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SCHEME FUNDING – THE NIGHTMARE BEFORE CHRISTMAS (!)

1 INTRODUCTION

Whilst the scheme funding process is contained in the Pensions Act 2004, much of the detail was left to Regulations and to a Code of Practice to be issued by the Pensions Regulator.

After a number of delays, the final Scheme Funding Regulations and the Code of Practice have been laid before Parliament and will come into force on 30 December 2005.

2 KEY POINTS

- The new scheme funding provisions come into force from 30 December 2005 for all actuarial valuations based on an effective date of 22 September 2005 or later
- "Prudent" will not be defined (see section 5 below)
- Schemes with less than 100 members will have reduced disclosure requirements (again, see section 5)
- There have been tweaks as to who sets the contribution rate where either the trustees or the actuary are currently responsible (section 6)
- Be aware of the regulatory jigsaw when setting recovery plans (section 7)
- Conflicts of interest are again under the spotlight (section 8)

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3 TO RECAP

The new scheme funding provisions will require trustees of defined benefit (DB) schemes to prepare a statement of funding principles (SFP) for ensuring, amongst other things, that the Statutory Funding Objective (SFO) is met.[1] SFO requires a DB scheme to have "sufficient and appropriate assets to cover its technical provisions" (namely, from the EC Directive, "the amount required, on an actuarial calculation, to make provision for the scheme's liabilities"). Trustees must also prepare a schedule of contributions.

Trustees will need to obtain annually either full actuarial valuations or interim actuarial reports on developments. If SFO is not met the trustees, with actuarial advice, will have to devise a "recovery plan" setting out proposals to make up the shortfall. The recovery plan must be sent to the Regulator.[2]

4 THE SCHEME FUNDING "PACK"

The following documents form the scheme funding regulatory "pack":

- The Occupational Pension Schemes (Scheme Funding) Regulations 2005 (which now includes the disclosure of information requirements);
- Code of Practice "Funding Defined Benefits" (now incorporating the Guidance for Trustees);
- Guidance on "How the Regulator will regulate Scheme Funding" (still subject to consultation)[3].

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[1] Please note that there are limited exceptions and transitional provisions.

[2] See our Sackers Extra Alert "Scheme Funding – consultation published" dated 23 March 2005, available on the client area of our website or from your usual contact

[3] See our Sackers Extra News "The new funding standard – the Regulator's role" dated November 2005

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5 VALUATION ISSUES

Prudence

Both the Regulations and the Code require that trustees choose both the method and the actuarial assumptions for calculating the technical provisions prudently - but fall short of giving an indication of what would be considered "prudent". This requirement has not changed from the drafts published in March 2005. As expected, the failure to define the term "prudent" was the subject of much concern but the Government's response to consultation makes it clear that this is a matter to be decided on a scheme-by-scheme basis:

> "Government policy is for scheme trustees to determine what constitutes prudence in the context of their particular scheme, and a definition in legislation would not therefore be appropriate."

Solvency Estimate

The solvency estimate is intended to be the actual cost of buying out benefits. Some large schemes were concerned about including the solvency estimate in the actuarial valuation, as it can be difficult to get figures because of lack of availability of annuities in the market. The Government have taken this on board and have provided flexibility in the regulations for an alternative estimate to be given if this issue affects a scheme.

Summary Funding Statement

Trustees are required to send a summary funding statement to members within 12 months of the end of the scheme year. This statement has been simplified to take account of comments on consultation. In addition, schemes with less than 100 members will only be required to send one out every 3 years (when they obtain a full valuation).

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6 CONTRIBUTION RATES

Who sets the contribution rate?

Under the Pensions Act 2004, the trustees have to get agreement from the employer on key scheme funding decisions – such as the contribution schedule, the statement of funding principles and the recovery plan.

But some respondents rightly pointed out that this did not preserve the current balance of powers under scheme rules where either the trustees or the actuary set the contribution rate. So, as a result of further informal consultation, the Regulations have been changed to allow the following:

- where the trustees set the contribution rate the trustees just have to "consult" the employer in future rather than obtain agreement; and
- where the actuary sets the contribution rate, both the trustees and employer have to agree the rate – but an underpin will apply so that the contribution rate cannot be less than the actuary would have recommended under the scheme rules.

Schedule of Contributions

The schedule of contributions should show the rates over the next 5 years – or (and this is the new bit) if the recovery period is longer, over that longer period.

Trustees are also now required to keep detailed records of the contributions made to the scheme (and, if applicable, any action taken to recover these amounts).

7 RECOVERY PLANS

Over what period?

On recovery plans, the Code now states that "the trustees should aim for any shortfall to be eliminated as quickly as the employer can reasonably

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afford. What is possible and reasonable, however, will depend on the trustees' assessment of the employer's covenant".

This is a softening of the position from the draft Code which had said that the shortfall should be made good as soon as practicable. But remember to tie this in with the Guidance "How the Regulator will regulate Scheme Funding" which has a three-pronged automatic trigger for the Regulator to investigate the scheme if the recovery period is:

- over 10 years;
- under 10 years but where the employer's position is such that the Regulator believes the deficit could be cleared more quickly; or
- back-end loaded (i.e. contributions are higher at the end of the period).

Revision of recovery plans

In addition, trustees are under a new duty to revise the recovery plan where they "consider that there are reasons that may justify a variation". And, if the recovery plan is revised, the trustees should also look at the schedule of contributions.

8 CONFLICTS OF INTEREST

Again, the spotlight is on conflicts of interest with the final Code stressing that:

"Trustees should remember that, when taking decisions as trustees, their other duties and interests must be set aside…It is of the greatest importance that the existence of conflicts is recognised as soon as possible (preferably before any negotiations have been conducted). Where appropriate, trustees should ensure that they obtain legal advice as to how to manage conflicts."

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