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SCHEME FUNDING – CONSULTATION PUBLISHED

1 INTRODUCTION

It has been a long time coming but we now have the Government's thinking on life after the minimum funding requirement (MFR). It will be replaced by a Statutory Funding Objective (SFO), which is designed to reflect the funding standard under the EC Pensions Directive.

Whilst the scheme funding process is contained in the Pensions Act 2004 (PA 2004)¹, much of the detail was left to Regulations and to a Code of Practice to be issued by the Pensions Regulator. Here we take an overview of these recently published draft documents.

2 SCHEME FUNDING - IN BRIEF

The new provisions will require trustees to prepare a statement of funding principles (SFP) for ensuring, amongst other things, that SFO is met. SFO requires a defined benefit (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.

The consultation gives 23 September 2005 as the proposed effective date for the new provisions² (although this, worryingly, remains in square brackets) but asks whether trustees should be given "flexibility" to apply the new provisions to a valuation not signed off by that date.

¹ PA 2004, sections 221- 233

² See section 6 below for transitional arrangements

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3 CONSULTATION

On 22 March 2005, the Department for Work and Pensions (DWP) and the Regulator jointly published a consultation on the documents which will supplement the provisions of PA 2004. These documents are:

- Code of Practice “Funding Defined Benefits”;
- Guidance (to be appended to the Code);
- The Occupational Pension Schemes (Scheme Funding) Regulations 2005;
- The Occupational Pension Schemes (Disclosure of Information) (Amendment) Regulations 2005; and
- Finally, consultation papers on proposals for transitional arrangements and consequential amendments.

The consultation period runs until 6 May 2005. Copies of the documents can be found at: <http://www.dwp.gov.uk/consultations/consult/2005/funding-pension-schemes/index.asp>

4 SCHEME FUNDING PROCESS

We have picked out below some of the key examples of where further information on the scheme funding process has been given in the consultation documents.

- The draft Code requires that the trustees set an action plan for the actuarial valuation, as there will be an overall time limit of 15 months from the effective valuation date for completion of the scheme funding process built into the Regulations. (This includes any action which the trustees may need to take to reach agreement with the employer on the contribution rate.)

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- In calculating liabilities, trustees must, under the draft Regulations, choose discount rates prudently, taking into account either or both the anticipated yield on fund assets and redemption yields on high quality bonds.
- The draft Code requires that trustees must “understand the implications of the alternative permitted funding methods” and then choose both the method and the actuarial assumptions for calculating the technical provisions prudently but falls short of giving an indication of what would be considered “prudent” (a term which is also used in the draft Regulations). There are 13 numbered points regarding the liability valuation alone which the trustees are advised to consider.
- The draft Code requires that trustees should act “independently and robustly when negotiating with the employer” (and includes a section on dealing with potential actuarial advice conflicts). It also advises that trustees “may need to sign a confidentiality agreement to obtain sensitive information from the employer”. The consultation asks if sufficient guidance is given on the negotiation aspect, and whether mediation may have a role.
- As expected, the draft Regulations include an exception to the general requirement that trustees must obtain the agreement of the employer to the contribution rate. The exception applies “in the case of a scheme under which there is a discretion to fix the rates of contributions, or the amount of any contribution, payable towards the scheme without the agreement of the employer”. Where agreement is not required, the trustees must consult the employer.
- Trustees should “ensure that any recovery plan aims to eliminate the shortfall within a finite time and that it is realistically capable of being followed ... [and] should seek to avoid adopting recovery plans which are ‘back-end-loaded’”. The draft Code also sets out a number of recovery plan structures likely to be acceptable and the Regulations set out factors to be taken into account. The trustees are required to send the recovery plan to the Regulator

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within 5 days of the schedule of contributions being certified.

- As with MFR, the trustees are obliged to keep the scheme funding documents under review – the draft Code gives guidance on the type of situations where review is required and includes, for instance, where an employer ceases to participate in the scheme or the strength of the employer covenant has changed (in this context the draft Code suggests that “trustees should be alert to information about the employer which is in the public domain”).

5 DISCLOSURE

Information on funding levels will be added to the list of disclosure requirements. Trustees will be required to provide members and beneficiaries with an “annual funding statement”, not later than 12 months after the end of the scheme year (and the first statement will need to be provided by 22 September 2006). Initially, for most schemes, this will be on an MFR basis.

Where an SFO valuation exists, the disclosure will need to include “as a minimum” summaries of:

- the most recent actuarial valuation (plus the SFP, on request);
- the solvency position of the scheme (and the impact of PPF protection); and
- any recovery plan.

Specimen statements are annexed to the Guidance document.

6 TRANSITIONAL ARRANGEMENTS

The proposed transitional provisions will require trustees to obtain their first SFO valuation with an effective date no later than three years after the effective date of the last MFR valuation. (Where an existing scheme is subject to the new scheme funding requirements but there is no previous MFR valuation, the trustees will be required to obtain their first valuation with reference to an effective date no later than 12 months after the commencement date.)

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PA 2004 requires trustees or managers to obtain actuarial valuations annually, but permits valuations every three years if they obtain actuarial reports for the intervening years. The requirement to obtain actuarial reports will only apply to trustees after they have obtained their first actuarial valuation under the new scheme funding provisions.

7 CONSEQUENTIAL AMENDMENTS

- Employer debt on exit - the consultation paper on consequential amendments notes that MFR is used for determining liabilities attributable to an employer exiting an ongoing scheme and states that "the MFR will continue to be used in such schemes until they obtain their first scheme funding valuation". It is unclear how this interrelates with the intention to lift this debt to full buy-out in the near future (originally scheduled for April 2005 but now seemingly postponed to July).
- Transfers - in future cash equivalent transfer values (CETVs) will be based on the SFO although schemes will be able to continue to base CETVs on the MFR until the scheme in question has obtained an SFO valuation.

8 CONCLUSIONS

These new provisions are complicated but the draft Code and Guidance add flesh to the bones of the scheme funding provisions contained in PA 2004.

SFO will be a tougher test than the current MFR and we expect many schemes to have to submit recovery plans to the Regulator. Transitional arrangements mean that SFO will only affect schemes at their next triennial valuation due after 23 September 2005. But trustees should be aware that Opra has made it clear that any valuations not due before 23 September 2005 whose effective date is brought forward without good reason will be viewed with suspicion.