

The Pension Regulator's consultation document on its guidance to "Good practice when choosing assumptions for defined benefit pension schemes with a special focus on mortality"

A response by

The National Association of Pension Funds

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Overview

1. The NAPF is the leading voice of workplace pensions in the UK, with over 1300 members, between them providing pensions to over 10 million working people. NAPF Member schemes hold assets of some £800bn.
2. The NAPF welcomes the opportunity to respond to the consultation by the Pensions Regulator (TPR). We are broadly in support of TPR's further moves towards making certain that pension schemes are properly funded and we agree that this involves adequate recognition of improvements in life expectancy. We agree that trustees should be aware of developments in knowledge of current trends in this area.
3. We are concerned, however, that by being included in TPR guidance as a "trigger" for further scrutiny, the long cohort projection will be seen by trustees as a minimum requirement for the mortality improvement assumption, regardless of their scheme-specific circumstances and the prudence they might have exercised in the selection of other valuation assumptions. (And this is highly likely to be reinforced by the proposed new power of the Regulator in clause 110 of the current version {23 April 2008} of the Pensions Bill, enabling TPR to require trustees and employers to change agreed funding assumptions where TPR does not consider these to be sufficiently prudent.) This would appear to undermine the basic principle of scheme-specific funding under the Pensions Act 2004, that there should be no 'minimum funding requirement' relating to how different schemes are funded.
4. We do not believe that the evidence supporting the validity of the long cohort projection is so conclusive as to justify the expectation proposed in the guidance. In the current discussion paper issued by the Board for Actuarial Standards (BAS) on Actuarial Mortality Assumptions, the uncertainties involved in modelling future changes in mortality are described as "immense" (para 6.40). While the Regulator claims that good practice requires assumptions to be evidence-based, the BAS paper suggests that it is too early for there to be strong evidence to favour the long over the medium cohort. "There is no single generally accepted theory about the cause of the observed cohort effect in the UK, so there are differing views on the extent to which cohort-related effects will feature in future changes in mortality" (para 6.16).

5. The Regulator's approach runs the risk of meeting resentment from the trustees and sponsoring employers of well run pension schemes, many of which will be NAPF members. The complexity and variety of UK pension schemes is not, we believe, best served by the introduction of a further trigger in TPR's procedures for ensuring widespread adequate funding. We believe that TPR has met with great success in meeting its aims to date and, at this stage, an educative emphasis to guidance in this area would be more appropriate. We see it as undesirable for already responsible trustees and sponsors to be made to feel further constrained in the way they run their pension arrangements in a way which goes beyond the legal requirements. And we see it as particularly undesirable for sponsors to have to consider the new, short-term increase in funding which the proposal could potentially introduce at a time when we are at last observing a slow-down in the closure of defined benefit pension schemes.
6. In addition, we are particularly concerned at TPR's plans to examine valuations with an effective date in the past (going back to March 2007). We believe there is a clear trend for trustees to select more prudent assumptions in their scheme valuations – and that TPR will provide evidence of this in its 2008 analysis of recovery plans. We do not think it is necessary to accelerate the process by effectively encouraging trustees to review valuation assumptions only recently agreed by actuary and employer. We strongly urge TPR to save trustees the additional costs incurred by such reviews and reconsider the retrospective nature of its approach.

Answers to specific questions

Q1 Do you agree that we should issue guidance on this subject?

7. Yes, the NAPF believes that trustees will welcome guidance on choosing assumptions for defined benefit scheme valuations. We also believe that the importance of longevity in assessing a pension scheme's liabilities, coupled with developments in studies of mortality, justifies the special focus.
8. In our experience, TPR's guidance is held in high esteem by trustees and, as an unintended consequence, is often attributed the same degree of legal standing as its Codes of Practice. There is a danger, therefore, that what is being described by TPR as a guideline designed to help trustees in making a decision becomes effectively a minimum position for trustees to take, removing the element of judgement which it would be appropriate for them to exercise. For example, previous guidance on Recovery Plans used a ten-year period as a guide rather than a target. But, in practice, this has quickly come to be seen by trustees as a limit.
9. We feel that there is room here for closer liaison with the actuarial profession in this area. Professional guidance issued to actuaries will certainly examine the appropriateness of different assumptions to be used in pension scheme valuations and the scheme actuary will have a duty to guide trustees through the process of choosing assumptions. The Regulator's guidance should put trustees in a stronger position to both understand and question any approach recommended by the actuary.

Q2 Have we identified the appropriate principles to apply when choosing prudent funding assumptions?

10. We are at odds with TPR's approach to the legislation here. We believe that the requirement on trustees to choose an assumption prudently means that prudence should be exercised in making that choice – not that a specific margin of prudence should necessarily be applied to any particular assumption choice to be made. Indeed, in the bulk of paragraph 1.9 in the consultation paper, TPR suggests that “a target level of prudence in the technical provisions as a whole” should be “the paramount objective”. We believe that choosing assumptions prudently - that is, exercising judgement in a holistic way – is the appropriate approach for trustees to take.

Q3 Have we identified the appropriate matters for trustees to consider with their actuary?

11. Yes, we think the relevant matters have been identified in this section.

Q4 Have you any other suggestions for the effective illustration of the impact of mortality choices?

12. No suggestions.

Q5 Are we right to discourage allowance for the effect of a factor by way of adjustment to another assumption?

13. We do not think that TPR should be particularly discouraging this occasional practice in cases where the approach is adequately explained. We believe that trustees and employers should have the flexibility to adjust the assumptions for their scheme, provided that they are 'prudent' when viewed as a whole. There are circumstances where trustees, based on advice from the scheme actuary, might have very good reason for wanting to make such an adjustment – and it would be wholly appropriate for TPR to encourage them to document their reasons for doing so. The actuary, of course, is subject to professional codes and regulation and this is referred to explicitly in paragraph 1.3 of the consultation document.

Q6 Are we right to encourage adoption of the CMI's recommended notation for describing mortality assumptions?

14. While we see merit in encouraging the adoption of CMI recommended notation, we do not see it necessary to be quite so specific. We would prefer a general encouragement for trustees to adopt terminology that aids transparency and understanding, with acknowledgement that large schemes will often generate sufficient data to adopt their own mortality tables. We believe that any guidance should state that where sufficient scheme-specific data is not available, an appropriate recognised notation should be adopted, which could, of course, be CMI recommended.

Q7 Is this background material helpful? Have you anything further you would like to see included?

15. While we found this material to be extremely interesting, we do not feel it should form part of this guidance as it is too technical for the majority of pension scheme trustees. Also, it would need regular revision, with a danger that it could become out of date quite quickly. We feel it would be more appropriate in guidance issued for actuaries, which others could access if they have the wish to do so.
16. One of the aims of TPR guidance is to give trustees greater confidence in approaching the difficult decisions they are expected to make. Including this information could, we believe, have the opposite effect in some cases. Trustees should not be made to feel that they have to understand this level of technical detail, which they will if it is included in TPR guidance.

Q8 Do you agree that a focus on mortality improvement assumptions is appropriate?

17. While we fully agree that guidance on mortality is appropriate, we feel that use of the phrase “the statutory requirement to adopt a prudent mortality assumption” in paragraph 1.2 of the consultation document paper is open to question. The legislation actually says,

“the mortality tables used and the demographic assumptions made must be based on prudent principles, having regard to the main characteristics of the members as a group and expected changes in the risks to the scheme”

which TPR has interpreted as meaning that schemes should adopt a prudent mortality assumption. We feel that it could equally be seen to mean that prudence should be applied to the act of choosing those assumptions.

18. We believe that the existing triggers employed by TPR provide it with sufficient tools to assess the risk of a scheme’s funding arrangements, taking into account that these are, or should be, scheme-specific. We feel that if the overall technical provisions are felt to be adequate, there should be no need to home in on any specific assumption in quite the way TPR describes. Guidance on the mortality improvement assumption is to be welcomed – it is a very complex area. But the ‘trigger’ approach indirectly provides prescription rather than focus. And by prescribing what it considers to be prudent, TPR is, in effect, setting a minimum requirement on a single assumption which schemes will feel bound to follow.
19. We would be very concerned if this type of focus on a single assumption were to extend to other individual assumptions. This would overturn the current statutory requirement that trustees make decisions on a scheme-specific basis and give TPR the inappropriate role of prescribing actuarial assumptions.
20. In addition, TPR’s expectation of recovery plans filed since its initial analysis was carried out (stated in the last sentence in paragraph 2.3 of the consultation document) suggests that the introduction of the trigger described in paragraph 2.7 could be seen to be premature at this stage. Responsible trustees are already acting responsibly.

Q9 Do you agree that our proposal offers the best way for the regulator to identify mortality assumption risks?

21. For the reasons set out above, we do not think that the proposed approach is the best one. We understand TPR advocating long cohort as a prudent and, therefore, desirable assumption – and would be supportive of such statements, with appropriate caveats about the uncertainty involved, being included in trustee guidance. But, again we object to the potentially prescriptive step of treating its non-adoption as a trigger. As a principle, prescription does not encourage trustees to truly take responsibility and meet the intent of the legislation. Nor does it retain for them the full flexibility to negotiate on the constituent parts of running a scheme that can aid sponsor/trustee discussions.
22. There could also be concern for any scheme which has already completed its valuation by reference to assumptions which are 'prudent' overall but which adopt the short cohort or medium cohort mortality projections. If such a scheme were to feel bound to adopt a long cohort projection at its next valuation, it would be unable to achieve the same overall level of prudence by adopting less prudent assumptions in other areas unless such action could be shown to reflect changes in "legal, demographic or economic circumstances" [see The Occupational Pension Schemes (Scheme Funding) Regulations 2005, regulation 5(4)(d)]. Effectively, that scheme's overall level of prudence could be increased in comparison with another scheme, which had been at the same level at its first scheme funding valuation but which had adopted a long cohort projection in conjunction with, for example, less stringent technical provisions in relation to the discount rate.

Q10 If your answer to question 9 is no, what other approach would you prefer and why?

23. We believe that in judging whether adequate prudence has been applied, a scheme valuation should be considered as a whole. An assumption-by-assumption approach could result in an overall outcome that is extremely (and possibly excessively) prudent. And if TPR takes the view that a particular margin of prudence is essential for some assumptions, the broader view could result in relaxation in setting other assumptions, thus achieving nothing overall. The temptation might then be for the Regulator to provide similar guidance on those other assumptions, eventually leading to full prescription on valuations.
24. In paragraph 3.16 of the Regulator's statement of May 2006, setting out how it will regulate the funding of defined benefits, TPR stated that one of the circumstances where the recovery plan trigger will apply is where underlying assumptions appear inappropriate. We believe that TPR, in issuing welcome guidance on good practice in choosing assumptions, should be illustrating where it might consider an assumption to be inappropriate and where it would expect a statement of explanation as to its use. In that way it will continue to encourage trustees to act responsibly without indirectly imposing inappropriate restrictions.