DB Funding - a call for action

October 2012

DB Funding – A Call for Action

Summary

The Bank of England's recent confirmation of the adverse consequences of Quantitative Easing (QE) for DB pension schemes and their sponsors is a welcome development and has raised important questions about the appropriate policy response from Government and regulators. By continuing to highlight this issue the NAPF aims to promote an environment where well-funded pension schemes can deliver benefits to members over the longer-term by ensuring pension provision is seen as sustainable by sponsoring employers.

We welcome the Pension Regulator's (TPR) acknowledgment of the pressures on DB schemes currently going through their triennial scheme funding valuations, and the assurances that have been offered on the flexibilities available for trustees and sponsors. However, we remain concerned that the strong focus on affordability for using these flexibilities will mean the majority of sponsoring employers (75% of them, according to TPR's latest analysis) will find their deficit contributions increased, and/or recovery plans extended, where this is being largely driven by artificially low gilt yields. This is a concern where sponsors could otherwise be channelling that investment elsewhere to the longer term benefit of employees, scheme members and the wider economy.

This paper compares scenarios for calculating technical provisions in scheme funding valuations and considers two approaches for a policy response to the economic conditions. One takes a 'smoothing' approach to discount rates, as proposed by others in the UK and as adopted by other countries including the United States and the Netherlands. The other makes a temporary adjustment by adding a mark-up to discount rates that are based off gilt yields, with the aim of mitigating some of the impact of the current artificially low yields. Our estimates suggest that a smoothing approach would serve to almost eliminate any deficits in the short-term, whilst a temporary adjustment would significantly reduce deficits. In the case of even a cautious 0.5% uplift to the discount rate, the reported aggregate funding deficits of the FTSE 350 between December 2011 and March 2012 would be 40-50% lower. Looking at the tranche of DB schemes going through their funding valuations now, the temporary adjustment approach could reduce the size of the deficits being reported by £20-£37bn.

Enabling trustees, sponsors and actuaries to address current adverse economic conditions directly through the calculation of their technical provisions would avoid the negotiations around recovery plans beginning from what might be described as a recklessly prudent starting point. This would ease burdens on sponsoring employers in the short-term and would in turn support business investment and economic growth. A temporary adjustment or mark-up is more in line with the flexibility in the existing regulatory landscape and can be reviewed and switched off as economic conditions and monetary policy responses evolve. We therefore argue that this is the most proportionate response to the extraordinary economic conditions DB schemes are facing. Our specific recommendations are that:

1) The Government and TPR should make it clear that, in the current environment of exceptionally low gilt yields, an adjustment to a gilts based rate to allow for the adverse impacts of QE on DB schemes is an acceptable part of a prudent valuation basis. This is likely to require a clear Government statement or direction, given TPR's current stance, through the Chancellor's Autumn statement if not before.
2) The current approach of TPR to allow flexibility in the length of recovery plans should be continued and, when trustees and sponsors agree it is in the long term interest of the pension scheme, extended to all schemes, not only those with affordability concerns.

We also recommend that TPR's objectives should be reviewed and amended to more fully take into account consideration of the long term economic prospects of employers and the sustainability of the pension scheme. This would ensure greater regard is given to the macroeconomic picture when setting guidance.

Introduction

1. The UK economy, like many others, is facing challenging economic conditions, with the Bank of England taking the exceptional action of buying £375bn of gilts between February 2009 and October 2012 to stimulate investment in the UK economy and lower borrowing costs. The NAPF recognises the wider benefits to the UK economy of the Bank of England's Quantitative Easing (QE) policy, but we remain concerned about the damaging impacts for defined benefit (DB) schemes – particularly where the discount rates used for scheme valuations are based on gilt yields that are held at artificially low levels through monetary policy interventions. Without mitigating action, there is a risk that the unintended consequences of the Bank's Asset Purchase Programme constrain the ability of DB scheme sponsors to invest in the economy.

2. Over the summer the NAPF talked to its fund members who have continued to raise very serious concerns about the impacts that low gilt yields are having on their funding valuation assumptions and the resulting impacts on scheme deficits. By highlighting this issue the NAPF aims to promote an environment where well-funded pension schemes can deliver benefits to members over the longer-term, by ensuring pension provision is seen as sustainable by sponsoring employers. In doing so we have endeavoured to balance the interests of both trustees (and, in turn, scheme members) and scheme sponsors.

3. Whilst there is a welcome degree of flexibility in the UK funding regime, the concerns being raised by those running DB schemes are three-fold:
    - Firstly, huge jumps in the deficit can 'spook' sponsors and trustees, prompting them to question whether they can continue to support the scheme;
    - Secondly, where details of the valuation are in the public domain, this can then damage corporate credit-ratings, with all the consequences that brings; and
    - Finally, the size of the scheme deficit does have a real bite, to the extent that any recovery plan subsequently agreed to fill the deficit leads to higher sponsor contributions into the scheme than would otherwise have been the case.

4. At a time when the Government is striving to encourage investment in the economy, we believe this should be a key concern for policymakers. The higher DB deficits likely to be reported in this latest round of scheme valuations run the risk of diverting cash away from investment and jobs and locking it away in the pension scheme, in some cases into more gilts as DB schemes seek to hedge themselves against further future movements in discount rates. This runs counter to the wider aims of the Bank of England's QE programme to encourage investors to increase investment in the UK economy.

5. There have already been calls on the Government to smooth the measure of gilt yields for businesses to help address the rising costs of funding DB schemes on corporate sponsors. This call for smoothing mirrors some of the action that has been adopted overseas, for example in the US and in Scandinavian countries, where a variety of approaches have been taken. Some of these approaches require caution in their application to the UK, particularly where they relate to more prescriptive regimes and could be seen to pave the way towards Solvency II style funding requirements for occupational pension schemes being proposed by the European Commission.

Even after the flexibilities in the UK's scheme specific regime are taken into account, there is strong merit in exploring how the Government and TPR could give greater reassurance to sponsors and trustees by signalling openness to an approach to discount rates other than one pegged to very low gilt yields. Given that such an approach could serve to reinforce monetary policy and support greater investment in jobs and growth in the UK we hope that this would be the case.

6. This paper is timed to inform the Government's deliberations on this matter in advance of the Chancellor's Autumn Statement[1]. Notably, in April the Treasury Select Committee, as part of its response to Budget 2012[2], recommended that *"the Government consider whether there are any measures that should be taken to mitigate the redistributive effects of quantitative easing, and if appropriate consult on them at the time of the Autumn Statement"*. In its response to the Select Committee[3], the Government noted that the Bank of England would be publishing analysis on the distributive impact of QE and commented that the Government keeps policy under review and would *"consider the Bank of England's findings"*. Given the urgency for those already going through their triennial valuations who are now well into the 15 month 'certification periods'[4], an announcement on this issue is now urgent.

7. This paper addresses these issues and proposes a solution that seeks to balance trustee and sponsor interests and fit within the existing legislative regulatory framework for DB funding. The paper reflects the views of the NAPF, and has been developed in consultation with the NAPF's DB funding working group, through discussions with our legal panel, and with other fund and business members. The working group (see Acknowledgements) included representatives from NAPF fund members, as well as investment managers, consultants, and representatives from the actuarial and legal profession. Our aim has been to use our unique position to balance the interests of trustees and sponsors and put forward a solution that mitigates some of the more acute impacts of the current economic crisis and response and that allows sponsors and trustees to begin their negotiations on recovery plans from a more realistic starting point.

8. This paper addresses:

- the regulatory landscape for DB scheme funding in the UK;
- the current economic conditions and impacts of QE;
- the appetite for change and action taken overseas;
- the impacts of different discount rate assumptions on DB scheme funding levels, deficits and sponsor contributions; and
- an assessment of these options and the NAPF's recommendations for action.

[1] Due on 5th December 2012.
[2] Treasury Select Committee Thirtieth Report
[3] Budget 2012: Government Response to the Committee's Thirtieth Report of Session 2010–12
[4] The 15 month window within which trustees are expected to complete their valuation and submit their recovery plans to TPR.

9. We do not seek to address the broader issue of valuations for the purpose of accounting standards where there are ties across to international accounting standards, but focus on the issue of triennial scheme funding valuations where the current low gilt yields are having the most immediate impact.

Regulatory Landscape for DB Scheme Funding in the UK

10. There is*,* in theory, sufficient flexibility within the legislative framework for trustees and sponsors (with assistance from their advisers) to discuss and agree a discount rate that takes into account long term asset returns, long term government and corporate bond yields, or something in between.

11. The extent to which the legislative framework prescribes the discount rate to be used is contained in regulation 5 of the Occupational Pension Schemes (Scheme Funding) Regulations 2005 which provides that;

> *The rates of interest used to discount future payments of benefits must be chosen 'prudently' taking into account i) the yield on scheme assets held to fund future benefits and the anticipated future investment returns and/or ii) market redemption yields on government or other high quality bonds*[5]*.*

12. There is no legislative definition of "prudently". This creates the potential for considerable flexibility in the funding regime and, in particular, the assumptions that can be used when calculating a scheme's technical provisions.

13. Although it is for trustees to choose the assumptions to be adopted for the calculation of the scheme's technical provisions (having taken advice from their actuary and reached agreement with the employer), it is TPR that monitors and enforces compliance with the funding regime. It is therefore TPR which ultimately determines whether any particular set of assumptions is considered sufficiently prudent or not. In essence, it is TPR's interpretation of the intent and scope of the legislation that governs the extent of the flexibility available within the legislative framework.

14. TPR has issued guidance, in the form of its 'Regulatory Code of Practice 03' Funding Defined Benefits[6], directed at trustees and their actuarial advisers regarding their duties under the scheme specific funding regime. This Code encourages trustees to obtain actuarial advice on, and discuss with the employer, a range of matters including:
    - the current price of UK government securities and the information this provides about the expected return on investments which are low risk in relation to liabilities;

[5] Calculation of Technical Provisions Regulation 5 (4)(b)
[6] TPR's Regulatory Code of Practice 03

- relevant economic and financial factors such as price and wage inflation, and the expected returns on, and risks associated with, asset classes other than UK government securities;
- the trustees' investment policy and the extent to which the expected returns on, and risks associated with, actual investments held should be reflected in assumptions about investment returns.

15. All of these factors should feed into the selection of discount rates. There is no legislative reason why the outcome of discussions on these matters may not result in a discount rate being chosen that takes account of yield on assets held to fund future benefits plus anticipated future returns (the factors in i) in Regulation 5). However in practice there appears to be a perception amongst those running DB schemes that TPR considers the most prudent approach to the calculation of the discount rate to take into account market redemption yields on high quality bonds (the factors in ii) in Regulation 5).

16. The feedback we have gathered from trustees, actuaries, consultants and sponsors involved in the triennial scheme valuation process suggests that they believe TPR's view to be that a risk free gilts based approach is the most appropriate approach and that this is driven by a desire to eliminate as much risk as possible. In addition, in its Annual Funding Statement (April 2012)[7] TPR states that it "*does not consider smoothing the discount rate to be consistent with the legislative requirement to value assets on a mark-to-market basis"* and "*it would not be prudent to try to second guess market movements by assuming that gilts will inevitably improve in the near term*". As a result we are concerned that the flexibility contained within the legislative framework is not being utilised and the Annual Funding Statement does not go far enough to enable schemes to change their discount rates appropriately to take account of the current economic climate and exceptional policy response.

17. Regulation 5 also provides that any movement away from the assumptions used in a scheme's previous valuation must be justified. TPR's Code of Practice on DB funding (page 33, paragraph 93) makes this clear:

    "*At subsequent valuations, trustees may choose a different method or different assumptions to those previously adopted where justified by a change of legal, demographic or economic circumstances.* "

18. We believe that the unprecedented scale of the Bank of England's Asset Purchase Programme would justify a signal from Government or TPR that different assumption economic may be adopted as part of the current round of triennial valuations. It would seem appropriate for trustees and sponsors to seriously consider adopting an alternative approach to discount rates, given that both the Bank of England and Government have recognised the very challenging economic conditions we are now facing. The Bank has taken the exceptional measure of stimulating the economy by buying gilts, and has done so against a backdrop of already strong demand for gilts from investors (against limited supply) due to conditions in the wider sovereign and corporate bond yield markets.

[7] Pension scheme funding in the current environment, April 2012

19. If a clearer statement was made by the Government on the impacts of QE on gilt prices, yields and other asset prices then trustees, actuaries and sponsors may take greater comfort in changing their discount rate assumptions to accommodate changes in the economic circumstances where it is appropriate for the scheme concerned. To date, this has not been encouraged. TPR has insisted that any changes to take advantage of the flexibility in the funding regime should be made through schemes' recovery plans rather than through adjustments to the technical provisions themselves. Given that TPR's remit currently prevents it from paying full regard to prevailing macroeconomic conditions it is difficult to understand the basis on which this judgement has been reached.

20. Whilst we welcome TPR's Annual Funding Statement and subsequent assurances around allowing extensions to recovery plans to offset the impact on sponsor contributions, we would argue this is not sufficient. Greater allowance should be given for changes to the discount rates used to calculate the technical provisions because:

    - Sponsors tell us that the triennial DB scheme valuations (as well as FRS17 accounting deficits) can, in some circumstances, feed into their corporate activity and the attitude of investors. This can occur, for example, through assessments of credit ratings and in the investment plans of overseas sponsors, both of which can react negatively to the potential for increases in pension deficits should asset values and discount rates continue to decline.
    - Sponsors who can afford to make higher contributions still believe they will come under significant pressure from TPR to fill the deficits in their DB plans, which may lead them to hoard cash, meaning that money is being diverted away from investment, expansion, and jobs.
    - TPR's approach to extending recovery plans is as yet untested and will take place on an individual scheme-by-scheme basis, creating uncertainty as to what length of recovery plans TPR will consider acceptable or not and whether the impact of higher deficits resulting from low gilt yields will be fully offset in practice.

21. Long-term pension scheme decisions should be based on an appropriate starting point. If trustees and sponsors are beginning their negotiations from a valuation which is based on atypical economic conditions then one could argue that the subsequent negotiation is potentially flawed.

22. For these reasons, we argue that the current Annual Funding Statement (April 2012)[8] and subsequent speech by TPR's Chairman[9], still does not go far enough to enable trustees, sponsors and their actuaries to make full use of the flexibility in the regulatory landscape and leaves DB scheme sponsors very concerned about the cash contributions they may be required to make over the next few years. Trustees are unlikely to feel comfortable taking a less conventional

[8] Pension scheme funding in the current environment, April 2012
[9] TPR Chairman Michael O'Higgins speech at Professional Pensions show

approach to agreeing discount rate assumptions given the guidance already issued by TPR, and the other communications they may have received, and may still feel pressured to challenge their sponsor to plug greater contributions into the scheme to fill artificially higher deficits.

23. The latest evidence and analysis published by TPR[10] concludes that, based on their current assumptions and modelling, around 25% of schemes will not need to extend their recovery plans or increase contributions, whilst the remaining 75% will. Of that 75%, they suggest that:

- 30% will need to extend their recovery plans by three years and increase contributions by 10%;
- 20% will need to extend their recovery plans by three years, increase their contributions by 10% and make use of further flexibilities including greater investment outperformance in the recovery plan; and
- 25% will need to significantly increase their contributions and/or make use of other flexibilities available where there are affordability challenges.

24. Despite the TPR Chairman urging trustees not to be *"recklessly prudent"* in the valuation assumptions and their negotiations with employers the subsequent TPR evidence and analysis still places a very heavy emphasis on affordability suggesting the full flexibilities should only be used where the employer cannot afford to increase its deficit recovery contributions into the pension scheme. This still places an onus on trustees to pursue higher contributions into the scheme, on the basis of current low gilt yields and higher deficits, where the employer is judged to have the resources to spare.

25. We acknowledge that TPR may feel hindered in applying fuller flexibility to scheme specific funding assumptions, including the economic assumptions that feed into technical provisions, because of the insufficient breadth in its objectives to take account of wider economic circumstances and pressures on employers. The TPR's statutory objectives are:

- To protect the benefits of members of work-based pension schemes.
- To promote, and to improve understanding of, the good administration of work-based pension schemes.
- To reduce the risk of situations arising which may lead to compensation being payable from the Pension Protection Fund (PPF).
- To maximise employer compliance with employer duties (including the requirement to automatically enrol eligible employees into a qualifying pension provision with a minimum contribution) and with certain employment safeguards.

26. If TPR had a more explicit objective which required it to give consideration to the longer-term health of the sponsoring employer and the future sustainability of pension provision, it might feel enabled to take a more balanced approach to scheme funding. This is important for the 2

[10] DB pensions flexibility and impact analysis, October 2012

million or so active members of private sector DB schemes in the UK who have a strong interest in their sponsoring employers keeping their schemes open and their contributions manageable.

Current Economic Conditions and Impacts of Quantitative Easing

27. The NAPF's report 'Exceptional times, exceptional measures?' summarised the developments since the Asset Purchase Facility Fund was first established in January 2009. Since that report was published, the Bank of England has announced a further £50bn of QE to take the full extent of the programme from £325bn to £375bn.

28. Gilt yields have been observed to react both to the announcements on QE and the prior expectations of those announcements. The largest reaction was in March 2009 when the first £75bn was announced, though all the reactions were found to be statistically significant and the Bank estimated in 2011 that, summing the reactions of gilt yields to each of the QE events, there was an average fall of 100 basis points[11]. This was largely attributed to portfolio rebalancing effects as the prices of corporate bonds and equities were also seen to respond to QE events – corporate bond yields fell over the period and the value of UK equities fell less than their international counterparts.

29. The Bank's overall assessment of the first round of QE (some £200 billion of asset purchases) was that it may have raised the level of real GDP by 1.5-2% and increased inflation by 0.75-1.5 percentage points and that, whilst highly uncertain, these effects were economically significant. To that extent, the first phase of QE was deemed by the Bank to have been a successful monetary intervention – with the economic effects equivalent to a 150 to 300 basis point cut in the Bank's interest rate. Its latest analysis[12], based on a simple ready reckoner from the primary forecasting model used by the Bank of England, suggests that when including the additional £125 billion of asset purchases, the total impact would be equivalent to a 250 to 500 basis point cut in the interest rate.

30. There has been some scepticism about the continued reliance on QE for the later rounds of Asset Purchases. Analysts at Morgan Stanley have suggested evidence[13] showing that the QE programme may be suffering from significant diminishing returns. They have suggested that alternative methods of stimulating the economy including cutting interest rates, cutting the remuneration rate paid on commercial bank reserves at the Bank of England and shifting the QE programme to non-gilt asset purchases will now have a greater impact.

[11] The United Kingdom's quantitative easing policy: design, operation and impact, 2011.
[12] The Distributional Effects of Asset Purchases, Bank of England, 2012
[13] Morgan Stanley Research Brief, 2012

31. In December 2011 the Pension Corporation[14] recognised the wider benefits of QE but called for any future rounds to be targeted away from the purchase of long-dated gilts and more towards purchasing stressed assets from banks' balance sheets. They claimed this could help pension schemes by increasing the investment returns on gilts and reducing downward pressure on yields. They argued that the fall in gilt yields has had a particularly big impact on longer term (> 25 year) liabilities of DB pension schemes. The Pension Corporation estimated that sponsors could be forced to pay £7.4bn a year into schemes until 2020 to cover the increase in liabilities resulting after the first round of QE alone. In May 2012 the Pension Corporation subsequently estimated[15] that up to £100 billion could move from corporate sponsors to plug their DB pension scheme deficits over the next three years, diverting money away from other investments.

32. The Bank of England's first explicit comments on the effects of QE on DB pension schemes were made by Deputy Governor, Charlie Bean, at the NAPF Local Authority Conference in May 2012[16]. He set out that, for a pension scheme starting in balance, the impact of QE had been broadly neutral, with positive movements in assets broadly matching the movement in liabilities. This assumed that DB pension schemes saw asset returns respond positively to QE over the period in line with the observed movements in UK equities and bonds, with the asset allocation assumed to be comprised of 60% equities and 40% fixed income.

33. However, he also acknowledged that the average DB pension scheme started from a position of deficit in 2007 of 30% of full buy out liabilities. For such schemes, deficits would have risen by a further 10% of liabilities between the start of the Asset Purchase programme in 2009 and early 2012. These estimates were broadly in line with those published by the NAPF in March, where we suggested that the impact of falling gilt yields since the summer of 2011 would have increased DB scheme deficits by around £90bn.

34. Table 1 below shows that, according to the NAPF Annual Survey, schemes in deficit (on a scheme specific funding basis, which is less stringent than the full buy out basis) represented 87% of all private sector DB schemes in 2011**.** In 2007, before the beginning of the economic downturn, around 75% of schemes were reporting being in deficit.

[14] Pension Corporation Press Release, 2011
[15] Pension Corporation Press Release, 2012
[16] Speech by Deputy Governor Charlie Bean to the NAPF Location Authority Conference, 2012.

Table 1 – Percentage of DB Schemes in Surplus/Deficit on a Scheme Specific Funding basis

	2007	2008	2009	2010	2011
Deficit	75%	73%	85%	85%	87%
Surplus	25%	27%	15%	15%	13%

Source: NAPF Annual Survey, 2007-2011. Notes: Based on schemes answering in each years Annual Survey in respect of their most recent valuation so will also pick up valuations in previous three years.

35. Deputy Governor Charlie Bean concluded that, *"it makes little sense to rush to close a deficit that is likely to prove temporary"* but *"if a deficit is likely to persist, then corrective action is required, initially to prevent it continuing to expand and ultimately to close it"*. He also noted that *"while there are reasons to expect yields to return towards historically more normal levels at some stage, it is difficult to know when that will be and how quickly it will occur"*. He therefore urged some caution in simply looking through the rises in deficits associated with lower gilt yields as pension funds and their sponsors may have to contend with low yields for some time.

36. The Bank's most recent analysis[17], published in July 2012, reiterated the points raised by Charlie Bean's speech. It identified that the impact of QE on a DB pension schemes position depends on the extent to which there is a mismatch between the funds' assets and liabilities (whether it is fully hedged against movements in discount rates) and on whether a DB pension scheme begins in a position of deficit or not.

37. The Bank modelled three different schemes as illustrative examples:
    i) A 'baseline' scheme, fully-funded at March 2007, and with matched assets and liabilities
    ii) 'Scheme 1', fully-funded at March 2007, but with 'mismatched' assets and liabilities
    iii) 'Scheme 2', under-funded at March 2007, and with 'mismatched' assets and liabilities

    The Bank's estimates of the isolated impacts of QE on these illustrative schemes are shown below in Table 2.

Table 2 – Illustrative examples of DB scheme deficits

	'Baseline Scheme'	'Scheme 1'	'Scheme 2'
Deficit at Mar-07	0.0	0.0	-30.0
Deficit at May-12	0.0	-33.5	-65.5
Mar-07-May-12	0 [0%]	-33.5 [-33.5%]	-35.5[-50.7%]
Due to QE	0	-5.1	-12.6
Change in assets	30.3	25.2	17.7
Change in liabilities	-30.3	-30.3	-30.3
Due to other factors	0	-28.4	-22.8

Notes: £m deficit for DB pension schemes with £100m starting deficit in March 2007

[17] The Distributional Effects of Asset Purchases, Bank of England, 2012

38. They found that QE has two effects: i) pushing up the value of the gilts and equities held by the scheme and ii) increasing the scheme's liabilities by reducing the discount rate the pension scheme applies to its future liabilities, thereby increasing the current value of its liabilities. 'Other factors' are then calculated by the residual and include other movements in gilt and equity prices that are not directly related to QE – including the flight to assets perceived as safe and high quality. The conclusion is that for a scheme ('Scheme 1') that was fully funded in 2007 but that was not fully matched (i.e. not fully invested in gilts) the deficit would have increased from £0m in 2007 to £33.5m in 2012. For a scheme that was not fully funded in 2007 and that was also not fully matched ('Scheme 2') the deficit would have increased from £30m in 2007 to £65.5m in 2012.

39. Whilst the Bank of England's analysis is helpful in identifying the direct impact of QE on DB schemes, we are concerned that the Bank has underestimated the impact by overestimating the positive effect on the assets side of the funding calculation. This is because the 'change in asset' values are based on applying the estimated positive increases in UK equity prices and gilt prices resulting from QE, with UK equities assumed to comprise 60% of total scheme assets and UK gilts 40% of total scheme assets. However, as Table 3 below shows, in practice private sector DB schemes invest only a minority of their assets in UK equities and gilts (some 12% and 18% respectively in 2011, based on the NAPF's Annual Survey).

Table 3 - Defined benefit schemes' investments 2009-2011 (private and 'other public sector')

	% invested in asset class		
	2011	2010	2009
Equities – UK	12.2	17.1	20.2
Europe, excluding UK	4.2	4.6	6.4
North America	4.8	4.9	7.5
Japan	2.0	1.8	3.0
Other developed economies	1.8	1.7	2.5
Emerging markets	3.6	2.5	1.7
Global	13.5	13.5	8.1
UK conventional gilts	5.2	4.0	5.4
UK index-linked gilts	12.8	12.6	7.9
Overseas government bonds	1.9	1.5	1.3
Corporate bonds	12.4	14.5	11.0
CDOs	0.1	0.0	0.6
Other fixed interest	0.8	2.6	5.5
Property	7.2	5.4	6.6
Private Equity/Venture Capital	3.8	3.0	2.1
Hedge Funds	4.1	2.6	1.8
Infrastructure/PFI/PPP	1.1	0.8	0.9
Insurance policies	0.1	0.5	0.8
Commodities	0.7	0.4	0.6
Cash/short-term investments	3.2	2.3	1.5
Active currency	0.2	0.2	0.1
Other	8.2	3.7	4.9

Source: NAPF Annual Survey 2009-2011

40. Therefore the positive impact on the assets side is likely to be overstated. This will be particularly marked where DB schemes hold more diverse assets that benefit less from domestic rounds of QE, and in the more recent years when holdings of UK equities have rapidly declined. Whilst it is difficult to disentangle the asset price effects from changes in asset allocations over time, we would welcome further analysis from the Bank that applied more realistic asset allocations over the period as this is likely to show a more adverse impact on DB scheme funding from QE.

41. The figures presented by the Bank of England might suggest that, for a typical scheme, around a third of the adverse impact on DB scheme funding since the beginning of the downturn and the Bank's asset purchase programme may be directly attributable to QE. Given that the intention of QE was to have an overall positive impact on the UK economy, there is a strong rationale that the Government and TPR should look for further opportunities to mitigate any of the adverse consequences and bolster the positive impacts.

Appetite for Change and Action Taken Overseas

42. There is a delicate balance to be struck in arguing for further action in the UK. The key challenges in proposing any action are i) unpacking the likely downward drag that gilt yields are having on DB scheme deficits in practice, and identifying how much of that may be attributable to QE as opposed to wider (and possibly longer term) economic conditions and ii) proposing a measure that provides some flexibility and alternatives to corporate sponsors in the current climate without undermining the position of trustees entering negotiations with sponsors on behalf of their members.

43. Trustees' views on these issues are mixed. The guidance issued by TPR has certainly been considered helpful, though recent polling results point towards trustees having some appetite for TPR to go further and a preference for adopting a discount rate approach that protects them from some of the recent volatility. An NAPF survey earlier this year asked our members what action they would like to see from TPR and others to help those running DB pension schemes at the current time. The most popular option was for TPR to allow use of an alternative discount rate, with 57% stating this as their first choice and 81% stating this as their first or second choice. The second most popular option was for TPR to extend recovery plans with 16% stating this as their first choice and 48% stating this as their first or second choice.

44. More recently, a poll published by SEI[18], a leading global provider of fiduciary management, revealed that, despite the April funding statement from TPR, UK pension schemes do not think that it has gone far enough in its efforts to reduce the impact of QE for pension schemes. The poll found that 80 per cent of those surveyed felt that TPR should provide more flexibility in the current rules to reduce the impact of QE on pension scheme liabilities. When asked what they thought would be the most impactful change from a range of options, 50 per cent of those

[18] SEI poll with pension scheme trustees

surveyed felt that pension scheme liabilities should be based on an average of the last three years' bond yields, whilst 38 per cent felt that the period for meeting funding objectives should be extended. SEI's poll, conducted in July 2012, was completed by trustees, finance directors, and other pension fund executives from 51 different pension funds.

45. In July 2012 the CBI[19] called for further action to prevent the growing costs of supporting DB scheme deficits undermining businesses' ability to invest and create jobs. They stated a view that the artificially high deficits resulting from exceptionally low gilt yields will prevent investment as trustees demand higher funding from scheme sponsors. Specifically they asked the Government to address the volatility of deficits by introducing a more long term method of calculating the pension liabilities, namely a smoothing of the gilt yield to reflect the long-term nature of pensions. Alternatively they suggested that the discount rate used for scheme valuations could be set by an independent body such as the Office of Budget Responsibility, based on the gilt rate but adjusted for cyclical factors.

46. A number of countries, including the United States, Sweden, the Netherlands and Denmark have already taken action to smooth the discount rates being used to value the liabilities of both occupational pension schemes and insurers. Caution needs to be applied to simply translating these across to the UK, given the differences in the institutional landscape and regulatory frameworks for pensions in each country. In particular, there is much to be said for the flexibility in the regulatory landscape in the UK (in particular in the legislative framework) and our view is that any temporary measure should be introduced within the current framework to maintain its flexibility to adapt to scheme circumstances.

47. The countries who have already adopted smoothing have a number of features in common. First and foremost, like the UK, the countries have all seen significant reductions in the yields on their sovereign bonds. This is as a result of them being considered to have 'safe-haven' status as sources of government-issued debt by international investors and in some cases as a result of their own QE programmes (e.g. in the United States). Second, an approach to smoothing or adopting longer term discount rates has typically been motivated by concerns from the Government and regulators about the impact of higher deficits and sponsor contributions on business investment and growth (in the case of the US) and/or concerns about the asset allocation incentives and a shift away from real assets into financial assets (in the case of Sweden and Denmark).

48. This section briefly discusses the different approaches being adopted and their potential applicability to the UK.

United States – Legislation has been passed to introduce a corridor around a longer-term (25 year) smoothed average discount rate. This will apply to those DB plans who have yet to shift to a fully marked to market approach and who are currently using 2 year averages of AA corporate bond rates to discount their liabilities. The change is a permanent one but the corridor widens over time from disregarding discount rates 10% above or below a 25 year smoothed average in

[19] CBI Press release, July 2012

2012 to discounting rates 30% above or below by 2016. In practice, this is expected to mean that by 2016 the legislation will have little impact and the smoothed discount rates under the corridor will revert to the 2 year average. The approach has received some criticism for pushing back the contributions to DB plans that sponsors will be required to make, with a strong focus on increasing profits and raising tax revenues in the short term. Others have welcomed the change as a mechanism through which the US Congress could raise tax revenues in order to pay for highway infrastructure development.

Sweden – Following concerns at government bond yields spiralling down, Sweden's financial regulator, Finansinspektionen, consulted on introducing a temporary floor for the discount rate used by the country's insurers and occupational pension funds. This was set at the level of yields as at 31 May, by which time yields had already fallen as low as 1.3%. The floor is currently proposed to apply for one year only. A driving concern of the Swedish regulator was that institutional investors might begin to short-sell assets and shift allocations into interest-bearing assets creating a *"negative spiral of continued falling share prices and interest rates".*

Netherlands – Late in 2011 the Dutch pensions supervisor announced that a 3-month average interest rate could be used to relieve pension funds of fluctuating coverage ratios triggered by volatility in long-term interest rates. In a pensions announcement in September the Dutch Ministry of Social Affairs and Employment adjusted the yield curve for ultra long-term obligations to bring it in line with the yield curve applicable to insurance companies. This adjustment is consistent with the proposed policy in the context of Solvency II for insurance companies. The adjustment of the yield curve does not affect obligations with maturities up to 20 years. For longer maturities, the market interest rates will be adjusted gradually over a period of 40 years using the Ultimate Forward Rate (UFR) of 4.2%.

Denmark – A pact was agreed between the Ministry of Business and Growth, Forsikring & Pension, and the regulator for pension companies and life insurers, Finanstilsynet, to raise the discount rate used to calculate liabilities to better reflect longer-term growth and inflation prospects. This change will see the long end of the discount yield curve raised to a level equivalent to normal market conditions and in line with generally agreed long-term projections for growth and inflation – again extrapolated into an 'Ultimate Forward Rate' of 4.2%. The Business and Growth Minister explicitly commented that *"it's key that companies have the possibility to create the best possible returns for pensioners in the future and rules and guidance shouldn't press companies to make short-term investment decisions due to unusual conditions in the capital markets*".

49. In all these cases, the changes announced have been the result of a judgement call, typically by those responsible for Business and Growth and the financial regulators, to offset the impacts of current economic turmoil on discount rates and levels of funding. The UK Government faces a similar judgement call in determining whether to offer corporates sponsoring UK DB pension schemes some form of relief, on the basis that artificially low gilt yields are having a distorting effect on the calculation of scheme liabilities and are therefore unduly constraining their flexibility to invest in the economy. We would urge the Government and the Regulator to exercise caution where approaches could be seen to pave the way for more prescriptive Solvency II type funding regimes, akin to those being proposed by EIOPA on the IORP Directive.

Impacts of Different Discount Rate Assumptions on DB Scheme Funding Levels, Deficits and Sponsor Contributions

50. In this section we have modelled the impact of a range of different discount rate scenarios on pension scheme liabilities, the resulting funding levels and deficits and the implied levels of employer contributions.

51. These different scenarios recognise that there is no 'one size fits all' discount rate assumption for funding valuations set out in legislation, regulation or guidance. There is no single consensus across the actuarial profession on the right approach, reflected by the notable differences between, for example, the approach taken for Local Government schemes and those schemes regulated by TPR and eligible for the PPF.

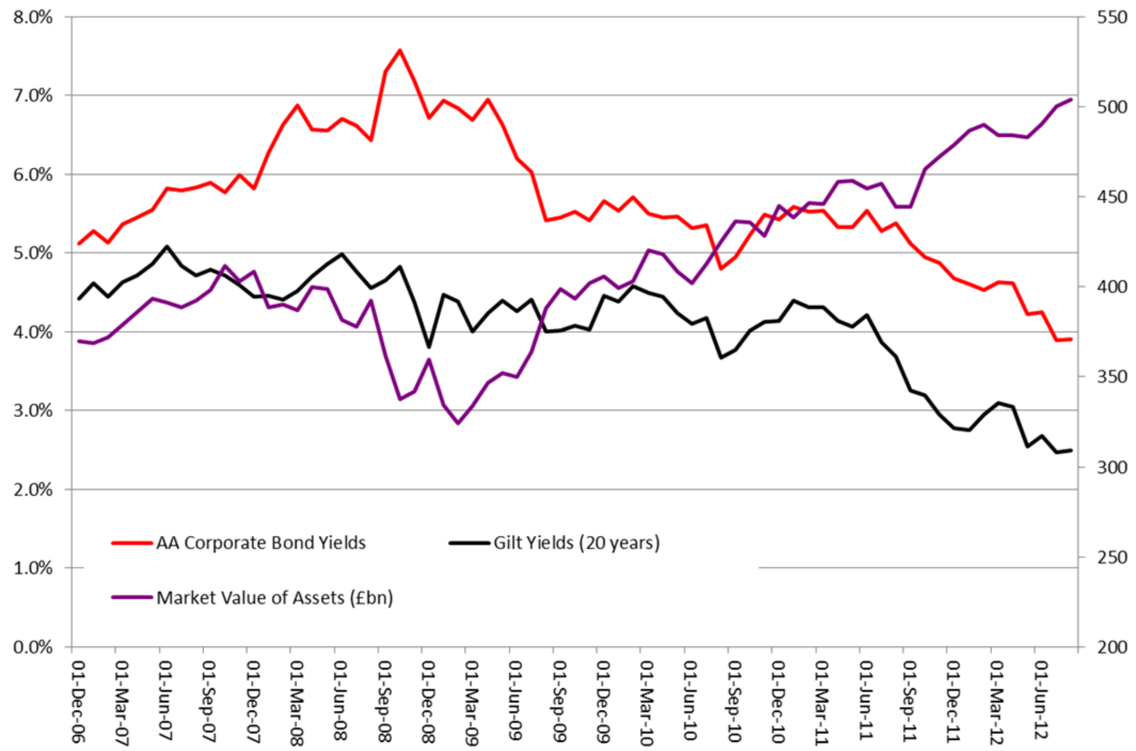
52. The discount rate scenarios we have modelled here are:
    1) A 'baseline' scenario taking a **gilts plus 1%** (G+1) approach which is deemed to be a proxy for a typical pension scheme's technical provisions funding basis. We readily acknowledge that not all schemes adopt this approach but include it as a reasonable working assumption for how many schemes will be approaching their funding valuations.
    2) An **IAS19** scenario that follows IAS19/FRS17 accounting standards and bases discount rates on AA corporate bond yields, to illustrate how the movements in corporate bond yields and gilt yields compare over the period.
    3) A **Smoothed Discount Rate** (SDR) scenario that smooths gilt yields over a 3 year period and then applies on top an equity risk premium of 1% on the same basis as scenario 1 above.
    4) A '**gilts plus plus' relief** scenario that adds an additional margin to the baseline scenario in 1 above to make a compensating adjustment for the likely QE impact on gilt yields – here modelled as a) a 0.5% mark up and b) a 1.0% mark up to illustrate the potential impacts of such an approach. This also makes an offsetting downward adjustment to the value of gilts on the assets side (see Technical Annex for details) – priced down by 6.5% for the 0.5% mark up and by 13% for the 1.0% mark up.
    5) An **Expected Return on Assets** (EROA) scenario that assumes a simplified long term return on assets of 7% for 70% of the assets assumed to be invested in growth assets and the FTSE 20 year gilt yield for 30% of assets assumed to be invested in fixed income/gilt-like assets.

53. Note that all these scenarios for calculating discount rates are, at least in theory, permissible within the current regulatory framework provided they are deemed sufficiently prudent. We present scenarios 3 (**a smoothed discount rate**) and 4 (a **gilts plus plus approach** with upward adjustments of 0.5%-1.0%) as the most plausible policy options to take forward that are still achievable within the current regulatory framework for the triennial scheme funding valuations.

54. The analysis below has been derived using the pensions accounting disclosures produced by the FTSE350, as collated by Aon Hewitt, and adjusted approximately to reflect the variations in the discount rates being modelled. These figures are provided for illustrative purposes only. For more detail on the specific assumptions underpinning these options please see the Technical Annex.

55. The first chart below shows the movements in market asset values for the FTSE 350 DB schemes plotted against the movements in corporate bond yields and gilt yields between 2006 and 2012. Notably, the previous DB funding low point of late 2008 and early 2009 was characterised by a period of both falling asset values and by falling gilt yields, with the spread between corporate bond yields and gilt yields rapidly increasing in 2008 as the impact of the financial crisis on confidence and corporate solvency kicked in and as investors rapidly shifted into perceived safer assets, including gilts. This helps to explain the patterns we observe in deficits and funding levels later in this section.

Chart 1 – Movements in DB Asset Values, Corporate Bond Yields and Gilt Yields



56. Charts 2 and 3 model the estimated funding levels and deficits resulting from different approaches to discount rate assumptions.

Chart 2 – Funding Levels of FTSE 350 on Different Funding Valuation and Discount Rate Assumption bases

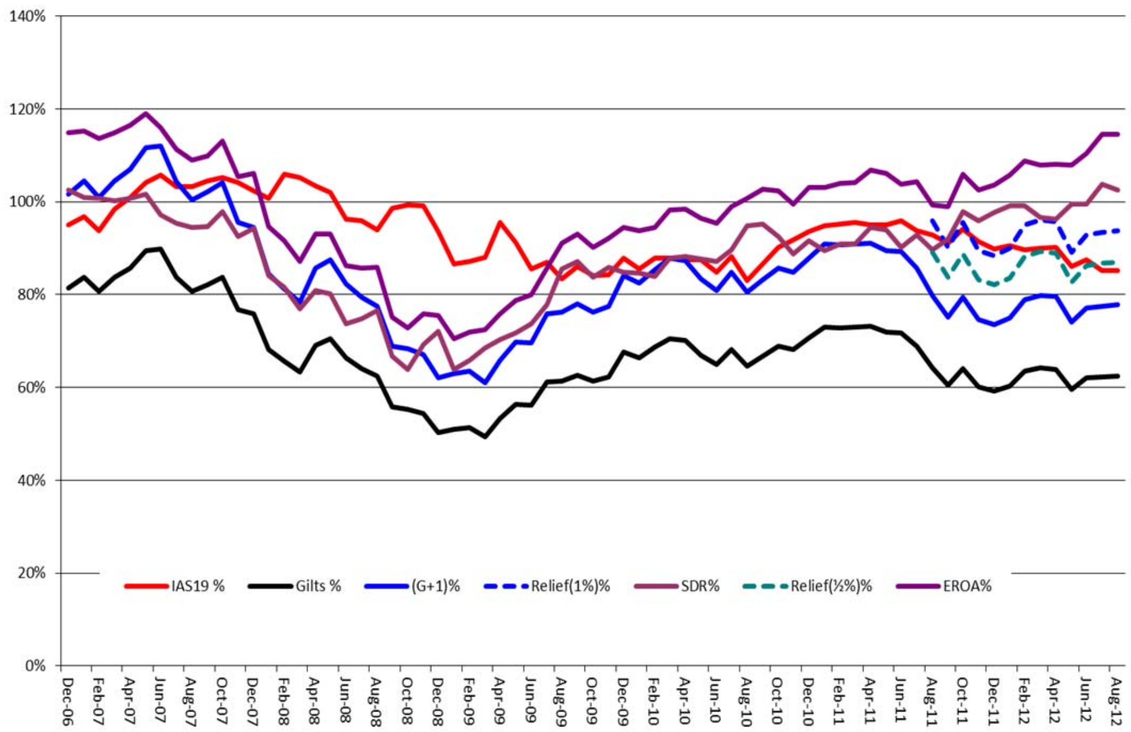
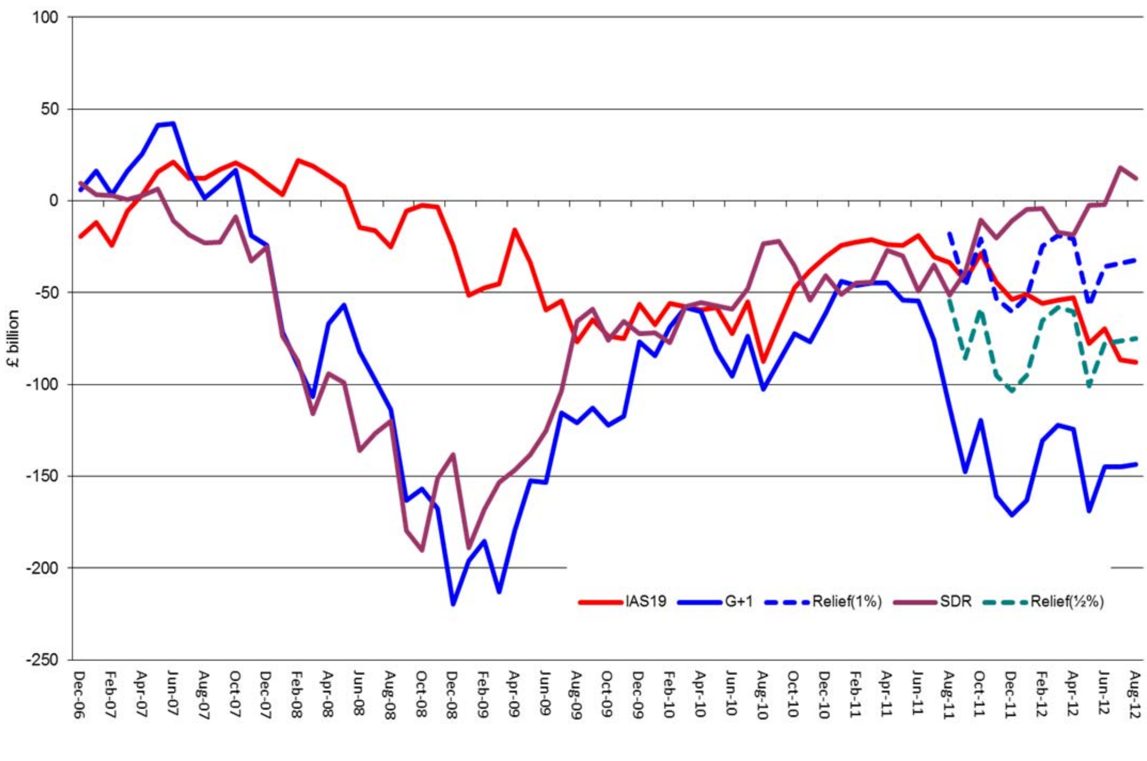


Chart 3 – Deficits of FTSE 350 on Different Funding Valuation and Discount Rate Assumption bases



57. These indicate that funding levels and deficits now are at slightly higher and lower levels, respectively, compared to 2009. However, whilst a combination of both falling equity market

and asset values and wider financial market instability were compounding the effects of lower gilt yields in 2009 it appears to be the falling gilt yields that are now driving the increases in deficits.

58. Compared to a **gilts plus 1%** approach, the options put forward would result in the deficits shown in Table 4 for FTSE 350 companies. A ready-reckoner for the impacts on the current tranche of sponsoring employers ('Tranche 7') with valuation dates of late 2011 and early 2012 is illustrated by simply dividing the aggregate deficit by three (years) to reflect the triennial scheme valuation cycle.

Table 4 – Estimated FTSE 350 Deficits (£bn) for different discount rate assumptions

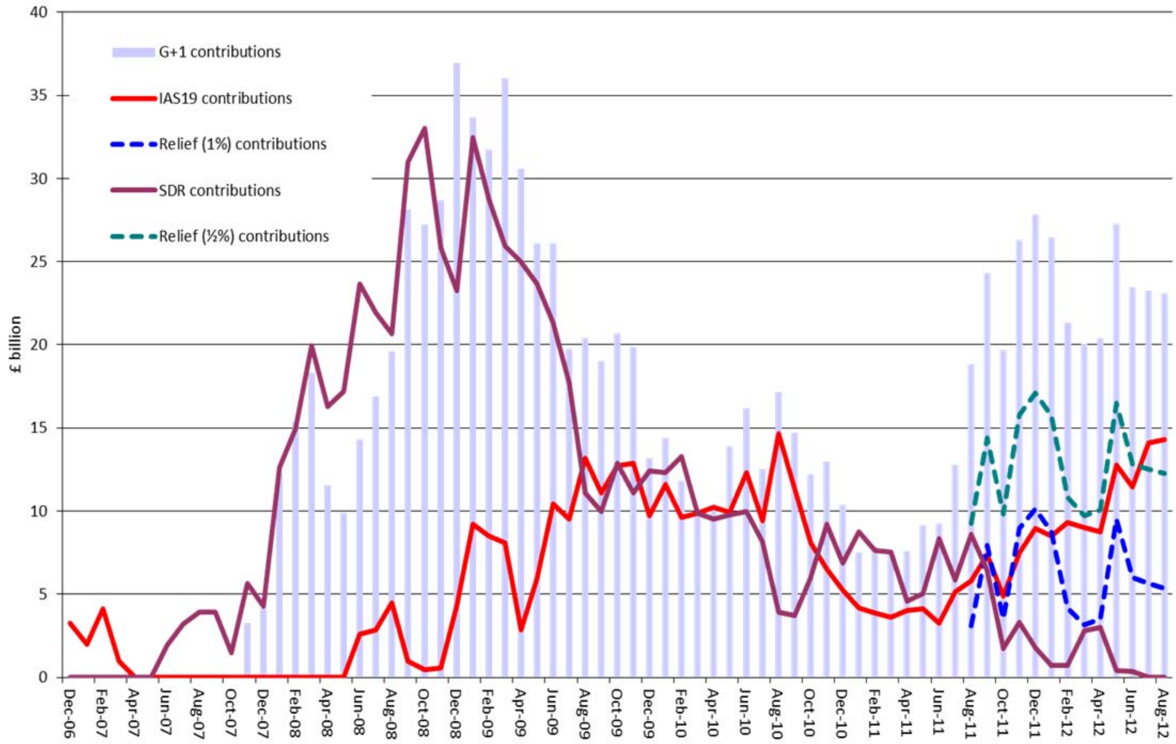
	Gilts plus 1%	**Gilts plus 1% plus 0.5%**		**Gilts plus 1% plus 1.0%**		**Smoothed over 3 years**	
	Deficit (£bn)	Deficit (£bn)	Change (£bn and %)	Deficit (£bn)	Change (£bn and %)	Deficit (£bn)	Change (£bn and %)
FTSE 350 – Dec'11	171.4	103.6	-67.8 (-40%)	60.3	-111.1 (-65%)	11.0	-160.4 (-94%)
One tranche – Dec'11	57.1	34.5	-22.6 (-40%)	20.1	-37.0 (-65%)	3.7	-53.5 (-94%)
FTSE 350 – Mar'12	122.0	58.3	-63.7 (-52%)	18.8	-103.2 (-85%)	17.1	-104.9 (-86%)
One tranche – Mar 12	40.7	19.4	-21.2 (-52%)	6.3	-34.4 (-85%)	5.7	-35.0 (-86%)

59. These estimates suggest that a smoothing approach (based on smoothing over three years) would serve to almost eliminate any deficits in the short-term, whilst a temporary adjustment would significantly reduce deficits compared to a gilts plus 1% approach. In the case of even a cautious 0.5% uplift to the discount rate (and an offsetting downward adjustment to the value of gilts assets held), the reported funding deficits of the FTSE 350 between December 2011 and March 2012 would fall by 40-50%. We show the dates in relation to December and March as these are common valuation dates for DB schemes.

60. Looking at the tranche of DB schemes going through their funding valuations now, the temporary adjustment approach could reduce the size of the deficits being reported by £20bn (for schemes with valuation dates in March 2012 with a 0.5% mark-up) to £37bn (for schemes with valuation dates in December 2011 with a 1.0% mark-up).

61. The implications for sponsor contributions are shown below. These assume a 7 year recovery period (based on the average recovery plan lengths back in 2007) and show how the implied deficit recovery contributions would fall for the different approaches to discount rate assumptions.

Chart 4 – Impact on Implied Sponsor Contributions of Different Discount Rate Assumptions (Annual Deficit Recovery Contributions Required, £ billions, to fill deficits over a 7 year period)



62. In line with the falling deficit figures in Table 4, the implied deficit recovery contributions almost completely trail off for a smoothed discount rate approach, whilst they are adjusted downwards for the 'gilts plus plus' approaches relative to the baseline of a gilts plus 1% approach.

63. TPR's recent evidence and analysis paper[20] showed that recovery plans have already been increasing. For the tranche currently going through their triennial scheme valuations ('tranche 7') they have increased from 7.8 years in 2006 to 9.5 years in 2009 and are now expected by TPR to be maintained at 9.5 years (i.e. rolling over for another 3 years) from 2012. This analysis suggests that, to maintain the level of deficit recovery contributions broadly constant with those from valuations over the last two years, and before making any further assumptions in the recovery plans for gilt yield reversion, the implied recovery plans would need to be extended to 12-20 years.

64. Based on the sponsor contributions that might be required to meet the deficits reported in Table 4 above, we find that maintaining sponsor contributions in line with those who have gone through their scheme valuations in the past two years (at their implied levels of £10-£15bn a year before gilt yields started to fall again in the Summer of 2011) would mean that:

[20] DB pensions flexibility and impact analysis, October 2012

- Under a **gilts plus 1% plus 1%** approach deficits would take 5-6 years to recover based on a deficit of £60bn in December 2011 and only 2 years to recover based on a deficit of £19bn in March 2012.
- Under a **gilts plus 1% plus 0.5%** approach deficits would take 8-13 years to recover based on a deficit of £104bn in December 2011 and only 5-6 years to recover based on a deficit of £58bn in March 2012.

65. We illustrate these differences to show that, compared to the TPR's published evidence and analysis, an adjustment to the discount rate is a more direct lever to mitigate the impact of lower gilt yields on DB scheme funding deficits. Even fairly modest adjustments to the discount rate can significantly reduce both the length of recovery plans and the deficit recovery contributions required.

Assessment of Options and NAPF's recommendations for action

66. TPR's recent statement on the scheme funding framework[21] reiterated the inherent flexibility in the existing legislation which enables measures specific to scheme circumstances to be adopted. However, it stopped short of highlighting that this flexibility includes an ability to adopt different methods and assumptions from those used on the last occasion the scheme's technical provisions were calculated if justified by a *change of legal, demographic, or economic circumstances.*

67. The adverse conditions in the financial markets over the last few years, the necessary response by the Bank of England to those conditions, and the behaviour of UK and international investors in response to those conditions have all driven down gilt yields to historically record low levels. In our view, these impacts are significant and exceptional enough to be considered a 'change of economic circumstances' for the purposes of enabling schemes to consider using different methods and assumptions than used in previous valuations.

Calculation of technical provisions and discount rate assumptions

68. Our analysis shows that the spread between DB scheme funding levels and deficits when based on gilt yields compared to other measures used for discount rate assumptions has increased since the summer of 2011 and is greater now than in the previous period of lower gilt yields back in 2009. This calls into question the suitability of current low gilt yields as a measure by which to discount long-term liabilities in DB pension schemes, particularly when investors are being deliberately encouraged to shift away from risk-free assets by the Bank of England's Quantitative Easing programme.

69. We have considered the potential impacts of both a temporary adjustment to the discount rate and a smoothing of the discount rate. Both options would mitigate the impact of the current low gilt yields on the value of DB scheme liabilities, the ensuing deficits and the resulting

[21] TPR Chairman Michael O'Higgins speech at Professional Pensions show

contributions that sponsoring employers are expected to make. The effect and impact of both options are considered below.

70. **Impacts on DB scheme funding levels, deficits and sponsor contributions** – to what extent does the option provide some support for UK sponsors and corporate and economic growth in the short term, as opposed to simply pushing DB liabilities into the long grass?

- The impact in practice would depend on i) the size of the adjustment made (in the case of the temporary measure) and ii) the period of smoothing and the discount rate assumptions that were permitted to be smoothed (i.e. whether just gilt yields for those adopting a gilts plus approach or other discount rate assumptions too). We do not suggest a specific level of adjustment or period of smoothing here but illustrate the impact that some measures could have.

- **Our estimates (Table 4) suggest that a smoothing approach would serve to almost eliminate any deficits in the short-term whilst a temporary adjustment would significantly reduce deficits.** In the case of even a cautious 0.5% uplift to the discount rate, the reported funding deficits of the FTSE 350 between December 2011 and March 2012 would fall by 40-50%.

- An important feature of a smoothed discount rate is that, because of the lagged effect, the implied deficits and sponsoring employer contributions would be falling at a time when gilt yields and other asset returns are also falling and deficits are rising. Whilst this is helpfully countercyclical for the sponsoring employers who may be facing adverse economic conditions more generally, it does appear counterintuitive for DB scheme funding that deficits appear to be falling whilst the latest market information is suggesting they are on the increase.

71. **Ease of implementation and impacts on flexibility** – what action would be needed to implement the option (and how quickly could it be implemented) and to what extent does it maintain the scheme-specific flexibility that currently exists?

- Our discussions with the working group told us that the flexibility that exists in the UK's current regulatory system, compared to the more prescriptive frameworks in some other countries, is highly valued. Concerns were also raised about the unintended consequences that any rushed changes to legislation could have and their application in future. In particular, being seen to pave the way towards a Solvency II regime was cautioned against in light of the current discussions with EIOPA on the IORP Directive. For those reasons, options that avoided the need for any legislative changes were generally favoured by those we consulted, though it was recognised that a steer or direction from Government may be necessary for TPR to feel empowered to go further than its current stance and utilise the full extent of the flexibility available in the current framework.

- Those pension schemes that are most affected by the falls in gilt yields (those with valuation dates between December 2011 and March 2012) will reach the end of their 15 month certification periods (by which time they need to have agreed and submitted a deficit recovery plan to TPR) between March 2013 and June 2013. There should be an impetus, therefore, on any further action being announced and implemented as quickly as possible so that trustees and sponsoring employers can feed this into their valuation assumptions and their subsequent negotiations in as timely a manner as practicable.

- **Our understanding is that both a temporary adjustment and a smoothing approach could be possible within the current framework without any legislative changes.** An adjustment approach is likely to require some clarification as to what is an acceptable range, which is likely to require input from the Bank of England or another independent source who can advise on the macroeconomic impacts of the financial crisis and QE.

- Within the existing regulatory framework a smoothing approach could be slightly more contentious. Guidance would need to be clear about the 'effective date' around which smoothing would be carried out, and about what different discount rate assumptions smoothing could apply to e.g. would it only apply to the liabilities side of the funding calculation and to those who are basing their discount rates off gilts, or to other valuation approaches too? It is worth noting that the Pension Protection Fund (PPF) already takes a smoothing approach to calculating the PPF levy but this is based on a precise definition of the discount rates to be used so it not a direct analogy with the scheme specific funding framework.

72. Impact on trustee negotiations and decisions – to what extent does the option maintain the integrity of trustees in negotiations with the sponsoring employers, and does it have different consequences depending on the position of individual schemes?

- Trustees have raised understandable concerns about undermining their position and handing over too much power to the sponsoring employer in the negotiations. This is a particular concern if any option was to prescribe exactly what discount rate should be used. **Ideally, trustees and sponsors would be given greater comfort to agree more favourable assumptions *if* the conditions for their scheme are right** (for example, where they have previously taken a gilts plus approach but where that gilts plus approach now looks increasingly out of line with their broader investment strategy). This would reflect the valued flexibility contained in the scheme funding framework as it stands and the ability for trustees and sponsors to take measures specific to their scheme's circumstances.

- This scheme specific approach would also avoid appearing to disadvantage those schemes that have already been able to take steps to fully hedge their liabilities for movement in gilt yields and prices where they might otherwise overshoot their asset return assumptions. **In our view, the temporary mark-up approach is more in line with the existing flexibilities and scheme specific negotiations between trustees and sponsors.**

73. **Impacts on demand for assets and market prices** – to what extent does the option change the demand for assets with which to hedge liabilities?

- Following on from the above, many DB pension schemes have been taking steps to derisk and hedge their liabilities against future changes in inflation. Whilst both a temporary adjustment and a smoothing approach could alter investment strategies, **a switch to smoothing discount rates may be more likely to discourage gilt investment as gilts no longer provide as good a match**. The extent to which this holds in practice depends on the smoothing period – a longer period implies a poorer match from current gilts and so a greater reallocation of assets away from gilts.

- **A temporary mark-up to gilt yields, if accepted as temporary, would create less of an incentive for schemes to unwind their existing positions**, since movements up or down in the liabilities would still be mirrored broadly by changes in gilt prices. The resulting higher funding levels could lead to some increases in allocation to riskier assets and some postponement of further hedging activity, but only at the margins.

- Under either approach, if the market anticipates this as a step to a new funding valuation methodology there may be some schemes who look to move their asset allocations. If there are no obvious hedging instruments for liabilities this will cause the most disruption to the markets as schemes will not know whether to unwind existing hedges or try to redesign their programmes to match the future regime.

74. **Ability to respond to future economic developments** – to what extent does the option require ongoing review over time and is it a permanent change or one that needs to be switched off if and when gilt yields improve?

    - **A smoothing approach is only likely to make sense as a *permanent switch*** as otherwise it would have the exact same impact in practice as the temporary adjustment – adding an uplift in the short term and also benefiting from the earlier years when gilt yields were higher and then switching off when the lower gilt yields currently being experienced begin to feed through. Smoothing over three years, for example, could quite quickly have the reverse impact if gilt yields remain low into 2013 and a cliff-edge effect was then experienced when the lower yields from 2011, 2012 and 2013 all feed through. Smoothing is therefore not a panacea and can suffer from some of the same pitfalls as a pure marked to market approach, albeit on a lagged basis. The US changes have incorporated complex corridor arrangements to mitigate against some of this.

    - **A temporary adjustment or uplift would require ongoing review to ensure it remains appropriate as a mitigating measure to counter the specific impacts of financial market conditions and QE on gilt yields in the UK**. TPR has already committed to making annual DB funding statements[22] and so could use that communication to confirm whether a more explicit uplift is allowed or not. The detail of the governance framework around that would be for Government to decide but could include discussions with the DWP and HMT (and a possible annual statement from Government), and consultation with the Bank of England

[22] DB pensions flexibility and impact analysis, October 2012

and others about the likely distortions in the gilts market resulting from monetary policy interventions at the current time.

Recommendations for action

75. In summary, our concerns around a smoothing approach, whilst having a similar impact on funding levels and deficits in the short term, would be that:

    i) It reflects a more radical departure from the current legislative and regulatory framework and a 'marked to market' approach;
    ii) It can still carry with it cliff-edge effects particularly where the smoothing is over a relatively short period where the main impact in practice is to introduce a lag effect;
    iii) It requires greater clarification around its application (for example, how it applies to discount rate assumptions other than gilts); and
    iv) As a more permanent change is more likely to have unanticipated effects on pension scheme demand for assets with which to hedge their liabilities.

76. Given the criteria set out above, and our concerns around the practical implementation of a smoothing approach, we have concluded that the most timely and proportionate action is for Government and TPR to permit trustees and sponsors to explicitly recognise the impact of the current economic conditions and QE on gilt yields. This would relate directly to the calculation of technical provisions and would allow a mark-up to be applied to gilt yields when gilts are being used as the basis of discount rate assumptions.

77. This could, for example, involve a statement or direction from the Government that, within the existing regulatory framework, historically used margins above gilts may not be appropriate for deriving technical provisions *given the current economic circumstances*. TPR could then issue guidance that it will consider such mark-ups prudent depending on the circumstances of the scheme. It could be made clear that this is a temporary measure that trustees and sponsors are expected to keep under review.

78. This would give trustees a more explicit 'green light' to change the approach taken from their previous valuation, and should give them some comfort, in their negotiations with sponsoring employers, to take a less 'recklessly prudent' approach when agreeing discount rates.

79. Given the political judgement required to trade off the UK corporate growth agenda against the TPR's objectives it is our view that some firm direction from Government, is required for TPR to feel empowered to take further action in this area without compromising its objectives.

80. When considering the **appropriate margin** to incorporate there are a number of factors to consider, which have already been acknowledged in the Bank of England's own analysis on the impacts of QE on DB pension scheme funding. We would expect individual trustee bodies, in conjunction with their advisors and sponsors, to determine the appropriate margin based upon their own individual scheme circumstances. For example, schemes with a much shorter time

horizon (either for strategic reasons or for concerns regarding the long-term strength of the sponsor) may not consider it appropriate to make allowances for long-term improvements.

- Broader factors, at a macro-economic level, include the wider changes to economic conditions and financial markets which have contributed to the downward movements in gilt yields and movements in other asset values e.g. concerns about corporate debt and European sovereign debt which have contributed to the flight to UK government debt. Isolating the impact of QE, if that is the aim in any policy intervention to mitigate impacts for corporate sponsors, is not a perfect science. And it is not a given that the Government would only wish to factor in the impact of QE, especially given that other countries have already taken action linked purely to their 'safe haven' status and the impact of low bond yields.

81. We would suggest that the appropriate mark-up to a gilts plus basis would be within the range of the Bank of England's estimates of the impact of Quantitative Easing on gilt yields (around the period December-March 2012 for schemes with those effective dates for their triennial valuations) with some downward adjustments to take into account the offsetting impact on the assets side (which will be greater for those schemes already heavily invested in gilts and hedged and who are in less need of relief) and the uncertainty around the extent to which current gilt yields reflect wider economic and financial market conditions. We have modelled here a very modest uplift of 0.5% as well as a more generous 1.0% to show the range and the potential impacts on liabilities, scheme funding levels, and implied sponsor contributions. Our modelling already includes an accompanying mark down of gilts prices on the assets side as noted in paragraph 52 and the Technical Annex.

Improvements over the longer term

82. We welcome the flexibility that exists within the current funding framework and TPR's recent clarification of this flexibility. Over the longer term, and as mentioned above, we would reiterate the scope for improvement in the application of the regulatory landscape to avoid the same challenges.

83. In practice, TPR's objective to reduce the risk of situations arising that might lead to claims for compensation from the Pension Protection Fund and is perceived to have dominated TPR's activities around DB funding, with the result that it has focussed more on managing what is known as the 'DB run off' than the continuation of good quality workplace pensions. To that end we welcome the comments of the TPR Chairman, Michael O'Higgins[23], that *"the best support for a DB pension is a properly funded scheme supported by a strong employer'* and that *'there will be occasions when the right thing to do for the employer and the scheme will be to invest in the growth of the sponsoring company rather than making higher pension contributions"*.

[23] TPR Chairman Michael O'Higgins speech at Professional Pensions show

84. To ensure this balance is reflected in the TPR's objectives we would reiterate our recommendation from the NAPF's vision for pensions[24] that TPR be given a new statutory objective to **promote good pension provision and to ensure their health and longevity**. This would rebalance the TPR's objectives further towards ensuring that strong sponsoring employers with high quality and sustainable pension provision are supported and encouraged.

[24] NAPF Vision for Pensions, March 2010

Acknowledgements

The views expressed in this report reflect those of the NAPF. We are grateful to the fund and business members that were represented on the DB funding working group for their input, including:

Aon Hewitt
Goldman Sachs
JP Morgan
The Pension Corporation
Towers Watson
RPMI
Sackers
Smiths Group
Universities Superannuation Scheme

We are particularly grateful for the assistance of Marcus Hurd, Visiting Researcher at the University of Leeds, and Consulting Actuary at Aon Hewitt, for his assistance with the modelling within this report.

Technical Annex

Key Model Assumptions

The various funding measures have been derived by adjusting the discount rate used from the published company accounts of the FTSE350, as collated by Aon Hewitt. No other changes have been made to the data (except where specified below), so the data incorporates changes made to other assumptions such as inflation, scheme demographics and mortality. Assets have been taken at market value on all bases, except where an adjustment is required in the **'gilts plus plus'** bases.

IAS19 basis

These figures are taken straight from the published pensions accounting disclosures of the FTSE350. For switches to other bases, the discount rate used as a proxy is the IBoxx over 15 year AA corporate bond index at the relevant date. This is a standard benchmark measure for most UK companies. No allowance has been made for duration of constituent changes, as this would vary considerably by company.

Notional funding basis (gilts+1%)

For the notional funding basis, a switch has been made on the discount rate to move from the IBoxx over 15 year AA corporate bond index yield to the yield available on the FTSE actuaries 20 year gilt index plus 1%. The 1% addition is a notional addition reflective of a typical scheme's funding basis, but the actual assumption will vary considerably by scheme. The TPR evidence and analysis paper[25] showed the spread of outperformance over gilts for earlier tranches of triennial scheme valuations and found that median assumptions fluctuate year on year but tend to cluster around 100 basis points.

'Gilts plus plus' bases

For the 'gilts plus plus' bases, the new discount rate has been derived as per the notional funding basis, but with an addition margin of (a) 0.5% and (b) 1% to reflect the relief being offered.

In addition, for the "relief bases" an appropriate deduction has been made to the value of the scheme assets to reflect the relief being provided to the technical provisions through the discount rate.

The adjustment assumes that 30% of the aggregate FTSE350's pension assets are depreciated. The depreciation factor is the difference in price of a notional 20 year bond with 5% coupons – one at the existing gilts plus 1% basis and the other at the relief gilts plus 1% plus 1% basis or gilts plus 1% plus 0.5% basis.

The relevant market gilt yield used is the yield available at the relevant date on the FTSE actuaries 20 year gilt index.

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[25] DB pensions flexibility and impact analysis, October 2012

“Risk-free” basis

This is assumed to be in line with the IAS19 basis, except that the discount rate is derived to be the yield available on the FTSE 20 year fixed interest gilt index. This is technically, not risk-free, but is illustrative of a risk-free type basis.

Smoothed discount rate basis

The discount rate used is the arithmetic average of the FTSE 20 year gilt yields that applied in the 36 month ends prior to and including the valuation date.

Recovery plans

Except where stated otherwise, the recovery plans assume that the scheme assets achieve returns in line with the discount rate applicable to the basis being considered and that there is no reversion of gilt yields in the recovery period.

The recovery plan calculations for the relief bases do not allow for additional asset returns in line with the additional relief. In other words, the assets are assumed to achieve returns in the with the yield available on the FTSE 20 year gilt index plus the 1% assumed in the standard funding technical provisions basis, but without an additional 0.5% per annum or 1% per annum relief.

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October 2012

‘Securing the future of pensions’