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Securing the future of pensions

NAPF response to the DWP Call for Evidence - Pensions and Growth

Whether to introduce a new statutory objective for the Pensions Regulator

February 2013

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About the NAPF

The National Association of Pension Funds (NAPF) is the leading voice of workplace pension provision in the UK. We represent some 1,300 pension schemes from all parts of the economy and 400 businesses providing essential services to the pensions industry. Ten million working people currently belong to NAPF member schemes, while around 5 million pensioners are receiving valuable retirement income from those schemes. NAPF member schemes hold assets of some £900 billion, and account for over one sixth of investment in the UK stock market. Our main objective is to ensure the security and sustainability of UK pensions

Melanie Duffield
Head of Research and Strategic Policy
melanie.duffield@napf.co.uk

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Executive Summary

The NAPF welcomes the Department for Work and Pensions' (DWP) Call for Evidence on Pensions and Growth and is pleased that the Chancellor's Autumn Statement acknowledged the concerns raised by the NAPF over the last 12-18 months on the impact that the current economic conditions are having on defined benefit (DB) pension schemes and their sponsoring employers. This consultation response relates to the first part of that Call for Evidence, on whether the Pensions Regulator (TPR) should be given a new statutory objective – "to consider the long-term affordability of deficit recovery plans to sponsoring employers". The NAPF is supportive of TPR being given a new objective. However we are concerned that the proposed wording of the new objective leaves it open to interpretation. Our preferred wording for a new statutory objective would be much broader - **'to promote good pension provision and to ensure the health and longevity of pensions' -** and would provide a stronger check and balance against the TPR's existing statutory objectives. Our views on the specific questions that were raised by DWP in the Call for Evidence are set out below.

- **What would be the advantages of a new statutory objective for the Pensions Regulator to consider the long-term affordability of deficit recovery plans to sponsoring employers?**

  This change would go some way to achieving the goals set out by the Chancellor in his Autumn Statement - to ensure that DB pension regulation does not act as a brake on investment and growth. However to achieve those goals a wider review of TPR's objectives, to promote the stability and sustainability of good pension provision, would be more appropriate. Both the affordability of recovery plans, and the volatility in the size of the scheme funding deficit, can have an impact on the activities of the sponsoring employer and their ability to borrow and invest. An additional objective should ensure that trustees and employers feel able to make use of the full flexibility within the funding regime and avoid employers being unnecessarily prompted to review and close their scheme, to the detriment of the 2 million still active members of private sector DB pension scheme, and future employees.

- **What could be the disadvantages in creating this further statutory objective for the Pensions Regulator?**

  As currently proposed this objective could be seen to further crystallise the TPR's current stance on DB funding valuations and could, in some cases, lead to behaviours that do not support the Chancellor's aims as set out in his Autumn Statement. It does also not go far enough, in our view, to support the Coalition commitment to reinvigorate occupational pensions and the NAPF's aims to secure the longevity of existing DB pension schemes. If this objective is taken forward it would need to be underpinned by clear examples of how it would affect TPR's behaviour in practice and how it would be held accountable.

- **Is the consideration of the long term affordability of deficit recovery plans to sponsoring employers already implicit in the existing objectives and requirements for the Pensions Regulator? If so, is this sufficient?**

  Whilst consideration is implicit within the existing objectives and requirements for TPR it does not provide the same clarity that an explicit statutory objective would. There are mixed views amongst those running DB pension schemes as to whether the TPR's existing guidance and behaviour is fully in line with the flexibility in the legislative framework. The proposed new statutory objective could provide greater reassurance in this regard.

- **Are there other options (including legislation) which would ensure that the Pensions Regulator carries out its functions in a way which appropriately balances protection of members, the Pension Protection Fund and sponsoring employers.**

  We have suggested some potential options the DWP could consider around issuing additional guidance to reiterate the flexibility in the legislative framework (placing less emphasis on a gilts-based approach), improving the transparency around the scheme valuation process, and allowing a greater role for the use of contingent assets.

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Introduction

1. The Chancellor's Autumn Statement[1] on 5 December 2012 announced that the Government "is determined to ensure that the defined-benefit pensions regulation does not act as a brake on investment and growth. The Department for Work and Pensions will consult on providing the Pensions Regulator with a new statutory objective to consider the long-term affordability of deficit recovery plans to sponsoring employers." The NAPF welcomes the recognition that Quantitative Easing (QE) and the wider economic conditions have had an adverse impact on the funding position of many DB pension funds. In October 2012 the NAPF called for those running DB pension funds to be able to make an adjustment to their discount rate assumptions to allow them to mitigate some of the adverse impacts of QE on gilt yields, and argued that the Pensions Regulator'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[2]. The Department for Work and Pensions (DWP) subsequently published a Call for Evidence[3] on pensions and growth considering whether there is a need for:

   - A new objective for the Pensions Regulator to consider the long-term affordability of deficit recovery plans to sponsoring employers to add to the current recognition of this in the Pensions Regulator's Code of Practice.

   - Legislation to explicitly allow the 'smoothing' of asset values and liabilities in funding valuations (i.e. averaging asset prices and discount rates over a longer period of time, instead of using current market spot rates) in order to counter the effects of the current economic situation.

2. This response relates to the Call for Evidence on the new objective. The NAPF will submit a response in relation to the second part of the consultation, on the issue of smoothing, in due course.

The Pension Regulator's Objectives

3. TPR is currently charged with five statutory objectives:

   - to protect the benefits under occupational pension schemes of, or in respect of, members of such schemes;
   - to protect the benefits under personal pension schemes, where direct payment arrangements exist or the scheme is a stakeholder pension;
   - to reduce the risk of situations arising which may lead to compensation being payable from the Pension Protection Fund;
   - to maximise compliance with the duties of automatic enrolment;
   - to promote, and to improve the understanding of, the good administration of work-based pension schemes.

4. The NAPF's Vision for Pensions, published in March 2010[4], argued that these objectives should be reviewed, due to concerns from many of our members that, in practice, the third of these objectives tends to dominate the TPR's

[1] Autumn Statement. December 2012.
[2] DB funding: a call to action. October 2012.
[3] DWP Call for Evidence – Pensions and Growth. January 2013.
[4] Fit for the Future. March 2010.

activities. As a result of that objective, TPR is overly focused in its activities on managing down the risks to the PPF of the DB run-off and insufficiently focused on the continuation of good quality workplace pensions. The NAPF has therefore previously argued that TPR should have a new statutory objective: **to promote good pension provision and to ensure their health and longevity.** This objective would go further than the proposed objective set out in the Chancellor's Autumn Statement and would support the broader commitment in the Coalition's programme for Government[5] to reinvigorate occupational pensions and encourage companies to offer high-quality pensions.

5. Amendments to the Pensions Act 2004 were suggested (by the now Chancellor, whilst in Opposition) during its passage which would have given TPR additional and specific statutory objectives – including an objective to promote occupational pension provision by minimising regulatory burdens applying to well-run schemes and their sponsoring employers. These amendments were debated and rejected at the time.

6. However, the very challenging economic environment DB pension schemes are facing has brought these issues into sharp relief. Record low gilt yields (due in part to the wider economic conditions but exacerbated by monetary interventions and the Bank of England's £375bn QE programme) have placed further pressures on trustees of DB schemes and their sponsoring employers when going through their scheme funding valuations – in particular when agreeing discount rate assumptions for their technical provisions and trying to come to an agreement on deficit recovery plans and employer contributions. TPR's guidance and practice in this area has come under much greater scrutiny as the scheme specific funding framework in place since 2006 has been increasingly tested by the economic conditions.

7. The latest figures from the NAPF's Annual Survey (2012) show that only 13% of private sector DB schemes are now open to new members, with 55% closed to new members but still open to future accrual, and 31% closed altogether. It does not appear, therefore, that either the Government or TPR have done enough to encourage employers to continue running their DB schemes. And in spite of the Coalition Government's commitment in 2010 to reinvigorate occupational pensions, the rate of closures amongst private sector DB schemes in the last 12 months has been the fastest since the new regime was introduced.

TPR's response to the current economic conditions

8. The NAPF's Autumn publication on DB funding argued that that there is already sufficient flexibility within the legislative framework to deal with the challenging economic conditions we face and for trustees, sponsors and actuaries to agree a discount rate for their scheme funding valuations that can offset some of the adverse consequences of record low gilt yields that have been observed over the last 12-18 months. The prescription within the legislative framework on 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[6].

[5] The Coalition: Our Programme for Government.
[6] Calculation of Technical Provisions Regulation 5 (4)(b)

However t here 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.

9. There is no legislative reason why the outcome of discussions between trustees and actuarial advisors on these matters may not result in a discount rate being selected that takes account of the yield on assets held to fund future benefits and anticipated future returns.

10. 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 an agreement with the sponsoring 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.

11. TPR has issued guidance, in the form of its 'Regulatory Code of Practice 03' Funding Defined Benefits[7], 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;
    - 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; and
    - 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.

12. 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 is a 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 and that it reinforces this through its guidance and communications.

> *“From the employer's perspective, it would be beneficial to have greater clarity from the Pension Regulator on what constitutes a prudent long term funding cost and recovery plan for defined benefit pension obligations. The current regime of 'gilts plus' approach has been applied prudently for our scheme and consequently, in the current economic environment, this is placing a disproportionate financial strain on the business. Greater clarity from the Regulator would potentially enable more effective discussions with trustees and scheme actuary on how the existing approach can be updated given prevailing conditions whilst still retaining appropriate prudence.”*
> **Employer Representative**

13. In the TPR’s Annual Funding Statement (April 2012)[8] it 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*

[7] TPR’s Regulatory Code of Practice 03

to try to second guess market movements by assuming that gilts will inevitably improve in the near term". This may lead some trustees to feel that they are unable to use the full flexibility contained within the legislative framework without coming under greater scrutiny from TPR.

14. As a result the NAPF is concerned that the flexibility available within the legislative framework is not being fully utilised and the TPR's 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.

15. 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.*"

16. The NAPF would argue that the unprecedented scale of the Bank of England's Asset Purchase Programme would justify a signal from Government or TPR that, where trustees feel a movement away from a gilts basis is appropriate for their scheme, different economic assumptions may be adopted as part of the current round of triennial valuations. The Bank has taken the exceptional measure of stimulating the economy by buying £375bn of gilts, and has done so against a backdrop of already strong demand for gilts from investors (against constrained supply in gilts issuance) due to turbulence since 2008 in the wider sovereign and corporate bond markets.

17. The latest evidence and analysis published by TPR[9] concludes that, based on their current assumptions and modelling, around 25% of schemes currently going through their scheme valuations will not need to extend their recovery plans or increase contributions, whilst the remaining 75% will. Of that 75%, they suggest that:

    a. 30% will need to extend their recovery plans by three years and increase contributions by 10%;
    b. 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
    c. 25% will need to significantly increase their contributions and/or make use of other flexibilities available where there are affordability challenges.

18. It is too early to know whether these predictions will ring true in practice as those schemes going through valuations from December 2011-March 2012 are only now reaching the end of their 15 month certification periods when they will need to submit their valuations and proposed recovery plans to the Pensions Regulator.

19. And, whilst gilt yields have recovered somewhat in recent months, the prospect of further QE is still on the table in Monetary Policy Committee discussions. It is also worth bearing in mind that trustees for the next tranche of DB schemes may encounter even greater difficulty in negotiating recovery plans with their sponsoring employers than trustees for the current tranche. This is because their previous valuation in 2010 would have been more favourable than that of the preceding tranche (who faced difficult market conditions and lower funding levels in both 2009 *and* 2012).

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[8] Pension scheme funding in the current environment. April 2012
[9] DB pensions flexibility and impact analysis. October 2012

Concerns of sponsors and trustees of DB pension funds

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, this has not been sufficient to allay the concerns of sponsoring employers and, in some cases, trustees. Sponsoring employers of DB pension funds argue that greater allowance should be given for changes to the discount rates used to calculate the technical provisions themselves because:

    - 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.
    - Those who can afford to make higher contributions still believe they will come under significant pressure from TPR to fill the deficits in their DB pension funds, 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.

    This would suggest that the TPR needs to go beyond its approach on only allowing flexibility through recovery plans if it is to meet the concerns of the Chancellor raised at Autumn Statement that DB pensions regulation does not act as a brake on investment and growth. A new statutory objective focussed on the long-term affordability of recovery plans would only partly address these concerns by making it more credible that the TPR's practice will be in line with its statements and guidance. Clear examples of how this objective would change TPR's behaviour and how it would be held accountable to this objective would need to underpin the objective itself, particularly if the only requirement in the drafting of the objective is for TPR to 'consider' long-term affordability.

21. Whilst some trustees (and actuaries) are reluctant of a discount rate approach that shifts away from the use of marked to market gilt yields, the anecdotal reports from trustees of their dealings with TPR are mixed.

22. Some trustees report positive experiences of discussing their valuations with caseworkers and are confident that they will be able to agree extensions to their recovery plans and maintain sponsor contributions broadly at current levels.

    "There is plenty of flexibility in the regime already." **Trustee**

23. Others are more anxious. Because TPR deals with schemes on a scheme-by-scheme basis it can be difficult for trustees and sponsors to be confident that the flexibilities TPR has talked about in guidance will be there in practice for their individual scheme.

    "A more flexible approach needs to be considered in the current economic climate when valuing scheme liabilities." **Trustee**

"Examples of where TPR have not been fully consistent include their TKU curriculum which pays lip service to the Scheme Funding and Investment Regs released in December 2005, and also the TPR statement on 28 April 2012 which was written as if the assets based approach did not exist within the regulatory framework." **Trustee**

"Gilt yields as at the effective date of a valuation are less appropriate than they used to be as a measure of the present value of future liabilities. They are partly driven by pension funds' need to manage risk with asset/liability matching rather than reflecting expectation of value. They are susceptible to short term market trading. They are susceptible to temporary factors, e.g. the impact of QE suppressing yields artificially. In negotiations of funding rates, it makes sense to encourage Trustees and Employers to consider a smoothed discount rate rather than rely on the rate as it happened to be at one past moment in time." **Scheme Secretary/Scheme Manager**

24. There is also a concern amongst sponsoring employers who may be judged as able to afford higher deficit recovery contributions in the short-term that they will be 'on the hook' for higher contributions because gilt yields are so low.

"The Government needs to "encourage" TPR to remember that trustees and employers can and should use the full flexibility available under the regime for both Technical Provisions and Recovery Plans - and avoid a dogmatic approach to regulation." **Employer Representative**

Questions in the Call for Evidence

25. In response to the specific questions raised in the DWP Call for Evidence, the NAPF's views are set out below.

Q6. What would be the advantages of a new statutory objective for the Pensions Regulator to consider the long term affordability of deficit recovery plans to sponsoring employers?

A new statutory objective would act as a check and balance against the perception amongst those running DB pension schemes that the third of TPR's objectives - to reduce the risk of situations arising that might lead to claims for compensation from the Pension Protection Fund – dominates its activities, with the result that it is overly focused on managing the DB run-off and insufficiently focused on the continuation of good quality workplace pensions.

However, we would argue that:

a) For a statutory objective, the wording needs to be made clearer as only 'considering' the long-term affordability still leaves this very open to interpretation.

b) The focus on long-term affordability of deficit recovery plans does not fully capture the issues which are i) short-medium term affordability for the sponsoring employer through the agreed recovery plan (depending on its length) and ii) the impact of volatility in the size of the calculated deficits which have wider impacts on the sponsoring employer, can prompt them to review and close the scheme, and can affect their ability to borrow and invest.

In the context of the current issues of DB funding and the current economic climate, we would still argue that there is a particular issue where discount rates are based off gilts and where gilt yields are currently very low (partly due to QE and partly due to other factors) making them less appropriate as a long term basis for discounting long term liabilities. It is not

clear how the statutory objective above would have changed TPR's advice and guidance in this regard over the previous 15 months – it is possible that it would have given trustees and employers more confidence that the flexibilities around recovery plans would be available in practice but it appears to have been deliberately drafted to fall in line with TPR's preferred approach to handling scheme funding valuations rather than change their behaviour.

Q7. What could be the disadvantages in creating this further statutory objective for the Pensions Regulator?

As currently drafted the proposed statutory objective could be interpreted in different ways by TPR. For example, an objective to 'consider the long-term affordability of deficit recovery plans to sponsoring employers' could arguably be consistent with regulatory behaviour that:

i) Front-loaded deficit recovery plans so that they are more affordable over the long-term (but less affordable in the short-medium term);

ii) Encouraged sponsoring employers to close their DB pension schemes to ensure that they are more affordable over the longer term (where associated with the DB pension scheme being replaced by a lower cost scheme for the employer and a reduction in the benefits that can be built up by both current and future members).

The proposed objective also, if anything, crystallises the existing position that all the flexibility in the scheme funding valuation should be focussed on the recovery plans and not through the calculation of the technical provisions – which is a hardening of the position compared to both the legislative framework and the earlier guidance. So unless the new objective is accompanied by a very clear set of guidelines as to how this objective would be achieved and how TPR would interpret it in practice, it is unlikely to provide either employers or trustees any comfort when they are faced with large fluctuations in their deficits based on their technical provision calculations.

We would therefore argue that a more suitable additional statutory objective that would be more in line with the Coalition's objective to reinvigorate occupational pensions would be for TPR **'to promote good pension provision and to ensure the health and longevity of pensions'.** This would be consistent with the additional statutory objective that was called for in the parliamentary debates on TPR's objectives during the passage of the Pensions Act 2004:

Mr Osborne:

"We propose to add a couple of objectives, one of which—on the regulator—would be to promote occupational pension provision by minimising regulatory burdens applying to well-run schemes and their sponsoring employers. It is a broad remit for the regulator; to look not just at itself, but at the world of occupational pension provision, how to encourage it and how to stop the Government—perhaps unwittingly, perhaps not—discouraging it."[10]

Q8. Is the consideration of the long term affordability of deficit recovery plans to sponsoring employers already implicit in the existing objectives and requirements for the Pensions Regulator? If so, is this sufficient?

[10] Hansard Extract from Pensions Bill May 2004.

Whilst consideration is implicit within the existing objectives and requirements for TPR it does not provide the clarity that an explicit statutory objective would. Whilst there are mixed views amongst NAPF fund members there are certainly some members (including trustee representatives) that do not feel the full flexibility in the funding regime is there in practice. This is likely to be particularly true for those schemes where the sponsoring employer is considered to be in a relatively strong position and where a significant increase in the deficit may create tensions between the trustees and sponsors who feel compelled to maximise the contributions into the scheme. Again, it is not clear how a new statutory objective that only considered the affordability of deficit recovery plans would change TPR's behaviour in this regard.

Q9. Are there other options (including legislation) which would ensure that the Pensions Regulator carries out its functions in a way which appropriately balances protection of members, the Pension Protection Fund and sponsoring employers.

Other options that could be considered include:

i) TPR issuing guidance that reiterates the flexibility in the legislative framework, regulation 5 of the Occupational Pension Schemes (Scheme Funding) Regulations, and the initial Code of Practice – in particular the guidance that:

> *"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".*

This point has not been emphasised in any of the TPR guidance issued for this current cycle of funding valuations despite monetary interventions having a significant impact on the gilts market and on discount rates that take a gilts plus approach. Instead, the guidance has generally insisted that any flexibility must be exercised through the recovery plan (and underpinned by a strong employer covenant) and not through the calculation of the technical provisions.

ii) TPR being more transparent about the flexibility it allows in practice for technical provisions and recovery plans, particularly around the variation in discount rates, gilt yield reversion assumptions, and the length of the recovery plans being agreed. TPR published some helpful analysis in October 2012[11] on the range of discount rate assumptions that were reported for previous tranches of valuations. Providing more context around the circumstances in which these were applied in practice could provide greater reassurance to trustees and employers in their negotiations. Sharing more information about the range of length of recovery plans being agreed would also allow trustees and employers to benchmark themselves against others in a similar position.

iii) An alternative approach that could rebalance the Pensions Regulator's activities in favour of the employer's longer-term investment aims, and support the ongoing health and longevity of pensions, would allow a greater role for the use of contingent assets. Contingent assets could, for example, be given a greater role in reducing the cash contributions required to target the full funding of the technical provisions and any additional prudence margins. Some of our fund members have argued that the current regulatory regime leaves trustees in a difficult position when negotiating between contingent security and the structure of the Schedule of Contributions which in turn incurs substantial legal and investment advice costs. This approach

[11] The Defined Benefit Regime – Evidence and Analysis. October 2012.

could, for example, form one of the practical steps that TPR would take as part of a broader statutory objective to ensure the health and longevity of pensions.

Conclusion

26. This consultation response responds to the first element of that Call for Evidence, on whether the Pensions Regulator should be given a new statutory objective – "to consider the long-term affordability of deficit recovery plans to sponsoring employers". The NAPF is supportive of the Pensions Regulator (TPR) being given a new statutory objective. However we are concerned that the proposed wording of the new objective leaves its interpretation by TPR too open. Our preferred wording for a new statutory objective would be much broader **'to promote good pension provision and to ensure the health and longevity of pensions'** and would provide a more powerful check and balance against the TPR's existing statutory objectives. We look forward to responding the Call for Evidence on the issues of smoothing in due course.