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**Institute of Actuaries**

**Faculty of Actuaries**

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 S 40(2)

**Minimum Funding Requirement: Effect of the Budget Changes**

Following your letter of 14 October 1997 in which you sent me the Government Actuary's advice on the effect of the Budget changes on MFR, the profession has now reviewed the MFR basis.

I attach our report which concludes that in order to maintain the strength of the MFR basis at its previous level, in relation to funding levels and transfer values, the assumptions in the MFR basis in relation to equity investments namely 9% pre MFR pension age and 10% post MFR pension age, should be reduced to 8.5% and 9.5% respectively. In addition, in calculating MVAs, the rate of 4.25% should be replaced by 3.50% and net dividend yields on the FT-SE Actuaries All-Share Index, rather than the gross dividend yields, should be used.

If you would like to discuss these conclusions and what action might be taken we should be happy to meet.

Yours sincerely

**Harvie Brown**  
**Chairman**  
**Pensions Board**

cc: WITHHELD  
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## **Effect of ACT changes on the calculation of the Minimum Funding Requirement**

### **1 Introduction**

- 1.1 In his Budget of 2 July 1997, the Chancellor announced changes which mean that pension funds are unable to recover the tax credits previously attached to dividends on UK equity stocks.
- 1.2 The purpose of this paper is to set out the conclusions of the Faculty and Institute of Actuaries in relation to the consequences on the Minimum Funding Requirement (MFR) taking account of the budget changes.
- 1.3 The strength of the MFR (in particular the balance between security for members and costs for employers) was set by the previous Government, following which the actuarial profession drew up the details of the basis. The basis for MFR is set out in the Faculty and Institute Guidance Note GN27 which, in accordance with the legislation, is approved by the Secretary of State for Social Security.
- 1.4 As well as setting a standard for the level of funding of defined-benefit occupational pension schemes, the Pensions Act 1995 requires the use of the MFR basis to establish minimum transfer values for members wishing to transfer the value of their benefits out of defined-benefit occupational pension schemes. We understand that, in setting the original basis, regard was had to the amounts which would be needed in order to have a specified level of probability of replacing the benefits given up if the transfer values were to be invested in personal pensions.
- 1.5 After the Budget, discussions were held with the DSS and it was agreed that the Faculty and Institute would carry out a review of the MFR basis. Pending the outcome of the review, the DSS decided that no change would be made to the basis.

## **2 Current MFR methodology**

- 2.1 Overall, it is assumed that benefits post MFR pension age should be matched by gilt-edged stocks. Benefits for non-pensioners more than ten years from MFR pension age can be matched by equities, with a run-in to matching by gilts over the ten years to MFR pension age. Schemes over a certain size can use equity-matching for part of their liabilities for benefits post MFR pension age. The assumed returns from equity investments for this purpose are 10% for benefits post MFR pension age and 9% for benefits pre MFR pension age (the 1% difference broadly represents the greater efficiency of equity investment through large occupational schemes as opposed to personal pensions). Various other factors are specified. In particular, the liabilities are adjusted by an equity market value adjustment (MVA) of the ratio of 4.25% to the gross dividend yield on the FT-SE Actuaries All-Share Index. This gives a broad adjustment to equity returns to reflect current market conditions.

## **3. The effect of the tax changes**

- 3.1 In our view, the impact of the changes is to reduce the long-term returns on new equity investments by around 0.5% (rounding to the nearer 0.25%), even after allowing for the reductions in the level of corporation tax which have been announced.
- 3.2 It has been suggested that the change in ACT may result in greater economic growth through the retention of dividends for investment back in the business. We do not consider that it would be appropriate to take advance credit for this until there is evidence that it is occurring. This would emerge as part of a general review of the returns from equities at a future date.
- 3.3 Following the Budget changes, the natural measure of the current level of equity dividends is the net dividend yield on the FT-SE Actuaries All-Share Index now published in the Financial Times, rather than the gross dividend yield currently used in the calculation of MVAs under the MFR basis. A net dividend yield of 3.50% would be equivalent to a gross dividend yield of 4.25%. It would now be appropriate to replace 4.25% in the MFR basis by 3.50% and to use net dividend yields in calculating the MVA: this would have a negligible effect on the calculation of MFRs.

**4. Conclusion**

- 4.1 In order to maintain the strength of the MFR basis at its previous level, in relation to funding levels and transfer values, the assumptions in the MFR basis in relation to equity investments, namely 9% pre MFR pension age and 10% post MFR pension age, should be reduced to 8.5% and 9.5% respectively. In addition, in calculating MVAs, the rate of 4.25% should be replaced by 3.50% and net dividend yields on the FT-SE Actuaries All-Share Index, rather than the gross dividend yields, should be used.
- 4.2 Any smaller change in the assumptions would, in our view, result in a reduction in the strength of MFR. This may, however, be felt appropriate in order to preserve the balance between security for members and costs for employers.

**5. Implementation of any change**

- 5.1 Any changes to the MFR basis would involve making changes to GN27 and obtaining the approval of the Secretary of State. Because the changes would affect transfer values, each scheme's trustees would need to consider the impact of the changes (and in particular whether there was a need to change their previous decisions as to the inclusion or exclusion of various discretionary benefits in transfer values). Trustee meetings are normally held not more frequently than quarterly. In addition, revised tables of factors (or computer programs) would need to be prepared and checked, for use by scheme administrators. Across schemes in general, this process would take of the order of six months.
- 5.2 In order therefore to give schemes and their advisers time to make the necessary changes, we recommend that six months notice should be given of any changes.