Pensions Convention 2003
Session B01 - A workable scheme-specific funding standard
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SUMMARY

Introduction

The Minimum Funding Requirement (MFR) came into force in April 1997, and requires private sector defined benefit occupational pension schemes to hold a minimum level of assets to meet their liabilities, as assessed on the basis of the MFR test. It also sets out time limits within which any underfunding on the MFR basis must be met.

The MFR has not worked as intended, and has proved to be inflexible, and unable to fully take account of the specific circumstances of individual schemes. Following a consultation on the future of the MFR the Government announced (in March 2001) proposals to replace it with a scheme specific funding approach.

The proposals for replacing the MFR include new requirements for schemes to automatically communicate key information about their funding position to scheme members (including those already drawing their pension). It is likely that such information would be communicated by means of a document prepared and issued by the trustees.

This qualitative research project was designed to help to provide input into the development of the policy for communicating information about the funding of defined benefit occupational pension schemes to scheme members. In particular to provide information about the extent to which it might be possible to engage members in information about scheme funding, the sort of information which might be included, and how often it should be sent out.

Methodology

The project involved 30 depth interviews with active members and pensioners belonging to defined benefit schemes run by private sector organisations. Respondents were sent an example document drafted by the DWP which provided information about the funding position of a hypothetical scheme (which was 95% funded on the basis of its scheme-specific funding strategy) and what would happen if it were to close. They were then interviewed about the messages that they took from this document and the action that they thought that they would take if they received such a document about their own scheme. Interviews were conducted face-to-face and lasted around 45 minutes to an hour each.

In order to be recruited for this research, respondents had to be able to identify whether they were part of an occupational scheme and then if they belonged to a defined benefit rather than a defined contribution scheme (from simplified descriptions given). This means that they may be slightly more knowledgeable about pensions than the general population.

Key Findings

PENSIONS HISTORY AND UNDERSTANDING

Respondents' knowledge about how their scheme operates was reasonable in terms of the salary percentages that they and their employer contribute and how their final pension will be determined. However they were less clear about how the money that they contribute is managed. In particular, some did not appreciate that defined benefit schemes involve a collective fund rather than a collection of individual funds managed centrally. This interfered with their

understanding of the example document particularly in terms of issues such as why they would not receive ‘all their money back’ if the scheme were to close down.

OVERALL VIEW OF DOCUMENTS

Generally respondents felt that the document that they were asked to look at used language and a format that were reasonably easy to understand. They were particularly positive about the ‘Question and Answer’ approach that the document took. They felt that the document was measured and factual without being daunting or ‘pompous’. Most of those who had received literature from their own pension schemes felt that this document compared favourably. Sometimes this was because respondents found the fact that letters/forecasts that they received about their own scheme came accompanied with booklets or reports that they found intimidating and difficult to understand.

Nearly all claim that they would read such a document if it arrived about their own scheme. One or two younger members felt that they might ignore it because their retirement feels ‘a long way off’. The majority stated that they would keep such a document.

When asked about the purpose or key message of the document respondents were equally as likely to mention issues around possible scheme closure as to mention issues relating to the overall funding position of the scheme. This is largely because the fact that the scheme could close to current members was new information for most and some found this worrying. Most of this group were more concerned about the information relating to possible scheme closure because they recognised that the shortage in the scheme’s funds was being addressed by way of increased employer contributions.

Individuals who were already retired were less likely to be concerned by the document and mostly recognised that they would be largely unaffected by the issues raised.

LEVEL OF UNDERSTANDING OF DOCUMENTS

Given the technical nature of the information it is unlikely that a situation whereby all members/pensioners understood the document fully could ever be reached. Against this background, the general understanding of the document was reasonably good. The sections that were most likely to cause confusion were those that detailed the actuarial assumptions used in the valuation of the scheme and the likely level of pension benefits that members could expect if the scheme were to close down with funding at its current level.

The section which describes the assumptions used by the actuary in his/her valuation of the scheme caused substantial confusion for some. Some admitted that they had skipped this section when reading through the document on their own because the number of figures was confusing. A few felt that the fact that the section mentions an assumption that pay will rise by an average of 4.5% a year in the future implied that they personally would be receiving a 4.5% pay rise. Others felt that although the assumption was that the return on investments would be around 6.5% per year, only 4.5% would be returned to individuals so that there would be a ‘missing 2%’. For some, the confusion that they ran into at this section made them question their ability to interpret the rest of the document.

The part of the document which explains what levels of benefit members could expect to receive if the scheme were to be closed down with funding at its current level was difficult for some people to understand. While the majority understood that, if the scheme were to close, they might not receive their full entitlement they did not necessarily understand why this would be the case. Several struggled to understand why they could only expect an average return of 75% of their entitlement if the scheme was fully funded (or even 95% funded). Despite this confusion, respondents felt that members should be given this information if it applied to their scheme.

UNDERSTANDING OF SECTIONS RELATING TO HEALTH OF SCHEME

The sections dealing with the fact that the scheme was underfunded at its last full valuation were generally well understood. The majority understood that the company was addressing the shortfall by increasing its contributions to the scheme and that scheme members would not be expected to increase the amount that they contributed. Hence most were not overly concerned by this section. Some more knowledgeable respondents did state that they would like to know more information about this shortfall such as the time period over which it had developed and the amount of time that it would take to correct the situation. Some stated that they would like this information so that they could track whether the action taken by the employer remedied the situation in the time expected.

FREQUENCY WITH WHICH INFORMATION SHOULD BE PROVIDED

Nearly all respondents stated that if similar information was provided by their own scheme, they would want to receive it annually. Some more knowledgeable members commented that they were unsure what the documents in between the 3-yearly actuarial valuations would include. However it seems that sending the document annually would have value in terms of:

- Reducing the alarm that some feel when reading the sections about what would happen in the event of scheme closure. If it appeared in documents that they saw regularly they would view this more as *‘standard’* information and less as implying imminent scheme closure;

- Allowing more knowledgeable respondents to track the progress of any remedial action that the company takes to correct any shortfall in its funding position;

- Keeping the issues raised in the document closer to ‘top of mind’.

ACTION PROMPTED BY DOCUMENTS

The action that members are most likely to take on receipt of such a document is to discuss its contents with colleagues. Others would go to their Human Resources department. Smaller numbers suggest that they would approach employee representatives such as the employee trustees of the scheme or trade union representatives. Even smaller numbers suggested that they would consider taking the advice of an independent financial adviser. A small number of respondents suggested that they may consider leaving the scheme but all of these would at least consult someone first (usually colleagues).

Some stated that the document would make them think more deeply about whether they would be adequately provided for in retirement and perhaps consider alternative investments. This was often quite a vague thought as respondents were unclear about what alternative investments they would consider. Some respondents, who did not fully understand the operation of defined benefit schemes, felt that they would want to correct the shortfall in ‘their own fund’ by increasing their own contribution level and stated that this was something that they would consider. One or two others suggested that they would take out additional investments such as Additional Voluntary Contributions (AVCs).

Respondents were asked about whether they felt that they would react differently if the funding deficit reported were greater. If the shortfall were greater (say around 20%) then more members stated that they would take action – again, most commonly to talk to colleagues. Several felt that if the shortfall was very large (around 40%) then they would consider leaving the scheme but all of these individuals stated that they would take advice from someone first.

Issues to consider

Based on the findings of this research, we would suggest that some scheme members will welcome receiving documents similar to those tested in this research and will absorb and react to the content about the health of their scheme, but there are some issues that need to be considered in terms of how the information is presented. We make the following suggestions in communicating information about scheme funding;

- a question and answer format similar to that used in the example document and a similar style and tone;

- the information is sent as a separate mailing and that other booklets and reports are not included with it;

- the information is sent out on an annual basis (even though the full actuarial valuation will only take place every 3 years);

- the document should include an explanation that with a defined benefit scheme the ‘pot’ is communal rather than involving a collection of individual funds. This would need to be very clearly explained;

- it includes an explanation of why the document has been sent out i.e that it has been sent to all members and that the trustees are obliged to disclose such information about the scheme’s funding position;

- it could include information about what would happen if the scheme were to close down with funding at its current level, but this should be prefaced with an explanation of why this information is included;

- any information about whether or not members could expect their full entitlement if the scheme were to close explains why members might not receive 100% of their entitlement even if the scheme might be 100% funded;

- the section which details some of the actuarial assumptions is omitted;

- if the scheme is underfunded then the document presents some sort of timeframe within which the scheme will be ‘back on track’;

- that both employers and trustees plan carefully (in advance of mailing such documents) how they will deal with the volume of queries that they are likely to receive and what they will say to ensure members receive consistent messages. Queries are equally as likely to be about possible scheme closure as to be about the funding position of the scheme and include questions about the documents themselves, whether they should remain in the scheme or whether they should take out additional investments;

- that the document states that members should take professional advice before transferring out of the scheme (in the event of scheme closure or otherwise) and also before taking out any additional investments.