Managing by funding objective

DAVID POLLARD EXPLAINS THE CHANGES TO PENSION SCHEME FUNDING AND INVESTMENT REQUIREMENTS.

Further parts of the Pensions Act 2004 came into force on 30 December 2005 to implement changes required by the EU's Occupational Pensions Directive. These changes to the Pensions Act 1995 – originally to have been introduced on 22 September 2005 – include new scheme funding and investment requirements.

CHANGES TO FUNDING REQUIREMENTS The new scheme-specific funding regime under sections 221-223 of the 2004 Act replaces the minimum funding requirement from 30 December 2005. Much of the detail of the new regime is set out in the Occupational Pension Schemes (Scheme Funding) Regulations 2005. In addition, the Pensions Regulator has issued a code of practice and a consultation (which closed on 26 January 2006) on its proposed approach to regulating the new regime.

When will the new regime apply? The new regime will apply to relevant defined benefit occupational pension schemes following their next actuarial valuation with an effective date on or after 22 September 2005. Until that time the minimum funding requirement will continue to apply. However, the requirement to send pension scheme members an annual funding statement applies immediately: the first one must be issued before 22 September 2006. Excluded from the new regime are schemes providing only money purchase benefits (and insured death benefits) and unapproved schemes with fewer than 100 members.

Executive summary

- A new scheme-specific funding regime applies to relevant defined benefit occupational pension schemes following their next actuarial valuation with an effective date on or after 22 September 2005. The legislation includes a requirement to send pension scheme members an annual funding statement – and the first one has to be issued before 22 September 2006.

KEY FEATURES OF THE NEW REGIME

Statutory funding objective Every scheme will be subject to a statutory funding objective that it has sufficient and appropriate assets to cover its "technical provisions". This is the term used in EU's Occupational Pensions Directive; broadly, it means the amount of assets a scheme needs to hold now, on the basis of the actuarial methods and assumptions used, to pay accrued benefits as they fall due in the future. A key change to the calculation of a scheme's technical provisions is that the trustees, not the scheme actuary, must now determine the actuarial methods and assumptions to be used, having obtained advice from the scheme actuary, within parameters set out in the funding regulations. These include the requirement for a large degree of "prudence" to be used in choosing the actuarial assumptions, and so on. Unfortunately, prudence is not defined.

A NEW REQUIREMENT IS FOR A TRIENNIAL REVIEW OF THE STATEMENT OF INVESTMENT PRINCIPLES AS WELL AS "IMMEDIATELY AFTER A SIGNIFICANT CHANGE IN POLICY".

Statement of funding principles Within 15 months of the date of the first valuation under the new regime, the trustees must prepare a statement of funding principles. This is a written statement of their policy for ensuring that the statutory funding objective is met, recording the methods and assumptions used in calculating the technical provisions.

Actuarial valuations and reports As previously, actuarial valuations must be prepared at least every three years. They must be based on a funding approach consistent with the strategy set out in the scheme's statement of funding principles and annual reports and contain the actuary's certification of the calculation of the technical provisions and estimate of the solvency of the scheme. There must also be annual actuarial reports and, following each actuarial valuation or report, members and beneficiaries must be sent a summary funding statement. Actuarial valuations must be in place within 15 months of the effective date and reports must be in place within 12 months. Transitional arrangements extend this to 18 months for valuations with an effective date between 22 September 2005 and 29 December 2005.

Recovery plan If the valuation shows that the statutory funding objective is not met, the trustees must put in place a recovery plan, setting out the period over which the deficit is to be remedied. This must similarly be in place within 15 months of the effective date of the actuarial valuation. A copy must be sent to the Pensions Regulator. The code of practice includes some useful guidance for trustees – for example, a shorter recovery period is likely to be appropriate if most members are already in receipt of pension or if there may be difficulty in pursuing an overseas employer.

Schedules of contributions Schedules of contributions for five-year periods must be in place within 15 months of the effective date of the actuarial valuation. The code of practice makes some recommendations as to structure and content, and specifically states that the Pension Protection Fund levy should be treated as an annual expense item; if it forms part of the employer's overall contribution rate a note should state this, indicating the assumed annual amount of the levy.

Employer agreement/consultation The Pensions Act 2004 and the funding regulations lay down that the trustees must agree with the employer the statement of funding principles, the recovery plan and the schedule of contributions. However, the requirement for employer consent does not apply where the scheme's trust deed gives the trustees unilateral power to determine the employer contribution rate with no power allowed for the employer to suspend contributions. In such cases the trustees must instead consult with the employer. The code of practice recommends, however, that the trustees seek to obtain the employer's agreement.

The consent requirement still applies if employers have the power to suspend their contribution obligation under the deed or if the contribution rate is determined by, or on the advice of, a person other than the trustees or the employer – usually the scheme actuary. The trustees must take into account the recommendations of that other person on the method and assumptions for calculating the technical provisions and on the preparation of any recovery plan. Where trustees are required to agree the funding rate with the employer but fail to reach agreement, the matter must be referred to the Pensions Regulator, which will have the power to give directions, including imposing a schedule of contributions.

CODE OF PRACTICE: GENERAL POINTS The code of practice is much more detailed than the March 2005 draft. It recommends that the trustees put in place an action plan and timetable for the valuation process and emphasises the importance of record keeping and of employers and trustees providing each other with information and keeping an open dialogue. The legislation contains numerous references to steps being taken within "a reasonable period". The code gives guidance on what constitutes a reasonable period – for example, a report of contribution failure should be sent to the Pensions Regulator within 10 working days, but where an immediate report is required, the trustees should make their initial report by telephone and follow it up in writing.

ACTION NOW Employers and trustees should examine their trust deed and rules to check the current balance of power. The statutory funding objective, the statement of funding principles, the valuation and any recovery plan should all be in place within 15 months (18 months in transitional cases) of the effective date of the actuarial valuation. Schemes should start thinking about how to manage the process in good time before the next effective date. Additionally, the first summary funding statement will need to be sent to members before 22 September 2006. Multi-employer schemes should consider putting in place arrangements to nominate one employer to act for the others (for example, on consultation and agreement).

CHANGES IN INVESTMENT LAWS The changes made by the Pensions Act 2004 to the investment provisions of the Pensions Act 1995 are fleshed out by the Occupational Pension Schemes (Investment) Regulations 2005. The major changes include:

- An obligation for trustees and fund managers to exercise their powers of investment or discretions in a manner calculated to ensure the "security, quality, liquidity and profitability" of the portfolio;
- A requirement that assets must be invested "predominantly" in regulated markets;
- Sanctioning of investment in derivatives to the extent they "contribute to a reduction of investment risks" or "facilitate efficient portfolio management"; and
- A prohibition on borrowing money (save for temporary liquidity).

There are exemptions from some of the requirements – for example, for schemes with fewer than 100 members. However, there is no express exemption in relation to assets in money purchase schemes or sections. This should not be a concern if the trust deed allows members to make a binding choice as to the form of investment, but there may be issues in applying the rules where the trustees retain the investment discretion.

STATEMENT OF INVESTMENT PRINCIPLES The primary requirement in section 35 of the Pensions Act 1995 to maintain and revise a statement of investment principles remains but is amended.

A new requirement is for a triennial review of the statement of investment principles as well as "immediately after a significant change in policy".

Wholly insured schemes (that is, whose only investment is an insurance policy) are subject to simplified requirements and must state the reasons why the scheme is wholly insured.

CHOOSING INVESTMENTS Trustees, and fund managers to whom trustees' discretion is delegated, continue to be required to exercise their powers of investment to comply with the statement of investment principles. A new requirement is that investment must be in accordance with regulations.

The requirement that trustees and fund managers exercise their investment powers or discretion in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole aroused concerns during consultation about potentially conflicting aims. The Department for Work and Pensions (DWP) said that the government's intention was not to impose on trustees a higher duty of care than that which already existed. The regulations now lay down that assets must also be invested "in a manner appropriate to the nature and duration of the expected future retirement benefits payable under the scheme". The DWP hopes this means that "the focus of the regulations will be on matters which trustees should consider when making their investment decisions, not on judging trustees against the outcomes of the overall investment strategy".

INVESTMENT OF ASSETS Assets must be invested "predominantly" in regulated markets. Collective investment schemes are deemed regulated markets to the extent that the underlying investments held by the schemes are so invested. Insurance policies are also to be treated as investments on regulated markets.

The DWP's response to concerns about the use of the undefined term "predominantly" was that the government did not want to preclude investment in any particular class of assets or set an arbitrary limit on the proportion of assets that must be invested in regulated markets, although if all of the scheme assets were invested outside regulated markets, the trustees would risk being in breach.

Assets not admitted to trading on a regulated market must be kept to a "prudent level". Trustees must ensure diversification to avoid "excessive reliance" on a particular asset, issuer or group of undertakings and to avoid "accumulations of risk in the portfolio as a whole". Investment in assets issued by the same issuer must not expose the scheme to 'excessive' risk concentration.

INVESTMENT IN DERIVATIVES Investments in derivative instruments may be made only insofar as they "contribute to a reduction of investment risks" or "facilitate efficient portfolio management". In making such an investment trustees must avoid "excessive risk exposure to a single counterparty and to other derivative operations".

In the first draft of the regulations, the DWP did not define derivative instruments and efficient portfolio management on the basis that they were familiar terms in the financial services sector. But in response to concerns about lack of clarity in this specific context, "derivative instruments" is now defined in the regulations in terms of the arrangements listed in the EU Directive on Markets in Financial Instruments; and the reference to "efficient portfolio management" is expanded to provide that transactions for this purpose will include ones where the intention is to reduce risk or costs or generate additional capital or income with an acceptable level of risk.

RESTRICTION ON BORROWING BY TRUSTEES Trustees (and fund managers to whom any discretion has been delegated) are now prohibited from borrowing "money" and acting as guarantor where the borrowing is likely to be repaid, or the liability under the guarantee is likely to be satisfied, out of the assets of the scheme. The DWP's response to the consultation confirmed that borrowing of "non-money" assets (such as shares or bonds) is permitted.

AN ARRAY OF SANCTIONS Trustees who fail to comply with the new requirements can be liable to a civil penalty imposed by the Pensions Regulator. However, there is no express sanction for breach of the new requirements.

It is unclear if breach of the investment provisions could also give rise to civil actions by affected parties (for example, the scheme beneficiaries) in the same way as a breach of trust.

NO EXPRESS TRANSITIONAL PROVISIONS There are no express transitional provisions. It seems that the new provisions apply to any arrangements in existence on 30 December 2005. It is possible that the courts could hold that existing arrangements can remain in place with a reasonable time for the trustees to unwind them – see, for example, Wright v Ginn (1994), although this particular case was based on a provision in the Trustee Act 1925 that has now been repealed.

EMPLOYER-RELATED INVESTMENTS The existing restrictions on self-investment are largely reproduced under the revisions to section 40 of the Pensions Act 1995 and the investment regulations.

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