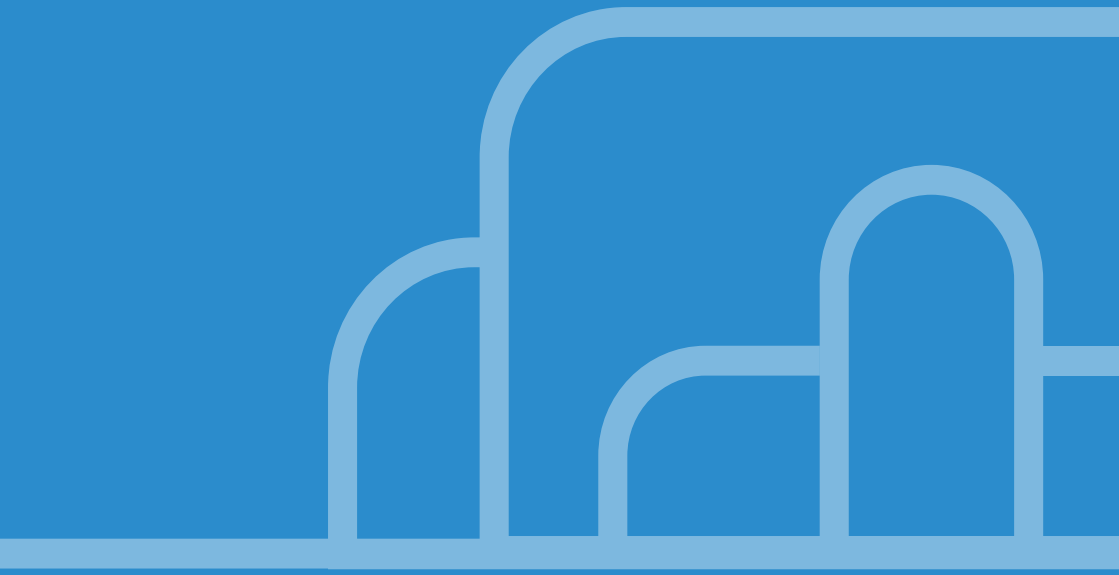
Cummins UK Pension Plan
Defined benefit (DB) Section

Early retirement and tax-free cash

A guide to actuarial factors for members.



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What are actuarial factors and why do we need them?

When you take your benefits from the Plan's DB Section, you'll receive a pension, which will be paid to you for the rest of your life. The amount of pension you'll receive is based on a calculation using your final pensionable salary and length of service in the Plan. Importantly, it's also based on you taking your benefits at the Plan's normal retirement age of 65.

In practice, not everyone wants to take their benefits at the Plan's normal retirement age – some members will want to retire early and others later. Many members might also choose to give up some of their pension in exchange for a tax-free cash lump sum at retirement.

The Plan gives you the option to do these things, but to be able to do so, we need to have a way of fairly converting the pension that would be payable from normal retirement age into a pension that's payable early, payable later, or converted into a cash lump sum. The Plan's actuary advises the Trustee on how to work this out in a way that's fair to all members of the Plan, regardless of when they take their benefits. These calculations are called actuarial factors.

The main actuarial factors the Plan uses are:

- early retirement factors
- late retirement factors
- commutation factors (if you want to exchange some pension for a cash lump sum).

Factors in action – example

Retiring early

Sam's normal retirement age is 65, but he's decided to retire a year early on his 64th birthday. Sam's pension will be paid for longer than usual because it's starting a year earlier. To make this fair, we reduce Sam's pension, using the early retirement factor, to allow for the extra year.

Working out Sam's early retirement pension

Sam's pension at normal retirement age	£10,000 a year
Early retirement factor	4.25%
Sam's pension reduced for early retirement	£9,575 a year

£10,000 – 4.25% = £9,575

If Sam wanted to retire more than one year early, his pension would be reduced by the early retirement factor for each year and month before his normal retirement age. The factor is 4.25% a year for up to five years and 3% for each year more than five years.

Taking a cash lump sum

Sam also wants to take a cash lump sum at retirement of £30,000. This means he'll exchange some of his pension to pay for the lump sum. For this, we use the commutation factor.

Working out Sam's cash lump sum

Sam's pension reduced for early retirement	£9,575 a year
Sam's tax-free lump sum	£30,000
Commutation factor	14.92
Sam's early retirement pension reduced for taking a lump sum	£7,564.28 a year

£30,000 / 14.92 = £2,010.72
£9,575 – £2,010.72 = £7,564.28

How does our actuary work out the factors?

It's about putting a value on each pound of pension. This means working out how much money the Plan needs to have now to be able to pay each pound of pension in the future.

For example, to pay £1 of pension in 10 years' time, the Plan doesn't need to hold that whole £1 right now. It holds enough money to be able to reach £1 with investment growth in 10 years' time.

This is a complex calculation. To work it out, the actuary makes some considered assumptions about what will happen in the future, including:

- how long a pension might be paid for
- how inflation might increase that pension over time
- what investment returns can be expected on the Plan's assets.

These assumptions can and do change over time, so it's important that we review the factors regularly. If we didn't and the terms became too generous, allowing members different retirement options could have a negative impact on the Plan as a whole, which would be unfair to the rest of the Plan's members.

Financial markets and the Plan's factors

Government bonds make up a large part of the Plan's assets. If the expected future return on government bonds changes, this impacts the value placed on each pound of pension when working out how much pension you'd need to exchange to take your lump sum.

For example, looking again at the money the Plan currently holds to pay £1 of pension in 10 years' time:

- If the Plan can earn 2% per year on its investments, we need to put aside 82p now to meet that future pension payment (because 82p with investment returns of 2% a year for 10 years will grow to become £1)
- Alternatively, if the Plan can earn an investment return of 5% a year, we only need to put aside 61p now to pay that £1 due in 10 years' time.

In this example, a rise in expected investment returns (from 2% to 5% a year) reduces the amount the Plan needs to have now to pay £1 of pension in 10 years' time by about a quarter (from 82p to 61p). This leads to a lower commutation factor which means you'd need to exchange more of your pension to take a cash lump sum.

A change in expected returns on government bonds is not just an issue affecting our Plan. Many other pension schemes in the UK are also adjusting their actuarial factors in a similar way.

Get in touch

If you have a question about your benefits in the DB Section, please contact Isio, the Plan administrator.

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