

## PREMIER PENSIONS MANAGEMENT

### LEGISLATION UPDATE : 11/05

## Statutory Funding Objective

### Introduction

The Pensions Regulator issued its consultation document on 31 October 2005 describing how it intends to regulate the funding of Defined Benefit (DB) pension plans. Although only a consultation document, it is firmly believed many of the provisions will be introduced.

### Funding

Actuarial valuations that have an effective date after 22 September 2005 will be subject to the new Statutory Funding Objective (SFO) legislation. This is replacing the current Minimum Funding Requirement (MFR).

The new legislation requires that the assumptions adopted are “prudent” although the term is not defined. In reality, actuaries are likely to recommend assumptions which are more prudent than those used in determining the MFR position, therefore leading to increased contributions for companies.

The Regulator will require Trustees to prepare a Statement of Funding Principles setting out the Plan’s strategy for funding its pension commitments and for correcting any funding deficit. Trustees will be required to carry out regular valuations based on a funding approach which is consistent with the strategy adopted in the Statement of Funding Principles, usually annually, but at least every three years.

### Monitoring

When a pension plan has completed its first SFO valuation the Regulator will, through the annual plan return, identify pension plan’s that require monitoring. This will depend on either the Trustees choice of funding standard and if there is a deficit with the plan, how that deficit is corrected through the “Recovery Plan”.

The consultation document sets out the Regulators expectations for how Trustees should act before the first SFO. The Regulator intends to show particular interest in plans where the MFR level is below 110%. If the plan meets this level of funding it is unlikely to make any further enquiries.

However, once the first SFO valuation has been carried out two separate triggers are being introduced to identify when the Regulator should consider involvement.

#### 1. Statement of Funding Principles

The method and assumptions used to value the plan’s technical provisions (the plan’s liabilities) sets the level of funding. The trigger in this instance is looking at what level of funding the Trustees are targeting.

The Regulator is placing a strong focus on the buy out funding level of the plan. The buy out funding level is the most costly as it measures solvency against the cost of buying out benefits with an insurance company. While Trustees will not be expected to

fully fund on the buy out basis (unless the plan is closed to future accrual!) comparing the funding target against the buy out cost will provide an indication of the strength of the Trustees Statement of Funding Principles.

Broadly, if the funding target is above 80% of the buy out cost, then the Regulator is likely to consider the funding target as being reasonable. However, if the funding target is below 70% of the buy out cost then the Regulator is likely to consider the funding target inadequate and make further enquiries of the Trustees over their choice of funding target.

Where the funding target falls between 70% and 80% of the buy out cost, the Regulator will consider the solvency risk of the employer and the maturity of the plan to assess whether the funding target is reasonable. For example a plan with a strong employer covenant might reasonably have a funding target set at 70% of the buyout cost. Alternatively a plan which is mature might be expected to have a funding target of 80% of the buyout cost.

## **2. Recovery Plan**

The Recovery Plan is the time over which any deficit within the plan is corrected. Historically, it has been common for the period over which the deficit is spread to be the average working lifetime of members. Depending on the maturity of the plan this could be 20 years.

It is clear that the Regulator is trying to increase the pace of funding to remove deficits and improve security for member's benefits. This is not surprising given that the Regulator is also responsible for protecting the Pension Protection Fund from all avoidable claims and the best way to do this is to have all plans fully funded. However, this is a difficult balancing act and could (and will in some cases) be self defeating.

The Regulator will consider closer scrutiny where the Recovery Plan:

- Is more than 10 years ,or,
- Is less than 10 years but given the strength of the employer covenant, the company could afford to pay off the shortfall sooner, or,
- Is loaded so that the majority of the contributions are paid towards the end of the period.

There is some debate in the industry that these triggers will become de-facto funding targets. However, Trustees will need to be careful when setting the Statement of Funding Principles and ensure they are not just aiming to clear these trigger points. If they think they are able to secure full funding they should aim to do this. Also, if the employer has a weak covenant then providing the Trustees set an appropriate funding target, this could justify a Recovery Plan (for instance) which is longer than 10 years.

### **Comment**

It is clear that in the future Trustees are going to have some robust discussion with employers in setting the appropriate funding target and this will involve assessing/understanding the strength of the employer covenant.

To see if you will be affected by the new funding triggers, complete the attached funding guide. This can be used to start discussions with the employer and Trustees about the likely impact it will have on future funding.

**December 2005**

## EXAMPLE OF HOW TO COMPLETE FUNDING MATRIX

**Name of Pension Plan** : XYZ Pension Plan

**Date of Valuation** : 6 April 2005

**Details of Funding**

	MFR	Ongoing	FRS17	PPF	Buy-out
Assets	£49.8m	£49.8m		£49.8m	£49.8m
Liability	£45.7m	£55.1m		£53.3m	£83.3m
% Funded	109%	90%		93%	60%
<b>Before Statutory Funding Objective Valuation</b>					

### Regulator Trigger Points

#### TESTS

1. Triggers for review prior to first Statutory Funding Objective (SFO) valuation
  - Was MFR below 110% at the last Valuation?
  - If YES - Regulator will be interested in the recovery plan
  - If NO - Regulator unlikely to get involved unless sponsor is particularly weak
  
2. Triggers for future review (after SFO valuation)
  - Funding standard adopted
  - Length of recovery plan
  - Buy-out **NOT** expected unless Plan is closed for future accrual. This would be reasonable target
  - Regulator therefore compares value of technical provisions (liabilities) against the buy-out costs
  - If funding is greater than 80% then this is acceptable – unless sponsor is particularly weak.
  - Funding is below 70% of buy-out cost, funding target inadequate
  - Funding is between 70% and 80% of the buy-out cost. The Regulator will:
    - consider maturity of the Pension Plan
    - solvency risk of Employer

How well funded are you?

Assets : £49.8m

Funding ratio : 60%

Buy-out Cost : £83.3m

80% : £16.8m required for Plan to be 80% funded

70% : £8.5m required for Plan to be 70% funded

Current target : £55.1m (the ongoing cost) [66% funded on a buy-out basis]