

Our Changing Future discussion series and the Faculty of Actuaries Students' Society

March 2007

# Current Topics

Pensions



## Authors

This paper was prepared by Adrian Jones, Paul Johnston, Catherine Hildebrand and Oliver King, with assistance from many actuaries and students.

## Acknowledgments

The authors would like to thank Spencer Thomas, Navneet Bassan and Andy Hoddinott of PricewaterhouseCoopers' pensions technical team<sup>1</sup> whose material proved an invaluable resource for preparing this document.

Any views expressed are those of the authors and not of their employers or other members of the Actuarial Profession unless specifically stated. The authors take responsibility for any errors or omissions. However, neither the authors nor their employers will be liable for any direct or consequential loss arising from any person or organisation acting or failing to act on the basis of information contained in this paper. Furthermore, neither the authors nor their employers take responsibility for the content of any external links.

---

<sup>1</sup> PwC pensions technical team  
<http://www.pensionsbrief.co.uk/uk/ghrs/pb/pensionsbrief.nsf/home>

# Contents

1	Industry update	4		
1.1	Changes in UK pension schemes	4		
1.2	Market changes	6		
2	Funding of pension schemes	10		
2.1	The new regime	10		
2.2	Scheme funding process	11		
2.3	The Pensions Regulator	12		
3	Pension Protection Fund	17		
3.1	Management of the PPF	17		
3.2	PPF valuations	18		
3.3	PPF levy	19		
3.4	PPF benefits	21		
4	Transfer values	22		
4.1	Background	22		
4.2	The new approach to transfer values	22		
4.3	Enhancements to transfer values	23		
5	Taxation changes	25		
5.1	Tax simplification – impact on benefits	25		
5.2	Company tax deductibility	26		
6	Age discrimination	28		
6.1	Background	28		
6.2	The changes	28		
7	White paper on pensions reform	31		
7.1	Pension Commission	31		
7.2	Government response – White Paper	31		
7.3	Personal Accounts	32		
8	Mortality risk	34		
8.1	The new “00” tables	34		
8.2	Hedging Longevity Risk	35		
9	Trustee knowledge	37		
9.1	The new rules	37		
10	Section 67 changes	39		
10.1	Revised Section 67	39		
11	Guidance note changes	42		
11.1	GN28: Retirement Benefit schemes – Adequacy of Benefits for Contracting-out	42		
11.2	GN48: Compliance Review: Pensions	42		
11.3	EXD71: Occupational Pension Schemes – Advisers to the Trustees (GN29)	42		

# 1 Industry update

- 45% of Final Salary Schemes are now closed to new members, with a further 12% closed to future accrual too.
- Average employer contribution rates to Final Salary Schemes have risen by 70% over the past five years.
- Equity rises during 2006 have reduced deficits in many Schemes.

## 1.1 Changes in UK pension schemes

The ongoing trend of moving from defined benefit (“DB”) final salary pension schemes to defined contribution (“DC”) schemes has been happening for several years now and this trend has continued in 2006.

### 1.1.1 Changes in 2006

The membership of employer sponsored DB schemes has fallen by over 20% in the last eight years (46% in 1997 to 35% in 2005). Membership of DC schemes increased by a third during the same period (10% to 15%). See Fig 1.

According to survey information 45% of DB schemes are closed to new members. A further 12% are paid up (no future accrual) - up from 10% in 2005. Renotkil Initial was the first high profile case to do this in 2005, with others following. See Fig 2.

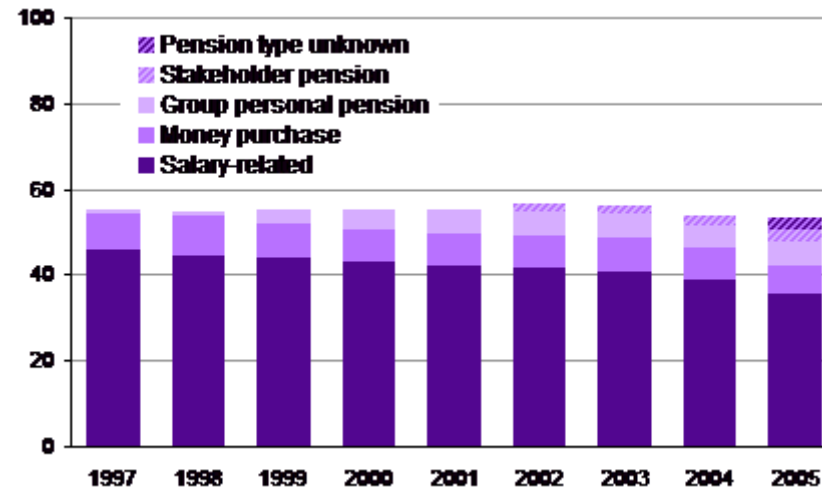


Fig 1: Employee membership of an employer-sponsored pension scheme: by pension type.

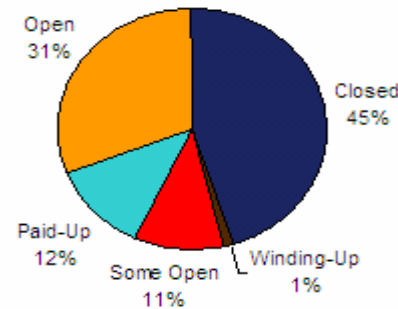


Fig 2: UK final salary pension schemes – status (source: PwC)

### 1.1.2 Decline in defined benefit pension schemes

The main reason for closing DB pension schemes appears to be the increased costs associated with such schemes as well as greater understanding of the risk involved. Over the last five years the average employer contribution rate to DB schemes has risen by 70% (from 12.2% in 2001 to 20.8% in 2006).

The costs of DB pension schemes have risen due to:

- Lower than expected stock market returns and long term interest rates (in particular the period in the early 2000s)
- Increased longevity
- Regulatory requirements (e.g. compulsory indexation)
- Increased legislation and compliance costs

Other reasons, which are contributing to DB schemes decreasing in popularity, are:

- Impact of legislation on benefits and funding in particular threat of regulator intervention
- Impact of accounting requirements (e.g. FRS 17) leading to volatile company balance sheets
- Impact of pension schemes on wider corporate strategy (e.g. acquisitions)
- Increasing burden of management time running schemes
- Difficulties with member communications
- Increasing Trustee responsibilities
- Insufficient competitive pressure to justify DB schemes

### 1.1.3 The defined contribution alternative

In contrast to rising defined benefit costs, employer contributions to DC pension schemes have remained relatively stable over the same period (8.2% in 2001 compared to 8.4% in 2006).

DC schemes do not suffer from a number of the DB issues listed above, and often increased costs of pension provision are passed to the member rather than the company. These issues mean that the employers are seeing DC schemes as a more viable option than DB schemes. In addition, many companies are looking to reduce their exposure to the risks associated with providing DB benefits.

This activity has fuelled the interest in specialist buyout vehicle providers as companies no longer want the burden of their DB obligation. See Life volume. At present, this has seen the introduction of several new players into the market, but there has been no 'flood' towards the vehicles.

In addition to this, companies are also being creative by providing security to their DB schemes in other ways than simply via additional funding. For example there is increasing use of contingent assets (assets payable on the triggering of a certain event), such as letters of credit, guarantees and escrow accounts (for use by scheme if needed, by company if not). For example, Marks & Spencers recently announced that it was forming a partnership with the pension scheme trustees.

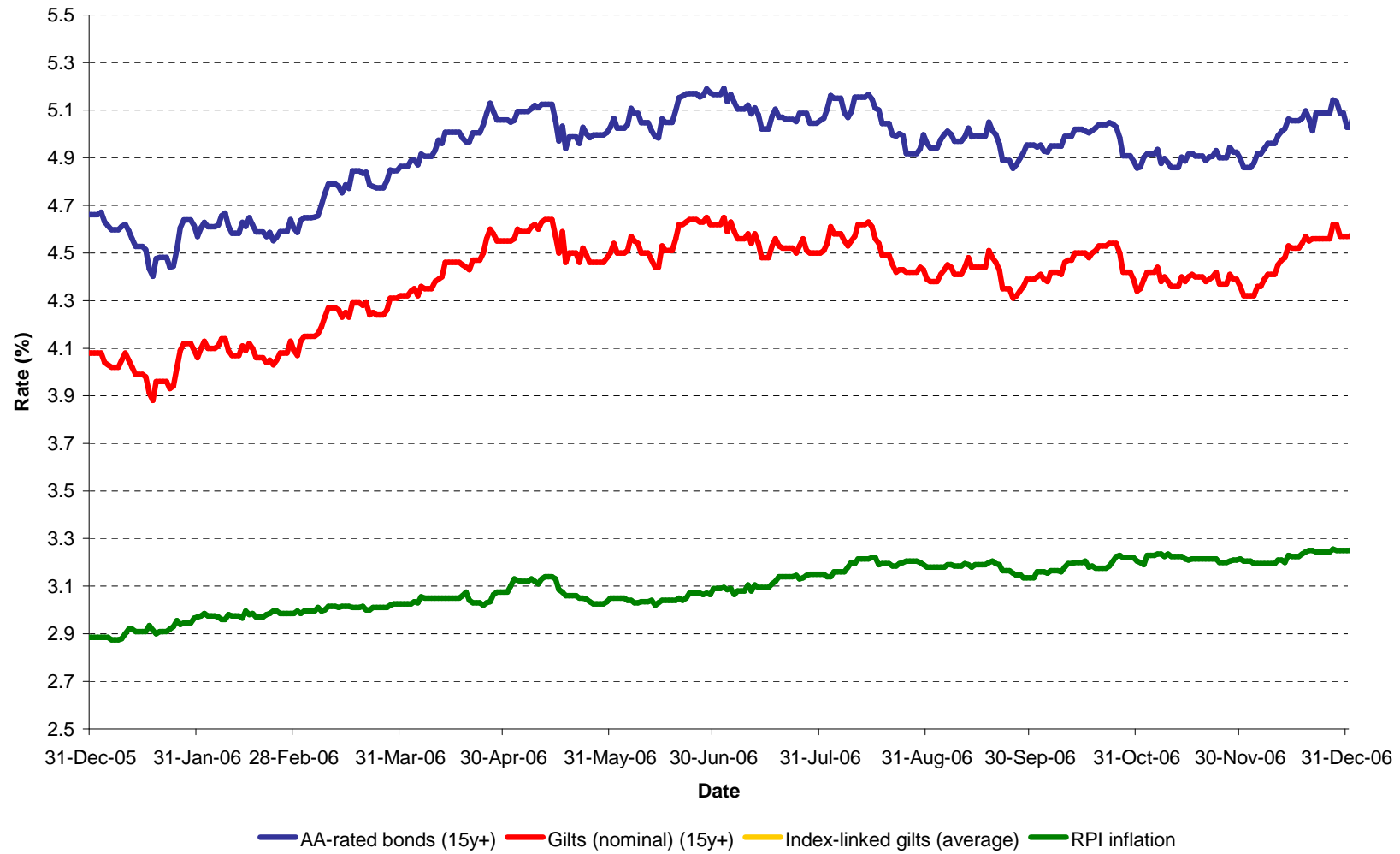
Further, many companies and pension schemes have been undertaking "deficit reduction" exercises. For example, companies have offered members enhanced transfer values to reduce the liabilities of the pension scheme.

## 1.2 Market changes

During 2006, many pension scheme deficits have reduced due to strong equity returns, with the FTSE All-Share Total Return Index being just under 17% higher at the end of 2006 than at the start. The FT-Actuaries Gilt Total Return Index was virtually at the same level at the end of 2006 as at the start.

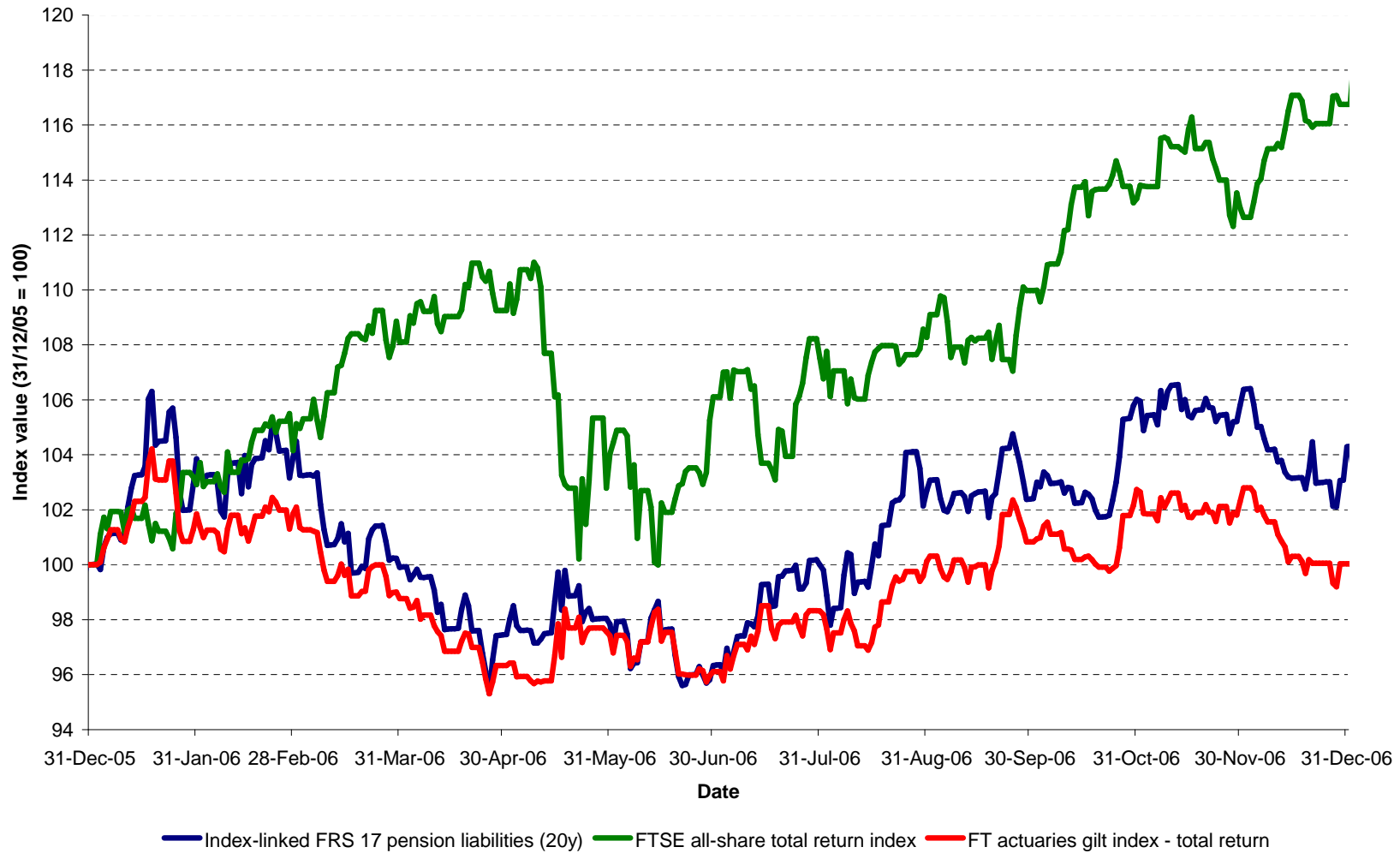
For a typical pension scheme, the net yield used to discount FRS 17 liabilities is likely to have increased. However, any benefit from this is likely to have been more than offset by interest on the liabilities (becoming one year closer to payment).

During the same period, many companies have made additional contributions to their pension schemes. Such contributions are not allowed for in the charts that follow which focus solely on market returns.



**Fig 3: Changes in key market yields during 2006**

Source: Barcap, FT, PricewaterhouseCoopers estimates



**Fig 4: Changes in market indices during 2006**  
 Source: FT indices, PricewaterhouseCoopers estimate

## **Further information**

Full results from GAD's thirteenth survey of occupational pension schemes (as at April 2005) can be found at:

[http://www.gad.gov.uk/OPSS/2005\\_OPSS/2005\\_OPSS.htm](http://www.gad.gov.uk/OPSS/2005_OPSS/2005_OPSS.htm)

The Pension Regulator's Purple Book which can be seen at:

<http://www.thepensionsregulator.gov.uk/pdf/PurpleBook.pdf>

Lane Clark and Peacock's annual survey of FRS 17/ IAS 19 accounting assumptions can be seen at:

<http://www.lcp.uk.com/information/documents/AFPSurvey2006.pdf>

## 2 Funding of pension schemes

- Trustees have more power to decide on funding of UK pension schemes.
- Negotiations and higher company contributions are expected to result.
- Consideration of the 'employer covenant' is key new factor for trustees to consider.

### 2.1 The new regime

The new regime came into force on 30 December 2005 and applies to all funding valuations with an effective date on or after 22 September 2005. Discussion was included in the 2006 Current Topics paper.

#### 2.1.1 Key points

As a reminder, the key features of the new regime are:

- **Statutory Funding Objective ("SFO")** – trustees need to set the funding objective (and technical provisions) they wish to target.
- **Statement of Funding Principles** – trustees need to prepare a statement setting out the principles adopted in their funding objective.
- **Regular actuarial valuations** – valuations continue to be triennial as a minimum, although valuations can be more frequent.
- **Recovery Plan** - in the event of a funding shortfall trustees and the company need to agree how any shortfall (deficit) is to be recovered.

- **Employer Covenant** – in setting the above, the trustees need to consider the strength of the 'employer covenant' – the ability and willingness of the employer to meet the costs of the pension scheme going forward.
- **Schedule of Contributions** – this will set out the agreement to pay contributions going forward and will be certified by the actuary.
- **Annual Funding Statements** – trustees need to provide annual statements to members setting out the funding position of the scheme.
- **The Pensions Regulator** – oversees the process, providing general guidance to trustees, reviewing agreements between companies and trustees, and acting as mediator when no agreement is reached.

The final Scheme Funding code of practice and guidance were issued by The Pensions Regulator ("TPR") in February 2006. Section 2.2 below outlines the typical process for the scheme funding process.

#### 2.1.2 Increased responsibility on trustees

For most pension schemes, the new regime has increased the responsibility placed on trustees (rather than company and actuaries). Whilst the power of trustees is widely felt to have increased, the need to obtain employer agreement is likely to lead to increased amounts of negotiations between trustees and company.

If agreement cannot be reached then the Regulator will intervene and has many powers, including:

- modifying future accrual,
- specifying how the technical provisions are calculated, and
- imposing a schedule of contributions.

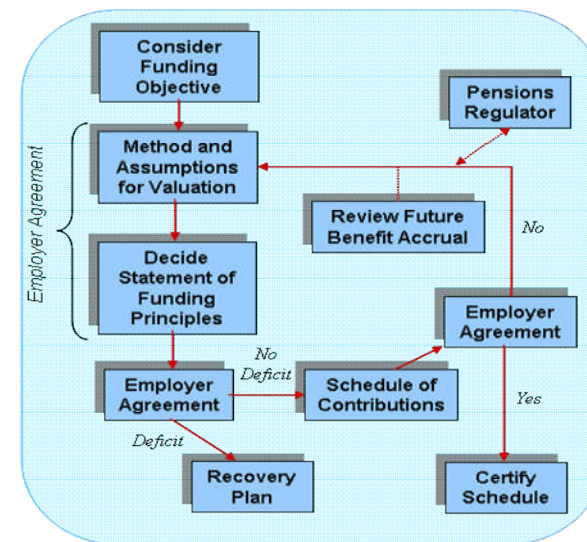
## 2.2 Scheme funding process

### 2.2.1 Process

For a typical funding valuation the following steps might be taken:

- i. **Consider 'Funding Objective'** - discussion between the trustees and scheme actuary to establish the trustees' attitude to risks, to setting prudent assumptions and other relevant matters. This will decide on the measure of 'technical provisions' to be adopted.
- ii. **Method and assumptions** - the scheme actuary provides advice on the method and assumptions to be used for the statutory funding objective and other initial advice with regard to GN49.
- iii. **Obtain Employer Agreement** - discussion and negotiation if necessary between the trustees and company
- iv. **Provisional results** – issue provisional results reflecting the trustees funding objective(s) and other prescribed bases such as PPF and solvency, leading to agreement between the trustees and company
- v. **Final GN49 advice** - final GN49 advice, together with the GN9 valuation report, and the trustees production of their scheme funding documents

In practice, the process will vary according to the experience and knowledge of the trustees, the relationship between trustees and company, the situation of the company and scheme, and the results. The figure below sets out how the process might vary.



**Fig 5: Possible scheme funding process**  
(Source: PricewaterhouseCoopers)

### 2.2.2 Reaching agreement

Trustees will be required to choose assumptions “prudently”, taking account of an appropriate margin for “adverse deviation”. Prudence is not defined in the guidance, but may allow for taking some credit in advance for the expected out-performance of equities relative to bonds. It is for trustees to decide to what extent this is prudent, including consideration of the employer's ability to cope with adverse fluctuations.

Trustees will want to be able to demonstrate that they have considered the risks involved and that they could not reasonably have achieved a better result for scheme members.

In particular, the new regime increases focus on the “employer covenant”. This is a new consideration for trustees. As well as the funding level and the investment strategy, they now have to consider the ability of the sponsoring employer(s) to continue to support the scheme. This may require support from new advisers such as credit advisory specialists and investment banks.

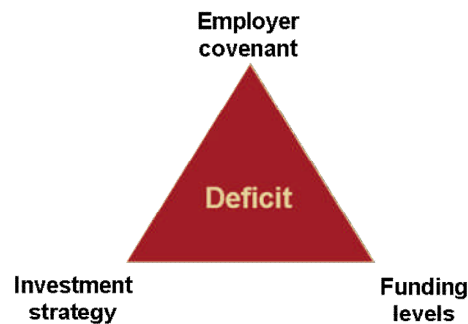


Fig 6: Scheme funding – the new balance

## 2.3 The Pensions Regulator

Another factor for trustees (and employers) to consider is the attitude of TPR. TPR published guidance in 2006 setting out how it will focus on those schemes it considers “at risk”.

### 2.3.1 Schemes “at risk”

Given the number of defined benefit schemes in the UK (over 10,000) and the fact that most would probably be underfunded on an FRS17 accounting basis, the staff of TPR have to focus their attention carefully. They cannot closely examine every scheme. Instead, TPR has stated that they will use as a filter a set of “trigger points” which are aimed at being a fairly objective and reasonable indication to them as to which schemes are most at risk.

The emphasis in TPR’s statements on this subject changed slightly from the approach outlined in the initial consultation. Previously, the Regulator made reference to the percentages of benefits which can be bought out with insurers; instead in the guidance published in 2006, TPR states only that it expects the scheme liabilities (the “technical provisions”) to be valued prudently.

TPR has also said that it will be prepared to be flexible when considering the suitability of a recovery plan. TPR will not automatically receive copies of the statement of funding principles or actuarial valuation reports (though they can ask for just about any information they require). However:

- schemes in deficit have to provide TPR with a copy of their recovery plan and schedule of contributions; and
- many schemes will come to their attention for other reasons, for instance:
  - where trustees report that they cannot reach agreement on scheme funding with the employer;

- where the actuary reports that they cannot certify the calculation of the technical provisions or the schedule of contributions;
- contribution failure reports;
- notifiable event reports;
- scheme returns (TPR may tailor these in future to flag risk more effectively);
- clearance requests;
- trustee requests for guidance; or
- market intelligence.

The trigger points will switch on TPR to the need for further involvement, but will not be considered in isolation.

### 2.3.2 Trigger points - the funding target

In determining whether a scheme's funding target is appropriate, TPR will consider whether this falls below the higher of:

- the FRS17 liability (or IAS19 if applicable), or
- the section 179 liability (the measure of the liability for Pension Protection Fund benefits used for PPF levy purposes).

If so, TPR will examine the scheme more closely. Where the target lies between the two measures, then TPR will focus on the maturity of the scheme, the strength of the employer, and whether any contingent assets are in place. Strong employers with immature schemes will tend to raise concern only if they are below the lower of the two values. Conversely, weak employers with mature schemes will be more likely to be of concern unless the technical provisions are at least as good as both measures.

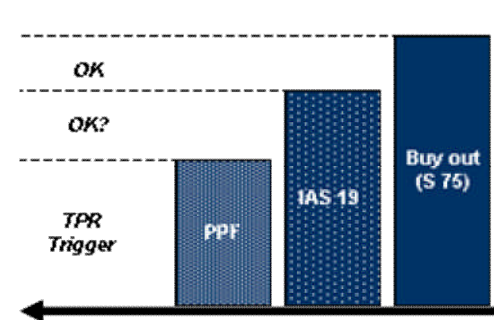


Fig 7: Funding target trigger (PPF may be higher than IAS19)

### 2.3.3 Trigger points - the recovery plan

The main focus of TPR is expected to be on schemes where:

- the length of the recovery plan exceeds 10 years;
- the recovery plan is significantly “back-end loaded”; or
- the assumptions underlying the recovery plan, especially the investment return, “appear inappropriate”.

Once a scheme has “triggered” the attention of TPR, the primary focus will be how the technical provisions have been calculated. They expect the method and assumptions used to be prudent, no matter how easily the employer can make good a deficit. “Prudent” is not specifically defined and may be the source of much discussion and debate.

When considering the appropriateness of a recovery plan, TPR is likely to be more flexible and will consider “the impact any alteration to the recovery plan may have on the employer’s viability”.

A recovery plan exceeding 10 years may still be acceptable, but this would have to be because of the particular situation of the employer and/or because some kind of contingent assets have

been put in place for additional short and medium term protection against certain events (such as employer insolvency). Nevertheless, it is likely that recovery plans exceeding 10 years will become less common than they have historically been.

TPR says that they may look at schemes where the employer can reasonably afford to pay off the shortfall more quickly, but in such cases they will focus on schemes with “weak or weakening” employers. It therefore seems that, so long as the technical provisions are calculated in a reasonable way, strong employers can probably pay off deficits over 10 years. However, where the employer is strong, the trustees may be reluctant to accept a recovery period as high as 10 years - at least not without good reasons that they can demonstrate.

Where schemes have triggered attention, TPR expects the trustees and employers to be able to demonstrate appropriate steps to adopt an “appropriate” investment strategy, and achieve a balance between deficit and accrual payments. In extreme cases, TPR may require a consideration of the potential for modification of future accrual rates.

### 2.3.4 Assumptions during the recovery period

It is a statutory requirement that any recovery plan must set out steps that will be taken in order to meet the funding objective. Therefore, it must aim for a 100% funding level on the method and basis set out in the statement of funding principles, ie to meet the funding target the trustees have set.

Perhaps the most significant change from the consultation released last year is the (brief) reference to the investment return assumption adopted in the recovery plan. TPR may now accept an ‘optimistic’ asset return assumption over the period of the recovery plan, especially where the employer is strong enough to withstand investment fluctuations or contingent assets are in place. Exactly

how this will work, and how optimistic the assumption can be, remains to be tested but it appears that the intention is two-fold:

- First, to further dissuade trustees from weakening funding assumptions in order to get the desired contribution result. This is because the funding deficit may not actually lead to increased contributions if trustees make allowance for assets to perform well and the employer is strong.
- Secondly, to provide some sort of incentive to retain investment in equities. (There had been concerns that adopting FRS17/IAS19 as a trigger would lead to a further major shift from equities into bonds.) The ability to allow for equity out-performance to form part of the recovery plan means that funding plans are themselves less likely to lead trustees to reduce equity investment.

### 2.3.5 Other factors the Pensions Regulator may consider

The most obvious and important factor is the strength of the employer covenant. External information, including credit rating agency views, will be used by TPR to judge this. Notwithstanding the general point that TPR will expect all schemes to be “prudently” funded, schemes with strong employers have slightly more leeway in valuing technical provisions, as well as in the recovery plan.

In the case of strong employers, TPR may regard a funding target of anywhere between PPF and FRS17 as reasonable. However, each case will be considered on its own merits and TPR has made no determinations to set any precedent. Another factor is the maturity of the scheme – more focus will be on mature schemes as they are believed to represent greater risk.

### 2.3.6 Contingent assets

Contingent assets are payable to the pension scheme on the triggering of a certain event (e.g. insolvency of the employer). Guidance from TPR provides guidance for trustees on their approach when considering whether to accept contingent assets in the scheme's funding strategy. Examples of such assets include:

- cash in a bank account (“escrow”) that is released to the scheme on the occurrence of a key event, such as employer insolvency;
- security over assets, where the assets are transferred to the trustees on the occurrence of a key event;
- group company guarantees; and
- a letter of credit (e.g. from a bank) or third party guarantee - effective should the employer default on contribution payments.

It is for the trustees to form a judgement on how appropriate the use of a contingent asset is in view of their specific circumstances. TPR would, of course, prefer that cash is paid into the scheme but if the employer wishes to put some kind of contingent asset in place they should put forward a business case. Trustees are expected to understand why such assets are being considered instead of monies being paid into the scheme.

It is important that trustees take appropriate legal advice to understand how effective any agreements are. In addition, trustees will need actuarial advice to understand the possible effect on the funding level and any risks associated with accepting contingent assets in their funding strategy. If a group company guarantee is put in place, for example, then the trustees will also need professional advice in assessing the strength of the covenant of the guarantor.

There are two scenarios in particular that may lead companies to want to put a contingent asset in place:

- they may provide for some sort of guarantee should investments (e.g. equities) under-perform. This may mean that trustees choose to adopt a weaker funding basis that allows for a higher investment return.
- they may allow for more flexibility in the recovery plan. For example, if the employer wishes to use a back-end loaded plan (i.e. with more contributions being paid later in the recovery period) the trustees may accept this if a bank effectively underwrites any “missed” contributions should the employer be unable to make future payments.

Such assets may also reduce the PPF levy but to do that the PPF conditions for what constitutes a contingent asset would have to be met. These conditions are not necessarily the same.

### 2.3.7 Transition from MFR to the new regime

In some cases the first valuation under the new regime will not be completed until 2009. In the meantime, trustees are encouraged to aim at funding targets higher than those implied by the MFR and to “bring the requirements of the scheme funding regime to the attention of the employer at the earliest opportunity; and begin discussing options for an increase in contributions over and above the MFR level”.

This is another way of saying that trustees should seek as high a contribution rate as they reasonably can from their employer, but stops short of saying that trustees should bring forward their next valuation (where they have the power) to move into the new funding regime.

### 2.3.8 Intervention process

Once a scheme triggers the Pensions Regulator's attention, it is likely that it will request further information in the first instance - such as company accounts and scheme funding documents. They will then further assess the scheme's circumstances to see whether the trustees have made imprudent or inappropriate funding decisions, bearing in mind any contingent assets that may exist. They say that formal powers will only be used in cases where they believe an informal approach would not work so well.

#### Further information

Guidance Note 49:

<http://www.actuaries.org.uk/files/pdf/map/GN49V1-0.pdf>

Details of the new regime are available at

[www.thepensionsregulator.gov.uk/schemeFunding](http://www.thepensionsregulator.gov.uk/schemeFunding)

Scheme Funding Code of Practice:

<http://www.thepensionsregulator.gov.uk/pdf/codeFundingFinal.pdf>

### 3 Pension Protection Fund

- The Pension Protection Fund (PPF) released accounts showing a net 'ongoing' deficit of £343 million.
- The total levy to be collected for 2007/08 is double that in the previous years (£675 million).
- Changes have been made to both PPF valuations and allowance for contingent assets.

#### 3.1 Management of the PPF

##### 3.1.1 Finances of the PPF

During 2006, the Board of the PPF published its Annual Report and Accounts for the financial year ending 31 March 2006. Some of the highlights (all as at 31 March 2006) were:

- 98 schemes were in an assessment period, covering 43,000 members (of which 10,000 were pensioners).
- £138 million was collected in levies for the 2005/06 year (compared to the estimate of £150 million).
- £324 million is expected to be collected for the 2006/07 year (compared to the earlier estimate of £575 million).
- A net deficit on an "ongoing basis" of £343 million.

Although a deficit in year 1 was expected, due to the number of schemes waiting to fall into the PPF when it opened, the levy the PPF expected to raise in 2006/07 was widely thought to be too low. To exacerbate matters, the amount it actually collected (£324 million) was considerably less than its estimate.

For the 2007/08 year, the PPF has announced that it intends to raise £675m, more than double the actual amount raised last year. This means that the levy for individual schemes will, on average, be twice that of the previous year.

##### 3.1.2 Investment policy

The Board of the PPF has published a revised Statement of Investment Principles, setting out the Board's principles and policies governing the investment of its assets (i.e. accumulated levy payments and inherited failed scheme assets). There is a requirement that the statement be reviewed annually or earlier if there are any significant changes to capital markets or the PPF liabilities.

Asset Class	Allocation	Benchmark
Cash	20%	Libor
Global Bonds	50%	JP Morgan Government Bond Index
UK Equities	12.5%	FTSE All Shares
Global Equities	7.5%	FTSE Global
Property	7.5%	IPD
Currency overlay	2.5%	3-month Libor

**Fig 8: PPF asset allocation and benchmark**

Derivatives will be used to attempt to better match the liability profile, reduce the impact of interest rate and inflation risk, and to provide some protection against fall in equities.

## 3.2 PPF valuations

### 3.2.1 Section 179 (levy) valuations

The PPF valuation guidance was amended during 2006 - now version 3. Rather than being one document, the guidance on assumptions has been separated out into another document.

More detail has been provided on certain issues - for instance, on how to split benefits into pre and post 1997 pension and on how to treat hybrid and cash balance schemes. Much of the additional text was previously included in the Frequently Asked Questions section of the PPF web site.

The changes to the basis/methodology put forward in the PPF Levy consultation have been made, ie that:

- the discount rate in deferment is calculated as an (average) index-linked gilt yield less 0.7% per annum (changed from 0.5% per annum), and
- the discount rate for post-1997 pensions in payment is the higher of the (average) index-linked gilt yield less 0.5% per annum and the 10-year fixed interest gilt yield less 2.5% per annum. (The second option has been added.)

The new guidance applies to valuations with an effective date on or after 11 September 2006, or for valuations with an effective date prior to 11 September 2006 that are signed on or after 1 November 2006.

The PPF estimate that the average effect of these two changes may be a reduction of around 5% of liabilities - but this will depend on market conditions and will vary considerably from scheme to scheme. The first change adds to the liabilities whereas the second change works the other way for post-1997 pension so that, in current market conditions, pre-1997 pension would be valued on a

conservative basis but post-1997 benefits on a more optimistic basis.

### 3.2.2 Section 143 (entry) valuations

As for levy valuations, the guidance applying to PPF entry valuations was updated. The guidance reflects questions that the PPF have been asked and allows for the change in assumptions (as per the levy valuations). Part 10 of the guidance specifies what information must be provided to the PPF when submitting a valuation, including the new requirement for actuaries to complete a data and valuation summary to help the Board validate a section 143 valuation. A spreadsheet has been placed on the PPF site for completion to provide this extra data.

The new guidance applies to valuations with an effective date on or after 11 September 2006, or for valuations with an effective date prior to 11 September 2006 that are signed on or after 1 January 2007.

### 3.2.3 Updated factors

To allow for the basis/methodology changes referred to above, revised commutation, early retirement and compensation cap factors (for ages other than 65) have been produced. They apply to valuations prepared under the new guidance.

The PPF have also revised the early retirement factors that applied for the period from 6 April 2005 up to 10 September 2006 inclusive, saying "this may involve some recalculation of previous early retirement quotations and of compensation in payment. Note that these new factors are more beneficial to the members involved. The affected schemes currently in an assessment period are being notified separately."

### 3.2.4 Insured Liabilities

The PPF Board's view is that annuities bought in the name of the trustees are assets of the scheme, and have previously required them to be included in scheme valuations. However, to recognise the situations where it would be either "disproportionate or impossible to identify historic annuity purchases" they have approached the DWP to request legislative change. As a result, draft regulations were released for consultation by the DWP which will permit scheme actuaries to exclude annuities where they were purchased before 6 April 1997 and where, in the scheme actuary's opinion, no record of the insurance contract is available.

It is expected that this legislation will come into force by April 2007 in time for the 2007/2008 levy year. The PPF advised scheme actuaries not to complete any section 179 valuations where insured liabilities would present difficulties due to missing historic data records.

## 3.3 PPF levy

### 3.3.1 Changes during 2006

In a major change from last year, the scaling factor for the risk-based part of the levy will not be known with certainty until April 2007. Last year the factor was 0.53 and, based on the PPF's "indicative estimate", this will increase to around 2.02.

The levy is capped at 1.25% of the liabilities calculated using the PPF basis. This will exacerbate the increase for 2007/08 for companies whose levy was capped in 2006/07 (when the cap was only 0.5%).

No risk-based levy is payable for schemes that are over 125% funded on a PPF liability calculation basis.

As for last year, 80% of the levy will be based on the size of the scheme's PPF deficit and Dun & Bradstreet's (D&B) assessment of

the employer's risk of insolvency that applies as at 30 March 2007. (risk based levy). The remaining 20% will be proportional to the amount of the scheme's liabilities (scheme-based levy).

The date at which assets and liabilities will be determined will be fixed at 30 October 2006, rather than 31 March 2007. Insolvency probabilities will still be measured on 30 March 2007 and any deficit reduction contributions, contingent asset agreements or PPF levy valuations submitted before then will still count towards reducing the levy.

The PPF announced that of the £675 million it proposes to raise through the levy in 2007/08, £540 million would come from the risk-based part and £135m from the scheme-based part. The £675m figure is an estimate and may change, for example to reflect further deficit reduction contributions or certifications of contingent assets.

### 3.3.2 Valuation basis

For 2007/08, the appropriate calculation can be determined by either:

- undertaking a specific valuation (section 179) of the PPF covered liabilities
- rolling forward (by more than one year if necessary) the results of a previous such valuation of liabilities and updating asset values; or
- adjusting the most recently calculated minimum funding requirement (MFR).

A first section 179 valuation must have been submitted to the PPF by 31 March 2008.

### 3.3.3 Allowance for contingent assets

For Type A (group company guarantees) and Type B (eg security over cash) contingent assets the definition of acceptable caps was broadened. Where the cap in the asset is set by reference to a funding level, an absolute maximum may be set. Existing arrangements will continue to be recognised provided trustees re-certify the contingent assets are to remain in place.

Credit default swaps may be considered in future.

### 3.3.4 Insolvency risk

The PPF now instruct Dun & Bradstreet (D&B) to provide failure scores ignoring the effect of County Court Judgements (CCJs) for employers in some circumstances (e.g. where the number of employees is greater than 500). The impact of CCJs was found to be relatively significant on the D&B rating and resulting levy.

For multi-employer schemes the PPF will consider an average insolvency probability (weighted by membership) rather than consider the insolvency risk of the largest employer, as in the past.

A revised table of insolvency probabilities associated with the Dun & Bradstreet failure scores was published in January 2007.

### 3.3.5 Levy exemptions

This gives the Board of the PPF the power to waive the PPF levy in certain circumstances, including:

- closed schemes as defined by the Pensions Act 2004 (schemes who have sufficient assets to cover the PPF liabilities but who cannot obtain a buyout quotation);
- schemes where the defined element of the scheme is fully insured (to the PPF Board's satisfaction);
- schemes that were superannuation funds before 1980; and
- schemes where the employer is in the process of securing voluntary winding-up that is expected to be completed by 31 December of the levy year.

### 3.3.6 Influencing the levy

There are a number of ways a company can influence its PPF levy:

- use the valuation basis that is most favourable (i.e. MFR roll forward or submitted S179 valuation);
- reduce the size of the PPF deficit (by taking measures to reduce liabilities or increase assets);
- take actions to improve the D&B risk rating used by the PPF;
- introduce contingent assets; and/or
- make an additional contribution after the valuation date but before 30 March and have their scheme actuary certify this.

### 3.4 PPF benefits

Benefits payable by the PPF are financed from:

- the assets of the pension funds it takes on from insolvent employers;
- other assets that the PPF may have claimed as a creditor to the insolvent employer;
- investment returns on PPF assets; and
- a levy on solvent employers with UK defined benefit pension schemes.

The benefits provided are subject to a 'compensation cap' which limits the amount of compensation payable to a person who is under normal pension age on the assessment date and whose compensation is not derived from a pension payable on the grounds of ill-health or a survivor's pension.

For the year starting 1 April 2006 the cap at age 65 was £28,944.45 (£26,050 after the 90% factor). For younger ages the cap reduces in line with the factors published on the PPF website.

### Further information

The full PPF accounts can be seen at:

[http://www.pensionprotectionfund.org.uk/annual\\_report\\_0506.pdf](http://www.pensionprotectionfund.org.uk/annual_report_0506.pdf)

With summary presentation:

[http://www.pensionprotectionfund.org.uk/annual\\_report\\_06\\_presentation.pdf](http://www.pensionprotectionfund.org.uk/annual_report_06_presentation.pdf)

The PPF investment policy can be found via the press release at:

<http://www.pensionprotectionfund.org.uk/news-details.htm?id=5432>

The PPF guidance on valuations can be seen at:

[http://www.pensionprotectionfund.org.uk/index/other\\_guidance/valuation\\_guidance.htm](http://www.pensionprotectionfund.org.uk/index/other_guidance/valuation_guidance.htm)

Draft regulations regarding annuities:

<http://www.dwp.gov.uk/publications/dwp/2006/ppf/draft-regs-mawpplma130906.pdf>

The PwC Pension File on the 2007/08 levy can be found at:

[http://www.pwc.com/uk/eng/ins-sol/publ/pensions/pwc\\_protection-fund-levy\\_feb07.pdf](http://www.pwc.com/uk/eng/ins-sol/publ/pensions/pwc_protection-fund-levy_feb07.pdf)

The PwC Pension File on the use of contingent assets can be found at:

[http://www.pwc.com/uk/eng/ins-sol/publ/pensions/PwC\\_Pension\\_Contingent-Assets.pdf](http://www.pwc.com/uk/eng/ins-sol/publ/pensions/PwC_Pension_Contingent-Assets.pdf)

## 4 Transfer values

- The approach to transfer values will now become the trustees rather than actuary's responsibility.
- The approach remains to value benefits based on best estimate, 'cost to the scheme', assumptions.

### 4.1 Background

Throughout 2006, the Department for Work and Pensions ("DWP") consulted on proposed changes to the approach followed to calculating transfer values from approved defined benefit pension schemes.

Previously, the responsibility for setting the principles behind calculating transfer values, was down to the actuarial profession via GN11.

In summary, the previous regime was that:

- members have a statutory right to transfer and their transfer values; and
- the transfer value needs to be at least the expected cost of the benefits that would be provided if they were to remain deferred pensioners.

During 2006, a number of companies offered enhancements to current transfer values. The aim of such an enhancement was often to reduce the assets and liabilities of the pension scheme. Under some measures, this led to a reduction in the deficit of the pension scheme.

### 4.2 The new approach to transfer values

#### 4.2.1 Changes

There is to be a fundamental change in who takes responsibility for setting the transfer value approach with this moving from the actuary to the trustees. However, the guiding principles behind the calculations will be largely unchanged.

In summary, the key features of the new approach are:

- the approach to determining transfer values has not yet been put forward by the DWP. The Institute and Faculty of Actuaries are expected to be relieved of this responsibility;
- the guidance will retain a "cost to the scheme" approach. Original consultation had suggested a market driven approach, which would have represented a fundamental shift;
- the level of information to be provided to members who receive transfer quotations is likely to increase.
- the DWP will prescribe, via new regulations, many aspects of the calculation of transfer values that are currently left to actuaries;
- the regulations are due to take effect on 6 April 2008 (a year later than originally intended) and DWP intends to lay them before Parliament in summer 2007. Revised actuarial guidance will also follow, if necessary.
- the new regulations will require trustees to take responsibility for assumptions used, taking advice from their actuary.
- The assumptions will continue to be best estimates, and have regard to the existing mix of the scheme's assets.

### 4.2.2 Impact on companies and pension schemes

Pension scheme trustees will need to consider what they believe are appropriate assumptions to use in calculating the transfer value. This will include consideration of:

- the investment return assumption to be used in determining costs
- underlying investments to be assumed in determining this (how much of mix represents deferred members)
- the assets backing the deferred pensions and there could be some room for flexibility of approach.
- reasonable administrative costs that can be deducted from transfer values
- any reduction to reflect any underfunding in the scheme

Trustees will need to continue to provide cash equivalent quotations to members on request, so long as the request is not within 12 months of a previous request.

Trustees may have to provide members considering transferring with more information than at present, although the DWP's intentions are unclear at this stage.

### 4.2.3 Impact on actuaries

Actuaries need to be aware of the new regulations and their impact. In particular:

- Less experienced and knowledgeable pension scheme trustees are likely to need significant assistance in determining their view on the above considerations, in particular on investment returns.
- The guidance is largely unchanged, so unless previous approaches were not robust or not in line with the trustees views, the process should be straight forward.

## 4.3 Enhancements to transfer values

As a result of an increased number of companies and pension schemes offering enhanced transfer values during 2006, the Regulator became concerned that members were being disadvantaged by accepting inducements.

In response, rather than placing restrictions on the types of inducements that may be offered, the Regulator issued guidance that seeks to ensure that employers provide members with sufficient information to make an informed choice. Twelve issues were listed which should be clearly expressed in any offer made to members - these are set out in section 4.3.3 below.

### 4.3.1 Communications

Trustees are asked to check the employers' communications to ensure certain key messages are given, including a recommendation to take independent financial advice. They are also reminded to consider their own duties under trust law and in relation to data protection and scheme funding.

### 4.3.2 Tax position

Alongside the Regulator's Guidance, HMRC announced that:

- Cash payments (inducements to take a transfer payment or to amend future benefits) will in future be subject to income tax and (where relevant) employer and employee National Insurance.
- Enhanced transfer values (where transferring scheme pays a higher transfer value to a receiving scheme), will not give rise to tax because the benefit will be taxed in due course on retirement. Nor will they be subject to National Insurance.
- However, there is a transitional regime and so no tax will be charged for many cases already in process.

### 4.3.3 Pensions Regulator guidance

Twelve issues (as outlined in the Pensions Regulator's Guidance) which should be clearly expressed in any offer made to members. The offer should explain:

- i. The nature of the benefits being given up in exchange for the inducement.
- ii. That the scheme which accepts the transfer value may not provide the same level of benefits.
- iii. The risks inherent in and the guarantees offered by the member's defined benefit scheme.
- iv. Where a rule change leading to a reduction of benefits is involved, the likely cost of making good the lost benefit.
- v. That there may also be tax implications for the member if they accept an inducement payment.
- vi. That the member should take independent financial advice before making any decision.
- vii. The amount of the inducement being offered to the particular member concerned.
- viii. Whether the inducement is a cash payment, an increase to the transfer value that would otherwise be paid, or a combination of these.
- ix. If the amount of the inducement is affected by any member choice.
- x. How long the offer will be open.
- xi. Why the employer is making the offer.
- xii. That the member does not have to accept the offer.

### Further information

The DWP press release can be seen at:

<http://www.dwp.gov.uk/mediacentre/pressreleases/2007/jan/pens013-180107.asp>;

The full paper at:

<http://www.dwp.gov.uk/publications/dwp/2006/response-calc-ptv.pdf>

See Pension Regulator's press release and guidance on inducements can be found here:

<http://www.thepensionsregulator.gov.uk/mediaCentre/pressReleases/pn07/pn07-02.aspx>  
<http://www.thepensionsregulator.gov.uk/pdf/inducements.pdf>

and the HMRC announcement here:

<http://www.hmrc.gov.uk/pensionschemes/draft-announcement.htm>

## 5 Taxation changes

- A single set of tax rules now apply to all UK Registered pension schemes.
- Companies and pension schemes need to review benefits and assumptions as a result.
- The tax 'relief' for contributions to UK schemes also changed during 2006.

### 5.1 Tax simplification – impact on benefits

On 6 April 2006 ("A-Day") the government's new tax regime for pension schemes came into effect.

The aim was to offer simpler and more flexible retirement arrangement. The many previous sets of tax approved regimes for tax-privileged pension savings were replaced with a single universal regime.

#### 5.1.1 Impact on employee benefits

The new rules for tax treatment of benefits were discussed in depth in the 2005 Current Topics paper. In summary for pension schemes the new benefit rules mean that:

- Provided the scheme rules allow, a member can take up to 25% of his/her pension fund as a tax free lump sum upon retirement.
- Provided a member's pension fund is less than "Lifetime Allowance" of £1.5m, rising to £1.8m by 2010/11 and reviewed thereafter, he/she would not be subject to tax charge when they start to draw the pension.

- Those with larger pension funds have three years from A-Day to apply for Enhanced and/or Primary protection to HMRC if they wish to protect their funds from the Lifetime Allowance Charge.
- For the first time, individuals can have multiple memberships and contribute to occupational, stakeholder and personal pensions at the same time.
- No limit is imposed on the amount of money a member can save in any of the pension schemes he/she chooses to participate.
- Members can get tax relief on contributions up to 100% of their annual earnings, or the Annual Allowance of £215,000, rising to £255,000 by 2010/11 and reviewed thereafter.
- Flexible retirement is endorsed. Provided the scheme rules allow, a pensioner may choose to continue working.
- From 6th April 2010, a member will not be able to take a pension before he/she turns 55, except on ill health ground or if the member has the right to retire before 50 at 6th April 2006.

#### 5.1.2 Impact on pension schemes

The rules of pension schemes have been or may still need to be amended to reflect the new regime. In particular, references to previous tax regimes (for example the earnings cap) need to be amended.

The changes have also proven a convenient opportunity to review the terms under which pension can be converted into a lump sum at retirement.

The benefit packages of senior employees need to be reviewed in view of the new tax regime. Many high earners with final salary defined benefits may no longer be able to earn benefits in their current schemes. Arrangements that are not approved by the Inland Revenue (and therefore not receive the same tax benefits)

may need to be set up. Alternative, non-pension, arrangements, may need to be considered by companies.

Companies and pension schemes will need to monitor the value of member benefits to ensure that the limits are not breached. For example pay rises in DB schemes should be reviewed where the tax changes may be triggered if the Annual Allowance is exceeded.

Salary sacrifice arrangements may be considered in order to gain NIC savings.

### 5.1.3 Impact on pension scheme liabilities

In calculating the value of the pension scheme liabilities (e.g. as part of accounting or funding valuations), companies need to consider: how the value of pension benefits compares to the lump sum that could be received in exchange, and whether to include an assumption to reflect the likely take-up of the lump sum option by members.

For accounting valuations, a best estimate is required. In most pension schemes, the take-up of lump sum is significant due to it being tax-free and also member's preference for cash in hand (liquidity preference). The company, the actuaries and their auditors might consider a best estimate to require a lump sum assumption to be made.

For funding valuations, a greater degree of prudence is required. In addition, the terms of converting pension to lump sum are very often set to be cost neutral using funding assumptions. An assumption may not be appropriate, or at least considered to be a margin for prudence.

The change in liabilities resulting from the changes to the rules of the scheme following A-Day, including changes to commutation terms, may be considered as a profit and loss item under accounting standards. Where the pension scheme is large relative

to the company, this could have a significant impact on the company's financial results.

## 5.2 Company tax deductibility

For accounting periods ending on or after 6 April 2006 the rules for employers deducting pension contributions and the spreading of tax relief (where relief is obtained) will change.

### 5.2.1 Basic principles

The rules for accounting periods ending up to 5 April 2006 give a statutory deduction (subject to possible spreading) for contributions paid by an employer to an exempt approved pension scheme in relation to its employees and ex-employees (under ICTA 1988). From April, the more general tax "wholly and exclusively" test applies so that deductions are allowed for contributions made wholly and exclusively for the purposes of the employer's trade or profession.

When tax inspectors assess deductions for employers' contributions they can refer to the HMRC Business Income Manual, and if they are uncertain as to whether a deduction should stand they should make a report to Audit & Pension Schemes Services before challenging the deduction. In response to requests from the pensions industry, the guidance for tax inspectors has now been released in draft form. Comments should be submitted by 17 February, but no major changes are expected before this guidance forms part of the Registered Pension Schemes Manual from April 2006.

### 5.2.2 Key points from the guidance

Key points noted by HMRC in the guidance include:

- All contributions are treated as revenue expenditure, not capital expenditure.

- Deductions are allowed for contributions made *wholly and exclusively* for the purposes of the employer's trade. Apart from the general "purpose" test, specific situations discussed cover: partial non-business contributions, controlling directors/shareholders, sale/cessation, purchase and industry-wide schemes.
- The accounting treatment is not followed for tax. Deductions for an employer's contributions are allowed for the period of account in which they are paid by the employer, and for no other period, unless the deduction is required to be spread over a number of periods. Spreading of deductions may be required broadly where there is an increase over 210% in the level of employer contribution from one period to the next.
- Where contributions to a group pension scheme are made by the holding company in the group with each employing subsidiary company in the group being recharged an appropriate amount relating to its employees, the intra-group recharge may be accepted as being a contribution paid by the employer to the registered scheme. Such recharges should be accepted as contributions paid by the employer in the period of account in which the holding company paid the contribution to the registered scheme.
- Payments under a Contribution Notice served by the Pensions Regulator differ according to whether they are served on the employer or a connected/associated party. Such payment by the employer is treated as a normal pension contribution under the scheme and if the Pensions Regulator requires the employer to make a payment after the trade has ceased, then the payment is treated as being made on the last day of trading. Whether a deduction is allowed in computing the trading profits of such a third party depends on the general principles as to whether the payments are revenue expenditure which is being laid out wholly and exclusively for the purposes of the trade being carried on by the third party.

- PPF levies are everyday costs of employing staff, in the same way as pension contributions, and will usually be an allowable deduction in computing the employer's trading profits for tax purposes.

### 5.2.3 Impact on companies

In the majority of cases, especially single employer schemes, there is unlikely to be any real change. Employer contributions to occupational pension schemes being treated in the same way as before. The rules on the spreading of relief will change especially for spreading of any special contributions.

In some cases it is not currently clear how the "wholly and exclusively" test will apply. Many companies are concerned on how contributions may be treated for tax (e.g. in cases where large payments are made to reduce deficits in multi-employer schemes or payments made as a result of corporate transactions). Each case will need to be looked at on its own merits by tax departments with the rules applying not necessarily "hard and fast".

In addition to ensuring tax relief is obtained where possible, employers will also want to address carefully how the relief may be spread under the new rules.

### Further information

The full document can be seen at:

<http://www.hmrc.gov.uk/practitioners/emp-contributions.htm>

The PwC Pension File on tax deductibility can be found at:

<http://www.pwc.com/uk/eng/ins-sol/publ/pensions/pwc-pension-file-tax-deductibility-mar07.pdf>

## 6 Age discrimination

- Many features of the way pension schemes operate involve judgements based on age.
- The new age discrimination legislation impacts upon these judgements.
- Pension benefits accrued and discriminatory practices up to 1 December will not be affected the changes.

### 6.1 Background

From 1 December 2006 it became unlawful for employers and trustees of an occupational pension scheme to discriminate against members or prospective members on the basis of age.

The driving force for the changes has been the government's obligation to incorporate in UK law the European Employment Directive of 2000. Discrimination can be direct (treating someone less favourably because of age) or indirect (applying a provision, criterion or practice which disadvantages a particular age group).

### 6.2 The changes

Pension benefits accrued and discriminatory practices up to 1 December 2006 will not be affected by the regulations.

Discrimination (direct or indirect) will only be lawful if one of the specific pensions exemptions applies or if it can be "objectively justified". The exemptions are in relation to occupational pension schemes and employer contributions to personal pension schemes.

It may also be possible for schemes to maintain their practice by using a length of service exemption.

If schemes do not comply with the regulations, a member or prospective member can bring a claim to an Employment Tribunal against the employer and trustees - there are penalties for non-compliance.

The consequences of an employer not complying with the Regulations include: trustees have been given a "levelling up" power, unlimited financial awards to members and members bringing complaints to an employment tribunal.

There is a default retirement age of 65, so employers will no longer be able to retire employees from their work before age 65, unless this can be objectively justified. However, a lower normal retirement age under the pension scheme is acceptable provided the general provisions of the regulations are met. Regulations only affect pension benefits accruing from 1 December 2006.

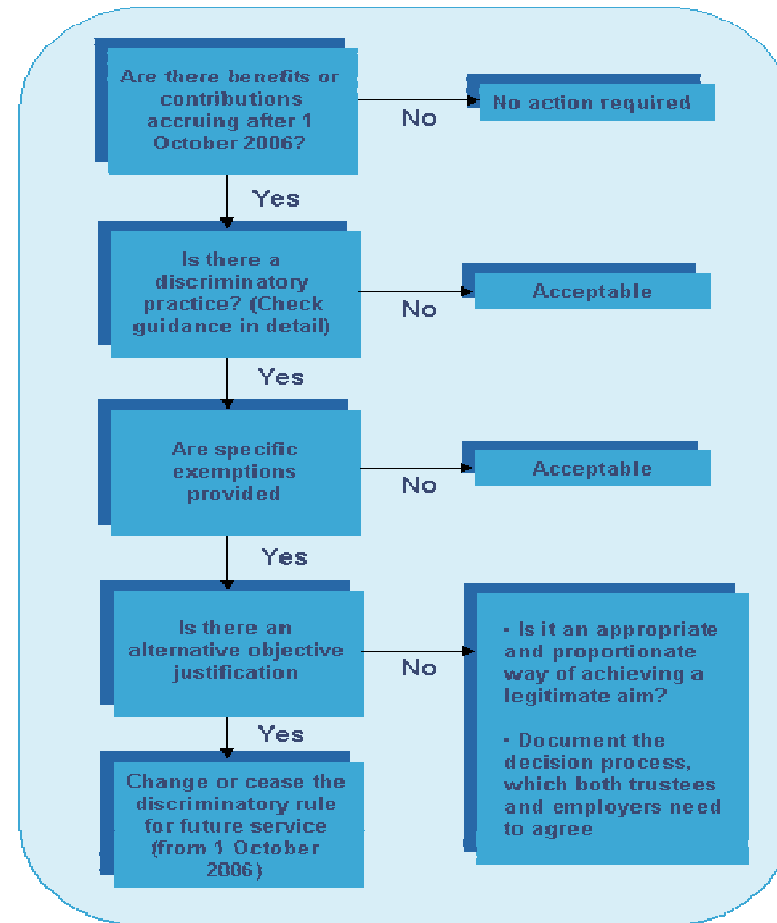
**6.2.1 Impact on companies and pension schemes**

Every occupational pension scheme will be treated as having a non-discrimination rule and trustees or managers will have power to alter scheme rules to comply with the rule.

Examples of practices that may need to be reviewed:

- Benefits that are dependent on ‘service’.
- Imposing an age at which you can take early retirement without consent.
- Group Personal Pensions that have a minimum age for admission.
- Defined contribution schemes that have age-related contribution scales.
- Age criteria used in actuarial calculations.
- Denying members from taking a pension while they continue to work.

Examples of legitimate business aims that might support justification for age discriminatory practices include business needs, rewarding loyalty or providing promotion opportunities to retain workers.



**Fig 9: Age discrimination flow chart (note: should refer to 1 December not October)**

### 6.2.2 Impact for actuaries

Actuaries need to be aware of the new rules and their impact. In particular:

- Pension schemes and companies may need continued help in identifying areas of rules and discretionary practices that may be age discrimination.
- When advising on pension scheme design, actuaries need to ensure that the design does not breach age discrimination laws
- For defined contribution schemes with age-related scales, actuaries will be required to comment on the extent to which this discriminate by age.
- Defined contribution scheme designs may need to be reviewed in light of the rules. Actuaries may need to provide support in this, including estimating benefit levels.
- Assess the impact on pension cash costs, liabilities and service costs of any implicit or explicit changes to the rules of the pension scheme (e.g. early retirement, fixed age retirement).

### Further information

The DTI document “Impact of the Age Regulations on pension schemes” can be found at:

<http://www.dti.gov.uk/files/file35877.pdf>

## 7 White paper on pensions reform

- Personal accounts are to be introduced in 2012.
- The Basic State Pension will be re-linked to earnings possibly by 2012.
- The State Pension Age is to be raised to 68 by 2046.

### 7.1 Pension Commission

The Pensions Commission, led by Lord Turner, published its third and final report in early 2006. The report responded to specific issues which arose in public debate since publication of the second report's conclusions. Though the Commission acknowledged certain concerns raised, they stood by their main recommendations. In summary, these were for:

- reforms of the state system to make it more generous and less means tested, with a gradual rise in state pension age;
- the creation of a low cost National Pension Savings Scheme (NPSS);
- automatic enrolment into the NPSS, but with the option to opt out; and
- some compulsion for employers to contribute 3% of earnings where the employee chooses to stay enrolled.

### 7.2 Government response – White Paper

In May 2006, the Government released their much-awaited response to the proposals put forward by the Pensions Commission in 2005.

The key elements of the Government proposals were:

- Introduction of new 'Personal Accounts' with compulsory employer contributions from 2012 (see 7.3 below)
- Basic State Pension to be linked to average earnings, possibly from 2012.
- State Second Pension to evolve into a flat pension from 2030 with changes to contribution levels.
- Abolition of contracting-out of defined contribution pension schemes.
- Increase to State Pension Age from 2026.
- Changes to the Financial Assistance Scheme.

#### 7.2.1 State pension changes

The Basic State Pension will be linked to average earnings, possibly from 2012.

The State Second Pension will evolve into a flat-rate pension by 2030. The exact details need to be clarified, but accruals will start to become a flat rate contribution-based top-up to the Basic State Pension, at the same time that the Basic State Pension becomes linked to earnings.

The contributory system of qualifying for State Pension will be revised:

- the number of years needed to qualify for the full basic State Pension is to be reduced to 30 (it is currently 44 for men and 39 for women);
- contributory credit will be available for those that care for disabled or children.

Contracting-out will be abolished for defined contribution schemes (possibly from 2012). Also, more "simplification" legislation will be

produced - eg to allow schemes to convert GMP to scheme benefits.

The State Pension Age will rise gradually - and sooner than Lord Turner had recommended. It will be:

- 66 from 2026 (affecting those born after 6 April 1959);
- 67 from 2036 (affecting those born after 6 April 1968); and
- 68 from 2046 (affecting those born after 6 April 1977).

There will be two-year phasing-in periods in each case.

### 7.2.2 Financial Assistance Scheme

The Financial Assistance Scheme (designed to assist people whose schemes went into wind-up before the PPF started) will be extended to those people within 15 years of their scheme's Normal Retirement Age. This is up from the current 3 year limit and will work by paying the full 80% compensation to those within 7 years of scheme pension age, 65% to those within 7-11 years, and 50% to those within 11-15 years. This is said to increase the total cash funding of the FAS from £400 million to over £2 billion.

At the same time, the Paper announced more finance for the Financial Assistance Scheme.

## 7.3 Personal Accounts

The White Paper ("Personal Accounts: A new way to save") proposed that personal accounts, featuring auto-enrolment, would be introduced in 2012. They will be delivered through a "National Pension Savings Scheme" model, as recommended by the Pensions Commission, rather than through private providers. Further details will emerge as consultation progresses - with responses to this White Paper requested by 20 March 2007.

### 7.3.1 Contributions

Contributions will be payable on the "personal accounts earnings band" (PAEB).

Initially (in 2012) this will be earnings between the national insurance primary threshold (currently £5,000) and the upper earnings limit (currently £33,000).

Thereafter it will increase in line with earnings.

Minimum contribution rates (on PAEB).

- Employer: 3% (phased in: 1% in the first year and 2% in the second year of operation).
- Employee: 4% (also phased in, proportionately to the employer rates).
- Treasury: 1% (possibly more for higher rate taxpayers).

The employer minimum rate will be set in legislation to remove uncertainty as to future increases.

Maximum annual contributions.

- £5000; but
- £10,000 permitted in first year of operation.

### 7.3.2 Auto-enrolment

Auto-enrolment will operate for new employees over age 22 and under state pension age. Employees may opt out, but those that do must automatically be re-enrolled every three years. Employees under age 22 may opt in and qualify for employer contributions.

Self employed people and those earning under £5,000 may also opt in but will not qualify for employer contributions.

### 7.3.3 Investment

There will be a default fund – probably "life-styled" with a switching into bonds as retirement approaches

Individuals may also choose from a small number of low charge bulk-bought funds and a wider range of specialised funds.

### 7.3.4 Employer exemption

To gain exemption from auto-enrolling employees in personal accounts, employers must operate auto-enrolment in their occupational schemes; and the pension scheme must:

- if a contracted-out defined benefit scheme - satisfy the existing reference scheme test;
- if a contracted-in defined benefit scheme, provide accrual of at least 1/120th of pensionable earnings for each year of service; or
- if a defined contribution scheme, provide a default investment option and receive contributions at least at the level required for personal accounts

### 7.3.5 Other points

Other points to note are:

- Responsibility for personal accounts will ultimately pass to a Personal Accounts Board.
- Administration will be sourced with licensed administrators.
- A clearing house will set up personal accounts, collect contributions and pass them to investment managers.
- The Government believes that in the long term charges of 0.3% or even lower will be attainable.

### Further information

The full Pensions Commission report and backing documents can be seen at:

<http://www.pensionscommission.org.uk/publications/2006/final-report/index.asp>

DWP press release on responses to White Paper:

<http://www.dwp.gov.uk/mediacentre/pressreleases/2006/oct/pen01-301006.asp>

## 8 Mortality risk

- This year has seen the official release of the "00" series mortality rates
- Plans are underway for a new securities market to hedge longevity risk.

### 8.1 The new "00" tables

During 2006, the Actuarial Profession released a final set of mortality tables based on the experience over the four-year period 1999-2002. These are known as the "00" series and are the first new base tables to be released since the "92" series which covered the period 1991-1994 (the tables were actually released for consultation last September). They include new tables for the experience of life office pensioners which are intended to ultimately replace the "92" series which are the most commonly used tables for the valuation of pension schemes (including PPF calculations).

#### 8.1.1 Tables available

There are two sets of tables - a set for a variety of types of pensioner and a set for assured lives.

The tables for pensioners relate to:

- Life office pensioners who retired at normal retirement age
- Life office pensioners who retired early
- Life office pensioners combined
- Life office widows
- Immediate annuitants

- Pensioners with personal pensions (deferred, vested or combined - lives only)
- Pensioners with retirement annuity contracts (deferred, vested or combined - lives only)

For all but the final two sets of tables, both "lives" (based on the mortality of a group of lives) and "amounts" (based on mortality per pound of pension) tables are produced.

The tables for Assured lives relate to:

- Permanent policy holders (smokers, non-smokers or combined - lives)
- Temporary policy holders (smokers, non-smokers or combined - lives)

#### 8.1.2 Investigation into the experience of Self Administered Pension Schemes (SAPS)

Both the 92 series and 00 series tables are based on insurance company data. An investigation into the experience of Self Administered Pension Scheme lives is currently being carried out. Preliminary analysis shows that the 92 series and the new 00 series are too light for the majority of retirees, although they may be reasonable for the highest-paid 25% of pensioners. The final tables are due out later this year.

#### 8.1.3 Projections

The previous "92" series included official projections set out by the profession to allow for expected future mortality improvements after 1992.

However, studies in 2002 showed that life expectancy had increased at a much faster rate than had previously been anticipated by the 92 series projections and was greatest for a cohort of members born around 1930. Long, medium and short adjustments were published to make allowance for this effect

depending on the extent to which the effect was expected to extend into the future. The PPF among others adopted the medium adjustment in its assessment of PPF liabilities.

More recently, a paper presented to Staple Inn argues that rates of improvements do not keep pace with historic trends, even with the medium cohort adjustment, and should be subject to an underpin. There is therefore some question whether even the medium cohort effect makes appropriate provision for future improvements in longevity.

In light of the uncertainty surrounding the allowance for future mortality improvements, and the fact that the 92 series tables (and indeed earlier table projections) were quickly found to understate life expectancy improvements, no projections have been issued alongside the 00 series tables. Instead, the Profession is hoping to assist actuaries by explaining the features and benefits of two projection methodologies, P-spline and Lee-Carter. Actuaries will then need to consider the appropriateness of these and other methods for use in a particular situation.

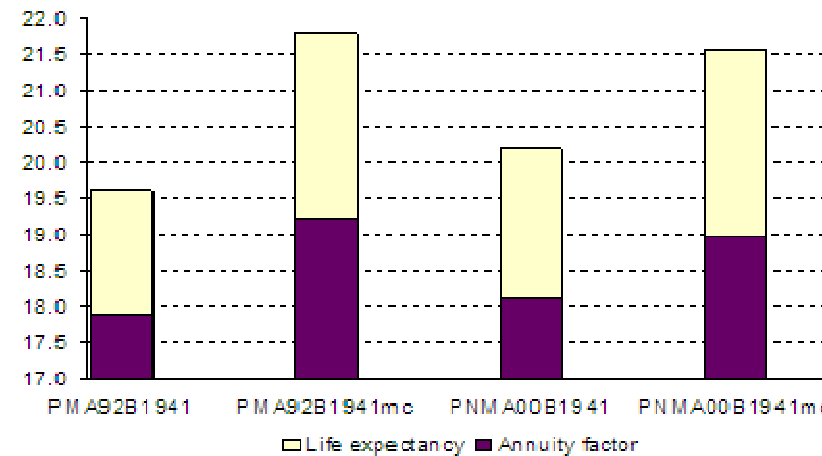


Fig 10: Life expectancies and annuities under “00” series

## 8.2 Hedging Longevity Risk

In 2006 plans have been growing to create a securities market which joins together those parties who wish to hedge longevity risk (such as Pension funds) with those parties who wish hedge the opposite risk of unexpectedly high mortality (such as Life Insurers). For this market to work there has to be sufficient demand. This will be met partly from hedge funds who see longevity risk as a great diversifying asset because it has a very low correlation to financial risk. But ultimately, demand will need to come from pension funds and life insurers. Therefore, the success of this market relies on the products on offer being suitably customised to be able to hedge the exposure of a particular scheme whilst also being ordinary enough to create liquidity.

Investment Banks have been leading the way in product development and some pension experts believe the coming year will see the kick start to a market which David Blake, professor of

pension economics at CASS Business School, feels could one day rival the vast credit derivatives market.

### **Further information**

The CASS business school paper on hedging mortality risk can be found at:

<http://www.cass.city.ac.uk/facact/progression/actsci/PeterClaresDissertationelectronicviewing.pdf>

The tables can be seen in Working Paper 22 via the CMI index at:

[http://www.actuaries.org.uk/Display\\_Page.cgi?url=/library/cmi/wp2122/wp2122\\_cover.xml](http://www.actuaries.org.uk/Display_Page.cgi?url=/library/cmi/wp2122/wp2122_cover.xml)

The PwC Pension File on longevity can be found at:

[http://www.pwc.com/uk/eng/ins-sol/publ/pensions/pwc\\_pensions\\_longevity-members\\_may06.pdf](http://www.pwc.com/uk/eng/ins-sol/publ/pensions/pwc_pensions_longevity-members_may06.pdf)

## 9 Trustee knowledge

- From 6 April 2006 trustees of UK pension schemes must demonstrate knowledge and understanding.
- Support is available from the Pensions Regulator.

### 9.1 The new rules

From 6 April 2006 trustees of occupational pension schemes must satisfy certain requirements so that they can properly exercise their functions as trustees - specifically that they have knowledge and understanding of certain relevant matters and are conversant with relevant scheme documentation.

#### 9.1.1 Exemptions

Regulations were laid this month which provide for limited exemptions. Trustees of small schemes are exempt provided that the scheme has fewer than twelve members, all the members are trustees (or the company is a trustee) and either:

- all decisions to be made by the trustees have to be made by unanimous agreement by the trustees (or directors for a company trustee), or
- the scheme has a registered independent trustee.

In addition, new trustees are allowed a period of grace for 6 months in order to meet the requirements unless they were appointed "as a consequence of holding themselves out as having expertise" (in pensions law, scheme funding, investment, or other matters than can be prescribed) or are independent trustees.

#### 9.1.2 Code of practice

This is intended to provide guidance to trustees who wish to be sure of what is expected of them, and has now been laid before Parliament. The code itself is around 20 pages (including the preamble), not including the scope documents which list pretty much everything that may be relevant to a trustee and are 6 and 9 pages long (for defined benefit and defined contribution schemes respectively).

The scope documents set out the scope of knowledge expected in broad areas, and can be found on the Regulator's website. Trustees are expected to use these documents as checklists to determine which elements apply to them.

#### 9.1.3 Demonstrating knowledge and understanding

Trustees will need to demonstrate what active steps they have taken to fill in their gaps, so they are encouraged to keep records of any internal/external training undertaken or any accredited examination taken. They can consider communicating what they have done to employers and members but there is no requirement to do this. Initially, it was suggested that trustees would have to explain how they have met the legislative requirements on knowledge and understanding in the annual scheme return sent to the Pensions Regulator. This has been dropped from the code for the moment, but this may be required in the future.

#### 9.1.4 E-learning

The Pensions Regulator's e-learning programme for trustees is available online covering:

- Introducing pension schemes
- The trustee's role
- Pensions law
- The four major asset classes

- How a DB scheme works
- Funding your DB scheme
- DB recovery plans, contributions and funding principles
- How a DC scheme works
- Fund management

### **Further information**

The full regulations can be seen at:

<http://www.opsi.gov.uk/si/si2006/20060686.htm>

The code, scope documents and e-learning can be seen via:

<http://www.thepensionsregulator.gov.uk/trustees/trusteeKnowledge/index.aspx>

Trustee training: [www.trusteetoolkit.com](http://www.trusteetoolkit.com)

## 10 Section 67 changes

- Changes were made to Section 67 of the Pensions Act in 2006.
- Member rights can only be changed if they are informed or changes are “actuarially equivalent”.
- Trustees must agree to the modifications and the Pensions Regulator has the power to void.

### 10.1 Revised Section 67

Changes to section 67 became effective from 6 April 2006 (effective 30 March 2006 for some provisions). These changes were effected by the replacement of section 67 of the Pensions Act 1995 with new provisions via section 262 of the Pensions Act 2004. The Code of Practice was laid before Parliament and finalised on 7 November 2006.

In addition, the actuarial profession released a new Guidance Note (GN51) to guide actuaries when advising on actuarial equivalence.

#### 10.1.1 Changes to existing rights

A rule change detrimental to members' subsisting rights is now allowed provided certain requirements are met. Trustees must agree to a modification being made and members must be informed about proposed changes.

There are two routes schemes can follow in order to modify subsisting rights:

- obtaining written consent from each affected member;

- meeting the actuarial equivalence requirements (and obtaining an appropriate certificate).

Both routes contain a reasonable time requirement. The Code of Practice specifies that under the consent route, the modification should be made within 7 months of the date consent is received. Under the actuarial equivalence route, actuarial certification should be obtained within 1 month of the effective date of change.

The following illustration demonstrates the two routes schemes can follow in order to modify subsisting rights.

Two types of modifications can be made. A scheme can only make a protected modification (conversion of defined benefits to defined contribution benefits or a reduction of pensions in payment) with the informed consent of members

Detrimental modifications can be made either with informed consent of members or by ensuring that at the time of modification, members' accrued rights do not suffer a reduction in actuarial value.

In addition the Pensions Regulator has the authority to void both forms of modification and impose penalties on trustees and any person who incorrectly make scheme modifications.

Schemes are allowed to make a rule change that could have a detrimental effect on some of the rights a member has acquired in the scheme ("subsisting rights") if certain steps are taken and requirements are met. The change must meet the actuarial equivalence requirements and the trustees obtain an actuarial certificate (see GN51 below), or else they need to obtain individual consents in writing.

### 10.1.2 Guidance Note 51

The new Guidance Note (51) advises actuaries of the information that they must give to Trustees to alert them of the need to consider wider issues in relation to a detrimental modification (without member consent). The circumstances when this information will be required are:

- A - when providing advice to trustees regarding how the actuarial value of subsisting rights can be maintained; or
- B - when issuing an actuarial equivalence statement.

Information that must be given to trustees by an actuary when providing advice on maintaining value of subsisting rights

There is no requirement for trustees to seek actuarial advice when fulfilling the "actuarial value requirement" (ie taking steps to ensure that the actuarial value of subsisting rights is not reduced), but even when this requirement is met the actuary may consider that there are matters that are relevant to the trustees' decision to approve the modification. These matters could include:

- an adverse modification that is not included in the definition of subsisting rights,
- the adverse modification of an element of subsisting rights,
- changes which could be material for some members, or
- funding or solvency issues such as the effect on an individual's asset coverage on wind-up.

It is not necessary for the actuary to investigate the potential effect of the issues above, but the trustees should be advised as to whether or not such investigations should be carried out.

The actuary must ensure that the trustees are aware of the need to take legal advice before approving the detrimental modification. Should the actuary believe that the trustees are wrongfully not

considering the points raised then they should consider such actions as reporting to the Pensions Regulator or resigning their appointment.

### 10.1.3 Requirements for the actuary when issuing an actuarial equivalence statement

The actuary should ensure that the information above has been provided to the trustees before issuing the actuarial equivalence statement.

The Code of Practice on the modification of subsisting rights was laid before Parliament on 7 November 2006. The Code provides guidance on:

- which schemes and modifications are affected by the legislation;
- trustees' duties and responsibilities; and
- the Pensions Regulator's expectations and powers to intervene.

### 10.1.4 Basics of the "new Section 67"

The benefits protected by Section 67 of the Pensions Act 1995 (as amended by the Pensions Act 2004) are "subsisting rights", relating to the leaving service benefits already earned. Schemes are allowed to make a rule change that could have a detrimental effect on the rights a member has acquired in the scheme ("subsisting rights"), but only provided certain steps are taken and requirements met. There are two routes to modifying subsisting rights, though a combination can be used:

- obtaining written consent from each affected member; or
- meeting the actuarial equivalence requirements, and obtaining an appropriate certificate.

Consent must be obtained for certain "protected modifications" (currently these are conversion of defined benefits to defined contribution benefits or a reduction of pensions in payment).

As well as providing general guidance to trustees, the Code also sets out the Pensions Regulator's views on reasonable periods.

#### **10.1.5 Reasonable periods**

Affected members should generally be given one month to make representations (for both the consent route and the actuarial equivalence route). If the consent route is used, the modification should generally be made within 7 months of the date consent is received and the trustees should generally make the decision within 6 months. In the case of the actuarial equivalence route, the actuarial certification should generally be obtained within a month of the effective date of the change. Trustees should generally inform affected members within one month of taking the decision to modify the scheme.

#### **Further information**

The Code can be seen via:

<http://www.thepensionsregulator.gov.uk/codesAndGuidance/codes/index.aspx>

The full guidance note (and covering letter) can be seen via:

[http://www.actuaries.org.uk/Display\\_Page.cgi?url=/pensions/pensions\\_gns.xml](http://www.actuaries.org.uk/Display_Page.cgi?url=/pensions/pensions_gns.xml)

## 11 Guidance note changes

- Minor change made to GN28.
- GN48 offers more clarity on the type of advice falling within its scope.
- EXD71 proposed changes to GN29.

### 11.1 GN28: Retirement Benefit schemes – Adequacy of Benefits for Contracting-out

This guidance note provides compulsory guidance about the Reference Scheme Test certificate which is required by HM Revenue and Customs in relation to the adequacy of benefits to contract-out of the State Second Pension. GN28 version 2.1 became effective from 29 July 2006 and will be adopted by BAS only after the DWP changes current legislative references.

The changes are minor and are summarised below:

- A statement of purpose is now included within the Guidance Note.
- The comparison period for benefits has been clarified. It is the three year period following the effective date of certification.
- The wording regarding transitional measures following the introduction of version 2.0 has been removed as the transitional period has ended.

### 11.2 GN48: Compliance Review: Pensions

GN48 was introduced to ensure that advice given by Scheme Actuaries under Practice Standard Guidance Notes is subject to a process of review. Version 2.0 became effective on 1 January 2007 as a Practice Standard. Version 1.0 was previously classified as Recommended Practice.

The changes are:

- A third appendix has been added: “A Non-exhaustive List of Written Advice that must be subject to Compliance Review”. It was added in the effort to address the uncertainty surrounding the scope of advice covered under GN28.
- Version 1.0 predated both GN49 and GN51 and as such references to these have been added to cover advice provided under these new Guidance Notes.

### 11.3 EXD71: Occupational Pension Schemes – Advisers to the Trustees (GN29)

EXD71 proposes major changes to version 6 of GN29 entitled Occupational Pension Schemes – Advisers to the Trustees or a Participating Employer. Version 7 is proposed to be effective from 26 February 2007 and EXD71 is currently being exposed under Due Process. The main proposed changes are summarised below:

It is proposed that GN29 will no longer apply to actuaries who advise participating employers. They are however still subject to the requirements of the Professional Conduct Standard. As a result, corporate advisors do not need to consider GN29 in relation to the advice they give except in terms of what the response of the Scheme Actuary will be.

Changes in the responsibilities of Scheme Actuaries are also proposed. When advising Trustees, Scheme Actuaries should highlight any related duties of the Trustees as set out by the Pensions Regulator.

Additionally, advice must be given to the Trustees when the Scheme Actuary thinks they have shown inconsistency in their decisions and are failing to consider matters to the degree required. The Scheme Actuary can consider whether any action should be taken. Such action can include a report to the Pensions Regulator under Section 70. This new guidance also applies to Trustees' Advisers.

It is proposed to remove Section 6 of GN29 entitled Reporting to the Pensions Regulator. Instead, actuaries should refer to the Pension Regulator's Code of Practice for such guidance.

Appendix B is to be restructured to list by category, examples of events which could affect the financing or solvency of a scheme and on which the Scheme Actuary requires notification from the Trustees. New examples to the list are:

- a change in the Trustees' opinion of the employer's covenant
- cessation of future accruals, and
- a determination to defer winding up.

This list remains non-exhaustive and the effect of categorisation of the events is to broaden the scope of events considered.