



Pensions: changes to scheme funding requirements

Pensions Act 2004

Employment, pensions and benefits: briefing 145

Summary

The new pension funding regime to replace the minimum funding requirement comes into force on 30 December 2005. Final regulations have now been published, together with a code of practice. The new regime will apply to relevant defined benefit occupational pension schemes following their next actuarial valuation with an effective date on or after 22 September 2005. Additionally, the Pensions Regulator has recently published a consultation document that provides an insight into how it intends to monitor and investigate funding arrangements under the new regime.

Scheme-specific funding

The new legislation

Under sections 221 to 223 of the Pensions Act 2004 the current minimum funding requirement (MFR) is to be replaced with a scheme-specific funding requirement. Much of the detail of the new regime is set out in The Occupational Pension Schemes (Scheme Funding) Regulations 2005 (referred to as the Funding Regulations). They come into force on 30 December 2005.

In addition to the Funding Regulations, the Pensions Regulator (TPR) has issued a code of practice. It also published (on 31 October 2005) a consultation document entitled 'How the Pensions Regulator will regulate the funding of defined benefits'. This identifies the proposed approach that TPR intends to adopt in relation to implementing the new funding regime. Consultation closes on 26 January 2006.

When will the new regime apply?

The Funding Regulations clarify that the new regime will apply to schemes with effect from the date of their first actuarial valuation after 22 September 2005. Until that time the MFR will continue to apply to schemes. One aspect of the new regime applies to all schemes immediately: a requirement to send pension scheme members an annual funding statement. The first one must be issued before 22 September 2006.

What schemes are excluded?

Certain occupational schemes are excluded from the new regime, including schemes that provide only money purchase benefits (and insured death benefits) and unapproved schemes with fewer than 100 members.

Key features of the new regime

Statutory funding objective

Every scheme will be subject to a statutory funding objective (SFO): a scheme must have sufficient and appropriate assets to cover its 'technical provisions' (the term used in the EU directive which means, broadly, the amount of assets a scheme needs to hold now, on the basis of the actuarial methods and assumptions used, in order to pay its accrued benefits as they fall due in the future).

The Funding Regulations give more detail on how the technical provisions of a scheme are to be calculated. A key change is that under the Funding Regulations, trustees must determine the actuarial methods and assumptions to be used, having obtained advice from the scheme actuary. The Funding Regulations provide that:

- an accrued benefits funding method must be used (described in the code of practice);
- in calculating the technical provisions the trustees must take into account the actuary's estimate of the solvency of the scheme on a buy-out basis and act in accordance with a set of principles; and
- the principles require a large degree of 'prudence' to be used in, for example, choosing the actuarial assumptions and the discount rates (but unhelpfully prudence is not defined).

Statement of funding principles

Within 15 months of the date of the first valuation under the new regime, the trustees must prepare a statement of funding principles (SFP). This is the written statement of

their policy for ensuring that the SFO is met. The statement must record the methods and assumptions used in calculating the scheme's technical provisions.

Actuarial valuations and reports

As under the current regime, actuarial valuations must be prepared at least every three years. These must be based on a funding approach consistent with the strategy set out in the scheme's SFP and annual reports. The Funding Regulations provide that actuarial valuations must contain the actuary's certification of the calculation of the technical provisions and the actuary's estimate of the solvency of the scheme.

In addition to triennial valuations there must be annual actuarial reports, and following each actuarial valuation or report, members and beneficiaries must be sent a summary funding statement.

Actuarial valuations must be in place within 15 months of the effective date and reports must be in place within 12 months. (Transitional arrangements apply where a scheme's valuation has an effective date between 22 September 2005 and 29 December 2005. For such valuations the period is extended to 18 months.)

Recovery plan

If the valuation shows that the SFO is not met, the trustees must put in place a recovery plan, setting out the period over which the deficit is to be remedied. A copy of each recovery plan must be sent to TPR. These must similarly be in place within 15 months of the effective date of the actuarial valuation.

The code of practice includes some useful points for the trustees to take into account when considering the structure of a recovery plan, eg a shorter recovery period is likely to be appropriate if most of the members are already in receipt of pension or if there may be difficulty in pursuing an overseas employer.

Schedules of contributions

Schedules of contributions for five-year periods must be in place within 15 months of the effective date of the actuarial valuation. The code of practice makes recommendations as to how the schedule should be structured in the interests of clarity and how certain items need not be included, provided an explanatory

note appears (eg professional fees met directly by the employer). It specifically states that the PPF levy should be treated as an annual expense item, and if it forms part of the employer's overall contribution rate a note to this effect should be included, indicating the assumed annual amount of the levy.

Employer agreement/consultation?

The Pensions Act 2004 and the Funding Regulations provide that the trustees must agree with the employer each of the SFP, the recovery plan and the schedule of contributions.

But this requirement for employer consent does not apply where the relevant scheme trust deed gives the trustees unilateral power to determine the employer contribution rate with no power for the employer to suspend contributions. In those cases the trustees must instead consult with the employer about each of these matters. The requirement for agreement with the employer still applies if, for example, it is currently the scheme actuary who fixes the employer contribution rate or if employers have the power to suspend their contribution obligation under the deed.

Where the new regime requires trustees to agree the funding rate with the employer, but they fail to reach agreement, the matter must be referred to TPR, who will have the power to give directions including imposing a schedule of contributions for the scheme.

To determine whether the new regime will change the current balance of power, employers and trustees should look at the funding rules in their governing trust documentation. A summary of the position is set out in the code of practice: see below.

Rules of the scheme

Trustees have, unrestrained by conditions, the power to determine the contribution rate and no other person has the power to reduce or suspend contributions.

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The contribution rate is determined by, or on the advice of, a person other than the trustees or the employer (usually the actuary).

Effect of legislation

Trustees are required to consult the employer but the employer's agreement is not required (paragraphs 9(1) to 9(3) of Schedule 2). The code of practice recommends, however, that the trustees should seek to obtain the employer's agreement.

If the conditions are satisfied, trustees are required to consult the employer but the employer's agreement is not required (paragraphs 9(1) to 9(4) of Schedule 2). The code of practice recommends, however, that the trustees should seek to obtain the employer's agreement.

Trustees must obtain the employer's agreement. They must take into account the recommendations of the other person on the method and assumptions for calculating the technical provisions and on the preparation of any recovery plan (regulations 5(3)(b) and 8(2)(e)); TPR must also take into account this other person's recommendations when exercising any of its Part 3 powers, see section 231(2) and regulation 14(1)).

Source: TPR code of practice

Code of practice

Parts of the code of practice have already been referred to. The code is much more detailed than TPR's draft of March 2005. It aims to summarise the requirements of the Funding Regulations as well as cross-refer to other codes of practice (eg notifiable events) where appropriate. It introduces a system of symbols, or flags, to indicate where the principle being set out is varied in certain cases (eg cross-border schemes, schemes with fewer than 100 members).

The code of practice recommends that the trustees put in place an action plan for the valuation process, taking into account all the steps which will need to be taken and the dates for completion of each step. It also emphasises the importance of record keeping, especially in relation to decisions made, and of employers and trustees providing each other with information and keeping an open dialogue.

The legislation contains numerous references to steps being taken within 'a reasonable period'. The code gives guidance on what constitutes a reasonable period, eg a recovery plan should be sent to TPR within 10 working days, as should a report to TPR that the trustees and the employer have failed to reach agreement where required. A report to TPR of contribution failure should similarly be made within 10 working days but where an immediate report is required, the trustees should make their initial report by telephone and follow it up in writing.

Next steps

Employers and trustees should examine their trust deed and rules to check the current balance of power. The Funding Regulations envisage that all the relevant documents (the SFO, the SFP, the valuation and the recovery plan) should be in place within 15 months (18 months in transitional cases) of the effective date of the scheme's actuarial valuation. Schemes should start thinking about how to manage the process in good time before the next effective date. Additionally, the first summary funding statement will need to be sent to members before 22 September 2006.

Multi-employer schemes should consider putting in place arrangements to nominate one employer to act for the others (eg on consultation and agreement) – see our briefing no 126, *Multi-employer pension schemes* (March 2005).

For further information please contact

Sarah Swift
T + 44 20 7427 3561
E sarah.swift@freshfields.com

