Pinsent Masons

Making DB funding easier

May 2016

Introduction

Most defined benefit pension schemes do not have enough money to pay the pension benefits promised – a concern for trustees and employers alike. The level of any deficit will depend on what assumptions are made about future investment performance, inflation, life expectancy, etc. Trustees and employers need to understand how those actuarial assumptions are set and how to make good the deficit.

This guide looks at what employers and trustees need to do to ensure compliance with the law. We have produced a separate guide that suggests how employers can reduce their funding costs.

10 steps to understanding DB scheme funding

1. Legislation provides a framework for setting the level of employer contributions. Scheme rules affect the roles employers and trustees have to play in this process. Usually, employers and trustees must agree funding matters jointly. In some schemes, the trustees need only consult with the employer, and do not need its agreement. Advice from the scheme actuary is fundamental. Trustees should make sure they understand the procedure for their scheme.
2. Trustees need to assess the employer's ability to continue funding the scheme. This will help the trustees decide how much the employer should pay and over what period any deficit should be paid off. The trustees should put in place procedures to monitor the employer's financial strength. They should ask the employer to share information about anything that might affect its ability to pay; for example, the employer increasing its borrowing, paying a dividend or losing a large commercial customer.
3. Trustees must obtain a full valuation at least every three years, as well as shorter valuation reports in the intervening years.
4. Trustees must agree a statement setting out what employer contributions are due and when they must be paid. This is known as a schedule of contributions. The trustees must also agree a policy to make sure the scheme is properly funded. This is known as a statement of funding principles.
5. If the scheme has a deficit, the trustees must also draw up a recovery plan. The recovery plan sets out what needs to be done to eliminate the deficit and how long it will take. The time frame will depend on factors, such as the employer's financial strength, the level of the deficit and the age profile of the members.
6. The trustees must put in place the schedule of contributions, the statement of funding principles and, if there is a deficit, the recovery plan within 15 months of the valuation date. To achieve this, the trustees should draw up an action plan well in advance, setting out responsibilities and deadlines. They should agree the plan with the employer and the actuary.
7. The trustees must send a copy of any recovery plan to the Pensions Regulator. The Regulator will usually object to the plan if it will take longer than 10 years to eliminate the deficit or if the employer will contribute significantly more towards the end of the recovery period.
8. Trustees must notify the scheme members of the funding position each year. The notice to members is called the summary funding statement.
9. In most schemes, the trustees and employers must agree funding matters together. Negotiations can be protracted. Trustees should try to preserve their working relationship with the employer. If agreement cannot be reached by the deadline, the trustees must inform the Regulator. The Regulator can intervene, but it will only do so as a last resort. It expects trustees and employers to try to reach an agreement themselves.
10. Before any funding discussion, trustees should consider any conflicts of interest. For example, any trustee who is also a director of the employer is likely to have a conflict. Trustees should seek legal advice where necessary.

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Further reading

The Pensions Regulator has published a Code of Practice on funding defined benefits and scheme funding FAQs. It has also produced guidance on conflicts of interest and on choosing mortality assumptions.

For more information on monitoring employer covenants see our making it easier guide.

Pensions law can be tricky… but it doesn't have to be. These 'making it easier' guides explain key issues in simple terms, giving practical help to trustees and employers.

The series is growing; additional copies can be downloaded from www.pinsentmasons.com

Current topics include: Using advisers; Scheme changes and Becoming a trustee

Comments and ideas for further topics are welcome…

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