The Trustee toolkit downloadable

DB recovery plans, contributions and funding principles

Tutorial six: The Statement of Funding Principles (SFP)

By the end of this tutorial you will better understand:

- what the statement of funding principles is
- the timeframe within which the trustees are required to prepare the statement of funding principles
- what must be included in the statement of funding principles
- what trustees should consider what setting a transfer value policy
- what cash commutation factors are
- what early or late retirement factors are

This tutorial is part of Scenario three.

Glossary

A detailed glossary of technical terms can be downloaded from the Resources tab when you log in at www.trusteetoolkit.com

The Pensions Regulator

Statement of Funding Principles (SFP)

Trustees must prepare a SFP which is then reviewed, and if necessary revised, within 15 months of the effective date of each subsequent valuation. However, they may review and revise it at other times.

- Trustees prepare a SFP primarily to summarise the policy for meeting the statutory funding objective.
- Where the trustees have made decisions about the manner and period within which to eliminate a shortfall (the recovery plan) then these decisions must also be recorded in the SFP. The trustees should also record all of the assumptions used in setting the technical provisions. They may prepare the SFP in conjunction with the Statement of Investment Principles (SIP) so that the two remain consistent.
- Scheme members are entitled to see the SFP on request.
- The Pensions Regulator may also ask to see it.

Review of transfer payment policy

The tutorials in this module have already covered other items included in the SFP, except the policy on the payment of transfer values and the actuarial factors in use under the scheme. Trustees need to consider:

Assumptions

In order to establish the fair value of cash equivalent transfer values (CETVs), trustees need to agree the assumptions on which the calculations are based, having taken advice from the scheme actuary, and ensure they take adequate account of:

- any options available to members which will increase the value of the benefits (eg generous early pension benefits) considering the scheme's experience of whether or not members exercise those options
- any discretionary benefits (eg pension increases) if members have good reason to expect them to be paid

The assumptions are chosen so that a best estimate is calculated.

Deficits and the employer covenant

However, if the scheme is in deficit, and the employer covenant is weak, the trustees may decide to reduce the amount offered to people who want to transfer their benefits out of the scheme in order to protect the security of the remaining members. In these circumstances they must obtain an assessment from the actuary (an 'insufficiency report') which calculates the liabilities using a different set of assumptions.

If the trustees do pay reduced transfer values they must explain their policy on reduction in the SFP and include it in the information for members with any CETV quotation. It is worth noting that the SFP refers to CETVs but in common parlance the term 'transfer values' is used.

Example: Badger Industries

For example, take the Badger Industries scheme, which is 80% funded based on the transfer value assumptions.

Broadly speaking, this means that the scheme has assets that cover 80% of the value of all members' benefits on an 'insufficiency report' basis. So if a member were allowed to transfer 100% of his own liabilities calculated on this basis, the remaining members would be at a disadvantage.

What is more, if this situation were widely known, members could queue up to take a transfer value, before the trustees decide to reduce transfers to the lower basis.

Trustees' discretion

That is why trustees have the discretion to reduce transfer values when the scheme is significantly in deficit following the assessments from the actuary. However, they should not normally do so if the employer covenant is strong and the funding shortfall is being remedied over a reasonably short period. If they have such a policy, it is usually reassessed following each valuation.

Incentive exercises

Sometimes employers will top up the transfer value to the full amount if they wish to encourage deferred members to transfer out of the scheme in order to reduce its residual liabilities. Trustees should approach these incentive exercises with caution.

You will find more information in the Tutorial: 'Individual and bulk transfers' in the Module: 'Funding your DB scheme'.

Actuarial factors

On completion of the triennial valuation process, trustees also normally review the actuarial factors which are in use in the scheme. These include:

Cash commutation factors

For schemes that allow some pension benefits to be surrendered in favour of a lump sum. Cash commutation factors determine the amount of the lump sum available for each £1 per annum of pension given up.

Early and late pension factors

These determine the amount by which benefits are reduced or increased because they are paid before or after a scheme's normal pension age.