

Technical Briefing

No.12



The new funding regime

Regulations establishing the Scheme Specific Funding Standard (SSFS) and replacing the Minimum Funding Requirement (MFR) came into effect on 30 December 2005. These supplement and expand upon the provisions contained in Part 3 of the Pensions Act 2004.

The Pensions Regulator has issued a Code of Practice on funding defined benefits that summarises these measures and also adds its own advice on the matters it thinks trustees should consider.

The Pensions Regulator is also consulting the pensions industry on its proposals for regulating the funding of defined benefits. This consultation finishes on 26 January 2006.

The new funding regime:

1. Formal valuations at least every three years
2. Annual valuation updates
3. A formal statement of funding principles, recovery plan and schedule of contributions
4. Increased disclosure to members

The Pensions Regulator's proposals:

1. It will intervene should certain triggers points be activated
2. One trigger looks at the prudence built in to the liability value
3. A second trigger looks at the pace at which deficits are cleared

In detail

The New Funding Regulations

The government announced in March 2001 that it would abolish the MFR and replace it with a new funding regime. The European Pensions Directive required the government to introduce the replacement regime no later than 23rd September 2005. However, the government missed this deadline and introduced the required legislation from 30th December 2005.

The new regulations place responsibility firmly on trustees to both (i) obtain appropriate actuarial advice and (ii) consult and seek the agreement of the employer during the funding process.

The specific requirements are as follows.

1 Statutory Funding Objective

Every occupational pension scheme will need to meet the Statutory Funding Objective of holding sufficient assets to meet its 'technical provisions'. Certain schemes, such as those providing benefits purely on a money-purchase basis, will be exempt.

Technical provisions must be calculated on prudent assumptions and using an accrued benefits method (i.e. one that takes full account of past-service benefits). The legislation places responsibility on trustees to set the assumptions and method, after taking actuarial advice. However, neither the legislation nor the Regulator's guidance specifies whether the technical provisions be based on ongoing or leaving service benefits.





No.12

2 Statement of Funding Principles

Trustees must establish and act upon a Statement of Funding Principles ('SFP'), which sets out their policy on ensuring the Statutory Funding Objective is met, the methods and assumptions used and the period over which funding shortfalls are to be made up. The trustees must also obtain actuarial advice when preparing or amending their SFP.

3 Actuarial valuations

Actuarial valuations will be required every year or, every three years if the trustees decide to obtain annual actuarial reports during intervening years. Annual reports must identify developments affecting the value of the scheme's technical provisions. Any valuation must be made available to the company within 7 days of the trustees receiving it. Valuations will be backed by a system of actuarial certification confirming the method and assumptions used.

4 Recovery Plan

If an actuarial valuation reveals that the value of the assets fails to cover the value of the technical provisions, then the trustees must implement a recovery plan, in accordance with their SFP. In preparing the recovery plan, the trustees must obtain the agreement of the employer and take actuarial advice, with a final copy sent to the Pensions Regulator. The Regulator must be informed if the trustees and company fail to agree a recovery plan.

5 Schedule of Contributions

All schemes covered by these regulations must produce a schedule of contributions, which sets out the rates, amounts and due dates of company and member contributions. As with the MFR, the actuary must certify that these are consistent with the SFP so that the Statutory Funding Objective will either continue to be met or, for a scheme in

deficit, that it will be expected to be met by the end of the recovery period.

The trustees must obtain the company's agreement or send a report to the Regulator, if agreement cannot be reached. The trustees must also inform the Regulator if there is reasonable cause to believe that late payment of contributions is of material significance.

The trustees are required to obtain actuarial advice when preparing or amending the schedule of contributions.

6 Statutory Deadlines

The trustees have fifteen months from the effective date in order to obtain actuarial valuations, prepare or revise the statement of funding principles, recovery plan and schedule of contributions. This deadline is reduced to twelve months for annual actuarial reports.

7 The Pensions Regulator's role

The Pensions Regulator can apply its powers to schemes should the trustees fail to follow the SFP, the trustees and company fail to agree a recovery plan or schedule of contributions, or the actuary is unable to provide a relevant certificate.

These new powers allow the Regulator to (i) change the way benefits are earned in the future, (ii) direct how the technical provisions are calculated, (iii) determine how quickly shortfalls are cleared and (iv) impose a schedule of contributions.

8 Disclosure

Regulations require that each year scheme members and beneficiaries be provided with a 'summary funding statement', containing details of the scheme's ongoing and solvency funding position, recovery plan and schedule of contributions. Members will also be entitled to obtain a copy of the scheme's SFP as a matter of course.



No.12

9 Multi-employer schemes

Special conditions apply to multi-employer schemes, be they sectionalised or non-sectionalised. In particular, the regulations permit separate categories within a scheme to be treated as individual schemes for the purposes of these regulations.

10 Cross-border schemes

More stringent requirements are placed on cross-border schemes, which the regulations define as those UK-based defined benefit schemes that are funded by one or more foreign but EU-based companies. Cross-border schemes have a shorter timescale of twelve months in order to obtain annual valuations and prepare/revise the SFP, recovery plan and schedule of contributions. In addition, contributions must be set to clear any deficit over the two years following the certification of the schedule of contributions.

11 Exemptions

The regulations do not apply to public sector schemes, money purchase schemes, schemes providing fully insured risk benefits, fully secured schemes, schemes that commenced winding up before 30 December 2005, schemes subject to failure notices and unapproved schemes with less than 100 members.

12 Transitional arrangements

The regulations apply from the date of the first formal actuarial valuation occurring on or after 23 September 2005.

The regulations do not affect the existing requirements placed on trustees to obtain valuations at earlier intervals should any of a range of events occur that are identified on the Undertaking given to the scheme actuary.

13 Reasonable periods

The Regulations require the trustees to provide the Regulator with copies of the scheme's funding documents within a reasonable period. The Regulator has confirmed in its Code of Practice that it considers ten working days to be a reasonable period.

The Regulator's Code of Practice

The Code of Practice summarises the legislation in a more understandable format. It also contains the Regulator's opinion on matters it expects trustees to consider. Such matters include

- Setting appropriate values for the assumptions underpinning the calculation of the technical provisions.
- Consideration of the meaning of prudence within the assumption values.
- The sensitivity of the scheme's funding position to adverse scheme experience.
- The relationship between ongoing and buyout liability values.
- Factors determining the nature of the recovery plan.
- The format of the schedule of contributions.
- The limits on re-spreading existing scheme deficits over extended future periods.

The Regulator's Consultation on regulating the funding of defined benefits

Legislation requires that trustees send copies of valuations, statements of funding principles, recovery plans and schedules of contributions to the Pensions Regulator. In its October 2005 consultation document, the Regulator proposed to assess each scheme to broad funding tests designed to identify those schemes whose funding regime appears to be inadequate. Such schemes would then be subject to closer scrutiny by the Pensions Regulator to determine whether further action is necessary. The broad funding tests comprise of two trigger mechanisms.



No.12

Adequacy of Technical Provisions

The Regulator proposes to assess the adequacy of the value placed on the scheme's liabilities by comparing this amount to the value placed on the same liabilities on both the buyout basis and to value under the FRS17 accounting standard. Low ratios are likely to indicate that weak assumptions and/or a weak funding method have been used to calculate the technical provisions.

Adequacy of the recovery plan

The Regulator proposes that deficit recovery periods be as short as possible and also be no longer than ten years. Contribution regimes should also avoid back-end loading, where the bulk of any deficit funding falls in later years. Further, schemes with financially strong sponsoring employers will be expected to adopt much shorter recovery periods than the ten year limit.

Should one or both of these criteria be triggered, the Regulator proposes looking at the scheme in more detail, liaising with the trustees and advisers if necessary. The Regulator has emphasised that it would prefer trustees and employer to reach agreement between themselves without the Regulator's intervention. However, the legislation permits the Regulator to impose (i) its own assumptions when calculating a scheme's technical provisions, (ii) a revised recovery period, and (iii) a schedule of contributions.

Further Information

The primary legislation is contained in sections 221 to 233 of the Pensions Act 2004, which can be found at <http://www.opsi.gov.uk/acts/acts2004/20040035.htm>.

The accompanying regulations are contained in the Occupational Pension Schemes (Scheme Funding) Regulations 2005 (SI 2005/3377) and can be accessed at <http://www.opsi.gov.uk/si/si2005/20053377.htm>.

The Pensions Regulator's Code of Practice on scheme funding can be obtained from its website at:

<http://www.thepensionsregulator.gov.uk/pdf/codeFundingLaid.pdf>

whereas its consultation document on how it intends to regulate the funding of defined benefits can be found at:

<http://www.thepensionsregulator.gov.uk/pdf/schemeFundingConsultation.pdf>

CPRM Commentary

Trustee responsibilities

The new funding regime retains some of the features of the MFR, such as regular valuations, schedules of contributions and formal actuarial certification. However, the new regime goes much further by placing much more responsibility onto trustees to ensure scheme deficits are cleared as quickly as possible. This will require trustees to gain a much greater understanding of scheme funding and also be alert to conflicts of interest arising when negotiating with the employer on the speed at which deficits can be cleared. We recommend all trustees read through the Regulator's Code of Practice in this regard and obtain further training on those topics of scheme funding to ensure they obtain a proper understanding of the fundamental principles. Any training should also be tailored to fit in with the proposed Trustee Knowledge and Understanding requirements, due from April 2006.

Increased contributions by companies

The new regime also raises the possibility that company contributions may have to increase significantly. This will depend mainly on the Regulator's trigger mechanisms but it is likely that will place bigger values on pension liabilities than being set currently. In addition, contributions will also increase if deficits are to be cleared over shorter periods.



No.12

Increased disclosure to members

Members will be provided with much more information as a matter of course under the new regime. However, it remains to be seen whether this results in any sea change in attitudes by members, especially as recent media coverage will have forewarned most members that funding deficits are a common if unwanted feature of defined benefit pension schemes at the moment.

If you would like further advice on this or other pension issues, please contact either Walker Yule or Philip Wheeler in Edinburgh (0131 220 8247) or Simon Chrystal in Newcastle (0191 233 9408).