.

Late retirement factors

The Board produces two sets of late retirement factors, one each in respect of pre 6 April 1997 and post 5 April 1997 PPF compensation.

Step-down factors

The Board produces two types of step-down factor for use with annual compensation that is paid for a temporary period rather than for the life of the member.

Lifetime equivalent step-down factors are used to convert temporary compensation into lifetime compensation, using the principle of actuarial equivalence. There are separate tables for pre 6 April 1997 and post 5 April 1997 PPF compensation.

This is required to test against the compensation cap, which is set in the context of lifetime compensation. Additionally, if a member chooses to commute temporary annual compensation for a lump sum payment, the lifetime equivalent value of that temporary annual compensation will be required so that the commutation factors can be applied.

The early retirement step-down factors are used for reducing temporary compensation upon early retirement. It is assumed that all compensation is from pre 6 April 1997 service.