THE MINIMUM FUNDING REQUIREMENT

The next stage of reform

Department for
Work and Pensions

HM TREASURY

MINIMUM FUNDING REQUIREMENT: THE NEXT STAGE OF REFORM

FOREWORD

On 7 March 2001 the Government announced its proposals to replace the Minimum Funding Requirement (MFR) with a long-term, scheme specific, funding standard in the context of a regime of transparency and disclosure, with additional measures to strengthen protection. Our proposals offer sustainable protection that provides more effective security for scheme members without damaging consequences for investment.

Since publishing our proposals on the future of the MFR we have received various comments and suggestions from the pensions industry and other interested parties for what might happen in the meantime. In the light of these comments this document sets out the Government's plans for the next stage of reform of the MFR, and seeks views on the workability of draft regulations that introduce changes to the current MFR in advance of its replacement.

Implementing the Government's proposals in full will require primary legislation. In the meantime we will continue to work closely with the pensions industry and other interested parties in developing the details of these proposals. We have today announced the setting up of a Consultation Panel to assist with this work, which will include representatives from:

- National Association of Pension Funds
- Association of British Insurers
- Faculty of Actuaries
- Institute of Actuaries
- Association of Consulting Actuaries
- Association of Pension Lawyers
- Society of Pension Consultants
- Fund Managers' Association
- Trades Union Congress

- Confederation of British Industry
- National Consumer Council
- British Chambers of Commerce

We look forward to working in partnership with these organisations to develop proposals that are workable and do not have any unintended effects. We will also work with the Occupational Pensions Regulatory Authority and the Financial Services Authority in developing proposals to put to the Consultation Panel.

Alistair Darling	Ruth Kelly
Secretary of State for Work and Pensions	Economic Secretary to the Treasury

September 2001

THE MINIMUM FUNDING REQUIREMENT: THE NEXT STAGE OF REFORM

INTRODUCTION

1.1 The Minimum Funding Requirement (MFR) was part of a package of measures, designed to provide protection for members of defined benefit occupational pensions schemes, that was introduced in the 1995 Pensions Act. The MFR came into force in April 1997. It requires defined benefit (salary-related) occupational pension schemes to hold a minimum level of assets to meet their liabilities, and sets out time limits within which any underfunding must be met.

1.2 Since its introduction there has been widespread criticism of the MFR. A joint DSS/HMT paper 'Security for Occupational Pensions: The Government's Proposals', was published on 7 March 2001, outlining the Government's proposals for replacing the MFR.

1.3 This document summarises the comments that have been received since the Government published its proposals. It sets out the Government's plans for the next stage of the reform of the MFR. And it seeks views on the workability of a package of draft regulations that has been developed in the light of the comments received. This package introduces changes to the current MFR in advance of its replacement, and introduces stricter conditions when a scheme winds up voluntarily. The draft regulations have no standing in law and may be subject to change before being laid before Parliament.

1.4 Comments on the draft regulations and the attached partial regulatory impact assessment are invited by Monday 10 December 2001 (sooner if possible). Please send your comments to:

Tim Found
Department for Work and Pensions
3rd Floor
The Adelphi
1-11 John Adam Street
LONDON
WC2N 6HT

Telephone: 020 7712 2409
FAX: 0207-962-8591
E-Mail: t.found@dwp.gsi.gov.uk

1.5 We may be asked at a later date to publish responses. If you do not wish your views to be made publicly available, please say so when you reply.

1.6 This document is on the former Department of Social Security website at: www.dss.gov.uk/publications/index.htm

RESPONSES TO THE GOVERNMENT'S PROPOSALS TO REPLACE THE MFR

2.1 On 7 March 2001 the Government published its proposals for a replacement for the MFR. These proposals consist of:

- a long-term, scheme specific, funding standard
- a strong regime of transparency and disclosure
- a recovery plan for returning schemes to full funding
- a statutory duty of care on the scheme actuary
- stricter conditions on wind-up of a scheme with a solvent employer
- an extension to the fraud compensation scheme.

2.2 Since the proposals were published a number of representations have been received. Views have been expressed on the proposals, and on what might happen in the period running up to the replacement of the MFR.

2.3 The Government's proposal to replace the MFR with a **long-term, scheme-specific, funding standard** has been generally welcomed. A customised funding standard is seen as better for defined benefit schemes than the more prescriptive "one size fits all" MFR regime. Most commentators agreed that funding and investment objectives should be linked to the scheme's own liability structure rather than to some external benchmark. However, a few respondents raised concerns about member security. The Government believes that by focussing on funding needs according to the circumstances of the individual scheme, a more appropriate standard will be applied which will provide more effective security for members. The Government's proposals also contain various additional measures to provide security for members.

2.4 Comment was made as to the role of the trustees and actuary in setting the funding standard for a particular scheme and how the employer should be involved in discussions of the funding and investment plans. Particular concern was expressed as to how the trustees and actuary should take into account the sponsoring employer's circumstances in this process. Abolishing the MFR and implementing its replacement

will require primary legislation. In the meantime these matters will be the subject of further discussions with the pensions industry and other interested parties.

2.5 Commentators queried how the **recovery plan** to return the scheme to adequate funding on a long-term basis will work in practice. They also questioned whether 3 years, to return to full funding on a long-term basis, is too short a period. The exact length of the recovery period is something that needs looking at very carefully, in consultation with the pensions industry and other interested parties. It is important to ensure that the right balance is struck between providing effective protection for scheme members and avoiding adverse effects on funding and investment behaviour that are not in the best interests of members.

2.6 **The regime of transparency and disclosure** was broadly welcomed though concerns were expressed as to how this might work in practice. There was a consensus of opinion that schemes should improve the way in which they communicate with their members. However, it was generally agreed that the majority of scheme members do not have a detailed knowledge of funding or investment-related issues. Various suggestions have been put forward on transparency and disclosure. It is important to get this right. The Government is giving careful consideration to the options and will work closely with interested parties to develop detailed proposals for legislation.

2.7 Commentators have queried how the **new statutory duty of care on the scheme actuary** directly to members will operate in practice and the importance of achieving the right balance between security and risk. Primary legislation is needed to implement this requirement. In the meantime the Government will be discussing detailed options with interested parties, including the actuarial profession.

2.8 Various comments have been received about **reform of the regulatory framework for schemes in wind-up.** There was general agreement that solvent employers of schemes in wind-up should be required to ensure that there are adequate funds to secure members' pension rights, but that schemes should not be required to fund on a "full buy-out basis", that is, on the basis of securing all the scheme's liabilities with guaranteed annuities. There was also concern that some

schemes might wind-up in advance of the introduction of any stricter conditions. Views are being sought on draft regulations, to be implemented in advance of abolition of the MFR, that bring in stricter conditions than currently apply on voluntary wind-up, but which do not require employers to fund on a "full buy-out" basis. Further details of this proposal are contained later in this document.

2.9 It was also agreed that there should be clarification of the priority status of pension funds where the sponsoring employer is insolvent. Some commentators argued that any shortfall in the fund should be made a priority debt on the employer. The Government is giving consideration to this matter in the context of wider proposals on priorities in insolvency.

2.10 It was recognised that, with the abolition of the MFR, the winding-up priorities would have to be reviewed in the light of the new regime. There are a range of options to be considered from altering the statutory priority order to reverting to the priority order in scheme rules.

2.11 Some respondents felt that the proposals did not give sufficient importance to the calculation of **cash-equivalent transfer values (**CETVs) post-MFR. This is an important element of the new regime. The consistent solution would be for these to be based on the new long-term funding basis.

2.12 Few respondents commented on the extension of the **fraud compensation arrangements**, but those that did responded favourably to the Government's proposed changes. Primary legislation is needed to bring about this change.

2.13 A number of respondents called for the immediate abolition of the MFR. As it has been realised that this is not possible ahead of the opportunity to bring in primary legislation, there have been calls for interim changes to the way the MFR works. The main areas that people have focussed upon are the deficit correction periods for making good underfunding, the requirement for annual recertifications, and what happens on voluntary wind-up. These views have been taken into account

in developing a package of proposals that can be implemented through changes to secondary legislation, and which form the next stage of reform of the MFR.

A CONSULTATION PANEL

3.1 The Government has set out its proposals for abolishing the MFR and replacing it with a long-term, scheme specific, funding standard in the context of a regime of transparency and disclosure with additional measures to strengthen protection. Implementing these proposals in full requires primary legislation. It is important to get the details right, and we want to work closely with the pensions industry and other interested parties to develop proposals for legislation when parliamentary time is available. That is why the Government has set up a Consultation Panel with representatives from:

- National Association of Pension Funds
- Association of British Insurers
- Faculty of Actuaries
- Institute of Actuaries
- Association of Consulting Actuaries
- Association of Pension Lawyers
- Society of Pension Consultants
- Fund Managers' Association
- Trades Union Congress
- Confederation of British Industry
- National Consumer Council
- British Chambers of Commerce

3.2 This panel will assist in developing the details of the policy on the replacement for the MFR to ensure that it is workable and does not have unintended consequences. The Government will also work with the Occupational Pensions Regulatory Authority and the Financial Services Authority in developing proposals to put to the Consultation Panel.

3.3 The Terms of Reference for the Consultation Panel are attached at Annex A.

NEXT STAGE OF REFORM: PACKAGE OF REGULATIONS

4.1 In the light of views expressed, the Government has developed a package of draft regulations which will form the next stage of the reform of the MFR. This is a balanced package that is good both for members, and for employers who provide pension schemes.

4.2 The proposed substantive measures included in the package are:

- to extend the deficit correction periods in which scheme funding is made good;
- to remove the requirement for annual recertifications of schemes that are fully funded; and
- to introduce stricter conditions on voluntary wind-up.

4.3 The first measure involves extending the deficit correction period to 3 years for seriously underfunded schemes to reach the 90% MFR funding level, and to 10 years for underfunded (including seriously underfunded) schemes to reach the 100% MFR funding level. This change modifies the current MFR rules in a way that is consistent with the Government's proposals to replace the MFR with a long-term funding standard. It will allow schemes to fund and invest in a more optimal way and smoothes out some of the short-term volatility associated with the current MFR regime.

4.4 The second measure removes the current requirement for automatic annual recertification of schedules of contributions where a scheme's last MFR valuation showed that the scheme was fully funded on the MFR basis. Again, this change is consistent with the Government's proposals to move to a long-term funding standard. It takes the focus, for a fully funded scheme, from the short-term to a more long-term basis. Consideration is also being given to the addition of a requirement for an out of cycle valuation where it appears that there has been a significant

change in the funding position of the scheme - by bringing into force regulation 11 of the current Minimum Funding Requirement Regulations. This would mean that although annual checks are being removed for fully funded schemes, security would still be re-assessed should there be a significant change in the funding position. We are particularly interested in your views on how best to secure the policy aim without unintended consequences, and would welcome alternative suggestions for achieving this. In the meantime we are continuing to work with the actuarial profession to refine the detailed wording of regulation 11.

4.5 The third measure introduces stricter conditions on voluntary wind-up. The Government has said it will legislate to make it clear that employers must meet in full the accrued entitlements of scheme members as they fall due. And the proposed policy for the longer term is that the method of calculating the debt on the employer when a scheme winds-up should be strengthened by including:

- the actual costs of winding-up the scheme;
- the actual costs of annuities for pensioner members; and
- cash-equivalent transfer values for non-pensioner members calculated on the new long-term funding basis.

4.6 We propose to move towards this policy in the period before the MFR is replaced by proceeding now to strengthen the debt on the employer as in the first two elements above, but continuing to calculate transfer values for non-pensioner members on the MFR basis. Thus the method of calculating the debt on a sponsoring employer who decides to wind the scheme up will include:

- the actual costs of winding-up the scheme;
- the actual costs of annuities for pensioner members; and
- cash-equivalent transfer values on the MFR basis for non-pensioner members.

4.7 The opportunity is also being taken to make some minor technical changes to the MFR Regulations.

4.8 A copy of the draft regulations which give effect to these measures is attached at Annex B, an explanatory note setting out the effect of each of the draft regulations is at Annex C, and a partial Regulatory Impact Assessment for the draft regulations is at Annex D.

ANNEX A

TERMS OF REFERENCE FOR THE CONSULTATION PANEL

Assist in developing the detailed policy for legislation on the replacement for the MFR, in particular to:

- assist officials in assessing the practical implications of a proposed policy or course of action, that is, to act as a sounding board of experts;
- work through the detailed policy package and draft legislation to ensure that it is coherent and workable across a wide range of occupational pension schemes but does not have adverse effects on investment behaviour or have unintended effects;
- facilitate a two-way communication process between the policy makers and the pensions industry.

ANNEX B

Consultation Draft

S T A T U T O R Y   I N S T R U M E N T S

2001 No.

PENSIONS

The Occupational Pension Schemes (Minimum Funding Requirement and Miscellaneous Amendments) Regulations 2001

Made - - - - - - - - - - - -	*2001*
Laid before Parliament	*2001*
Coming into force	*2001*

The Secretary of State for Work and Pensions, in exercise of the powers conferred by sections 181(1), 182(2) and (3), 185(1) and 186(1) of the Pension Schemes Act 1993(**a**) and of sections 57(1)(b), (2) and (5), 58(2) and (6)(a), 59(3), 61, 73(3), 75(5), 119, 120(1), 124(1), 125(2), 174(2) and (3) and 175(1) of the Pensions Act 1995(**b**), and of all other powers enabling him in that behalf, having consulted with such persons as he considered appropriate(**c**), hereby makes the following Regulations:

(a) 1993 c.48. Section 181(1) is cited for the meaning given to "prescribe" and "regulations".

(b) 1995 c.26. Sections 58(6)(a) and 59(3) were amended by paragraphs 14(1) and (2) of Schedule 2 to the Welfare Reform and Pensions Act 1999 (c.30). Section 124(1) is cited for the meaning given to "prescribed" and "regulations".

(c) *See* section 185(1) of the Pension Schemes Act 1993 and section 120(1) of the Pensions Act 1995 for the requirement to consult. Section 185(1) of the Pension Schemes Act 1993 was amended by paragraph 80 of Schedule 5 to the Pensions Act 1995.

Citation, commencement and interpretation

1.-(1) These Regulations may be cited as the Occupational Pension Schemes (Minimum Funding Requirement and Miscellaneous Amendments) Regulations 2001 and, except as provided for in paragraph (2) of this regulation, shall come into force on [ ] 2001.

(2) Regulations 3 and 4 of these Regulations shall come into force on the day after that on which these Regulations are made.

(3) In these Regulations –

"the 1993 Act" means the Pension Schemes Act 1993(**a**);

"the 1995 Act" means the Pensions Act 1995(**b**);

"the Minimum Funding Requirement Regulations" means the Occupational Pension Schemes (Minimum Funding Requirement and Actuarial Valuations) Regulations 1996(**c**);

"the Winding Up Regulations" means the Occupational Pension Schemes (Winding Up) Regulations 1996(**d**); and

"the Deficiency Regulations" means the Occupational Pension Schemes (Deficiency on Winding Up) Regulations 1996(**e**).

(**a**) 1993 c.48.

(**b**) 1995 c.26.

(**c**) S.I.1996/1536; a relevant amending instrument is S.I.1997/786.

(**d**) S.I.1996/3126 to which there are no relevant amendments.

(**e**) S.I.1996/3128 to which there are no relevant amendments.

Amendment of the Minimum Funding Requirement Regulations

2.-(1) The Minimum Funding Requirement Regulations shall be amended in accordance with the following paragraphs of this regulation.

(2) In regulation 2(1) (interpretation), for the definition of "the transitional period" there shall be substituted the following definition:

> ""the transitional period" means the period beginning on the commencement date and ending on 31st December 2004."

(3) In regulation 7(9) (determination and valuation of liabilities; gilts-matching policy), after the words "the trustees' policy is to meet all liabilities" there shall be inserted the words "(excluding liabilities in respect of any money purchase benefits)".

(4) In regulation 11 (duty to obtain minimum funding valuations following events with significant effects on funding), for the words "during the transitional period" in paragraph (2)(b) there shall be substituted the words "before [***insert date of coming into force of regulation 2***]".

(5) In subparagraph (b) of regulation 12(1) (duty to obtain minimum funding valuations where new serious underfunding suspected), after the words "the scheme would meet the minimum funding requirement on or before the" there shall be inserted the words "date 7 days before the".

(6) Paragraph (2) of regulation 16 shall be substituted by the following paragraph:

> "(2) Where a minimum funding valuation which has been signed on or after [***insert date of coming into force of regulation 2***] shows that, on the effective date or on the date falling 7 days before that on which the certificate of the rates of contributions shown in the schedule is signed, the minimum funding requirement is not met, the period referred to in paragraph (1) which applies for the schedule which must be prepared following that valuation by virtue of paragraph (a) or (c) of section 58(3) is extended so as to end with the expiry of the period of 10 years beginning with the date on which the rates of contributions shown in the schedule are certified.".

(7) In regulation 17 (content and certification of schedules of contributions)-

(a) in paragraph (1)-

(i) the word "and" shall be deleted at the end of subparagraph (b); and

(ii) for subparagraph (c) there shall be substituted the following subparagraphs:

"(c) the due dates and amounts of any payments required by paragraph (a) of section 60(2); and

(d) if separate contributions to cover expenses which are likely to fall due for payment by the trustees or managers in the schedule period are made to the scheme, the rates and due dates of those contributions.".

(b) after paragraph (1) there shall be inserted the following paragraph:

"(1A) Where paragraph (a) of section 58(6) applies, the prescribed date mentioned is the date 7 days before the date on which the actuary signs the certificate of the rates of contributions shown in the schedule.".

(c) in paragraph (2)(b)-

(i) the words "date he signs the certificate" shall be substituted by the words "date 7 days before the date on which he signs the certificate"; and

(ii) the word "is" shall be substituted by the word "was".

(d) in paragraph (3)(b)-

(i) the words "date he signs the certificate" shall be substituted by the words "date 7 days before the date on which he signs the certificate"; and

(ii) the word "is" shall be substituted by the word "was".

(e) in paragraph (4)(a), the word "additional" shall be inserted between the words "year" and "contributions".

(f) in paragraph (5), the words "additional payments and contributions" shall be substituted by the words "additional payments and additional contributions".

(8) In regulation 18 (occasional and periodic certification of adequacy of contributions)-

(a) at the beginning of paragraph (1), for the word "The" there shall be substituted the words "Subject to paragraphs (1A) and (1B), the"; and

(b) after paragraph (1) there shall be inserted the following paragraphs:

"(1A) Paragraph (1) shall not apply in the case of any scheme in respect of which the last valuation under section 57 obtained by the trustees or managers showed that, at the effective date of that valuation, the value of the scheme's assets was not less than 100% of the amount of its liabilities.

(1B) In a case where the trustees or managers of a scheme have obtained a minimum funding valuation since the relevant date of the last certificate under section 58, no certificate need be obtained under paragraph (1) in relation to the anniversary of that date.".

(9) In regulation 20 (minimum funding valuations showing serious under-provision where no remedial steps required)-

(a) for the words "In paragraph (1)(a)" in paragraph (2), there shall be substituted the words "In paragraphs (1)(a) and (3) of this regulation".

(b) for the words "is extended so as to end with the expiry" in paragraph (3) to the words "commencement date", there shall be substituted the words "is extended so as to end with the expiry of the period of three years from the appropriate date.".

(c) for the words "on the date he signs the certificate" in paragraph (b) of section 60(7A) there shall be substituted the words "on the date 7 days before the date on which he signs the certificate";

(d) for the word "is" in subparagraph (b)(i) of section 60(7A) there shall be substituted the word "was"; and

(e) for the word "is" in subparagraph (b)(ii) of section 60(7A) there shall be substituted the word "was".

(10) In regulation 21(1) (failure reports), after the words "they shall" following the end of subparagraph (b) there shall be inserted the words "before the end of the period of 3 months beginning with the end of any such period".

(11) In Part I of Schedule 2 (certification)-

(a) in paragraph 1, the words "(minimum funding requirement met on date certificate signed)" shall be substituted by the words "(minimum funding requirement met on date 7 days before date certificate signed)";

(b) in paragraph 2, the words "(minimum funding requirement not met on date certificate signed)" shall be substituted by the words "(minimum funding requirement not met on date 7 days before date certificate signed)";

(c) paragraph 5 shall be substituted by the following paragraph:

"(5) If, in a case where there has been a serious shortfall valuation, the actuary is of the opinion that on the date 7 days before the date on which he signs the certificate there is no
longer such a difference as is mentioned in section 60(1), he must insert the following statement after paragraph 1 of the certificate-

"1A. **Cessation of serious shortfall in assets**

In my opinion an actuarial valuation for the scheme as at the date 7 days before the date of this certificate would not show a shortfall as is mentioned in section 60(1) of the Pensions Act 1995 (value of scheme assets less than 90 per cent. of amount of scheme liabilities).""; and

(d) paragraph 6 shall be substituted by the following paragraph-

"(6) If, in a case where there has been a serious shortfall valuation, the actuary is of the opinion that on the date 7 days before the date on which he signs the certificate the difference mentioned in section 60(1) has decreased, he must insert the following statement after paragraph 1 of the certificate-

"1A. **Decrease in serious shortfall in assets**

In my opinion an actuarial valuation for the scheme as at the date 7 days before the date of this certificate would show that the shortfall mentioned in section 60(1) of the Pensions Act 1995 (value of scheme assets less than 90 per cent. of amount of scheme liabilities) has decreased since the last actuarial valuation for the purposes of section 57 and is now .""."

(12) In Part II of Schedule 2, paragraph 1 of the form of actuary's certificate shall be substituted by the following paragraph:

"1. I hereby certify that, in my opinion, the rates of the contributions payable in accordance with the schedule of contributions dated are adequate for the purpose of securing that throughout the period it covers the scheme will meet the minimum funding requirement imposed by section 56(1) of the Pensions Act 1995.".

(13) In paragraph 5 of Schedule 3, the statement mentioned in regulation 12(1) (duty to obtain minimum funding valuations where actuary suspects new serious underfunding) shall be substituted by the following statement:

""3. *Serious shortfall in assets*

In my opinion an actuarial valuation for the scheme as at the date 7 days before the date of this certificate would show such a shortfall as is mentioned in section 60(1) of the Pensions Act 1995 (value of scheme assets less than 90 per cent. of amount of scheme liabilities).”";

(14) In paragraph 1(1) of Schedule 4, the words "(or, in a case where section 60(7A) applies, the date on which the actuary signed the certificate)" where they appear in the definition of "section 60 shortfall" shall be substituted by the words "(or, in a case where section 60(7A) applies, the date 7 days before the date on which the actuary signs the certificate)".

Amendment of the Winding Up Regulations

3.-(1) The Winding Up Regulations shall be amended in accordance with the following paragraphs of this regulation.

(2) In regulation 4(1) (calculation of amounts of liabilities), after the words "Subject to" there shall be inserted the words "regulation 4A and".

(3) After regulation 4 there shall be inserted the following regulation:

"**Calculation of liabilities where employer not insolvent**

4A.-(1) In the case of a scheme in respect of which the employer was not insolvent immediately before the winding up of the scheme commenced, regulation 4 shall have effect as if-

(a) for the words "paragraph (3)" in paragraph (1)(c) there were substituted the words "paragraphs (2A) and (3)";

(b) after paragraph (2) there were inserted the following paragraph:

"(2A) For the purpose of calculating the amount of the liabilities in respect of the pensions or other benefits (including increases in pensions) which have become payable under the scheme on or before the crystallisation date -

(a) it shall be assumed that all such liabilities will be discharged by the purchase of annuities of a kind described in section 74(3)(c); and

(b) paragraph (1)(b) above shall not have effect.";

(c) for the word "If" in paragraph (5) there were substituted the words "Subject to paragraph (5A)"; and

(d) after paragraph (5) there were inserted the following paragraph:

"(5A) Paragraph (5) shall not apply in the case of any liabilities which fall to be calculated in accordance with paragraph (2A).

(2) For the purposes of paragraph (1) above, an employer is insolvent if a relevant insolvency event within the meaning given by section 75(4) has occurred in relation to that employer.".

(4) In regulation 13(4) (hybrid schemes – calculation of liability for underpin benefits), after the words "that regulation)" there shall be inserted the words ", but regulation 4A shall not apply for that purpose".

Amendment of the Deficiency Regulations

4.-(1) The Deficiency Regulations shall be amended in accordance with the following paragraphs of this regulation.

(2) In regulation 3 (calculation of the value of the scheme's liabilities and assets), for the words "The liabilities" at the beginning of paragraph (1) there shall be substituted the words "Subject to regulation 3A, the liabilities".

(3) After regulation 3 there shall be inserted the following regulation:

"**Valuation of liabilities where employer not insolvent**

3A. –(1) Where a scheme (including a section of a scheme in relation to which there is more than one employer which is treated as a separate scheme for the purposes of section 75) is being wound up and the employer was not insolvent immediately before the winding up of the scheme commenced, regulation 3 shall have effect as if-

(a) in paragraph (1)-

(i) at the beginning of subparagraph (a), there were inserted the words "except to the extent that the liabilities are in respect of pensions or other benefits that have become payable under the scheme and in respect of which paragraph (2A) below applies,";

(ii) for the words "paragraphs (2) and (3)" in subparagraph (a), there were substituted the words "paragraphs (2)(a) to (c) and (3)";

(iii) for the words "paragraphs (3) and (4)" in subparagraph (b), there were substituted the words "paragraphs (2A), (3) and (4)"; and

(iv) after the words "regulations 3(2) and (3) and 4 to 8 of the MFR Regulations" in subparagraph (c), there were inserted the words "or as respects paragraphs (1A) and (2A) below";

(b) after paragraph (1) there were inserted the following paragraph:

"(1A) The liabilities of a scheme which are to be taken into account under paragraph (1) above shall include the whole of the costs which, in the opinion of the trustees or managers of the scheme, are likely to be incurred by them in connection with the winding up of the scheme."; and

(c) after paragraph (2) there were inserted the following paragraph:

"(2A) For the purpose of calculating the liabilities of the scheme in respect of the pensions or other benefits (including increases in pensions) which have become payable under the scheme on or before the applicable date, it shall be assumed that all such liabilities will be discharged by the purchase of annuities of a kind described in section 74(3)(c) (discharge of liabilities by insurance – annuity purchase).".

(2) Where a scheme to which regulation 4 of these Regulations (multi-employer schemes) applies (including a section of a scheme in relation to which there is more than one employer which is treated as a separate scheme for the purposes of section 75) is being wound up in circumstances where-

(a) an employer in relation to the scheme ceases to employ persons in the description or category of employment to which the scheme relates at a time when there are no other employers in relation to the scheme continuing to employ such persons; and

(b) that employer was not insolvent immediately before the winding up commenced,

regulation 3 shall have effect as if paragraphs (1)(a) to (c) of this regulation applied to it.

(3) For the purposes of paragraphs (1) and (2) above, an employer is insolvent if a relevant insolvency event within the meaning given by section 75(4) has occurred in relation to that employer.”.

(4) In the Note at the end of the form of certificate set out in Schedule 1 (form of actuary’s certificate), after the word “securing” there shall be inserted the words “all of”.

Saving

5. Where, in relation to an occupational pension scheme, an actuarial valuation for the purposes of section 57(1)(a) or (2) of the 1995 Act (valuation and certification of assets and liabilities) has been signed before the coming into force of regulation 2 above, regulation 16(2) of the Minimum Funding Requirement Regulations shall (where appropriate) apply as respects the consequences of that valuation as if regulation 2(6) above had not come into force.

Signed by authority of the Secretary of State for Work and Pensions.

2001.

Parliamentary Under-Secretary of State,
Department for Work and Pensions.

EXPLANATORY NOTE

(*This note is not part of the Regulations*)

These Regulations are made under the Pension Schemes Act 1993 ("the 1993 Act") and the Pensions Act 1995 ("the 1995 Act"). They make amendments to the Occupational Pension Schemes (Minimum Funding Requirement and Actuarial Valuations) Regulations 1996 , the Occupational Pension Schemes (Deficiency on Winding Up) Regulations 1996 and to the occupational Pension Schemes (Winding Up) Regulations 1996.

Regulation 1 provides for citation, commencement and interpretation.

Regulation 2 amends the Occupational Pension Schemes (Minimum Funding Requirement and Actuarial Valuations) Regulations 1996 so as to make miscellaneous amendments to regulations 2, 7, 11, 12, 16, 17, 18, 20 and 21 of, and Schedules 2, 3 and 4 to, those Regulations.

Regulations 3 amends the Occupational Pension Schemes (Winding Up) Regulations 1996 so as to amend the calculation of liabilities in respect of pensions or other benefits (including increases in pensions) which have become payable under a scheme in circumstances where the scheme winds up and the employer is not insolvent immediately before the winding up commenced.

Regulation 4 amends the Occupational Pension Schemes (Deficiency on Winding Up) Regulations 1996 so to provide that, where a scheme is in the process of winding up and the employer is not insolvent, the scheme's liabilities are to be calculated so as to include the actual cost of winding up and the cost of securing pensions or other benefits in payment by way of annuities.

Regulation 5 disapplies the changes made by regulation 2(6) in relation to any case where the relevant actuarial valuation was signed before regulation 2 came into force.

An assessment of the cost to business of complying with these Regulations has been prepared and copies may be obtained from the Department for Work and Pensions, 3rd floor, The Adelphi, 1-11 John Adam Street, London WC2N 6HD. A copy has been placed in the library of each House of Parliament.

ANNEX C

DETAILS OF WHAT EACH OF THE REGULATIONS SET OUT TO DO

Background

The Regulations are made under powers in the Pension Schemes Act 1993 and the Pensions Act 1995. They amend provisions concerning the Minimum Funding Requirement (MFR), debt on the employer, and winding-up.

The MFR was introduced by the Pensions Act 1995 as a measure designed to promote security for pension scheme members. It requires funded defined benefit (salary-related) pension schemes to hold a minimum level of assets to meet their liabilities, and sets out time limits within which any underfunding must be made good (often referred to as 'deficit correction periods'). The MFR took effect for actuarial valuations after 5 April 1997, though various modifications apply to its operation during a transitional period, which is set to expire on 5 April 2002.

Some changes to the detail of how the MFR works were exposed for consultation in January 2001[*]. These have been reconsidered in the light of the Government's proposals to replace the MFR and, as appropriate, a number of them are included in the package of draft regulations forming the next stage of reform of the MFR.

The Regulations

Regulation 1 provides details of the commencement dates and interpretation of the Regulations.

Regulation 2 introduces a number of amendments to the Occupational Pension Schemes (Minimum Funding Requirement and Actuarial Valuation) Regulations 1996.

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[*] The Occupational Pension Schemes (Miscellaneous Amendments) Regulations 2001, issued for consultation on 29 January 2001.

Current Regulations – transitional period

"Transitional period" is defined as the period of 5 years beginning with the commencement date (6 April 1997).

The change

"Transitional period" is defined as the period from the commencement date to 31 December 2004.

Current Regulations – deficit correction periods

During the transitional period, a sponsoring employer whose scheme is funded at below 90% of the MFR level (a 'seriously underfunded scheme') has until 5 April 2003 to bring funding up to that level, and a sponsoring employer whose scheme is funded at below 100% of the MFR level (an 'underfunded scheme') has until 5 April 2007 to bring funding up to that level.

The change

During the extended transitional period, seriously underfunded schemes must be brought up to 90% MFR funding within 3 years of the 'appropriate date' (the date the MFR valuation was required to be obtained or the date that it was signed) and underfunded schemes (including seriously underfunded schemes) must be brought up to 100% MFR funding within 10 years of the date that the schedule of contributions was certified.

Current Regulations – automatic recertification of schedule of contributions

The trustees or managers of a scheme must ensure that the schedule of contributions is recertified as adequate by the scheme's actuary on an annual basis.

The change

The schedule of contributions for a scheme which was fully funded at its last MFR valuation need not be recertified every year. But a full MFR valuation must be undertaken if any event occurs which significantly affects the value of the scheme's assets or liabilities, such that there is a serious risk that the MFR will not continue to

be met. Additionally, no recertification will be required for any scheme where a MFR valuation has been obtained since the date of the last certificate.

Current Regulations – certification of schedule of contributions (calculation date)

(This measure was previously included in a package of draft regulations issued for consultation in January 2001*).

The actuary must certify the schedule of contributions based on the funding position at the date he certifies the schedule.

The change

Actuaries must certify the schedule of contributions by reference to the funding position 7 days before he certifies the schedule. A number of consequential changes are being made to other provisions in the MFR regulations to reflect this.

Current Regulations – report on funding position

(This measure was previously included in a package of draft regulations issued for consultation in January 2001*).

Trustees must prepare a report about the funding position where the MFR is not met by the end of a prescribed period and they must make that report available to members within one month of a request being received. There is no time limit within which the report must be prepared.

The change

Trustees must prepare the report within 3 months of the requirement being triggered.

Clarifications

(These measures were included in a package of draft regulations issued for consultation in January 2001*).

* The Occupational Pension Schemes (Miscellaneous Amendments) Regulations 2001, issued for consultation on 29 January 2001.

Regulation 2 also makes a number of changes to clarify the existing position. Paragraph (3) makes it clear that the gilts matching requirement applies only to the salary related liabilities in the scheme and not liabilities for money purchase benefits (eg in respect of additional voluntary contributions). Paragraph (6) includes amendments to make it clear that the schedule of contributions must also show any payments required to make good any serious shortfall in the scheme and that additional contributions, as well as any additional payments, to make good the shortfall must be made within the required period. Paragraph (11) requires the scheme's actuary to cite the date of the schedule of contributions which he is certifying, avoiding any possible confusion at a later date.

Regulation 3 amends the Occupational Pensions (Winding Up) Regulations 1996.

Current Regulations
The amount of liabilities for pensions is calculated on the MFR basis, but liabilities for pensions in payment can be increased to make sure there are sufficient funds to secure those liabilities.

The change
Where a solvent employer is winding the scheme up voluntarily the amount of liabilities for existing pensioners will be calculated on the basis of the cost of buying an annuity to secure those liabilities. This ties in with the changes to the calculation of employer debt (see Regulation 4).

Regulation 4 amends the Occupational Pensions (Deficiency on Wind Up etc) Regulations 1996.

Current Regulations – debt on the employer
When calculating any debt on the employer when the scheme winds up or the employer becomes insolvent, the amount of the liabilities must be calculated in the

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[*] The Occupational Pension Schemes (Miscellaneous Amendments) Regulations 2001, issued for consultation on 29 January 2001.

same way as they would do for the purposes of a MFR valuation, with a standard allowance for the estimated expenses of administering the process built in.

The change
Where a solvent employer is winding up the scheme voluntarily the amount of liabilities will have to include the actual costs of winding up the scheme, the cost of buying annuities to secure pensions in payment, and liabilities for non-pensioners calculated on an MFR basis.

Regulation 5 is a saving provision, ensuring that the changes made to schedules of contributions by amending regulation 2(6) apply only to valuations signed after the date this regulation comes into force.

ANNEX D

REGULATORY IMPACT ASSESSMENT

Introduction

1. This partial Regulatory Impact Assessment supports the draft Occupational Pension Schemes (Minimum Funding Requirement and Miscellaneous Amendments) Regulations 2001, issued for consultation in September 2001. A full Regulatory Impact Assessment will be published alongside the final version of these regulations. Comments on the partial regulatory impact assessment are invited, together with comments on the draft regulations, by Monday 10 December 2001 (sooner if possible).

Issues and Objective

2. The proposed package would principally amend regulations on the Minimum Funding Requirement (MFR) for occupational pension schemes. The MFR was introduced by the Pensions Act 1995 as a measure designed to promote security for pension scheme members. It requires funded defined benefit (ie salary-related) pension schemes to hold a minimum level of assets to meet their liabilities, and sets out time limits within which any underfunding must be made good (often referred to as 'deficit correction periods'). The MFR took effect for actuarial valuations after 5 April 1997, though various modifications apply to its operation during a transitional period which is set to expire on 5 April 2002.

3. There has been widespread criticism of the MFR since its introduction. And in March 2001, following public consultation, the Government published "Security for Occupational Pensions: the Government's proposals" in which it set out its plans to abolish the MFR and replace it with a long-term, scheme-specific, funding standard in the context of a strong regime of transparency and disclosure, with various additional measures to strengthen protection further. The new arrangements will offer sustainable protection that will provide more effective security for members. Implementing these arrangements in full will require primary and secondary legislation. As the next stage of bringing in the new regime the Government proposes to make changes to the current MFR in advance of its replacement, consistent with the new arrangements, and to strengthen the conditions that apply on voluntary wind-up.

4. The proposed substantive measures included in the package are:-

(i) *to extend the deficit correction periods for schemes*, modifying the current MFR rules in a way that is consistent with the proposals for a long-term funding standard;

(ii) *to remove the current requirement for automatic annual recertification* of schedules of contributions where a scheme's last MFR valuation (required to be carried out every 3 years) showed that the scheme was fully funded on the

MFR basis. Consideration is being given to adding a requirement for an out of cycle valuation where it appears that there has been a significant change in the funding position.

(iii) *to strengthen the method of calculating a debt on a solvent employer when a scheme winds up*, to include the actual costs of the winding-up process, of the purchase of annuities for pensioner members, together with cash-equivalent transfer values on an MFR basis for non-pensioner members.

5. The opportunity is also being taken to make a number of minor changes to the MFR regulations. These minor amendments were included in an earlier consultation issued in January 2001*, but that proposed package of amending regulations was deferred pending assessment of the implications of the Government's decision on the MFR. These measures will have no significant cost or administrative implications for schemes or businesses.

Risk Assessment

6. The proposed changes form a balanced package which introduces the next stage of reform. The new regime will be more sustainable, and will provide more effective security for members of defined benefit occupational pension schemes. The risk of not proceeding with these amendments is that:

(i) schemes would continue to have to respond to short-term market fluctuations over an inappropriately short time frame. This may distort investment behaviour by encouraging extra investment in gilts (to reduce volatility), or lead to short-term cash injections, which may have damaging consequences for the employer, and act against the long-term interests of members;

(ii) fully funded schemes would continue to have to invest time, energy and money every year on complex checks which are of doubtful value for these schemes, whereas the change being considered would mean security is re-assessed more effectively by out-of-cycle valuations, but only when that is necessary; and

(iii) members would not benefit from the greater security which the amendments to the calculation of debt on the employer when a scheme winds-up would introduce. Furthermore, some employers might choose to wind up schemes quickly, under the current rules, to avoid becoming subject to the proposed stricter conditions on voluntary wind-up which the Government has announced.

Options

Do nothing

* The Occupational Pension Schemes (Miscellaneous Amendments) Regulations 2001, issued for consultation on 29 January 2001.

7. In drawing up these proposals the Government gave careful consideration to making no change to the current arrangements in advance of the replacement of the MFR. This option was rejected in the light of the risks outlined in the Risk Assessment Section above, and after taking account of the suggestions made by those calling for some changes to be made to the current MFR in advance of its replacement.

Alternative options

8. The Government considered, but rejected, the possibility of extending the removal of the automatic requirement for annual recertification by the scheme actuary to schemes which are 90% or better funded on the MFR basis (ie rather than applying the cut-off at 100%). This would involve a further reduction in costs (see below). The Government is clear, however, that annual checks should continue for schemes which are underfunded on the MFR basis. Removing a security measure for schemes where pensions are potentially at risk would be imprudent, and is not in members' best interests.

9. The Government also considered, but rejected, imposing a debt on the employer in scheme wind-ups of the full amount needed to buy out (through annuities and guaranteed deferred annuities) the pension liabilities for all members. While the Government is keen to strengthen protection for members when their schemes wind up, moving to such a stringent requirement would lead to high and uncertain costs hanging over ongoing schemes. This could be unsustainable for many UK companies and could have damaging consequences, including scheme closures in some cases. This would be in no-one's interests. It should also be realised that guaranteed deferred annuities are not necessarily the most appropriate vehicle for younger scheme members, who might do better over the long period before retirement by investing the value of their existing pension rights in a stakeholder pension or other arrangements. Finally, the very large size of some schemes is such that movement to an annuity buy-out basis for wind-ups might simply be impractical: there are doubts as to whether the insurance industry could deal with what might be required. Under current conditions and based on the estimated number of schemes which would normally wind-up each year, based on past experience, the cost of moving to a full annuity buy-out basis could amount to around £1 billion a year, as against a broad estimate of £100 million a year under the current rules (both figures net of Corporation Tax).

Benefits / Costs

Extending deficit correction periods

10. This measure leads to changes in the timing of employers' contributions. Altering the pace of funding does not generally alter the total cost of pension provision because these monies will eventually need to be paid into the scheme, albeit over a longer time scale. However, sudden cash calls made within a short-term framework can entail the employer incurring extra costs now which later prove to have been unnecessary.

11. It is estimated that the proposed extension of deficit correction periods may result in cash flow savings of £750 million a year in early years, though with a somewhat higher ultimate aggregate of payments made by the employer, to account for the later timing of contributions. (Schemes would have to put in £1.25 billion per year over 10 years, instead of £2 billion per year over 5 years.) Underfunded schemes are more likely to be found among small and medium sized schemes, so these reductions in immediate contributions will generally have more of an impact on smaller schemes. For example, a small scheme with about 30 members and assets worth about £3 $^{1}/_{3}$ million that is 90% funded would have to put in £70,000 a year over a five year period under the current arrangements. This would reduce by about £30,000 a year over the first five years, on the basis of annual contributions of about £40,000 scheduled to continue for 10 years under the proposed arrangements.[1]

Removing automatic annual recertifications for fully funded schemes

12. It is estimated that this may result in an administrative saving for employers in the order of £45 million a year net of Corporation Tax. The average cost of an annual recertification for a scheme is estimated to be about £1750 (including VAT).[2] This change may also have a small positive impact on investment behaviour and hence costs, in that investment decisions will be slightly less constrained by concerns as to whether a scheme might have to put money in to fund any deficit over a relatively short period of time. This could mean higher investment returns in the long term which might result in either higher pensions or lower contributions to the fund. These savings are more likely to benefit larger schemes, because they tend to be better funded. However, the generally fixed costs of annual recertification will give rise to proportionately greater savings for small schemes which are fully funded under the MFR.

13. Consideration is being given, for schemes which are exempted from automatic annual recertifications, to introducing a requirement for out-of-cycle actuarial valuations where it appears that there has been a significant change in the

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[1] These estimates are based on data from 586 schemes that had had an MFR valuation reported by April 1999. This data was collected by the actuarial profession from consulting actuaries and insurance companies. This database may under-represent underfunded schemes and consequently these estimates may underestimate slightly the likely reduction in costs.

These figures make allowance for Corporation Tax at 30%. This figure would reduce for less profitable companies that might be more likely to be associated with underfunded schemes. This will also mean that the figures presented may underestimate the likely reduction in costs.

These estimates assume that for most seriously underfunded schemes the deficit contributions paid in the first 3 years of the ten year correction period are sufficient to clear the serious shortfall in 3 years.

[2] These estimates are based on the assumption that about one in seven schemes are below 100% on an MFR basis and that the typical costs, including VAT, for recertification are about £2,000-£5,000 for schemes that are less than, or only just, fully funded on an MFR basis, £1000-£2,500 for schemes that are about 120% funded on an MFR basis, and £250-£750 for schemes that are about 150% funded on an MFR basis.

funding position of the scheme. The savings above may then be offset to some extent, depending on the final form of this requirement.

14. The option of extending the removal of the automatic requirement for annual recertification by the scheme actuary to schemes which are 90% or better funded on the MFR basis, which the Government considered but rejected, would increase the administrative saving for employers from £45 million to an estimated £50 million a year, net of Corporation Tax.

Changes to the winding up rules

15. Broad estimates are that, in relation to voluntary wind-ups, an additional cost to employers of £55 million a year net of Corporation Tax[3] could be incurred, mainly by small and medium sized schemes (ie the estimated increase in payments required from employers before allowing for Corporation Tax is from £125 million to £200 million a year - £75 million gross, from which 30% Corporation Tax is deducted to reach around £55m). However, it should be noted that these costs would fall only on those schemes where the employer decides to wind-up a scheme where the assets are insufficient to ensure that no debt arises under the strengthened requirements.

16. Overall, the effect of the package could be to impose costs of around £10 million a year in the period before the MFR is removed, together with a net cash flow saving in the short term of around £750 million a year.

Consultation

17. The policy to replace the MFR with alternative scheme security arrangements has been developed after a formal consultation exercise with the pensions industry, employers and trade unions. The results of this exercise showed a general consensus that the current regime is not working as intended. The Government's announcement of the way forward in "Security for Occupational Pensions: the Government's Proposals" was widely welcomed. The measures included in this proposed package of secondary legislation represent the next stage of reform.

Summary and Recommendation

18. The Government's assessment is that these proposed changes form a balanced and coherent package. They form the next stage of the Government's proposals to replace the MFR, which give sustainable protection while providing more effective security for scheme members.

Contact Point: Tim Found
Department for Work & Pensions
3rd Floor The Adelphi, 1-11 John Adam Street, London WC2N 6HT
Tel: 020 7712 2409

[3] This figure makes allowance for Corporation Tax at 30%. This figure would reduce for less profitable companies that might be more likely to be associated with underfunded schemes. This will also mean that the figures presented may underestimate the likely extra net costs.