PENSIONS IN 30 PODCASTS

08 ONGOING SCHEME FUNDING - overview

Key points

- Most defined benefit pension schemes are funded through a combination of employer contributions and investment returns, although the requirement for member contributions is increasing
- Rules exist that seek to ensure that pension schemes will be able to afford to pay member benefits when they fall due
- Pension schemes have an ongoing "statutory funding objective" to have sufficient and appropriate assets to cover their technical provisions (i.e. the actuarially-assessed value of each scheme's liabilities)
- Pension schemes must undergo an actuarial valuation every three years in accordance with section 224 of the Pensions Act 2004
- Trustees must put in place various documents as part of an actuarial valuation, including a statement of funding principles (section 223 of the Pensions Act 2004), a recovery plan (section 226 of the Pensions Act 2004) and a schedule of contributions (section 227 of the Pensions Act 2004)

Main sources

- Directive 2003/41/EC (the IORP directive)
- Pensions Act 2004 (Part 3)
- The Occupational Pension Schemes (Scheme Funding) Regulations 2005 (SI 2005/3377)
- The Pensions Regulator Code of Practice No. 3 "Funding defined benefits": link (revised July 2014) and quick guide to the Code (July 2015)
- The Pensions Regulator's Guidance on integrated risk management (December 2015)

Introduction

Most private sector occupational pension schemes in the UK are funded. Broadly speaking, this means that contributions from the sponsor(s) and sometimes also from scheme members are set aside and invested in order to provide a fund from which the scheme's benefits are ultimately paid. This is in contrast to an unfunded scheme where no assets are set aside and the benefits are paid for by the scheme's sponsor(s) as and when they fall due. Most public sector schemes are unfunded.

The future returns on the investments, and the future benefits to be paid from a scheme, are not known in advance, so there is no guarantee that a given level of contributions will be enough to provide the benefits. In a defined benefit pension scheme, the risk that there are insufficient funds available to provide the promised benefits is typically assumed by the sponsor(s) and not by the individual members.

Having a properly-funded scheme should ensure that each member receives the pension due to them at retirement, irrespective of the sponsor's resources. If a scheme is not maintained in a well-funded state, the scheme's sponsor(s) might not have the financial resources to meet the pension commitment at the time the benefits become payable.

The provisions of the scheme's governing documentation will contain rules relating to funding. These provisions need to be read in conjunction with the scheme-specific funding provisions contained in the Pensions Act 2004 which are intended to help ensure that a scheme is funded adequately. The Pensions Act 2004 provisions on funding override the scheme's governing documentation to the extent that there is a conflict. They are, however, also subject to modification, depending on the exact provisions of the scheme's rules.

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Pensions Act 2004 and underlying regulations

The provisions of Part 3 of the Pensions Act 2004 and underlying regulations replaced the old minimum funding requirement introduced in the Pensions Act 1995 with the statutory funding objective. It radically altered the obligations of trustees and employers with regard to the ongoing funding of occupational pension schemes that operate on a defined benefit basis.

Statutory funding objective ("SFO")

The SFO is set out in section 222 of the Pensions Act 2004. It requires that a scheme must have "sufficient and appropriate assets to cover its technical provisions". The term "technical provisions" means "the amount required, on an actuarial calculation, to make provision for the scheme's liabilities". The technical provisions are to be calculated in accordance with prescribed methods and assumptions. It is for the trustees to decide exactly which methods and assumptions are used for their scheme after taking into account advice from the scheme actuary and, usually (unless a modification applies to the position set out in section 229 of the Pensions Act 2004), after obtaining the sponsor's agreement.

The SFO applies to all defined benefit occupational pension schemes unless the scheme is exempted from the statutory funding regime by regulations.

Statement of funding principles

Section 223 of the Pensions Act 2004 requires trustees to prepare, from time to time review and, if necessary, revise a written statement of funding principles setting out their policy for meeting the SFO. The content of the statement of funding principles is prescribed by legislation. In particular, it must record decisions made about the actuarial methods and assumptions used for calculating the scheme's technical provisions.

Actuarial valuations and reports

Section 224 of the Pensions Act 2004 requires trustees to obtain actuarial valuations:

(a) at intervals of not more than one year; or

(b) if they obtain actuarial reports for each of the intervening years, at intervals of not more than three years (this is the usual practice).

An actuarial report is a written report, prepared and signed by the actuary, on developments affecting the scheme's technical provisions since the last actuarial valuation was prepared.

An actuarial valuation is a written report, prepared and signed by the actuary, valuing the scheme's assets and calculating its technical provisions. As part of the actuarial valuation process, the actuary must certify the calculation of the technical provisions (section 225 of the Pensions Act 2004).

Small schemes (those with fewer than 100 members) are exempted from the requirement to obtain actuarial reports between triennial actuarial valuations.

Recovery Plan

If an actuarial valuation shows that the SFO was not met on the effective date (i.e. if the scheme's assets are not sufficient to meet its liabilities), section 226 of the Pensions Act 2004 specifies that the trustees must:

(a) if there is no existing recovery plan in force, prepare a recovery plan; or

(b) if there is an existing recovery plan in force, review and if necessary revise it.

The recovery plan must set out the steps to be taken to meet the SFO and the period within which it is to be achieved, as well as comply with other requirements prescribed by legislation.

Pensions Regulator Code of Practice No. 3 provides that trustees should implement an approach which integrates the management of employer covenant, investment and funding risks, and identify, assess, monitor and address those risks effectively. Trustees' decisions should be consistent with their long-term funding and investment targets and their view of the employer covenant. Trustees should seek an appropriate funding outcome that reflects a reasonable balance between the need to pay promised benefits and minimising any adverse impact on an employer's sustainable growth. Having agreed an appropriate funding target, trustees should agree funding to eliminate any deficit over an appropriate period.

See the Employer Covenant fact card for more information. Note also that in relation to funding, the Regulator's Guidance (December 2015) on integrated risk management provides practical help on what an integrated approach to managing risks might look like in relation to the employer covenant, investment and funding.

Schedule of Contributions

The trustees must prepare, and from time to time review and if necessary revise, a schedule of contributions showing the rates of contributions payable towards the scheme by or on behalf of the employer and the active members of the scheme, and the dates on or before which such contributions are to be paid (section 227 of the Pensions Act 2004).

The schedule of contributions must satisfy prescribed requirements. In particular, the schedule of contributions must cover the period of five years from the date of its certification by the actuary, or the recovery plan period, if longer.