GN 27: Retirement Benefit Schemes - Minimum Funding Requirement

Classification
Practice Standard

MEMBERS ARE REMINDED THAT EVERY GUIDANCE NOTE MUST BE READ IN THE CONTEXT OF THE PROFESSIONAL CONDUCT STANDARDS (PCS)

Application
An actuary to an occupational pension scheme appointed under Section 47 of the Pensions Act 1995.

Legislation or Authority
Pensions Act 1995 (c 26)('the Act'). Sections 56 to 61.

The Occupational Pension Schemes (Minimum Funding Requirement and Actuarial Valuations) Regulations 1996. SI 1996/1536 ('the MFR Regulations') as amended.

The Occupational Pension Schemes (Scheme Administration) Regulations 1996. SI 1996/1715 as amended.

Northern Ireland has its own body of law relating to pensions and, in relation to Northern Ireland, references to the Great Britain legislation contained in this Guidance Note should be read as including references to the corresponding Northern Ireland legislation. Appendix 1 shows Northern Ireland legislation corresponding to the Great Britain legislation mentioned in this Guidance Note. Except as indicated in the table there is no difference in the numbering of the provisions mentioned in this Guidance Note.

This Guidance Note has been approved by the Secretary of State in accordance with Section 119 of the Act and the Department for Social Development in Northern Ireland in accordance with Article 116 of the Pensions (Northern Ireland) Order 1995.

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1 Introduction

1.1 Under Section 57 of the Act trustees are required periodically to obtain a valuation from the actuary on the prescribed basis. Under Section 58, trustees are also required to prepare a Schedule of Contributions which must be certified by the actuary. In addition the actuary may be required periodically to certify the Schedule of Contributions in accordance with Section 57(1)(b).

1.2 Schemes to be covered are those defined in Section 56(2) of the Act and the MFR Regulations.

1.3 The actuary's advice must be addressed to the trustees of the scheme.

1.4 In this Guidance Note, the 'MFR Effective Date' means the effective date as defined in Section 56(5)(d) of the Act.

1.5 In this Guidance Note, references to non-pensioners and deferred pensioners should be read as including non-pensioners and deferred pensioners who are 'pension credit members' as defined in Section 124(1) of the Act. References to pensioners should be read as including 'pension credit benefit members' as defined in MFR Regulation 2.

2 MFR Valuation and Schedule of Contributions: Principles

2.1 The Secretary of State has instructed that, in addition to the principles set out in the MFR Regulations, the Minimum Funding Requirement ('MFR') should be interpreted in accordance with the principles set down in 2.1.1 to 2.1.6.

2.1.1 Subject to 2.1.2, any non-pensioner should be assumed to retire at the end of the switch-over period as defined in MFR Regulation 7(10) (see 3.5).

2.1.2 Any non-pensioner who has reached the end of the switch-over period should be assumed to retire at the MFR Effective Date with an immediate pension and their benefits should be valued accordingly.

2.1.3 It should be assumed that average equity returns will exceed average gilt returns by 2% per annum, but in the period prior to the end of the switch-over period this excess should be reduced to 1% per annum to give a reasonable expectation of achieving equivalent benefits through a personal pension.

2.1.4 It should be assumed that a scheme has been, and will continue to be, administered efficiently and that records are kept in good order.

2.1.5 An expense provision in relation to money purchase liabilities must be included if the scheme rules say that expenses cannot be met out of the assets attributable to those liabilities; no such provision is required in other circumstances.

2.1.6 Any opinion on the Schedule of Contributions should reflect a prudent view of the future without taking into account all possible unfavourable developments. In particular, it should not be based on an assumption that investment conditions will improve but should be based on an assumption that any favourable levels will revert to normal.

3 MFR Valuation Methodology

3.1 Accurate data must be used for calculating deferred benefit entitlements for employed members as at the MFR Effective Date where possible. Where accurate historical salary data is not available and estimates are required, it must be assumed that salaries have increased in line with actual increases in the Retail Prices Index.

3.2 If members have an unfettered right under the terms of the scheme to commute pension for a lump sum at retirement and the terms of commutation are specified under the terms of the scheme, it must be assumed that the member will exercise this option to the maximum allowable degree if this would increase the amount of the scheme's liabilities. If members are entitled to commute the maximum amount allowed by the Inland Revenue, this must be assumed to be 2.25 times the annual amount of member's pension at retirement. If the option or the terms are subject to the discretion of the employer, trustees or managers, it must be assumed that the option is not exercised. The same principles must be applied to other options under the terms of the scheme that the member might exercise at retirement.

3.3 The value of the liabilities must not be limited to the value of the assets, even where the scheme rules may so provide. In particular, in the valuation of the liabilities in hybrid schemes which give a money purchase benefit subject to a defined benefit promise, the value of the defined benefit promise must not be limited to the value of the assets of the scheme, even if the rules of the scheme restrict the benefit promise where there are not sufficient assets in the scheme.

3.4 The liability in relation to money purchase benefits will, where contributions are accumulated, either in identifiable assets or otherwise, be the accumulated value at the MFR Effective Date, and, where contributions are used to provide minimum benefit rights payable as at a future date, be the value of those rights using the relevant assumptions specified in Appendix 2. Money purchase benefits which have been converted into defined pension rights on the retirement of the member must be valued in the same way as other benefits for pensioners.

3.5 Benefits for non-pensioners must be assumed to be payable in accordance with the principles set out in 2.1.1 and 2.1.2. For the purpose of this Guidance Note, the end of the switch-over period as defined in MFR Regulation 7(10) is referred to as the 'MFR pension age'. There will only be one MFR pension age for an individual member, but that age may vary between members of the same scheme, possibly dependent on whether early retirement rights apply to either the whole or just part of their pension. The MFR pension age is set, for an individual member, irrespective of whether GMP revaluation is added at a later date. In accordance with MFR Regulation 7(10), the MFR pension age for an individual member is set by reference to the member's full benefit entitlement and it remains unchanged even when a transfer is made of part of the member's benefits (for example leaving only the GMP liability in the scheme).

3.6 Liabilities must relate only to benefits to which members are entitled. Therefore, whilst allowance must be made for discretionary benefits already granted, the actuary must make no allowance for future discretionary benefits. In all cases allowance must be made for any associated benefit entitlements, such as survivors' pensions. The actuary must make no allowance for any additions to money purchase benefits which are dependent on future investment performance.

3.7 Where there is any doubt as to the interpretation of the equal treatment rule under Section 62 of the Act, the actuary must take advice from the trustees.

3.8 The circumstance under which it is appropriate under MFR Regulation 5(4) to disregard the value of an insurance contract and the corresponding liabilities secured by the contract, or to adopt a value equal to the value of those liabilities, is that minimum payments under the contract are set out in the contract conditions. For this purpose, the amounts of the corresponding liabilities secured by the contract are to be taken as the liabilities which, but for the minimum payments under the contract, would fall to be met by other assets of the scheme, but excluding any liabilities which do not fall due within 12 months of the dates of the relevant minimum payments under the contract.

3.9 Any reasonable age definition and consistent revaluation periods (where applicable) for the purpose of the calculation is acceptable.

3.10 For all liabilities, the demographic assumptions specified in Appendix 2 must be used. Where no assumption is specified, the actuary should use his or her judgement.

3.11 For each non-pensioner the liability must be calculated as the present value of the accrued benefits using the long-term financial assumptions specified in Appendix 2. In particular, subject to 3.15, the long-term effective rate of return on equities for pre MFR pension age must be used throughout deferment and the long term effective rate of return on gilts throughout payment. The calculated value will then be adjusted by multiplying by the factor:

$$(1+0.005n)$$

where n is the number of years before MFR pension age (with a maximum of 10).

3.12 The present value so calculated must then be adjusted by a Market Value Adjustment ('MVA') to allow for current market conditions. The method of calculating the MVA is specified in Appendix 2. Subject to 3.15, the MVA for a person 10 years or more below MFR pension age must be the equity MVA and the MVA for a person within 10 years of MFR pension age must be the linear combination of the equity and gilt MVAs arrived at by making a uniform progressive transition from a 100% equity MVA for a person 10 years before MFR pension age to a 100% gilt MVA for a person at MFR pension age.

3.13 For pensioners the liability must first be calculated as the present value of all payments due after the MFR Effective Date using appropriate current gilt yields as specified in Appendix 2.

3.14 If the liability calculated under 3.13 is greater than £100 million, and subject to 3.15, the liability must instead be calculated as:

> the present value of payments due to be made within 12 years of the MFR Effective Date, using current gilt yields;
>
> plus
>
> if the present value of the payments in the first 12 years is less than £100 million, the present value of payments during such further period of integral years as is necessary to increase the total present value to at least £100 million, using current gilt yields;
>
> plus
>
> the present value of any remaining payments, using the assumed long-term effective rate of return on equities for post MFR pension age, multiplied by the equity MVA calculated in accordance with Appendix 2.

3.15 In the case of a scheme with a gilts-matching policy for pensioners as defined in MFR Regulation 7(9), the calculation under 3.14 does not apply. If the gilts-matching policy applies to deferred pensioners, the liability for them must be calculated assuming the long-term effective rate of return on gilts and the appropriate gilt MVA throughout.

3.16 An additional allowance must be made for the expenses connected with the closure of the scheme, continuation as a closed scheme and eventual wind-up as specified in Appendix 2. For the avoidance of doubt, where defined benefits are subject to a money purchase benefit underpin, an appropriate expense allowance must be included in both the defined benefit and money purchase liabilities (at the appropriate marginal rate and, in the latter case, only if relevant) before any comparison between the liabilities is made.

3.17 Assets must be taken into account at their audited market value with the exceptions specified in the MFR Regulations. An MFR valuation must not be completed in the absence of an audited market value as at the MFR Effective Date. Where appropriate, and in particular for an MFR valuation under Section 57(2), the MFR Effective Date should be chosen to coincide with a date when an audited market value is available.

3.18 For the purpose of MFR Regulation 3(3), the value at the MFR Effective Date of any assets transferred prior to the MFR Effective Date must be the value at the date of transfer adjusted by the return on the FTSE Actuaries All-Share Index over the period from the date of transfer to the MFR Effective Date. The value as at the MFR Effective Date must be treated as being invested in equities.

3.19 The form of the actuary's Statement is specified in Schedule 1 to the MFR Regulations. Paragraph 2 of the Statement must be completed on the basis of the MFR calculations; it does not require the actuary to consider whether the method and assumptions specified for the MFR accurately reflect what might happen if the scheme were to wind up. Where figures are required to be shown in paragraph 2, it must be assumed that the expense allowance specified in Appendix 2 is a first charge on the assets.

4 Certification of Schedule of Contributions following a valuation

4.1 Paragraphs 4.2 to 4.8 of this Guidance Note apply only where the actuary is providing a certificate for the purposes of Section 58 of the Act following a valuation obtained by the trustees under Section 57 of the Act, when the certificate to be provided by the actuary must be in the form specified in Schedule 2 to the MFR Regulations. Any opinion given to the trustees for the purpose of MFR Regulation 18(1A)(b) or when setting the period of the Schedule of Contributions under Regulation 16(2)(b) must be based only on the estimated MFR position at the Calculation Date (see 4.6).

4.2 The actuary is required to give a different certificate depending on whether or not it appears to him or her that the MFR was met at the date seven days before the date of signing the certificate This date is referred to as the Calculation Date in 4.6 and 4.7 of this Guidance Note.

4.3 The actuary must not certify the Schedule of Contributions unless the value of the contributions shown in the Schedule is no less than the value of the aggregate of the MFR Regular Contributions and the MFR Contribution Adjustment calculated in accordance with 4.5 to 4.8 of this Guidance Note. The value comparison must be made for every period starting on the date of signing the certificate and ending on the annual anniversaries of that date falling within the period of the Schedule of Contributions, with a final comparison over the whole period of the Schedule.

4.4 The long-term effective rate of return on equities for pre MFR pension age set out in Appendix 2 must be used to calculate the values of actual or notional contributions during the period of the Schedule of Contributions, except in the case of a scheme where there are no active members and where deferred pensioners and pensioners are covered by a gilts-matching policy as defined in MFR Regulation 7(9), when the long-term effective rate of return on gilts must be used. Any additional liabilities or special additional accrued rights must be valued using the long term assumptions appropriate to the nature of the liability or accrued right. Special additional accrued rights are accrued rights not covered by the MFR Regular Contribution and would typically be augmentations agreed by the trustees.

4.5 MFR Regular Contribution

4.5.1 The actuary must assume that the additional MFR liabilities arising from additional accrued rights - either from the completion of further service, or from salary/earnings increases in excess of the rate of revaluation of accrued rights - during the period from the MFR Effective Date to the end of the period covered by the Schedule will be met by assets arising from the payment of MFR Regular Contributions.

4.5.2 The MFR Regular Contribution must be calculated using the Current Unit Method as at the MFR Effective Date. As an alternative to calculating a single rate for the MFR Regular Contribution covering the whole of the Control Period, the actuary may choose to calculate a series of two or more rates, each rate covering a separate part of the Control Period. The Control Period and any decision to calculate more than one rate must be appropriate to the circumstances of the scheme, taking into account any likely change in the active membership and in the pattern in which benefits under the method accrue during the period up to the end of the Schedule of Contributions. The Control Period must not be longer than the period between the MFR Effective Date and the end of the period covered by the Schedule of Contributions.

4.5.3 To calculate the MFR Regular Contribution, the actuary must:

4.5.3.1 assume that any members past their MFR pension age retire immediately;

4.5.3.2 allow for identifiable expenses, excluding investment management expenses, due to be met by the scheme;

4.5.3.3 calculate present values during the Control Period using the long term effective rate of return on equities for pre MFR pension age, except in the case of a scheme where there are no active members and where deferred pensioners and pensioners are covered by a gilts-matching policy as defined in MFR Regulation 7(9), when the long-term effective rate of return on gilts must be used;

4.5.3.4 otherwise, use the long-term financial assumptions and demographic assumptions set out in Appendix 2. If for a particular matter, no assumption is set out in Appendix 2, the actuary is free to make any suitable assumption, provided, overall, the assumptions are reasonable and consistent.

4.6 Estimated MFR position at the Calculation Date

4.6.1 In estimating the position as at the Calculation Date (see 4.2 above) the actuary must consider:

4.6.1.1 the difference between:

(a) the value of the actual contributions paid, the difference between transfer values received and transfer values paid, and debts due under Section 75 of the Act which have been received since the MFR Effective Date; and

(b) the aggregate value of the MFR Regular Contributions over that period and any additional liabilities or special additional accrued rights (as defined in 4.4) assumed by the scheme over that period. The value of any additional liabilities must include the difference between the liabilities in respect of transfer values received and the liabilities in respect of transfer values paid; this value may therefore be a negative amount if liabilities in respect of transfer values paid exceed those in respect of transfer values received;

4.6.1.2 the difference in investment conditions as at the MFR Effective Date and the Calculation Date - this must be assessed by considering changes in the MVAs;

4.6.1.3 any changes in the trustees' stated investment policy agreed and put into effect;

4.6.1.4 any investment transactions resulting in material gains or losses over the value as at the MFR Effective Date. Such transactions would normally only include property transactions.

4.6.2 The actuary need not consider the investment returns actually achieved by the scheme, nor any general change in the MFR liabilities.

4.6.3 The actuary need not take into account expected changes in the proportion of MFR liabilities which is measured by reference to gilt yields.

4.7 Notional MFR position at the Calculation Date

4.7.1 The difference between the notional and estimated MFR position at the Calculation Date (see 4.2 above) is a reflection of the mismatching between assets and liabilities. The notional MFR surplus or deficit as at the Calculation Date must first be estimated as the difference between:

4.7.1.1 the notional market value of the actual assets as at the MFR Effective Date were the indicator market yields such that the MVAs would be 100%. This value must be taken as the value as at the Calculation Date subject to adjustment for any changes in the trustees' stated investment policy agreed, and put into effect, between the MFR Effective Date and the Calculation Date; and

4.7.1.2 the MFR liabilities as at the MFR Effective Date using the long-term financial assumptions and MVAs of 100% plus the difference between:

(a) the aggregate value of the MFR Regular Contributions due and any additional liabilities or special additional accrued rights (as defined in 4.4) assumed by the scheme over the period between the MFR Effective Date and the Calculation Date. The value of any additional liabilities must include the difference between the liabilities in respect of transfer values received and the liabilities in respect of transfer values paid; this value may therefore be a negative amount if liabilities in respect of transfer values paid exceed those in respect of transfer values received; and

(b) the value of the actual contributions paid, the difference between transfer values received and transfer values paid, and debts due under Section 75 of the Act which have been received during that period.

4.7.2 The actuary may then, if he or she considers it appropriate, adjust the result in 4.7.1 above by allowing for any general change in the MFR liabilities that has been allowed for in determining the estimated MFR position at the Calculation Date.

4.7.3 To calculate the notional value of the assets other than cash, UK equities and UK gilts, the actuary must:

4.7.3.1 treat property and overseas equities as though they were UK equities;

4.7.3.2 treat overseas fixed interest stocks as though they were UK fixed interest stocks;

4.7.3.3 treat insurance policies, other than policies which are stated to be linked to a particular asset category, as whichever category, including cash, seems reasonable to the actuary, after having made enquiries as to the basis on which the surrender value is calculated;

4.7.3.4 treat any other investments which are not readily categorised, as cash. The actuary may, however, make appropriate allowance for the change in the market value of options and related market instruments that would result from a change to the notional market conditions.

4.8 **MFR Contribution Adjustment**

4.8.1 The MFR Contribution Adjustment must be calculated from the less favourable result of the estimated MFR position in 4.6 above and the notional MFR position in 4.7 above: that is by using the greater deficit, or the smaller surplus. The less favourable result calculated in this way should be assumed to remain unaltered over the seven day period between the Calculation Date and the date of signing the certificate.

4.8.2 If the less favourable result is a surplus, the MFR Contribution Adjustment is a single negative contribution equal to the surplus, payable as at the date of signing the certificate.

4.8.3 If the less favourable result is a deficit, the MFR Contribution Adjustment must be calculated as the total of:

4.8.3.1 the contributions to meet the estimated deficit, if any, as at the date of signing the certificate in accordance with MFR Regulation 17; and

4.8.3.2 the contributions payable annually in arrears, starting from the beginning of the period of the Schedule of Contributions, and either as a series of payments of equal amounts, or as a level percentage of the payroll, which, using the long-term financial assumptions, would eliminate the excess, if any, of the notional deficit over the estimated deficit above, or if the estimated position is a surplus, the whole of the notional deficit, before the end of the period of the Schedule of Contributions.

5 Occasional Certification of Schedule of Contributions

5.1 Paragraphs 5.2 to 5.4 of this Guidance Note apply only where:

5.1.1 the actuary is providing a certificate for the purposes of Section 57(1)(b) of the Act (occasional or periodical certification of contributions), when the certificate to be provided by the actuary must be in the form specified in Schedule 3 to the MFR Regulations; or

5.1.2 the actuary is providing a certificate for the purposes of Section 58(3)(b) of the Act (certification following a revision in the rates of contributions), when the certificate to be provided by the actuary must be in the form specified in Schedule 2 to the MFR Regulations.

5.2 For the purpose of providing either certificate, the actuary must consider the matters noted below over the period since the last MFR valuation:

5.2.1 all matters of which the actuary has been informed by the trustees and the employer in accordance with Regulation 6 of the Occupational Pension Schemes (Scheme Administration) Regulations 1996;

5.2.2 changes in investment markets;

5.2.3 the trustees' stated investment policy;

5.2.4 the investment return actually achieved by the scheme (if known);

5.2.5 the level of salary and pension increases granted (if known);

5.2.6 the actual contributions paid;

5.2.7 any other matters of which the actuary is aware.

5.3 To comply with 2.1.6, the actuary will generally need to consider both an updated estimated MFR position and an updated notional MFR position.

5.4 'Relevant changes' for the purpose of paragraph 2 of the certificate provided under 5.1.1 above are any of the matters referred to in 5.2 above which have significantly affected the extent to which the MFR liabilities are met by the value of the assets.

Appendix 1 : Northern Ireland Legislation

GB Provision	NI Provision
'S148 Orders' under the Social Security Administration Act 1992 (c 5)	'S130 Orders' under the Social Security Administration (Northern Ireland) Act 1992 (c 8)
Pensions Act 1995 (c26)	Pensions (Northern Ireland) Order 1995 (SI 1995/3213 (NI 22))
Section 119	Article 116
Section 124(1)	Article 121(1)
Occupational Pension Schemes (Minimum Funding Requirement and Actuarial Valuations) Regulations 1996 SI 1996/1536	Occupational Pension Schemes (Minimum Funding Requirement and Actuarial Valuations) Regulations (Northern Ireland) 1996 (SR 1996 No. 570)
Occupational Pension Schemes (Scheme Administration) Regulations 1996 SI 1996/1715	Occupational Pension Schemes (Scheme Administration) Regulations (Northern Ireland) 1997 (SR 1997 No.94)

Appendix 2 : Current Factors for Use in MFR Valuation

A	The current gilt yields to be used for valuing pensioner liabilities must be the gross annualised redemption yield on the FTSE Actuaries Government Securities 15 year Yield Index or the FTSE Actuaries Government Securities Index-linked annualised Real Yield Over 5 years (5% inflation) Index, as appropriate. In the case of LPI pension increases, either fixed-interest gilts with 5% pension increases or index-linked gilts with a 0.5% addition to the gross redemption yield must be used, whichever gives the lower value of liabilities. Similar principles must be applied for other pensions which are index-linked but subject to a cap other than 5%.

B.1	The long-term financial assumptions to be used are as follows:

	% per annum
Rate of inflation	4
Effective rate of return on gilts	8
Effective rate of return on equities - pre MFR pension age	9
Effective rate of return on equities - post MFR pension age	10
Rate of increase of GMP under Limited Revaluation	5
Rate of statutory revaluation for deferred benefits	4
Rate of LPI increase in payment	3.5
Rate of increase in post 1988 GMPs	2.75
Rate of increase of S148 Orders	6

The real rate of return on index-linked stocks is i, where $(1+i) = 1.08/1.04$.

B.2	Additional assumption needed for the projection calculations for the Schedule of Contributions

	% per annum
Rate of salary growth	6

C Market Value Adjustments (MVAs)

C.1	The MVA in relation to equities must be the ratio of 3.00% to the actual dividend yield on the FTSE Actuaries All-Share Index.

C.2	The MVA in respect of gilts must be the value at the annualised yield on the FTSE Actuaries Government Securities 15 year Yield Index or the FTSE Actuaries Government Securities Index-linked Real Yield Over 5 years (5% inflation) Index, as appropriate, of a 15 year stock with coupon equal to the relevant long-term assumption, payable annually in arrears.

C.3 For liabilities which when in payment might be valued using either the yield on a fixed-interest gilt basis or that on an index-linked gilt basis, the MVA to be used must be that which produces the lower liability.

C.4 If the liability includes a retirement lump sum payment for a non-pensioner who is within the switch-over period as defined in MFR Regulation 7(10), for the lump sum liability the market value adjustment must be:

$$1 + 0.1n \times (\text{gilt MVA} - 1)$$

on the whole of the liability for a scheme with a gilts-matching policy, as defined in 3.15, which applies to deferred pensioners,

or for other schemes on that part of the liability deemed invested in gilts,

where n is the number of years before MFR pension age (with a maximum of 10) and the gilt MVA is as follows:

for a cash benefit derived from an option to commute pension for a lump sum at retirement as described in 3.2, the fixed interest or index-linked gilt MVA as appropriate to that pension benefit

for other cash benefits, the fixed interest or index-linked gilt MVA as appropriate to the form of the cash benefit.

D Demographic Assumptions

D.1 Mortality (before and after retirement) PA(90) rated down 2 years

D.2 In the case of schemes which have a pensioner liability (assessed on the gilt basis) of at least £100 million, the mortality basis to be adopted must be that which the actuary considers appropriate for that scheme in respect of current pensioners and other members who have reached MFR pension age. In the case of all other schemes, and for non-pensioners below MFR pension age, the standard mortality table specified above must be adopted.

D.3 Proportions married

For pensioners, the assumption must be consistent with 80% (men) or 70% (women) at age 60.

For non-pensioners, the assumption must be, at the assumed date of retirement or earlier death, 80% (men) or 70% (women).

D.4 Age difference between husband and wife + 3 years

E Expenses

E.1 The allowance to be made for the expenses connected with closure of the scheme, continuation as a closed scheme and eventual wind-up must be 4% of the value of accrued liabilities for the first £50 million of such liabilities, 3% of the value of the accrued liabilities for the next £50 million of such liabilities and 2% of the remainder of the value of accrued liabilities. For this purpose money purchase liabilities must be included in the value of accrued liabilities, if the scheme rules state that expenses cannot be met out of assets attributable to those liabilities; no such provision is required in other circumstances. This allowance must be made irrespective of the likely actual costs for the particular scheme.