Consultation on How the Regulator will regulate the funding of defined benefits

A response by

The National Association of Pension Funds

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Introduction

1. The National Association of Pension Funds (NAPF) is the leading voice of workplace pension provision in the UK. Some 10 million working people are currently in NAPF Member schemes, while around 5 million pensioners are receiving valuable retirement income from such schemes. NAPF Member schemes hold assets of some £750bn, and account for over one sixth of investment in the UK stock market

2. The NAPF welcomes the opportunity to comment on the proposals on how the Regulator will regulate the funding of defined benefits. We set out our views below.

Executive Summary

- The Regulator has a difficult task in balancing the needs of pension schemes against the dangers of too harsh a regulatory regime. The way in which the Regulator interprets the requirements of the legislation in this area is arguably the most important task he is charged with doing.

- We welcome the recognition that buy-out cost is not an appropriate basis for a scheme-specific funding regime but regret the emphasis given to this flawed measure in the consultation document.

- We agree that a filter mechanism is required to identify the schemes that present the greatest risk and welcome the suggested use of trigger points.

- The regime should recognise the asymmetry between the consequences of under-funding and those of over-funding – a scheme sponsor is required to make good any shortfall over a relatively short period (compared to the expected life of a pension fund) but has extremely limited access to any excess assets.

- There is a need to consider funding target and recovery period separately but we are concerned that the proposed funding target of a percentage of buy-out cost will become the de facto statutory minimum.

- If a base line, expressed in terms of a consistent minimum-risk standard, is required, consideration should be given to using a basis consistent with the reserving requirements of an insurance company.

- Rather than basing the funding target trigger on its relationship with buy-out cost, we suggest a less oblique approach be considered, based on consideration of the discount rate adopted.

Scheme Funding – getting the balance right

3. The Pensions Regulator has an unenviable task in balancing its statutory duties of protecting benefits of members of occupational pension schemes and reducing the likelihood of claims on the PPF against the dangers of imposing a financial or regulatory burden on schemes and the employers who sponsor them such that their ability to survive is threatened or they abandon the provision of defined benefits, to the extent that they are able. The manner in which the Regulator interprets the Statutory Funding Objective, introduced by the Pensions Act 2004, will be a major determinant of whether employers will continue to and be able to support defined benefit arrangements.

4. The issues of funding and security, whilst interlinked, are separate and we welcome the fact that this is, at least to an extent, recognised in the consultation document, specifically in the section relating to use of contingent assets. However, we would prefer an approach which explicitly acknowledges, at the outset, that funding and security are not synonymous. Security for benefit promises is provided by a combination of the accumulated assets held in the fund (funding), the future contributions that the plan sponsor is willing and able to pay into the fund, and other assets held outside the fund that would be available in defined circumstances such as insolvency (contingent assets and, in the new legislative environment, the insurance provided by the PPF). The manner in which the balance between these elements is determined, and how it varies over time, is central to the issue of funding.

5. The sum which is needed at a specific point in time to meet the accrued benefit entitlements of scheme members is uncertain. It may be estimated in any of a number of different ways, the limits generally regarded as ranging from a true best estimate on an on-going basis to the notional cost of buy-out

from an insurer. Whilst the former would not provide a suitable basis on which a funding regime should be based, the latter represents an upper bound to the cost of benefits and, for this and the other reasons set out below, is equally inappropriate as a funding target in an on-going scheme with a viable scheme sponsor. It must always be recognised that whatever measure is used, it remains an estimate, at least until an actual buy-out is undertaken.

6. It should also be recognised that the legislative environment, under which contributions into a pension scheme pass through the equivalent of a one-way valve, results in an asymmetry, when looking at funding from the perspective of the scheme sponsor, between a strong and a weak funding regime. In the case of a excessively stringent funding requirement which results in over-funding, the higher rates of contribution involved lead to unnecessarily tying up money which would otherwise be available to invest in increased employment, capital expenditure or expanding markets. As schemes become increasingly mature, the opportunity to recover any such over-funding by adjustments to contribution rates will be increasingly constrained and many will have no access to recover the over-funding in the short term and only severely limited access (measured as compared to surplus on a buy-out basis) in the longer term. In contrast, a weaker funding basis, which in the event underestimates the actual costs involved, will lead to a requirement for additional contributions payable over a timeframe much shorter than that applying to recovery if over-funding were the outcome. As long as this asymmetry persists, an unnecessarily stringent funding (as opposed to security) regime will act as a serious disincentive to defined benefit provision.

7. It is not in the interests of scheme members that employers should be required to fund to a level which is damaging to the well-being of the sponsoring entity. In a corporate context, apart from the obvious threat to job security and capital investment, higher contribution requirements are likely to feed through into share-price performance which, in turn, will have an impact on the returns achieved by the owners of those shares, including other pension schemes, both DB and DC. In the case of non-corporate entities, particularly charities, an excessively stringent funding requirement may prejudice their ability to fulfil their objectives and could, in some cases, threaten their very existence. It is not an adequate response to say that any unnecessary pension costs will eventually be recompensed either by reduced future contribution requirements or a release back to the plan sponsor – by then the damage may be irreversible, and the inter-generational impact is manifestly unfair.

Funding triggers

8. The proposed funding trigger level must be considered against this background.

9. It is reassuring that the consultation document explicitly states that it is not the intention of the Regulator (nor Government) to require funding to the full

buy-out level. Nevertheless, the buy-out standard assumes a degree of prominence in the proposals. This is a source of concern, primarily because the buy-out measure is so seriously flawed. It is wholly inappropriate to base a funding standard on this measure because:

- there is severely limited competition in the buy-out market with only two, and at times only one, provider prepared to quote;
- it is no longer possible to obtain details of the premium rates or underlying basis on which those currently in the market are prepared to do business;
- the cost of buy-out includes numerous loadings, such as those for shareholders' profit, overheads and contingency margins;
- the buy-out market involves the cost of 'packaging' of administration and other services which large schemes are able to carry out internally more cost effectively;
- the capacity of the market is seriously constrained, able to absorb only around 0.1% of the total of defined benefit liabilities in any year; and
- even from the perspective of a single scheme, capacity is an issue. For the largest schemes (over 5,000 members), whose liabilities in aggregate account for more than 70% of the total, the measure is totally irrelevant.

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10. The use of the buy-out measure as a base-line is also flawed because it assumes that the relationship between buy-out and an assessment of funding on an on-going basis (as implied by the proposed 70% to 80% trigger levels) is constant over time. Regrettably this is not the case and the actual relationship, for a scheme with a diversified investment strategy (ie not invested entirely in bonds), will fluctuate as the returns on different asset classes diverge. Notwithstanding the view of PwC, reported in Annex B to the consultation document, that an increase in equity market values of 40% is unlikely, if such a change were to occur with no change in bond yields, the average relationship between on-going funding level and buy-out cost would change by around 20%. This would imply that a scheme which was at present somewhat below the trigger level (say 65%) could easily move to be outside the trigger zone (at 85%).

11. The Regulator's proposals imply that buy-out cost has been identified as a base-line measure for the scheme funding regime which has the characteristics of consistency and represents a minimum risk position. If such a base line is required, we suggest consideration should be given to using a basis which is more consistent with the reserving basis which would apply if the entity were an insurance company. Many of the largest schemes are of a size comparable with an insurance company and this approach would overcome most of the objections to the buy-out basis set out above. In

addition, it would reduce the prominence given to buy-out cost in the proposals. We believe such an approach should be applied to all schemes, irrespective of size, and, subject to appropriate changes elsewhere, might also be used (for large schemes) as a more relevant measure of solvency.

12. In Section 4 of the consultation document, the issue of trigger points for identifying schemes with inappropriate funding targets is discussed. We found the proposals in this section confusing and difficult to reconcile with the approach which, in conversation with representatives of the Regulator, we now understand to be contemplated. In this connection, it should be recognised that if a prime test of funding objectives is a comparison with PPF solvency, either implicitly or explicitly, then this may become a replacement for the discredited MFR and at least some of the practical problems of that prescribed regime would resurface (with the added complication of compliance with the requirement to meet technical reserves).

13. If the approach described in the consultation document is eventually adopted, we suggest that the explanation of how it will be applied should be reviewed to remove any continuing confusion.

14. The intention of the Regulator, in proposing trigger points, is to provide a mechanism to identify schemes for further investigation either because the funding target may be too low or because the recovery period appears excessive. We agree with principle behind this approach. However, the proposed approach to funding target is oblique, and there is a danger that '70% of buy-out cost' will be regarded as a de facto new minimum funding requirement. We suggest below an alternative which we consider has a number of advantages and approaches the issue of funding strength and risk more directly. Even if our suggested approach is rejected, we believe that the basis of any further enquiries on the funding objective, for schemes that trigger such investigation, should incorporate an analysis along the lines we are advocating.

15. We suggest for consideration by the Regulator an approach (to the required 'filter' for identifying schemes that merit further enquiry on the strength of their a funding target) that is based on a consideration of the discount rate (or rates) adopted in valuing the liabilities. Making some fairly broad assumptions about liability structure and buy-out terms, in today's market conditions the trigger levels of 70% (less mature scheme) and 80% (more mature scheme) of buy-out cost both correspond to effective discount rates of about 2.75% pa real, or some 1.25% in excess of the prospective return on index-linked gilts. We recognise that the discount rate is not the only factor determining the strength of a funding basis and it would be necessary to ensure that there were not hidden weaknesses in, for example, the mortality assumptions but we believe that this direct measure of the fundamental strength of the funding arrangements has four clear advantages over the funding level compared to buy-out:

- the 'acceptable' margin can readily be varied over time as the relative valuations of different asset classes change;

- it would be easy to apply a range of acceptable discount rates which explicitly and transparently allows for the maturity of an individual scheme and the strength of the sponsor's covenant;

- the 'test' would not be subject to distortion according to the short-term vagaries of the buy-out market; and

- if the strategic asset mix is taken into account, it would be possible to assess (and test the prudence of) the extent to which the funding basis is anticipating excess returns from asset classes other than bonds. This would provide a clear indication of the investment risk the scheme needed to accept in order for its funding target to be achieved. In this context, it is important to note that under both the Pensions Directive and the Scheme Funding Regulations it is permissible to choose ("prudently") a discount rate which takes into account the yield on assets held by the scheme and the future investment returns. Our suggested approach would accommodate this requirement whereas it seems to be overlooked in the current proposals.

16. If such an approach were adopted, the trigger could either be simply the level of the discount rate (perhaps measured in real terms, relative to a specified gilt or bond index yield) or a table of such rates for specified degrees of maturity of the scheme (measured for example by the proportion of the liabilities that relate to pensions in payment) and sponsor strength. An example of how such a table might be structured is set out below:

Scheme maturity	Excess over gilts	
	Weak sponsor	Strong sponsor
	%	%
Mature	1.25	1.75
Medium	1.5	2.0
Immature	1.75	2.25

17. It would still be possible to incorporate two separate triggers (discount rate and recovery period) to help identify those schemes potentially most at risk, as is proposed in the consultation document.

<u>Detailed response to questions in the consultation document</u>

Question 1: Do you agree that the key risks caused by scheme funding are that:

- *schemes could close with insufficient funds to meet their liabilities;*
- *the resulting claims on the PPF would be a potential burden to all schemes and sponsoring employers;*

- *trustees may set technical provisions too low or recovery plans too long to adequately mitigate risks;*
- *the regulator may be drawn into actions as the arbiter of scheme funding for many schemes, causing the regulator to take a much larger role with significantly higher associated costs;*

and that

- *these are the risks which the regulator should seek to address*

The risks identified relate only to the risks caused by an inadequate funding level. There are also risks associated with the consequences of applying too strong a requirement, which include risks to jobs as well as macro-economic effects.

Question 2: Do you agree that the following principles are those on which the Pensions Regulator should base its approach to scheme funding?

- *protecting members;*
- *scheme specific;*
- *risk-based;*
- *proportionate;*
- *preventative;*
- *practicable;*
- *referee not player.*

If you believe there are other principles we should follow please make suggestions.

While the Regulator's preference to be a referee is clear and understandable, it must be acknowledged that the Regulator has a statutory duty to become a player in prescribed circumstances. Furthermore, the Regulator should also be sensitive to the wider impact of the implementation of a funding regime, including the potential for causing job losses and effects in the wider economy.

Question3: Do you agree that building a filter using distinct triggers for funding targets and recovery plans is the best way for the regulator to identify funding risks?

Neither funding level nor recovery period considered in isolation would prove an adequate trigger. Subject to our comments above on how to construct the funding level trigger, we agree that introducing such triggers provides a reasonably practical filtering mechanism to help tPR identify schemes with specific circumstances posing the greatest risks to members' benefits and to the PPF.

Question 4: Have we set the technical provisions triggers appropriately? If not, please provide suggestions.

The consultation document suggests that the trigger levels have been determined having regard to funding assessed on two measures – the cost of PPF benefits in accordance with the s179 basis and the FRS17 valuation basis. Full funding on either of these bases would not comply with the requirements of the legislation as meeting the requirements of the statutory funding objective - the former does not involve the calculation of technical provisions (only protected benefits are valued) whilst the latter involves a prescribed bond-based discount rate and prescribed allowance for future salary increases but “best-estimate” for this and other assumptions. The proposal (paragraph 4.1.20) that these bases of valuation provide a suitable foundation for the trigger points therefore seems technically flawed. Furthermore, the proposed trigger points seem to be based on a comparison of liability values on these bases with liability values on a full buy-out basis, without any direct reference to liability values calculated using the scheme’s funding objective. This may be an area where our interpretation is as at variance with the intention, but in any event the approach seems unnecessarily oblique, notwithstanding the clear and understandable reluctance to be seen to prescribe. Instead, the triggers should relate directly and specifically to the statutory funding objective and we believe our proposal to use funding target triggers based on the discount rate adopted would be better suited to the Regulator’s purpose.

If the funding level (rather than discount rate) trigger is to be retained, as noted above, our analysis indicates that the proposed technical provisions trigger in today’s market conditions equates to a discount rate some 1.25% in excess of gilt yields. It is a matter for debate as to the extent to which it is appropriate to anticipate additional returns from riskier asset classes in formulating a funding plan and this will, no doubt, feature in the enquiries that the Regulator undertakes with schemes that trigger further investigation. Nevertheless, and bearing in mind the practical necessity to constrain the number of schemes that the Regulator investigates further, the trigger could appear to be somewhat over-cautious and believe that a further 0.5% in the margin could readily be justified. In terms of funding levels relative to buy-out cost, this would convert into a range of around 65% to 75%.

Also, the implied yields corresponding to 70% for a less mature scheme and 80% for a more mature scheme are, on our analysis, virtually the same. A greater margin would be justified for the former, leading to a 5% reduction in the trigger level.

Taking these two factors together, a range of 60% to 75% of buy-out in today’s market conditions would be appropriate.

Question 5: Have we set the recovery plan triggers appropriately? If not, please provide suggestions.

For the reasons we set out above, we suggest that the trigger in relation to funding should be the discount rate rather than the oblique reference to s179 or FRS17 comparisons with full buy-out liabilities.

The recovery period should take into account the maturity of the scheme as well as the strength of the employer's covenant. For a mature scheme, with a small active membership and short potential service to retirement age, a shorter period than 10 years might be more appropriate. Conversely with a large young workforce a longer period could be allowed.

While a 10 year period may be considered to be a suitable initial trigger, we suggest that it would be helpful if the guidance acknowledges that a period based on the average prospective working lifetime of active members may well be considered reasonable.

Question 6: Do you consider that employers should be able to use contingent assets to lengthen recovery periods? Which contingent assets should the regulator take into account in deciding how it deals with a scheme and how should it do this?

Yes. Contingent assets should also be taken into account in assessing funding level.

The Regulator is unlikely to have the resources to make an assessment of the relevance, security and value of contingent assets and it would be sensible to place a responsibility on the scheme's advisors (perhaps primarily the auditors, but in some circumstances the scheme actuary, or the trustees' legal adviser or an appointed specialist may be more appropriate) to certify the relevant figures for schemes that have access to such contingent funding.

Question 7: Do you agree that the impact of the regulator's proposals is likely to balance its duty of protecting members and the PPF with a need to take a proportionate approach for employers?

We believe that the new requirements are likely to have a major impact on employers and there are potential wider consequences of implementing the regime. We appreciate that the Regulator recognises these issues but suggest that might be appropriate to emphasise this in the response to the consultation.

Question 8: Do you agree that we have proposed reasonable factors to consider how to intervene? If not, please suggest alternatives.

Yes, subject to our comment in relation to buy-out costs.

Question 9: Do you have any comments on how we propose to regulate when there is a failure to agree, failure to obtain funding documents, contribution failure or modification of future accrual?

No.

Question 10: Do you have any substantive (as opposed to drafting) comments on the regulator's proposed statement?

Yes, to the extent that the statement should be changed to accommodate the points made above.

Question 11: Do you agree to the funding trigger we propose for schemes reviewing subject to the MFR?

From the information set out in figure 7 of the consultation document, the proportion of schemes caught by the proposed trigger would appear to be rather large and a lower trigger, perhaps a 100% funding level on the MFR basis, might therefore be more appropriate.

Question 12: Do you have any other comments on the regulator's proposals contained in this consultation document?

No.