



## Pensions Act 2004

### The new funding framework

We have now seen many pieces of the new “funding framework” that will come into place for defined benefit pension schemes with effect from 23 September 2005. The Pensions Act 2004 introduces the legislation. Draft Scheme Funding Regulations and a draft Code of Practice on funding have been issued. A consultation process on the drafts has now closed and we await any changes. However, we do not expect them to be fundamental. The other missing piece of the jigsaw will be an Actuarial Guidance Note for Scheme Actuaries.

The present much criticised Minimum Funding Requirement (MFR) will be consigned to the dustbin as schemes adopt the new basis. Schemes will have to comply with the new legislation when they carry out their next regular triennial valuation. However, they can comply earlier by carrying out an “out of cycle” valuation from 23 September 2005.

This document outlines many of the features of the new legislation including:

- a summary of the main legislative requirements
- the required content of the new annual funding statement and the statement of funding principles
- items on which Trustees need to take advice
- information Trustees may require
- a possible action plan for an actuarial valuation.

Fundamentally, for the majority of pension schemes, the new funding requirements will pass additional powers to trustees when it comes to setting contributions. They will be responsible for choosing the actuarial method and assumptions after taking advice from the actuary. However, where trustees are acquiring new powers, they will need to seek agreement from the sponsoring employers to their chosen approach.

There is to be no prescribed set of actuarial assumptions. The trustees have freedom of choice provided they adopt ‘prudent’ assumptions. However, ‘prudent’ will not be defined.

They will also need to look at the likely ongoing strength of the sponsor to assess the future ability to pay contributions. The new Pensions

Regulator has stated that trustees should act “robustly” with employers and try to make Recovery (deficit run off) Periods as short as possible.

The Regulator has powers to intervene in the funding process, although, he seems to prefer not to be called in to settle disputes until trustees and sponsoring employers have exhausted negotiations.

We cannot say whether the new regime will mean additional contributions from employers – only time will tell. However, we can be certain that pressure will be upwards only.

Actuarial valuations can either be annual, or remain on the presently typical three-year cycle with annual updates. For the first time it will be compulsory to pass detailed scheme funding information to all members, including deferreds, via an annual funding statement. It was originally intended that the first such statement had to be issued prior to 23 September 2006, irrespective of the date of the first valuation on the new basis. However, it would now appear that the Regulator will be happy for publication to be delayed until after that valuation. Once issued employers and trustees can expect a number of probing questions.

Trustees and employers should start assessing the consequences of the new legislation now. We recommend that you discuss the implications with your actuary.

## Scheme funding - summary of provisions

### Main legislative requirements at a glance

#### Key elements

- A **statutory funding objective** for all schemes to fund their technical provisions
- A **statement of funding principles** specifying how the statutory funding objective will be met
- Periodic **actuarial valuations and actuarial reports**
- A **schedule of contributions** specifying rates of contributions due to be paid by the employer and active members
- A **recovery plan** where the statutory funding objective is not met.
- An **annual funding statement** providing information about the scheme.

#### To whom do the requirements apply?

- Trustees of most private sector funded occupational schemes providing defined benefits.

#### Who else needs to be involved?

- **The sponsoring employer**  
The employer's agreement is required to cover:
  - how the scheme's technical provisions are to be calculated
  - the statement of funding principles
  - how the statutory funding objective will be met
  - the schedule of contributions and any recovery plan.
- **The scheme actuary**  
The scheme actuary will, following the trustees' instructions:
  - prepare the periodic actuarial valuation
  - provide advice about funding principles, calculation of technical provisions, the schedule of contributions, any recovery plan or modification of future benefit accrual rates
  - certify the calculation of the technical provisions and the adequacy of the schedule of contributions or advise the Pensions Regulator of failure to do so.

### What should be in the annual funding statement?

A statement must be issued to members within twelve months of the end of each scheme year. However, there is now some uncertainty as to when the first statement will be required.

Where a statutory funding objective valuation has been prepared, the statement should include:

- an explanation of any changes in the funding position since the last statement in relation to the technical provisions, or to the cost of securing, with an insurance company, accrued leaving service benefits, and of any difference between these two funding positions
- a summary, based on the most recent actuarial valuation and any subsequent actuarial reports, of the extent to which the scheme assets were sufficient to cover the technical provisions
- a summary of the estimated scheme solvency position as shown in the most recent actuarial valuation
- a summary of any recovery plan
- a summary of the scheme's investment policy as it relates to achievement of the statutory funding objective
- a summary of the protection offered by the Pension Protection Fund (PPF) as it relates to the particular benefits promised by the scheme, and who to contact if members need more information about the PPF
- a statement that the documents prepared in connection with the scheme's funding are available on request.

If an annual funding statement is needed before the first statutory funding objective valuation has been prepared, the statement should include:

- a summary of the funding position as shown in the most recent MFR certificate, together with a statement showing the period over which any funding shortfall identified with such a certificate is to be corrected
- a statement that the documents prepared in connection with the scheme's funding are available on request
- if available, the funding position at the last full actuarial valuation in relation to the cost of securing, with an insurance company, accrued leaving service benefits
- when the trustees expect to have in place the first schedule of contributions under the new regime
- a summary of the protection offered by the PPF as it relates to the particular benefits promised by the scheme, and who to contact if members need more information about the PPF.

In the case of active (and in some cases deferred) members, trustees should issue the annual funding statement to members at the same time as annual benefit statements (where these are issued automatically). Trustees may, if they wish, combine the two statements in one document.

## What needs to be in the statement of funding principles?

Trustees must prepare, periodically review and revise as necessary, a written statement of their policy for securing the statutory funding objective.

The first statement must be prepared within fifteen months of the effective date of the first valuation under the new legislation and then revised within fifteen months of subsequent valuations.

The statement records any decisions by the trustees or managers on:

- the methods and assumptions to be used in calculating the scheme's technical provisions; and
- the period over which a failure to meet the statutory funding objective would be rectified, and the manner in which it will be rectified.

The statement should also include the following matters:

- any funding objectives provided for in the scheme rules, or which have been adopted by the trustees, in addition to the statutory funding objective
- any direction from the Pensions Regulator to which the scheme is subject
- whether there are arrangements for a third party to contribute to the scheme and, if so, the circumstances in which they apply
- whether there is power to make payments to the employer out of scheme funds and, if so, the circumstances in which that power may be exercised
- whether there is a discretionary power to provide benefits for, or in respect of, all or any of the members and, if so, the trustees' policy for exercising the power
- the manner in which cash equivalents are calculated, and whether cash equivalents may be reduced because of the state of the scheme's funding, and if so, the way in which they will be reduced
- the intervals at which the trustees will obtain actuarial valuations, and the circumstances in which and occasions on which, they will, or will consider whether to, obtain additional valuations.

## Information the trustees may require

In order to negotiate, and to protect scheme members' interests, trustees need to understand the sponsoring employer's financial position and the strength of its commitment to the funding of the scheme. They should monitor corporate activity and seek the employer's agreement to be given information at an early stage, subject to the usual restrictions such as those on handling price-sensitive information. If the trustees are concerned, they should raise their concerns with the sponsoring employer and, where appropriate, other companies in the group.

Trustees can also contact the Pensions Regulator, which will be able to help and advise them.

## What trustees need to agree / take advice on

The table on the right summarises matters on which trustees are normally required to seek the agreement of the employer and advice from the scheme actuary. Where the trustees or actuary currently have the power to set contributions the provisions differ.

Component	Agreement, advice or action
Technical provisions – agreement of assumptions and method for use in calculation of	Advice of actuary Actuarial certification of calculation Agreement of employer
Statement of funding principles	Advice of actuary Agreement of employer
Actuarial valuations	Produced by actuary Obtained by trustees Made available to employer
Recovery plan	Advice of actuary Agreement of employer
Schedule of contributions	Advice of actuary Actuarial certification of consistency with statement of funding principles and adequacy to meet statutory funding objective Agreement of employer

The type of questions that the trustees may wish to put to the company when negotiating over contribution rates could include:

### Questions about the company

1. Can the company provide the trustees with information that demonstrates the viability of the business and strength of the employer's covenant to the scheme. The company should note that the code of conduct obliges the trustees to undertake this analysis?
2. What would be the impact on the company of making a contribution at various levels?
3. As an alternative to contributions, is there any form of tangible security that could be provided to protect beneficiaries from the risk of insolvency?
4. Are there any impending membership movements which could have a potentially significant effect on funding?



## Action plan for an actuarial valuation

An important feature of the legislative requirements relating to actuarial valuations is the absence of separate deadlines for the various stages, other than the overall deadline of 15 months from the effective date of the actuarial valuation for most schemes.

Trustees should therefore draw up an action plan following discussions with the employer and in conjunction with their scheme actuary. They should consider starting at least three months before the valuation's effective date. The plan needs to factor in some margins for contingencies and make allowance for taking actuarial advice and reaching agreement with the employer. Trustees should press ahead with its implementation even if full agreement cannot be reached with the employer. The trustees should circulate the plan and any subsequent amendments to all relevant parties.

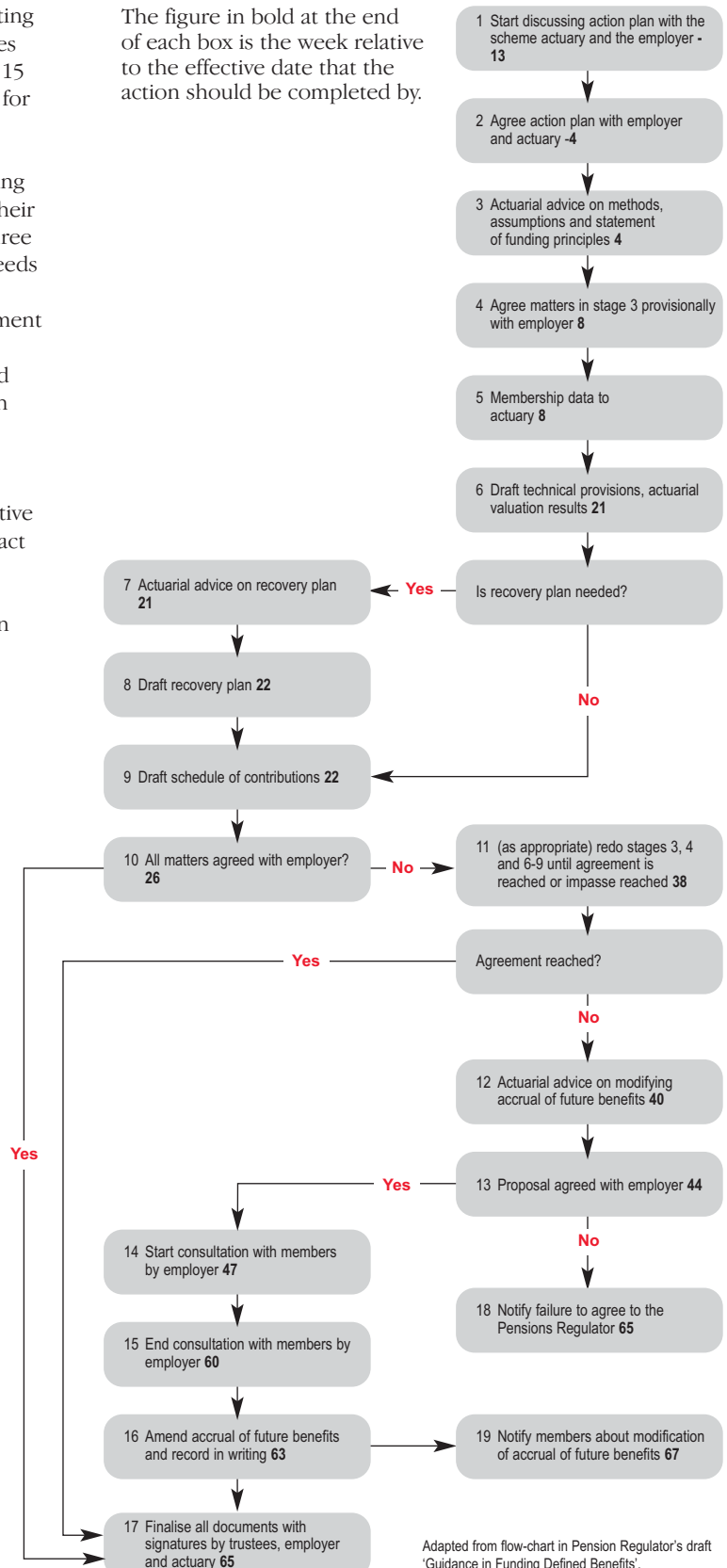
Trustees should aim for initial calculations of technical provisions to be available within five months of the effective date. This will allow adequate time for assessing the impact of these results, discussing them with the employer and, if necessary, making amendments to the method and assumptions to arrive at a mutually acceptable calculation of the technical provisions.

When drawing up an action plan trustees and employers need to consider the possible need for the employer to consult with employees about modification of future pension accrual.

The action plan should allow time for consideration of a recovery plan where there is a shortfall, allowing for contingencies such as modifying future accrual of benefits. Trustees should identify potential areas for disagreement with the employer early on in the process to allow adequate time for their resolution.

Trustees should actively monitor adherence to the action plan and prompt relevant parties when actions are needed from them under the plan.

The figure in bold at the end of each box is the week relative to the effective date that the action should be completed by.



Adapted from flow-chart in Pension Regulator's draft 'Guidance in Funding Defined Benefits'.

## Glossary of terms

### **Statutory funding objective**

Every scheme subject to the scheme funding requirements must adopt the statutory funding objective, which means having sufficient and appropriate assets to cover its technical provisions.

### **Technical provisions**

The technical provisions are an estimate of the assets needed to make provision for the benefits when they fall due.

### **Statement of funding principles**

This sets out in writing the trustees' policy for securing the statutory funding objective. The statement must also record decisions by the trustees as to the method and assumptions used for calculating technical provisions. It must include the trustees' policies on various other matters relevant to funding, including how they would eliminate any shortfall and the period over which this would be achieved. The statement is subject to review at each actuarial valuation but may be reviewed beforehand.

### **Recovery plan**

If, as a result of an actuarial valuation, the scheme's assets are less than its technical provisions, there will be a shortfall. Trustees of most schemes must then agree a recovery plan with the employer. This plan must aim to meet the statutory funding objective within a stated period by the payment of additional employer contributions.

Trustees must send a copy of any recovery plan to the Pensions Regulator within a reasonable period, accompanied by a summary of the information contained in the most recent actuarial valuation.

### **Schedule of contributions**

Ongoing contributions, and contributions required by virtue of any recovery plan, must be shown separately in a schedule of contributions covering a five-year period, setting out due dates and amounts. Trustees must subsequently monitor adherence to the schedule and report materially significant payment failures to the Pensions Regulator.

### **Actuarial valuations and reports**

Trustees must arrange for a written valuation of the assets and technical provisions of the scheme from the scheme actuary to assess whether the statutory funding objective is being met. They must be undertaken annually, although valuations may take place every three years if the trustees arrange for actuarial reports for the intervening years.

### **Annual funding statement**

The annual funding statement is issued automatically to all scheme members and beneficiaries, and is their primary source of information on funding matters. The document must be clear and understandable, with any technical terms used explained, and undefined jargon avoided.

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