



## Pensions Act 2004

### The New Funding Framework – update

In Buck Issues 97, published in July, we outlined the new defined benefit funding framework that was intended to replace the minimum funding requirement legislation from 23 September 2005. Since then, the date for finalisation of the legislation and the Pension Regulator's code of practice has been put back twice and they are now not expected to be in place before December. It will nevertheless apply to any valuation effective on or after 22 September that has not been signed off by 30 December.

Although we still don't have final details of the legislative framework, what has recently been published is a consultation document from the Regulator, setting out how it intends to implement the legislation. Bearing in mind that the nature of the new regime is to avoid legislative prescription, it is the Regulator's thinking on what will be regarded as reasonable that is all important. The latest document is therefore of considerable interest to trustees and employers.

The consultation will run until 26 January 2006, after which the Regulator will issue a policy statement, providing guidance on how it will regulate the funding of defined benefit schemes. The consultation paper contains a draft of this statement, and the remainder of the document essentially expands upon the rationale behind what is proposed. We highlight some of the key issues below.

#### Overview of proposed regulatory approach

Under the post April 2005 regime, the Pensions Regulator will receive information relating to scheme funding in a number of ways, such as through the annual scheme return, through any matters referred to it under the legislation (such as details of any funding recovery plan) and even possibly as a result of whistleblowing reports.

In order to focus its investigative effort, the Regulator will set trigger points to help identify those schemes where more detailed consideration may be appropriate. Separate triggers are envisaged: one related to the target level of funding (technical provisions) and the other related to term and structure of any recovery plan. Inevitably, there are links between the two.

## Funding target – technical provisions

Under the legislation, trustees will be responsible for making a prudent choice of assumptions for the calculation of a scheme's technical provisions, having obtained and considered the advice of their actuary. Legislation will not define what is prudent, nor be prescriptive in setting other parameters.

The Regulator's code of practice is likely to contain the following messages:

- prudence is scheme-specific; that is, it relates to the circumstances of each scheme;
- trustees are not obliged to seek to eliminate all risks. In particular, legislation does not require full buyout funding for an ongoing scheme. It is not necessarily imprudent to include some element of equity out-performance relative to bonds if the employer's covenant appears strong enough;
- trustees should pay particular attention to future improvements in mortality;
- trustees should consider an overall level of prudence consistent with the confidence they want to have that the technical provisions will prove adequate; and
- the assumptions underlying the full solvency calculation provide useful reference points.

The code of practice is also likely to state that decisions on assumptions should take into account the circumstances of the scheme and, for the investment return assumption, the strength of the employer's covenant.

The lack of legislative prescription has led to much concerned debate about just what level of funding will be considered appropriate in practice. It is therefore helpful, if not entirely encouraging, that the Regulator has given some indication of its trigger points. In the area of funding, it is not totally clear what is being said but the proposal seems to be to use a trigger range, expressed as a percentage of full buyout, but linked to both FRS17 and PPF funding levels. For a typical scheme, a range of 70% to 80% of buyout might be appropriate. Schemes targeting a level of funding below this level will be considered in more detail.

## Recovery plan triggers

Where a valuation shows a scheme to be funded below its technical provisions, a recovery plan has to be agreed between the trustees and employer. The plan should be designed to bring the funding up to the technical provisions within a given period. Again, the legislation is non-prescriptive as to the recovery period or pattern of contributions. The Regulator envisages using the following basic triggers to determine whether it will wish to investigate a recovery plan further:

- the recovery period is ten years or longer. This is because of the risk of a significant deterioration in an employer's financial position over periods this long;
- the recovery period is less than ten years and the Regulator considers that the financial position of the employer is such that it could reasonably clear the shortfall in a shorter period, bearing in mind the strength of the funding target (technical provisions);
- the recovery plan appears to be significantly back-end loaded (higher contributions towards the end).

If a trigger is activated, the Regulator will need to consider other factors before deciding whether it needs to intervene. These factors may include:

- the level of technical provisions being targeted;
- the financial position of the employer;
- whether the scheme holds contingent security;
- what action has been or is being taken to reduce future benefit accrual; and
- the size of the scheme.

## Contingent security

The Regulator fully accepts that the use of contingent security can have a valuable part to play in the risk management of a pension scheme and wishes to investigate further how such security should be taken into account when assessing funding arrangements that would otherwise be regarded as unacceptable. Such contingent security might take the form of a third-party or intra-group letter of guarantee, or earmarked assets of one form or another that would go to the pension scheme in the event of the sponsoring employer's insolvency. Contingent security does not, of itself, improve the solvency of the scheme over a finite period but, depending on its nature, should make the trustees and the Regulator more able to accept recovery plans that would otherwise be regarded as imprudent.

## How the Regulator intends to use its powers

The stated intention is that the Regulator will use its powers to intervene sparingly, assuming that trustees and employers will usually wish to secure an appropriate level of funding of the pension scheme and hence comply with the legal requirements. It will help them do this where appropriate with explanation and encouragement.

It is also encouraging to note that it will not seek to overturn past decisions by the trustees where they acted reasonably in deciding that their assumptions were prudent and that they adequately protect members' interests. Nor will it reach a judgement on the trustees' decision-making retrospectively, on information that they could not reasonably have been expected to have, or views they could not reasonably have been expected to hold, at the time they made their judgements. Such sentiments are very welcome: we hope they are borne out in practice and continue to be at the heart of the regulatory approach.

Before taking any decision on appropriate action to take and powers to use, the Regulator may:

- make an assessment of the degree of knowledge and understanding shown by the trustees in their discussions with the employer;
- make an assessment of the employer's part in discussions with the trustees;
- have regard to the party who can set the contribution rate according to the trust deed;
- take account of the strength of the scheme's funding basis in comparison with the cost of securing benefits with an insurer;
- take account of the employer's financial strength and prospects;
- take independent advice on this aspect;
- consider whether the employer is under-resourced or a service company;
- consider whether other matters, for example, poor administration or notifiable events, have been brought to its attention
- take account of the scheme's membership profile; and
- take account of the scheme's investment policy.

Where appropriate, it will refer trustees to relevant parts of the Regulator's code of practice and suggest actions that would secure compliance with the legislation and allow a reasonable time for these actions to be completed. It will always indicate the time after which, if compliance has not been achieved, it will consider using its formal powers.

## Schemes still subject to the minimum funding requirement (MFR)

Schemes will not normally be required to complete a valuation under the new legislation until the third anniversary of the last valuation prior to 23 September 2005. However, this will not stop the Regulator looking further at the funding position of schemes based on their latest declared MFR funding position. Where the Regulator identifies that a scheme is less than 110% funded on the MFR basis, it may examine whether the trustees have taken all appropriate actions to improve funding or, if necessary, have considered bringing forward their first valuation under the new basis.

## Conclusion

We already knew that the funding of defined benefit schemes would be taking an even more crucial place on trustee's and sponsoring employer's agendas. Although the Regulator's proposals are still in consultation, it is probably safe to say that we are now in a position to begin meaningful discussions on the subject. We will be in contact with our clients in due course, but please contact us if you wish to start the dialogue earlier. We will also be running seminars on this topic early in the new year.

Our view is that there will be a move to setting funding targets akin to FRS17, which calculates liabilities based on a corporate bond or debt basis. Although this may be unpopular, it seems to be the logical implication of the Regulator's latest pronouncement. This does not necessarily mean that we will see investments primarily in corporate debt. Scheme investment policy, and likely changes under the new funding framework, is an interesting topic that we will cover in a future Buck Issues.

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