Minimum Funding Requirement

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The Minimum Funding Requirement (MFR) was introduced by the *Pensions Act 1995* and took effect from April 1997. It was a funding standard applying to private sector, funded, defined benefit pension schemes. It was designed to keep pensions in payment but would only provide non-pensioner members with an "even chance" of receiving a cash equivalent transfer value that would, following investment, produce a pension equivalent to that which would have been provided by the scheme.

The MFR was criticised both for "distorting investment decisions without providing effective protection for members" and for being insufficiently flexible to respond to the circumstances of individual schemes. In Budget 2001, the Government announced that it would legislate to replace the MFR with a "long term scheme-specific funding standard." Following further consultation, the Government legislated for this in Part 3 of the *Pensions Act 2004.* The current scheme funding requirements are covered in Library Standard Note SN/BT 4877 *Pension scheme funding requirements.*

The Parliamentary Ombudsman in a March 2006 report, 'Trusting in the Pensions Promise', found that official information provided regarding the security that members of final salary occupational pension schemes could expect from the MFR was "inaccurate, often incomplete, largely inconsistent and therefore potentially misleading." She recommended that the Government should consider whether it should make arrangements for restoration of benefits to scheme members affected. The Government did not accept the findings but, following a judgment by the High Court, further extended the scope and generosity of the Financial Assistance Scheme (set up to provide some compensation to members of schemes that started to wind up between 1 January 1997 and April 2005.). This is covered in more detail in Library Standard Note SN/BT 2010 – *Financial Assistance Scheme – developments to 2007.*

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1 Introduction of the MFR

The Minimum Funding Requirement (MFR) was established under the *Pensions Act 1995* and came into effect from 6 April 1997. It applied to most funded, defined benefit private sector pension schemes.[1]

1.1 Aims

The *Pensions Act 1995* aimed in part to respond to public concerns about the perceived lack of safeguards to protect occupational pensions in the light of the Maxwell scandal. The then government established the Pension Law Review Committee under Professor Roy Goode and the Committee's report provided the basis of some of the provisions in the Act.[2] The Goode report recommended what it called a minimum solvency requirement to secure the pension rights of members.[3]

The 2006 report of the Parliamentary Ombudsman, '*Trusting in the Pensions Promise'* provides an account of the introduction of the MFR and the various statements made on its aims (see in particular, paragraphs 4.1 to 4.58). The Ombudsman found that:

> …the then Government chose in November 1995 to instruct the actuarial profession to devise a basis for the Minimum Funding Requirement that would keep pensions in payment but would only provide non-pensioner members with an 'even chance' of receiving a cash equivalent transfer value that would, following investment, produce a

1 Section 56, *Pensions Act 1995;* OPRA, 'A guide to the Minimum Funding Requirement', May 1999, p3
2 *Pension Law Reform: the report of the pension law review committee*, Cm 2342-1, September 1993
3 Ibid, p 249

pension equivalent to that which would have been provided by the relevant scheme (see paragraph 4.64).[4]

In its response to this report, the Government confirmed that the MFR was never intended to require schemes to hold sufficient assets to ensure that all members' benefits could be fully secured should the scheme wind up:

> …Prior to 1997 there were no legislative requirements about the level of assets an on-going scheme needed to hold - this was decided in accordance with the rules of their scheme. The 1995 Act built on these arrangements and provided scheme members with greater (but not total) protection by introducing the MFR, which required private sector salary-related pension schemes to hold a minimum level of assets to meet their liabilities.
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> 11. The MFR was never intended to require schemes to hold sufficient assets to ensure that all members' benefits could be fully secured should the scheme wind up (by purchasing annuities and deferred annuities from an insurance company). Instead it was intended to ensure that a scheme which was fully (ie 100%) funded on the basis of the MFR should have sufficient assets, in the event of it winding up, to protect fully pensions already in payment (by buying annuities), and to give younger members a cash amount which, if placed in a personal pension, would allow them a reasonable expectation - but not a guarantee - of achieving, at retirement, benefits equivalent to those lost.[5]

1.2 The MFR in its original form

DWP has set out the following overview of the operation of the MFR:

> 12. The funding position was to be tested by the scheme actuary on at least a three-yearly cycle. Where the scheme did not satisfy the MFR, it had a given time to make up the shortfall. Nothing prevented the scheme holding more assets than the MFR required. It was envisaged that an appropriate level of scheme funding would continue to be determined in accordance with the rules of the scheme, with the MFR being precisely that: a minimum.
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> 13. The MFR was introduced on a phased basis from April 1997. To allow schemes and employers the time to move smoothly from their old system to the new requirement, transitional rules allowed trustees to obtain their first MFR valuation in line with their scheme's existing (generally three-yearly) actuarial valuation cycle.
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> 14. The MFR valuation involved the scheme actuary comparing the market value of the scheme's assets (stocks, shares, bonds etc) with a value placed on its liabilities (pensions in payment and, for those who had not retired, the value of the deferred benefits built up to the date of the valuation) on a specified date. The actuary followed guidance issued by the UK actuarial profession, and approved by Ministers, in carrying out these valuations. The actuary then provided a certificate to the scheme's trustees stating that either the scheme met the MFR or, if it did not, how much the shortfall was. This certificate, the format of which was laid down in legislation, emphasised to the

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4 'Guide to the Parliamentary Ombudsman's Report 'Trusting in the Pensions Promise: Government bodies and the security of final salary occupational pensions', March 2006; http://www.ombudsman.org.uk/pdfs/pensions_report_06_guide.pdf (retrieved 20 October 2008)

5 DWP, 'Response to the Report by the Parliamentary Ombudsman, 'Trusting in the Pensions Promise', June 2006, para 10-11; http://www.dwp.gov.uk/publications/dwp/2006/pensions/response-ombudsman.pdf (retrieved 20 October 2008)

trustees that meeting the MFR did not mean that the scheme could buy out fully all its liabilities. It said:

> "Note:
>
> The certification of the adequacy of rates of contribution for the purpose of securing the meeting of the minimum funding requirement is not a certification of their adequacy for the purpose of securing the scheme's liabilities by the purchase of annuities, if the scheme wound up."
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> *(Occupational Pension Schemes (Minimum Funding Requirement) and Actuarial Valuations) Regulations 1996)*
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> 15. If the scheme's first MFR valuation showed a shortfall, the trustees generally had until April 2003 to bring the funding up to 90 per cent of the MFR level and until April 2007 to reach 100 per cent.[6]

The MFR was provided for in sections 56 to 61 of the *Pensions Act 1995*, and the regulations made under it - the *Occupational Pension Schemes (Minimum Funding Requirement and Actuarial Valuations) Regulations 1996*.[7] The relevant sections of the *Pensions Act 1995* are as follows:

- Section 57 required scheme trustees to obtain valuation from an actuary, generally on a three yearly basis.[8]
- Section 58 required trustees to prepare a schedule of contributions payable over a five year period.[9] The actuary had to certify that these contributions were adequate to meet the MFR over this five year period. A schedule of contributions could only be certified if it would ensure that the scheme would continue to be 100% funded under the MFR during the five years or, if it was funded between 90% and 100% at the time of valuation, that it reached 100% funding by the end of the five year period. However, there was a transitional period for schemes valued under the MFR prior to April 2002. They were allowed extra time. [10]
- Section 60 of the 1995 Act and regulation 20 of the MFR regulations provided for action to be taken in the case of serious under-provision: i.e. where the funding was less than 90% of the amount of the scheme's liabilities. In such cases, the schedule of contributions had to ensure that the scheme would be at least 90% funded within 12 months. Where serious under-provision was identified during the transitional period, schemes had six years from the commencement date of the regulations to reach a 90% funding level.[11] An increase in employer contributions would be the main way of reducing any shortfall. However, other methods were also allowed. For example, the trustees could be given a charge over some of the employer's assets.[12]

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[6] DWP, 'Response to the Report by the Parliamentary Ombudsman, 'Trusting in the Pensions Promise', June 2006, para 12-14; http://www.dwp.gov.uk/publications/dwp/2006/pensions/response-ombudsman.pdf (retrieved 20 October 2008)

[7] SI 1996/1536

[8] Occupational Pension Schemes (Minimum Funding Requirement) and Actuarial Valuations) Regulations 1996, regulation 10

[9] regulation 16(1)

[10] regulation 16(2)

[11] regulation 20(3)

[12] regulation 22 and schedule 4 to the regulations

- Certain matters had to be reported to the Occupational Pensions Regulatory Authority (OPRA), for example, if the MFR had not been met or an employer had failed to make required contributions by the due date.[13] OPRA could impose financial penalties on trustees for failing to comply with their obligations under the legislation and employers could face criminal penalties for failing to make contributions within the required time. OPRA published a guide to the MFR for trustees.[14]

Guidance notes issued by the Institute and Faculty of Actuaries set out the assumptions to be made when calculating liabilities and assets under the MFR. See, for example, "GN27, Retirement Benefit Schemes – Minimum Funding Requirement", June 1999.[15]

1.3 Changes to the basis of the MFR

DWP explains that the operation of the MFR was monitored by the UK actuarial profession with a view to recommending changes if needed:

> The operation of the MFR affected by economic and demographic factors such as increases in longevity, changes in yields from equities and other investments, and changes in the costs of buying annuities. It was therefore inevitable that it would fluctuate against its original objective. It was for this reason that the UK actuarial profession monitored the operation of the MFR test from the outset, with a view to recommending changes when they considered adjustments were needed to ensure that the operation of the MFR remained consistent with the original policy objective.
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> To put it simply, if the MFR test was operating above the required level it would be offering a higher level or security than intended and would have required the employer to put more money than needed to meet the policy objective; if operating below the required level, it would be offering a lower level of security than intended and would not have required the employer to put in as much money as needed to meet the policy objective.[16]

As explained by the Parliamentary Ombudsman, the basis of the MFR was changed in 1998 and in 2002:

> …in response to recommendations by the actuarial profession on four occasions, the Department for Work and Pensions decided to weaken the Minimum Funding Requirement – which relieved the burden on sponsoring employers – twice but decided not to strengthen it – and thus increase the protection it afforded to scheme members – twice (see paragraphs 4.106-10, 4.320, 4.371-2 and 4.545 for the four recommendations – and paragraphs 4.111-4 and 4.352-4, 4.420 and 5.101 for the Government's decisions.[17]

The 1998 change was made in response to the abolition of tax credits paid to pension funds and companies receiving dividend income net of advance corporation tax (ACT)[18] and

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[13] section 59

[14] *A guide to the Minimum Funding Requirement: summary for pension scheme trustees*, OPRA

[15] http://www.actuaries.org.uk/__data/assets/pdf_file/0005/33377/gn27v1-5.pdf (retrieved 21 October 2008)

[16] DWP, 'Response to the Report by the Parliamentary Ombudsman, 'Trusting in the Pensions Promise', June 2006, para 16-17; http://www.dwp.gov.uk/publications/dwp/2006/pensions/response-ombudsman.pdf (retrieved 20 October 2008)

[17] 'Guide to the Parliamentary Ombudsman's Report 'Trusting in the Pensions Promise: Government bodies and the security of final salary occupational pensions', March 2006; http://www.ombudsman.org.uk/pdfs/pensions_report_06_guide.pdf (retrieved 20 October 2008)

[18] This is discussed in more detail in Library Standard Note SNBT/581, 'Advance Corporation Tax (ACT) and pension funds'

evidence regarding the performance of the equity market, (which was considered to be "inconsistent with the way equity MVA [Market Value Adjustment] is calculated").[19] The Ombudsman found no evidence the decision to change the basis of the MFR in 1998 was taken with maladministration.[20]

However, she did make a finding of maladministration in relation to a decision to change the MFR in 2002. The *Occupational Pension Schemes (Minimum Funding Requirement and Miscellaneous Amendments) Regulations 2002* (SI 2002 No 380) introduced a number of changes. One change was to equity MVA to recognise "current market conditions and the lower dividend changes in recent years."[21] The Ombudsman found that:

> There was insufficient documentary evidence to explain the rationale for that decision – and that the Department for Work and Pensions appeared to have relied on professional advice which could not be sufficient in itself to enable the Department to come to a decision, as it should have done, that took account of all relevant considerations and which ignored relevant ones (paragraphs 5.95 to 5.105).

In response, the Government argued that there was "ample evidence to demonstrate why the decision was made to accept the actuarial profession's September 2001 recommendation."[22] The Ombudsman's Report and the Government's response is covered in more detail in section 3 below.

2 Review of the MFR

2.1 DSS review

In March 1999, the Government announced a review of the MFR in response to concern that "the valuation method is not as robust as originally expected under changing economic conditions and that it should be re-examined".[23] In September 2000, the Department of Social Security (DSS) published a consultation document.[24] At the same time a review of the MFR by the Institute and Faculty of Actuaries summarised the concerns raised by employers, trustees and actuaries:

- it has led employers and trustees to pay too much regard to short term market conditions, instead of focusing on long term funding and investment policy
- it appears to have created some extra demand in the long end of the gilts market, which may have contributed to the depression of yields

> the dividend yield is no longer a reliable measure of "value" for UK equities – this is partly due to the abolition of tax credits on UK dividends in the July 1997 Budget, which has changed companies' behaviour over profit distribution, and partly because

19 Parliamentary Ombudsman, 'Trusting in the pensions promise', March 2006, HC 984, para 4.106-110;

20 'Guide to the Parliamentary Ombudsman's Report 'Trusting in the Pensions Promise: Government bodies and the security of final salary occupational pensions', March 2006; para 27; http://www.ombudsman.org.uk/pdfs/pensions_report_06_guide.pdf (retrieved 20 October 2008)

21 Parliamentary Ombudsman, 'Trusting in the pensions promise', March 2006, HC 984, para 4.432. The Pensions Management Institute explains that a "market value adjustment" is "an adjustment applied to an actuarial liability to reflect the difference between the market value and actuarial value of assets." http://www.pensions-pmi.org.uk/Definitions/List.asp (retrieved December 2008)

22 DWP, 'Response to the report by the Parliamentary Ombudsman, 'Trusting in the Pensions Promise', June 2006, para 43; http://www.dwp.gov.uk/publications/dwp/2006/pensions/response-ombudsman.pdf (retrieved 20 October 2008)

23 DSS press release, *Timms announces review of Minimum Funding Requirement*, 3 March 1999

24 'Security for Occupational Pensions: A consultation document' September 2000

investors are willing to value shares on future long term expectations, despite the absence of dividends or profits

- there are technical problems:
- for schemes which try to match their assets to their MFR liabilities
- for certain types of insured schemes
- with the rigid and mechanical rules for setting minimum contributions
- there is a large and worrying gap between the level of security which the MFR test actually delivers and the public's perception of what it will deliver.[25]

The DSS sought views on amending the MFR to deal with these perceived problems and possible alternatives to the funding test such as prudential supervision by a regulator, compulsory insurance and a central discontinuance fund.[26] The closing date for responses was 31 January 2001. The relatively long consultation period was to allow consideration of recommendations by Paul Myners who had been asked to consider the MFR as part of his review of institutional investment established by the Treasury at the time of the 2000 Budget (see below).

The review by the Institute and Faculty of Actuaries outlined proposals for a revised MFR test within the remit it had been given by the DSS. It argued for a new test in addition to the MFR:

> We recommend that, in addition to the MFR test, there should be a security measure which is clearly disclosed to members. This security measure would indicate the level of cover achieved against a stronger test, designed to give all members a very high chance of receiving their accrued benefits on winding up. The MFR test, to which statutory controls apply, gives pensioners a very high chance and non pensioners a "reasonable expectation" of achieving their benefits, in accordance with the objectives set by Government. Members would be informed that the MFR test differs from a true security test and does not give 100% security, as they currently believe.[27]

It proposed the adoption of a valuation method based solely on bond yields with an explicit risk based addition to take into account the excess expected return from investments other than bonds. A new index of bond yields would be derived from a large range of gilts and corporate bonds. It also recommended extending the MFR deficit correction periods with the new test and implementing some interim changes to the current MFR basis. [28]

A number of responses to the DSS consultation also argued for the abolition of the MFR and at least a consideration of the alternatives. The Association of British Insurers, for example, proposed a panel of “wise men” to set and continually review the appropriate discount rate for assessing pension funds.[29] An article in the *Financial Times,* published after the closing date for responses to the DSS consultation, summarised the various approaches taken by different sectors in the pensions industry:

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[25] The Faculty of Actuaries and Institute of Actuaries, *Review of the Minimum Funding Requirement – a report to the Secretary of State*, May 2000, p I; http://www.actuaries.org.uk/__data/assets/pdf_file/0004/33655/mfr_report.pdf (retrieved 21 September 2008)

[26] DSS, *Security for Occupational Pensions – a consultation document*, September 2000

[27] Ibid, Executive Summary, para 4 d

[28] Ibid, Executive Summary

[29] ABI press release, 31 January 2001

Among the pension consultants, Watson Wyatt said the MFR should be replaced, but it warned against the creation of another funding standard or rigid test. It said there should be a tougher governance structure, and trustees should be empowered to wind up a scheme to protect members if they thought the underfunding was so serious that the pensions were put at risk.

KPMG, the professional services company, said the MFR should go, and a less prescriptive system should be introduced, allowing clear disclosure of pension scheme's solvency position.

William M. Mercer offers two solutions: a radical one that would sweep away MFR and revert to a less prescriptive pre-MFR situation; and a less radical option for restructuring the MFR.

These submissions follow those by the Association of British Insurers, the National Association of Pension Funds and the Association of Consulting Actuaries - all of which called for the scrapping of the MFR.

Scottish Equitable warned that to abolish the MFR "could be construed as choosing investment flexibility over the security of company scheme member's pensions".[30]

2.2 The Myners Review and Budget 2001

The Chancellor of the Exchequer announced in the March 2000 Budget that he had asked Paul Myners of Gartmore Investment Management to review the patterns of institutional investment in the UK, to see in particular whether any structural factors contribute to a relative aversion among such investors to invest in smaller companies.

In November 2000, in an open letter to the Chancellor and Secretary of State for Social Security, Paul Myners argued that the MFR was a source of distortions in investment decision-making and should be replaced:

> Providing security for members of defined benefit pension schemes is an essential objective for any responsibly run pensions system. While I am sure that the overwhelming majority of pension funds are run both properly and effectively, it is essential to have effective safeguards to ensure that members of defined benefit pension schemes can have confidence in the system. I do not believe that the MFR is such a safeguard. An effective alternative is needed. It is also a source of distortions in investment decision-making. I propose instead that it should be replaced by an enhanced compensation scheme for fraud, mandatory arrangements for safe custody of pension fund assets, and transparency and independent review of pension funds' finances and plans.[31]

The industry response to this was described in *Pensions World* as "overwhelming and varied".[32] The National Association of Pension Funds (NAPF) argued that the MFR was "fatally flawed" and should be abolished. Others questioned whether sufficient attention had been paid to the protection of pension funds. The proposed alternative to the MFR was described as "little more than an opaque statement".[33]

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30 "Ministers under pressure to scrap test to protect employee pensions", *Financial Times*, 2 February 2001

31 Letter from Paul Myners to the Chancellor of the Exchequer and the Secretary of State for Social Security, 8 November 200o, http://www.hm-treasury.gov.uk/d/MybersLetter.pdf (retrieved 20 October 2008)

32 "MFR meltdown", *Pensions World*, December 2000

33 Ibid

Paul Myners' final report was published with the March 2001 Budget. It recommended that the MFR should be replaced with a scheme-specific and long-term approach, based on transparency and disclosure:

> 8.62 The review concludes that the MFR is distorting investment patterns without providing effective protection for members of defined benefit pension schemes. By making calculations based on standard assumptions it can give a misleading picture of the level of security of pensions. It is distorting investment choices. It is increasing the cost of defined benefit provision and thereby creating artificial incentives to move to defined contribution. Indeed, its effects may actually be counterproductive to the extent that it gives trustees a spurious sense of certainty about funding levels, weakening the sense of fiduciary responsibility.
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> **The review recommends that the MFR should be replaced by a scheme-specific long-term approach based on transparency and disclosure, under which pension funds would report publicly on the current financial state of the fund and on future funding plans.**
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> 8.63 This would make clear where funds' ability to pay future pensions was based on reckless or unsuitable assumptions about investment returns, level of contribution, life expectancy and so on. The precise nature of secondary controls that should exist within this framework is a matter for Government.[34]

At the same time, the Government announced its intention to abolish the MFR:

> **3.48** The Government is also publishing a separate document alongside this Budget setting out its proposed way forward on the MFR, on which it received consultation responses from Mr Myners and others. The Government believes that the MFR should be abolished and replaced by a long-term scheme-specific approach based on transparency. The Government also wishes to draw on a number of points from consultation responses including, in particular, useful suggestions from the National Association of Pension Funds. **The Government will legislate to replace the MFR with a long term scheme-specific funding standard, with additional protective measures, including a statutory duty of care for the scheme actuary, stricter rules on voluntary wind-up and extension of compensation for fraud**.[35]

A separate document set out the Government's proposals and summarised responses to the DSS consultation.[36] Few respondents were said to be attracted to the idea of a "central discontinuance fund" for similar reasons to those set out by the Goode report. The Association of British Insurers was "dubious" that a commercial insurance market could be developed and there was little support for some form of compulsory mutual insurance. Among other reservations, respondents argued that this would result in employers who sponsored well funded schemes subsidising firms which neglect their obligations. Respondents also felt that prudential supervision of pension schemes by a regulator would lead to significant burdens on schemes and increased bureaucracy.

The document said that two models for replacing the MFR attracted support. The first was for a common funding standard which would be designed to ensure an adequate level of long-term scheme funding without distorting schemes' investment decisions. This would

[34] HM Treasury, *Institutional investment in the UK: a review*, March 2001; http://www.hm-treasury.gov.uk/d/31.pdf (retrieved 20 October 2008)

[35] HM Treasury, *Budget 2001 – investing for the long-term future: building opportunity and prosperity for all*, HC 279, March 2001, p 48; http://www.hm-treasury.gov.uk/4013.htm (retrieved 20 October 2008)

[36] DSS and HM Treasury, *Security for occupational pensions: the government's proposals*, March 2001

effectively constitute a revised MFR. The Government considered this proposal but rejected it because it was "not satisfied that a practical regime can be devised which avoids the drawbacks affecting the current MFR".[37] It therefore decided to proceed with the other general approach which it argued received substantial support in the consultation exercise, notably from the National Association of Pension Funds (NAPF). This was for a long-term scheme-specific funding standard which incorporated additional measures to strengthen protection for members to those suggested by Paul Myners. The key elements of the proposals were:

- **a long-term scheme-specific funding standard.** This means that trustees and their advisers will be required to take a view on the proper funding and investment of the scheme in the light of the scheme's own circumstances. And any professional guidance must emphasise the duty on all parties to look at the circumstances of the particular scheme and sponsoring employer;

- **a strong regime of transparency and disclosure.** Each scheme will have to set out in a clear and straightforward way how it sees its liabilities growing over time and how, through contributions to the fund and growth in the value of the assets through investment returns, it proposes to meet its liabilities. This 'Funding Statement', which might form part of a strengthened Statement of Investment Principles, will promote transparency and scrutiny. It will be distributed to members and made publicly available;

- **a recovery plan for returning the scheme to full funding.** Each employer will have to ensure that their scheme is adequately funded and, if it is not, to implement a recovery plan for returning to adequate funding within a relatively short period of time, say three years;

- **a statutory duty of care towards scheme members on the scheme actuary.** This will mean there will be a key adviser with a duty of care directly to the scheme members. This will enhance member protection and will clarify the actuary's whistle-blowing role if something goes wrong;

- **stricter conditions about voluntary wind-up than at present.** The Government will legislate to make it clear that companies will be required to meet in full the accrued entitlements of scheme members as they fall due. This will ensure that an employer who remains in existence cannot walk away from the scheme leaving it insufficiently funded to pay the accrued pension liabilities; and

- **extension of the fraud compensation scheme.** The level of compensation for fraud will be increased to cover not simply the MFR liabilities as at present, but the cost of securing members' accrued benefits (or the amount of the loss from fraud, whichever is the lesser).[38]

The Government argued that these would provide protection for scheme members without adversely affecting investment decisions:

The earlier variety of views about any potential replacement for the MFR was reflected in initial responses to the Chancellor's announcement.[39] Some argued that the proposals offered much needed protection for scheme members but could lead to employers closing schemes to avoid the new requirements. Alternatively, others pointed to the "gaping hole" in

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[37] Ibid, p 2
[38] Ibid, p 3
[39] see, "Concerns over son of MFR", *Pensions Week*, 12 March 2001, p 6

terms of the protection of benefits left by the abolition of the MFR and argued that there was an over-reliance on a transparency statement which would mean little or nothing to most scheme members.[40] The major trade bodies: the NAPF, the Society of Pension Consultants and the Association of Consulting Actuaries, all advocated a scheme-specific funding standard and supported the proposals. However, some pointed to the lack of published detail about the proposed scheme specific standards and concluded that the proposals were "long on concepts but short on practicalities".[41]

2.3 September 2001 proposals – 'the next stage of reform'

In the light of comments received, the Government published proposals in a September 2001 document, *The Minimum Funding Requirement: the next stage of reform*. This proposed a twin track approach to reform of the MFR. Draft regulations (*The Occupational Pension Schemes (Minimum Funding Requirement and Miscellaneous Amendments) Regulations)* would make some changes to the existing regulations governing the MFR. Longer term changes would require primary legislation. A consultation panel was set up to help develop the proposals.

2.4 2002 Pensions Green Paper – 'Simplicity, security and choice'

The Government's December 2002, Pensions Green Paper, *Simplicity, security and choice* included details of the standard as developed in connection with key stakeholders: the pensions industry, employers trade unions and consumer organisations. The main elements of the new requirements would be:

- a requirement for scheme trustees to agree a Statement of Funding Principles with the sponsoring employer, based on the advice of the scheme actuary. This Statement will be a record of decisions taken about the funding of the scheme, setting out the scheme's strategy for funding its pension commitments, and for correcting any funding deficits. The information in the Statement will complement that in the Statement of Investment Principles;

- trustees will be required to obtain a full actuarial valuation of their scheme at least every three years. It will be for the trustees, with the agreement of the employer, and based on advice from the scheme actuary, to determine the funding method used, including the detailed economic and demographic assumptions appropriate to the specific circumstances of the scheme;

- more effective communication with scheme members. A copy of the Statement of Funding Principles will be made available to members on request. We also propose that trustees should be required to send regularly updated information to scheme members containing key information about the funding position of their scheme (see also Section E on communications with scheme members);

- the scheme actuary's duty of care towards scheme members will be clarified.[42]

2.5 June 2003 – White Paper on occupational pensions

The White Paper published in June 2003, *Simplicity, security and choice: Working and saving for retirement. Action on occupational pensions* set out the proposals in more detail:

[40] "Building security into a new regime" and "'Myners' transparency statement an ineffective check'", *Financial Times,* 10/11 March 2001

[41] PricewaterhouseCoopers (PWC) as quoted in *Pensions Week*, 12 March 2001, p 6

[42] DWP *Simplicity, security and choice: technical paper* December 2002 p12-13

Introduction of scheme-specific funding

4. In the Green Paper, we restated our intention to replace the Minimum Funding Requirement (MFR) with more flexible scheme-specific funding requirements. The MFR was a flawed approach. It distorted investment decisions for some schemes and it increased regulation and costs for sponsoring employers, without delivering the level of security which many people expected. Our proposals will allow schemes greater flexibility to match their investment strategy to the profile of their members – for example, schemes with younger members may be freed to invest more heavily in assets expected to give a higher return over the long term.

5. The detail of the planned new framework for scheme funding was developed with the assistance of a consultation panel of representatives from the pensions industry, consumer organisations, employers and trade unions. Employers and the pensions industry responding to the consultation were broadly in favour, while members and consumer groups were concerned that it could weaken protection of members' benefits, particularly in cases where the employer became insolvent. We have taken account of these concerns by developing plans to strengthen the protection offered to pension scheme members as set out in Chapter 2.

6. The key elements of the scheme-specific funding requirements will be that:

● scheme trustees will be required to draw up a Statement of Funding Principles;

● trustees will be required to obtain a full actuarial valuation of their scheme at least every three years;

● following the valuation, the trustees will be required to put a Schedule of Contributions in place, setting out how much the employer and employee will pay into the scheme;

● where trustees and employers cannot reach agreement on issues fundamental to the funding of the scheme, the trustees will be given, as a last resort, powers to freeze or wind up the scheme;

● trustees will be required to send regularly updated information to scheme members each year, containing key information about the funding position of their scheme, in line with the likely requirement of the EU Occupational Pensions Directive; and

● the scheme actuary's duty of care towards scheme members will be clarified.

7. These proposals require employers, trustees and the scheme actuary to work together to develop an appropriate funding strategy for their scheme. Providing scheme members with funding information about their scheme will raise their awareness and understanding of the funding proposals of their scheme and increase accountability. We estimate that there will be savings of around £100 million a year arising from the impact of the removal of the MFR on schemes' investment strategies.[43]

The Annex to the White Paper explains how the £100 million saving figure was reached:

Replacement of the Minimum Funding Requirement

[43] Department for Work and Pensions, *Simplicity, security and choice: working and saving for retirement: action on occupational pensions,* June 2003, Cm 5835, http://www.dwp.gov.uk/consultations/consult/2002/pensions/actionplanfull.pdf

> 6. We estimate that replacing the Minimum Funding Requirement (MFR) with scheme-specific funding arrangements will result in funding savings of £100 million across all private sector defined benefit schemes. The MFR is considered to have had an impact on the demand for gilts, and its removal will therefore lead to some reversal of this trend. At present it is estimated that schemes have some £100 billion invested in gilts overall. On the assumption that 5 per cent (£5 billion) of this was switched to equities following the removal of the MFR and that an extra 2 per cent return was achieved on those assets as a result, the extra investment income would amount to £100 million.[44]

Scheme specific funding requirements are covered in more detail in Library Standard Note SNBT/4877: *Pension scheme funding.*

3 Parliamentary Ombudsman's report, 'Trusting in the pensions promise.'

The MFR, and the official information provided in connection with it, was considered as part of the Parliamentary Ombudsman's investigation into complaints about occupational pensions. The investigation was announced on 16 November 2004:

> The Ombudsman has received approximately 100 complaints from members and trustees of pension schemes across the United Kingdom. These include former employees of companies which are now insolvent and whose schemes have been wound up; and employees and former employees of companies which are in administration and whose schemes are in doubt. …
>
> Ms Abraham has decided to investigate representative complaints which cover all these situations. Specifically, she will be looking at allegations that:
>
> -Government ministers and officials ignored relevant evidence when taking decisions on whether to warn scheme members of the risks to their pensions should their scheme wind up and
>
> -Information and advice provided by Government bodies to scheme members and trustees was inaccurate.[45]

The report – *Trusting in the pensions promise* – was published on 15 March 2006.[46] The Ombudsman made the following three findings of maladministration:

- first, that official information - about the security that members of final salary occupational pension schemes could expect from the Minimum Funding Requirement provided by the bodies under investigation - was sometimes inaccurate, often incomplete, largely inconsistent and therefore potentially misleading, which was contrary to the Department for Work and Pensions' own standards and also to principles of good administration (paragraphs 5.36 to 5.74);
- secondly, that the response by the Department for Work and Pensions to the actuarial profession's recommendation that disclosure should be made to pension scheme members of the risks of wind-up – in the light of the fact that scheme members and member-nominated trustees did not know the risks to their accrued pension rights – had no regard to the role that its own deficient information had

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[44] Ibid

[45] http://www.ombudsman.org.uk/news/press_releases/pr09-04.html (retrieved 8 June 2006)

[46] Parliamentary and Health Service Ombudsman, 'Trusting in the pensions promise', March 2006, HC 984 2005/06; http://www.ombudsman.org.uk/pdfs/pensions_report_06.pdf; (retrieved 20 October 2008)

played in creating the position in which scheme members were unaware of risk, which thereby ignored a relevant consideration (paragraphs 5.82 to 5.94); and

- thirdly, that, in relation to the decision in 2002 by the Department for Work and Pensions to approve a change to the Minimum Funding Requirement basis, there was insufficient documentary evidence to explain the rationale for that decision - and that the Department for Work and Pensions appeared to have relied on professional advice which could not be sufficient in itself to enable the Department to come to a decision, as it should have done, that took account of all relevant considerations and which ignored irrelevant ones (paragraphs 5.95 to 5.150).[47]

The Ombudsman recommended that:

> the Government should consider whether it should make arrangements for the restoration of the core pension and non-core benefits to those scheme members covered by her recommendations[48]

3.1 Government's response

The Government rejected to the Ombudsman's findings of maladministration and accepted only the recommendation that there should be a review of the time taken to wind up schemes. The then Pensions Minister, Stephen Timms, said:

> In respect of the Ombudsman's specific findings the Government do not consider that any of the named leaflets or quoted statements could have formed a proper basis for scheme members, still less trustees who were professionally advised, to assess the security of their individual pension schemes. The leaflets were general and introductory in nature. They were not a full statement of the law. They made both those points clear. In addition, the Government believe that the report fails to demonstrate that decisions taken by individual scheme members were influenced by the information which the Government did, or did not, make available.
>
> As far as the 2002 decision on the Minimum Funding Requirement is concerned, the Government believe that we acted wholly responsibly in implementing the recommendation of the actuarial profession which had received the backing of the Government Actuary's Department.
>
> Against this background, the Government have considered carefully the Ombudsman's first four recommendations—which involve considering whether to restore the lost pension rights of affected scheme members, making consolatory payments and apologising to scheme trustees. As the Government are unable to accept the findings on which those recommendations are based and do not consider that it would be in the wider public interest for tax payers to fund all lost pension benefits we do not believe that it would be appropriate to take the action suggested.
>
> The Government do, however, accept the Ombudsman's fifth recommendation with regard to reviewing the time it takes to wind up a defined benefit pension scheme. Work is already underway in this area.[49]

In June 2006, the Government published a fuller response, explaining the basis for the conclusions it had come to in relation to the report.[50]

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[47] 'Guide to the Parliamentary Ombudsman's Report, 'Trusting in the Pensions Promise: Government bodies and the security of final salary occupational pensions', http://www.ombudsman.org.uk/pdfs/pensions_report_06_guide.pdf (retrieved 20 October 2008)

[48] Ibid

[49] HC Deb, 15 March 2006, c101-02WS

On 21 February 2007, the High Court delivered its judgment on an application for judicial review. It quashed the Secretary of State's rejection of the Ombudsman's first finding of maladministration (regarding official information) and directed the Secretary of State to reconsider the Ombudsman's first recommendation (that the Government should consider whether it should make arrangements for the restoration of the core pension and non-core benefits to scheme members):

> (a) The Secretary of State's rejection of the Ombudsman's First Finding of maladministration (consisting of the provision of misleading official information) is quashed;
>
> (b) The Secretary of State's rejection of the Ombudsman's First Finding, in so far as it went on to conclude that the maladministration which she had identified had caused injustice to all those individuals who had suffered losses on the winding-up of their occupational schemes during the relevant period, is upheld;
>
> (c) The Secretary of State's rejection of the Ombudsman's Third Finding of maladministration (relating to the change in the Minimum Funding Requirement in 2002) is upheld;
>
> (d) The free-standing claim under Article 1 of the First Protocol to the European Convention on Human Rights is dismissed;
>
> (e) The Secretary of State is directed to reconsider the Ombudsman's First Recommendation in the light of this decision.[51]

The Government subsequently announced extensions to the Financial Assistance Scheme, established to provide some compensation to members of schemes that started to wind up between 1 January 1997 and April 2005. This is covered in more detail in Library Standard note SN/BT/2010, *Financial Assistance Scheme – developments to 2007*

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50 DWP, 'Response to the Report by the Parliamentary Ombudsman. 'Trusting in the Pensions Promise', June 2006,

51 R v Secretary of State for Work and Pensions ex parte Bradley and Others [2007] EWHC 242 (Admin), para 92. http://www.bailii.org/ew/cases/EWHC/Admin/2007/242.html (retrieved 22 October 2008)