EXPLANATORY MEMORANDUM TO THE

OCCUPATIONAL PENSION SCHEMES (SCHEME FUNDING) REGULATIONS 2005

2005 No. 3377

AND

THE PENSIONS REGULATOR'S CODE OF PRACTICE ON FUNDING DEFINED BENEFITS

1. This explanatory memorandum has been prepared by the Department for Work and Pensions and is laid before Parliament by Command of Her Majesty.

This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Description

2.1 The Scheme Funding Regulations, made principally under Part 3 of the Pensions Act 2004 (the 2004 Act), set out the details of new funding requirements for defined benefit occupational pension schemes; these requirements replace the minimum funding requirement under the Pensions Act 1995.

2.2 The Pensions Regulator is required under section 90 of the 2004 Act to produce codes of practice containing practical guidance, including one concerning the duties imposed on trustees of occupational pension schemes by Part 3 of the 2004 Act. Codes of practice will be admissible in evidence in any legal proceedings. It is intended that the code of practice on the funding of defined benefits will be supplemented by specimen documents designed to assist trustees or managers in preparing the funding documents provided for in the legislation.

3. Matters of special interest to the Joint Committee on Statutory Instruments

<u>Timing of the Regulations</u>

3.1 The Regulations come into force on 30 December 2005. They are subject to transitional provisions which reflect the fact that member States are required to implement the requirements of the IORP Directive before 23 September 2005.

3.2 It was not possible to bring these Regulations into force before 23 September given the need to take full account of the responses to extensive consultation on draft proposals with the pensions industry and other interested parties. However, there was wide expectation within the pensions industry that the new requirements would apply to valuations as at a date after 21 September and schemes have begun to prepare on that basis. Key stakeholders agreed that it would be less disruptive for such schemes for the Regulations to apply to valuations from 22 September onwards rather than from the coming into force date of 30 December.

3.3 Actuarial valuations comparing the assets and liabilities of private sector defined benefit occupational pension schemes involve considerable work, for which the Regulations will normally allow up to fifteen months for completion. They are usually triennial and are based on a particular date (known as the "effective date"), by reference to which the scheme's assets are valued and compared with its liabilities for future pension payments, calculated according to actuarial assumptions as to future investment returns, life expectancy etc. The effective dates of most scheme valuations are clustered around the turn of the calendar and tax years. The early stages of a valuation primarily involve data collection and validation, including the obtaining of audited accounts. It would be exceptional for a valuation to be completed in less than six months, with most taking longer. As a result it is expected that the timing of the Regulations will have minimal practical effect on the small number of schemes required to commence a valuation between 22 September and 30 December and which would otherwise be required to carry out an unexpected further valuation on the basis of the current minimum funding requirement (MFR). Moreover, the Regulations allow such schemes to have longer to complete their first valuation under the new provisions - eighteen months rather than the fifteen usually allowed.

3.4 Regulations which impact on business should normally come into force on either 6 April or 1 October (the two recognised common commencement dates). A departure from these dates is permitted, however, for Regulations which implement requirements arising from European legislation.

Inclusion of Amendment to Northern Ireland Legislation

3.5 With the exception of the amendment contained in paragraph 1(5) of Schedule 3 to these Regulations, corresponding provision will be made by Northern Ireland in the Occupational Pension Schemes (Scheme Funding) Regulations (Northern Ireland) 2005. Paragraph 1(5) of Schedule 3 amends regulation 49(4)(a)(i) of the Occupational Pension Schemes (Contracting-out) Regulations 1996 (S.I. 1996/1172) which relate, among other things, to the restoration of a scheme member's state scheme rights. Although Northern Ireland has equivalent legislation, i.e. regulation 49(4)(a)(i) of the Occupational Pension Schemes (Contracting-out) Regulations (Northern Ireland) 1996 (S.R. 1996 No. 493) ("the Contracting-out Regulations") under paragraph 10 of Schedule 2 to the Northern Ireland Act 1998 (c. 47), "rights to return to the state pension scheme” are an “excepted matter” for which Northern Ireland cannot legislate.

3.6 Paragraph 77(5) of Schedule 1 to the Social Security Contributions (Transfer of Functions, etc.) (Northern Ireland) Order 1999 (S.I. 1999/671) confers power on the Secretary of State to make regulations under paragraph 5(3C) of Schedule 1 to the Pension Schemes (Northern Ireland0 Act 1993 (c. 49), the power under which regulation 49 of the Contracting-out Regulations was made. Accordingly, paragraph 8 of Schedule 3 to these Regulations makes provision for Northern Ireland corresponding to that contained in paragraph 1(5) of that Schedule.

4. Legislative Background

4.1 The Regulations constitute the first exercise of the powers contained in Part 3 of the 2004 Act. Together with provisions in Part 3 of the 2004 Act, they replace the MFR provided for in sections 56-61 of the Pensions Act 1995 and the Occupational Pension Schemes (Minimum Funding Requirement and Actuarial Valuations) Regulations 1996.

4.2 The Regulations also implement article 15 and the funding requirements of article 16 of European Union Directive 2003/41/EC (the IORP Directive) on the activities and supervision of institutions for occupational retirement provision (OJ No. L 235, 23.9.03, p.10). A Transposition Note is attached as Appendix A to this memorandum.

4.3 The Pensions Regulator is the new regulator of work-based pension schemes in the UK, created under the Pensions Act 2004 to replace the Occupational Pensions Regulatory Authority. The code of practice on funding defined benefits meets the requirements in section 90(2)(a), (d) and (g) for the Pensions Regulator to issue one or more codes relating to what constitutes a 'reasonable period' for compliance with any provision which requires action to be taken within such a period, the duties imposed on trustees or managers by Part 3 of the 2004 Act, and the duty imposed on them to report material failures by employers to pay contributions.

4.4 The 2004 Act requires the Regulator to consult on draft codes of practice and to modify a draft to take account of responses. The Regulator must then submit the draft to the Secretary of State for Work and Pensions for approval.

4.5 A draft of the code of practice has been approved under section 91 of the 2004 Act by the Minster for Pensions Reform on behalf of the Secretary of State for Work and Pensions and is being laid before Parliament at the same time as these Regulations. Section 91(7) of the 2004 Act specifies a period of 40 days’ consideration before a code of practice is issued. If no representations are made, the Secretary of State may, by order, bring the code into force. In the meantime the draft will be available on the Pensions Regulator's website in the form in which it is laid.

Scrutiny history

4.6 The Government submitted explanatory memoranda to Parliament dated 11 December 2000 and 16 May 2001in respect of the *'Proposal for a Directive of the European Parliament and of the Council on the coordination of laws, Regulations and administrative provisions relating to institutions for occupational retirement provisions'* (Doc Ref 13420/00, COM(200)507).

4.7 The House of Commons European Scrutiny Committee reported on the proposal and the Government's explanatory memoranda in Report no.2, Session 00/01 and in Report no. 31, Session 01/02.

4.8 The proposal and explanatory memoranda were sifted to Sub-Committee A of the House of Lords European Union Committee and were cleared by that Committee following correspondence with Ministers on 17 June 2002.

5. Extent

5.1 Apart from the provision relating to Northern Ireland referred to in paragraph 3.6 above, this instrument and the code of practice apply to Great Britain.

6. European Convention on Human Rights

As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

7.1 The MFR currently applies to all private sector defined benefit occupational pension schemes, except those expressly exempted by legislation. It requires schemes to hold a minimum level of assets to meet their liabilities (as assessed on the basis of the MFR test), and to make up any funding shortfalls against the MFR within fixed periods (the MFR deficit correction periods). It is generally accepted that the MFR was a flawed approach; it increased regulation and costs for sponsoring employers, and may have contributed to the decision of some employers to close their defined benefit pension schemes.

7.2 Part 3 of the 2004 Act and these Regulations replace the MFR with more flexible, scheme-specific funding requirements. This is a significant de-regulatory initiative which has been widely welcomed. Key differences include:

- more flexibility, allowing the trustees of each scheme to adopt the most appropriate funding strategy for meeting their pension commitments;
- greater focus on partnership, with trustees working with the sponsoring employer to develop and agree an appropriate funding strategy for their scheme, having taken actuarial advice;

- greater emphasis on the role of the trustees in determining the appropriate funding strategy for their scheme. Where they cannot agree on a matter with the sponsoring employer they must report to the new Pensions Regulator;
- new powers for the Pensions Regulator to help resolve disputes about funding issues between the trustees and the sponsoring employer;
- scheme members will be better informed about the funding position of their scheme, and any associated risks.

7.3 The Government initially announced proposals to replace the MFR in March 2001. There followed a lengthy period of consultation, including the setting up of a Consultation Panel of key stakeholders to develop the detail of the new proposals. Those proposals were modified to take account of subsequent developments, particularly the decision to introduce a Pension Protection Fund, and the funding requirements of the IORP Directive which was published in September 2003.

7.4 The key component of the proposals is that pension schemes will be required to fund on a scheme-specific basis rather than according to a "one size fits all" prescribed basis as with the MFR. The framework for the new funding requirements is set out in Part 3 of the 2004 Act, and these Regulations set out the detailed requirements.

7.5 The aim is to allow schemes the flexibility to take account of circumstances specific to their scheme (such as the willingness and ability of the employer to continue to fund the scheme, the age profile of the scheme's members, staff turnover, the trustees' investment policy, the age at which people retire, and the employer's policy on future salary increases) when determining their detailed funding strategy and, where relevant, determining an appropriate deficit correction period. Together with Part 3 of the 2004 Act, the Regulations require trustees, having taken actuarial advice, to agree a prudent funding strategy with the sponsoring employer to provide for benefits to be paid when they fall due.

Code of practice

7.6 The code of practice to be issued by the Pensions Regulator gives trustees practical guidance on meeting their duties under Part 3 and these Regulations. For instance, it sets out the factors which trustees should consider when deciding what would be a prudent funding strategy for the particular circumstances of their scheme; and it provides guidance which will assist trustees in understanding the advice of their actuary and in negotiating with the sponsoring employer.

7.7 A public consultation was held jointly on the Regulations and the code of practice and an outline of the responses and how they have been taken into account is contained in Appendix B to this memorandum.

8. Impact

8.1 An assessment of the impact on business, charities and the voluntary sector of the provisions of these Regulations was included in the Regulatory Impact Assessment that accompanied the Pensions Bill 2004. A copy of the relevant extract is attached at Appendix C.

8.2 Public sector pension schemes are generally exempt from the scheme funding requirements and there will therefore be minimal impact on the public sector.

9 Contact

9.1 Margaret Watchorn at the Department for Work and Pensions, Tel: 020 7962 8067 or e-mail: margaret.watchorn@dwp.gsi.gov.uk can answer any queries regarding the instrument.

Transposition Note

Appendix A

Occupational Pension Schemes (Scheme Funding) Regulations 2005

Transposing those parts of the European Union Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision[1] (IORP Directive) which concern the funding of private sector defined benefit occupational pension schemes

Article	**Requirements**	**Implementation**
2	Sets out the scope of the Directive and identifies institutions to which the Directive does not apply.	Part 3 of the Pensions Act 2004 applies to all occupational schemes other than money purchase schemes and those which are exempted by Regulations (section 221). The Occupational Pension Schemes (Scheme Funding) Regulations 2005 ("the Regulations") set out in regulation 17 those schemes or types of scheme which are exempted. These either fall outside the scope of the Directive as determined in article 2 or may be exempted from the requirements of the Directive under article 5 (see below).
5	Member States may choose not to apply the Directive in whole or in part to institutions with less than 100 members. Member States may choose not to apply articles 9 to 17 (which include the funding requirements) of the Directive to institutions where occupational retirement provision is made under statute, pursuant to legislation, and is guaranteed by a public authority.	The UK has not elected to make full use of the small scheme derogation. The Regulations allow schemes with fewer than 100 members, and which are not operating on a cross-border basis, to obtain actuarial valuations every three years without the need to obtain actuarial reports for the intervening years (paragraph 11 of Schedule 2). Where such a scheme does not obtain actuarial reports for the intervening years it will also be free to send members funding information every three years rather than annually (paragraph 2(3)(b) of Schedule 3). The Regulations exempt (Regulation 17(1)(a)) schemes where provision is made under an enactment and is guaranteed by a Minister of the Crown or other public authority.

[1] (OJ No. L 235, 23.9.03, p.10)

Article	Requirements	Implementation
11	Article 11.4 (second paragraph) requires members to be given every year brief particulars of the situation of the institution and the current level of financing of their accrued individual entitlements.	Paragraph 2(3)(b) of Schedule 3 to the Regulations amends the Occupational Pension Schemes (Disclosure of Information) Regulations 1996 (SI 1996/1655) to require trustees to send members a funding statement following each actuarial valuation and each report for an intervening year between valuations. This statement will set out key information about the funding of the scheme together with an indication of the funding level were the scheme to wind up.
15	Technical provisions **1)** requirement to ensure that institutions establish adequate liabilities in respect of their pension commitments **2)** requirement to ensure that institutions establish sufficient technical provisions **3)** technical provisions shall be calculated annually, or triennially if the institution provides a certification or a report of adjustments for the intervening years **4)** technical provisions calculations shall be executed and certified by an actuary (or similar) according to the following principles: **a)** the minimum amount of technical provisions shall be calculated by a sufficiently prudent actuarial valuation **b)** the maximum rates of interest shall be chosen prudently **c)** the biometric tables shall be based on prudent principles	Regulations 3 and 4 set out how a defined benefit scheme's pension commitments are to be determined and valued. There is no definition of technical provisions given in the Directive. Technical provisions are defined in section 222(2) of the 2004 Act as "the amount required, on an actuarial calculation, to make provision for the scheme's liabilities". Regulation 5 sets out requirements about the manner in which technical provisions are to be calculated. Section 224(1) of the 2004 Act requires scheme trustees or managers to obtain valuations annually, or at least every 3 years if they obtain actuarial reports for the intervening years, showing developments affecting the technical provisions since the most recent valuation. Section 224(2)(c) and Regulation 7(5) set out the requirements for actuarial reports. Paragraphs 2 and 3 of Schedule 3 to the Regulations require that the funding statement for members required under the second paragraph of article 11.4 contains information based on the latest actuarial valuation and any actuarial report received subsequently. Section 225 of the 2004 Act requires the scheme actuary to certify that the calculation of the technical provisions has been made in accordance with the requirements of the subordinate legislation. The form of the certificate is set out in Schedule 1 to the Regulations. If the actuary is unable to certify, he must notify the Regulator. Regulation 5 requires the trustees or managers of schemes to choose an accrued benefits funding method, and prudent actuarial assumptions for calculating the technical provisions according to principles which follow the requirements of article 15.4 (a)–(d). The Regulator will issue a code of practice under section 90(2) of the 2004 Act, which will include guidance on the factors trustees should consider in determining which accrued benefits funding method and which actuarial assumptions are appropriate for calculating the technical provisions for

Article	Requirements	Implementation
	d) the method and basis of calculation shall remain constant, unless justified by a change of legal, demographic or economic circumstances underlying the actuarial assumptions. **5)** Member States may make the calculation of the technical provisions subject to further requirements.	their scheme. The UK is not introducing additional requirements beyond those outlined above regarding the calculation of technical provisions.
16	Funding of technical provisions. **1)** All institutions must have at all times sufficient and appropriate assets to cover the technical provisions. **2)** In the case of insufficient assets to cover the technical provisions: **a)** the institution must set up a recovery plan which is to be made available to members or representatives and/or subject to approval by the competent authorities **b)** the plan shall take into account the specific situation of the institution. **c)** the institution must inform the competent authorities if it starts to wind up whilst a recovery plan is in place. **3)** Technical provisions must at all times be fully funded in the event of cross-border activity.	Under section 222 of the 2004 Act, schemes are subject to a statutory funding objective to have sufficient and appropriate assets to cover their technical provisions. Where an actuarial valuation shows that a scheme does not meet this objective, section 226 of the 2004 Act requires the trustees to put in place a recovery plan. This plan must be time-limited and show the steps to be taken to meet the statutory funding objective (section 226(2) of the 2004 Act). The plan must be agreed with the sponsoring employer (section 229 of the Pensions Act 2004) and be drawn up after obtaining advice from the actuary (section 230(1)). A copy must be sent to the Pensions Regulator (section 226(6)) and be made available to members (paragraph 20 of Schedule 2 to the Occupational Pension Schemes (Disclosure of Information) Regulations 1996 as amended by paragraph 2(6) of Schedule 3 to these Regulations). In addition a summary of the recovery plan must be included in the funding statement sent to members in compliance with the second paragraph of article 11.4 (paragraph 2(7) of Schedule 2 to these Regulations). . Section 226(3) of the 2004 Act requires the plan to take account of the circumstances and nature of the scheme. Regulation 8(2) requires the matters set out in article 16.2(b) to be taken into account in drawing up a recovery plan. Under regulation 8(8) there is a requirement for the Pensions Regulator to be notified if a scheme with a recovery plan commences wind up. Paragraph 6 of Schedule 2 to the Regulations modifies the requirements of Part 3 of the 2004 Act for schemes engaged in cross-border activity. Such schemes are required to obtain annual valuations and to make up any shortfall identified at a valuation within two years of the effective date of that valuation.

Scrutiny history

Doc Ref 13420/00, COM(200)507: *Proposal for a Directive of the European Parliament and of the Council on the coordination of laws, Regulations and administrative provisions relating to institutions for occupational retirement provisions*.

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The House of Commons European Scrutiny Committee reported on the proposal and the Governments explanatory memoranda in report no.2, Session 00/01 and in report no. 31, Session 01/02.

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Appendix B

Consultation

There was no statutory duty to consult on the provisions of these Regulations made under Part 3 of the Pensions Act 2004. Consultation was nevertheless considered appropriate in view of the technical nature of these provisions, and their significance for private sector defined benefit schemes.

There was a statutory duty for the Pensions Regulator to consult on the code of practice. A joint consultation package containing draft Regulations, a draft code of practice, and proposals for transitional and consequential provisions, was issued on 22 March 2005.

The consultation period ended on 6 May and was followed by four consultation events around the country, and a meeting of the Scheme Funding Consultation Panel.

<u>Outcomes on consultation for the Regulations</u>

Key themes concerning the Regulations to emerge from the consultation, including many of a technical nature, were:

(1) the wording of the actuarial certification of the schedule of contributions;
(2) the content of the actuarial reports required between full valuations;
(3) the problems of obtaining a solvency estimate for a scheme too large to wind up;
(4) how the Regulations apply to schemes in wind-up;
(5) how discretionary benefits should be treated;
(6) what basis should be used for funding statements in the period until schemes have obtained their first valuation under Part 3 of the 2004 Act;
(7) the scope for changing the actuarial method and assumptions from one valuation to the next; and
(8) concern that the draft Regulations altered the balance of power in schemes where someone other than the trustees or the employer currently sets the contribution rate – for example, the scheme actuary.

<u>Actions</u>

As a result, the Regulations have been amended to:

(1) provide modified wording for the certification of the schedule of contributions according to different circumstances;
(2) clarify what the actuarial reports required between full valuations must cover; further guidance on this is included in the code of practice;
(3) reshape the definition of a solvency estimate to allow the actuary to estimate the position for a scheme in circumstances where the cost of securing the scheme's benefits with an insurance company cannot be readily determined;
(4) revise the provisions to exclude schemes in wind up;
(5) clarify how the treatment of discretionary benefits should be described in the statement of funding principles;
(6) provide an alternative basis for summary funding statements for schemes that have not yet obtained their first valuation under Part 3 of the 2004 Act so that useful information is supplied to scheme members during this period;

(7) clarify the circumstances under which the actuarial methods and assumptions can be changed from one valuation to the next. These circumstances are constrained by the requirements of the IORP Directive and so it was not possible to accommodate the full flexibility sought in some of the comments made; and
(8) modify the provisions for schemes where, for example, the scheme actuary currently sets the contribution rate, following further informal consultation with the pensions industry and a number of affected schemes. It was not possible to reconcile the views of all the interested parties within the new legislative framework set out in Part 3 of the 2004 Act, which gives trustees a central decision-making role. The Regulations have been amended so as to preserve as much of the balance of power which currently exists in the rules of these schemes as is possible within that framework.

Point of note

Actuarial reports for the years between triennial valuations are required to implement article 15.3 of the IORP Directive. Article 15.3, which is implemented by section 224(2)(c) of the 2004 Act, requires that these reports reflect the "adjusted development of [the scheme's] technical provisions". (The term "technical provisions" means the amount required, on an actuarial calculation, to make provision for the scheme's liabilities.) The overwhelming response on this issue from the consultation was that these reports should additionally cover developments in the asset position in the intervening period in order to make for meaningful comparison. This is provided for in regulation 7(5). Since the information should be available from the scheme's annual accounts required by legislation for other purposes, this further requirement should result in negligible additional costs.

Outcomes on consultation for the code of practice

Key themes concerning the code of practice to emerge from the consultation were:
(1) code and associated guidance were lengthy documents with too much purely "educative" material included and some repetition. The code should be restricted to high level principles;
(2) clearer guidance around prudence was needed. As drafted, many considered it to be encouraging trustees to adopt a very cautious approach;
(3) the guidance around assessing the employer's covenant needed strengthening;
(4) more guidance for trustees was needed on dealing with conflicts of duty and interest;
(5) the guidance on recovery plans did not take sufficient account of the need to maintain employers' viability; and
(6) 'reasonable periods' for reporting to the Regulator and to scheme members (in the case of contribution failures) were impracticably short.

Actions

The response has been as follows:
(1) under section 90 of the 2004 Act, there is a requirement to provide 'practical guidance' and it was not possible to reconcile this with the suggestion that the code should cover only high level principles;

(2) the code was extensively amended to address detailed comments made on individual sections; partly as a result of this, it was decided to adopt one document and dispense with the accompanying guidance. It was accepted that it is not the role of a code to address the matter of trustee education, and this will be taken forward as part of the separate work to address issues around trustee knowledge and understanding;

(3) much of the criticism of the draft code in the area of prudence has been accepted. The code has been strengthened to address the points made and now makes it clear that:
   - the legislation does not require setting technical provisions at ‘full buy-out’ level;
   - an appropriate allowance for the out-performance of scheme assets relative to the yields available on government stock can be prudent where the employer’s covenant is judged to be strong enough to cope with the consequences of assumptions not being borne out by experience;
   - a margin for adverse deviation will not be necessary where trustees are satisfied with the overall degree of prudence of the assumptions;
   - trustees should be satisfied as to the overall level of adequacy of the technical provisions;

(4) the code has been amended to emphasise that there is a range of sources of information and/or advice on the employer's financial situation and the likelihood of the employer’s insolvency;

(5) the code has been amended to address in more detail the issue of conflicts of interest/duty for some trustees, and advises them to consider in advance how they will recognise and deal with any that arise in the course of negotiating with the employer;

(6) the code has been changed to reflect respondents’ suggestions that 'trustees should aim for any shortfall to be eliminated as quickly as the employer can reasonably afford'. The code now also makes it clear that trustees must take into account the likely effect of any recovery plan on the employer's future viability and that they should consider the employer's business plans. In addition, the code provides guidance on how contingent security might allow trustees to agree a longer recovery plan.

It was accepted that a period of five days in which to make a report was unreasonably tight in some circumstances, and particularly when reporting to members. Accordingly, different ‘reasonable periods’ have been adopted for reports to scheme members and to the Regulator in the case of material contribution failures: the revised code proposes ten days for all reports to the Regulator and one month for reports to scheme members. The code stresses that where circumstances give rise to the need for an immediate report, this should be done initially by telephone to be followed up in writing as soon as reasonably practicable.

Appendix C

Extract from the Regulatory Impact Assessment for the Pensions Bill 2004

(as prepared for the Lords reading of the Bill and signed by the Secretary of State for Work and Pensions on 8 June 2004)

Chapter 4: Simplification

4.1 A new framework for scheme funding

4.1.1 The Minimum Funding Requirement (MFR) was introduced from April 1997, and applies to most private sector DB pension schemes. Schemes subject to the MFR are required to hold a minimum level of assets to meet their pension liabilities (as assessed on the basis of the MFR test), and any funding shortfalls under the MFR must be made good within prescribed timescales (the MFR deficit correction periods).

4.1.2 The MFR will be replaced with scheme-specific funding requirements. Key elements of the new arrangements will be:

- a requirement for scheme trustees to prepare a Statement of Funding Principles (SFP) setting out the scheme's strategy for funding its pension commitments and for correcting funding deficits. The SFP will complement the Statement of Investment Principles which trustees are already required to prepare;
- regular actuarial valuations, based on a funding approach consistent with the strategy set out in the scheme's SFP;
- more effective communication with scheme members to ensure that they are better informed about the funding of their scheme;
- powers for The Pensions Regulator to help resolve disputes about funding issues between the trustees and the sponsoring employer; and
- clarification of the scheme actuary's role in respect of scheme funding.

4.1.3 The MFR has been widely criticised since its introduction, and it is clear that it has not worked as intended. It has increased regulation and costs for sponsoring employers, without delivering the level of security which many people expected. It is also considered to have inhibited investment decisions by some schemes, causing them to focus on meeting the conditions of the MFR, rather than on developing an appropriate funding strategy for meeting their specific pension commitments.

Summary of options and impact of consultation

4.1.4 A consultation document on the future of the MFR was published in September 2000. Responses confirmed a lack of support for the MFR, and an alternative approach to a common funding standard was rejected because a practical regime could not be devised without replicating the drawbacks associated with the MFR. In March 2001 the Government published *Security for Occupational Pensions: The Government's Proposals*, announcing plans to replace the MFR with a scheme-specific funding approach.

4.1.5 Two further papers[2] form part of an ongoing process of consultation, as did the establishment of a Consultation Panel of representatives from the pensions industry, consumer organisations, employers and trades unions. This Panel has assisted in developing the details of the proposals for replacing the MFR.

4.1.6 As the Government had already announced its intention to replace the MFR following this earlier extensive consultation, the Green Paper did not specifically seek further comments on these proposals. Around 140 respondents did nevertheless refer to them in their responses to the Green Paper. Employers and the pensions industry remained broadly in favour, while consumer groups and some individual members expressed some concern that replacing the MFR might weaken protection for scheme members.

Benefits

4.1.7 The Government believes that the new framework for scheme funding, together with the proposals for improving protection for members of schemes which are winding up, strikes an appropriate balance between flexibility and affordability for employers, and protection for scheme members.

4.1.8 The proposals for replacing the MFR will have a financial effect on both the pace of funding, and the administration of pension schemes. There is very limited information on which to base reliable estimates of the costs and benefits of replacing the MFR, and estimates must therefore be regarded with considerable caution. Such estimates will also be affected by future changes in economic conditions (such as stock market movements), demographic factors (such as revised mortality expectations), and by changes in the number and membership of defined benefit schemes (partly as a result of employers' decisions about future pension provision).

Scheme funding levels & correction of shortfalls

4.1.9 There is no information on which to base an estimate of the likely impact that replacing the MFR will have on assessments of schemes' funding levels. A range of assumptions is likely to be adopted in actuarial valuations, and the overall effect might therefore be expected to be broadly neutral. On this basis the impact on the assessed overall level of scheme underfunding would be broadly unchanged.

4.1.10 There will also be an impact on the period over which schemes choose to correct deficits identified by actuarial valuations in the scheme-specific context. The impact of extended deficit correction periods can be illustrated by reference to current MFR funding deficits. On the basis of the MFR, the total funding deficit across all underfunded schemes was estimated (as at 31st December 2003) to be around £25 billion[3]. The timing of individual schemes' MFR valuations depends on the three

[2] The Minimum Funding Requirement: The next stage of reform (September 2001), and The Minimum Funding Requirement: Summary of responses to consultation on draft regulations (February 2002).

[3] This estimate is based on data collected from the actuarial profession from consulting actuaries and insurance companies on the MFR funding levels of just over 1,000 schemes that had had an MFR valuation with an effective date between April 1997 and April 2000. The database may under-represent underfunded schemes and consequently this estimate may underestimate slightly the likely level of underfunding.

yearly MFR valuation cycle. But if all schemes were to carry out an MFR valuation now, they would, broadly speaking, be required to make up this £25 billion deficit over a 10-year period (the MFR deficit correction period, which was extended from 5 to 10 years from March 2002). Assuming the amounts are constant, sponsoring employers would therefore need to pay additional contributions of around £3.7 billion a year over 10 years to eliminate this MFR deficit, allowing for the interest due to the £25 billion being spread over future years.

4.1.11 There is no information on which to base an assessment of the likely period over which individual schemes will choose to correct deficits identified under the new arrangements. Estimates are therefore based on the assumption that, overall, schemes might generally be expected to revert to an approach similar to that used before the MFR was introduced. This, typically, involved spreading the correction of deficits over the average remaining period of the working life of current active scheme members (currently estimated to be around 15 years, on average across all schemes). The total deficit of £25 billion would therefore be spread over 15 years instead of 10, at a rate of around £3.0 billion a year. The estimated difference in the additional money being paid by sponsoring employers in each of the first 10 years is therefore £700 million a year[4].

4.1.12 Other things being equal, however, this difference represents neither a cost nor a saving in the long term. The actual cost of providing the pension benefits is not altered, simply the period over which they are being funded. The estimate assumes that schemes would generally choose to correct funding deficits over a longer period, but any short-term cash flow saving is offset by higher aggregate payments over the longer-term (so that schemes which put more money in now will have to put less in later, and vice versa).

Investment strategies

4.1.13 The removal of the MFR can be expected to have at least some influence on the investment strategies adopted by some schemes. Estimates made when the MFR was introduced assumed that it would result, overall, in a higher level of investment by pension funds in gilts, and a somewhat lower level of investment in equities. Although the MFR did not require schemes to invest in any particular asset classes, the requirements of the MFR (including the impact of short-term deficit correction period) could produce volatility in the employer's contribution rate. This may have created an incentive for some schemes which were not particularly well funded to arrange their asset allocation in a way that would minimise this volatility under the MFR.

4.1.14 Estimates about the likely impact of removing the MFR under current economic conditions must necessarily be treated with considerable caution, as the approach taken to pension fund investment will have been influenced by a number of

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[4] The estimate assumes that overall the target level of funding will not change as a result of the abolition of the MFR. However it is assumed that the average period over which underfunding will be corrected when schemes are able to approach this on a long-term, scheme-specific basis will increase from the currently required years to an average of 15 years.

developments since the MFR was introduced. But it has been assumed that there is nevertheless likely to be at least some modest reversal of the trend towards a higher overall level of investment in gilts attributed to the introduction of the MFR.

4.1.15 At present it is estimated that private sector defined benefit schemes have, in total, some £100 billion invested in gilts and UK Corporate Bonds[5]. If it is assumed that 5% (£5 billion) of these investments will be switched to equities following the removal of the MFR, and that on average an additional 2% rate of return a year is achieved on the switched investments, the additional investment return would amount to around £100 million a year.

Actuarial valuations

4.1.16 Schemes are generally required to carry out full actuarial valuations every three years. In addition to valuations carried out for the purposes of the MFR, trustees also obtain an actuarial valuation which would generally show the scheme's funding position assessed on an ongoing basis (as opposed to a discontinuance basis, the approach underlying the MFR). The overall requirement for full actuarial valuations on a triennial basis will be retained following the replacement of the MFR, and it is assumed that the costs involved in carrying out scheme-specific actuarial valuations is likely to be broadly similar to the costs currently involved in preparing schemes' ongoing valuations. The removal of the requirement to carry out MFR valuations, however, is expected to result in administrative savings.

4.1.17 It is estimated that there are around 10,000[6] private sector DB occupational pension schemes currently subject to the MFR (this includes schemes that are open, closed, frozen and winding up). The typical cost of an MFR valuation for larger schemes is estimated to be around £10,000. MFR valuations will, on average, be considerably less expensive for smaller schemes, since many of these are insured schemes, with simpler scheme administration arrangements. Assuming £10,000 as an average administrative saving for the 5,000 schemes with more than 100 members, and £2,000 as an average for 5,000 smaller schemes, the total estimated savings over the normal 3 yearly valuation cycle would amount to around £60 million (£50+£10 million). This is equivalent to annual savings of around £20 million a year.

Inter-valuation checks & reports

4.1.18 Under the MFR, schemes were initially required to obtain an annual re-certification of their schedule of contributions from the scheme actuary for each of the two years between triennial actuarial valuations. In March 2002, this requirement was

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[5] Source: Office for National Statistics (MQ5 series)

[6] Source: The GAD Survey of Occupational Pension Schemes (2000) indicate that there were around 40,000 such schemes as at mid-2000, and this was the figure shown in the partial RIA. However, around 30,000 of these schemes were very small schemes, with fewer than 12 members. Although, in responding to the Survey, such schemes indicated that they offered pensions on a defined benefit basis, analysis of the GAD survey indicates that many of these schemes may not in fact provide such benefits, offering pensions instead on a defined contribution basis. As such it has been assumed for the purposes of these estimates that these very small schemes are not subject to the MFR.

removed for schemes that were at least 100% funded on the MFR basis at their last valuation. It had been the policy intention to remove this requirement for the remainder of schemes, and the RIA which accompanied the Green Paper indicated that this would result in administrative savings of around £10 million a year (an updated estimate reflecting the number of underfunded schemes as at 31 December 2003 would indicate a revised savings figure of around £6.75 million a year[7]).

4.1.19 The European Directive on the Activities and Supervision of Institutions for Occupational Retirement Provision (Directive 2003/41/EC) has, however, introduced a requirement for schemes to calculate their "technical provisions" (in the terms of the Directive) annually. (Technical provisions are understood to be the actuarial value of the accrued pension commitments of the scheme, based on a set of actuarial assumptions). The Directive does, however, contain an easement, under which schemes will be able to obtain this calculation every three years if they send members a report in the intervening years, reflecting any changes to the technical provisions.

4.1.20 It is assumed that schemes will generally choose to take advantage of this easement. The detailed requirements for the contents of the inter-valuation report will be prescribed in regulations. It is assumed that schemes will be able to combine the additional information with the annual funding statement which schemes will be required to send to members, and as such there should be no significant additional distribution costs. It is also assumed that the input from the scheme actuary which will be needed is likely to be no more than that provided for the purposes of preparing annual re-certifications under the MFR legislation. On this basis the additional costs involved in including this information in schemes' annual funding statements might be around £7.5 million a year.[8] (This estimated cost reflects the fact that the previously anticipated savings of around £6.75 million a year referred to above will no longer be realised).

Introduction of the Statement of Funding Principles

4.1.21 To some extent the information to be included in the Statement of Funding Principles (SFP) will already be available. For example, the professional guidance issued to scheme actuaries requires them to include in actuarial valuation reports an outline of the scheme's funding objectives and the method being employed to meet those objectives, and a statement indicating what actuarial assumptions have been used in the valuation. The requirement to prepare a formal stand-alone document will, however, inevitably lead to some additional administrative costs. Estimates based on the experience of producing current Statements of Investment Principles indicate that

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[7] This estimate assumes that there are around 10,000 private sector defined benefit schemes currently subject to the MFR (based on the GAD Survey of Occupational Pensions Schemes, 2000); and that, as at 31 December 2003, around 4,500 of these were less than 100% funded on the MFR basis (and therefore subject to annual recertifications) at the most recent full MFR valuation. The cost of re-certification is estimated to be around £1,500 a year, on average.

[8] This estimate assumes, as at 31 December 2003, that there were around 5,500 schemes which were at least 100% funded on the MFR basis (and therefore not subject to annual re-certifications) at the most recent full MFR valuation. The estimate also assumes that the largest 500 schemes are at least 100% funded on the basis of the MFR, but that they currently carry out annual valuations or approximate updates and will not, therefore, incur additional costs.

these additional costs might be in the region of £2,500 per statement. For the estimated 10,000 DB schemes currently subject to the MFR, this would represent total one-off administrative costs of around £25 million.

4.1.22 It is assumed that the SFP will be reviewed every three years (in line with the cycle of actuarial valuations), with additional reviews on an exception basis, and that such reviews will cost about 50 per cent of the cost of the initial SFP. On this basis the additional annual ongoing costs for reviewing SFPs (rounded up to allow for reviews on an exception basis) is estimated to be around £4.25 million.

Annual Funding Statements

4.1.23 In addition to preparing a Statement of Funding Principles, it is also proposed that trustees should send members key information about the funding position of their scheme each year. The requirement for schemes to send an annual funding statement can be introduced in regulations under powers in existing primary legislation (section 113 of the Pension Schemes Act 1993). The measure is nevertheless included in this RIA, however, because it forms a key part of the scheme-specific funding framework which will replace the MFR. As such the regulations giving effect to the requirement will be wholly consequential to the primary legislation introducing scheme-specific funding.

4.1.24 Pension schemes are already required to disclose some information on request (for example annual reports and actuarial valuations). A requirement for all schemes to issue key information about funding to all members will, however, inevitably lead to some additional administrative costs. There is limited information on which to base an estimate of these additional costs. If it is assumed that 80% of DB scheme members[9] already receive an annual communication from their scheme, and that it will cost an average of around £10 per member to prepare and distribute such information to the other 20%, the additional costs could be expected to be in the order of around £25 million a year.

New powers for The Pensions Regulator

4.1.25 The Pensions Regulator will have powers to help resolve disputes about funding issues between the trustees and the sponsoring employer. These will include a power to impose a "default" schedule of contributions in cases where the trustees and the sponsoring employer have been unable to reach agreement. Of itself this is not, however, expected to lead to any significant increase in employer costs. In cases of dispute, where the Regulator does propose to impose a contribution schedule it will still be open to the employer to reach agreement with the trustees on the basis of the level of contributions originally sought. And it is assumed that the employer will generally choose to do so if the schedule proposed by the Regulator would result in a higher contribution rate.

[9] An estimate based on the GAD Survey of Occupational Pensions Schemes 2000 (broadly adjusted to reflect changes since the time of the Survey) indicates that there are around 12.5 million individual entitlements to benefits in private sector defined benefit schemes. Some people will, however, have entitlements in more than one scheme.

Recovery Plans

4.1.26 Where an actuarial valuation identifies a funding deficit, the scheme will be required to prepare a Recovery Plan which sets out the steps being taken to restore the scheme's funding level. Schemes will be required to send a copy of the Recovery Plan to the Regulator. The information to be included in the Plan will already be available from the actuarial valuation and the schedule of contributions, and as such any additional costs resulting from the requirement to prepare a Recovery Plan are expected to be minimal.

Summary of costs and benefits

4.1.27 In summary, the proposals for replacing the MFR will lead to estimated one-off administration costs for pension schemes of around £25 million (for introducing the Statement of Funding Principles), and estimated administrative costs of around £17 million a year on an ongoing basis (as shown in the table). It should be noted that the requirement imposed by the IORP Directive, outlined at paragraph 4.1.20, has had a direct bearing on these costings.

Summary of estimated ongoing administrative impact annually

Costs	£million	Benefits	£million
Maintaining statement of funding principles	4.3	Removal of MFR valuations	20.0
Annual funding statements	25.0		
Inter valuation reports	7.5		
Total	36.8	**Total**	20.0

4.1.28 In addition to the impact on administration costs, it is estimated that the overall effect of replacing the MFR might result in benefits of around £100 million a year arising from the impact on schemes' investment strategies. In addition it is estimated that there will be a cash flow effect for underfunded schemes, as outlined in paragraph 4.1.10 of this section.

4.1.29 The proposals will apply on an equal basis to most private sector defined benefit occupational pension schemes, and are not expected to have a disproportionate impact on different business sectors.

4.1.30 It is necessary to ensure that the regulatory burden on employers who choose to run DB occupational pension schemes is proportionate, and to ensure appropriate protection for scheme members. The proposals for replacing the MFR, coupled with other proposals on simplification and protection, aim to strike that balance.

Securing compliance

4.1.31 The new framework for scheme funding will operate in an environment of greater transparency and disclosure of information about scheme funding to scheme members. In addition there will be a series of checks and balances aimed at securing compliance. The scheme actuary will play a key role in advising trustees on the preparation of the Statement of Funding Principles, and the risks associated with particular funding approaches and, as currently, scheme actuaries and auditors will also be required to consider reporting breaches of the new requirements to The Pensions Regulator. In addition, the Regulator will adopt a proactive and risk-based approach to securing compliance, and will have the power to impose sanctions, and to order corrective action.