

SECURITY IN OCCUPATIONAL PENSIONS

A REPORT TO THE DEPARTMENT FOR WORK AND PENSIONS AND HM TREASURY

September 2001

EXECUTIVE SUMMARY**1 Statutory Duty of Care**

- 1.1 The Government proposes a direct duty of care of the Scheme Actuary to scheme members. This will include, for example, that the Scheme Actuary will have an explicit duty to consider the implications of funding plans for scheme members. This duty already exists to a significant extent through our professional code of conduct (PCS), supplementary professional guidance for Scheme Actuaries, trust law and statute. These existing requirements, left as they are, should operate very much in the way intended by Government in the new environment of scheme specific funding standards rather than MFR. However, these various requirements are not to be found in a single source of reference by actuaries, trustees, pension scheme members etc. Thus the application of these requirements may not be fully transparent enough, particularly to trustees and scheme members who, directly and indirectly, rely on the actuarial advice given by the Scheme Actuary. Therefore, we believe that it would better assist the Government's proposal if the relevant professional requirements, linking to the relevant statutory requirements, were re-cast and presented anew, perhaps in a separate free-standing professional guidance note.
- 1.2 Such a new guidance note for the Scheme Actuary's duty of care, would set out explicitly, and in a single source of reference, the relevant professional requirements of the duty of care that already exist. The guidance could be strengthened further, if necessary and appropriate, to ensure that the Government's requirements were fully met. The Government may wish to consider giving such a guidance note "statutory backing" in legislation, to further strengthen the status of such professional guidance. As now, additional statutory requirements would in any case be needed, for example with respect to any statutory duty of the Scheme Actuary to report to Opra on the late payment of contributions.
- 1.3 We believe it would be extremely difficult for the scheme actuary to be responsible for forming a view as to the strength of the employer. This would run the real danger of turning the responsibility of the scheme actuary into that of a credit rating agency. We believe this would be an inappropriate purpose for the pension scheme valuation report.

2 Voluntary Winding Up

- 2.1 Policy needs to clarify “accrued entitlements” and legitimate means of satisfying these. We expect a strong debate will be needed in this area contrasting the degree of security attaching to the benefits and the provision of funding/ investment freedom offered by a more vaguely-defined entitlement.

3 Recovery Plan/Scheme Specific Funding Plan

- 3.1 We see these two topics as linked. For example a “strong” funding plan with a “long” recovery period may be somehow better than a “weaker” plan with “shorter” recovery. We are also concerned that too short a recovery period is inconsistent with the apparent aim to encourage funding flexibility. This issue is well covered in Section 4.8 on backtesting of our May 2000 Review of the Minimum Funding Requirement to the Secretary of State for Social Security (http://www.actuaries.org.uk/pensions/mfr_report.pdf).
- 3.2 With regard to the Funding Plan, we suggest this could be similar to the Statement of Investment Principles in that it is a document of principle rather than detail. Once agreed, it would establish the framework for actuarial valuations, investment decisions and even contribution requirements. We will expand on this later.
- 3.3 Clearly the procedure for settling this policy amongst the interested parties will need careful thought, and in particular what the default position would be in the absence of agreement between parties. It is worth noting that the MFR currently provides the default position in these matters.

4 Consequences of MFR Abolition

- 4.1 The MFR affects more than just the funding position of the scheme. We set out in Appendix 6 a list of consequential changes as well as a summary of legal references to the MFR in Appendix 9.

5 Transparency and Disclosure

- 5.1 Our analysis concludes that much of the intended disclosure is already available through guidance and legislation. Solvency on winding up is not yet a required disclosure and we would propose that an approved measure reflecting the solvency position of a scheme should be a requirement. We are also aware that this fuller and wider disclosure has the potential to cause some confusion to members but we are equally concerned that lack of disclosure may hide important information. To that end we encourage full disclosure with greater consumer education.

6 Proposal for Consideration

- 6.1 As outlined in Appendix 4 on the scheme specific funding plan, we believe the debate about setting scheme contribution rates is vitally important. Most informed commentators will agree that there is no single “correct” contribution rate. Therefore, unless a prescribed basis like MFR is set, there is no minimum commitment a company has to pay. In turn this means there is no obvious process for calculating a debt on the employer. Appendix 5 sets out an idea for such a process.
- 6.2 We therefore suggest in Appendix 5 that the debt on the employer be linked to a schedule of contributions agreed by the Employer and the Trustees and certified by the Scheme Actuary as complying with a scheme specific funding standard. This process will encompass many of the concepts introduced in the DWP/Treasury proposal (Duty of Care, funding standard, recovery plan) as well as providing some certainty (or at least limit) on an employer’s liability in the short term. We envisage the schedule running for 5 or 10 years but renewable after 3 and being split into an ongoing part (which can be stopped at any time) and a recovery part (which cannot be stopped – or it becomes a debt). The Company is then not exposed to a market mismatch risk UNLESS it agrees to renew the schedule after such an event, when it clearly does so from an informed position – as do the Trustees. Adjustments must be made to the schedule when, for example, the company and trustees agree to an augmentation of benefits on a redundancy exercise.
- 6.3 This proposal can be developed more fully but we believe merits consideration. We note that a material issue will be what happens when the schedule of contributions cannot be agreed, or not agreed with an employer in the multi-employer scheme. This detail would need development if the thrust were accepted.

Appendix 1

Statutory Duty of Care

1. Proposal

The Scheme Actuary will have a duty of care direct to scheme members set out in legislation. The actuary will have an explicit duty to consider the implication of funding plans for scheme members and will take into account the strength of the employer. The actuary will have a duty to report to Opra if contributions are not being paid in accordance with funding or recovery plans.

2. Current situation

- 2.1. Under a Scheme's Trust Deed & Rules, funding plans can be set by the trustees, by the employer or as a joint decision, depending on the particular wording. The law as it currently stands sets a statutory level of security for members in terms of a funding plan, ie MFR, which many companies naturally regard as adequate. The role of actuarial advice and obligations to scheme members (as opposed to MFR calculations performed by the Scheme Actuary) may have little impact on contribution levels though in some cases the actuary does have power to set contribution rates.

The situation will be different in future - the trustees and company must agree a scheme specific funding standard, having received advice from the Scheme Actuary. The company can potentially have undue influence either explicitly or because of the conflicts of senior company managers who are also trustees.

We understand the objective of Government's proposals is to have a framework to prevent the company having too much influence, whilst recognising that the trustees and members need the goodwill of the sponsoring employer to continue the scheme. It will be vital to ensure that there is clarity in the new regime as to how legislation and scheme rules will interact.

Bearing in mind these objectives, we have reviewed the current position regarding the Scheme Actuary's duties relative to this new position. Our conclusion is that the framework of a duty by the Scheme Actuary to members already largely exists.

Also it is the intention (independent of Government's proposals) to include explicit reference to scheme members in our code - the Professional Conduct Standards (PCS). This continues to build within our code on our objective that third parties - scheme members - are key and warrant greater prominence.

- 2.2 Under the Pensions Act the Scheme Actuary (SA) must be appointed by the Trustees. Under our professional code the SA must put the interests of his client, the Trustees, before any other considerations. Under trust law, the Trustees must act in the best interests of all the beneficiaries under the pension scheme in general terms and act within their powers and carry out their duties as specified in the individual Trust deed and rules of the scheme of which they are Trustees. Under our code, the Professional

Conduct Standards (PCS) the SA must take into account these obligations and duties of his client and therefore the SA has always had to take the interests of the beneficiaries into account in advising his client. Equally the Trustees could bring an action against the SA in circumstances where his negligent actions have resulted in a loss to the members.

- 2.3 The current edition of the PCS compels all actuaries to take into account the interests of third parties. It is currently intended to amend this to require the actuary to “include sufficient information and discussion about each relevant factor and about the results of the member’s investigations to enable the client to judge both the appropriateness of the recommendations and the implications of accepting them, including, where the advice relates to ... a retirement benefit arrangement, the implications for ... the beneficiaries of the retirement benefit arrangement ...”

3. Issues arising from the proposals

- 3.1 We are very concerned about the requirement to take into account the strength of the employer, as this is not a necessary skill to become a scheme actuary. We are aware of the various credit rating facilities for many companies but feel their relevance is limited and not every participating employer (e.g. subsidiaries and partnerships) will be covered..

- 3.2 We would also question the implications of asking a scheme actuary to assess the strength of the employer:

- the potentially circular consequence of a weakening employer being required to make larger scheme contributions thereby weakening further the employer’s financial strength;
- the continuous review of credit status contrasted with the “spot” measurement nature of actuarial reviews.
- the alteration in the focus of a valuation report to the extent that it may include credit rating judgments, in particular for an unquoted company or a partnership or small business.

Appendix 2

Voluntary Wind-up

1. Policy Statement

- 1.1 The Government will legislate to make it clear that companies will be required to meet in full the accrued entitlements of scheme members as they fall due. This will ensure that an employer who remains in existence cannot walk away from a scheme leaving it insufficiently funded to pay the accrued pension liabilities.
- 1.2 The company will have the choice whether to meet these liabilities immediately, in full, or to set in place arrangements to meet them as they fall due.

2. Present Situation (Debt on the employer)

- 2.1 At present if a scheme is placed in voluntary wind-up with insufficient assets to meet the scheme liabilities, the principal route available to the Trustee is the calculation of the debt on the employer. Whilst the rest of this section concentrates on this aspect, it should be noted that other aspects may also apply – such as the contribution schedule and the Trust Deed itself which may influence the scheme's position.
- 2.2 Simplistically the debt is currently calculated at a date determined by the Trustees to be equal to the then MFR shortfall. This date is currently totally open (provided the employer is solvent) but draft regulations propose limiting this to within 12 months from the wind-up start. Whether these come into effect remains in some doubt.
- 2.3 There is a body of opinion which suggests that in such circumstances Trustees should act to maximise this debt by adopting the following actions:

Review investment strategy to see if a "gilt matching MFR" calculation is more appropriate, buying out as many liabilities as the existing assets will allow so as to "gear up" the MFR debt. This assumes that buyout cost is greater than MFR cost – which it probably is.

- 2.4 Once established there is no clear procedure for enforcing the debt, although it is a requirement that Trustees keep records about how they go about recovering the debt.

3. Issues arising from proposal

- 3.1 Clearly members' accrued entitlements will need to be defined. One suspects that benefits in payment will be relatively straightforward although there may be some debate about future pension increases, whether statutory, by scheme rules, or by discretion.

- 3.2 For members not yet retired, there is more room for interpretation. For example, entitlements could mean the full defined benefit on wind-up (for example a deferred pension with or without future inflation-linked increases) or the current implied minimum benefit of “MFR (or cash equivalent) values”. This latter approach would probably require an overriding review as the current “MFR minimum” is calculated at an aggregate level allowing scheme rules to distribute down to individuals.
- 3.3 A company will need to know how it can meet these entitlements immediately. This should be a practical solution (e.g. certified cash equivalent transfers to stakeholder compliant personal pensions) or the choice proposed will not be realistic.
- 3.4 Similarly, the alternative arrangements should be practical, and enforceable. For example, following an agreed funding proposal which aims to meet a long term funding objective appropriate to a scheme that has ceased to accrue benefits. Again, overriding legislation may be required as most Trust Deeds require Trustees to secure benefits once schemes are in wind-up. As an aside, it should be noted that anecdotal evidence suggests that Trustees of schemes in wind-up offered the choice of running as a closed scheme or purchasing benefits, have generally purchased benefits.
- 3.5 Whilst there are no proposals as to where pension responsibilities lie in debt priorities of the company, the Government is clearly aware of the issue and will be giving consideration to see if workable improvements to the current arrangements can be made. The recent intention to relax the priority for payment of tax behind such matters as pension fund contributions is likely to be welcome.
- 3.6 We do not intend to speculate over possible improvements but would observe that in many companies the size of the scheme assets will be significant in relation to the company's value. This could create areas of concern if market fluctuations cause sudden shortfalls. However, a balance will need to be struck to ensure that “distressed” companies do not deliberately under fund schemes in the periods approaching insolvency.

Appendix 3

Recovery Plan to full funding

1 Policy statement:

- 1.1 “If the scheme is not adequately funded, it will have to produce [and implement] a recovery plan for returning the scheme to adequate funding within a relatively short period of time, say three years.” The scheme actuary will have to whistleblow to Opra if contributions are not paid accordingly.

2. Current position:

- 2.1 The existing rules about correcting funding shortfalls are determined by a combination of:

- individual scheme rules;
- the Valuation Regulations long-term requirement to set contribution rates that will be adequate to meet the liabilities of the Scheme as they fall due (set out in the Regulation 30 certificate) - this does not define an "adequate level of funding" and can essentially be ignored in the context of providing security for accrued benefits;
- the regulations relating to the Schedule of Contributions which require the correction of an MFR deficit over 1 year (< 90% funding) or 5 years (90%-100% funding) depending on the extent of the shortfall (measured relative to the MFR liability, i.e. generally less than the cost of buying-out accrued benefits if the scheme winds-up) - we assume these requirements will be repealed when the MFR is abolished.

3. Issues arising from the proposals

- 3.1 Will the deficit recovery period be fixed in legislation? That would seem to be inconsistent with the overall principle of the Government's proposals that each scheme should be able to establish funding arrangements that suit its own circumstances.
- 3.2 For example, consider a scheme that is established on a long-term basis where employees clearly understand that their accrued benefits would not be secure in the event of the employer ceasing contributions. It would seem quite appropriate for the scheme to operate with a longer deficit recovery period, and for that to be included in the scheme-specific funding statement.
- 3.3 Other schemes with a stronger commitment to short-term security might choose to operate with a short recovery period, without the need for statutory constraints.
- 3.4 The Pensions Board May 2000 Review of the Minimum Funding Requirement for the Secretary of State for Social Security (http://www.actuaries.org.uk/pensions/mfr_report.pdf) argued against a short statutory

recovery period, primarily because funding levels can be expected to be volatile. Although that was in the context of a bond-based statutory funding basis, similar arguments would apply if a scheme-specific funding basis is bond-based (many actuaries now measure liabilities by reference to bond yields). Even a funding basis which attempts to smooth out day-to-day fluctuations (such as existing MFR) gives volatile results from one triennial valuation to the next.

3.5 The overall strength of a funding policy is determined both by the funding target and by the recovery period. It is not clear what is achieved by regulating one piece but not the other. The effect might be to prevent a scheme from operating with a high funding target and long correction periods – it would instead operate with a lower funding target.

3.6 Therefore we recommend that the recovery period should be disclosed in the funding statement rather than covered by legislation separately.

4. Further guidance required:

4.1 What does “adequate funding” mean?

4.2 The consultation document implies that it means 100% on the scheme-specific funding basis.

4.3 However, could schemes determine that a lower percentage (say 80%) would represent adequate funding for automatic basic benefits? Could lower percentages be used for certain liability classes (such as pension increases)? This would naturally be tied to scheme specific priority orders.

4.4 In practice, many schemes will not operate with one simple funding objective. Employers/trustees will be concerned about discontinuance, corporate accounting, etc. as well as about long-term funding. For example, the objective might be to meet both the following targets:

- A minimum “adequate” level, perhaps on a discontinuance basis but with say 90% coverage for the lowest priority category of liabilities, with a short deficit recovery period.
- A higher (ordinarily) long-term target, including allowance for discretionary benefits and salary growth, with a long recovery period.

4.5 In cases like this, guidance will be required on what is an adequate funding level, as well as on what is appropriate for the long-term funding standard.

4.6 If the proposal goes ahead, there will be practical issues such as whether it is necessary to make up the deficit evenly over the period.

4.7 It will also be necessary to develop guidance on when/how to report to Opra. At present this process is clearly laid out with reference to the statutory contributions schedule.

Appendix 4

Scheme Specific Funding Standard/Statement of Funding Principles

1. Proposal Statement

- 1.1 “..each scheme will set out a long-term scheme specific funding standard set by the trustees and their advisers in light of the schemes own circumstances. It will set out:
- the funding objectives of the scheme;
 - the funds investment policy and projected returns on its assets;
 - assumptions projecting its liabilities;
 - a contribution schedule agreed by the trustees and the employer.”

2. Current situation

- 2.1 There is no requirement on Trustees to establish a funding objective (other than MFR), although it is a requirement that actuarial reports under GN9 set out what the objective is. MFR sets out assumptions and effectively determines the (minimum) scheme contribution rate.
- 2.2 There are many criticisms of the MFR, but the main criticism revolves around the basis being:
- incapable of rapid change to meet changing economic circumstances, and
 - a single basis for all schemes, which therefore cannot take into account the different circumstances (particularly the investment policies and the exact nature of the employer’s commitment) of schemes.

A scheme-specific statement of funding principles (as proposed by NAPF and ACA amongst others) may address these criticisms.

3. Issues arising from the proposals

- 3.1 We see that the Funding Statement could be successful provided it is a guidance document similar to the Statement of Investment Principles in that it is prepared, maintained and from time to time revised, and includes consultation with the employer in its construction and input from experienced professionals (such as actuaries and lawyers).
- 3.2 We believe that the information to be included should be extended to include:
- a commentary on security objectives for each membership class (as set out in the scheme’s windup rules);
 - what will happen if deficits appear (now or in the future).

- 3.3 The most difficult part to address is what happens when the sponsor and trustee cannot agree and where the balance of power then lies. In principle we feel the trustee can only be responsible for accrued benefits and should only accept to take on new benefits if sufficient funds are forthcoming from the sponsor (and to some extent guaranteed). We would therefore encourage some regular re-affirmation of the company to a contribution schedule or principle which is limited in time (say 5 years) but by signing up to create a power of debt for the trustees over the company. The role of the actuary in this process needs to be considered as well as any effect on the trust deed and rules of the scheme. The legal position of the actuary must be clearly defined and linked to issues surrounding the scheme actuary's duty of care.

4. Differences from Government proposals

- 4.1 There is no single correct funding strategy so it is important that the statement should aim to set out funding policy in all circumstances, not just work on the assumption that nothing unexpected will occur.
- 4.2 Also, disclosure of a scheme's solvency position is essential - both the actual position at the most recent valuation, and information about the likely position if the scheme were to wind up in the short/medium term. Otherwise members may have unrealistic expectations about the benefits they would receive.
- 4.3 We therefore assume that the new regime will be "scheme specific" but not necessarily solely "long-term".
- 4.4 The consultation document proposed that the Statement should include a contribution schedule. We see the Statement as being a fairly permanent document, with a separate contribution schedule setting out what will actually be paid which will be updated at every valuation. It should require a degree of effort to change the policy Statement.

Appendix 5

Debt on the Employer - Proposal for Consideration

1. Background

- 1.1 Despite the idiosyncrasies of its calculation, one of the advantages that MFR introduced for Companies and Trustees is that it established a clear minimum level of contribution and a clear debt on the employer if the scheme were placed into wind-up or the Company went into liquidation.
- 1.2 The proposed abolition of MFR would potentially remove this certainty and this appendix examines a proposal for possibly restoring certainty whilst retaining the spirit of the proposed “new” approach.

2. Considerations

- 2.1 As most informed commentators recognise, there is no single “correct” contribution rate or funding approach, but rather a range of possibilities. Furthermore, there is a natural tension between the security requirement of members and the reasonable cost constraints required by the Scheme Sponsor. Pre MFR there was (usually) no explicit minimum contribution nor was there a well-defined debt calculation process. Post MFR abolition this could be the same state.
- 2.2 It would clearly be helpful to the Sponsor if, when committing to support a defined benefit scheme, it is able to limit its commitment to, say, 5 or 10 years, the typical span of business plans. This may allow Sponsors more willingness to commit than the proposed, potentially uncontrollable, open ended promises. Furthermore, such a commitment could also become the basis for Trustees enforcing debt against Employers should the Sponsor face difficulties during the commitment period. Finally this approach could force Trustees to recognise, and liaise with, Companies over the investment strategy of the Scheme.
- 2.3 The process would commence with the agreement of a schedule of contributions between the Sponsor and the Trustee certified by the Scheme Actuary as complying with the Scheme specific funding. The schedule would identify a regular cost, covering accrual of future benefits, and a “recovery” cost to meet any shortfall in the funding target. Whilst the Sponsor could be agree to stop the regular cost (and hence accrual of benefits) at any time the recovery obligation would last for the full length of the schedule. This means the Sponsor is not exposed to a mis-match risk after agreeing to a schedule and only accepts such a risk if he agrees to another schedule following the next 3 yearly valuation. At this time both the Sponsor and the Trustee will be agreeing to a revised schedule from an informed position.
- 2.4 Further refinements from this basic plan will be needed. Some issues are considered here, but others are also expect to arise in detailed progression.
 - What happens if the Sponsor and Trustee cannot agree to a schedule? A hard route would be to say the Scheme cannot continue and must be closed, any outstanding debt collected and the Trustees must apply assets as they see fit with no control or influence from the Company. This would place pressure on the Actuary regarding what is meant by a suitable Scheme specific funding standard and it may become the responsibility of the Trustees to define what they feel this is appropriate to be.
 - This issue becomes more complex in multi-employer schemes, but the same principles can be followed (ie Trustees determine funding standard parameters, actuaries certify schedules, companies agree to pay for length of schedule or no benefits granted and partial wind-up or closure).

- Should benefit changes or augmentations be required, this will need an amendment to the Schedule of Contributions, agreed by both parties and again certified as being consistent with the Scheme specific funding target.
- Schedules may need to be reviewed if there are significant events (eg redundancy or sales).

Overall we believe these proposals merit further consideration.

Appendix 6

Consequences for abolition of the MFR

1. Policy statement

- 1.1 Budget Speech on 7 March 2001: "We will abolish the minimum funding requirement."

2. Current position:

- 2.1 The minimum funding requirement underpins a number of calculations relating to pension schemes. These calculations are as follows:

- the minimum contribution rate payable to a defined benefit pension scheme;
- the minimum contribution required to be paid by the employer when a defined benefit pension scheme winds up or when that employer ceases to participate in a defined benefit pension scheme;
- financial supervision of a contracted-out defined benefit pension scheme;
- compensation to a defined benefit pension scheme in the event of fraud;
- disclosure of level of funding of accrued benefits held within a defined benefit pension scheme.
- the statutory minimum for cash equivalent transfer values from a defined benefit pension scheme;
- one of the two methods for calculating the statutory maximum for cash equivalent transfer values from a defined benefit pension scheme to a personal pension;
- the priority order used to allocate assets to members when a defined benefit pension scheme winds up; and
- division of pension benefits in a divorce.

- 2.2 The Government will need to decide which of these areas should continue to be subject to a statutory calculation basis, and, where Government decides such a basis is appropriate, what that basis should be.

3. Implications of the policy statement:

- 3.1 The above calculations can be divided into two groups as follows:

- Those relating to the funding of defined benefit schemes. This category includes the first five points set out above.
- Those relating to payments from the scheme in lieu of benefits. This category includes the last four points set out above.

- 3.2 There is logic in using the same approach for each of the above groupings.

- 3.3 The Government has announced that it wishes on-going funding to be covered by a Statement of Funding Principles. The Government needs to decide if the same approach

is to be used for all other calculations relating to the funding of defined benefit schemes, or if, in particular circumstances, a different approach is more appropriate.

- 3.4 No Government announcement has been made about the future approach to calculating payments in lieu of benefits. These calculations could be underpinned by a statutory basis. Alternatively, these calculations could be carried out by the Scheme Actuary on the basis of his professional opinion. The latter option would, broadly, represent a return to the position in place prior to 6 April 1997.
- 3.5 The statutory basis has resulted in a reduction in the range of different values given to the same benefits by different defined benefit pension schemes. Removal of the statutory basis could reverse this generally welcome change.
- 3.6 In addition, there is an advantage in linking the amount payable by the employer when a scheme winds up and the priority order. This would help ensure that, when a scheme winds up and the employer pays any debt in full, the assets of the scheme would be sufficient to satisfy any priorities set by Government.
- 3.7 This would improve on the current situation where an employer can satisfy the debt on the employer regulations by ensuring that the pension scheme has assets to cover the MFR liability for both pensions in payment and deferred pensions. However, when pensions in payment are secured, the priority order allocates them funds equal to the cost of purchasing annuities. Annuities currently tend to cost more than the value of a pension in payment on the MFR basis. Hence, currently, where an employer pays this debt in full, the assets remaining after purchasing annuities for pensioners, tend to be insufficient to pay full transfer values for deferred pensioners.

Appendix 7

Transparency and Disclosure

1. Proposal Statement

- 1.1 The Government's proposals "Security for Occupational Pensions" published in March 2001 include a proposal for a strong regime of transparency and disclosure under which each scheme will prepare a "Funding Statement" to be distributed to members and made publicly available.

2. The Current Rules

- 2.1 The current rules for funding statements are included in the Faculty/Institute of Actuaries guidance note GN9 which is specifically referred to in the valuation regulations (SI1996/1536). GN9 requires the actuary to set out the Trustees' funding objectives and the actuarial method and assumptions, including the assumed rate of investment return, used to develop the contribution recommendation. The Trustees' investment policy is set out in the Statement of Investment Principles.
- 2.2 The funding objectives used for ongoing schemes are almost invariably long-term which tends to produce a relatively stable contribution rate and permit investment in assets that are not well matched to the liabilities of the scheme. There are a number of possible funding methods which produce different allocations of costs between the "target fund" and future contributions. In practice, a single method, the projected unit method, is almost invariably used.
- 2.3 GN9 requires the disclosure of the accrued solvency position. For active service members and deferred members this can be on the basis of either cash equivalents or the cost of deferred annuities. A member's cash equivalent can be significantly less than the cost of securing his/her benefits by purchasing a deferred annuity with an insurance company. For a 25 year-old, for example, the cash equivalent may currently be about 30% of the deferred annuity buy-out cost.
- 2.4 It is unusual to include an explicit solvency objective in the funding objectives. A short-term solvency objective would produce more volatile contribution rates and/or necessitate schemes to invest a greater proportion of their assets in bonds and gilts.

3. Changes required to achieve stated proposals

- 3.1 It appears that most of the contents of the new Funding Statement are already available by extracting certain items of information from a scheme's actuarial valuation report, which will have been prepared in accordance with the guidance note GN9.
- 3.2 Currently, under Regulation 7 of the Occupational Pension Schemes (Disclosure of Information) Regulations 1996, members and certain other parties are entitled to receive a copy of the latest actuarial valuation report. Currently however, the information from

the actuarial valuation report that is to be included in the new Funding Statement is not provided automatically and is not publicly available, so the Government will need to legislate to address these two points.

- 3.3 The new Funding Statement is to contain details from a contribution schedule agreed by the trustees and the employer.
- 3.4 As the MFR and consequently the current requirement for there to be a Schedule of Contributions are to be removed, the Government will need to:
 - a) introduce a requirement for the trustees and the employer of a scheme to agree a contribution schedule,
 - b) set out what contributions will be shown on the contribution schedule in the event of no agreement being reached, and
 - c) require the (new) contribution schedule to be disclosed to members and made publicly available.

4 Possible extensions to stated proposals

- 4.1 The Government may wish to consider requiring the Funding Statement to include details of the contributions actually being received by the scheme, as these may be different from the contributions shown on the contribution schedule, particularly in the case of a scheme to which b) above applies.
- 4.2 The Government may wish to consider requiring the Funding Statement to contain details of the accrued solvency position of the scheme on discontinuance on the basis of purchasing deferred annuities for active service members and deferred members.
- 4.3 As a first step towards this, actuarial valuation reports could be required to include such information.
- 4.4 There can be practical difficulties in schemes obtaining an assessment of the cost of deferred annuities for active service members and deferred members. The market in deferred annuities is narrow. Companies that are in the business of selling deferred annuities will, from time to time, change the basis used for pricing. The actual cost of deferred annuities for a particular scheme cannot be known unless and until that scheme actually purchases deferred annuities. Some schemes are too large for the deferred annuity market; i.e. the deferred annuity providers would not be willing/able to quote a price.
- 4.5 If the Government wished to consider requiring schemes to include details in their Funding Statement of an assessment of the accrued solvency position on the basis of purchasing deferred annuities for active service members and deferred members, consideration would need to be given to the practical difficulties of schemes obtaining such an assessment, including those given above.

- 4.6 The Government may wish to consider requiring schemes to have a specific solvency objective, which for active service members and deferred members, could be on the basis of either cash equivalents or the cost of purchasing deferred annuities, and a time frame for recovery where the scheme was less than 100% funded on such an objective.

Appendix 8

International Considerations

1. Illustrative comparison of effective “solvency” standards in Europe and US

General Comments

The UK is not the only country to operate a Minimum Funding Requirement (MFR), or a standard that in essence meets the same “solvency” objective as the UK MFR. The table below summarises the “solvency” tests that apply in the major European countries that apply a “solvency” test. The US has been added for comparison.

The table below is not intended to be definitive, the “solvency” rules in each country are complicated. The table is instead intended to provide a quick overview of the type of “solvency” and its relative strength compared to the UK MFR. Some important points of detail :-

- each standard excludes any allowance for discretionary benefits
- however where there is a statutory requirement to increase benefits, either in deferment of in payment, the table takes this into account as such increases in effect strengthen the impact of the MFR in that country relative to others (applies to UK, Ireland and Germany)
- some countries are moving to a funded system of occupational retirement provision over time. In such cases, the solvency measures shown exclude any transition rules – ie the table summarises the long term intent of the funding legislation in each country
- the definition of “accrued benefits” in the event of a winding up, and the actuarial methodology used to measure the value of such “accrued benefits”, is not necessarily the same in each of the different jurisdictions. For simplicity, however, the term “accrued benefits” has been used throughout

Country	“Solvency” test		“Deficit” recovery period
	Comparative strength vs UK MFR	Technical description	
Austria – Book reserved	Weak	Accrued benefits valued at 6% interest rate	Immediate recognition in book reserve (no cashflow outgo)
Belgium – Pension Funds	Weak	Accrued benefits valued at 6% interest rate	Immediate , ie full cash injection equal to deficit
Belgium – Group insurance	Strong	Accrued benefits valued at 3.25% ⁽¹⁾ interest rate	N/A – insurer bears risk
Germany – Book reserved	Weak	Accrued for benefits valued at 6% interest rate, no allowance for pension increases ⁽²⁾	Immediate recognition in book reserve (no cashflow outgo)
Germany - Pension Funds (<i>Pensionskassen</i>)	Similar	Accrued benefits valued at 3.25%/3.5% interest rate, no allowance for pension increases ⁽²⁾	Discuss with authorities

Country	“Solvency” test		“Deficit” recovery period
	Comparative strength vs UK MFR	Technical description	
Ireland	Similar	Actuary’s judgment based on Guidance Notes, typically accrued benefits valued at bond discount rate	“Contribution schedule” over 3½ years
Netherlands	Slightly weaker	Accrued benefits valued at 4% interest rate, plus investment reserve ⁽³⁾	Typically 1 year
Portugal	Slightly weaker	Accrued benefits valued at 4.5% interest rate	1 year
Spain	Similar	Accrued benefits valued at 4% interest rate	Discuss with authorities
Switzerland	Slightly weaker	Accrued benefits valued at 4% interest rate ⁽⁴⁾	Discuss with authorities
UK		Prescribed basis, accrued benefits valued at blend of equity & bond discount rate	Contribution Schedule over 5 years (shorter if substantial deficit)
US	Weaker	Complex approach, effectively accrued benefits valued at government bond discount rate	Complex contribution schedule approach, typically 5 years

- (1) Discount rate in premium basis depends on year contribution was paid. Current rate is 3.25%
- (2) It is a statutory requirement to increase pensions in payment in line with price inflation. However, the solvency standard does not make explicit allowance for this
- (3) The reserve is higher the higher the proportion of assets invested in equities
- (4) It is common practice that actuaries add investment and longevity reserves according to their professional judgment

2. Draft European Directive on the activities of institutions for occupational retirement provision

- This was issued by the Commission in the autumn of 2000 and is due to be considered by the Council of Ministers in October 2001. The earliest expected date of coming into force is 31 December 2003.
- Relevant Articles are:-
 5. The Directive need not apply to schemes with less than 100 members.
 - 9 (f) Members must be informed of the contractual rights and obligations of all parties, the financial, technical and other risks and their distribution between the parties.
 - 11 (3) On request, members get detailed and substantial information on: -
 - (b) the actual financing of accrued pension entitlements.
 - (d) where the member bears the investment risk, the range of investment possibilities, the actual portfolio and information on risk exposure and costs.
 - 13 Governments to ensure a competent authority (CA), (such as say OPRA), has powers to: -
 - (c) obtain regularly internal interim reports, actuarial valuations and asset-liability studies.
 - 15 (4b) The rate of interest to be prudent in accordance with the rules of the CA.
 - 16 Requires full funding at all times, although UK government can allow derogation for schemes not involved in cross border activity. Derogation is only for a limited period and the CA must approve the plan to return to full funding. The plan can take account of the specific situation, asset-liability structure, risk profile, liquidity plan, age profile, start up schemes and schemes changing from non or partial funding to full funding. A procedure must be established and disclosed to the CA to transfer assets to a financial institution in the event of termination during the derogation period.

Appendix 9

Abolition of MFR – Legislative Consequences

Statute	Ref	Subject
Pensions Act 1995	s35(2)	Statements of Investment Principles
do.	s41(3)	Disclosure of actuarial information
do.	s56-61	MFR
do.	s73	Preferential liabilities on winding up
do.	s74	Discharge of liabilities
do.	s81(7)	Calculation of compensation
do.	s89(1)(a)	Possible application to money purchase schemes (!)
do.	s119	Permissive delegation of calculation bases
do.	s124	Interpretation (of MFR)
Welfare Reform & Pensions Act 1999	s38	Pension sharing
do.	Sch 1 para 1(2)(b)	Stakeholder schemes
do.	Sch 5 para 8	Pension sharing
Occupational Pension Schemes (Contracting-out) Regulations 1996 (SI 1996/1172)	Regs 1, 6, 18, 49, 72	Resources of schemes, insolvency
The Occupational Pension Schemes (Minimum Funding Requirement and Actuarial Valuation) Regulations 1996 (SI 1996/1536)	Most of it	MFR and schedules of contributions
The Occupational Pension Schemes (Disclosure of Information) Regulations 1996 (SI 1996/1655)	Regs 6(1), 7	Disclosure of actuarial information
The Occupational Pension Schemes (Transfer Values) Regulations 1996 (SI 1996/1847)	Reg 7(3)&(4), 8(4)-(7)	Calculation of TVs
The Occupational Pension Schemes (Requirement to obtain Audited Accounts and a Statement from the auditor) Regulations 1996 (SI 1996/1975)	Reg 4	Schedules of contributions

The Occupational Pension Schemes (Winding Up) Regulations 1996 (SI 1996/3126)	Reg 3(2), 4(1)-(3), 12, 13(6)	Application and calculation of liabilities
The Occupational Pension Schemes (Deficiency on Winding Up etc) Regulations 1996 (SI 1996/3128)	Regs 2,3,5, Sch 1	Application and calculation
The Pensions Act 1995 (Commencement No. 10) Order 1997 (SI 1997/664)	Regs 4,7	Application (transitional)
The Occupational Pension Schemes (Pensions Compensation Provisions) Regulations 1997 (SI 1997/665)	Reg 5(5)	Calculation of liabilities
The Pension Sharing (Valuation) Regulations 2000		
The Pension Sharing (Implementation and Discharge of Liability) Regulations 2000		
The Stakeholder Pension Schemes Regulations 2000	Reg 19	
Occupational Pension Schemes (Republic of Ireland Schemes Exemption) Regulations 2000	(Schedule)	

8 August, 2001

h:\tech2\penboard\reports\2001\20 august\annex.doc

18 September, 2001

h:\tech2\penboard\policy\mfr\2001\8.1 security in occ pens - rpt to aug fimc.doc