FINAL SALARY PENSIONS (FSP)

Financial Health of the Scheme

Summary
If a final salary scheme is properly funded, then there are very valuable guarantees, including, mostly, an escalating income for life. These guarantees would be lost by transferring out. Members of such schemes should consider their options very carefully and seek properly qualified advice before taking any action.

Scheme Funding Requirements
All FSP are required by law to meet funding objectives. The Trustees role is to ensure the scheme benefits can be paid as they fall due. The employer role is to run the business and grow them as a appropriate ensuring they are able to provide the pension they promised. Schemes must provide a statement of funding principles. This details how the liabilities are likely to grow and how they will be covered by existing investments and future contributions.

Actuaries
The actuary certifies the financial provisions calculation and the schedule of contributions. They have a duty of care directly to the scheme members. They will provide a periodical actuarial valuation, advice about funding principles and calculate the technical provisions. The technical provisions show the extent of the liabilities to pay the pension benefits as they fall due.

Valuations and Reports
There are two valuation/funding types:
1 ***Ongoing funding***
2 ***Wind up funding***

Ongoing funding assumes the scheme continues with a solvent trading company. The report shows the level of the pot and the ability of the employer to meet its obligations if the scheme continued to run.

Wind up funding is an estimate of the value that might flow to the scheme in case of insolvency of the employer or scheme wind up. The positions are reported every three years. Summary funding statements are generally produced annually.

The valuations must show an estimate of the solvency of the scheme. The three year valuation is prepared using accounting standards (FRS17) and international standards (IAS19).

How to fill the pension pot gaps
The trustees set objectives to rebuild the scheme. They can use increased employer contributions, review the investment strategies, change the investment risk, change the way that benefits are calculated. The pension is effectively deferred pay.

Failure to make payments
The trustees must report late payments to the Pension Regulator where they believe the employer is unable to pay the outstanding contributions. There will be an insolvency event at the company that sponsors the pension scheme.

Consequences of scheme closure
When the scheme closes and there is a qualifying solvency event in relation to the employer, and insufficient assets in the pension scheme to cover the PPF level of compensation, then a section 120 notice is issued to the Pension Protection Fund (The lifeboat protection scheme).

The Lifeboat Protection Scheme
The government life boat protection scheme is the PPF. This was introduced 6th April 2005.
All schemes go through an assessment period before entering the PPF. This can take two years. The insolvency event is notified to the PPF. The insolvency practitioner notifies the PPF with a s120 notice. During the assessment period the scheme information is checked for accuracy. The trustees remain responsible for paying the pensions throughout this period. Pensions must be paid at the PPF levels. i.e. 100% of pensions in payment over the Normal Retirement Date. 90% of the PPF for pensions below Normal Retirement Date.

People sometimes think that if they take early retirement from the scheme they will be eligible for 100% coverage. They won't.

If the scheme can buy benefits greater than the PPF limits, then the pension can be wound up and members get a wind up pension. This will be greater than the PPF level but less than the scheme pension.

They will then confirm if the scheme can pay the member benefits above the PPF levels or not. If not, the scheme will transfer to the PPF.

The scheme will then transition to the PPF and all the member data and assets are moved. This takes about six months.

Once the pension is owned by the PPF, all members are notified.

If the employer has been rescued as a going concern or the business sold to another body, then the PPF will withdraw from the process.

Risk
Many large corporations have gaping holes in their pension funds, including two we have worked with recently. Even big seemingly impregnable companies can fail; Carillion being a very recent example.

For the higher earner, the government protection (PPF) would not compensate adequately in the event of company collapse. The "guarantee" afforded by final salary pensions is only as good as the health of the company, its markets and the competence and honesty of the senior management.

By transferring out and investing the resulting pot across a wide range of funds, the risk is spread across hundreds/thousands of entities.

Lack of transparency
It is not easy for members to see the true and real value of their final salary pension. For example, someone with an employer over 20 years had paid in £110,000 to the final salary pension scheme. The cash equivalent transfer value was £1.6m.

With a cash equivalent transfer the employee can OWN the fund that would have hypothetically generated the income (golden eggs) the employee would have been paid on retirement.

Ownership brings all the obvious benefits, such as control, inheritance, flexibility. This makes a massive difference. Staying in the final salary scheme means that that fund would never be owned and the widow's pension could be as low as half. On the widow's death, all benefits end.

When you transfer out, the fund is yours and can be passed to your children/family/grandchildren if you want.