R04 2020/2021
Final Salary Schemes
Part 3: Scheme Governance, Funding and Member Protection

This part will look at the principles of how final salary schemes aim to ensure that it can pay the promised benefits to its members.

The milestones are to understand:

- The role of the Pensions Regulator
- The principles of scheme governance and the role of trustees.
- What is meant by a fund surplus or deficit
- The principles and methods of fund valuation.
- The options open to trustees and the employer if the scheme is in deficit
- How members are protected if the sponsoring employer goes into liquidation.

The Pensions Regulator

In their own words, "We protect the UK's workplace pensions. We make sure employers, trustees, pension specialists and business advisers can fulfil their duties to scheme members"

Their main concern with DB schemes is that there are sufficient funds to be able to pay all the promised benefits. They have Codes of Conduct to give guidance to those running workplace pensions on how to deal with their legal responsibilities They also control the Pension Protection Scheme.

Scheme governance

The first line of protection for members is that a DB scheme is invariably set up as a trust. This means that the pension scheme's assets are separate from the sponsoring employer so should the latter go out of business its creditors cannot claim them.

As in any trust there are trustees who are responsible for the running of the scheme and ensuring that the promised benefits are paid. At least 1/3rd of members must be member nominated. New trustees are expected to have acquired a basic knowledge of how the scheme works within six months of being appointed.

The Pensions Regulator sees trustees as being their eyes and ears and expect them to alert the regulator if they have any cause for concern.

The trustees also deal with complaints from members but once this is exhausted the member can take it to the Pensions Ombudsman.

Whilst the trustees are ultimately responsible for running the scheme they can bring in specialists such as accountants, actuaries, solicitors and investment firms to help them make decisions.

One of the key responsibilities of trustees is to commission a report into the level of its funding.

Fund surplus and deficits

A defined benefit or final salary scheme makes a commitment that it will pay out benefits to its members in line with an agreed formula. Its ability to deliver this relies on there being sufficient assets within the fund which in turn depends on the capability and willingness of the sponsoring employer to make sufficient contributions.

At its most basic the scheme needs to maintain sufficient assets to cover its liabilities; that is the cost of providing future benefits.

- If the scheme has just sufficient assets to cover the liabilities it is 100% funded
- If the scheme has insufficient assets it is in deficit
- If the assets are greater than the liabilities it is in surplus

The trustees have the responsibility in ensuring that the scheme can deliver its promised benefits and must commission an actuarial valuation every three years.

Principles of calculating a fund's liability

In any scheme there are likely to be three types of member:

- Active members, that is employees who are contributing and accruing benefits.
- Deferred members, those who have left the company but will get a pension at some stage
- Retired members, those who are receiving a pension as a member or as a dependant of a former member.

It's fairly simple to see why the final cost to the scheme is difficult to calculate.

- The scheme will know how much it is paying to each retired member but has to estimate how long each one will live and by how much the pension will increase each year.
- There is the same problem with deferred members and whilst the scheme knows the current value of their deferred rights it must estimate how much these will increase by the time they are taken.
- For active members, there is the further complication that the scheme has to estimate by how much their salary will increase until retirement.

These are also long term liabilities. For example, an active member who gets a pension in 2044 at the age of 60 could expect, assuming life expectancy continues to increase, to live for another 30 years so the scheme will only finish paying in 2074.

There are also many variables:

- The split between active, deferred and retired members
- The increase in salaries (since this will increase the size of pensions)
- The rate of inflation
- The assumed growth rate that will be achieved on the fund's investments
- The changing demographics of the membership, both the age distribution and split between married and single members
- Changes in life expectancy

Change any one of these factors and you will get a different result.

Before looking at the different methods of valuing a fund, it's worth noting that this isn't a problem with a money purchase scheme. Once the employer has paid its contribution they have no further liability, all the risk is passed to the member.

Pension fund valuation

There are four main methods:

- Ongoing
- Insurance or Solvency
- Accounting
- Statutory Funding Objective

Ongoing measure

A scheme does not need to pay all its benefits out at once. Rather they are paid as they fall due. The trustees therefore need to make a prudent estimate of the contributions required to be able to pay the benefits at the right time. It assumes the sponsoring employer will continue so contributions will keep coming in. The trustees and actuary have a wide discretion in selecting the assumptions used to establish the liability. Some schemes have decided that they will no longer carry out thus valuation as it has been superseded by the Statutory Funding Objective.

This method will tend to produce the lowest liability.

Solvency measure

This is used to establish the liability if the scheme was wound up. The trustees would have to secure retired member's benefits by buying immediate annuities. Deferred members' rights would have to be secured by buying deferred annuities. This would be very expensive hence

this measure will usually produce the largest liability. There is virtually no room for discretion in estimating the cost since the funding level depends on market rates for annuities.

Accounting Measure

Since a scheme in deficit is an unsecured creditor of the sponsoring scheme, this debt needs to be shown on the employer's balance sheet. There are rules to do the calculation and this method is normally referred to as the **FRS17** or **IAS19** basis

The main rule is that the assumed investment return must be based on AA rated corporate bond yields rather than equities which results in a higher liability than the ongoing basis.

Statutory Funding Objective

A final salary scheme makes a commitment to its members that they will receive the promised benefits at scheme retirement age.

- The ongoing and accountancy measures assume the employer is always going to be around but there is no guarantee that this will always be the case.
- The Insurance measure would give absolute certainty but is prohibitively expensive.

There is a further method which is known as the **Statutory Funding Objective.** This valuation must be carried out every three years

It starts with the premise that the sponsoring employer of a scheme has gone into liquidation. Clearly no future benefits would accrue but the scheme would still be liable for:

- Pensions in Payment, including survivors of former members
- Future benefits already accrued by active and deferred members including death in service, ill health and early retirement benefits.

The liability to pay these is known as the scheme's **technical provisions** and derives from the EU's Occupational Pensions Directive. It is defined as, "the amount of assets the scheme needs to hold now on the basis of the actuarial methods and assumptions, in order to pay its accrued pension commitments as they fall due in the future."

If this produces a deficit the trustees must negotiate a recovery plan and communicate this to the members in a **statement of funding principles**.

Options if the scheme is in deficit

The media love to use the phrase "pension scheme black hole." It looks and sounds dramatic but in reality things are slightly more complicated.

- Most major schemes hold billions of Pounds of assets so they could carry on paying benefits for many years without any remedial action.

- A valuation is a snapshot of the scheme's assets and liabilities on the valuation date. Any change such as a rise or fall in their assets will render the valuation out of date.

Nevertheless, apart from it being a legal requirement, trustees would want to ensure that the deficit is eliminated so that the long term viability of the scheme is assured.

The first approach the trustees are likely to adopt is to request that the sponsoring employer increases its contributions over the coming years. The employer in turn will want the members to share the pain. As well as increasing member contributions changes could be made to the scheme benefits as follows:

- Close scheme to new members.
- Increase member contributions.
- Reduction in benefits e.g amount of dependent's pensions.
- Increase in accrual rate e.g from 60th to 80th.
- Increase in pension age.
- Reduction in other benefits.
- Move from final salary to career average earnings.
- Close the scheme to future accrual.

If the trustees and employer cannot agree the Pensions Regulator (TPR) can impose a solution.

Member Protection

The ability of a scheme to pay the promised benefits depends on there being sufficient funds to pay these. If the employer goes into liquidation there won't be an employer to fund the scheme. If the scheme has met its statutory funding objective the fund, in theory, will be able to pay its promised benefits until the last member dies. Unfortunately, the likelihood is that the scheme would be in deficit so there is a danger that members may lose out.

The 1995 Pension Act made the first attempt at securing member's benefits but this proved inadequate. It had an unintended consequence since priority was given to members who were already in receipt of a pension. This often meant that there was nothing left for the members below retirement age. The Pensions Act 2004 introduced the **Pension Protection Fund** (PPF) to give protection to all members of final salary schemes that where the sponsoring employer failed **after 6 April 2005**

Occupational Money Purchase schemes aren't covered by the PPF as the member will still retain their own fund.

Public sector schemes that are unfunded such as the NHS or Teacher's scheme do not come under the FSCS as the Government guarantees these pensions.

Schemes do not automatically enter the PPF once the employer becomes insolvent. Once an insolvency event occurs the trustees will notify TPR and the scheme will enter a minimum 12 month assessment period. During this time:

- No new members can be admitted.
- No further benefits earned and no transfer values paid. The only exception is if the member, before the assessment period started, requested a CETV, gave instructions in writing to transfer and designated a scheme to accept the transfer value
- Benefits can be paid out but only to the level of PPF compensation
- The PPF can intervene in the management of the scheme and give directions to trustees
- The PPF will review any moral hazard issues
- It will review any recent rule changes
- The PPF will instruct the scheme actuary to carry out an actuarial valuation at the date the assessment period started

The trustees and TPR will investigate possibilities of a rescue (by a take-over for example). They will also assess whether the assets of the scheme are sufficient to pay the benefits at PPF levels which may be lower than what the scheme was originally offering. If neither is possible the scheme can be admitted to the PPF. This means that all the scheme's assets are placed into the PPF which becomes responsible for paying the members' pensions

Pensions will be paid on the following basis

- Members who have retired over the scheme normal retirement age, or in receipt of an ill health pension or a dependent's pension will get 100% of benefits, without limit.
- Members who haven't reached the scheme's NRD including those who took early retirement will only get 90% of benefits subject to a maximum amount
- This cap is set each April 1 and for 2020/21 it is **£41,461** if the Scheme retirement age is 65. The maximum compensation at 65 is 90% of this or **£37,315**
- If the scheme retirement date is 60 the 100% figure is £34,750
- From April 6 2017 the cap can be increased by the **Long Service Cap.** This increases the cap for members who have 21 years or more service by 3% for each complete year of service over 20 years up to a maximum of double the annual cap. All retired members who were disadvantaged by the cap have been informed of the new limits
- A further actuarial adjustment may be applied to those who take early retirement
- Spouse's pension of 50% of the member's PPF compensation
- Revaluation of deferred pensions will be CPI to a maximum of 5% for benefits accrued up to April 2009 and 2.5% for post April 2009 benefits.
- Escalation only applies to post April 1997 benefits and only at CPI subject to a maximum of 2.5%.

Schemes where the employer failed before April 6 2005 originally had a lower level of protection under the **Financial Assistance Scheme (FAS).** After lobbying by different pensioner groups the benefits have been increased.

- FAS is administered by the Pension Protection Fund.
- FAS is paid as a top up to any benefits the member is receiving from the scheme.
- FAS payments will be made from normal retirement age but not before 60.
- It will pay up to 90% of the pension built up in the scheme before it started to wind up
- The maximum pension that can be paid (including any benefits from the failed scheme), assuming a scheme retirement age of 60 is £36,717. Note that this figure is for someone whose benefits start in 20/21.
- However if someone is a member of two failed schemes that qualify for FAS, the £36,717 limit applies to each scheme
- Ill health pensions can only be paid from five years before the scheme retirement age
- A severe ill health payment which is defined as "a progressive disease where the member has a much lower life expectancy because of the disease", can only be paid from 55.
- A payment for a terminal illness may be paid without an age restriction but this is at the discretion of the FAS
- Pensions in payment will increase by CPI but capped at 2.5% but only for post April 97 benefits.

That concludes this part so you should understand:

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- The principles and methods of fund valuation.
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