

GN 27: Retirement Benefit Schemes - Minimum Funding Requirement

Classification

Practice Standard

Application

An actuary to an occupational pension scheme appointed under Section 47 of the Pensions Act 1995.

Legislation or Authority

Pensions Act 1995 (c 26)('the Act'). Sections 56 to 61.

The Occupational Pension Schemes (Minimum Funding Requirement and Actuarial Valuations) Regulations 1996. SI 1996/1536 , as amended by paragraph 8 of Schedule 1 to The Personal and Occupational Pension Schemes (Miscellaneous Amendments) Regulations 1997. SI 1997/786 ('the MFR Regulations').

The Occupational Pension Schemes (Scheme Administration) Regulations 1996. SI 1996/1715.

Northern Ireland has its own body of law relating to pensions and, in relation to Northern Ireland, references to the Great Britain legislation contained in this Guidance Note should be read as including references to the corresponding Northern Ireland legislation. Appendix 1 shows Northern Ireland legislation corresponding to the Great Britain legislation mentioned in this Guidance Note. Except as indicated in the table there is no difference in the numbering of the provisions mentioned in this Guidance Note.

This Guidance Note has been approved by the Secretary of State in accordance with Section 119 of the Act and the Department of Health and Social Services for Northern Ireland in accordance with Article 116 of the Pensions (Northern Ireland) Order 1995.

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Status

Approved under Due Process (Technical Amendment).

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1 Introduction

- 1.1 Under Section 57 of the Act Trustees are required periodically to obtain a valuation from the actuary on the prescribed basis. Under Section 58, Trustees are also required to prepare a Schedule of Contributions which must be certified by the actuary. In addition the actuary must periodically certify the Schedule of Contributions in accordance with Section 57(1)(b).
- 1.2 Schemes to be covered are those defined in Section 56(2) of the Act and the MFR Regulations.
- 1.3 The actuary's advice should be addressed to the Trustees of the scheme.
- 1.4 In this Guidance Note, the MFR Effective Date means the effective date as defined in Section 56(5)(d) of the Act.

2 MFR Valuation and Schedule of Contributions: Principles

- 2.1 The Secretary of State has instructed that, in addition to the principles set out in the MFR Regulations, the Minimum Funding Requirement ('MFR') should be interpreted in accordance with the principles set down in 2.1.1 to 2.1.6.
 - 2.1.1 Subject to 2.1.2., any non-pensioner should be assumed to retire at the end of the switch-over period as defined in MFR Regulation 7(10).
 - 2.1.2 Any non-pensioner who has reached the end of the switch-over period should be assumed to retire at the MFR Effective Date with an immediate pension and their benefits should be valued accordingly.
 - 2.1.3 It should be assumed that average equity returns will exceed average gilt returns by 2% per annum, but in the period prior to the end of the switch-over period this excess should be reduced to 1% per annum to give a reasonable expectation of achieving equivalent benefits through a Personal Pension.
 - 2.1.4 It should be assumed that a scheme has been, and will continue to be, administered efficiently and that records are kept in good order.
 - 2.1.5 An expense provision in relation to money purchase liabilities need only be included if the scheme rules say that expenses cannot be met out of the assets attributable to those liabilities.
 - 2.1.6 Any opinion on the Schedule of Contributions should reflect a prudent view of the future without taking into account all possible unfavourable developments. In particular, it should not be based on an assumption that investment conditions will improve but should be based on an assumption that any favourable levels will revert to normal.

3 MFR Valuation Methodology

- 3.1 Accurate data should be used for calculating deferred benefit entitlements for employed members as at the MFR Effective Date where possible. Where accurate historical salary data is not available and estimates are required, it should be assumed that salaries have increased in line with actual increases in the Retail Prices Index.
- 3.2 If members have an unfettered right under the terms of the scheme to commute pension for a lump sum at retirement and the terms of commutation are specified in the scheme documentation, it should be assumed that the member will exercise this option to the maximum allowable degree if this would increase the amount of the scheme's liabilities. The same principle should be applied to other options under the terms of the scheme that the member might exercise at retirement. If members are entitled to commute the maximum amount allowed by the Inland Revenue, this should be assumed to be 2.25 times the annual amount of member's pension at retirement. If the option or the terms are subject to the discretion of the employer, Trustees or managers, no allowance should be made.
- 3.3 The value of the liabilities should not be limited to the value of the assets, even where the scheme rules may so provide. In particular, in the valuation of the liabilities in hybrid schemes which give a money purchase benefit subject to a defined benefit promise, the value of the defined benefit promise should not be limited to the value of the assets of the scheme, even if the rules of the scheme restrict the benefit promise where there are not sufficient assets in the scheme.
- 3.4 The liability in relation to money purchase benefits will, where contributions are accumulated, either in identifiable assets or otherwise, be the accumulated value at the MFR Effective Date, and, where contributions are used to provide minimum benefit rights payable as at a future date, be the value of those rights using the relevant assumptions specified in Appendix 2. Money purchase benefits which have been converted into defined pension rights on the retirement of the member should be valued in the same way as other benefits for pensioners.
- 3.5 Benefits for non-pensioners should be assumed to be payable in accordance with the principles set out in 2.1.1. and 2.1.2. For the purpose of this Guidance Note, the end of the switch-over period as defined in MFR Regulation 7(10) is referred to as the 'MFR pension age'. There will only be one MFR pension age for an individual member, but that age may vary between members of the same scheme, possibly dependent on whether early retirement rights apply to either the whole or just part of their pension. The MFR pension age is set, for an individual member, irrespective of whether GMP revaluation is added at a later date. In accordance with MFR Regulation 7(10), the MFR pension age for an individual member is set by

reference to the member's full benefit entitlement and it remains unchanged even when a transfer is made of part of the member's benefits (e.g. leaving only the GMP liability in the scheme).

- 3.6 Liabilities should relate only to benefits to which members are entitled. Therefore, whilst allowance should be made for discretionary benefits already granted, no allowance should be made for future discretionary benefits. In all cases allowance should be made for any associated benefit entitlements, such as survivors' pensions. No allowance should be made for any additions to money purchase benefits which are dependent on future investment performance.
- 3.7 Where there is any doubt as to the interpretation of the equal treatment rule under Section 62 of the Pensions Act 1995, the actuary should take advice from the Trustees.
- 3.8 The circumstance under which it is appropriate under MFR Regulation 5(4) to disregard the value of an insurance contract and the corresponding liabilities secured by the contract, or to adopt a value equal to the value of those liabilities, is that minimum payments under the contract are set out in the contract conditions. For this purpose, the amounts of the corresponding liabilities secured by the contract are to be taken as the liabilities which, but for the minimum payments under the contract, would fall to be met by other assets of the scheme, but excluding any liabilities which do not fall due within 12 months of the dates of the relevant minimum payments under the contract.
- 3.9 Any reasonable age definition and consistent revaluation periods (where applicable) for the purpose of the calculation will be acceptable.
- 3.10 For all liabilities, the demographic assumptions specified in Appendix 2 should be used. Where no assumption is specified, the actuary should use his or her judgement.
- 3.11 For each non-pensioner the liability should be calculated as the present value of the accrued benefits using the long-term financial assumptions specified in Appendix 2. In particular, subject to 3.15., the long-term effective rate of return on equities for pre MFR pension age should be used throughout deferment and the long term effective rate of return on gilts throughout payment. The calculated value will then be adjusted by multiplying by the factor:

$$(1+0.005n)$$

where n is the number of years before MFR pension age (with a maximum of 10).

- 3.12 The present value so calculated should then be adjusted by a Market Value Adjustment ('MVA') to allow for current market conditions. The method

of calculating the MVA is specified in Appendix 2. Subject to 3.15., the MVA for a person 10 years or more below MFR pension age should be the equity MVA and the MVA for a person within 10 years of MFR pension age should be a linear combination of the equity and gilt MVAs assuming a uniform progressive switch from 100% equity investment 10 years before MFR pension age to 100% gilt investment at MFR pension age.

3.13 For pensioners the liability should first be calculated as the present value of all payments due after the MFR Effective Date using appropriate current gilt yields as specified in Appendix 2.

3.14 If the liability calculated under 3.13. is greater than £100 million, and subject to 3.15., the liability should instead be calculated as:

the present value of payments due to be made within 12 years of the MFR Effective Date, using current gilt yields;

plus

if the present value of the payments in the first 12 years is less than £100 million, the present value of payments during such further period of integral years as is necessary to increase the total present value to at least £100 million, using current gilt yields;

plus

the present value of any remaining payments, using the assumed long-term effective rate of return on equities for post MFR pension age, multiplied by the equity MVA calculated in accordance with Appendix 2.

3.15 In the case of a scheme with a gilts-matching policy as defined in MFR Regulation 7(9), the calculation under 3.14. should not apply and, if the gilts-matching policy applies to deferred pensioners, the liability for deferred pensioners should be calculated assuming the long-term effective rate of return on gilts and the appropriate gilt MVA throughout.

3.16 An additional allowance should be made for the expenses connected with the closure of the scheme, continuation as a closed scheme and eventual wind-up as specified in Appendix 2. For the avoidance of doubt, where defined benefits are subject to a money purchase benefit underpin, an appropriate expense allowance should be included in both the defined benefit and money purchase liabilities (at the appropriate marginal rate and, in the latter case, only if relevant) before any comparison between the liabilities is made.

3.17 Assets should be taken into account at their audited market value with the exceptions specified in the MFR Regulations. An MFR Valuation should

not be completed in the absence of an audited market value as at the MFR Effective Date. Where appropriate, and in particular for an MFR Valuation under Section 57(2), the MFR Effective Date should be chosen to coincide with a date when an audited market value is available.

- 3.18 For the purpose of MFR Regulation 3(3), the value at the MFR Effective Date of any assets transferred prior to the MFR Effective Date shall be the value at the date of transfer adjusted by the return on the FTSE Actuaries All-Share Index over the period from the date of transfer to the MFR Effective Date. The value as at the MFR Effective Date shall be treated as being invested in equities.
- 3.19 The form of the actuary's Statement is specified in Schedule 1 to the MFR Regulations. Paragraph 2 of the Statement should be completed on the basis of the MFR calculations; it does not require the actuary to consider whether the method and assumptions specified for MFR accurately reflect what might happen if the scheme were to wind up. Where figures are required to be shown in paragraph 2, it should be assumed that the expense allowance specified in Appendix 2 is a first charge on the assets.

4 Schedule of Contributions

- 4.1 The certificate to be provided by the actuary should be in the form specified in Schedule 2 to the MFR Regulations.
- 4.2 The actuary is required to give a different certificate depending on whether or not it appears to him that the MFR was met at the date of signing the certificate (ie not the MFR Effective Date).
- 4.3 The actuary should only certify the Schedule of Contributions if the value of the contributions shown in the Schedule is no less than the value, as at the date of signing the certificate, of the aggregate of the MFR Regular Contributions and the MFR Contribution Adjustment calculated in accordance with Paragraphs 4.6. to 4.13. of this Guidance Note. The value comparison should be made over every period starting on the date of signing the certificate and ending on the annual anniversaries of that date falling within the period of the Schedule of Contributions, with a final comparison over the whole period of the Schedule.
- 4.4 The long-term effective rate of return on equities for pre MFR pension age set out in Appendix 2 should be used to calculate the values of actual or notional contributions during the period of the Schedule of Contributions. Any additional liabilities or special additional accrued rights should be valued using the long term assumptions appropriate to the nature of the liability or accrued right.
- 4.5 In estimating the position as at the date of signing the certificate the actuary should consider:

- 4.5.1. the difference between the value of the actual contributions paid since the MFR Effective Date and the aggregate value of the MFR Regular Contributions over that period and any special additional liabilities or special additional accrued rights assumed by the scheme. Special additional accrued rights are accrued rights not covered by the MFR Regular Contribution and would typically be augmentations agreed by the Trustees;
- 4.5.2. the difference in investment conditions as at the MFR Effective Date and the date of signing - this should be assessed by considering changes in the MVAs;
- 4.5.3. any changes in the Trustees' stated investment policy agreed and put into effect;
- 4.5.4. any investment transactions resulting in material gains or losses over the value as at the MFR Effective Date. Such transactions would normally only include property transactions.
- 4.5.5. It is not necessary to consider the investment returns actually achieved by the scheme, nor any general change in the MFR liabilities.
- 4.5.6. The notional position under 4.9 should be ignored.

4.6 **MFR Regular Contribution**

- 4.6.1. The actuary should assume that the additional MFR liabilities arising from additional accrued rights - either from the completion of further service, or from salary/earnings increases in excess of the rate of revaluation of accrued rights - during the period from the MFR Effective Date to the end of the period covered by the Schedule will be met by assets arising from the payment of MFR Regular Contributions.
- 4.6.2. The MFR Regular Contribution due each year should be the rate calculated on the Current Unit Method as at the MFR Effective Date. The Control Period should be appropriate to the circumstances of the scheme, taking into account any likely change in the active membership, but should not be longer than the period covered by the Contribution Schedule.
- 4.6.3. To calculate the MFR Regular Contribution, the actuary should:
 - 4.6.3.1. assume that any members past their MFR pension age retire immediately;
 - 4.6.3.2. allow for identifiable expenses due to be met by the scheme;
 - 4.6.3.3. calculate present values during the Control Period using the long term effective rate of return on equities for pre MFR pension age;

4.6.3.4 otherwise, use the long-term financial assumptions and demographic assumptions set out in Appendix 2. If for a particular matter, no assumption is set out in Appendix 2, the actuary is free to make any suitable assumption, provided, overall, the assumptions are reasonable and consistent.

4.7 **MFR Contribution Adjustment**

4.7.1. The actuary should assume that contributions equal to the MFR Contribution Adjustment will:

4.7.1.1 cover the effect of any mis-matching of assets;

4.7.1.2 if the value of the assets is less than the MFR liabilities, meet that shortfall of past MFR liabilities;

4.7.1.3 if the value of the assets exceeds the MFR liabilities, be available to meet future MFR liabilities.

4.8 The effect of any mis-matching should be determined by calculating the notional MFR surplus or deficit as at the date of signing the certificate in conditions where the MVAs are 100%. The MFR Contribution Adjustment should then be calculated from the less favourable result of the estimated MFR position in 4.5 above and this notional MFR valuation: that is by using the greater deficit, or the smaller surplus.

4.9 The notional MFR surplus or deficit as at the date of signing the certificate should be estimated as the difference between:-

4.9.1 the notional market value of the actual assets as at the MFR Effective Date were the market yields such that the MVAs would be 100%. This value should be taken as the value as at the date of signing the certificate subject to adjustment for any changes in the Trustees' stated investment policy agreed, and put into effect, between the MFR Effective Date and the date of signing the certificate; and

4.9.2 the MFR liabilities as at the MFR Effective Date using the long-term financial assumptions and MVAs of 100% plus the difference between:

4.9.2.1 the aggregate value as at the MFR Effective Date of the MFR Regular Contributions due and any special additional liabilities or special additional accrued rights assumed by the scheme over the period between the MFR Effective Date and the date of signing; and

4.9.2.2 the value of the actual contributions paid during that period.

4.9.3 (This difference should be the same amount as considered when estimating the MFR position as at the date of signing the certificate under 4.5 above.)

- 4.10 If the less favourable result of the estimated valuation and the notional valuation is a surplus, the MFR Contribution Adjustment is a single negative contribution equal to the surplus, payable as at the date of signing the certificate.
- 4.11 If the less favourable result is a deficit, the MFR Contribution Adjustment should be calculated as the total of:
- 4.11.1 the contributions to meet the estimated deficit, if any, as at the date of signing the certificate in accordance with MFR Regulation 17; and
- 4.11.2 the contributions payable annually in arrears, starting from the beginning of the period of the Schedule of Contributions, and either as a series of payments of equal amounts, or as a level percentage of the payroll, which, using the long-term financial assumptions, would eliminate the excess, if any, of the notional deficit over the estimated deficit above, or if the estimated position is a surplus, the whole of the notional deficit, before the end of the period of the Schedule of Contributions.
- 4.12 To calculate the notional value of the assets other than cash, UK equities and UK gilts, the actuary should:
- 4.12.1 treat property and overseas equities as though they were UK equities;
- 4.12.2 treat overseas fixed interest stocks as though they were UK fixed interest stocks;
- 4.12.3 treat insurance policies, other than policies which are stated to be linked to a particular asset category, as whichever category seems reasonable to the actuary, after having made enquiries as to the basis on which the surrender value is calculated;
- 4.12.4 treat any other investments which are not readily categorised, as cash. The actuary may, however, make appropriate allowance for the change in the market value of options and related market instruments that would result from a change to the notional market conditions.
- 4.13 The actuary need not take into account expected changes in the proportion of MFR liabilities which is measured by reference to gilt yields.

5 Periodical Certification of Contributions

- 5.1 The certificate to be provided by the actuary should be in the form specified in Schedule 3 to the MFR Regulations.
- 5.2 For the purpose of providing the certificate, the actuary should take into account the matters noted below over the period since the last MFR valuation:

- 5.2.1 All matters of which the actuary has been informed by the Trustees and the Employer in accordance with Regulation 6 of the Occupational Pension Schemes (Scheme Administration) Regulations 1996;
- 5.2.2 Changes in investment markets;
- 5.2.3 The Trustees' stated investment policy;
- 5.2.4 The investment return actually achieved by the scheme (if known);
- 5.2.5 The level of salary and pension increases granted (if known);
- 5.2.6 The actual contributions paid;
- 5.2.7 Any other matters of which the actuary is aware.
- 5.3 'Relevant changes' for the purpose of paragraph 2 of the certificate are any of the matters referred to in 5.2 above which have significantly affected the extent to which the MFR liabilities are met by the value of the assets.

Appendix 1 : Northern Ireland Legislation

GB Provision

'S148 Orders' under the Social Security Administration Act 1992 (c 5)

Pensions Act 1995 (c26)

Section

Section 119

Occupational Pension Schemes (Minimum Funding Requirement and Actuarial Valuations) Regulations 1996
SI 1996/1536

Occupational Pension Schemes (Investment) Regulations 1996
SI 1996/3127

Personal and Occupational Pension Schemes (Miscellaneous Amendments) Regulations 1997
SI 1997/786

Occupational Pension Schemes (Scheme Administration) Regulations 1996
SI 1996/1715

NI Provision

'S130 Orders' under the Social Security Administration (Northern Ireland) Act 1992 (c 8)

Pensions (Northern Ireland) Order 1995
(SI 1995/3213 (NI 22))

Article

Article 116

Occupational Pension Schemes (Minimum Funding Requirement and Actuarial Valuations) Regulations (Northern Ireland) 1996
(SR 1996 No 570)

Occupational Pension Schemes (Investment) Regulations (Northern Ireland) 1996
(SR 1996 No.584)

Personal and Occupational Pension Schemes (Miscellaneous Amendments) Regulations (Northern Ireland) 1997
(SR 1997 No.160)

Occupational Pension Schemes (Scheme Administration) Regulations (Northern Ireland) 1997 (SR 1997 No.94)

Appendix 2 : Current Factors for Use in MFR Valuation

A The current gilt yields to be used for valuing pensioner liabilities should be the gross redemption yield on the FTSE Actuaries Government Securities 15 year Yield Index or the FTSE Actuaries Government Securities Index-linked Real Yield Over 5 years (5% inflation) Index, as appropriate. In the case of LPI pension increases, either fixed-interest gilts with 5% pension increases or index-linked gilts with a 0.5% addition to the gross redemption yield should be used, whichever gives the lower value of liabilities. Similar principles should be applied for other pensions which are index-linked but subject to a cap other than 5%.

B.1 The long-term financial assumptions to be used are as follows:

	% per annum
Rate of inflation	4
Effective rate of return on gilts	8
Effective rate of return on equities - pre MFR pension age	9
Effective rate of return on equities - post MFR pension age	10
Rate of increase of GMP under Limited Revaluation	5
Rate of statutory revaluation for deferred benefits	4
Rate of LPI increase in payment	3.5
Rate of increase in post 1988 GMPs	2.75
Rate of increase of S148 Orders	6

The real rate of return on index-linked stocks is i , where

$$(1+i) = 1.08/1.04.$$

B.2 Additional assumption needed for the projection calculations for the Schedule of Contributions

	% per annum
Rate of salary growth	6

C Market Value Adjustments (MVAs)

C.1 The MVA in relation to equities should be the ratio of 3.25% to the net dividend yield on the FTSE Actuaries All-Share Index.

C.2 The MVA in respect of gilts should be the value at the annualised yield on the FTSE Actuaries Government Securities 15 year Yield Index or the FTSE Actuaries Government Securities Index-linked Real Yield Over 5 years (5% inflation) Index, as appropriate, of a 15 year stock with coupon equal to the relevant long-term assumption, payable annually in arrears.

- C.3 For liabilities which when in payment might be valued using either the yield on a fixed-interest gilt basis or that on an index-linked gilt basis, the MVA to be used should be that which produces the lower liability.
- C.4 If the liability includes a retirement lump sum payment, for the lump sum liability the market value adjustment on the proportion (g) of that part of the liability deemed invested in gilts (eg 0.3 if seven years from MFR pension age) should be:

$$g + (1 - g) \times \text{giltMVA}$$

D Demographic Assumptions

- D.1 Mortality (before and after retirement)PA90 rated down 2 years
- D.2 In the case of schemes which have a pensioner liability (assessed on the gilt basis) of at least £100 million, the mortality basis to be adopted should be that which the actuary considers appropriate for that scheme in respect of current pensioners and other members who have reached MFR pension age. In the case of all other schemes, and for non-pensioners below MFR pension age, the standard mortality table specified above should be adopted.

D.3 Proportions married

For pensioners, the assumption should be consistent with 80% (men) or 70% (women) at age 60.

For non-pensioners, the assumption should be, at the assumed date of retirement or earlier death, 80% (men) or 70% (women).

D.4 Age difference between husband and wife + 3 years

E Expenses

- E.1 The allowance to be made for the expenses connected with closure of the scheme, continuation as a closed scheme and eventual wind-up should be 4% of the value of accrued liabilities for the first £50 million of such liabilities, 3% of the value of the accrued liabilities for the next £50 million of such liabilities and 2% of the remainder of the value of accrued liabilities. For this purpose money purchase liabilities are only included in the value of accrued liabilities, if the scheme rules state that expenses cannot be met out of assets attributable to those liabilities.