

## Pensions Update

# Scheme-specific funding takes effect

The Pensions Act 2004 sets out a new funding regime for defined benefit pension schemes. After significant delays in autumn 2005, we now have the regulations and a code of practice which detail how these new requirements are to take effect.

The regulations came into force on 30 December 2005, introducing these new scheme funding arrangements to apply to actuarial valuations with effective dates on and after 22 September 2005. The scheme funding regulations extend the framework set out in the Act and provide for the transition from the MFR. The lengthy code of practice, aimed principally at trustees, sets out the behaviours expected. This update focuses on the most significant changes affecting employers and trustees.

### **Trustees likely to gain from shift in the balance of power**

The Act provides that any scheme rule provisions that reserve contribution setting solely to the employer are overridden. In future, the employer and the trustees must agree to the key elements of the funding of the scheme. These include the methods and assumptions to be used to determine the funding target and the timescale for funding any deficit. Trustees already holding the power to set contributions will retain it under the new regime - subject to a requirement to consult the employer. If the actuary currently holds the contribution setting power, under the scheme rules, he will retain, in effect, a power of veto on the contributions. This is likely to significantly bolster the trustees' position in any negotiation, affording them the opportunity to seek higher levels of contributions and the making good of any funding deficits over a shorter timescale. If any trustee/employer negotiation is inconclusive, the Regulator has power to step in and determine the approach to be adopted.

### **Prudence pays?**

There is a need for trustees to take advice from the actuary when settling the actuarial method and assumptions. The

trustees are required, by the regulations, to adopt a prudent approach. Prudence, however, remains a somewhat elusive concept, both in the regulations and the code of practice. It seems that the fear is that, if prudence were more prescriptively set out, it may serve only to reintroduce the MFR via another route. The code does, however, state that prudence is to be assessed by reference to the basis as a whole - and not for each element individually.

There is no compulsion placed upon trustees to fund at the level necessary to buy out accrued liabilities with an insurance company. The code anticipates that trustees might take advance credit for additional investment returns from equity assets over bonds (the "equity risk premium") but depending on the specific circumstances of the scheme and employer. The code does however, curiously, set out a lower threshold on prudence, stating that the level of assets required to secure the PPF benefits "is a useful point of reference". The Regulator is proposing trigger points linked to this, but expressed as a percentage of full buy-out. Target funding below the trigger points may attract questions from the Regulator.

### **Trustee knowledge and understanding of the employer's covenant**

The code requires trustees to form an objective assessment of the employer's financial position and prospects as well as the employer's willingness to continue to fund the scheme's benefits. Together this forms the employer's covenant and it will inform decisions on both the level of prudence in the funding target and the approach to making good any scheme deficits.

It is clear that this is one of the corner stones of the new regime that makes it "scheme-specific". The Regulator has discovered, perhaps somewhat belatedly, that there is an existing wide power under the Pensions Act 1995 that can now be used by trustees to obtain information about the covenant from the employer.

## Rapid response to deficits

If the actuarial valuation reveals a deficit the trustees must agree with the employer a plan to fund it. The code gives the trustees some strong guidance as to their approach in this important area. They should aim for any deficit to be eliminated as quickly as the employer can reasonably afford. The trustees' objective assessment of the employer's covenant is crucial to their conclusion as to what may be considered reasonable or possible. The trustees will need to take into account the employer's business plans and planned expenditure among other factors. There is, potentially, a real problem here: stronger employers being called upon to make good any deficits in much shorter timescales than those which the Regulator concludes appear weaker and in need of greater flexibility in the interests of not jeopardising the business.

Employers can take some comfort though from the wording in the code which has been softened somewhat from its draft form: Trustees are now requested to "work with the employer" rather than "negotiate independently and robustly".

## Discovery of the disclosure regulations opportunities

As expected, the disclosure regulations are amended to require, among other matters, trustees to send a "summary funding statement" to members and beneficiaries within a reasonable period (three months) of the date by which the actuarial valuation and each annual actuarial report must be delivered to the trustees.

In addition, the European Pensions Directive also requires summary funding statements on an annual basis ahead of the first scheme funding valuation - the first such statement must be issued before 22 September 2006. These statements have to disclose the funding position at the last valuation and an explanation of any changes since then.

This change will almost certainly increase the administrative burden on schemes required, in the first instance, to produce such statements together with the annual benefit statement: the two almost certain not to coincide.

## Implementation

The scheme funding rules apply to most valuations with effective dates on or after 22 September 2005.

There should be time for trustees and employers to adjust to the new regime as, for many schemes, their first scheme funding valuation will not be required until three years after the effective date of the last MFR valuation. There should be no doubt though that the transition will be complex, both from a legal and actuarial perspective.

It has been a long journey from the 2004 Act to the eventual publication of the scheme funding regulations and code of practice. In the interim, though the principles remain broadly the same, the text in the code has undergone significant change throughout, importantly stepping back from the somewhat strident language in certain sections of the draft.

Interest now shifts to the practical operation and implementation of the framework so set out: the challenge being for employers and trustees to achieve the best results for their interests within this brave new world.

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