

**The
OCCUPATIONAL PENSION SCHEMES
(SCHEME FUNDING) REGULATIONS 2005**

**CODE OF PRACTICE: FUNDING DEFINED
BENEFITS**

Joint response to the consultation by the
Government and the Pensions Regulator

The Pensions
Regulator 

DWP Department for
Work and Pensions

December 2005

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INTRODUCTION

On 22 March 2005 the Department for Work and Pensions issued a package of proposals for consultation on the detailed legislative arrangements for the new scheme funding requirements which, following the Pensions Act 2004, will replace the minimum funding requirement.

The draft code of practice covering the funding of defined benefits was also issued on 22 March 2005 by the Pensions Regulator. The code supplements the legislative requirements, and the Department for Work and Pensions and the Pensions Regulator therefore conducted a joint consultation to invite views on the package as a whole. The consultation documentation may be viewed on the Department for Work and Pensions website at: <http://www.dwp.gov.uk/consultations/consult/2005/funding-pension-schemes/index.asp>

The consultation period ended on 6 May 2005, and was supplemented by four consultation events at different locations around the country. The Department for Work and Pensions and the Pensions Regulator would like to thank everybody who responded to the consultation. There were 57 written responses running to more than 400 pages. Of the responses, 16 were from organisations in the pensions and insurance industries, 38 from pension schemes or employers and 3 from private individuals. In addition to the formal responses, additional discussions also took place with appropriate stakeholders on specific issues.

This paper summarises the responses received (including those received after the consultation period ended on 6 May 2005).

The Regulations are due to come into force on 30 December 2005. A copy of the Regulations will be available on the Office of Public Information's website at: <http://www.legislation.hmso.gov.uk>. The code of practice has been approved by the Secretary of State for Work and Pensions, and a copy of the code will be available on the Pensions Regulator's website at: <http://www.thepensionsregulator.gov.uk>

A paper copy of the documents can be obtained from:

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Analysis of responses to the consultation on the scheme funding Regulations and the code of practice

1. This document sets out the main issues raised in the consultation and the response of the Government and the Pensions Regulator. These include:
 - the interpretation of what is prudent, in the context of the calculation of the technical provisions;
 - the balance of power where the trustees or the scheme actuary are responsible under a scheme's rules for setting the contribution rate;
 - the wording of the certification by the actuary of the calculation of the technical provisions and the schedule of contributions;
 - the definition of the actuary's estimate of the solvency of the scheme;
 - guidance on the preparation of recovery plans;
 - the weight to be given to the strength of the employer's covenant;
 - how to deal with conflicts of interest (for instance where a Finance Director is also a trustee);
 - how to make the annual funding statement clear to scheme members;
 - the length and layout of the code; and
 - the regulatory impact assessment (RIA) for the code.

Interpretation of "prudence"

2. The legislation requires the assumptions to be used in the calculation of the technical provisions to be chosen prudently by the trustees. A number of respondents felt that there should be a definition of prudence in either the legislation or the code, and some questioned whether the legislation required each individual assumption to be chosen prudently, or whether prudence should be applied to the set of assumptions as a whole. Some respondents felt that, in the absence of a definition, some trustees might feel compelled to require unreasonably strong funding targets (such as full solvency, or a target based solely on gilt returns).

Government policy is for scheme trustees to determine what constitutes prudence in the context of their particular scheme, and a definition in legislation would not therefore be appropriate. The issues raised in the consultation are, however, reflected in the revised code of practice. The code now makes it clear that some allowance for equity out-performance relative to bonds will not necessarily be imprudent, that only the key assumptions need

to be considered in this context, and that trustees should form a view about the overall level of adequacy of the technical provisions.

Schemes where the trustees or the scheme actuary currently set the contribution rate

3. A number of respondents expressed concerns that the draft Regulations would fundamentally alter the balance of power for those schemes under which the trustees or the scheme actuary is responsible under the rules of the scheme for setting the contribution rate. Further informal consultation also took place with many of those who had responded to the original consultation and other stakeholders concerned with this aspect of the Regulations.

The Regulations have been modified as far as possible within the new funding framework (which gives trustees the ultimate responsibility for funding decisions) in order to take account of the concerns raised. The existing balance of power will be preserved where the trustees currently have the power to set the contribution rate, and there will be no requirement to seek the employer's agreement to the key funding decisions. Where the power to set the contribution rate currently rests with the scheme actuary, the trustees will be required to seek the employer's agreement. However, when considering the key funding issues, trustees of such schemes will also be required to take account of the actuary's recommendations. Furthermore, in certifying the schedule of contributions, the actuary will be required to confirm that the contribution rate is no lower than it would have been had the actuary been responsible for determining the rate in accordance with the new funding requirements.

Certification by the actuary of the calculation of the technical provisions and the schedule of contributions

4. A number of comments were received about the precise wording of the prescribed certificates to be used by actuaries when certifying the calculation of the technical provisions and the schedule of contributions.

The comments received have been considered carefully, and further consultation has taken place with key stakeholders. A number of changes have been made to the wording of the actuarial certificates included in the Regulations as a result.

Solvency estimate

5. Some respondents expressed concerns about the definition of the estimate of scheme solvency which actuaries will be required to include in actuarial valuations. The definition required an estimate (for disclosure and awareness purposes) of the cost of buying annuities and deferred annuities from an insurance company, and it was pointed out that this would present difficulties for large schemes, because sufficient annuities would not be available for purchase.

The Regulations have been amended to allow flexibility for actuaries to provide an alternative estimate of solvency where it might not be possible for a particular scheme to purchase sufficient annuities in the open market.

Taking account of the strength of the employer's covenant

6. A number of respondents commented on the factors to be taken into account by trustees when assessing the financial strength of the sponsoring employer. Some felt the draft code placed undue reliance on financial specialists, and pointed out that a number of commercial services (such as rating agencies) were already available. Some respondents were concerned about the suggestion in the code that trustees could be asked to sign confidentiality agreements before being provided with information.

These comments are reflected in the revised code of practice. Employers are required under current legislation to provide trustees with the information they need to carry out their duties, and as such the code no longer refers to the possibility of a confidentiality agreement. The revised code also explains that there is a range of sources from which the trustees might seek information and advice about the employer's financial situation.

Recovery Plans

7. A number of respondents commented on the code's guidance on the preparation of recovery plans. Some considered it to be very helpful, whereas others felt it was more prescriptive than necessary. Some respondents felt the code did not provide for appropriate consideration by the trustees of employers' business plans when preparing a recovery plan, and a number felt that requiring shortfalls to be made good as soon as practicable would encourage trustees to insist on very short recovery periods (to the possible detriment of the employer).

The revised code now says that trustees should aim for any shortfall to be eliminated as quickly as the employer can reasonably afford, whilst taking into account the likely effect of any recovery plan on the employer's future viability and its business plans.

Conflicts of interest

8. Some respondents believed that the code needed to say more about the potential for trustees to be faced with conflicts of interest or duty, such as where a trustee is also a director of the company.

The revised code stresses that trustees should set aside their other duties and interests when making decisions as trustees, and that they should consider in advance how they will recognise and deal with any conflicts, and may need to take legal advice. This is a wider issue which concerns matters other than funding, and goes to the heart of the nature of the role of the trustee.

Summary funding statement

9. A number of respondents commented on the sample annual funding statement included in the draft Pensions Regulator guidance, and a wide range of views were expressed. A number felt the statement was too long, and that it should be brief and easy to understand, whereas others felt that information about issues like solvency needed to be carefully explained in order to prevent misunderstanding and confusion.

The comments received have been carefully considered, and a number of them are reflected in a revised sample document which will be issued by the Pensions Regulator. The document will now be called a summary funding statement, since schemes with fewer than 100 members will only be required to send them at least every three years in line with full actuarial valuations and for each intervening year between valuations when they are required to obtain actuarial reports.

The length and content of the code and guidance

10. There were a number of comments about the length, structure and layout of the code. A number of respondents felt that the code and the separate guidance document, taken together, were too long. There were some suggestions that the code should provide more guidance on trustees' duties generally, whilst other respondents felt that the code should focus on high level principles only.

The Pensions Act requires the code to provide practical guidance, and the Regulator considers that this will not be possible in a document which focuses only on high level principles. The code has been extensively amended to address the detailed comments made on individual sections. All the appropriate guidance is now to be contained in the code, dispensing with the proposed accompanying guidance. In addition, specimen documents (for example a specimen summary funding statement) will be available on the Pensions Regulator's website. The general issue of trustee education will be taken forward as part of the trustee knowledge and understanding agenda.

The RIA of the code

11. The draft RIA which accompanied the draft code suggested that there could be some additional costs to business arising from the code of practice.

The Pensions Regulator has concluded that since the code only gives practical guidance on the fulfilment of the legislative requirements and is not mandatory, it does not impose additional costs on business above those arising from the legislation.

List of organisations to which the draft Regulations were issued

Association of British Insurers
Association of Consulting Actuaries
Association of Corporate Trustees
Association of Pension Lawyers
Association of Pensions Trustees
Auditing Practices Board
British Chamber of Commerce
Cabinet Office (Regulatory Impact Unit)
Confederation of British Industry
Consumers Association
Equal Opportunities Commission
Faculty and Institute of Actuaries
Federation of Small Businesses
Financial Services Authority
HM Revenue and Customs
Industry Wide Pension Schemes Group
Institute of Chartered Accountants in England and Wales
Institute of Chartered Accountants in Scotland
Institute of Directors
Investment Management Association
Law Society
Law Society of Scotland
National Association of Pension Funds
National Consumer Council
National Pensioners Convention
TPAS
Pensions Management Institute
Pensions Ombudsman
Scottish Executive
Small Business Service
Social Security Policy and Legislation Division, DSD Northern Ireland
Society of Pensions Consultants
Trades Union Congress
Welsh Assembly

List of organisations which responded to the consultation

Association of British Insurers
ACCA
Amicus
Aon Consulting
Association of Consulting Actuaries
Association of Pension Lawyers
AstraZeneca
Aviva Staff Pension Trustees Limited
Barclays plc
Barnett Waddingham
Beaufort Trust Corporation Ltd
Building and Civil Engineering Benefits Scheme
Cable and Wireless
Confederation of British Industry
Co-Operative Group Pensions Department
Corus
EDF Energy
Electricity Supply Pension Scheme
Faculty and Institute of Actuaries
First Actuarial plc
GMB
HBOS plc
Hewitt, Bacon and Woodrow Limited
ICI Pensions Trustee Ltd
Independent Pension Trustee Group
KPMG LLP Ltd
Lane Clark & Peacock
Law Debenture
Marconi
Mellon HR & IS
Mercer
Metal Box Pension Trustees Ltd
National Association of Pension Funds
National Grid Transco
Nestlé UK Pension Fund
Norwich Union
Occupational Pensioners' Alliance
Plumbing Pensions (UK) Ltd
Pensions Management Institute
Prudential
Punter Southall
SAUL
Scottish Widows

Society of Pension Consultants
Standard & Poors
Standard Life
Tesco Stores Ltd
Trades Union Congress
Unilever plc
USS Ltd
Vauxhall Motors Ltd
Watson Wyatt