An Bord Pinsean – The Pensions Board

Review of the Funding Standard

Report to the Minister for Social and Family Affairs

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Chapter 1: Executive summary and recommendations

Background

1.1 The Pensions Act, 1990, as amended (the "Act") sets out a minimum Funding Standard for defined benefit schemes generally. This is a wind-up standard, based on the benefits a scheme is obliged to provide should the scheme be wound up. The Funding Standard defines the minimum assets that each scheme must hold, and sets out the rules that apply if a scheme falls short.

Many schemes are now having difficulty meeting the Standard. The Pensions Board (the "Board") has therefore reviewed the Standard and examined possible alternatives. This document sets out the results of that Review and the recommendations of the Board.

The Review covers:

- Why the Standard is now more difficult to meet;
- The recent short-term changes to the Funding Standard;
- The Pensions Board's recent experience of schemes that do not meet the current Standard;
- The objectives the Funding Standard should achieve;
- The options considered by the Board;
- The Board's recommended changes to the Standard; and
- Recommendations on other matters related to scheme funding and winding-up.

1.2 When the present Standard was introduced, it was not onerous, and most schemes had no problem meeting the Standard.

This is no longer true. The difficulties are partly because of the investment losses that many schemes have suffered since 2000. However, there are a number of other reasons why most schemes now find the Standard more demanding:

- When the Standard was first introduced, the Standard was more demanding for post-1991 benefits than for other benefits. At that time, these formed a very small proportion of total benefits, but this proportion has increased over time. Furthermore, all benefits must now be valued on this basis, and as a result, the Standard is higher;

- The current Funding Standard for pensions in payment is based on the cost of buying annuities from insurance companies. For a number of reasons, this cost is usually higher than the cost assumed in schemes' long-term funding calculations; and

- The Funding Standard is calculated using current Government bond interest rates. These are at historically low levels, and as a result, the Funding Standard is correspondingly high.

(See Chapter 3.1 to 3.11)

1.3 Under the general rules, schemes that do not meet the Standard have to restore full funding within 3½ years. In 2003, additional flexibility was allowed in anticipation of this Review. Schemes that do not meet the Standard wholly or mainly because of investment losses can apply to the Board for an extended period in which to restore full funding. Applications are granted on a case-by-case basis, and the maximum extension is normally 10 years. These changes were intended to be short-term, in anticipation of the review of the Standard.

(See Chapter 3.12 to 3.17)

Recent Experience

1.4 The following table shows the experience since the longer funding period was allowed:

	Funding certificate received	**Schemes satisfied Funding Standard**	**Schemes didn't satisfy Funding Standard**	
			Did not apply for extension	**Applied for extension /pending**
2003	484	408	56	20
2004 (to 5 Nov.)	549	317	148	84
Applied for funding period extension before funding certificate due			40	

(See Chapter 4.1 and 4.2)

1.5 Comments on the Board's experience of these applications and on the policy issues that arise are:

- Many schemes used the surpluses accumulated during the 1990s to improve benefits, grant pension increases, or to permit contribution holidays. As a result, the surpluses were not available to set against the investment losses experienced since 2000;

- The schemes included above represent about two thirds of defined benefit schemes subject to the Funding Standard. Although applications include schemes of all sizes and membership profiles, there is evidence that larger schemes are more likely to apply for a funding period extension;.

- The proportion of schemes satisfying the Funding Standard in 2004 fell sharply compared to 2003. The 2004 figures are broadly consistent with other information available to the Board, which indicates that 40-50% of schemes are failing to meet the Standard;

- Of the schemes that do not meet the Standard, over half intend to restore funding within 3½ years, i.e. they are not applying for an extended funding period;

- Although all schemes are facing increased contributions, so far, very few defined benefit schemes appear to have been closed to new entrants;

- Very few of the schemes that have applied for funding extensions have reduced member benefits or increased member contributions;

- All schemes that applied for funding extensions did so because of investment losses. However, it is clear that they were more vulnerable to the effect of those losses because of a number of factors, most importantly:

    - Almost all of these schemes are paying pensioners from the fund, even in the case of small schemes. However, in almost all cases, their investment policies have not been adjusted to take account of this;

    - Their investment policies do not reflect how much more demanding the Funding Standard has become since it was first introduced; and

    - In some schemes, members' earnings increased significantly, which increased the liabilities of those schemes.

- Some schemes have applied for longer funding periods because they had taken investment positions with relatively high risks and have

suffered losses. These schemes' failure to meet the Standard does not necessarily mean that the Standard needs to be changed; and

- The longer a period over which schemes are allowed to restore full funding, the more likely it is that members' transfer values will be reduced during that period. In addition, the members are more vulnerable if something should go wrong during that period.

(See Chapter 4.3 and 4.4)

1.6 It is important that any change to the Funding Standard be a long-term change. Defined benefit schemes are very long-term arrangements, and need stability in order to plan and invest to reflect their long-term commitments. Any regulatory change can add planning, compliance and administration costs. Any new standard should if possible be robust enough to cope with a wide range of economic circumstances, must be stable in its effect over time, and should comply with the European Union Directive on the activities and supervision of institutions for occupational retirement provision ("IORPs Directive") to avoid the need for subsequent corrective legislation.

(See Chapter 4.9 to 4.12)

Objectives

1.7 A funding standard must try to balance two objectives:

1. To safeguard the benefits that members have accrued to date; and

2. To encourage defined benefit provision.

The Funding Standard must also now abide by the provisions of the IORPs Directive.

If a funding standard provided absolute security to members, it would be so demanding and inflexible that it would be likely to end defined benefit scheme provision. On the other hand, a funding standard that has no effect from time to time, especially in terms of requiring increased contributions, is unlikely to be providing any useful protection to scheme members.

(See Chapter 5.1 to 5.6)

Possible Approaches

1.8 Member security can be achieved by advance funding, i.e. the accumulation of assets in advance of benefit payment, or by exit funding, which is an injection of assets from whatever source to cover any shortfall when a scheme is wound up. Security might also rely on a combination of both approaches.

Pension security in Ireland has always relied on advance funding, and the Board recommends that that this approach is continued.

(See Chapter 5.18 to 5.21)

1.9 Within the framework of advance funding, the Board considered six possible funding standards. In summary, the options considered were:

A Continue the current Standard, including the ‘short-term’ measures, modified for pre-retirement members;

B Set a new funding standard equal to a percentage of the current Standard;

C Modify the current Standard basis;

D Apply a short-term funding standard to a per member benefit limit;

E Use scheme specific funding; and

F Apply standard A for most schemes, but allow a modified basis for some schemes..

The Board decided after discussion to consider A, C, D and F further.

(See Chapter 6.1 to 6.9)

1.10 The criteria that the Board used in considering options were:

(a) The effect on members’ security in the event of a wind-up.

(b) The effect on the long term funding stability of a scheme.

(c) Equity among members.

(d) Whether the proposal would comply with the IORPs Directive.

(e) How radical a departure the proposal represents from the demands of the current Standard.

(f) The complexity of the proposal.

(g) How a proposal would affect the provision of defined benefit schemes.

(See Chapter 6.10 to 6.14)

Board recommendation

1.11 The Board decided after much discussion that its recommended option would be option A. This is the current Funding Standard, including the current provision for an extended funding period in some circumstances, together with a modification of the calculation of the Standard for active and deferred members.

In Chapter 6.25 to 6.31, the Board recommends that the grounds on which funding period extensions are granted should be extended. This recommendation should be considered as part of the recommended option rather than as a separate matter.

The Board also recommends that that the introduction of a State Annuity Fund be explored thoroughly because of the potential beneficial effect on the Funding Standard.

(See Chapter 6.19 to 6.31)

Related matters

1.12 As part of the Funding Standard Review, the Board considered a number of other matters:

- The Board recommends that in the wind-up of a scheme which provides index-linked or salary related pensions, the scheme trustees be allowed to purchase annuities with fixed increases of equivalent value where it is not possible or practical to buy pensions exactly as specified in the rules of the scheme.

(See Chapter 7.2 and 7.3)

- A majority of the Board recommends a change to the current order in which assets are allocated where a scheme is wound up with a deficit. Other members of the Board believe that no change should be made to the current order.

(See Chapter 7.4 to 7.14)

- The Board recommends that the legislation be changed so that the benefits on early retirement from underfunded schemes would require the consent of the Trustees of the scheme and/or could be reduced to reflect any funding deficiency, i.e. they are treated in the same way as transfers from such schemes are currently treated.

(See Chapter 7.15 to 7.22)

- The Board considered the question of making scheme shortfalls an employer debt if the scheme winds up, but does not recommend any change to the current legislation.

  (See Chapter 7.23 to 7.29)

- The Board considered the question of pension protection arrangements to top-up benefits when a scheme winds-up with a shortfall. There are many technical and practical issues to be considered, and the Board believes that it should be explored further, and proposes to consider it further in the medium term.

  (See Chapter 7.30 to 7.35)

Chapter 2: Introduction

Defined benefit schemes

2.1 At the end of 2003, there were 1,626 defined benefit schemes in Ireland, with over 480,000 employee members. Of these schemes, 1,541 are subject to the Funding Standard set out in the Pensions Act. These schemes have undertaken to provide benefits to over 230,000 current employees, to their dependants, and to many thousands of former employees and current pensioners. The remaining 85 schemes, containing almost 250,000 employees, are exempted from the requirement to meet the Funding Standard because their members are employed directly or indirectly by the State. A majority of members of defined benefit schemes are therefore in public service schemes not subject to the Funding Standard.

Defined benefit schemes are clearly a very important part of private pension provision, particularly because such schemes usually provide higher benefits than many defined contribution schemes. The Board believes that it is important that the provision of pension benefits through such schemes should be encouraged. The regulatory system must seek to balance the encouragement and maintenance of defined benefit schemes with appropriate safeguards for the members of these schemes.

2.2 The cost of providing defined benefits has increased for a number of reasons. The most significant include:

(a) The significant investment losses suffered by most if not all defined benefit schemes since 2000;

(b) Increasing longevity, resulting in pensions being paid for longer;

(c) Reduced investment return outlook, necessitating higher contributions; and

(d) Increased compliance costs

There is concern that the increasing cost may prompt some employers to close their defined benefit schemes, with inevitable consequences for pension adequacy and even coverage for many current and former employees.

2.3 The Funding Standard sets the minimum assets that a pension scheme must hold, and the Act defines the steps that must be taken to restore the finances of a scheme where it fails to meet this standard. By 2002, it was clear to the Board that many, possibly a majority of schemes were failing to meet the Funding Standard. Some pension practitioners expressed the view that the Standard itself might be contributing to the problems that schemes were

facing by setting the asset requirements too high, and failing to achieve the right balance between security and encouraging defined benefit pension provision. Although changes made in 2003 allowed some schemes longer periods to restore funding in certain circumstances, it was nonetheless felt that the Funding Standard should be reviewed.

Review of the Funding Standard

2.4 At its meeting on 1 November 2002, The Pensions Board decided to initiate a review of the Funding Standard as part of a long-term response to the difficulties being experienced by defined benefit schemes. Initially, this review took the form of an examination, commencing in January 2003, by an Expert Funding Group under the auspices of the Board's Policy Committee.

On 27 February 2003, the Minister for Social and Family Affairs, in an address to the Irish Association of Pension Funds, indicated that the Board had initiated a review of the Funding Standard, part of which would involve a consultation process.

Following an initial period of review, in July 2004 the Board published a consultation document on the Funding Standard. This document reviewed the Funding Standard and its background, identified a number of alternatives to the current Standard, and indicated its preferred approach, based on its considerations to date. The document also dealt with a number of related funding and other pension issues and invited views.

The consultation was addressed to all those with an interest in defined benefit pension provision, including trustees, sponsoring employers, scheme members as well as the various professional and practitioner bodies involved in the operation of schemes. It also included those in the wider community with an interest in defined benefit provision.

2.5 23 responses were received to the consultation, and these are summarised in Appendix 1. These responses were made both by individuals and by organisations, and encompassed a wide range of views. Many of the responses were extremely thorough and well-considered, and often lengthy, and the Board would like to record its thanks to all who took the trouble to contribute to the process.

2.6 Following consideration of the responses, the Board has recommended a number of changes to the current Funding Standard and to other aspects of pension legislation. These recommendations and the background are summarised in Chapter 1 of this document, and set out more fully in the succeeding chapters.

Chapter 3: Background

Funding Standard as in the Pensions Act 1990

3.1 Part IV of the Pensions Act, 1990 sets out a funding standard for funded defined benefit occupational pension schemes. This had its origins in the First Report of the National Pensions Board, which recommended that such a statutory minimum funding standard should be introduced. The key features of the Funding Standard are set out in Appendix 2. The Pensions Board has supervised the operation of the Funding Standard since its implementation. It has generally worked satisfactorily and has been a key element of the framework of member protection introduced by the 1990 Act.

The Funding Standard set out in the Act is a wind-up standard, which means that it obliges schemes to aim to hold assets that would be enough, if the scheme wound up, to meet the scheme's accrued liabilities. This would normally involve the scheme arranging for an insurance company to take over payment of benefits for pensioners, and paying a transfer value to another pension arrangement for people who had not retired. Under the original 1990 Act, a scheme not holding sufficient assets must plan to build up the scheme's funding to the required level within a period of no longer than 3½ years.

Changes to the Funding Standard, 1990 to 2002

3.2 Since the introduction of the Funding Standard, the following regulatory and actuarial issues have affected its impact on schemes:

- The Funding Standard requires schemes to provide limited revaluation on post-1991 service where the member leaves the scheme or the scheme is wound up. As a result, the Funding Standard liability for such benefits is higher than for benefits without revaluation. In the years immediately after the Standard was originally introduced, post-1991 service comprised only a small proportion of total service. However, the passage of time has increased this proportion, and as a result has increased the impact of the Funding Standard;

- The Funding Standard specifically requires a scheme to hold the actuarial value of benefits for each member. This actuarial value is defined in guidance note GN11(ROI), issued by the Society of Actuaries in Ireland. Originally, the actuarial value could vary scheme by scheme, but successive versions of the guidance note have made the method and basis of the calculation more and more specific. The result for many schemes has been an increase in the scheme's Funding Standard obligations; and

- In the original 1990 Act, schemes did not have to provide revaluation on pre-1991 benefits. However, since 2002, these benefits must be revalued. Although the impact of this change is not significant for many schemes, it has nonetheless further increased the burden of the Funding Standard on some schemes.

Impact on funding of recent economic/financial developments

3.3 The Funding Standard has now been in place for over ten years. Until 2000, few schemes had any difficulty meeting the Standard.

A number of factors, in particular economic and financial developments, have had an adverse impact on scheme funding over the last four years.

Value of Assets

3.4 There are a number of different measures of the investment performance of Irish pension schemes but they all suggest that typical performance for the four years to 31 March 2004 was approximately – 4% per annum. The first three years of this period averaged – 11% per annum followed by a market recovery in the final year with returns of approximately 23%. At the start of this period, many schemes were assuming that assets would return approximately 7% per annum. Accordingly, despite the improvement in returns in the last year, most actuaries were assuming that the assets in schemes at 31 March 2000 would by 31 March 2004 be worth about 50% more than was actually the case at that time.

This problem is compounded by the fact that scheme surpluses generated in the 1990s were often used to reduce contributions, to provide increases in pensions, to enhance early retirement benefits or to increase other benefits.

Value of Liabilities

3.5 The value of liabilities under the Funding Standard depends on interest rates. The reductions in interest rates in recent years have therefore resulted in increased liabilities. Although pensioner liabilities were always intended to be directly linked to current rates, it was not until early 2001 and the introduction of the Standard Transfer Value basis by the Society of Actuaries in Ireland that the Funding Standard liabilities in respect of active and deferred members became effectively linked to interest rates.

Pensioner Liabilities

3.6 Annuity costs are based on interest rates, mortality assumptions and expenses. Interest rate falls have resulted in higher costs for annuities. Insurance companies, on the basis of strong evidence from the U.K. and other countries and from their own annuity books, are also assuming people will live longer,

which has resulted in increased annuity costs. Expenses are normally charged as a percentage of the annuity cost so that, although the percentage charged for expenses and commission has not increased, the monetary amount of these expenses has increased in line with the increase in annuity costs.

3.7 In the last few years, more schemes have elected to pay pensions from the fund rather than purchase annuities as members retire. Previously, few small schemes would have paid pensions themselves. This change in practice has exposed schemes to investment and interest rate risk that many of them would not previously have borne.

Active Member Liabilities

3.8 Since pensions in most defined benefit schemes are a function of salaries, the relatively strong salary inflation in Ireland over the last decade has caused significant increases in pension liabilities. The average industrial wage increased by 6.5% per annum over the four-year period to the end of December 2003. Experience has been very varied across sectors but the average increase implies current salary levels are 6% higher than would have been expected four years ago.

3.9 Due to interest rate falls, transfer values have increased in recent years. For instance, between 1 April 2001 and 1 April 2004, typical transfer values would have increased by between 10% and 15% depending on the pension benefits provided.

Deferred Member Liabilities

3.10 Changes in economic and other circumstances have affected deferred member liabilities and transfer values in the same way as active member liabilities.

Movement between liability categories

3.11 Due to the closure of some schemes to new entrants, the general maturing of schemes, and less frequent annuity purchase, the balance of the liabilities in many schemes has moved from active members towards deferred members and particularly pensioners. Because the Funding Standard is relatively more expensive for pensioners than for active and deferred members, a shift towards pensioners has resulted in an increase in liabilities as assessed by the Funding Standard.

Short-term funding measures

3.12 A number of changes were made to the Funding Standard in 2002 and 2003. These are as follows:

- Additional Voluntary Contributions (AVCs) are now given first priority on winding up, ahead of pensions in payment and deferred and active members' accrued benefits. The current statutory priority order can be seen in greater detail in Appendix 3.

- Increased entitlements were given to early leavers. Previously, under the 1990 Act, early leavers needed more than five years' qualifying service to be entitled to a preserved benefit. However, for those leaving a scheme after 1 June, 2002, the requirement was reduced to only two years qualifying service. Also since 2002 the preserved benefit will now relate to all accrued service and not just post-91 service. Accordingly, the full accrued pension is now subject to revaluation.

- The Social Welfare (Miscellaneous Provisions) Act 2003 amended the Act to provide that transfer payments could be reduced if, in the actuary's opinion, the scheme would not satisfy the Funding Standard at the time of the transfer value. This has increased the administrative burden and the cost of running underfunded schemes but has enabled transfer values to be paid without diluting the interests of remaining members.

3.13 During the second half of 2002, the Board became aware that a number of employers were finding that the level of contributions needed to restore funding within the 3½-year period was more than they could afford. This reflected in large part the exceptional fall in global equity markets over the period 2000-2002 and the consequent fall in a scheme's funding level as compared with the Funding Standard. Concerns were expressed that the Funding Standard was forcing companies to make additional contributions to schemes over a relatively short timeframe in situations where the long-term funding position of a scheme was believed to be satisfactory.

It was felt that employers who had a genuine commitment to their defined benefit pension scheme in the long-term might find themselves unable or unwilling to pay the increased contributions necessary to restore their scheme to meet the Funding Standard in the shorter term. They might therefore decide to close the scheme or alter it to a defined contribution basis.

3.14 The Board discussed this issue with interested parties such as the Society of Actuaries in Ireland, scheme trustees, the Irish Association of Pension Funds, and the social partners. Following this discussion, the Board's views were that:

- its primary objective is to protect members' interests and in this context it should remain conscious that most pension schemes do not wind up and can be expected to continue and pay out their promised benefit entitlements;

- it wishes to avoid a situation where regulatory requirements would cause otherwise viable pension schemes to close or change from their existing defined benefit basis; and

- it should consider some flexibility in the area of allowing these otherwise viable pension schemes to have more time to get back into a position of meeting the Funding Standard.

3.15 In November 2002, the Board decided to recommend the introduction of a short-term response to the funding issues for defined benefit schemes.

In February 2003, the Minister for Social and Family Affairs responded to the Board's recommendation as to a short-term response. The Minister announced that the Social Welfare Bill 2003 would include provision to change the Pensions Act to allow the Board to respond, on a case-by-case basis, where schemes find themselves with funding difficulties wholly or mainly as a result of falls in global equity markets.

This change came into force in April 2003, following the enactment of the Social Welfare (Miscellaneous Provisions) Act, 2003. This change allowed scheme trustees apply to the Board for an extension of the usual period of 3½ years within which schemes must plan to meet the Funding Standard. The Board published guidelines on 14 August 2003 for scheme trustees who were considering applying for extensions under these measures. The maximum extension the Board was usually willing to consider was limited to 10 years from the date of the funding proposal.

3.16 Applications could only be made if certain conditions were satisfied. The most important of these was that the scheme actuary must certify that the failure to meet the Funding Standard was wholly or mainly a result of the fall in investment markets. In granting such applications, the Board must be satisfied that it is necessary or appropriate and not contrary to the interests of the members of the scheme for the scheme to be allowed a longer period to satisfy the Funding Standard.

3.17 Following intensive discussion and consultation, the Board subsequently agreed that additional flexibility should be granted, and published revised guidelines. These revised guidelines, which came into effect on 5 December 2003, indicate, inter alia, that while normal Board policy is to consider only extensions for up to 10 years, it will now consider applications for longer extensions in exceptional circumstances (see Appendix 4 for the most recent guidelines).

Review of Funding Standard to apply going forward

3.18 Because of the problems that many schemes were encountering in meeting the requirements of the Funding Standard, the Board decided in November

2002 that a long-term response to the funding issues for defined benefit schemes should be considered. This was effected by requesting the Board's Policy Committee to prioritise their examination of the Funding Standard.

Terms of Reference for consideration of a longer term response were agreed in December 2002, and the Board established a Funding Standard Expert Group to take this work forward. The terms of reference for the Expert Group and its membership are set out in Appendix 5.

Most importantly, the long-term solution should be practical taking account of the trade-off between reserving in the long term for pension benefits whilst proving solvency regularly to ensure any potential problems can be identified as early as possible.

Findings of Expert Funding Group

3.19 In taking forward their work, the Expert Group appreciated that there were a number of constraints in meeting their key objective, notably:

a) the wind-up focus of the current Funding Standard;

b) the nature of Irish private sector defined benefit pension schemes – in particular the large number of small insured schemes – which pointed to the need for a degree of prescription of the details of any reshaped funding standard. A standard that did not specify to some extent the actuarial methods and assumptions to be adopted would not be appropriate; and

c) the IORPs Directive that was subsequently published on 23 September 2003, and which must be transposed into Member States' national legislation before 23 September 2005.

3.20 The Group met four times in Spring 2003 and considered a number of options for amending the Funding Standard – the three main options are set out below. These options move progressively further away from the wind-up approach of the current Funding Standard.

Option XG1

- review the requirement that, for pensioners, the Funding Standard liability should be assessed having regard to actual annuity rates – an alternative might be to prescribe in actuarial guidance parameters that would allow an appropriate estimate of the cost of providing the benefits to be made.

Option XG2

As option XG1, but in addition:

- amend the requirement in actuarial guidance so that, for non-pensioners, the calculation of transfer values that forms part of the Funding Standard assessment should have some regard to assumed returns on equities rather than being wholly related to assumed returns on Government stock.

Option XG3

- A third option might involve less emphasis on the ‘wind-up’ focus of the current Funding Standard. For example, the Society of Actuaries in Ireland could specify a framework of actuarial methods and assumptions that would have to be used to assess the funding position of schemes on an ongoing approach. These assumptions would include an allowance for future salary increases, and might not necessarily look to actual – or estimated – annuity costs for pensioners. The specified assumptions would have to be reviewed on a regular basis. The Society’s guidance in this area might require actuaries to illustrate the sensitivity of the scheme’s funding position under alternative assumptions, thus testing the resilience of the scheme’s funding in different scenarios. There would also have to be some specification of the period over which any funding shortfalls should be made good.

After careful consideration, the Group concluded that Option XG1 should be explored further, and recommended that consideration be given to changing the framework of legislation and associated actuarial guidance on this matter. However, this conclusion was not unanimous in that one member of the Group had a strong preference for Option XG3.

3.21 The Group considered that, where a Funding Proposal is called for, the usual timescales for planning to meet the Funding Standard – generally 3½ years - should not be amended. An initial step might be to invite the Society of Actuaries to consider the feasibility of developing appropriate actuarial guidance. Members of the Group had varied views on Option XG2. However, the Group recommended that the Society of Actuaries be asked to review the framework for the calculation of transfer values in the light of developments since that framework was put in place.

3.22 Option XG3 could limit the flexibility currently afforded to the actuary in determining the actuarial method and assumptions used to assess the scheme’s funding in the long-term on an ongoing basis. It also represented a significant departure from the rationale of the current Standard. Accordingly, the Group did not feel that there were strong grounds for pursuing this option

further as a replacement for the current Standard. However, it was considered that there might be merit in amending actuarial guidance to require the sensitivity of the scheme's ongoing funding position to be included in actuarial valuation reports.

3.23 The recommendations of the Group on funding issues are summarised below:

a) the current requirement that, for pensioners, the Funding Standard liability should be assessed having regard to actual annuity rates should be reviewed;

b) the Society of Actuaries in Ireland should be asked to review the framework for the calculation of transfer values in the light of developments since that framework was put in place;

c) as part of each regular actuarial valuation, the scheme actuary should be required to quantify the impact of the scheme's priority order under the current Funding Standard – as affected by the overriding statutory priority order – on the different categories of benefit, had the scheme wound-up on the effective date of the valuation. Legislation should be introduced to require the results of these calculations to be communicated to members through the first trustee annual report issued after the results of the actuarial valuation have been obtained; and

d) the Society of Actuaries should consider amending actuarial guidance to require the sensitivity of the scheme's ongoing funding position to be included in actuarial valuation reports.

The findings of the Expert Group were considered by the Board as part of the Funding Standard Review.

Developments in selected other countries

3.24 Chapter 3.3 to 3.11 above set out how scheme funding in Ireland has been affected by financial and demographic developments in recent years. These developments have also affected other countries. In part, these have prompted changes in those countries' minimum funding standards. This section illustrates this by reference to the United Kingdom, the Netherlands and the United States.

United Kingdom

3.25 The Pensions Act 1995 introduced a Minimum Funding Requirement ("MFR") that applies to most private sector defined benefit schemes in the U.K. The original rationale of the MFR was that schemes should hold assets that would be sufficient, if the scheme were to wind up, to enable pensions in payment to be secured with an insurance company and to give those who had

not retired a transfer payment that would give those individuals a reasonable expectation that they would receive the benefits that they had built up in the scheme. The MFR was not designed to offer a guarantee that all members' benefits could be fully secured in the event of the scheme winding up.

Detailed requirements and actuarial assumptions for the calculation of a scheme's MFR liabilities are set out in regulations and actuarial guidance. The aim is that, in general, two actuaries undertaking an MFR valuation for the same scheme will obtain results that are virtually identical. The MFR liability for pensioners is worked out by discounting future pension payments by reference to returns on U.K. Government stock, with the liability for younger members being discounted by reference to assumed returns on U.K. equities. MFR actuarial valuations must be carried out at least every three years. If the valuation shows that the market value of a scheme's assets does not meet the MFR target, the scheme must plan to pay additional contributions to meet a 90% MFR funding level within three years, and a 100% MFR funding level within ten years.

The MFR came into force in April 1997. It has been criticised as being too inflexible – for example, the actuarial assumptions underpinning the MFR cannot be adapted readily to take account of financial and demographic changes. There was also concern that a 'one size fits all' standard could not take account of the particular circumstances of each scheme, and that the use of Government bond/equity returns to discount liabilities could constrain a scheme's investment policy. It is also clear that many scheme members thought that the MFR gave a greater degree of protection than that it was designed to provide.

In March 2001, the U.K. Government announced that the MFR would be abolished, and replaced with a scheme-specific funding approach that would allow schemes to determine the funding strategy that was most appropriate to their particular circumstances. There will be no prescribed statutory minimum standard. Instead, there will be more emphasis on the role of the trustees, and regular communication with scheme members about the funding of their scheme. The trustees will work to agree a funding strategy with the sponsoring employer, having taken advice from the scheme actuary. This will have to be set out in a statement of funding principles that will be made available to the scheme members. The trustees will be required to determine, on actuarial advice, the method and assumptions used to assess the value of the scheme's accrued pension commitments. Where an actuarial valuation shows that a scheme is underfunded on the scheme-specific approach adopted, it will be for the trustees to agree with the employer the period over which the scheme should plan to restore funding.

Outline legislation on scheme-specific funding was set out in a Bill published by the U.K. Government in February 2004. This Bill was enacted in November 2004. Much of the detail will be set out in regulations at a later

stage, to allow for full consultation. The detailed framework will reflect the provisions of the IORPs Directive, while retaining the key elements of the scheme-specific approach – for example, it is not intended to prescribe the actuarial assumptions that must be used.

The Netherlands

3.26 From 1 January 2000, a revised minimum funding standard was put in place, which requires that the market value of a scheme's assets is at least equal to its accrued liabilities. These accrued liabilities are worked out on the basis of a 4% p.a. discount rate, with no allowance for future salary growth or staff turnover. A ten-year transition period was allowed, with schemes having to be fully funded thereafter at all times on this test.

On 30 September 2002, the Dutch pension supervisor proposed, in addition to this test, a requirement for schemes to hold additional reserves of 30% of liabilities. Schemes have 15 years to achieve this funding level of 130%, but if they fall below 100%, must return to at least 100% funding within one year.

U.S.A.

3.27 Minimum funding rules in the U.S. are overseen by the US Internal Revenue Service, which is part of the U.S. Treasury Department.

These rules require a comparison to be made between the 'actuarial value' of a scheme's assets (which need not be the market value) and the actuarial value of the scheme's accrued liabilities, using a prescribed discount rate.

Until recently, the discount rate had to fall in the range of 90% to 120% of the four-year weighted average yield on 30-year US Treasury bonds. Recently the prescribed discount rate was changed for scheme years starting in 2004 and 2005. The discount rate is now permitted to fall in the range 90% to 100% of the four-year weighted average composite corporate bond rate. The effect is to make the funding test somewhat less demanding.

If the comparison between the scheme's assets and accrued liabilities shows that the scheme is less than 90% funded, generally additional contributions must be made to restore funding.

IORPs Directive funding requirements

3.28 Articles 15, 16, and 17 of the IORPs Directive deal with funding requirements, and the text of these articles is set out in Appendix 6. Taken together, these Articles provide for the funding framework set out below. The Directive also allows schemes to operate on a 'cross-border' basis, i.e. a scheme in one Member State may cover employees of a company in another

Member State, including where there are employees in more than one Member State.

3.29 Broadly speaking, defined benefit schemes must work out their ‘technical provisions’ on a regular basis. The term ‘technical provisions’ is not explicitly defined in the IORPs Directive. However, the provisions of Article 15(4)(a) point to technical provisions being equivalent to the actuarial value of a scheme’s accrued liabilities – in other words, the amount of money that would be needed now that, on the basis of the actuarial assumptions adopted, would enable the scheme to pay, as they fell due, the pensions of those who have retired and the accrued entitlements of those not yet retired.

The calculation of the scheme’s technical provisions must generally be made by an actuary, on the basis of recognised actuarial methods.

The actuarial assumptions used to make this calculation – both financial and demographic – must be chosen prudently. The assumptions may incorporate a greater degree of caution if that is considered appropriate.

In particular, the discount rates used to value the scheme’s liabilities must be chosen prudently, having regard to the anticipated yield on the assets that the scheme holds (for example, equities) and/or the yields available on Government or high quality corporate bonds.

3.30 A scheme’s technical provisions must be calculated once a year. However, a calculation may be made every three years provided that, in the intervening years, the scheme reports to members and/or the pensions supervisor on broad changes in the technical provisions and on changes in the risks covered by the scheme. Changes in the method and assumptions used to work out the technical provisions from year to year may be made if they can be justified by reference to changes in legal requirements or in the light of changes in financial or demographic circumstances.

3.31 Schemes must have ‘at all times sufficient and appropriate assets’ to cover their technical provisions. Where a comparison of the scheme’s assets and technical provisions shows that the scheme does not satisfy this requirement, it is not necessary for immediate action to be taken to restore funding, if the scheme does not operate on a ‘cross-border’ basis. The scheme is, however, required to put in place a plan to restore funding ‘in due time’. This plan must reflect the particular circumstances of the scheme. It must be made available to scheme members and/or be subject to approval by the pension supervisor.

3.32 If the scheme winds up during the period of the plan, the scheme must inform the pension supervisor, notifying both the supervisor and scheme members of the arrangements being made to discharge the assets and liabilities of the scheme.

3.33 A scheme that operates on a 'cross-border' basis is required 'at all times [to] be fully funded'. If a scheme fails to meet this requirement, the pension supervisor is required to take action.

3.34 Article 17 sets out additional funding requirements ('regulatory own funds') which must be met where, broadly, a scheme itself provides a guarantee of benefits. The 'regulatory own funds' held must be calculated in accordance with the relevant life insurance requirements.

The usual situation in Ireland is that the security of scheme benefits is provided by both the assets held by the scheme and by the support of the sponsoring employer, rather than the scheme in isolation, and so this article will have no effect.

3.35 It should be borne in mind that there are still some areas of uncertainty in the interpretation of the IORPs Directive.

Chapter 4: Policy considerations

Assessment of short-term measures

4.1 There is no comprehensive database in existence of the funding situation of Irish defined benefit schemes. The Board must rely on other sources of information.

Under the terms of the 2003 changes detailed in 3.15 to 3.17 above, schemes can apply to the Board for an extension to the 3½-year period over which the scheme must normally restore funding to 100% of the Standard. The information provided with these applications gives some insight into the current position of defined benefit schemes.

4.2 The table below summarises the Board's experience of funding certificates and proposals from the beginning of 2003 to 5 November, 2004.

	Funding certificate received	**Schemes satisfied Funding Standard**	**Schemes didn't satisfy Funding Standard**	
			Did not apply for extension	**Applied for extension /pending**
2003	484	408	56	20
2004 (to 5 Nov.)	549	317	148	84
Applied for funding period extension before funding certificate due			40	

Of the 56 schemes which didn't apply for an extension in 2003, 49 have submitted 3½ year proposals (which do not require specific Board approval), and the remaining 7 have such proposals pending.

Of the 148 schemes that did not apply for a funding period extension in 2004, 103 have submitted 3½ year proposals and a further 25 have such a proposal pending. The remaining 20 encompass a variety of situations, including schemes where the employer has injected sufficient cash or assets to restore funding immediately, schemes in the process of merging with another defined benefit scheme, and cases where winding-up is being considered.

There is a time interval of up to 9 months between the date on which the funding position is calculated and the date by which a funding certificate is due, and this should be borne in mind when considering the above figures.

4.3 Comments on the Board's experience are:

- At the end of 2003, there were 1,541 defined benefit schemes subject to the Funding Standard. The above schemes therefore represent about two thirds of all such schemes;

- The proportion of funding certificates submitted which satisfied the Funding Standard fell significantly in 2004 in comparison to 2003;

- Before applying to the Board for a funding extension, scheme trustees must agree a funding plan with the sponsoring employer and the scheme actuary. This can involve a considerable amount of negotiation. There may be some schemes where this negotiation is ongoing. Taking this into account, the 2004 proportion of approximately 55% meeting the Standard appears broadly consistent with other anecdotal evidence of a proportion of about 40-50%;

- In 2004, more than half schemes failing to meet the Standard intend to restore funding within 3½ years, i.e. without taking advantage of the 2003 short-term measures. This proportion again seems broadly consistent with other evidence available to the Board;

- All schemes applying for funding extensions are facing significant contribution increases, even taking account of the longer period. However, only a minority of schemes are increasing member contributions, and only a small minority of such schemes are reducing benefits. So far, the Board is not aware of significant numbers closing to new members, but there is anecdotal evidence of an increasing trend;

- The Board has no evidence to date of any noticeable number of defined benefit schemes being wound up as a result of a failure to meet the Funding Standard. However, it is aware that such closures may be delayed, and may depend on whether markets recover and/or interest rates increase;

- The applications for funding extensions include all sizes and membership profiles, but on average, larger schemes are somewhat more likely to apply for an extension;

- Approximately half of the schemes granted funding extensions are contributing no more than the long term funding rate calculated in the most recent valuation of the scheme. This long-term rate is the minimum rate required to maintain the benefits of the scheme, and the Board will not grant funding extensions where the proposed contribution is less than this rate. The implication of contributing

only the long term rate is that contributions would not be reduced even if the Funding Standard were weakened;

- Very few of the schemes applying for extensions indicated that they intended to change their investment policy; and

- As well as suffering the impact of investment losses, almost all the schemes applying for funding extensions fall into one or both of the following categories;

  (a) Schemes that are paying pensioners from the fund (rather than buying annuities with an insurance company at the member's retirement) and have chosen to match part of those pension liabilities with equity investment;

  (b) Schemes whose active members have received relatively high average pay increases (i.e. over 9% p.a.) in the period since the previous valuation, and, as a result, whose pension liabilities have increased proportionately over a period where the scheme's investment return was usually negative.

4.4 The policy considerations that occur from the above experience are:

- During the 1990s, defined benefit schemes typically enjoyed regular surpluses. In many cases, these surpluses were applied to improving benefits, granting pension increases, or to contribution holidays. As a result, the surpluses were not available to set against the investment losses experienced since 2000;

- Some of the schemes that have failed to meet the current Funding Standard have taken investment positions with relatively high risks and this has resulted in losses. These schemes' failure to meet the Standard is not automatically evidence that the Standard needs to be changed;

- All schemes that have applied for funding extensions have certified that they would have met the current Standard but for investment losses. However, such schemes were made more vulnerable to those losses by a variety of factors:

  - Their investment policies did not take account of the effect on the Funding Standard of the issues described above in Chapters 3.2 and 3.3.

  - Many schemes did not change their investment policies despite an increase in the proportion of their liabilities represented by pensioners.

  - Benefit increases were granted at a time when the schemes were in surplus.

  - Members' earnings increased significantly in some schemes, which increased the liabilities of such schemes.

- Although relatively few employers have decided to close their defined benefit schemes, the increased contributions they are obliged to pay to meet the Funding Standard are likely in some cases to represent a longer-term threat to the future of those schemes;

- Almost all schemes applying for funding extensions are currently paying pension benefits, irrespective of their size. Because the current Funding Standard usually puts a higher value on pension liabilities than the ongoing valuation basis, such schemes have smaller margins between their assets and the Standard. As a result, they are more likely to fail to meet the Standard in times of poor investment returns. Any review of the Standard must consider this pensioner issue;

- It must be remembered that the longer period of time within which schemes may be allowed to achieve the Funding Standard means that there is a longer period over which members' benefits are not fully funded and therefore liable to reduction in the event of a transfer out of the scheme or if the scheme is wound up; and

- Because so few schemes seem to intend to change their investment policy, the current Funding Standard even in the light of recent investment conditions does not seem to be acting as a constraint on scheme investment freedom.

Impact on funding of economic/markets recovery (to date and future)

4.5 The recovery of the equity markets over the last year has helped to provide some relief for the funding problems. However, expectations that such good performance will continue into the near future and thereby quickly resolve the still significant funding deficits are being optimistic. The asset side of the problem can be solved by a number of years of good equity returns. However, this will not have any impact on the liabilities.

4.6 Active and deferred member values under the Funding Standard are calculated using Euro long bond yields. These yields are still at historically low levels. As a result, Funding Standard liabilities are at historically high levels. If these interest rates increased, these liabilities would be reduced. However, it is possible that an increase in interest rates might at the same time cause a fall in the value of scheme assets.

4.7 Some schemes may have moved to lower risk, more matched positions by investing more of their assets in bonds. Although this reduces the risk in the scheme, it also crystallises the underfunded position. Such schemes would have removed the possibility of the scheme benefiting from interest rate increases to the same extent as they suffered as interest rates fell. These schemes were mismatched as interest rates fell and are more matched as interest rates are expected to rise. Any additional focus on risk is to be encouraged but there must also be a realisation that a return to "normal levels" for stock markets and interest rates will not rectify the solvency issue.

4.8 The continuous improvement in life expectancy means that pensions are becoming more expensive and this trend is expected to continue. Therefore, the value of liabilities under both the Funding Standard and the scheme's valuation basis will continue to increase.

Need to comply with IORPs Directive

4.9 The essential requirements of the IORPs Directive, set out in Chapter 3.28 to 3.34 above, set a framework within which the Review of the Funding Standard must operate.

4.10 The particular criteria that any revised funding standard should meet in order to be compliant with the Directive are summarised below.

Scope: broadly speaking, private sector defined benefit schemes are subject to the funding provisions of the IORPs Directive.

Frequency of actuarial valuations: a scheme's regular actuarial valuation is the natural context for the calculation of a scheme's technical provisions. The IORPs Directive provides for such actuarial valuations to be carried out on an annual basis. However, it does allow valuations to be undertaken every three years, in line with general practice in Ireland, if the scheme undertakes an interim assessment of the scheme's technical provisions in each year between full actuarial valuations. Under the current Funding Standard provisions, a scheme's actuary has to check each year between full actuarial valuations whether the scheme continues to satisfy the Funding Standard. The result of the actuary's investigations must be included in the scheme annual report. Such a process could serve as a basis for the annual interim assessments that the Directive requires.

Calculation of a scheme's technical provisions: as explained in Chapter 3.29 above, a scheme's technical provisions may be taken to correspond to the value placed on the scheme's accrued liabilities, on the basis of the actuarial method and assumptions adopted for this purpose. To ensure compliance with the IORPs Directive the calculation must use an actuarial funding method that is specified in the pension regulatory framework, and must also satisfy the principles set out in Article 15(4) of the Directive. A critical

aspect of these principles is that they must be subject to approval by the pension regulator, and meet the requirement of the Directive that the method and assumptions are prudent.

Scheme funding target: irrespective of the way in which technical provisions are defined, the general obligation of the IORPs Directive is that the assets held by the scheme should ‘at all times’ be at least equal to those technical provisions. Provided that a scheme is not operating on a ‘cross-border’ basis, the Directive does allow some departure from this stringent requirement ‘for a limited period of time’. If the scheme’s assets fall short of the technical provisions, the scheme must put in place a plan to eliminate the funding deficit. This plan must be made available to scheme members and/or subject to approval by the pension supervisor, and must reflect the particular circumstances of the scheme. The current provision for a funding proposal to be prepared where a scheme does not satisfy the Funding Standard would appear to go some way to meeting this requirement. The period within which the scheme would have to plan to restore funding would have to meet the IORPs Directive’s requirement for this period to be ‘limited’.

Full funding for cross-border schemes: the requirement for cross-border schemes to be fully funded at all times is very onerous. Indeed, the dynamics of defined benefit schemes are such that it is well nigh impossible to satisfy this test, unless the scheme holds very substantial reserves over and above the technical provisions, as demonstrated by the regulatory framework in the Netherlands (see Chapter 3.26 above). One option might be to require that cross-border schemes carry out a full actuarial valuation every year, and to require that any shortfall identified be eliminated within a short timescale – for example, within a year of the valuation being obtained. This is broadly similar to the current framework in the Netherlands.

Schemes that themselves guarantee benefits: where, exceptionally, the scheme, and the scheme alone, guarantees the benefits provided by the scheme, the IORPs Directive requires the scheme to maintain additional reserves as required under life insurance Directives. It is not envisaged that this requirement will apply to any schemes in Ireland.

Need for regulatory stability

4.11 The time horizon for pension planning and investment is very long: a newly hired employee could be a member of a pension scheme for up to 70 years.

Defined benefit schemes are likely to be more affected by regulatory change than are defined contribution arrangements. Regulatory change imposes immediate advice and administrative costs, even if no change to the scheme results. Such change may make benefit revisions necessary or desirable, and

it can also make long-term investment planning difficult. Almost all regulatory change can therefore discourage defined benefit pension provision.

4.12 Any change implemented to the current Funding Standard must be designed as far as possible to avoid the need for any further change for the foreseeable future. The following considerations must therefore be taken into account:

- The new standard must be robust enough to cope with a wide range of future economic situations;

- The standard must be stable over time, and not liable to systemic increase over time such as happened during the 1990s as post 1991 benefits formed an increasing proportion of scheme liabilities;

- It must be compliant with the IORPS Directive as far as possible so as to avoid the need for substantial corrective legislation;

- All details of the planned changes must be decided and, where necessary, agreed before any legislation is enacted; and

- In future, more account must be taken of the direct and indirect effect that changes to the Act and actuarial guidance may make to the Funding Standard obligations of individual schemes.

Key objectives underlying the Funding Standard

5.1 The purpose of this Review is to recommend a standard that balances the following objectives:

(a) Protection of the accrued rights of scheme members

(b) Encouragement of continued provision of pensions through defined benefit schemes

The Funding Standard must also comply with the IORPs Directive.

5.2 The objective of any funding standard is to provide security for defined benefit scheme members for the entitlements they have built up. However, a funding standard must balance that objective against the constraints and costs it imposes on the funding of schemes.

5.3 The underlying cost of a defined benefit scheme is determined by the benefits provided by the scheme and the investment returns earned on the contributions. It is not determined by the Funding Standard. Therefore, the only (though potentially significant) effect of a funding standard may be to change the timing of the contributions made to the scheme.

However, in practice, a funding standard is likely to affect the costs of a scheme in two ways:

(a) the operation of a funding standard may constrain directly or indirectly the investment freedom of a scheme. As a result, the returns may be lower than they would otherwise be, and the contributions consequently higher.

(b) meeting the requirements of a funding standard may impose a compliance and administrative cost. These costs can be considerable, particularly in the case of smaller schemes.

Furthermore, the effect of a funding standard on the timing of the employer's required contributions must not be underestimated. If the employer's contributions are subject to unpredictable increases that put pressure on an employer's cash flow and competitiveness, the employer will become less committed to defined benefit pension provision.

5.4 No funding standard can provide absolute security. The closer a standard approaches absolute security, the more of a disincentive it becomes to the defined benefit provision it seeks to protect. Conversely, a standard that has

no impact on the management of a scheme is unlikely to be providing much, if any, useful additional protection for members. However, some reduction in the current Standard might reduce the pressure on defined benefit provision, and in extreme cases, forestall a scheme being wound up.

A funding standard could provide absolute security by setting the standard at an amount equal to the market cost of replacing members' benefits, and requiring this value to be held at all times. This would be an unrealistically restrictive standard, and would allow little or no funding or investment flexibility. In practice, such a standard would mean the end of defined benefit provision, and so would not achieve the objectives of this Review.

5.5 A practical funding standard differs from an absolute standard as described above in two ways:

(a) By reducing the amount that must be held in respect of the benefits of each scheme member; and/or

(b) By setting a period over which schemes which fail to meet the standard are allowed to restore funding to the required level.

The first fundamental decision to be made about the Funding Standard is how close to full buy-out the Standard should be set. Once a view has been taken about an appropriate level of protection, it must then be decided how long a period will be allowed to schemes to achieve this standard. These two decisions do not depend on actuarial or technical factors, but are the policy decisions that underlie the Standard.

5.6 There are a number of further considerations against which any revisions to the Funding Standard may be judged, within the overriding framework of the IORPs Directive:

A clearly defined and meaningful objective that can be readily understood by scheme members. For instance, a funding standard that does not guarantee scheme benefits must not be thought by members to do so.

A transparent approach that is straightforward to apply. This is of particular relevance in Ireland, given the large number of small insured schemes.

Allowing employers to meet funding requirements in a regular and controlled way. The reason why the exceptions were allowed to the general funding requirements in 2003 was the relatively short timescales over which underfunding originally had to be eliminated and the resulting volatility of contributions.

The need to avoid investment distortions. If the Funding Standard is too restrictive, and particularly if the time allowed to restore full funding is short, the Standard will constrain the investment policies of schemes.

Review of effectiveness of the current Standard in meeting key objectives

5.7 There is a widespread perception among many people involved with pensions that the current Standard may not be achieving an appropriate balance among the objectives identified in the previous Chapter. This Review is itself evidence of this perception.

5.8 Before deciding to change the Funding Standard, it is worth considering why schemes are facing increased contributions. There are at least four potential reasons:

(a) The underlying cost of the scheme could have increased due to increased longevity, increases in benefits and/or increased member salaries;

(b) The scheme's investments may, with hindsight, have been inappropriate;

(c) The Standard may be working as intended, and requiring appropriate extra contributions because of investment losses; and

(d) The Standard may not be working as intended, and it may be obliging unnecessary short-term contribution increases.

5.9 The most frequent criticism of the current Standard is that it too high, i.e. it is emphasising wind-up protection at the expense of stable ongoing funding of the scheme. For the reasons set out in Chapters 3.2 above, the Funding Standard liabilities of all schemes are now a much higher proportion of ongoing valuation liabilities than they were at the introduction of the Standard in the early 1990s.

5.10 In assessing the current Standard's effectiveness, we should be aware of a potential imbalance in the assessment. The effects of the Standard on investment and on contribution rates are issues that scheme trustees and their advisers will be made aware of at least every three years when the scheme's valuation is prepared. In recent years, the Standard has been an issue every year because the trustees' annual report must include an opinion from the scheme actuary as to whether the scheme would or would not meet the Standard at the date of the report.

In contrast, the protection that the Standard offers to members is only fully apparent in the relatively rare instances where a scheme is wound up. However, this should not mean that the protection offered by the Standard is seen as less important than the constraints it imposes on defined benefit pension provision.

5.11 For most of the period since the current Funding Standard was introduced, conditions for defined benefit schemes were on balance extremely benign.

For many years, investment returns enjoyed by pension schemes' assets were very good, and the real returns were usually in excess of what were assumed in their valuations. As a result, for much of the period, schemes recorded regular surpluses, and meeting the requirements of the Funding Standard was not an issue. Although investment results have been poor since early 2000, the effect of this on compliance with the Funding Standard is still emerging, as was discussed in Chapter 4.2 above. Nonetheless, it should be remembered that failure by schemes to meet the Standard is not always per se a failure of the Standard.

5.12 In relation to the objectives identified in Chapter 5.1, a description of the effectiveness of the current Standard is as follows:

Protection of accrued rights

5.13 Members' accrued rights can be said to be protected if:

- In the event that their scheme winds up, they are provided with reasonable alternative benefits or transfer values; and
- If in the event of a transfer out from an ongoing scheme, they receive a reasonable transfer value, and this value is not reduced because of the scheme's funding position.

As will be seen in Chapter 6 below, there is no agreed definition of what is a 'reasonable' benefit on wind-up or transfer. However, the Board would tend to the view that the current standards for scheme members, whether retired or not, are at the higher end of the range of likely standards.

5.14 There are no statistics available on the number of schemes winding-up with a shortfall, or on the number of members receiving transfer values which are reduced. Nonetheless, the following points can be noted:

- The Board believes that there have been very few schemes wound-up where members' benefits are reduced. However, a period of strong economic growth combined with high investment returns is the time when this is least likely to occur. There is likely to be a time lag before the change in climate since 2000 manifests itself in an effect on schemes. Nonetheless, there is no evidence at present of any significant issue in the short term;
- Until 2002/2003, schemes were not allowed to reduce transfer values to reflect the schemes funding. However, before 2000, there would have been very little occasion to do so. It appears that, at the time of writing, about half of all schemes could do so, though not all schemes reduce values even when permitted by law to do so; and

- When schemes are granted an extension to the date by which they must meet the Standard, this extends the period during which members' benefits are less protected on wind-up or transfer. The result of the 2003 changes is therefore likely to be that more members will not receive their accrued benefits as currently defined over the coming years.

Encouragement of defined benefit pension provision

5.15 Appendix 7 compares the membership of defined benefit schemes subject to the Funding Standard at the end of 1991 with the end of 2003. A summary of the results is:

- The numbers of active members have increased by 21% from 189,948 to 230,685;

- The active membership as a percentage of those employed has fallen from about 17% to 12%. The percentage as a proportion of those employed in the private sector (which is where most defined benefit schemes subject to the Standard are found) has fallen from approximately 21% to 15%; and

- The number of defined benefit schemes subject to the Funding Standard has fallen from 2,514 to 1,541. The decline has been greatest among smaller schemes – the number of schemes with less than 50 members has fallen from just under 2,000 to 1,029. The average number of members per scheme has increased from 76 to 150.

The 21% increase in membership over the period compares very well with experience in the U.K. and the U.S., which have a broadly similar pensions provision regime. Furthermore, the percentage coverage has fallen in a period where total employment in Ireland increased by 64%.

The proportionately greater compliance costs for smaller schemes as well as their greater vulnerability to investment and other variations contributed to the reduced number of small defined benefit schemes. The lower number of schemes also reflects the reluctance of employers to set up new defined benefit arrangements. This is partly a consequence of the Funding Standard and the changes since it was first introduced. It is also partly because employer contribution rates to typical defined contribution schemes are in most cases lower than for typical defined benefit arrangements: in the period since 1991, the number of defined contribution schemes has increased from 33,440 to 110,972, and the number of active members of such schemes from 81,567 to 241,302.

Compliance with the IORPs Directive

5.16 The current Funding Standard is believed to be generally compliant with the IORPs Directive, though some changes of detail will be required.

Other considerations

5.17 Brief comments on the other considerations raised in Chapter 5.6 are:

A clearly defined and meaningful objective that can be readily understood by scheme members

Under current regulations, schemes are not obliged to inform members of the current funding status of their scheme, though the information must be provided on request. Once the information is available, it is probably reasonably understandable.

A transparent approach that is straightforward to apply

The current Funding Standard is conceptually straightforward, being in principle the cost of replacing pensions and paying transfer value entitlements. The cost of actuarial advice has increased in recent years, particularly because of the need to state an opinion on the funding each year. However, it is unlikely that any alternative standard would have resulted in any significantly lower compliance burden.

Allowing employers to meet funding requirements in a regular and controlled way.

Since 2000, the Funding Standard has obliged many employers to contribute at rates higher than their long-term funding plan would require. The scale of the increase has been more than many employers expected, and some schemes have reduced benefits as a result.

The need to avoid investment distortions

Since the original Funding Standard was introduced in the early 1990s, there has been little change in the investment strategy of most Irish schemes. The Standard does not therefore seem to have had any significant influence on the investment strategy of defined benefit schemes.

Possible alternative systems

5.18 There are two different systemic approaches to providing the primary protection of the accrued pension rights of scheme members:

- advance funding, which seeks to ensure that adequate assets are accumulated so that, in the event of a scheme winding up, the necessary assets are already in place; and

- exit funding, which aims to provide, in the event of a scheme shortfall on wind-up, an injection of assets from whatever source to cover that shortfall.

Pension security in Ireland has always relied on advance funding.

The two systems are not mutually exclusive: exit funding can be used to add extra security to that provided by the accumulation of funds, and/or to provide for a difference between a required level of advance funding and a higher required level on wind-up.

5.19 Exit funding is usually achieved through a debt on the employer and/or an insurance-type fund. These are discussed in more detail in Chapter 7.23 to 7.35 below.

5.20 The advantage of advance funding over any alternative is that it provides more tangible security for scheme members. The advantage of the exit funding approach is in the flexibility of funding that it offers.

The Pensions Board's recommended systemic approach

5.21 The Board recommends that advance funding be the core feature of the pension funding standard, for the following reasons:

- The member security that advance funding provides is more certain and more easily understood by scheme members than any alternative;

- International experience of exit funding arrangements suggests that, without a State back-up guarantee, they cannot provide a satisfactory level of security to members unless advance funding is also required;

- Advance funding is more consistent with the requirements of the IORPs Directive. However, the Directive does not rule out exit arrangements in addition to advance funding;

- Recently introduced accounting standards would oblige many companies to provide for pension liabilities in their annual accounts if they were not provided for through advance funding in a pension scheme;

- Those responses to the consultation that commented on advance versus exit funding were unanimously in favour of advance funding; and

- Advance funding, being the current approach used, should continue to be the basis of the Funding Standard unless an overwhelming case can be made for an alternative.

The Board’s preference for advance funding does not exclude a possible exit funding mechanism in addition.

Chapter 6: Funding Standard recommendation

Outline of options considered

6.1 Within the systemic approach (primarily advance funding) recommended in Chapter 5, the Board considered a range of alternative funding standards. In summary, the options considered were:

A Continue the current Standard, including the 'short-term' measures, modified for pre-retirement members;

B Set a new funding standard equal to a percentage of the current Standard;

C Modify the current Standard basis;

D Apply a short-term funding standard to a per member benefit limit;

E Use scheme-specific funding; and

F Apply standard A for most schemes, but allow a modified basis for some schemes.

A fuller description of each standard is as follows:

Option A – modified current standard

6.2 Option A is very similar to the current Funding Standard, including the 'short-term' measures introduced in 2003, but modified for those members who are not yet drawing a pension.

6.3 The current Funding Standard is described in Appendix 1. A summary of its requirements as follows:

- The Funding Standard for a scheme equals the sum of the relevant transfer values for all active, deferred and pensioner members of the scheme. The rules for calculating these values are set out in detail in guidance note number GN11, issued by the Society of Actuaries in Ireland. In summary, these are:
  - For pensioner members, the cost of buying an equivalent annuity or similar; and
  - For other members, the current transfer value (i.e. benefits based on current salary and service, revalued to retirement and discounted at a gilt rate.)

A further allowance has to be made for the costs that would have to be met in winding-up a scheme.

- When the assets of a scheme are less than the amount as calculated above, the trustees of the scheme must agree a funding proposal with the employer. This proposal will specify a level of contribution which the scheme actuary is satisfied is reasonably likely to restore the scheme to full funding within a set period. The period of such a proposal is generally 3½ years, but in the case of investment losses, a scheme can apply to the Board for a longer period, usually up to 10 years. During the period of the proposal, the trustees must confirm each year to the Board that the plan is on track.

Option A comprises the above standard with a modification to the calculation of the standard for active and deferred members. The Funding Standard for these members would be calculated on a combined equity/gilt rate, rather than the current gilt rate. The effect of this change would depend on the membership profile of each scheme, but the average reduction in the Funding Standard would be 5% to 10%.

This option as considered by the Board would make permanent the 'short-term' changes introduced in 2003. It was the Board's view that, were this standard adopted, schemes that were not fully funded should be required to disclose their situation clearly and regularly to members.

Option B – standard equals set percentage of current standard

6.4 Under this proposal, schemes would be required to maintain assets equal to a set percentage of the current Standard. However, members would be regularly informed of the funding position of the scheme relative to the current Standard.

There was no specific consideration of what percentage would be appropriate, though it would be unlikely that a percentage of less than 80% or so would be acceptable.

Where schemes failed to meet the Funding Standard, they would be obliged to restore funding within a set timescale. The appropriate length of this period would depend on the level chosen for the percentage. Were this percentage to be, say, 80%, the maximum allowed time would be 3½ years.

Option C – modification of the current Standard

6.5 The provisions of the current Funding Standard would be replaced by the following:

- For pensioner members, the standard would be based on the liability in the ongoing funding valuation calculations, rather than on the prices of annuities from insurance companies; and

- For other members, the value would be the current transfer value but calculated on an equity return basis.

Where a scheme fails to meet the standard, schemes would be obliged to restore funding within 3½ years.

The effect of changing the pensioner basis as described above would depend on a number of factors, but reductions of 25-30% would not be uncommon. For other members, the effect of the suggested changes would depend on their term to retirement, but the average reduction would be 5% to 10%.

A funding standard as described above would be more akin to an 'ongoing' standard than the current wind-up standard. Schemes would be obliged to inform members of the scheme's funding situation, including the extent to which pensions would be reduced in the event of a wind-up.

Option D – twin standard

6.6 Under this option, there would be a basic funding standard, which schemes would have to meet or restore over a short period. There would also be a longer-term higher standard, but schemes would have a longer period to meet this.

The short-term standard would be:

- For pensioners and all other members over 65, the cost of buying an annuity for the first €8,700 p.a. of benefit. This benefit would include increases at the rate provided in the scheme rules; and

- For active and deferred members, the amount of their transfer value based on the first €8,700 p.a. of benefit reduced by 2% per annum for each year to 65. This value would be calculated using gilt rates.

The €8,700 cap on benefits equals the contributory Social Welfare old age pension, and would increase in line with it. Where schemes failed to meet this short-term standard, they would be required to reach it within 3½ years, equal to the period required under the general rules of the current Standard.

The liabilities to be met under the longer-term standard would be determined by the regular actuarial valuation of the scheme. Where this valuation showed that assets were less than the liabilities for service to the valuation date, the scheme would be required to agree a funding plan to restore this over the average working lifetime of the active members.

This standard, unlike any of the others examined, would require a change in the wind-up priority order. Priority would be given to the basic ‘per member’ benefit ahead of the priority for any balance of benefits.

Under this standard, schemes would be obliged to inform members of the funding status of the scheme both in respect of the minimum benefits and of their total benefits.

Option E – scheme-specific funding

6.7 This approach would remove the general obligation to meet a statutory standard based on transfer values. However, all schemes would be required to disclose regularly to members the current funding situation as assessed in the regular actuarial valuation, and to make up any shortfall over the working lives of the active members. It was also proposed that, in the event of a wind-up, any shortfall in scheme funding would be treated as a debt of the employer.

Option F – two-tier standard

6.8 This proposal would apply the option A standard, as described above, to all schemes. However, schemes believed to be more secure would be allowed to opt for an option C standard, subject to certain conditions. This would operate as follows:

- All schemes would measure their position against option A, and this position would be fully disclosed to all relevant parties;
- Some schemes which failed to meet the A standard would have the option of testing against a lower option F. This alternative would be subject to the agreement of the trustees, and such schemes would only be permitted to follow this route if the employer was willing to accept a debt of the difference between the scheme assets and the value of the liabilities on the option A basis. This debt would be enforced in the event of the scheme being wound up; and
- Schemes which failed to meet the option F standard would be obliged to submit a funding plan to restore the assets to option F level.

The proposal suggested that schemes which are allowed to opt for the alternative standard would be either:

(a) schemes of all sizes where the employer covenant and commitment is so secure that financial support will always be available, and the schemes are therefore unlikely ever to be wound up; or

(b) schemes that are so large that they can be run as closed funds, even if the employer sponsorship ceases, voluntarily or otherwise.

6.9 The Board agreed that options B and E would not achieve the objectives of the Review and did not subject them to further detailed consideration.

Criteria for identifying a recommendation

6.10 In order to assess the relative merits of the options available, it is necessary to specify criteria against which they will be measured. The list below reflects the issues raised in Chapter 5.1 to 5.6 above.

(a) What effect the proposal would have on members' security in the event of a wind-up;

(b) How the proposal would affect the long-term funding stability of a scheme, and the investment flexibility of the scheme;

(c) The effect on perceived equity among members. The issue of equity arises only when a scheme winds up with a shortfall, and considers whether the amounts received by each member are appropriate;

(d) Whether the proposal is likely to comply with the IORPs Directive;

(e) How radical a departure the proposal represents from the demands of the current Standard. This will also take account of how effective each option is likely to be in meeting the concerns expressed about the effect of the current Standard;

(f) The complexity of the proposal relative to the current Funding Standard. This assessment encompasses both the work involved in implementing the required changes to the current Standard, and the ongoing burden of compliance and regulation; and

(g) The impact of the proposal on the provision of defined benefit schemes, and in particular on the willingness of the sponsoring employers to maintain such provision.

The next section assesses each of options A, C, D and F as described above against these criteria.

6.11 Option A

Security – slightly less than at present. Most schemes have active members, whose entitlements on wind-up would be somewhat reduced under this option. However, it should be noted that this option makes permanent the longer period allowed for restoring funding introduced in 2003. Members of schemes granted such extensions are less secure than they would be under the legislation that applied before then.

Long-term funding stability – more favourable. Because this standard would be slightly lower than the current Standard, it would assist long-term funding.

Equity – active/deferred member values reduced. Some consider the current Standard too weighted in favour of pensioners. This option would slightly increase this weighting.

IORPs – likely to be compliant. This standard is believed to be compliant with the Directive. If it not compliant, it is most unlikely that options C, D and F would be compliant either.

Radical – This represents very little change to the current system. The funding position of almost all schemes would improve. Some schemes currently applying for funding extensions would no longer need them, but this would not be a significant number.

Complexity – The standard would be slightly more complex than the current Standard.

Defined benefit provision – this standard would reduce the pressure on defined benefit, though not by as much as the other options considered.

6.12 Option C

Security – weaker than option A for schemes which are currently paying pensions. In a wind-up, pensioners are unlikely to be able to retain their current pension, even if the scheme was 100% funded, and other members would receive less than at present.

Long-term funding stability – as or more favourable than option A for all schemes. The Funding Standard total discontinuance level would be reduced for all schemes compared to the current Standard, and, as a result, contribution rates are likely to be more stable despite 10 year extensions not being available.

Equity – similar to current. Both pensioner and active/deferred values would be reduced. Smallest reductions for those near retirement.

IORPs – believed to be compliant.

Radical – some effect. The reduction in coverage for pensions is likely to be contentious. This option would probably benefit almost all schemes who have applied for funding extensions.

Complexity – little change. This standard would be slightly more complex than the current Standard.

Defined benefit provision – this standard would reduce the pressure on DB.

Other issues – the justification for using a pensioner standard lower than annuity rates is that in most cases schemes will not in practice buy such annuities. However, for smaller schemes, there is a case for requiring them to hold additional reserves in any event; larger schemes may be required by the IORPs Directive to hold additional reserves in the event of employer wind-up. The adoption of this standard is likely to discourage schemes further from buying annuities.

6.13 Option D

Security – mostly reduced, but depends on the scheme. Would represent a reduction in the short-term security for members of schemes with long service and/or high pensionable earnings. For those schemes with mostly lower benefits, it would represent an increase in member security because the scheme would be required to fund any shortfall over a shorter period than is currently required.

Long-term funding stability – usually more emphasis on long-term. Schemes with high average benefits would need to take little or no account of the Funding Standard in deciding funding levels or investment policy. Some schemes with low benefits would be more constrained than currently.

Equity – priority based on benefit amount rather than scheme status or age. This proposal was specifically designed to meet a perceived inequity in the current system, by ensuring that a basic level of benefits are secured for all scheme members before higher benefits are funded. However, some do not agree with the reduction in priority for some pensioner benefits.

IORPs – some compliance risk. The short term 'per member' standard does not appear to be compliant with the Directive. Compliance would therefore be assessed by reference to the longer term standard, which is likely but not certain to be compliant.

Radical – considerable change. A survey would be needed to quantify the effect of this proposal on funding. However, it seems likely that many schemes that need funding extensions under the current Standard would meet this new standard. However, a number of schemes that have applied for extensions would be worse off. The change in priorities on wind-up may be contentious.

Complexity – some increase. The requirement to report discontinuance both on the capped benefits and on the current benefits represents additional work. However, for many schemes, verifying 100% coverage on the new basis would be very simple.

Defined benefit provision – reduced risk. For many schemes, this standard would reduce the pressure caused by current high contribution requirements.

Other issues – some avoidance possible. There might be some incentive to divide schemes into higher-paid and lower-paid members, to avoid any reduction in the priority of part of the benefits of the higher paid members.

6.14 Option F

Security – on balance, similar to option A. Although some schemes can use a lower funding standard than option A, this is coupled with a debt on the employer in the event of a wind-up and is in any case only available to those schemes believed to be least likely to wind-up.

Long-term funding stability – as or more favourable than option A for all schemes. The total discontinuance level would be reduced for some schemes compared to the current Standard.

Equity – active/deferred member values reduced, as for option A. Some consider the current Standard too weighted in favour of pensioners. This option would increase this weighting.

IORPs – likely to be compliant. This standard is probably compliant with the Directive.

Radical – this represents some change to the current system. The funding position of almost all schemes would improve, as for option A, and for a small number would improve significantly. Some schemes currently applying for 49(3) extensions would no longer need them.

Complexity – The standard would be more complex than the current Standard.

Defined benefit provision – this standard would reduce the pressure on some larger schemes which are likely to include a significant proportion of defined benefit members.

Responses to consultation document

6.15 The consultation document issued in July set out options A to E above. It analysed A, C and D in further depth, identified option A as the Board's preferred option at that time, and invited comment on this and the other options.

The great majority of the responses favoured options A or C. None favoured option D, and two made alternative suggestions which were essentially option B. However, a number suggested that the Funding Standard should differ for large and/or more secure schemes, and this alternative was incorporated into the range of options considered as option F.

6.16 Among the comments made in favour of option A were:

"… we have reservations concerning the effect that option A would have, by reducing perhaps the urgency to correct the underfunding of pension funds… however despite these reservations, we believe that the Funding Standard should remain at 100% and that flexibility should be allowed to enable the Fund to meet its liabilities under the Standard where genuine difficulties are being experienced."

"We are not in favour of any weakening of the Funding Standard… We also believe that the Standard has, by and large, acted in the best interests of members."

"We note that both the current Standard and The Pensions Board's preferred option (option A) involves the valuation of pensioner liabilities on a basis consistent with market annuity rates. Ultimately in pension scheme wind-ups, pensioner liabilities are normally bought out as annuities unless it is possible to transfer these liabilities to another scheme. The principle behind the Funding Standard is an assessment of the wind-up liabilities, and we therefore believe that it is important to continue to use a valuation approach for pensioners which is consistent with annuity costs."

6.17 Among the comments made in favour of option C were:

"If the Funding Standard is not fundamentally changed, we believe it is likely that we will see a continued decline in defined benefit schemes, with more wind-ups, closures to new entrants and reductions in benefits. The Funding Standard which has an overriding objective of protecting defined benefit provision is arguably having the opposite effect."

"We believe the discontinuance standard currently in place is too high a standard. It requires companies to certify a degree of solvency which most will never require in practice."

"Requiring pension schemes to fund on the basis of annuity prices which are beyond what the actuary would recommend to trustees in an ongoing or even closed fund situations is not sustainable."

6.18 Among the comments made in favour of option F were:

"We believe that consideration should be given to allowing larger pension schemes to value pensions in payment by reference to corporate bond yields and a prudent mortality basis, without including the significant margins currently contained in life office immediate annuity pricing."

"The [organisation] is broadly supportive of option A in preference to the other options set out in the consultation document. However, the

[organisation]'s view is that there is a viable alternative option, consisting of a combination of option A and an ongoing standard."

Recommended option and rationale

6.19 There is no single ideal solution that suits all schemes, and there are aspects of each of the above options that are clearly superior to the alternatives.

After considerable discussion, the Board identified option A as its recommended option. This is the current Funding Standard with a modification of the Funding Standard basis for non-pension members, and includes the extension of the funding period introduced in 2003 and the addition of some further grounds for extension of the funding period. There was a view, however, that even with the changes proposed, the standard was unnecessarily onerous on large schemes with a strong employer commitment because of the use of annuity rates to value pensioner liabilities. A means of addressing this concern within the recommended option is addressed in Chapter 6.20.

6.20 The Board recognises that many schemes are encountering difficulties in meeting their contribution requirements. The measures introduced in 2003 have eased the burden for a considerable number of schemes, but there are still some schemes which are having difficulty meeting the current Standard. The recommended option A may not make a significant difference for such schemes, particularly because of the requirement to use commercially available annuity rates as an integral part of the Funding Standard.

The Board recommends that option A be accompanied by the changes to the operation of the Funding Standard set out in 6.31 below. It is recognised that these changes also represent a relaxation of the Standard in comparison to the Funding Standard which applies at present.

In Chapter 7.36 to 7.40 below, the Board recommends that the introduction of a State Annuity Fund be explored thoroughly. There was some support for the view that the implementation of such a fund would cause the benchmark annuity cost for option A to be reduced. The severity of the Funding Standard would thereby be eased for schemes generally without reducing the security of scheme members.

If a State Annuity Fund is not implemented, the Board agrees that a further review of the Funding Standard may be required in the light of experience in the meantime.

6.21 Option A was chosen for the following reasons:

- The changes made to the Standard in 2003 have already had some noticeable effect in meeting the twin objectives of safeguarding

member benefits and preserving defined benefit provision. The Board believes that it is too early to conclude that further reduction of the Standard would be appropriate; and

- The current Standard provides the best possible protection for those receiving pensions, who are the most vulnerable scheme members, and usually not in a position to replace any benefit shortfall that might arise on a wind-up.

6.22 Option C is very similar to that recommended by the Funding Standard Expert Group, and would have a number of advantages:

- Although there is little evidence so far of a strong move away from defined benefit, there is no doubt that there is pressure. Option C would provide immediate relief for those schemes facing the largest contribution increases; and

- This approach would better align the Funding Standard with the long-term funding of typical defined benefit schemes.

However, there are a number of drawbacks:

- In the event of scheme wind-up, pensioners being paid from the fund would usually face a reduction in their income which might be significant relative to what they were receiving before the wind-up; and.

- There is considerable disagreement about what would be an appropriate funding standard for the liabilities of pensions in payment.

It should be noted that the contributions required by many schemes which have applied for a funding period extension would not benefit from any move to an option C standard, as they are currently only paying the long-term contribution rate in any event.

6.23 Option D is designed to ensure that a basic benefit is secured for all scheme members, whether or not they are retired. It represents a radical change to the structure of the Funding Standard, and stimulated considerable interest and discussion among the members of the Board. However, the Board decided not to propose it as a basis for the Funding Standard:

- Although it is designed to safeguard basic benefits, the effect of this standard on schemes with low benefits would be to impose a more demanding standard than the current Standard;

- Although it is believed that this standard is probably compliant with the IORPs Directive, there is some risk that it would be found not to be;

- This standard would increase the complexity of compliance, and would impose additional actuarial and administration costs, particularly on smaller schemes; and

- There was no support for option D among any of the responses received as a result of the consultation process

6.24 The rationale behind option F is to identify those schemes least likely to buy annuities at any stage in the future, and to allow such schemes a standard that does not depend on annuity costs. This approach recognises that many schemes do not buy annuities, and the number of schemes that actually wind up is very small.

The merit of option F is that it is likely to be of most benefit to the larger schemes, possibly including the majority of defined benefit members. Nonetheless, the Board decided not to recommend it as a basis for the Funding Standard. In practice, it is not possible to identify those employers most likely to support a scheme throughout the lifetime of current members. In addition, in practice, when an employer goes into liquidation or ceases scheme contributions, few, if any, pension schemes are run off as closed funds, so a standard based on such an approach is difficult to justify.

Funding proposals

6.25 When a defined benefit scheme fails to meet the Funding Standard, a funding proposal must be agreed between the scheme trustees and the sponsoring employer, and approved by the scheme actuary. Under Section 49(3) of the Act, if the period of this proposal is longer than 3½ years, the proposal must get the approval of The Pensions Board. This approval may only be granted if the actuary certifies that the failure to meet the Funding Standard is due wholly or mainly to investment losses.

6.26 A number of the responses to the consultation process by pension practitioners criticised the current requirements and suggested some changes to them. Among their comments were:

"We have found that for many schemes that fail the Funding Standard, the cost of the valuation has more than doubled, in addition to significant additional annual costs as a result of the annual certification requirements."

"If the extended funding period is limited to cases where investment losses are the primary cause of the deficit, we have some concerns as to how this would operate over the longer term."

"We believe that The Pensions Board should have the power in all circumstances to give the necessary relief where it is clear that the fund was depleted through no fault of, or advantage to, the members."

"While we accept that there has to be some protection for members in relation to schemes that currently fail to meet the Funding Standard, we would favour a regime whereby an extension in the funding period of up to ten years would be automatically granted in cases where the trustees are prepared to abide by more onerous disclosure requirements."

6.27 Among the specific suggested changes to the current requirements were:

(a) Where a scheme fails to meet the Funding Standard, it should be allowed a 10-year period to recover irrespective of the cause of the shortfall;

(b) The ten-year period typically granted by the Board under Section 49(3) should be longer; and

(c) The process for gaining an extension under 49(3) should be quicker, more transparent and should not rely on the discretion of the Board.

6.28 There are clearly a number of issues with the process of approving funding proposals under the existing Section 49(3) measures:

(a) The fact that the great majority of schemes that apply for an extension are granted one seems to indicate that there is scope for a somewhat more automatic process;

(b) The approval process is very time-consuming both for trustees, employers and their advisers as well as absorbing resources of The Pensions Board;

(c) Applicant schemes find the process to be slow, unpredictable and subject to a large number of follow-up queries. Furthermore, because the employer and trustees cannot be certain that the application will be granted, there is a considerable period of financial uncertainty; and

(d) Because of the time taken to deal with applications, it is common for the first annual certification of the progress of a plan to follow quickly after the approval. This certification itself can be time-consuming for trustees and their advisers.

6.29 The Board favours some modification of the current Section 49(3) process, but is not in favour of granting 10 year funding periods (or longer) in all cases.

(i) The Board favours an easing of the current requirements governing funding period extensions in the context of a funding standard similar to the current Standard. It does not believe that such extensions would necessarily be appropriate were the Funding Standard less demanding than the current level;

(ii) The Board is not in favour of extending the current 10-year funding period extension that is the maximum period granted to most schemes under Section 49(3). A longer period may expose the scheme to a significant risk of further funding shortfalls before the first problem has been dealt with. Furthermore, if a scheme cannot recover over a ten-year period, there are likely to be significant concerns to be addressed about the sustainability of the scheme;

(iii) Although the great majority of schemes that apply for extensions under the current system receive them, it is a cause for concern to the Board that in many cases, important issues do not appear to be considered by trustees until they are brought to their attention by the Board during the application, most notably issues of investment strategy and member disclosure. For this reason, the Board is not in favour of a wholly automatic process; and

(iv) The Board is in favour of some widening of the current grounds for granting funding extensions, but is not in favour of a longer period in all cases.

6.30 There are a number of potential reasons why a scheme may be underfunded. Some of these are within the control of trustees and/or the sponsoring employer, some not. A scheme may be underfunded for some or all of the following reasons:

(a) Investment returns less than expected;

(b) Interest rate falls;

(c) Consumer prince inflation higher than expected;

(d) Salaries (and hence benefits) increasing by more than expected;

(e) Uninsured death benefits;

(f) Failure to pay contributions; and

(g) Benefit improvements, including discretionary increases

It does not seem reasonable to allow ten-year extensions for (f) or (g). These issues are under the control of the trustees and/or the employer, and should not be allowed to affect the security of the existing benefits of scheme members.

A failure to insure death benefits is within the control of the trustees, and there are rarely if ever grounds for self-insurance by the scheme, given the competitive nature of the insurance market and the resulting low costs. Although there is therefore a strong argument against allowing this to be used

as grounds for an extended funding period, it has been argued that were such a case to arise, and there was agreement with the employer to restore funding over a reasonable period, the Board should be in a position to facilitate this rather than force reduction of the benefits of the scheme. However, clearly such cases would be rare, and should be considered individually.

The level of salary increases is in many cases under the control of the employer, and the extent of the effect on the pension scheme liabilities would be predictable. However, there may be instances where salary increases occur where the employer had no control. The Board would not be in favour of automatically granting extensions for shortfalls due to salary increases, particularly because of the risk of abuse where salary increases are granted only to certain individuals. However, there are grounds for granting extensions in some cases.

(a), (b) and (c) are to a great extent outside direct control and the Board believes that there is a good case for allowing an extension to be considered in all such cases.

6.31 In summary, the Board's recommended approach is as follows:

(i) A relaxation of some of the conditions attaching the granting of extended funding periods in the context of a funding standard based on options A or F;

(ii) 10-year extensions would be available to schemes on the grounds of investment (i.e. no change to the current requirements), interest rates and CPI on the basis of policy and guidelines issued by The Pensions Board from time to time;

(iii) Where a scheme qualified for a 10-year extension as defined above, this would be available through a simpler process, subject to appropriate certification by the trustees and scheme actuary. However, specific case-by-case approval by the Board would be required where a longer period was sought or where the scheme sought to extend the period of an existing funding plan;

(iv) Extensions would be granted to schemes underfunded as a result of salary increases on the basis of policy set by the Board from time to time and on a case-by-case basis;

(v) Even where an extension is automatically available, certain information would have to be provided to the Board within a set timescale;

(vi) The current rules governing the definition and certification of investment loss would be reviewed to remove some anomalies; and

(vii) The disclosure requirements where a funding plan is being considered or is in place should be reviewed to ensure that all members are made aware of the position.

6.32 It should be noted that the approach recommended in 6.31 is in the context of the recommendation that the Section 49(3) measures be made a permanent part of the Funding Standard.

Other funding issues

6.33 Irrespective of any changes to the Funding Standard, the Board recommends that schemes which fail to meet the Standard be required to communicate to all members regularly the current funding position of the scheme. This information should show the funding position by class of member and benefit, and should be designed to be easily understood by members who may have little or no financial knowledge.

6.34 The proposed Funding Standard would apply to local pension schemes only. The Standard for cross-border schemes will be as close as possible to the local schemes' Standard, but the IORPs Directive will impose some additional requirements, and further consultation may be necessary.

6.35 The Board also recommends that further consideration be given to the treatment of scheme surpluses. There is no doubt that many schemes which cannot currently meet the Funding Standard would be in a better position had they not reduced previous surpluses by some combination of contribution reductions or holidays, benefit increases (including pension increases) and enhanced early retirement schemes.

Although there appears to be little prospect of substantial surpluses for most schemes in the immediate future, they will no doubt arise at some future date. The Funding Standard needs to be robust across a range of conditions, and therefore the issue of surpluses must be taken into account. The Board's views are as follows:

- The Revenue should be asked to consider reviewing the rules governing the level at which they require scheme surpluses to be reduced; and

- Further restrictions on contribution holidays or benefit improvements may be counterproductive, as it might make employers more reluctant to contribute if there is less flexibility about how the funds are applied.

7.1 In addition to discussing the Funding Standard, the Board considered a number of other aspects of scheme regulation relevant to funding and wind-ups. Each of these issues is considered separately below.

Index-linked pension buy-out

7.2 Where the pension scheme guarantees to pay pensions linked to inflation or to salary increases, the Funding Standard calculation allows the actuary to use an equivalent fixed rate increase. However, when such a scheme winds up, the trustees cannot make such a substitution, and must try to buy a pension as defined in the scheme rules. This may be impossible to buy in the market, or may be considerably more expensive than was assumed in the Funding Standard. As a result, a scheme which satisfied the Funding Standard may on wind-up have a shortfall on actual wind-up, and the active members benefits must be reduced as a result.

7.3 The Board recommends that legislation be changed so that, in the event of a scheme as described above being wound up, the trustees are allowed to substitute annuities with appropriate equivalent fixed or index-linked increases (as advised by the scheme actuary) where it is not possible or unreasonably expensive to buy pensions increasing exactly as defined in the scheme rules. Where the scheme trustees make use of this provision, they would be required to explain clearly to members what is being done and the reasons for it.

Statutory priorities on wind-up

Current priorities

7.4 Section 48 of the Act sets out the order in which assets must be applied to meet the liabilities of a scheme on wind-up. The current statutory priority order may be summarised as follows:

1. Benefits in respect of AVCs, or transferred-in AVCs.

2. Benefits for those currently in receipt of pension, or those who have passed normal pensionable age but whose pension has not yet commenced. This includes pension increases guaranteed under the rules of the scheme.

3. Transferred-in benefits and preserved benefits, including prospective revaluation on basic preserved benefit (i.e. benefits earned after 1 January 1991).

4. Additional preserved benefit (revaluation on pre 1 January 1991 benefits).

The order of priority has remained substantially unchanged since the introduction of the Act in 1990, apart from the increase in priority for AVCs for wind-ups after 1 June 2002, prior to which these had ranked behind pensions in payment. The priority order was extended with effect from 1 June 2002 to reflect the preservation of pre 1 January 1991 benefits for those who leave service (or who are in service at date of wind-up) after that date, with revaluation on these benefits being given a lower priority. A scheme has ten years in which to build up sufficient assets to meet the wind-up liabilities in respect of this lowest priority benefit.

7.5 The statutory order of priority is of no consequence where a scheme winds up with sufficient assets to meet all of its liabilities. However, where this is not the case, Section 48 of the Act requires that all of the liabilities with the same statutory priority must be satisfied in full before any assets whatsoever are applied to secure benefits with a lower statutory priority. It is likely that, for many defined benefit schemes, were they to wind up now, pensions in payment would be secured in full, but deferred members and those who are active at the date of wind-up would receive only a proportion of the actuarial value of their accrued benefits.

7.6 Recent legislation in the U.K. has introduced a change in the Statutory Order of Priority on the wind-up of pension schemes in that jurisdiction. Draft regulations were issued last year for comment, which incorporated changes similar to those suggested below. Regulations have now been made which amend the priority order for schemes that begin to wind-up on or after 10 May 2004. These reduce the level of priority for increases to pensions in payment (although these still rank ahead of future increases for non-pensioners), but a proposal to use complex service related scaling factors for active and deferred members has not been implemented due to concerns that the proposal was not practical. More detail on the U.K. legislative changes is set out in Appendix 8.

Priority order issues

7.7 There is a widely held but by no means unanimous view that the current winding-up priority order is not equitable. The Board first examined this issue in 2003, in order to address the following areas of concern:

(i) the existing priority order is perceived to give disproportionate weight to pensioners particularly by the inclusion of guaranteed pension increases in the pensioner priority (which is the second highest priority, AVCs being the first); and

(ii) within the non-pensioners group (i.e. actives and deferreds) in the third priority, all members are treated with the same priority regardless of age or length of service.

7.8 In more detail, the current statutory order of priority could be said to be inequitable in a number of ways:

- Those in receipt of pension receive their full benefit (including any future increases to that pension guaranteed under the rules of the scheme) before active or deferred members receive anything. This is exacerbated by the fact that pensions are normally secured on wind-up by the purchase of annuities, which have become much more expensive in the last few years because of falling interest rates and increasing life expectancy;

- A pensioner who retired early after relatively short service might have his or her benefits and future increases guaranteed whereas a long serving member who was a few months short of retirement at the date of wind-up might receive no benefit at all;

- Where there are not enough assets to provide fully for active and deferred members, the same percentage must be provided for all such members. A long serving member close to retirement might have benefits worth, say, €100,000, whereas a short service member might have benefits worth €5,000. If the assets were sufficient only to provide for 40% of the benefits, the longer serving member would receive €40,000 (i.e. he would "lose" €60,000), whereas the short service member would receive €2,000 ("losing" €3,000). It is likely that the short service member will be considerably younger, will have opportunity to build up additional pension provision prior to retirement, and hence is better placed to mitigate the effects of a higher percentage reduction in his or her benefits than somebody closer to retirement age;

- A member who takes early retirement just before a scheme is wound up receives the same priority as all other pensioners, and is ranked ahead of active members, even those who are older and/or who have longer service. Becoming a pensioner in a scheme that is not fully funded therefore can make a significant difference to the likelihood of receiving benefits in full. This has been described as anomalous, and may also favour those members who are more aware of the funding situation of the scheme; and

- Where a scheme has both defined contribution and defined benefit members, or where members' benefit comprise both a defined contribution and defined benefit element, the defined contribution entitlements are not ring-fenced, and in the event of a wind-up in

shortfall, are used to secure pensioner benefits if necessary. As any shortfall will have arisen in the defined benefit part of the scheme only, this is not considered to be equitable.

A number of arguments are advanced against any change to the current order of priority:

- It is not unanimous that pensioner benefits, including increases guaranteed under scheme rules, should have lower priority, or that any change would necessarily be effective;

- The reduction in priority for all pensioner benefits, including increases, could significantly affect older pensioners, especially those without social insurance entitlements. It has been pointed out that those currently receiving pensions usually have pensions which are lower than the potential entitlements of current employees, and therefore these lower benefits should be entitled to a higher level of protection; and

- Any change to the priority order could result in a significant reduction in the benefits of pensioners in the case of a wind-up without any significant increase in the benefits of other scheme members.

Possible alternatives

7.9 A number of changes to the current priority order were suggested by interested parties, and are listed below. These changes are not mutually exclusive.

- Increases in pensions in payment should have a lower priority than benefits for active and deferred members. There would be no change to the priority of the current amount of the pension.

- A minimum per annum benefit for all members, pensioners, active and deferred, should have highest priority after AVC benefits. Any remaining benefit for pensioners would have next priority, followed by the remaining benefit for other members. The suggested annual amount was equal to the contributory old age pension, currently €8,700 p.a. In the event that the assets of a scheme were not sufficient to cover this amount, all members would be treated equally.

- Benefits for those who have taken early retirement should have the same priority as active and deferred members until the member reaches normal retirement age, after which they would be ranked with other pensioners.

- The entitlement priority of those approaching normal retirement age should be increased as they get older.

- Defined contribution members and benefits should be ranked equally with AVCs, i.e. should rank before other benefits.

Considerations

7.10 There are a number of practical issues to be borne in mind when any change to the priority order is being considered. The points listed below relate to the practicality rather than the equity of any proposed change.

- Legal advice is required about whether any priority order related to the age of scheme members would constitute age discrimination;

- Priority rights can be changed for all members' benefits, or only in respect of benefits earned after a given date. The advantage of the former approach is that it immediately achieves the objective of the change: however, it can result in significant disadvantages for some scheme members. These are avoided by changing only the benefits earned after the implementation date. However, this latter approach will not achieve its objectives for a considerable time, and will add a layer of compliance complexity; and

- Where a scheme purchases annuities for retiring members, there may be difficulties implementing any changed priority order.

Responses to the consultation process

7.11 The consultation document included a proposed change to the statutory priority order and invited comments on proposals to change the current priority order. Responses were mixed: although a majority of the responses were in favour of a change, there were a significant number which opposed any change to the current priority, and one response recommended that the priority for AVC benefits should be reduced in favour of pensioners.

Among the comments received were:

"The [organisation] believes the current wind-up priority ranking to be appropriate."

"We believe that the loss of some or all of a member's future pension increases is more palatable than an immediate reduction in the benefit being paid and more equitable than a situation whereby the entire shortfall is spread among the active and deferred members."

"The [organisation] supports the proposed changes to wind-up priorities but our view is that they do not go far enough in redressing the balance between pensioners and other scheme members."

"In any review of the Funding Standard, we believe that it is imperative that the priority order in the event of a pension scheme winding up should be reviewed. We believe the current priority system is inequitably weighted."

"There should be no alteration made to the present wind-up priorities."

"We would challenge any changes to the existing priorities. Pension increases do not match salary increases, and even those pensions linked to CPI are not a true reflection of actual cost of living increases. Also, existing pensioners have suffered financially during their working life when taxation rates were exorbitant, and should not be penalised further in the scenario of a pension scheme wind-up."

Current experience

7.12 When considering any change in the order of priority, it is useful to consider the effect that changes would have on those schemes most likely to wind-up with a deficit. The Board has information on many of the schemes which have applied for extended funding periods, which provided data on the current level of funding and its effect on different classes of membership. This information is given in Appendix 9, which includes data for all schemes where such data was provided to the Board as part of the application process.

Data on schemes applying for funding extensions are especially relevant. These are schemes where the sponsoring employer has stated that it is unable or unwilling to cover the shortfall over 3½ years, and therefore are the schemes with the highest risk of being wound up with a shortfall, and to experience the effects of the current priority order.

The following points can be noted from the information:

- In 86% of the cases, the pensioners would have received 100% of their benefits had the scheme been would up at the date of calculation, whereas the active members would have received a lesser amount;

- The average coverage for the entitlements of active and deferred members was 55%;

- Almost 70% of those schemes applying for funding extensions guarantee pension increases. There are no reliable statistics available on the number of schemes providing guaranteed increases on pensions. However, it is generally agreed by those with experience in pensions that approximately one third of schemes provide such increases. The higher proportion of schemes applying for funding

extensions confirms expectations that such schemes are more likely to experience funding difficulties in the current environment; and

- 86% of the schemes in the sample are currently paying pensions from the fund. Although there are no comparative statistic available, this is believed to be higher than average.

Recommended approach

7.13 The Board has considered proposals for changes in the statutory priority order. While not unanimous, the majority view of the Board is that the current priority order should be changed as follows:

- Increases on all pensions in payment (excluding those already granted) should have a lower priority than securing the amount of the benefit; and

- The priority of benefits for active and deferred scheme members should depend on the length of service such members have or had.

Full details of this proposal are set out in Appendix 10.

It is, however, the view of some members of the Board that the current winding-up order should not be changed.

The following are among the arguments advanced in favour of a change to the priority order:

- if the proposal were adopted, the changes (like the existing priorities) would, in circumstances of schemes winding-up, only become relevant where assets were insufficient to meet the liabilities;

- the proposed relegation of future guaranteed increases would affect only that proportion of pensioners in schemes which wound-up in an insolvent condition and which provided for such guaranteed increases;

- such schemes would be likely to have a good level of provision so that the future impact on their pensioners would probably not be significant;

- the proposal would effect a necessary re-balancing of priorities on wind-up in a number of important respects, in particular:

    - between pensioners and non-pensioners where, if the existing priorities were left unchanged, at worst pensioners could retain both their existing pension and future expectation of guaranteed increases while non-pensioners, including in

particular members close to retirement age, could receive no pension at all, and

    - between different categories of non-pensioner where, under the proposal, non-pensioners would have an entitlement to scarce resources in proportion to their length of service, so that longer serving members would not, as at present, be treated in the same priority as those with short service;

- the re-ordering of priorities in the proposal was important in order to ensure the confidence of active members in the occupational pension system and to encourage them to continue to contribute or increase their contributions to schemes in the interest of all members (including present and future pensioners); and

- in particular, if in a scheme wind up which was widely publicised, active members received little if anything of their entitlements, there could be a significant adverse impact on confidence in the system; it could not be relied on that such a wind-up would not take place in the short to medium term future.

The arguments against the proposal being adopted either at all and/or in the immediate future included the following:

- from a pensioner perspective, it was not necessarily accepted that the existing statutory priorities were inequitable;

- there were many different circumstances which could give rise to a scheme wind-up of which in various cases it would seem unfair that pensioners should suffer due to scheme insolvency; such cases would, for example, include a decision of the employer to re-locate his business operation (and assets) out of Ireland;

- the effectiveness and fairness of the proposal was questioned in circumstances of scheme wind-up where relegation of guaranteed increases resulted in an amount of resources (though significant for the small number of pensioners affected yet small in the overall) being re-allocated with little effect amongst a large number of non-pensioners;

- the fairness of the proposal was questioned given that (in most private sector schemes in which guaranteed increases to pensions-in-payment arise), the increase is related to price inflation while the entitlement of active members is related to pay which normally increase faster than prices;

- while the parameters of the proposal were accepted, it seemed inequitable that in the case of wind-up of an insolvent scheme pensioners could suffer while employer assets were not affected;

- withdrawal of guaranteed increases could significantly affect older pensioners especially those without a social welfare pension (due, for example, to their having earlier decided not to make voluntary contributions to a social insurance pension – if falling outside the system on change in income limits for insurability – on the basis of having an occupational pension with guaranteed increases); and

- while the Board had received legal advice that the proposed relegation of guaranteed increases would be likely to withstand legal challenge, there was a concern that trust law may be being interfered with.

7.14 As noted above, the statutory order of priority must be taken into account by the actuary in determining the extent of coverage for benefits where the Standard is not met. The changes proposed above would not, in themselves, affect the ability of a scheme to meet the Funding Standard, but would affect only the level of coverage for lower priority benefits, and the level of transfer values that could be paid from schemes which did not meet the Funding Standard.

In the event of a scheme winding-up with a shortfall, the proposed changes would mean that pension members might receive less than under the current rules. Nonetheless, it is the majority view of the Board that the suggested change would be more equitable.

Early retirement from underfunded schemes

7.15 Section 34(2) of the Act was amended in 2003 to enable Trustees to reduce transfer payments in respect of members who had left service to reflect the level of funding of the scheme, as advised by the actuary. Accordingly, those who leave service with entitlement to deferred benefits may now be offered only a proportion of the full transfer value as an alternative to their deferred benefits. A member may, of course, elect to retain his deferred benefits and take a transfer at a later date when the funding position of the scheme has recovered, although it should be noted that a statutory right to a transfer payment exists only for a period of two years after leaving service.

7.16 For a member who leaves a scheme having attained age 50, the option to take an immediate pension in lieu of his or her deferred entitlements may be available, and this is usually subject to an actuarial reduction of the benefits to provide an immediate pension of equivalent value to the deferred pension entitlement. Scheme rules will commonly provide for such early retirement

to be with the consent of the trustees, and in some cases will also, or alternatively, require consent of the principal employer.

7.17 Where the scheme rules require trustee consent before an early retirement pension can be paid, the trustees are able to protect the interests of the other members of the scheme by refusing to consent to early payment of the benefit. If, however, trustee consent is not required, the trustees have no power to reduce the early retirement pension to reflect the underfunding of the scheme, similar to that which is available under Section 34(2) of the Act as amended in the case of payment of a transfer value. Furthermore, as the member is now in the pensioner category, he or she will be in a higher priority in the event of subsequent wind-up than if a deferred pension had been elected. An early retirement that does not require trustee consent can therefore have a significant effect on the security of the benefits for other members who have not yet retired, particularly in smaller schemes.

Any funding proposal designed to make good the shortfall in scheme assets over a period of time should have regard to the possibility of members taking early retirement, if no trustee or employer consent is required, leading to additional contribution requirements for the employer (or possibly, in the extreme, the wind-up of the scheme in deficiency).

7.18 It has been proposed that trustees consent be required in all cases, and not just those where the rules require such consent. It has also been suggested that, where a scheme is underfunded, the trustees would have the right to reduce early retirement benefits, and to restore them, including arrears, when the scheme next becomes fully funded.

7.19 None of the responses to the consultation process opposed the proposed change to the early retirement rules, and a number supported it strongly.

7.20 A number of implementation issues would arise in any change to the current regulations on early retirement:

(a) The possible exclusion of ill-health early retirements;

(b) Possible issues of age discrimination

(c) A methodology for restoring benefits when the scheme becomes fully funded

(d) The status and priority entitlements of such early retirements in the event of a winding-up.

7.21 Subject to appropriate legal advice, and to further discussion on the issues raised in 7.20, the Board recommends that an amendment be made to the Act to give trustees statutory powers to withhold consent to early retirement, or reduce early retirement benefits on actuarial advice if the funding of the

scheme and the interests of other members would thereby be adversely affected. A member who elected to take early retirement, and whose benefits were reduced, would be entitled to receive an uplift in benefits (including arrears) when the funding position was fully restored. Where the member has died before the arrears were restored, these would be payable to the member's estate.

The treatment of such members in the event of a wind-up before the funding position was restored would also need to be considered in the context of any review of the statutory order of priority as discussed above. This proposed change would have no effect on the benefits of members retiring at the scheme's normal retirement age.

7.22 The suggested change would reduce the scope for employers to encourage early retirement where a scheme is underfunded. However, the current provisions of the Act mean that such early retirement reduces the security of the remaining active and deferred members of the scheme, and hence the Board is in favour of such a change.

Employer obligations on wind-up of insolvent schemes

7.23 The Board considered the question of whether, on the wind-up of a scheme, any shortfall should be a debt on the employer.

A debt on the employer makes any shortfall in funding the legal responsibility of the employer. It therefore acts as an additional level of security for scheme members over and above the assets of the scheme. Such an arrangement can be used in conjunction with any Funding Standard.

7.24 As normally understood, the debt is activated at any time when a scheme is wound up and/or when a sponsoring employer goes into liquidation. The employer is liable for any difference between the Funding Standard level and the assets of the scheme. In the event of liquidation, the amount of this difference is treated as a creditor.

Because the amount of the debt is usually set by reference to the Funding Standard, the security provided depends on how demanding the Funding Standard is. If the Funding Standard is set at a low level, the employer debt will not benefit members over and above that standard.

7.25 This system has operated in the U.K. since the early 90s, and has caused no significant legal or financial problems. In a liquidation, the pension scheme is treated as one of the unsecured creditors. However, the amount of the debt was calculated by reference to the U.K.'s Minimum Funding Standard, which would be less demanding than the current Irish Standard. The U.K. rules have recently been changed to set the standard to a more demanding level.

7.26 The advantages of introducing such a concept are:

- Security for members is better than with a funding standard alone;
- The debt acts as a disincentive for solvent employers to wind up underfunded schemes;
- Where schemes do not meet the Funding Standard, the existence of the debt allows longer term and therefore less demanding funding plans to be put in place; and
- There is no immediate cost to employers

Among the potential disadvantages are:

- In many cases where the employer is in liquidation, particularly for smaller companies, there may be little or no assets available once the claims of preferred and secured creditors have been satisfied. The net benefit of this provision may therefore be small unless the scheme is ranked as a preferred creditor;
- It is likely to be opposed by those whose rights in liquidation would be affected;
- The existence of a potential debt might in some cases affect the ability of the sponsoring employer to raise funds. However, the introduction of FRS17 in company accounts may have this effect in any event;
- There is a risk that the introduction of this measure would prompt the wind-up of some underfunded schemes before it took effect; and
- There may be some concern that, in the event of a debt on the employer, some scheme trustees may be more likely to follow more aggressive investment policies in the belief that any shortfalls would be covered by the employer.

7.27 The Funding Standard Expert Group recommended against the introduction of such a debt on employers. They saw it as introducing a retrospective cost on employers and feared that it would undermine the voluntary basis on which defined benefit schemes were set up. On the other hand, there is a view that a debt on a solvent employer should be part and parcel of any decision relating to the statutory order of priority on wind-up that would affect pensioners' rights.

7.28 The consultation document issued by the Board discussed the issue of employer debt, but did not specify a preferred option. Opinion was divided among the responses. All recognised the additional security that a mandatory

debt would provide for scheme members, though some questioned whether this would be significant and would be worth the drawbacks. Some responses believed that the advantages to members outweighed the disadvantages, while others had the view that the effect of the introduction of a debt would further weaken defined benefit pension provision.

7.29 After consideration of this issue, including the submissions made as part of the consultation process, the Board does not recommend the introduction of a mandatory employer debt.

Pension protection arrangements

7.30 There is considerable interest in the possibility of some arrangement that would provide protection for scheme members in the event that their scheme is wound up with a shortfall.

A number of jurisdictions have set up funds or institutions to cover such shortfalls. Such a fund pays the difference between the assets of the scheme and the discontinuance value, if higher. If an employer debt also applies, the fund covers any shortfall remaining after available monies are recovered from the employer. Depending on the rules in the jurisdiction, the fund may pay only a set percentage, or there may be a cap on the benefits covered. To work properly, such a fund must be compulsory.

7.31 The U.K. Government is in the process of introducing a Pension Protection Fund, and the necessary powers are included in the recent Pensions Act. This fund is intended to cover a proportion of shortfalls in the event of schemes winding up where the employer is insolvent. It will be funded by a levy on all defined benefit schemes. There still are a considerable number of uncertainties about how exactly it will work, but Appendix 11 provides more information.

7.32 A similar fund, the Pension Benefit Guaranty Corporation, has operated in the U.S. since the mid-1970s. It currently has a large deficit. Further details are provided in Appendix 12.

7.33 The advantages of such arrangements are the additional level of security they offer to members, and, as for an employer debt, the additional flexibility they allow for the long-term funding of schemes. However, there are a number of issues which would have to be resolved:

- The existence of such a fund creates a moral hazard by creating an incentive for employers and trustees to fund their schemes at the minimum level possible while relying on the protection fund to cover any shortfall. There may also be some temptation to follow higher risk investment strategies. The U.K. Government has sought to build in measures to avoid this;

- The fund could be paid for by defined benefit schemes, by all pension schemes, and/or from taxation. The question of a State guarantee for such a fund could also be considered;

- It is difficult to design a charging structure for such a fund that is both fair and practical. Ideally, schemes which are underfunded and whose employers are most likely to go into liquidation should pay higher premiums. In practice, assessing scheme and/or employer risk accurately is extremely difficult, and may raise legal issues;

- No matter how charges are levied, healthy well-funded schemes will end up paying most of the cost. The result would be extra expense for such schemes and a further disincentive to defined benefit arrangements;

- A pension protection fund could be structured as an insurance arrangement or as a fund with no strict legal liability. An insurance structure would be subject to E.U. rules about solvency and valuations, and would be considerably more expensive than the alternative. On the other hand, a non-insurance fund would have a higher risk of being unable to meet its commitments, and there might be public misunderstanding of its role and the value of its covenant;

- It is inevitable that there would be few demands on such a fund in times of economic growth, but many in a downturn. As a result, the fund would oscillate between an apparently unjustifiable surplus and potential insolvency. This would complicate the management of the fund and put pressure on the contributions basis; and

- Managing such a pension protection fund would be technically demanding and therefore expensive.

7.34 Many of the responses to the consultation were in favour of the concept of such a protection fund, and recommended that it be pursued further. A number of other responses were not convinced of the practicality of such an arrangement, and some were opposed to the idea because of the costs it would impose on those schemes least likely to suffer a shortfall on wind-up.

7.35 The Board recognises the substantial potential benefits of a well-designed pension protection fund. However, the practical and technical issues require considerable further discussion, and further consideration of international experience. The Board does not recommend the immediate introduction of such a fund, but intends to consider this issue further in the medium term.

State Annuity Fund

7.36 Because the Funding Standard for pensioner scheme members is based on the cost of commercially available annuities, the level of the Funding Standard for many schemes has increased as annuity costs have increased. This has led to consideration of alternative approaches to providing pensioner security. There was considerable interest in and discussion of the possibility of a State Annuity Fund, and the possible advantages and disadvantages, on an initial examination only, are set out below.

7.37 A State Annuity Fund would be intended to provide pensioner insurance at less cost than it is available from commercial insurers. In summary, such a fund would work as follows:

(a) The fund would take responsibility for the payment of pensioners, including pension increases where appropriate. In exchange, the fund would receive a lump sum from the assets of the scheme;

(b) The fund would base its costs on assumed long-term rates of return and on mortality rates closer to those typically used in ongoing valuation calculations than to those underlying annuity rates. There would be allowance for administration costs but not for profit, solvency or risk margins; and

(c) Where a scheme was wound up with a shortfall, this fund would not make good any of the shortfall. The normal wind-up priority rules would apply, and the fund would provide pensions only in respect of the funds paid to it.

7.38 Arguments in favour of a State Annuity Fund include:

(a) The benefits of such a fund would be that it would not incur the margins that commercial insurers include on their charges. The savings could potentially arise from a number of sources:

(i) Although the fund charges would include appropriate allowance for administration costs, there would be no margins for profit or solvency or other contingencies.

(ii) The mortality rates assumed by the fund might be less cautious than a commercial insurer, as the fund would only be seeking to break-even.

(b) Although such a fund would only be available to schemes that are wound up, the existence of the fund would allow the Funding Standard for pensioners to be lowered. The standard would be based not on the commercial insurance cost, but on the charge made by the fund in the event of a wind-up; and

(c) It is noted that the State bears a considerable longevity risk in respect of Social Welfare and public service pensions, so that the real additional quantum of risk represented by an annuity fund as described would not be significant.

7.39 Arguments against a State Annuity Fund include:

(a) In the absence of any detailed examination of the subject, it remains to be proven that pensioner insurance would be provided at less cost by the State Annuity Fund than by commercial insurers. Annuity prices reflect low interest rates and greater longevity and the State cannot hope to avoid the impact of such developments. In addition, if the State were to establish such a Fund, the Fund would have to take responsibility for the payment of pensioners out into the future and, inevitably, it would have to incur real extra costs in acquiring pensions-related expertise hitherto confined to the private sector;

(b) Being operated under the auspices of the State, it would be unrealistic to assume that the Fund would not be subject to intense pressure to pay pension increases (even where they were not guaranteed under the original scheme) and to make good shortfalls in pension funds of companies involuntarily wound up. It would be exceedingly difficult for such pressure to be resisted;

(c) It should not be assumed that the Fund could be confined to members of defined benefit schemes connected with involuntarily-wound up companies, especially if the members involved were found to be in a more favourable position than members of other DB schemes, let alone, of course, members of DC schemes and PRSA holders. Demands for parity of protection from the State against the vagaries of the pension marketplace (involving some form of State guarantee, perhaps) would be inevitable and, on grounds of equity, could well be difficult to resist, at potentially very substantial cost to the Exchequer. In addition, State involvement in the annuities business, through the Fund, could well be mirrored by a corresponding disengagement on the private sector's part over time, on the basis of the latter's perception that the State would play an ever-increasing part in the area. This would have substantive consequences for both the State and the pensions industry generally;

(d) The contention that the real additional quantum of risk represented by an Annuity Fund would not be significant requires to be proven. Already, the cost to the State of a partial pre-funding of social welfare and public service pensions is extremely significant at 1% of GNP per annum, i.e. about 10% of social welfare expenditure at present. The cost to the State of an Annuity Fund, even on the scale envisaged by its proponents, let alone any extensions on the lines suggested in paragraph

7.38, could only be a tangible addition to the burden already borne by the Exchequer; and

(e) There is concern that the expedient of establishing a State Annuity Fund is being proposed in the comparatively narrow context of devising a viable Funding Standard for defined benefit schemes. Insufficient regard is being paid to the possible consequences for the wider pensions area, for example, or the Exchequer, which through very sizeable tax foregone on an annual basis (estimated to be of the order of at least €2.5 billion at present), already provides a very significant degree of support for the sector. All the implications of the initiative would need to be explored fully before a proposal for action were submitted for approval to relevant Departments, the Government and the Oireachtas.

7.40 The Board recommends that the implications of the establishment of a State Annuity Fund should be considered thoroughly taking account, inter alia, of the advantages and disadvantages set out above. Such an examination would enable the Board to consider the proposition further in the medium term.

APPENDICES

APPENDIX 1 – Chapter 2.5

Funding Standard submissions - summary

A	▪ Use 'long term' rate of return or apply annuity based funding standard only to c. 2/3rds of benefit.
B	▪ Favours advance funding ▪ Favours option A as suggested ▪ Does not favour change in older pension priority ▪ Early retirements should have lower priority, and trustees should have the power to decline/reduce such applications. ▪ Favours higher priority for older actives, subject to cost and complexity ▪ On balance, in favour of employer debt ▪ In favour of PPF
C	▪ In favour of advance funding ▪ Although supports the Board's preferred option, the [organisation] does not feel necessarily well placed to comment on the funding standard level, but feels there is scope for lessening the distinction between continuance and discontinuance liabilities. ▪ The Board should discuss with the Revenue how to make it easier for employers to recover previous special contributions from overfunded schemes. ▪ Not in favour of option D approach ▪ Supports the suggested changes to the priority order. Defined contribution benefits should also have higher priority ▪ Trustees should have the power to refuse early retirements in underfunded schemes (except for ill health) and/or to

	reduce the benefits. ▪ In favour of debt on employer – disadvantages ‘do not appear compelling’. Board might consider further and make a definite proposal.
D	▪ Favours more onerous requirements on trustees to provide an appropriate and relevant framework for investment. ▪ Suggests that the 49(3) extension facility be reviewed, as it may increase risks to benefits. ▪ Transfers should be more transparent.
E	▪ Favours option C, especially for large mature schemes. Argues against a ‘one size fits all’ standard. ▪ Would have favoured option E – dismissal is disappointing ▪ Supports easing of Revenue rules on surplus ▪ Supports changes to priority order ▪ Supports observation of U.K. experience of PPF, but not generally in favour
F	▪ Supports option A ▪ 10 year extension should be available automatically, not at the Board’s discretion, even where the deficit is not due to market falls. ▪ In favour of proposed changes to priority order, though notes that the effects would be limited ▪ Supports employer debt
G	▪ Supports option C – annuity purchase requirement is the “key flaw” and is not economically feasible ▪ Seeking reduction in compliance burden – is onerous and unwieldy. Compliance alone can cause employers to abandon defined benefit. ▪ In favour of employer debt (to option C level only) ▪ Proposes State Insolvency Fund for providing pensions of insolvent companies, costed on option C basis.

	▪ Supports modification of priority order, though somewhat different from consultation document view ▪ Proposes improved member communication
H	▪ Believes that review of the funding standard is no use
I	▪ Not in favour of any reduction in the funding standard ▪ Opposes any change to existing wind-up priority ▪ Supports further exploration of PPF
J	▪ Supports option A ▪ Proposes an annual scheme AGM ▪ Supports loosening of Revenue restrictions on scheme surpluses ▪ Opposes suggested changes to the wind-up order; wants some reversal of priority already given to AVCs. Suggests that priority should be based on service rather than age. ▪ Proposes that shortfalls should be treated as a preferred creditor of the employer
K	▪ Has concerns that a scheme may be funded according to the standard, but the contribution rate may be insufficient for future benefits. ▪ Suggests further information should be included in AFCs. ▪ Proposes that multi-employer schemes provide information separately for each employer
L	▪ Advocates a reduction in the current funding standard. Suggests an alternative of either pensioner liabilities on an ongoing basis (subject to a minimum of 100% of the benefit ignoring increases) or 90% of the current standard. ▪ Are not in favour of option D. ▪ Proposes changes to the current wind-up priority, including priority for defined contribution benefits, and other detailed changes for DB benefits. ▪ Agrees with the proposed change to early retirement rules

	▪ Does not favour employer debt ▪ Would not be in favour of a PPF
M	▪ Do not favour any weakening of the current funding standard. ▪ Supports changes to the priority order ▪ Would like to see the concept of equity based annuities explored ▪ Wants legislation changed to allow trustees to purchase annuities with fixed increases at a reasonable level in cases where CPI related increases are provided for in the scheme rules. ▪ Want 10 year funding in all cases ▪ In favour of a relaxation of the rules governing investment concentration ▪ Supports proposed early retirement changes ▪ Would argue for a system of wind-up priority that differentiates among members on the basis of service/age. ▪ Supports debt on the employer ▪ Wants more flexibility in transfers from DB to DC schemes ▪ Board should prescribe minimum rules regarding member communication during the funding proposal process. ▪ The Board should have the power in the case of schemes with no active members to allow whatever is in the members' best interests rather than force a winding-up.
N	▪ Queries whether the current problems are a funding standard or a funding issue. ▪ Supports option A, though has reservations about the funding extensions. ▪ Does not support any change to the current wind-up order. Believes further research is necessary

	▪ Supports debt on the employer ▪ Supports further consideration of a PPF
O	▪ Support a strong funding standard, but should be accompanied by guidance about how schemes should proceed, with lower guaranteed benefits but relatively high contributions.
P	▪ Actuarial funding and reporting should have more transparency ▪ Assumed rates of return should take account of membership mix and underfunding position. ▪ The cost of maintaining established discretionary pension increases should be quantified. ▪ There may be scope for a different standard for different circumstances. ▪ Supports employer debt, ranking alongside pay. ▪ Wind-up priorities should take account of what opportunity those affected have to recover their position. ▪ Recommends the provision of State index linked investments and also some form of State underwriting of pension longevity risk. ▪ Supports a PPF, but recognises the design difficulties
Q	▪ Current discontinuance standard is too high and is of little direct relevance to most schemes. ▪ Supports option A, but option C looks worthwhile subject to further assessment. ▪ Employers should have the option of purchasing annuities or of valuing pensions on the assumption that the scheme itself will pay. ▪ ‘Short-term’ measures should be continued ▪ The current priority order is inequitable ▪ A PPF would be inequitable and a burden on well-

	managed schemes ▪ Do not support employer debt. Given the increasingly transient nature of employment, pension policy should emphasise individual responsibility. ▪ Employers should be further tax-incentivised to encourage pension provision and take-up.
R	▪ More flexibility about the form of annuity purchase should be allowed on wind-up. ▪ 10 year funding period should be more widely and more automatically available. ▪ Option A is a reasonable approach. ▪ An alternative, option F, should be available to strong employers: this would combine a funding standard on an ongoing basis with a voluntary employer debt on the current wind-up basis ▪ AFCs should provide more information to members ▪ The tax regime should facilitate the retention of surpluses in the fund. ▪ Trustees should be obliged to obtain and consider actuarial advice before any benefit improvements, and the cost of such improvements should be communicated to members. ▪ The suggested changes to wind-up priority do not sufficiently redress the balance between pensioners and other members. There are also some practical difficulties. ▪ On balance, supports the introduction of an employer debt ▪ Supports proposed changes to early retirement rules. ▪ Does not recommend the introduction of a PPF.
S	▪ Larger pension schemes should be allowed to value pensioners on the basis of corporate yields, prudent mortality but without allowance for life office margins. ▪ 10 year funding extensions should not require Board approval and should be available for a wider range of causes. However, there should be a corresponding

	requirement that augmentations or discretionary increases during the course of a funding proposal should require additional funding so as not to affect progress. ▪ Supports the suggested reduction in priority for pension increases. Believes that the increase in priority for older members not yet retired is too complex, and suggests that age rather than service related approach might be a better way. Proposes that DC benefits be given priority similar to AVC benefits. ▪ Proposes that in the event of a wind-up, appropriate fixed rate increases should be permitted as a substitute for index linked or other variable increases. ▪ Only supports the concept of employer debt in the context of more flexibility in the funding standard. ▪ Not in favour of a PPF. ▪ Recommends improved disclosure to members about scheme funding position.
T	▪ Supports employer debt
U	▪ Current standard should continue. However, some schemes should have the alternative of an ongoing standard basis, combined with an employer debt. ▪ Funding position of scheme should be measured and disclosed to members on a wind-up basis. ▪ Funding standard must not constrain the investment policy of the scheme, and schemes should be allowed to fund based on the long term economic cost of such benefits. ▪ Proposes a State backed annuity purchase scheme which, in the event of an involuntary insolvent wind-up, would accept pension liabilities in exchange for the ongoing rather than annuity pension cost. ▪ Does not support changes to the wind-up priority, but proposes that pensioner values in a wind-up be calculated on an 'ongoing' basis. ▪ Funding proposals should be allowed to use a term longer than 10 years.

	▪ Section 50 should be amended to allow the Board to reduce all member benefits where appropriate. ▪ Where a scheme fails the standard and a reduction of benefits is necessary, there should be a requirement to submit to the Board details of the best proposal that could be agreed without any benefit reduction. ▪ Intervaluation actuarial certification is too onerous. ▪ Multi-employer schemes should have a partial wind-up facility available. ▪ Supports proposed changes to early retirement rules. ▪ The grounds for applying 49(3) extensions should include interest rate movements. ▪ Consideration should be given to allowing ARFs on insolvent wind-up and share-of-fund early retirements.
V	▪ Supports option A ▪ Supports the proposed changes to early retirement rules ▪ Supports a pension protection fund, and proposed further exploration.
W	▪ Supports advance funding ▪ Notes that IORPS Directive requirements may not make lowering the standard for pensions appropriate. Believes that proposed changes for active/deferreds (as in A and C) would be consistent with the Directive ▪ Does not support option D – there are 'very clear compliance issues with the Directive'. ▪ Supports reducing the priority for current pensioners' future increases. ▪ Suggests that service rather than age related might be a better basis for prioritising active/deferred rights on winding-up. Makes some suggestions for simplifying/ clarifying the suggested alternative priority order. ▪ Supports proposed changes to early retirement rules.

	▪ Suggest an extension to the rights of trustees to transfer out members without consent. ▪ Does not support the concept of employer debt. Supports the view of the Expert Group, and notes the 'significant litigation' in the U.K. ▪ Supports further exploration of a pension protection fund.

APPENDIX 2 – Chapter 3.1

Key features of current Funding Standard

1. Actuarial Funding Certificate:

Section 42 of the Pensions Act 1990 generally requires that trustees of funded defined benefit pension schemes must submit an Actuarial Funding Certificate (AFC) at regular intervals to The Pensions Board. In the AFC, the scheme's actuary certifies whether the scheme does or does not satisfy the Funding Standard at the effective date of the AFC.

The Funding Standard is satisfied if, broadly, in the actuary's opinion, the scheme's assets at the AFC effective date were more than the sum of:

- the transfer values to which the members would be entitled to; and
- the estimated expenses of winding up the scheme.

Although the trustees can choose the effective date of the AFC, the period between successive AFCs prepared and submitted to the Board must generally be no longer than 3½ years. AFCs must be submitted to the Board within nine months of the effective date.

The Pensions (Amendment) Act 2002 provides for more regular checking whether a scheme satisfies the Funding Standard in the intervals between each AFC. The trustee annual report must now state whether the actuary could certify that, at the last day of the reporting period, the scheme would have satisfied the Funding Standard. Such a statement has to be included in any annual report being prepared from 1st July 2003 that has an AFC in place with an effective date after 1st January 2001. If the actuary cannot make such a statement, the trustees must notify the Board, and a revised AFC must be submitted to the Board within 12 months of the last day of the reporting period, with an effective date that falls during that 12 month period.

2. Calculating the liabilities

The detailed rules for determining the Funding Standard benefit for each member derive from the rules for calculating transfer values, laid down in guidance note GN11(ROI) issued by the Society of Actuaries in Ireland. In summary, these are as follows:

- the liability for pensioners should be determined by reference to the estimated actual cost of annuity purchase; and

- the transfer values determined for non-pensioners should be worked out assuming prescribed future investment returns linked to Government stock, rather than equities. There are also prescribed assumptions for future price inflation, statutory increases in deferred pensions and earnings-linked pension increases.

The value placed on the scheme's liabilities must reflect statutory and/or any guaranteed increases to benefit both in deferment and while in payment.

Actuarial guidance also requires the actuary to make the scheme trustees or sponsoring employer aware of any differences between the statutory Funding Standard and the approach used by the actuary in framing his or her advice to the trustees about the scheme's funding position. And the guidance provides that the 'financial and other assumptions' that the actuary should have regard to when certifying an AFC 'should comprehend a prudent view of the future without taking into account every conceivable unfavourable development'.

3. The Funding Proposal:

If an AFC indicates that, in the actuary's opinion, the scheme does not satisfy the Funding Standard on the relevant effective date, the trustees must submit a Funding Proposal to the Board along with the AFC. This must set out a contribution plan that the actuary can certify as being such that he or she reasonably expects to be enough to allow the scheme to satisfy the Funding Standard within the period of the proposal. The Funding Proposal should also set out the key assumptions adopted by the actuary and the assumed rate and timing of contributions over the period it covers. The funding period is generally, under the legislation, no longer than 3½ years though under measures introduced in 2003, the Board may allow a longer period.

If the trustees of a scheme do not submit an AFC, or, where necessary, a Funding Proposal, under Section 50 of the Act the Board may require a reduction in the scheme benefits to a level that will enable an AFC and/or Funding Proposal to be submitted.

APPENDIX 3 – Chapter 3.12

Current statutory wind-up priority

If a scheme is wound up and the assets are not sufficient to meet the minimum Funding Standard benefits, the assets are applied in the order specified in Section 48 of the Act. This Section overrides any provisions in the rules of the scheme.

For all schemes wound up after 1 June, 2002, the order of priority is as follows:

1. The expenses of winding up the scheme;

2. Benefits in respect of additional voluntary contributions or transferred in additional voluntary contributions.

3. Benefits for those currently in receipt of pensions, or those who have passed normal pensionable age, but whose pension has not yet commenced. These benefits include increases already granted and those guaranteed under the rules of the scheme.

4. Transferred in benefits and preserved benefits, including prospective revaluation on basic preserved benefit (i.e. benefits earned after 1 January, 1991).

5. Additional preserved benefit (revaluation on pre 1 January, 1991 benefits).

The entitlements of all members in a category must be satisfied before any assets are applied to a lower ranked category.

Where the assets of the scheme are not sufficient to cover all the benefits within a specific category, the same percentage must be applied to all benefits within that category.

APPENDIX 4 – Chapter 3.17

The Pensions Board 49(3) guidelines

Trustees of defined benefit pension schemes are required under Part IV of the Pensions Acts 1990-2003 ("the Acts") to certify at 3½ yearly intervals that the assets of the scheme would have been sufficient at a specified date to meet the liabilities of the scheme if the scheme had wound up at that date. If the assets would not have been sufficient, a funding proposal must be submitted to the Board.

Under Section 49(2)(a) the trustees of a scheme must, when submitting a funding proposal to the Board, ensure that the proposal is designed to ensure that, in the opinion of the actuary, the scheme could reasonably be expected to satisfy the Funding Standard at the effective date of the next actuarial funding certificate (i.e. in 3½ years time).

Section 49(3) allows the Board, on application to it by the trustees, to specify a later date than the effective date of the next actuarial funding certificate where certain specified conditions are met and in the circumstances and on the terms that the Board consider appropriate.

In August 2003, the Board set out the guidelines to be followed when making an application to it under Section 49(3). These guidelines have now been amended by the Board with effect from 5th December 2003.

Each individual application received by the Board will be considered on a case by case basis. These recommended guidelines also identify the information that would assist the Board in considering each application.

1. Application by Trustees:

The trustees of the relevant scheme may apply to the Board requesting the Board to specify a date (as proposed by the trustees) later than the effective date of the next actuarial funding certificate as the date at which the funding proposal will be designed to ensure that the scheme can reasonably be expected to satisfy the Funding Standard.

The Board would expect the trustees to give their reasons as to why the later date is necessary or appropriate and not contrary to the interests of the members of the scheme. The trustees should also confirm that the members will be made fully aware of funding position of the scheme on a discontinuance basis by category of beneficiary.

As the legislation states that the application should be by the trustees, the Board expects the trustees, and not an agent of the trustees, to make the application. All applications should be made within such reasonable timescale as to ensure that the

time limits for submission of actuarial funding certificates and proposals specified in the Acts can be met.

2. Certificate by Actuary:

The application by the trustees for specification of a later date under Section 49(3) must enclose a statement whereby the actuary for the scheme certifies that the failure of the scheme to satisfy the Funding Standard relates wholly or mainly to the performance of relevant markets in relation to investments made with the resources of the scheme and that the performance of those markets in relation to those investments is not inconsistent with the performance generally of relevant markets for investment in the same period.

To assist, the Board has prepared a pro-forma certificate (see attached) which may be used for this purpose.

3. Actuarial Information and Documentation:

In order to assist the Board to make a decision as to whether or not to exercise its power, the Board would expect to consider the following information:

(a) Confirmation whether or not the funding proposal will be prepared in accordance with the Guidance Note GN3A(ROI) as issued by the Society of Actuaries in Ireland;

(b) The "ongoing" contribution rate (or amount) i.e. the aggregate of

- the "normal" contribution rate (or amount) necessary to fund the benefits under the scheme if the scheme had neither a deficit nor surplus, and

- the contribution rate (or amount) necessary to fund any deficiency in the scheme over the working life of its active members;

(c) The annual contribution rate (or amount) which, in the opinion of the actuary, would be needed to enable him or her to certify that the scheme could reasonably be expected to satisfy the Funding Standard at the latest effective date of the next Actuarial Funding Certificate (i.e. in 3½ years time);

(d) The proposed annual contribution rate (or amount) for the purposes of the funding proposal to be submitted assuming the Board specifies the later date sought by the trustees. This rate should be such that would enable the actuary to certify that the scheme could reasonably be expected to satisfy the Funding Standard by the later date sought;

(e) The funding level at the effective date of the funding proposal;

(f) A copy of the Actuarial Valuation Report relevant to the funding proposal being prepared;

(g) If not available in the Actuarial Valuation Report a breakdown of the percentage of assets of the scheme invested in the following sectors - Irish Equities, Eurobloc Equities, UK Equities, European Equities (ex Euro and UK), North American Equities, Japanese Equities, Pacific Equities (ex Japan), World Equities, Bonds, Cash and Other Current Assets and Property.

4. The Board's Decision:

The Board may, in accordance with the requirements of the Acts, specify a date later than the effective date of the next actuarial funding certificate if, having received the certificate of the actuary pursuant to Section 49(3), the Board considers, in the context of the performance generally of relevant markets for investment, a later date is necessary or appropriate and not contrary to the interests of the members of the scheme.

If the Board decides to specify a later date it may do so in the circumstances and on the terms it considers appropriate. Such circumstances or terms will be specified with the Board's decision.

In reaching a decision, the Board would expect to take into account, inter alia, the following considerations:

(a) The interests of the members of the scheme;

(b) The certification provided by the actuary;

(c) The policy of the Board is to only consider granting a later effective date no longer than ten years from that of the funding proposal. However, the Board may, at its discretion, consider an application for a longer period. This would be in exceptional circumstances, and in no circumstances could the extended period be longer than the average working life of the active members;

(d) The Board expects that the proposed contribution rate (or amount) is at least equal to the "ongoing" contribution rate i.e. the aggregate of

- the "normal" contribution rate (or amount) necessary to fund the benefits under the scheme if the scheme had neither a deficit nor surplus, and

- the contribution rate (or amount) necessary to fund any deficiency in the scheme over the working life of its active members;

(e) The proposed contributions should not be weighted disproportionately to the end of the specified period and should be spread broadly evenly over the period.

5. The Funding Proposal

Once the Board has specified a later date the trustees should submit the actuarial funding certificate and funding proposal to the Board in accordance with the legislative requirements.

APPENDIX 5 – Chapter 3.18

Funding Standard Expert Group

Terms of reference

1. Look at the background to funding of occupational pension schemes in Ireland and, in particular, changes in that environment since the introduction of the Funding Standard.

2. Examine the appropriateness of the Funding Standard as set out in Part IV of the Pensions Act 1990.

3. Consider relevant overseas experience in relation to Funding Standards and, in particular, the UK experience and current developments.

4. Identify and agree the requirements for a Funding Standard going forward which would most effectively protect the interests of Irish pension scheme members.

Outcome

The outcome would be to recommend whether or not a change to the existing Funding Standard would be necessary. In the event that a change were recommended, the Group would be required to outline the parameters for any such proposed changes to the Standard.

It is proposed that the outcome of the Expert Group's considerations would be considered by the Policy Committee. Regard would be had to the findings of the Group, if appropriate, in the preparation of a brief for external professional consultants to draft proposed changes or revisions to the existing Funding Standard. Recommendations made would be considered by The Pensions Board with a view to forwarding such recommendations to the Minister for Social and Family Affairs for inclusion in pension legislation.

Membership

The membership of the Funding Standard Expert Group was:

Paul Kelly (Chairperson)
Brian Buggy
Joe Byrne
Eamonn Heffernan
Brid Horan
James Kehoe
Anne Kershaw
Ciarán Long
Derek McNamee
Ultan Stephenson
Anne Vaughan (as observer)

Consultant Support: George Russell, UK Government Actuary's Department

In support from The Pensions Board Executive:

Anne Maher, Chief Executive Officer
Jerry Moriarty, Head of Investigations and Compliance
Tom Carney, Head of Technical Services and Research

APPENDIX 6 – Chapter 3.28

Extract from IORPs directive

Article 15

Technical provisions

1. The home Member State shall ensure that institutions operating occupational pension schemes establish at all times in respect of the total range of their pension schemes an adequate amount of liabilities corresponding to the financial commitments which arise out of their portfolio of existing pension contracts.

2. The home Member State shall ensure that institutions operating occupational pension schemes, where they provide cover against biometric risks and/or guarantee either an investment performance or a given level of benefits, establish sufficient technical provisions in respect of the total range of these schemes.

3. The calculation of technical provisions shall take place every year. However, the home Member State may allow a calculation once every three years if the institution provides members and/or the competent authorities with a certification or a report of adjustments for the intervening years. The certification or the report shall reflect the adjusted development of the technical provisions and changes in risks covered.

4. The calculation of the technical provisions shall be carried out and certified by an actuary or, if not by an actuary, by another specialist in this field, including an auditor, according to national legislation, on the basis of actuarial methods recognised by the competent authorities of the home Member State, in conformity with the following principles:

   (a) the minimum amount of the technical provisions shall be calculated by a sufficiently prudent actuarial valuation, taking account of all commitments with regard to benefits and contributions, in accordance with the pension arrangements of the institution. It must be sufficient both to enable pensions and benefits already being paid to beneficiaries to continue to be paid, and to reflect the commitments which arise out of members' accrued pension rights. The economic and actuarial assumptions chosen for the valuation of the liabilities shall also be chosen prudently taking account, if applicable, of an appropriate margin for adverse deviation;

   (b) the maximum rates of interest used shall be chosen prudently and determined in accordance with any relevant rules of the home Member State. These prudent rates of interest shall be determined by taking into account:

- the yield on the corresponding assets held by the institution and the future investment returns and/or

- the market yields of high quality or Government bonds;

(c) the biometrical tables used for the calculation of technical provisions shall be based on prudent principles, having regard to the main characteristics of the group of members and the pension schemes, in particular the expected changes in the relevant risks;

(d) the method and basis of calculation of technical provisions shall in general remain constant from one financial year to another. However, modifications may be justified by a change of legal, demographic or economic circumstances underlying the assumptions.

5. The home Member State may make the calculation of technical provisions subject to additional and more detailed requirements, with a view to ensuring that the interests of members and beneficiaries are adequately protected.

6. With a view to further harmonisation of the rules for the calculation of technical provisions which may be justified – particularly as regards interest rates and other assumptions influencing the level of technical provisions – the Commission shall, every two years or at the request of a Member State, issue a report on the situation concerning developments in cross-border activities. The Commission shall propose any necessary measures to prevent possible distortions caused by different levels of interest rates and to protect the interests of beneficiaries and members of any scheme.

Article 16

Funding of technical provisions

1. The home Member State shall require every institution to have at all times sufficient and appropriate assets to cover the technical provisions in respect of the total range of pension schemes operated.

2. The home Member State may allow an institution, for a limited period of time, to have insufficient assets to cover the technical provisions. In this case the competent authorities shall require the institution to adopt a concrete and realisable recovery plan in order to ensure that the requirements of paragraph 1 are met once again. The plan shall be subject to the following conditions:

(a) the institution shall set up a concrete and realisable plan to re-establish the required amount of assets to cover fully the technical provisions in due time. The plan shall be made available to members or, where applicable, to their representatives and/or shall be subject to approval by the competent authorities of the home Member State;

(b) in drawing up the plan, account shall be taken of the specific situation of the institution, in particular the asset/liability structure, risk profile, liquidity plan, the age profile of the members entitled to receive retirement benefits, start-up schemes and schemes changing from non-funding or partial funding to full funding;

(c) in the event of termination of a pension scheme during the period referred to above in this paragraph the institution shall inform the competent authorities of the home Member State. The institution shall establish a procedure in order to transfer the assets and the corresponding liabilities to another financial institution or a similar body. This procedure shall be disclosed to the competent authorities of the home Member State and a general outline of the procedure shall be made available to members or, where applicable, to their representatives in accordance with the principle of confidentiality.

3. In the event of cross-border activity as referred to in Article 20, the technical provisions shall at all times be fully funded in respect of the total range of pension schemes operated. If these conditions are not met, the competent authorities of the home Member State shall intervene in accordance with Article 14. To comply with this requirement the home Member State may require ring-fencing of the assets and liabilities.

Article 17

Regulatory own funds

1 The home Member State shall ensure that institutions operating pension schemes, where the institution itself, and not the sponsoring undertaking, underwrites the liability to cover against biometric risk, or guarantees a given investment performance or a given level of benefits, hold on a permanent basis additional assets above the technical provisions to serve as a buffer. The amount thereof shall reflect the type of risk and asset base in respect of the total range of schemes operated. These assets shall be free of all foreseeable liabilities and serve as a safety capital to absorb discrepancies between the anticipated and the actual expenses and profits.

2 For the purposes of calculating the minimum amount of the additional assets, the rules laid down in Articles 18 and 19 of Directive 79/267/EEC shall apply.

3. Paragraph 1 shall, however, not prevent Member States from requiring institutions located in their territory to hold regulatory own funds or from laying down more detailed rules provided that they are prudentially justified.

APPENDIX 7 – Chapter 5.15

Defined benefit pension scheme membership

The number and membership of defined benefit schemes subject to the Funding Standard at the end of 2003 were as follows:

Scheme size	Number of schemes	Number of members
One member	70	70
1-50	959	16,078
51-99	182	12,970
100-500	249	55,613
501-1,000	46	32,566
1,001+	35	113,388
Total	**1,541**	**230,685**

The numbers of defined benefit schemes at the end of 1991 were as follows:

All defined benefit schemes		
Scheme size	Number of schemes	Number of members
One member	295	295
1-50	1,690	25,268
51-99	229	16,512
100-500	273	59,199
501-1,000	38	25,388
1,001+	32	260,874
Total	**2,557**	**387,536**
Not subject to the Funding Standard	**43**	**197,588**
Subject to the Funding Standard	**2,514**	**189,948**

Note that all membership figures refer to number of active members only.

Defined benefit membership (subject to the Funding Standard) as a percentage of those at work

	Scheme members	**Nos. at work**	**%**	**At work excl. public service**	**%**
1991	189,948	1,125,000	17%	900,000*	21%*
2003	230,685	1,849,000	12%	1,560,000*	15%*

* Estimate

Sources: The Pensions Board, CSO Labour Force Surveys

APPENDIX 8 – Chapter 7.6

U.K. statutory order of priority

The following is a summary of the proposed U.K. statutory order of priority to apply from April, 2007:

1. Expenses of wind-up
2. All additional voluntary contribution benefits
3. Pensions secured by insurance contracts pre April 1997
4. Pensions in payment, excluding future increases
5. All other benefits, but excluding pension increases
6. Pension increases

APPENDIX 9 – Chapter 7.12

Asset coverage of schemes applying for funding extensions

Scheme no.	No. of actives/ deferreds	No. of pensioners	Active/ deferred % coverage	Pension increases
1	28	0	43%	N
2	173	153	28%	Y
3	260	23	52%	Y
4	916	47	78%	Y
5	23	3	0%	Y
6	56	73	69%	Y
7	70	7	87%	Y
8	6	1	0%	Y
9	188	0	70%	N
10	54	1	91%	N
11	61	6	84%	Y
12	3	0	70%	Y
13	244	30	69%	Y
14	230	136	48%	Y
15	209	34	55%	Y
16	40	4	0%	Y
17	258	104	0%	Y
18	23	0	59%	N
19	43	12	29%	Y
20	1713	657	57%	Y
21	137	0	91%	Y
22	7	4	62%	N
23	504	11	82%	N
24	196	23	46%	Y
25	94	10	80%	Y
26	565	505	74%	Y
27	115	14	3%	N
28	107	26	89%	Y
29	80	50	88%	N
30	135	12	98%	Y
31	33	0	90%	N
32	121	0	67%	Y
33	12	3	79%	Y
34	73	40	64%	Y
35	105	3	87%	Y
36	600	201	23%	Y
37	29	8	72%	Y

38	38	0	84%	Y
39	275	185	91%	N
40	59	1	70%	Y
41	4	1	49%	N
42	48	11	71%	N
43	187	33	40%	Y
44	2142	593	55%	N
45	405	141	47%	N
46	376	86	45%	N
47	11	14	17%	Y
48	52	0	66%	Y
49	815	60	0%	N
50	10	4	63%	N
51	7	9	21%	N
52	19	5	71%	Y
53	217	80	81%	Y
54	177	22	75%	Y
55	244	30	62%	Y
56	178	325	54%	N
57	776	365	56%	Y
58	31	2	0%	Y
59	68	14	63%	Y
60	103	23	58%	N
61	567	133	56%	N
62	128	27	44%	Y
63	30	21	0%	Y
64	1434	57	54%	Y
65	615	203	54%	Y
66	15	12	64%	Y
67	281	13	75%	N
68	32	16	58%	Y
69	13	3	50%	Y
70	41	8	45%	Y
71	624	93	65%	Y
72	32	3	60%	N
73	33	4	42%	Y
74	23	6	0%	Y
75	524	66	85%	Y
76	193	26	84%	Y
77	9	5	57%	Y
78	0	0	82%	N
79	126	29	49%	Y
80	74	2	80%	Y
81	121	0	75%	Y
82	8	1	59%	Y
83	13	0	87%	Y

84	37	1	67%	N
85	2133	471	76%	N
86	196	45	65%	Y
87	61	1	83%	Y
88	1509	147	76%	Y
89	32	52	73%	Y
90	18	10	24%	Y
91	35	0	0%	N
92	51	23	0%	Y
93	298	54	66%	Y
94	673	0	79%	Y
95	16	3	57%	Y
96	351	40	0%	Y
97	15	3	78%	N
98	10	0	0%	N
99	834	196	71%	N
100	131	2	20%	Y
101	4	0	63%	N
102	73	7	0%	N
103	41	11	38%	Y
104	268	20	58%	Y
105	50	0	57%	Y
106	2133	471	76%	N
107	41	7	97%	Y
108	21	3	66%	Y
109	3	14	0%	Y
110	9	5	0%	Y
111	48	4	72%	N
112	152	18	0%	Y
113	6	2	74%	Y
114	5	1	66%	Y
115	84	34	86%	N
116	246	58	78%	Y
117	84	18	0%	Y
118	184	12	90%	N

Average active member coverage: 55%

Average active member coverage, weighted by scheme membership: 61%

APPENDIX 10 – Chapter 7.13

Proposed new statutory order of priority

1. The expenses of winding up the scheme;

2. Additional voluntary contribution benefits, including transfers in

3. Pensions in payment (irrespective of age) and benefits to those who have reached the normal retirement age. All increases to date granted under the rules of the scheme are included, but no future increases, whether discretionary or guaranteed are included.

4. Benefits arising from transfers from other occupational schemes; preserved benefits (including prospective revaluation to retirement for post 1991 benefits) on a service-related scale (see below) from 100% for those with 40 years' service to 22% for those with one year. No allowance would be made for pension increases after retirement, guaranteed or otherwise.

5. The balance of preserved benefits, excluding guaranteed increases.

6. Guaranteed post-retirement increases on all member benefits

7. Prospective revaluation on pre-1991 benefits

The entitlements of all members in a category must be satisfied before any assets are applied to a lower ranked category.

The service related scale referred to in category 4 is as follows:

Service (years)	Factor	Service (years)	Factor	Service (years)	Factor	Service (years)	Factor
40	100%	30	80%	20	60%	10	40%
39	98%	29	78%	19	58%	9	38%
38	96%	28	76%	18	56%	8	36%
37	94%	27	74%	17	54%	7	34%
36	92%	26	72%	16	52%	6	32%
35	90%	25	70%	15	50%	5	30%
34	88%	24	68%	14	48%	4	28%
33	86%	23	66%	13	46%	3	26%
32	84%	22	64%	12	44%	2	24%

APPENDIX 11 – Chapter 7.31

Pension protection fund (U.K.)

(The information below is an edited extract from The Pension Service website www.thepensionservice.gov.uk. The Pension Service is part of the U.K. Department of Work and Pensions.)

The Pension Protection Fund

A brand new compensation scheme is being established. It will be called the **Pension Protection Fund (PPF)** and run by an independent board to protect the pension promise. It will provide compensation in two areas:

1. Firstly the new organisation will ensure that where a company with a defined benefit pension scheme becomes insolvent, and its pension fund is not sufficiently funded, members can be reassured they will still receive the core of the benefits to which they are entitled, by providing compensation covering:

    - 100% of the original pension promise for people who have reached the scheme's pension age,

    - 90% for people below that age, subject to an overall benefit cap, calculated using a mixture of the schemes individual rates and standardised rules, linked to earnings.

    It will also include:

    - Indexation of pensions in payment on rights built up after '97 in line with inflation capped at 2.5%, and revaluation of all deferred rights in line with inflation capped at 5% to ensure the PPF compensation retains its value over time and provides a meaningful level of retirement income.

    - Survivors' benefits for married and civil partnerships, in most cases.

    This approach strikes a balance between providing a high level of compensation and maintaining administrative simplicity to help keep costs down.

    Compensation will be funded by taking on the pension assets of insolvent employers, and through a levy on schemes.

2. The PPF Board will also take over the existing responsibilities of the Pensions Compensation Board and compensate members of both defined-benefit and defined-contribution schemes in cases of fraud and misappropriation.

How will the Levy work?

The levy will be charged to all private sector defined-benefit or hybrid occupational pension schemes and collected by The Pensions Regulator.

The levy has been designed drawing on US experience. Risk-based factors will be the major component of the levy, so that costs are minimised for good employers with well funded schemes. The Pensions Bill specifies a number of factors that can be considered in assessing risk – scheme underfunding, credit-rating and investment strategy – and also leaves flexibility for the PPF board to add more.

The Levy will be split into three parts:

1. Pension Protection levy

    - One element will be based on scheme factors, such as number of members and the balance between active and retired members;

    - The other element will be based on risk factors, linked to the level of under-funding and other risk factors. The risk-based element will constitute at least 50% of the total charge;

2. Administration levy, covering the set-up and on-going costs of the PPF;

3. Fraud compensation levy, to cover and be paid by both defined-benefit and defined-contribution schemes, if and when a case of fraud occurs.

For the first year, only the scheme-factors based part of the Pension Protection levy will be collected. Well run schemes will not lose out as the Pension Protection levy will be set to raise just half of what the levy will raise in later years. The Board will be enabled to introduce a risk-based component from the second year, so that the risk-related factors can be added in the way that suits schemes best. If schemes think it is in their interest to have an early valuation done, then they can do this as soon as they like; alternatively, they can wait until their next tri-annual valuation is completed. Therefore, schemes face a low levy in the first year and the flexibility to move towards a more risk-based system as it suits them.

It is likely that the levy will be simpler for small employers so that they will not be forced to incur disproportionate administrative costs in providing information on which the levy will be based.

The aim is to set the levy so that it can be maintained at a steady level in order to allow employers to plan ahead financially with confidence.

How do scheme members enter the PPF?

A scheme will become eligible to enter the PPF and its members receive compensation when triggers in the employer's insolvency procedure occur, and where the scheme has insufficient assets to buy out the PPF level of benefits with an insurance company.

Who will run the PPF?

The Board will consist of a chairman (to be appointed by Secretary of State) and directors drawn from relevant sectors of the pension and financial markets, who will be responsible for:

- paying pension compensation;
- paying fraud compensation
- managing the calculation and application of the three levies (pension compensation, administration, and fraud compensation); and
- setting and overseeing the investment strategy.

In line with good corporate governance guidelines, the PPF will have a majority of non-executive members.

It must provide an annual report and accounts describing the activities of the Board in that financial year, which the Secretary of State must then present to Parliament.

The Pension Protection Fund has been designed so that Government funding is not required. The Fund can control its own income (through the levy) and its own liabilities, as well as being able to borrow on the market to smooth these over time. This will avoid the costs falling ultimately on taxpayers, the vast majority of whom will not be members of defined benefit occupational pension schemes.

How will the fund/assets be managed?

The Pension Protection Fund's investment strategy is the responsibility of the Pension Protection Fund Board, who must appoint at least two independent fund managers. The Pension Protection Fund Board may borrow commercially on a short-term basis should cash-flow difficulties arise.

Why should well run company schemes pay a levy?

The US experience shows that good firms participate because "you never know what's around the corner", especially 30, or even 60 years down the line. Pensions are a long-term commitment, which is why the PPF is taking a long-term view.

However, the PPF will reduce cross-subsidy by charging a risk-based levy so that schemes that pose a higher risk pay more for the PPF compensation cover, and costs are

kept down for good employers with well-funded schemes. This effect is guaranteed to be significant because the levy must be at least 50% risk-based.

Won't this reform discourage firms from running Defined Benefit (DB) schemes?

The levy represents only a very low percentage of the flow of contributions into DB schemes.

It greatly increases the value of DB pensions to firms, as they will be more useful to recruit and retain the best once the workforce have confidence that pensions paid will be pensions delivered.

APPENDIX 12 – Chapter 7.32

Pension Benefit Guaranty Corporation (U.S.A.)

(The information below is an edited extract from the PBGC's website *www.pbgc.gov*)

What is the Pension Benefit Guaranty Corporation (PBGC)?

PBGC is a federal agency created by the Employee Retirement Income Security Act of 1974 (ERISA) to protect pension benefits in defined benefit private-sector traditional pension plans. If a plan ends without sufficient money to pay all benefits, PBGC's insurance program will pay the benefit provided by the pension plan up to the limits set by law. (Most people receive the full benefit they had earned before the plan ended.) A plan is insured even if the employer fails to pay the required premiums. Financing comes from insurance premiums paid by companies whose plans are covered, from investments, and from the assets of pension plans taken over, but not from taxes.

What types of plans are insured by PBGC?

Although PBGC insures most defined benefit plans, some are not covered. For example, plans offered by "professional service employers" (such as doctors and lawyers) with fewer than 26 employees, by church groups or by federal, state or local governments usually are not insured.

When can an employer end a pension plan?

There are two ways an employer can terminate its pension plan. The employer can end the plan in a **standard termination** but only after showing PBGC that the plan has enough money to pay all benefits owed to participants. If the plan is not fully funded, the employer may apply for a **distress termination** if the employer is in financial distress. To do so, however, the employer must prove to a bankruptcy court or to PBGC that the employer cannot remain in business unless the plan is terminated. If the application is granted, PBGC will take over the plan as trustee and pay plan benefits, up to the legal limits, using plan assets and PBGC guarantee funds.

When does PBGC terminate a pension plan?

Under certain circumstances, PBGC may take action on its own to end a pension plan. Most terminations initiated by PBGC occur when PBGC determines that plan termination is needed to protect the interests of plan participants or of the PBGC insurance program. PBGC can do so if, for example, a plan does not have enough money to pay benefits currently due.

What benefits does PBGC guarantee?

PBGC guarantees “basic benefits” earned before the plan ended, which include (1) pension benefits at normal retirement age, (2) most early retirement benefits, (3) disability benefits for disabilities that occurred before the plan was terminated, and (4) certain benefits for survivors of plan participants.

What is the maximum amount that PBGC can guarantee?

PBGC’s maximum benefit guarantee is set each year under provisions of ERISA. For pension plans ending in 2004, the maximum guaranteed amount is $3,698.86 per month ($44,386.32 per year) for workers who retire at age 65. This guarantee amount is lower if payments from PBGC begin before age 65 or if the pension includes benefits for a survivor or other beneficiary. The guarantee amount may be higher for retirements after age 65 or for those over age 65 and receiving benefits when the plan ends.

Will PBGC adjust the pension yearly for inflation?

There is no cost-of-living adjustment. Benefits are fixed as of the date the plan ended.

PBGC Fiscal Year 2003 Financial Results

(The following information is taken from a PBGC press release dated 15 January, 2004)

The Pension Benefit Guaranty Corporation's insurance program for pension plans sponsored by a single employer suffered a net loss of $7.6 billion in fiscal year 2003. As a result, the program's fiscal year-end deficit worsened to a record $11.2 billion, three times larger than any previously recorded deficit.

The PBGC’s single-employer program insures the pensions of 34.5 million Americans in 29,500 plans. Of the $7.6 billion net loss for 2003, the two biggest factors were a $5.4 billion loss from completed and probable pension plan terminations, and a $4.3 billion loss due to declining interest rates.

Partially offsetting the single-employer program's losses were premium income of $948 million and investment income of $3.3 billion. Overall, including the assets of terminated plans for which PBGC took responsibility during the year, the single-employer program had $34 billion in assets to cover $45.3 billion in liabilities. The previous year, the program had $25.4 billion in assets to cover $29 billion in liabilities.

Single-Employer Program Exposure

In addition to losses already incurred, the PBGC calculates "reasonably possible" exposure, an estimate of the amount of unfunded vested benefits in pension plans sponsored by financially weak employers. The 2003 Annual Report estimates that PBGC's reasonably possible exposure is $85.5 billion, nearly two and a half times higher than the previous year's estimate of $35.4 billion. Two industries-air transportation at

$23.4 billion and primary metals & fabricated metal products at $10.2 billion-account for nearly 40 percent of the total.

PBGC's Multiemployer Insurance Program

The PBGC's separate insurance program for multiemployer pension plans sustained a net loss of $419 million in fiscal year 2003, resulting in fiscal year-end deficit of $261 million. This was the program's first deficit in more than 20 years and its largest deficit ever.

The multiemployer program covers 9.7 million participants in more than 1,600 plans. The sharp reversal in the program's financial condition is due largely to a decline in interest rates and the recording of new probable losses for plans that are projected to become insolvent and require financial assistance from PBGC to pay benefits. The multiemployer program has $1 billion in assets and receives $25 million a year in premium income. PBGC estimates that total underfunding in multiemployer plans is roughly $100 billion.

Other Key Facts from the FY 2003 Annual Report

The PBGC became trustee of 152 pension plans covering 206,000 people, up from 144 plans and 187,000 participants the year before. This was the largest one-year increase in the total number of people owed guaranteed benefits by the agency.

The total number of participants owed or receiving guaranteed benefits from the PBGC, including participants in multiemployer plans receiving financial assistance, rose to 934,000 from 783,000.

The PBGC paid a record $2.5 billion in benefits, nearly $1 billion more than in 2002.

Premium income rose to $973 million from $812 million the year before.

PBGC's total return on invested assets was a positive 10.3 percent in 2003 compared with 2.1 percent in 2002.