Interested Parties

Benefit schemes will only be set up if the parties concerned want them to be. Understanding their motivations is therefore key. The main parties are typically

The state
Employers
Individuals

We will look at each of their motivations in turn, and what risks and practical considerations would affect choices they make.

These parties may be aided by facilitators whose goals are to perform their duties effectively and collect the rewards for doing so. These include

Trustees
Actuaries
Administrators
Investment managers
Regulators
Tax officials
Lawyers
Insurance companies
etc.

We will consider the duties of some of these groups later.

The State

The state provides benefits and shapes the landscape for benefit provision. Its key motivations are to stay in power by ensuring

- People able to remove it from power are pleased with it
- People displeased with it are unable to remove it from power

Democracies concentrate on the former, in which benefit provision plays an important role. The main factors the state takes into account are

What recipients want
- Safety net for the needy
- Rewards for good workers

Needs of the state
- Macroeconomic effect
- Social goals (limit dependancy, maximise social inclusion)

Political beliefs
- Paternalism

Value for money
- Minimise costs
- Simple administration

Financial planning
- Stable, predictable costs
- Take account of socioeconomic trends

Employers

Employers may have to offer certain benefits by law. Otherwise, they will want to offer benefits that help the aims of the business. For example benefits wit a low cost and high perceived value allow employers to attract and retain staff. The main factors employers take into account are

- What recipients want
  - Safety net for the needy
  - Rewards for good workers
  - State provision
  - Competitor provision
  - Supportive attitude
- Needs of the employer
  - Image of the company
  - Competitors image
  - Industrial relations
  - Mergers / downsizing / reorganisation
- Political beliefs
  - Paternalism
  - Aims of the company
- Value for money
  - Minimise cost
  - Simple administration
  - Tax efficient
  - Freedom from legislation
- Financial planning
  - Stable, predictable costs
  - Flexability of payments

Individuals

An individual may be forced to finance benefits by the state or by employers. Otherwise they will wish to maximise the value of what they recieve, balancing long term benefits against short term and protection against events like illness/death. The main factors individuals take into account are

- What individuals need or want
  - Compensation for their activities
  - Maintain standard of living
  - Safety net in case of illness or death
  - What the state provides
  - What employers provide
- Political beliefs
  - Degree of long term thinking
- Value for money
  - Minimise costs
  - Simple to understand
  - Simple to administer
  - Tax efficient
- Financial planning
  - Stable, predictable cost
  - Stable, predictable benefit
  - Flexability
  - Security

Risks

A key influence on motivation is the attitude to risk. The gap between promising and providing benefits means benefit provision has inherent risk, expressed as uncertainties in levels and timings of costs for sponsors or benefits for recipients. It is important to understand risks to assign, manage, mitigate or transfer them. The main risks can be catagorised as follows

Risks due to design
- Inadequate benefits (misunderstood or changed needs)
- Benefits not appreciated (money spent wasted)
- Unexpected benefit changes (usually by state)
- Exercise of employee options (not properly allowed for)
- Bad models / parameters / data (funding projections incorrect)

Risks due to the market
- Investment risk
- Inflation risk
- Guarantee risk
- Illiquid assets
- Market value risk

Risks due to funding
- Employers underfunding
- Employers insolvency
- Unaffordable contributions
- Unexpected costs
- Overfunding (inefficient money use, possible fines / tax)

Risks due to management
- Sponsor mismanagement
- Bad advice
- Fraud / Bad integrity

Practical Considerations

When arranging benefit provision, in addition to meeting the goals of the interested parties, there are a number of practical considerations

Current position

This will have a big impact in terms of expectation, transitional arrangements, budgetting for the cost of change and expertise.

Experience and expertise

This will make it easier to avoid certain benefits

Perception and communication

Benefit provision should not only be suitable but be percieved to be suitable. This will have to be communicated to the members or potential members.

Miscellanious requirements

There are often legal, tax, administrative, etc requirement which must be fulfilled.

Scheme Design

There are a number of different choices to be made when arranging benefit provision.
We will look at these choices in abstract, to give an overview of the issues involved.
We will then look at how the state, employers and individuals approach pension
provision in the UK.

Arranging Provision

The state and employers can use several methods to ensure adequate benefit provision

Providing benefits

This is the most expensive but valuable method. Care must be taken to avoid excessive costs which are hard to finance

Compelling benefit provision

Methods include forcing employers or individuals to make minimum contributions or forcing employers to provide minimum benefits.

Encouraging benefit provision

Methods include cash incentives, benefit enhancement, tax breaks, guarantees to mitigate risk and providing vehicles for benefit provision. There is usually an upper limit to prevent abuse.

Education

This ranges from campaigns to encourage provision to ensuring appropriate parties have access to relevant information.

Regulating benefit provision

The state may regulate to ensure that appropriate benefits are provided and that parties are capable of providing promised benefits. This includes advanced funding, measures in case of insolvency and disclosure of information.

Types of Benefit

Benefits typically fall into the following categories

Retirement and death
This includes pensions, survivor benefits, lump sums and nursing care

Temporary absence
This includes paid holiday, sickness and maternity leave

Permanent absence or disability
This includes pension, survivor benefits, salary continuation, unemployment income and termination indemnity.

Family support
This includes birth grants, creche facilities, family income support and scholarships

Subsidised goods and services
This includes subsidised health care (such as dental or optical), cars, parking, food, housing and leisure facilities, legal and financial advisors and loans.

Savings
This includes share schemes and profit sharing.

Types of Pensions

The most valuable benefits that are commonly provided are pensions. They are usually provided in one of the following forms

Flat rate

The same fixed pension is paid to all members

Means tested

Pensions are paid according to a members financial status

Defined benefit

The formula for the amount of pension is predefined, typically a multiple of some salary definition times service, sometimes with offsets for other benefits.

Defined contribution

A fixed contribution is paid into the scheme and invested. When the member retires, their invested fund buys a pension at the market rate.

Hybrid

A scheme offering elements of both defined benefit and defined contribution. Often it offers the better of the two.

Scheme Design Choices

When arranging benefit provision, the following choices must be made

Eligability

Who is entitled to which benefits?

Possible factors include age, sex, job, service length, etc.

Benefit triggers

What events trigger benefit payments?

(In a defined benefit pension scheme, normal retirement age, or the age at which benefits can be taken unreduced by right are key. Other triggers are death and ill health.)

Benefit amounts

When triggered, what benefits do recipients get?

This includes the overall amount (predetermined or depending on contributions), the form, the timing, member options and future increases or benefit changes.

(In a defined benefit pension scheme, key areas are accrual, salary (definition and averaging), service (part time and incomplete years) and state benefit adjustments.)

Residual benefits

What benefits does the member get on leaving (voluntarily or involuntarily)?

Financing

How is responsibility for financing the benefits split between parties?

(In a defined benefit pension scheme, balance of cost is usual, as paying a fixed proportion of salary is easiest for members to plan for.)

Funding Methods

The money required to fund benefits is about the same regardless of when it is paid. There are therefore many methods for choosing the timing of the payments.

Pay as you go - The sponsor makes payments as each tranche of benefit becomes due

Book reserving - Like PAYG, but funds are notionally set aside.

Smoothed PAYG - Like PAYG, but with an active fund for irregular payments.

Terminal funding - The sponsor fully funds the benefit when the first payment becom ue.

Just in time - The sponsor fully funds the benefit at the last possible moment. This may be an external trigger like the sale or insolvency of the employer.

Regular contributions - The sponsor funds the expected value of benefits promised so far. There are different ways of calculating this value and the corresponding contribution level.

Entry age   contributions over working lifetime, joined at entry age
Attained age   contributions over working lifetime, joined at current date
Projected unit   contributions over next year, salary at retirement
Current unit   contributions over next year, salary now.

General average premium - At scheme onset, the contribution rate is chosen to be that needed to fund it over the life of the scheme

Lump sum in advance - The sponsor fully funds the benefit when it is promised.

Regular Contributions

When considering regular contributions, there are three key values

Actuarial Liability	The expected value of assets needed to cover the promised benefits
Standard contribution rate	The rate to cover future benefit accrual if assets = AL
Modified contribution rate	The actual rate to cover future benefit accrual (equals SCR + variation from spreading surplus / deficit)

For the four methods mentioned, these are calculated as follows

Entry age
AL = P.V. of all benefits − SCR × P.V. of future earnings

$$SCR = \frac{\text{Value of benefits at Entry age}}{\text{Value of future salary at Entry age}}$$

Attained age
AL = P.V of accrued benefits

$$SCR = \frac{\text{P.V. of future benefits}}{\text{P.V. of future salary}}$$

Projected unit
AL = P.V. of accrued benefits

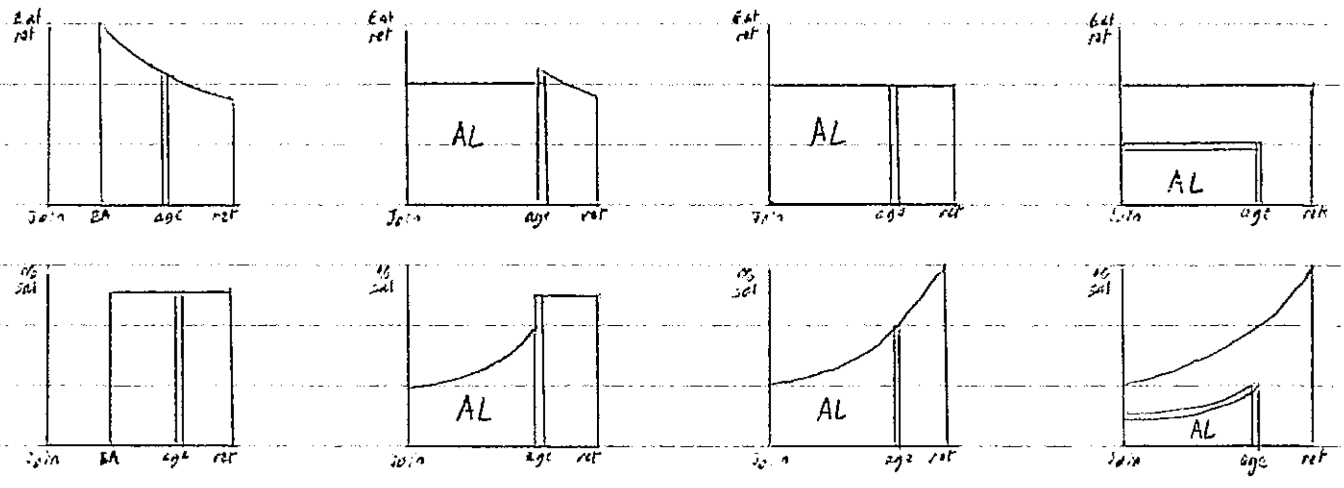
$$SCR = \frac{\text{P.V. of benefits accrued this year}}{\text{P.V. of salary paid this year}}$$

Current unit
AL = P.V. of accrued benefits assuming FPS is current salary

$$SCR = \frac{\text{P.V. of benefits accrued this year assuming FPS is current salary + AL increase due to salary incre}}{\text{P.V. of salary paid this year}}$$

The build up in liability can be shown graphically like below

Entry age | Attained Age | Projected unit | Current unit



Investment

A prefunded scheme will need to invest its assets until they are needed. Possible investment products include

- Shares - Inflation and salary related, but volatile with a low income stream
- Bonds - Secure non-inflation linked with low returns
- IL Bonds - Secure inflation linked with low returns
- Property - Unmarketable long term inflation and salary related
- Cash - Short term frictional investment

- Annuities - Remove longevity risk, but benefits may be hard to match
- Insurance - Removes liquidity requirement in day-to-day business
- Managed fund - Allows diversification for medium level schemes
- Derivative - Used mainly for overlays when changing strategy.

There are also some specialist pension scheme vehicles

- Insured scheme - a scheme where the only long term investments are insurance policies. These are usually administered by the insurance company and smaller than self administered schemes
- With profits deferred annuity - standard with-profits arrangements that may buy annuities, but are usually arranged with a more valuable cash option
- Deposit administration - a contract giving a guaranteed rate plus a bonus if investments do well, tending for cash.

These are usually sold on the back of a bundled all-in-one package making them most suitable for small schemes.

State Provision

The state has free choice about how to organise benefit provision. However, in doing so it must take account of a number of practical considerations.

- It needs to arrange things so that people cannot abuse the benefits offered. For example, offering direct provision of final salary benefits would not work, as employers would boost salaries in the last year to increase pension provision.

- It will generally wish to avoid prefunding as its presence in the market would distort the market. Instead it will usually take advantage of its financial robustness to use pay-as-you-go.

- It will have a wide range of claimants about whom it does not know, does not have suitable data, etc. This makes financial planning harder, and causes issues with means testing.

Direct State Provision

The state provides benefits as consolidated in the Pension Schemes Act 1993. They are funded on a PAYG basis from National Insurance contributions, the level being set by the Government Actuaries Department every five years. They are paid from State Pension Age (65 for men, 60 increasing to 65 between 2010 and 2020 for women), and consist of the following parts

BSP A flat rate pension for those who have contributed to NI for 90% of their working life from 16 to SPA, decreased proportionally for lower contributions. If married to a spouse with no BSP, you get married BSP and your spouse gets single BSP on your death. BSP increases according to the government - currently in line with RPI but expected to be in line with earnings

SERPS A revalued (NAE) career average scheme based on upper band earnings. It was accrued between 6/4/78 and 6/4/02 by all except self-employed, and married women who elected lower NI contributions. It provides

SPA before 5/4/98	1·25% total UBE
6/4/98 to 6/4/00	25% average UBE
6/4/00 to 6/4/10	... decreasing to ...
6/4/10 and later	20% average UBE post 86, 25% average UBE pre 86

SERPS increases according to the government, typically in line with RPI, and has a 50% spouses benefit.

S2P This replaced SERPS in 6/4/02, giving a different accrual

LEL to LET	40%	
LET to UET (= 3 LET - 2LEL)	10%	Originally planned to be phased out, however does not seem to be happening
UET to UEL	20%	

MIG / State pension credit The minimum income guarantee was introduced in April 1999 and replaced by the state pension credit in April 2003. This is

Guarantee credit - Minimum income guarantee

Savings credit - Boost earnings for people with a certain level of earnings.

Non-state Provision

Employers decisions about how to provide benefits, subsidise benefits or provide vehicles for individual provision depend on what the state does in terms of provision, compulsi incentives and regulation. As they usually want to target benefits at more valuable employees, salary and service links are usual (in terms of benefits or contributions)

In the UK, employers providing benefits directly usually do so through registered schemes due to the tax advantages. Benefits which cannot be provided through registered schemes are provided through (non registered) Employer Financed Retirement Benefit Schemes

Employers with more than five employees who have no occupational scheme are obliged to offer access to a stakeholder scheme.

Individual decisions about how to provide benefits depend on the state and employers. Due to the lack of cross-subsidies, individual provision is always defined contribution. There are a number of standard registered vehicles

- Personal Pension
- Stakeholder (personal pension with minimum contribution of £20 and management charge of 1.5% p.a. decreasing to 1.0% p.a. after ten years)
- Section 226 policy (obsoleted by personal pensions)
- Free standing AVC

Non-registered provision is normally done outside schemes, for example through ISAs or property.

Scheme Tax Positions

Schemes designed along certain lines can be registered and gain considerable tax advantages
The tax position is broadly as follows

	Registered	EFRBS
Employer conts taxable	No, and not Benefit in kind	Tax relief when benefit paid, not BIK
Employee conts taxable	No	Yes
Investment return taxable	No except ACT	Yes
Employer benefits taxable	(As income, with up to 25% tax free cash sum)	As income
Employee benefits taxable		No
DIS benefit taxable	No	Inheritance tax
Refund of conts taxable	Yes at 20% up to £10,800 and 40% thereafter.	

EFRBSs in place at A-day will get some relief on employer conts and DIS benefits.

To prevent abuse, limits are put on contributions to and benefits from registered schemes.

Individuals must pay tax when contributing more than 3,600 or 100% salary.
Employers do not have a limit. However, there is an overall limit on increases in value (ten times increase in accrued value for DB, contributions for DC) of the Annual Allowance, with excess increases taxed at the individuals marginal rate.
This limit does not apply in the year benefits are taken in full.

When benefits come into payment, total benefits are checked against the Life Time Allowance (twenty times pension for DB, market value for DC, twenty five times pre A-day pension).
Excess benefit is taxed at 55% if cash and 25% plus as income if pension.

Members with high benefits at A-day can protect their benefit entitlement through primary protection (get LTA scaled up by A-day benefits / A-day LTA) or through enhanced protection (all benefits accrued up to A-day protected but restricted future accrual).

Registered Schemes

In order to be registered, a scheme must

- Offer certain benefits
  - NRA must be 60 to 75 and ERA must be 50 to 75 (55 to 75 from 6/4/10)
  - Pension increases for DB schemes must be LPI5 for post 97 and LPI 2.5 for post 05.
  - TFCS cannot exceed 25% value $\left(= \frac{20PF}{20+3F}\right)$; DISCS cannot exceed 4× salary.
  - On leaving: 3 months to 2 years offer transfer value; 2 years plus offer deferred pension.
  - Employment law prohibits direct / indirect sex discrimination and illegal age discrimination
- Have separate assets to those of its sponsor - usually done through a trust - and have restricted and disclosed self-investment.

As a result of being registered, schemes must

- Obey The Pensions Regulator. This body has the power to
  - appoint, suspend, prohibit or disqualify trustees
  - impose schedules of contribution
  - issue improvement notices
  - apply to courts to reverse transactions
  - freeze DB schemes while deciding whether they should be wound up
- Appoint a Scheme Actuary and Scheme Auditor with the ability to ask for any information about the scheme and report trustees or the employer to TPR.
- Issue a Section 75 debt if assets are insufficient when a scheme is closed or sponsoring employers cease participating or are wound up.
- Pay a levy to the Pension Protection Fund. This fund guarantees 90% of benefits up to a cap in event of insolvency. It uses a standardised benefit structure of LPI5 revaluation, 0% pre 97 escalation and LPI2.5 post 97 escalation.

Trust Law

Pension schemes set up through a trust are governed by trust law. A Trust Deed sets out the various parties and their key powers and responsibilities, including

Financing - Consultative or trustee only
Investment - Trustee only; includes choice of strategy, managers and SIP.
Administration - Trustee proceedings, records, audits, expenses and advisor appointment
Benefit Aug^{n} - Discretionary for employers and trustees. May require contributions
Transfers - Acceptance into and payments from the scheme

Trustee change - Employer can usually appoint / remove trustees. A third must be member nominated, and an independant trustee must be appointed on sponsor insolvency
Amendment - Employer can usually change, subject to section 67I of Pensions Act 1995 which requires member consent for detremental or protected modifications, or actuarial certification that the benefit value has stayed the same. Changes to future accrual require member consultation but not agreement.
Wind up - Employers and trustees usually have the power to wind up the scheme.

A set of rules will cover how the scheme is run, including benefits, eligability, contributions and where trustees have discretion

Contracting Out

Registered schemes can contract out of S2P / SERPS by providing a replacement. In return, the NI contributions paying for S2P / SERPS are paid into the scheme. There are a number of ways schemes can contract out.

Scheme based test (Defined benefit before 6/4/97)

Have to provide a guaranteed minimum pension calculated by the state. The state provides the difference between this and SERPS.

Reference scheme test (Defined benefit after 6/4/97)

Have to provide benefits on no worse terms than, and no worse than the Reference Scheme Test for 90% of members (1/80ths on 90% of three year average UBE, providing pension from 65 with LPI increases and 50% spouse benefit).

Protected Rights basis (Defined contribution)

All NI conts get paid into a protected rights fund which must give pension from 60 with 50% spouses benefit, LPI3 pre 97, LPI5 post 97, 0% post 05 or better. Unisex mortality must be used and DBR gives the fund to the spouse.

State Supervision

There are two government departments and four bodies overseeing UK pension provision.

Treasury - This sets regulations relating to tax.

- Inland Revenue Savings Pensions Share Schemes - This enforces tax concessions
- Financial Services Authority - This monitors commercial financial offerings

Department for Works and Pensions - This sets regulations relating to security and provides pension

- The Pensions Regulator - This enforces security regulations
- The Contributions Agency - This enforces contracting out security

Running Schemes

In the UK, the most complex non-state schemes are registered occupational DB schemes. We will look at the issues of running one, and so cover the issues of less complex schemes.

Registered occupational DB schemes are always set up under trust, and running them is the responsibility of the trustees with support from the scheme actuary, employer and beneficiaries. We will look at the roles and duties of each.

Running a scheme can incorporate a number of activities, including

- Scheme administration
- Disclosure to interested parties
- Producing accounts
- Funding strategy
- Investment strategy
- Valuing assets and liabilities
- Dealing with mergers and acquisitions
- Discontinuing the scheme

Again, we will look at each in more detail

Roles and Duties of Trustees

The roles and duties of trustees fall in three main areas

Administering the trust

- According to the trust deed and rules, trust law and prevailing legislation
- Being familiar with the TD&R, SFP and SIP, with the issues on which descisions are taken and taking professional advice on areas outside their expertise
- Acting in the best interests of all beneficiaries, not seeking to profit from their duties and being aware of any conflicts of interest.

Exercising discretion where required

- Setting the scheme funding and investment strategies
- Deciding member options such as factors, whether to allow early retirement, etc.
- Protect the schemes tax free status

Day-to-day running

- Administer the benefits (or delegate appropriately) including keeping member records.
- Have regular meetings with minutes recording the descisions taken.
- Communicate appropriately with members.

Roles and Duties of the Scheme Actuary

Registered occupational schemes are required to appoint a scheme actuary with a current scheme actuary certificate. This is a personal appointment - not of the actuaries firm. The roles and duties of the scheme actuary fall in five main areas.

Acting professionally

- In accordance with legislation (Pensions Act 1995) and professional guidance

Providing advice

- As necessary under the TDLR and as requested by the trustees as primary client.
- To other parties where requested and not in conflict with the primary duty of care.

Providing periodic certification

- Producing a valuation report on the ongoing and solvency bases
- Certifying benefits meet contracted out minimum, change of past service benefits, bulk transfers without consent, transfer value bases, debt on employer, security of benefits for accounts, S179 valuations, deficit reduction, schedule of contributions, etc

Reporting scheme problems

- Report to TPR about non-compliance of relevant duties which are material when taken with non-reported breeches (which should be logged)
- In non-fraud cases, keep the trustees informed

Transitional obligations

- Provide and agree a letter of appointment
- Provide a letter of resignation, outlining any circumstances giving cause for concern.
- Recieve and pass on details of breeches, reports to TPR, trustee and auditor reports and contracting out details. Consider if events in the intervening period cause problems
- Get an undertaking from the trustees to provide data necessary for duties.
- Arrange relationship with scheme auditor and other advising actuaries.

Professional Guidance

This is provided primarily through a series of guidance notes, including

GN3 - Wind ups before 6/4/97 - contracting out
GN4 - Insolvency contributions safeguards
GN9 ▷ Valuation reports
GN11 ▷ Transfer values
GN13 - FAS 87, 88, 132
GN16 ▷ Bulk transfers
GN19 ▷ Wind ups
GN24 - Expert witness
GN25 - Derivatives
GN26 ▷ Terminology
GN27 ▷ Minimum Funding Requirement
GN28 ▷ Contracting out
GN29 ▷ Advising trustees / employers
GN31 - APPs
GN34 - DC Illustrations
GN36 ▷ FRS17
GN48 - Compliance review
GN49 - Advice on scheme funding
GN51 - Change of existing benefits

Roles and Duties of Employers

The roles and duties of employers fall in four main areas

Meeting obligations
- According to the TD&R, trust law and prevailing legislation

Acting in the best interests of shareholders
- Motivating staff using the scheme
- Avoiding payment of contributions that would best be invested elsewhere.

Setting the scheme structure
- Initially designing the benefit structure and making rules amendments
- Applying discretion under the rules (e.g. augmentations, early retirements)
- Appointing and removing trustees
- Winding up the scheme

Financing the scheme
- Agreeing funding and investment strategy
- Paying contributions above and beyond those paid by the members
- Meeting costs not paid by the scheme
- Making good underfunding, especially on windup.

Roles and Duties of Beneficiaries

The roles and duties of beneficiaries fall in three main areas

Provide contributions
- According to the TD&R
- Make additional voluntary contributions

Exercise discretion
- Choose investments (for DC), benefit options and timings.

Advise administration
- About changes in circumstances, address, etc.

Scheme Administration and Factors

Trustees are responsible for scheme administration (ensuring benefits paid, records kept, etc.) However they usually delegate this to specialists. One area in which they retain direct involvement is setting Factors (and applying discretion) in

- Cash commutation
- Early / late retirement
- Augmenting members / spouses benefits
- Transfers in / out

etc

When doing this, trustees must act in accordance with their duties set out by the Trust Deed and Rules, trust law and prevailing legislation. This may determine or restrict what can be offered, under what circumstances, and what maximum or minimum terms can be.

Trustees should act in the best interests of all beneficiaries. This means they should neither be unfair to the member nor jeopardise the security of other members benefits. Special care should thus be taken when options directly affect scheme funding. In practice, a cautious basis is chosen as members do not have to take options, or one which biases choice to the option funded for. If there is still possibility of selection, trustees may limit amounts, times choices can be made or insist on things like medical checks.

Trustees will want to ensure that options are generally consistent with each other. Where the effect on funding is not significant, they may also choose to smooth factors or use the same factors for different NRAs, sexes, sections, etc. This aids simple administration and helps members understanding of their benefits.

Finally, when considering these options, trustees should take professional advice.

Transfer Values

This is an area with special guidance in the form of GN11. This currently says that the transfer value must reflect the cost of meeting the benefit and may allow for assets held - however it is currently being reviewed.

If the scheme is fully funded, this implies that the transfer value basis should lie between the ongoing and solvency bases. Care should be taken where these do not properly reflect the scheme - for example aggressive equity outperformance assumptions penalise the young, and solvency bases allowing for profit are arguably too high.

If the scheme is overfunded, a standard transfer value is usually paid. This is because the employer is usually considered to have ownership of surplus and the transferring member to have given up their interest by transferring.

If the scheme is underfunded, a similar argument can apply - the employer or PPF guarantees the benefit so a full transfer value (or PPF transfer value) should be paid. Alternatively, the trustees may decide to reduce benefits based on the employer covenant and priority order. This should result in fewer TVs as members stay with the scheme hoping for full benefits. Employers may not like this as transfers out can be a good way of extinguishing liabilities.

Other relevant considerations include mortality and members dependants.

Trustee Training

The Pensions Act 2004 obliges trustees to get enough knowledge about scheme issues to take fully informed decisions. This is an onerous requirement given the complex technical and financial issues, which can be broken down as follows

Legislative issues

Trust law, pensions legislation, legislation affecting pensions and regulator requirements

Scheme documents

Knowing the TD&R, SFP and SIP, and thus what decisions and obligations fall to trustees and how to discharge them.

Financial and investment concepts

Actuarial funding methods, valuation bases, funding and security, concepts of risk and reward, relationship between assets and liabilities, nature of asset classes.

Governance issues

Strategic objectives, cyclical business plans, risks and mitigations, managing conflicts.

The trustees may seek professional advice or consider delegating some or all decisions to professionals

Disclosure

One way the state helps security is requiring disclosure of certain information

Trustees must automatically give members
- Information about the scheme through a scheme booklet
- Annual summary funding statements
- Details of defined benefits within two months of the scheme year end
- Benefit details on leaving, retirement or death

Trustees must provide members with access to
- Scheme documentation
- Annual report and accounts (including an actuarial funding statement, Statement of Funding Principles and a recovery plan (if there is one))
- The most recent actuarial valuation

Employers must disclose the status of the pension plan in their accounts (if material). They must also disclose the following details of directors pensions
- The increase in accrued DB pension (net and gross of inflation) and the increase in transfer value of DB benefits net of directors contributions
- The contributions paid into DC schemes.

Anyone involved in administration of, or giving advice to pension schemes who has reasonable cause to believe in non-compliance of duties material to The Pensions Regulator must report the matter to The Pensions Regulator

Statement of Funding Principles

The Statutory Funding Objective requires schemes to have assets meeting technical provisions, an actuarial assessment of the amount required to meet scheme liabilities as they fall due on trustee determined scheme specific assumptions.

The trustees must prepare a Statement of Funding Principles setting out how this is met, includi

- The scheme funding objective (ie how to determine scheme specific assumptions)
- The policy for ensuring the SFO is met (i.e. how to determine the contributions, including, if applicable, the manner and period to make up any shortfall)
- What discretionary powers to increase benefits exist and how to fund for them
- Frequency of valuations, and what circumstances cause extra valuations.
- Circumstances in which parties other than the employer would contribute to the scheme.
- Circumstances in which the scheme would make payments to the employer
- What the policy on reducing transfer values is if the scheme is underfunded

The SFP is the basis for all funding decisions, including scheme specific assumptions, Schedules of Contribution and recovery plans. These will all be determined with consultation with the employer or require agreement from the employer, depending on the TDRR

If agreement is required but cannot be reached, the trustees must refer to TPR who can reduce benefit accrual, direct funding objectives or recovery plans or impose schedules of contribution

Funding Considerations

Key areas when looking at different funding approaches are

Security	meeting benefits in all circumstances including insolvency
Opportunity cost	the cost of financing benefits instead of something else
Stability	contributions that are not disturbed by fluctuations in experience
Durability	stable contributions as the membership profile changes
Flexability	ability to vary contributions according to need
Realism	contributions match accrual (useful for accounting)
Liquidity	how much cash needs to be available at short notice

When determining the funding rate, trustees must act in accordance with the TD&R. This usually says something like "contributions necessary to provide the benefits." When interpreting this, trustees must be prudent and act in the best interests of all beneficiaries. Their key focus will therefore be on security.

Demanding maximum levels of funding would provide the best levels of security. However, trustees generally accept that continuing employer prosperity helps ensure the schemes long term continuation and solvency, and so allow flexability over the funding method and timing of contributions. This helps keep active members in their jobs and raises the possibility of benefit augmentations from surplus.

The typical interpretation is to fund on an ongoing basis over the working life of an active member or on a solvency basis over the company life if shorter. This means the trustees will need to assess the employers covenant. There are also a number of practical issues that the trustees should consider

Employer Covenant

This is the ability of the trustees to require that the employer makes sufficient contributions, encompassing both the ability and willingness of the employer to pay. It should be considered whenever it has a material effect on scheme funding.

Employers typically fall in or between two categories
- Viable ongoing - any deficit is likely to be paid off in a reasonable time frame
- In distress - there is no likelyhood of any deficit being completely paid off and trustees should concentrate on maximising available funding.

Categorising the employer is not an exact science. The trustees should consider the corporate structure, level of borrowing and future prospects, or use one of the following

Business outlook - cheap but subjective analysis of employer prospects in their sector
Financial metrics - cheap comparison of financial statistics with past and similar companies
Does not give absolute risk and needs management account access to be up to date.
Implied market default risk - where employer has traded bonds / shares, these can be compared with risk free gilts / models to give the market valuation of the risk.
Credit rating - employers can work with credit rating agencies to get them.
Quantitatively derived credit risk - credit rating from publically available information
Independant business review - employers can work with advisory specialists to give reports.
D&B rating - Publically available insolvency likelyhood measure used by the PPF

Trustees should monitor changes in the employer covenant using

Changes in publically available metrics
Regular meetings with the finance director or board
Covenants requiring the employer to inform them of changes

If the employer covenant get's worse, trustees may change investment strategy, invest in assets protecting against insolvency, or demand extra contributions or a charge on fixed assets.

Practical Funding Considerations

There are a number of practical issues that trustees should consider when deciding funding strategy, many related to the fact that the employer has different views.

External advice

Legal interpretation of TD&R

Actuarial advice on consequences to the scheme in different scenarios

Advice on negotiation stance, minimum position etc

Advice on future legislation

Employer covenant

How much are they able or willing to pay

How much did they expect to pay / what does the SFP say

Are they getting other advice and what is it

Consequences

Default position if no agreement is reached

What happens if the employer refuses to contribute at the level requested

What triggers windup and what happens to the debt on windup

What additional funding would requests secure

What happens if this makes the employer uncompetitive

Disclosure to employers

Lower contributions now mean higher contributions and potential loss of confidence

Employers should abide by the trust deed and rules

The actuary should point out areas of concern and may have to resign if not paid

Statement of Investment Principles

Trustees are responsible for investing trust assets, but usually lack the expertise required. Instead they delegate to an investment manager who invests according to the Statement of Investment Principles the trustees put together in consultation with the employer. This covers

- The policy for meeting the Statutory Funding Objective
- Risks and expected returns for the investment policy
- The balance (including maximum / minimum) between different asset classes
- Limits on derivatives, illiquid assets, self investment, foreign currency investment, etc

It should be reviewed when investment policy changes, or at least every three years. The review should consider the schemes funding position, liability profile and investment manager performance.

When determining investment strategy, trustees must act in accordance with the TDCR, they must be prudent and act in the best interests of all beneficiaries. Typically these demands can be summarised as

- Holding sufficient assets to meet the liabilities as they fall due
- Holding assets appropriate to the nature and term of the liabilities
- Given these, maximising return subject to the employers attitude to risk.

These mean that the investment strategy should be consistent with the funding strategy.

- A weak funding strategy gives an aggressive investment strategy with high equity, venture capital and hedge fund holdings aiming to generate surplus
- A strong funding strategy gives a cautious investment strategy with high corporate bond, gilt and annuity holdings aiming to meet predicted cashflows.

Investment Considerations

When deciding investment policy, trustees should follow the Myners principles.

Effective decision making (by people with appropriate skills, information and resources)
- Expert advice

Clear objectives (overall objective represents the trustees judgement of how best to meet liabilities
- Explicit mandates
- Appropriate benchmarks
- Focus on asset allocation
- Strategy on activism

Performance measurement (both of the fund and of themselves as trustees)
- Regular reporting

Transparancy (the SIP should show decisions above with explaination)
(For DC, choice of a default fund)

The actual choice of asset classes and assets will be determined by their characteristics

Security - Matching asset cashflows with benefits
Yield
Spread - Diversification across asset classes, geographies and within asset clas
Term - Generally long term to match benefits
Exchange
Marketability - Particularly liquidity for mature schemes with negative cash flow
Tax - and other expenses

In addition, there are a number of practical considerations including the size of fund, trustee or investment manager expertise, availability of assets, perception and frictional costs.

Asset liability modelling should be considered to give an idea about volitility.

Accounts

Companies pension contributions and liabilities can be sizable. It is therefore important to produce pension scheme accounts to allow investors to make informed descisions.

All accounts should follow the accounting principles, the most important of which are prudence, consistency, ongoing-concern and accruals.

Accounts consist of two parts

Balance sheet - list of all assets and liabilities
Profit and loss account - reconciliation of this years with last years balance sheet

There are four main accounting standards in use in the UK at the moment - IAS19, FRS17, SSAP24 and FAS87. These differ in

Different emphisis on the balance sheet and profit and loss accounts
Choice of actuarial methodology and assumptions
Smoothing of fluctuations
Information to be disclosed

Items which may be disclosed include

Details of the assumptions and methods
Value of the accrued liabilities
Increase in past service liabilities
Return on assets
The surplus or deficit in the scheme

FRS17

This is the current UK standard, although it has not yet been fully introduced and will soon be replaced by IAS19. It is described in GN36.

Assets are taken at midmarket value, and liabilities are calculated using the PU method, using the discount rate corresponding to AA rated bonds, and other assumptio chosen by company directors after recieving actuarial advice.

The profit and loss accounts consists of

Pension cost	=	current service cost	(employers share only)
	+	interest cost	(liabilities times balance sheet discount.
	-	expected return on assets	(using long term yields)
	+	past service cost change	(immediately vesting benefit improvement.
	-	gains on settlements and curtailments	

FRS17 is balance sheet focused. This means that we add a balancing item into the profit and loss account below the line to ensure that the two reconcile. This is the value from the statement of recognised gains and losses (STRGL). This consists of

STRGL	=	difference between expected and actual return on assets
	+	gains and losses due to other experience
	+	gains and losses due to changes in assumptions

When reporting, we should include

The remit of the accounts
The valuation the numbers are based on, and the information and instructions used.
Where appropriate, highlight approximations and inherent volitility.
State allowances for tax.
Include a 5 year history of the STRGL

SSAP 24

This is the old UK standard and can still be used providing limited FRS17 disclosures are made. It is described in GN17.

Under SSAP24, the actuary in consultation with the company not only has the choice of assumptions, but also the choice of method. These should tie in with the accounting objective and taken as a whole, should provide a best estimat of the cost of providing benefits. Typically projected unit, attained age or entry age methods are used.

The profit and loss account consists of

Net pension cost	=	regular cost	(employers share only)
	+	interest cost	(surplus / deficit times discount rate)
	+	variation cost	(amortisation of past surplus / deficit)

The variation cost should amortise over employers future working life, using some systematic rational basis. These include

- Percentage of pensionable payroll
- Fixed annual amounts
- Installments of capital plus decreasing interest amounts.

Certain things should not be amortised, including unfunded benefit improvements extraordinary events, and at the companies discretion, refunds of surplus.

SSAP24 is profit and loss focused. This means that we add a balancing item into the balance sheet consisting of the difference between Net Pensio. Cost and the actual payment. This is known as the pension prepayment, and cumulates over the years.

FAS 87

This is the US standard, which must be followed by companies that file accounts in the USA. It is described in GN13.

Assets are taken at market value but may be smoothed over 5 years. The liabilities are calculated using the PU method using the discount rate corresponding to AA rated bonds. The long term return on assets should represent the average future earnings expected from the fund, and other assumptions should be chosen by the employer with the actuary's comments.

The balance sheet needs three values to be calculated

Projected benefit obligation (PBO)	(Value of liabilities)
Accrued benefit obligation (ABO)	(Value of liabilities assuming zero salary increa
Vested benefit obligation (VBO)	(Value of liabilities assuming members defer).

The profit and loss account consists of

Net periodic pension cost	=	service cost	(employers share only)
	+	interest cost	(liabilities times balance sheet rate)
	−	return on assets	(using asset yields)
	+	amortisation	

Surplus or deficit in a corridor of 10% max (PBO, Assets) does not have to be recognised. Outside this, it must be amortised over the future working lifetime

FAS 87 is balance sheet based. Dispite this, the balancing item of the difference between Net periodic pension cost and the actual payment is recorded on the balance sheet as the prepaid pension cost, and cumulates over the years.

Valuations

The purpose of valuations is to look at, under various scenarios

- What proportion of the promised benefits can be paid
- What contributions need to be paid in the future

They typically involve calculating the current value of assets and benefits promised and the value of assets and promised benefits expected over some future timescale.

The values calculated depend on the method, assumptions and data used which in turn depend on the question that the valuation is trying to answer. Questions include

- Are the funds adequate if the sponsor becomes insolvent
- What savings could be made by changing the benefit accrual
- What liability profile should the assets be matched to
- When transferring members, how much should be paid

Types of Valuation

There are a number of standard valuation types in the UK.

Ongoing valuation - This gives the funding level and a stable future contribution rate, assuming that the scheme continues over the long term. Allowance is made for future accrual, salary increases and benefits being paid from the scheme. It assumes assets return as gilts plus outperformance and inflation matches the long term expectation. Assets are taken at market value and sometimes smoothed.

Solvency valuation - This gives the security of benefits if the scheme is wound up, accrual ceases and immediate and deferred annuities are bought for all members from insurance companies. The basis reflects how these are valued - typically based on the prices of long term fixed interest and index linked stocks with allowance for expenses, administration cost, profit margin, reinvestment of income, future mortality improvements. The limited UK market makes this expensive. The level of cover for each category of benefit should also be shown.

SFO valuation - This will typically be the same as the ongoing valuation.

Section 179 valuation - A valuation of the benefits provided by the PPF on proscribed assumptions, similar to those of the solvency valuation.

Valuation Models

A good valuation model has the following properties

- Based on similar experience to that being projected
- Features all relevant aspects in the model
- Practical to set up an run
- Consistent between assets and liabilities
- Produces stable outputs
- Produces outputs with a known level of accuracy

The main valuation models used are as follows

Replicating portfolio - Take assets at market value, and calculate liabilities by constructing a portfolio of assets with the same future cashflows. Finding suitable assets to match mortality or salary growth is hard, so this is usually unsuitable.

Asset based discount rate - Take assets at market value, and calculate liabilities by using a discount rate derived from market yields.

MVA variant - Take assets at market value, and calculate liabilities by using long term discount rates and multiply them by a market value adjustment.

Discounted cashflow - Value assets and liabilities using long term assumptions.

Stochastic model - Use any of the last three methods but with stochastic methods.

Smoothed market value - Use any of the first three methods but use a smoothed market value for assets and indices used when calculating liabilities.

These can be varied depending on how future accrual is allowed for, including entry age, attained age, projected unit and current unit methods.

Valuation Assumptions

Valuation assumptions can be split into two categories

Economic assumptions - discount rate (pre/post retirement), salary increases, price inflation and corresponding revaluation, discretionary increases.
Demographic assumptions - mortality (pre/post retirement, scheme experience), withdrawal, early/late retirement, proportion married and dependants, commutation

The choice of assumptions depends on

- Purpose of the valuation
- Legislative and professional guidance
- Method and data used
- Current and historic market levels
- Membership profile
- Degree of prudence required

The choice of degree of prudence is not trivial

- It must encompass all assumptions
- Different parties have different views on how much prudence is justified
- Overly prudent/optimistic valuations can lead to unexpected results (e.g. the company reducing benefits or going insolvent)

Valuation Data

The key pieces of valuation data can be broken down as follows

Scheme data - Trust deed and rules
- Scheme booklet and member announcements
- Previous reports, information and advice
- Past / future discretionary practice, relevant trustee decisions
- Changes in sponsor, scheme, investments, etc.

Member data - Including identifiers, DOB, DJS, DOE, status, membership category, pensionable salary, part time hours, commuted pension, etc.

Asset data - As at date of valuation

Accounts - Audited accounts provide a cross check of membership and asset data

Data should be checked for completeness and accuracy. The usual checks are for self-consistency, consistency with previous data and consistency with the trust deed and rules. (Inability to do such checks is one reason summarised data is not ideal.)

Valuation Reports

Any valuation based on proscribed assumptions or an update of previous advice must follow Guidance Note 9 about what should be included in it

Introduction and background

Who for, what purpose, legal section and legislative provisions the report is made under

Previous and current date and actuary, recommended and actual contributions and experience.

Funding objectives

What they are and changes from previous valuation, implications on cost stability

What 100% funding objective (and SFO) is in terms of solvency and CETV basis.

Risks for meeting objective (sponsor, investment return, asset falls, mortality, member options)

Impact of other funding objectives in terms of Statutory Funding Objective.

Method and Assumptions

Funding method, demographic and financial assumptions, changes since previous, illustration of sensitivity assumptions and market changes, compatability of assets and liabilities

Data

Benefits valued and excluded, discretionary benefits, accrual ceasing, description of a summary of member and assets, insurance, audited accounts, confirmation of checks.

Results

Funding level relative to target, analysis of surplus, unambiguous future contributions (split), solvency liability on priority order (assets no more than market value, liabilities actual cost, or appropriate principles). Describe method, risks, expenses.

Recovery Plan

Assumptions beyond valuation assumptions and sensitivity where different.

Where separate, ask to be made available to members.

Further Calculations

There are a number of further calculations done as part of the valuation process

Analysis of surplus - This acts as a check on valuation results and highlights where experience gains and losses have been. We project last times results forward and replace, step by step, expected with actual experience. Typical items include

- Interest on surplus / deficit
- Change of basis
- Investment return
- Contributions different to service cost
- Salary increases
- Inflation increases
- Demographics (withdrawal, retirement, etc.)

Analysis of experience - how actual and expected experience compare

Scenario analysis - looking at future scheme position under economic scenarios

Valuing options - these are typically complications to the valuation process as options and guarantees generally are tricky to value exactly

Removing surplus / deficit - this depends on whether it is actual or notional, the size of it, legislative treatment, tax implications, what is mandated in the trust deed and rules, sponsor and trustee attitude, source of the surplus, etc.

M & A Considerations

When members transfer employer as part of a merger or acquisition, the selling company no longer has interest in financing their pension benefits. The buying company may choose to take on the past service liability. Possible methods include

Mirror scheme - past and future service the same as the old scheme
Match past benefits - past service the same as the old scheme, future service on a different basis (often that of the buyers existing scheme)
Added years - past service (often individually calculated) as added years. Future service on a different basis (often that of the buyers existing scheme)

In addition, the buying company may offer guarantees or special redundancy terms. The advantages depend on the method chosen, but may include

- Minimisation of employee disruption and uncertainty
- In a final salary scheme, it gives an incentive to stay with the company
- It shows interest in and commitment to the company
- It may be a condition of sale or help with union negotiations
- It is largely cost neutral due to the bulk transfer value

Possible disadvantages include

- The company is taking on risk and the cost of uncertain future funding
- There will still be disruption if there are benefit changes
- In a final salary scheme, they are losing the release of funds on withdrawal.
- The process of transferring benefits is complex and may be costly.

M&A Interested Parties

The key parties in mergers and acquisitions are as follows

Selling company		Transferring trustees	Remaining members	IRSPSS
↑	|	|	|	IRNICO
Price	Business	Transfer value	Transferring members	Actuaries
|	↓	↓	↓	Solicitors
Buying company		Receiving trustees	Existing members	

The various parties have different roles

Buying / selling companies - They initialise the process and are trying to further the aims of their business by getting as good a deal as possible. They will wan to ensure members are happy and minimise pension scheme complexity and cost. However they may give up an advantage in pensions for one elsewhere or vice vers

Transferring / receiving trustees - They act on behalf of their members and may halt the process if they believe their members are losing out as a result of the deal

IR Savings, Pensions, Share Schemes - Their agreement is required for any bulk transfer or participation in another scheme (to avoid tax dodges).

IR National Insurance Contributions Office - Their agreement is needed to safeguard GMPs

Actuaries - These advise companies and trustees on financial implications of the deal including methods, assumptions, member terms, administration, etc.

Solicitors - These advise on legal aspects of the deal.

M&A Process

Due to the complexity and number of parties involved, bulk transfers cannot happen in a day. They usually follow a timetable similar to the following

	Buyers and sellers negotiate terms of the deal
Completion date	Sale and Purchase agreement signed
Participation period	Third parties agreement sought and transfer calculated
Transfer date	Transferring members start in new scheme
Payment date	Transfer amount paid between schemes

The participation period is required to give time to get agreement from members and inland revenue, and to establish a new scheme (if necessary) and calculate the TV. In the mean time, the buyer usually contributes to the sellers scheme (although section 75 issues cause problems). There are three main methods

Fund within a fund - The transfer is calculated as at completion date and forms a sub-fund into which contributions are paid. Leavers are the buyers responsibility.
Variant method - As above, but leavers transfer back to the sellers scheme
Transfer date - The transfer is calculated at transfer date - for the participation period, the buyer pays into the fund at a predetermined rate.

Payments later than the calculation date will typically be adjusted by investment returns or interest over the period. Interim payments may also be used.

Sale and Purchase Agreement

In a merger or acquisition, this is a legal document between the buyer and seller setting out terms and conditions. Pensions will usually form a distinct schedule, including

- Definition of terms used
- Obligations of the seller - including supplying relevant data, ensuring trustees pay the agreed amount, making up shortfall, allowing participation and seeking approval
- Obligations of the buyer - including providing certain benefits, paying back excess, participating in the scheme and making suitable member announcements
- Details about the transfer - calculating the amount, timing of payments, dispute resolution, etc.

Actuaries letter - From the seller to the buyers actuary setting out details of method and assumptions for bulk transfer

Warranties - Pensions warranties often form part of a longer list of warranties in which the seller guarantees the accuracy of data provided.

Employer Considerations of Mergers

Issues surrounding mergers and acquisitions also apply if an employer chooses to merge two or more schemes. Possible advantages include

Economies of scale

- Reduced professional fees, administration and investment management costs
- More purchasing power for investment funds and insurance contracts
- Less management time required

Corporate Identity

- Benefit harmonisation aids corporate identity and employee mobility
- Group can exercise control over subsidiaries consistently.

Misc.

- Some employees better off and happier
- May be able to offset deficits against surpluses

Possible disadvantages include

Benefit structure

- Benefits may not be suitable for all employees
- May need benefit improvement to get trustee and union agreement
- Likely to lead to higher overall contributions

Frictional costs of merging

- Including communication exercise, administration harmonisation and independent advice
- Employees may be unhappy with changes

Misc

- I will be harder to separate businesses if a sale takes place
- There may be issues over employment contracts.

Member Considerations of Mergers

Members views on mergers will be very member and scheme specific. Areas of interest will be the following

- Benefit improvements / getting worse
- Conditional benefit improvements / getting worse (i.e. people with low salary, etc.)
- Improvement / reduction in security
- Lower / higher costs ultimately leading to improvement / reduction in security
- Lower / higher contributions
- Additional / reduction in government benefits

- Options on retirement (early / late / commutation)
- Underpins
- Investment options
- Continuity of benefits

Trustee Consideration of Mergers

In mergers and acquisitions, trustees should act in accordance with their duties set out in the trust deed and rules, trust law and prevailing legislation. They should be prudent, act in the best interests of all members and seek specialist advice where required.

The trustees of the selling scheme must determine if the scheme can transfer members, who determines if the bulk transfer takes place, how the bulk transfer is calculated (the method - past service reserve, cash equivalent, share of fund; the basis - funding, accounting, solvency; ownership of surplus - members, selling business, buying business) and who can change these by altering the trust deed and rules.

They will need to check the benefits granted in the new scheme are suitable, whether member consent is required and whether the scheme actuary can sign the necessary certificates. They should consider ring-fencing surplus transferred, seek assurances about discretionary increases and consider the balance of power in the scheme.

The trustees of the receiving schemes need to check if they can accept or reject transfers, what benefits must be granted to transferring members and who can change these by altering the trust deed and rules.

They will need to check that enough money has been paid to cover the benefits and demand more money if necessary. They may wish to ensure that current surplus is ringfenced or negotiate benefit improvements or discretionary increase protection for their members. They should consider the priority order.

Additional considerations include doing due diligence on the other side, arranging future trustee and administration arrangements and communicating with members.

Transfer without Consent

Guidance note 16 sets out the conditions that should be met for the scheme actuary to sign a certificate allowing transfer without consent. These are

Guaranteed benefits
- Must be broadly no less favourable
- Do not need to be identical

Discretionary practices
- Must be broadly no less favourable
- Need 'good cause to believe' (i.e. stated policy)

Security of accrued benefits
- Both guaranteed and discretionary benefits
- Is there likely to be a significant reduction
- Review ongoing and solvency before and after merger
- Consider changes in wind up provision
- Consider how the PPF affects things

The actuary should confirm they are the scheme actuary and have enough data. They should point out that while the certificate allows them to transfer, it is ultimately the trustees decision and subject to legal advice and other consideration

Discontinuance

A scheme may discontinue (stop accruing benefits) for a number of reasons

- The sponsor becomes insolvent or stops contributing
- The sponsor requests that the trustees wind the scheme up
- The trustees believe winding the scheme up is in the members best interests

When this occurs, there are a number of options

Closure - The scheme closes to new entrants but otherwise continues normally.
Continuation - The scheme closes to future accrual, but continues normally.
(This may also include ignoring future salary growth)
Transfer to another scheme - All assets and liabilities are transferred
Transfer to beneficiary - All members receive a cash value for their benefits
Wind-up - Assets and liabilities are transferred to an insurance company
Central discontinuance fund - This takes scheme assets and pays (reduced?) benefits

The choice of method depends on legislation, employer and trustee desire, scheme liability profile and funding level. Note that the funding can vary with the method chosen - the trustees urgently need legal and actuarial advice here.

Surplus and Deficit

Ideally, there will be enough assets to meet the liabilities exactly. In practice, there will usually be a surplus or deficit. If there is a deficit, the trustees have the right to demand extra funds from the employer

- If the employer is solvent and windup started before 11 June 2003, they can demand MFR for non pensioners, buyout for pensioners and actual expenses
- If the employer is insolvent and windup started before 15 February 2005, they can demand MFR for all members
- Otherwise they can demand buyout for all members and actual expenses.

After such a payment, if the scheme cannot meet the PPF benefits as follows

Pensioners receive full pension, non-pensioners receive 90% subject to a cap.
Escalation is RPI, pre 97 increases are 0%, post 97 increases are 2.5% LPI
Members may commute up to 25%, spouses pension is 50% post commutation

and the scheme is eligible, commenced windup after 6 April 05, had an employer which became insolvent after 6 April 06 and has no chance of being rescued then the PPF may take the scheme assets and provide PPF benefits to the members.

If there is sufficient, then the PPF benefits must be met, then those arising from defined benefit AVCs, then any other benefits.

If there is a surplus, then this should be distributed according to the Trust Deed and Rules and the expectations of beneficiaries.

Windup Process

This is typically as follows

Crystalisation date - It is determined that the scheme will wind up. Member data is collected and members are allocated to categories. The investment strategy is reviewed and legal advice is taken. Members are told

- The reason the scheme wound up
- The date from which benefits ceased to accrue
- The actions to establish assets and liabilities and their implications (annual updates of actions taken should also be provided)
- The name and address for queries

Calculation date - The scheme liabilities and employer debt should be valued under various future scenarios

Applicable time - GN19 calculations should be carried out and debt should be paid.

If the scheme is not being taken over by the PPF, the priority order should be established, debts with members should be settled (with a default arrangement). Finally a 'dispersal of assets' form must be submitted to the SPSS and the NICO must be contacted in respect of contracted out rights.

For post 1 April 2003 windups, TPR must be notified within three months, then annually