

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

**Whether to smooth assets and liabilities in
scheme funding valuations**

March 2013

Contents

Executive Summary	2
Introduction	3
Regulatory Landscape for DB Funding in the UK	3
Smoothing of assets and liabilities	7
Responses from our members	9
Questions in the Call for Evidence	10
Conclusion	12
Annex A – Survey Responses	14

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

March 2013

Executive Summary

The NAPF welcomes the Department for Work and Pensions' (DWP) Call for Evidence on Pensions and Growth and the recognition in the Chancellor's Autumn Statement of the concerns raised by the NAPF 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 second part of that Call for Evidence¹, on whether to smooth assets and liabilities in scheme funding valuations.

Our responses to the specific questions below reiterate many of the concerns we raised in our October 2012 report, 'DB funding: a call to action'. We explained in that report that, whilst the flexibility in the scheme specific funding regime is very welcome, it does not always appear to be used in practice. Therefore a more explicit allowance may be needed in the legislation or regulations for schemes to exercise flexibility around their discount rate assumptions for technical provisions as well as through the deficit recovery plans. We do not consider that the introduction of smoothing is the right approach. We remain of the view that the best solution is for the full flexibility in the existing regime to be used. However, we believe that legislative change, whether through a new statutory objective or through further clarification of the regulations around discount rate assumptions, is likely to be required in order to achieve this. Our views on the specific questions that were raised in the DWP Call for Evidence are set out below.

1. What would be the effect of smoothing assets and liabilities in schemes undertaking valuations in 2013 and going forward? Would it materially improve the sponsoring employers' ability to attract investment or to invest in the short term? If so, what evidence is there of this?

This would be entirely dependent on how 'smoothing' was implemented and on the position of the individual schemes that are going through their valuations in 2013 ('tranche 8'). On the assumption that smoothing of gilt yields is more likely to occur over a relatively short period (e.g. 2-3 years) the impact in 2013/14 could be to lock in the previous years' very low gilt yields (from 2011 onwards), with a detrimental impact on the funding position for the majority of schemes. We would argue that a smoothing regime is best introduced, if at all, in a more benign economic environment. The introduction of smoothing in the near future, particularly if mandatory or overly prescriptive, is likely to do more harm than good.

2. Given that there is no one defined method for calculating scheme liabilities, how would you implement smoothing?

We have previously proposed an alternative form of smoothing that would i) work within the flexibilities in the existing regime and ii) counter the perception that TPR has a strong preference for trustees and employers to agree a relatively 'risk-free' gilts based approach. This would make it explicit that, with the current adverse economic conditions and with gilt yields being deliberately lowered by the Bank of England through QE, an alternative discount rate may be more appropriate for valuing long-term liabilities. In practice, our members have told us that the 'gilts plus plus' approach that we have previously proposed would achieve broadly the same outcome as an expected return on assets approach and give trustees and sponsors some comfort that they could use the flexibility in the legislation without being unduly scrutinised by TPR. This approach would only be adopted where schemes agree it is appropriate for their circumstances.

3. What are the advantages and disadvantages of smoothing for sponsoring employers, scheme members and the Pension Protection Fund?

Again this is entirely dependent, at least in the short-term, on how and when smoothing is implemented. Over the

¹ [DB funding: a call to action. October 2012.](#)

longer-term the impacts of smoothing should eventually balance out for those schemes that consistently use smoothing as an approach. If it was optional then smoothing could create an opportunity for employers to game the system and reduce the size of their deficit recovery contributions on average. However, the implementation of a mandatory smoothing system carries far greater risks both for pension schemes and the wider economy. We did not support smoothing last year precisely for that reason and argued for an alternative approach that allowed more flexibility through the temporary upward adjustment of gilts based discount rates. The most risky approach from the Pension Protection Fund's perspective would be if an optional smoothing approach was allowed that was not carefully regulated.

4. Is the current regime flexible enough to ensure that defined-benefit pensions regulation does not act as a material brake on investment and growth for the UK economy?

In theory, and in legislative and regulatory terms, yes. However the experience of a significant number of schemes (whether the trustee, the scheme secretary, the employer, or another representative) suggests that the TPR's current stance is not seen as flexible enough for all schemes in practice. Just over 50% of those members we surveyed told us that they did not feel that TPRs guidance and practice around valuations is fully consistent with the flexibility in the legislative regime.

5. Should a specific model of smoothing be introduced, the Government would welcome views as to what schemes, in terms of their valuation date, should be able to take advantage of the change.

It would put trustees in a disadvantageous position to unpick well advanced negotiations around deficit recovery plans and would increase the costs of the actuarial valuations. Given the current timetables, and given that those schemes with 2011/12 valuation dates are now very close to the end of their 15 month certification periods, any legislative or regulatory change announced now is unlikely to be of benefit. Going forward, 'tranche 8', who are now beginning their valuation cycle, should be issued with a clear annual funding statement that again reiterates the full flexibility in the framework. This would be reinforced by an announcement that the Government intends to introduce a new statutory objective for TPR. However, TPR has already indicated it will not change its approach until that has happened. In which case, stronger action is likely to be required, including specific allowances within the regulations for schemes to make an additional upward adjustment to their discount rates where based on gilts.

Finally, we recognise that members' views on this issue are mixed and there is no single consensus. We have spoken to a large number of our fund members, including trustees, scheme secretaries and employer representatives in the previous months and in the course of preparing this consultation response. Their views tend to depend on the individual circumstances and experiences of dealing with TPR for their own scheme.

Our view is that the balance of responses points to TPR not regulating in practice fully in line with the legislative and regulatory framework. This has been exacerbated by some of the perceived lack of flexibility in the statements that have been issued in the last 12 months on this issue.

Introduction

1. The Chancellor's Autumn Statement² on 5 December 2012 announced that the Government "is determined to ensure that defined-benefit pensions regulation does not act as a brake on investment and growth... the Government also recognises that volatility in measures of pension scheme deficits can make it hard for companies to manage their investment plans and attract external funding. DWP will... consult on whether to allow companies undergoing valuations in 2013 or later to smooth asset and liability values."
2. 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.³ The Department for Work and Pensions (DWP) subsequently published a Call for Evidence⁴ 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.
3. This response relates to the Call for Evidence on the smoothing of assets and liabilities. The NAPF's submission to the first part of the Call for Evidence can be found on our website⁵. We supported the proposal that TPR be given a new statutory objective but argued that an objective "to promote good pension provision and ensure the health and longevity of pensions" would be more appropriate.

Regulatory Landscape for DB Scheme Funding in the UK

4. As we explained in our October report, there is, at least 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.
5. 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 bonds⁶.

6. 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.

² [Autumn Statement. December 2012.](#)

³ [DB funding: a call to action. October 2012.](#)

⁴ [DWP Call for Evidence – Pensions and Growth. January 2013.](#)

⁵ [A new statutory objective for The Pensions Regulator – An NAPF response to the DWP Call for Evidence.](#)

⁶ Calculation of Technical Provisions Regulation 5 (4)(b)

7. 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 that 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.
8. TPR has issued guidance, in the form of its 'Regulatory Code of Practice 03' Funding Defined Benefits⁷, 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;
 - 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.
9. 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 the 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 government bonds (the factors in ii) in Regulation 5).
10. The feedback we have gathered from trustees, actuaries, consultants and sponsors involved in the triennial scheme valuation process suggests that many of them believe TPR's view to be that a relatively 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)⁸ 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"*.
11. As a result we are concerned that the flexibility contained within the legislative framework is not being utilised and that 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 the impacts of QE:

"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

12. 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. "

⁷ [TPR's Regulatory Code of Practice 03](#)

⁸ [Pension scheme funding in the current environment, April 2012](#)

13. We have previously argued 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.
14. 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.
15. 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. There is also some inconsistency in the messages from TPR, with TPR’s Chairman encouraging trustees not to be “recklessly prudent” in a speech, just days before TPR issued analysis reinforcing earlier messages about flexibility being exercised through the recovery plans rather than the technical provisions. 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. This creates 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.
16. For these reasons, we argue that the current Annual Funding Statement (April 2012)⁹ and subsequent speech by TPR’s Chairman¹⁰, 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 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.
17. 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.

⁹ [Pension scheme funding in the current environment, April 2012](#)

¹⁰ [TPR Chairman Michael O’Higgins speech at Professional Pensions show](#)

- 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.

18. 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. We therefore supported the proposal in the DWP Call for Evidence to give TPR a new statutory objective but have argued that the wording of it should be broadened out from only considering the impact of the deficit recovery plans on long-term affordability for employers.

Smoothing of assets and liabilities

19. The DWP Call for Evidence is considering whether there is a need for “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.” This followed calls from the CBI in July 2012 for the Government to introduce smoothing, and calls from the NAPF in October 2012 to allow adjustments to be made to gilts based rates through greater flexibility in the discount rate assumptions that feed into the technical provision calculations.
20. The NAPF has previously argued against smoothing, and in favour of ensuring full flexibility within the existing scheme funding framework, because we were concerned about the amount of prescription required to introduce smoothing and the associated implementation risks. Whilst some of our members support the logic behind smoothing to reduce the volatility in scheme deficits they have raised concerns about what it could mean in practice:

“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/manager

“The “smoothing” argument I am afraid is a few years too late; I foresee that no sooner does the Government or Regulator allow the practice than gilt yields will start to revert to historically “normal” levels. However schemes may not take advantage of the swing back to normal yield levels because they will have to make provision for some “smoothing” of that beneficial effect.” Trustee

“I believe that an approach focusing on future expected return on assets would be more appropriate for the discount rate than smoothing. In addition, further guidance on using different assumptions for technical provisions and future service cost would be useful.” Employer Representative

21. These concerns have increased as the timetable for the potential implementation of smoothing is pushed back. In particular, a smoothing regime or option introduced within the next 12-18 months, unless smoothing over a very long period, would be likely to backfire and result in higher rather than lower deficits in the short-term. This is because it would have the effect of locking in the very low gilt yields experienced since the summer of 2011.
22. For that reason we proposed a 'gilts plus plus' approach which would work within the existing funding framework and would allow those using gilts based rates to offset some of the downward drag from the effects of QE and low gilt yields. We have argued that this is a more pragmatic, short-term approach to the challenging economic conditions we are facing and would ensure the full flexibility can be used. This approach is likely to be particularly suitable for those schemes that have shifted to a gilts based approach for their discount rate assumptions but where the investments are not predominantly held in gilts. Those schemes with a more return seeking asset portfolio might expect to see discount rates set with reference to long-term expected asset returns (in the region of gilts plus 2.0% to 2.5%). Taking a 'gilts plus plus' approach would return them to a similar path.
23. The box below illustrates a case study of how a 'gilts plus plus' approach might apply in practice, based on the actuarial valuation of one of our members.

Case Study of Technical Provisions calculations

The XXXXX Group Pension Scheme has seen the value of its Technical Provisions rise by 35%, during a one year period between 2011 and 2012 in which the cost of accrual was less than half the value of the benefits paid out.

As a result, the expected future returns, which are set by reference to market gilt yields, have fallen by 1.35% per annum, despite the asset portfolio being less than 10% invested in gilts and the allocation between asset classes barely changing during that timeframe.

A 1% per annum rise in real yields is – other things being equal - likely to lead to a fall in the value placed on the liabilities of the XXXXX Group Scheme by around 20%. For example, using the position in the actuarial report produced for March 2012 and assuming a Gilts Plus Plus approach with the additional plus at +1% then:-

Funding (Technical Provisions), £000s

	Triennial Valuation 31/3/2011	Actuarial Valuation 31/3/2012	'Gilts Plus Plus' 31/3/2012
Assets	33,100	36,107	36,107
Liabilities	45,600	61,130	48,904
Surplus/Deficit	12,500	25,023	12,797
Funding Level	73%	59%	74%

The impact of the additional '+' (if assumed to be 1%) would have had an impact of reducing liabilities by £12,226k as at 31/3/12 and the deficit from £25,023k to £12,797k (similar to the prior year).

24. In practice, taking a gilts plus plus approach can offset the significant falls in gilt yields between March 2011 and March 2012 and would return a scheme to a similar position to a long-term expected asset returns approach. We recognise that this may not be appropriate for all schemes and that the size of the adjustment would need to be discussed and agreed between trustees, sponsors and actuaries, taking into consideration the investment strategy of the scheme as well.

Responses from our members

25. We surveyed our members to explore their views on: TPR's current regulatory behaviour and interaction with schemes; discount rate approaches and the impact the current low yield environment is having on scheme valuations; making adjustments to their discount rates where going through a scheme valuation now; smoothing for future valuations; and the key factors influencing their investment strategies. We received a total of 34 responses to the survey, 8 of whom described themselves as trustees, 14 who described themselves as scheme secretary or manager, 6 who described themselves as employer representatives and the remaining respondents at 'others'.

26. The results are set out in full in Annex A on page 13 but, in summary:

- Just over 50% said that they did not feel that TPR's guidance and practice around DB funding valuations is fully consistent with the flexibility in the legislative framework (35% said they thought it was and 12% said they did not know).
- 59% said that they thought TPR should be given a new statutory objective (32% said they should not and 9% did not know). 27% voted in favour of the new statutory objective proposed in the Chancellor's Autumn Statement. 35% agreed with our proposal put forward in our response to the first part of the Call for Evidence – "to promote good pension provision and to ensure the health and longevity of pensions." A further 18% opted for an objective that would "reduce the burdens placed on sponsoring employers where this is in the long term interest of the pension scheme and current and future pension scheme members".
- 47% said that they felt able to use the full flexibility in the legislative framework when agreeing a discount rate for the purpose of scheme funding valuations. However, 47% said they felt under pressure from TPR to take a more cautious approach than they otherwise would, whilst 6% said they did not know.
- Two thirds of respondents (65%) said they took a gilts based approach to discount rates for triennial scheme funding valuations rather than a return on assets based approach (32%).
- Whilst there were fewer (21) respondents to this question as it was only relevant to those currently going through their triennial scheme valuations, 52% said they would consider using an upward adjustment to a gilts plus based approach to discount rates if the Government or TPR gave reassurance that it is a prudent approach in the current low yield environment. 24% said they would not and 24% said they did not know.
- 36% of those currently going through their valuations said that they expected to be able to meet any increases in the level of the deficit through an extension to the recovery plan alone. 46% said they did not expect to be able to, and 18% did not know.
- Of those who answered no (9 respondents), the largest group said they expected their deficit recovery contributions to increase by between 10-25%.
- When asked for their views on smoothing for future valuations, 41% said they would consider it, 35% said they would not consider it, and 24% said they did not know. Under a smoothing approach, 20% thought this could weaken the trustees negotiating position with the employer, 47% thought it would make little difference, and 15% thought it would actually strengthen the trustee's position. 18% said they did not know.

- Finally, we asked what considerations were most important in relation to investment strategies. The need to hedge liabilities to reduce the volatility of scheme funding valuations, the discount rate that would be applied to the scheme valuations on the basis of expected returns, and the need to increase investment returns to full the funding gap were the most likely areas for respondents to say these were ‘very important’.

27. This broad mix of views reflects the conversations we have had with other members on the issues with no single consensus on any one issue. This is likely to reflect the scheme specific nature of the current regulatory regime and also the differing experiences of schemes when dealing directly with TPR, interpreting TPR’s guidance, and their interactions with advisors.

Questions in the Call for Evidence

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

Question 1. What would be the effect of smoothing assets and liabilities in schemes undertaking valuations in 2013 and going forward? Would it materially improve the sponsoring employers’ ability to attract investment or to invest in the short term? If so, what evidence is there of this?

This would be entirely dependent on how ‘smoothing’ was implemented and on the position of the individual schemes that are going through their valuations in 2013 (‘tranche 8’). On the assumption that smoothing of gilt yields is more likely to occur over a relatively short period (e.g. 2-3 years) the impact in 2013/14 could be to lock in the previous years’ very low gilt yields (from 2011 onwards), with a detrimental impact on the funding position for the majority of schemes. This will be exacerbated because those schemes that previously went through their valuations in 2010 would have experienced more favourable economic conditions at the time and would face more of a jump in their liabilities. Beyond 2013 the impact would depend on the movements in gilt yields (and other asset values) which is difficult to predict at the current time. We would argue that a smoothing regime is best introduced, if at all, in a more benign economic environment. The introduction of smoothing in the near future, particularly if mandatory or overly prescriptive, is likely to do more harm than good.

Question 2. Given that there is no one defined method for calculating scheme liabilities, how would you implement smoothing?

We have previously proposed an alternative form of smoothing that would i) work within the flexibilities in the existing regime and ii) counter the perception that TPR has a strong preference for trustees and employers to agree a relatively ‘risk-free’ gilts based approach. This would make it explicit that, with the current adverse economic conditions and with gilt yields deliberately lowered by the Bank of England through QE, an alternative discount rate may be more appropriate for valuing long-term liabilities. In our paper ‘DB funding: a call to action’ we proposed that a ‘gilts plus plus’ approach be allowed that would make a prudent upward adjustment to the discount rate to offset some of the downward drag of QE. In practice, our members have told us that this could achieve broadly the same outcome as the alternative return-on-assets approach (also permitted in the existing legislative framework) but which some schemes appear to shy away from for fear of being unduly scrutinised by TPR.

- a. **How should schemes calculate liabilities on a smoothed basis?** For a smoothed gilts plus approach the gilts yield should be smoothed by taking an average of the spot yields at a date in the preceding years in relation to the scheme valuation date. There is then an issue as to whether any risk premium on top of the gilts yield should be smoothed also.
- b. **Over what period of time should smoothing occur?** On the one hand, the longer the period of smoothing the more difficult it becomes for those schemes looking to match their liabilities (for the purpose of managing fluctuations in their valuations) to hedge using the assets available. There is already a restricted supply of suitable assets for DB schemes and a gilts based smoothing approach could exacerbate the problem with low or negative real yields for inflation linked gilts at the long end. On the other hand, a shorter period of smoothing is likely to create similar cliff-edges between valuations as the current system and increases the risks of a detrimental impact in the short-term. A 3-5 year window looks to be a sensible range with a 3 year window ensuring some alignment with the triennial scheme valuation cycle.
- c. **Would smoothing be a voluntary or mandatory requirement? Should there be any other restrictions applied to schemes if smoothing is used?** Mandatory smoothing could be highly detrimental – both in terms of timetables for implementation and on its suitability for different groups of schemes. Optional smoothing would be preferable but would raise issues about the ability of sponsoring employers to game the system and make lower deficit recovery contributions on average.
- d. **Should schemes be locked into smoothing (if they choose to smooth) for more than one valuation cycle or permanently? Would this make deficit repair contributions more counter cyclical to the wider economy in the longer term?** If schemes were locked into smoothing it is unlikely that many would adopt it as an approach, for fear of losing the flexibility in the existing system for future valuations. If schemes were locked in the impact is likely to be more one of a lagged effect than directly counter-cyclical. So, for example, in the current economic environment introducing smoothing now could exacerbate already difficult conditions and further hold back recovery.
- e. **How would you apply smoothing to assets?** There are established methodologies within the actuarial profession for the smoothing of assets.
- f. **Would smoothing enable the breadth of differing scheme circumstances to be appropriately accounted for (e.g. schemes that have hedging/risk management strategies in place)?** Only if smoothing was optional and not overly prescriptive about the smoothed discount rate e.g. by allowing varying assumptions about risk premia and smoothed asset values.
- g. **Should this be a permanent or temporary change?** Smoothing as a temporary change is counterintuitive as the logic is that it balances out over the longer term. In the current economic environment the allowance for a temporary uplift to gilts based rates, or exercising the full flexibility in the existing framework and focusing more on long term expected asset returns would be more appropriate.

Question 3. What are the advantages and disadvantages of smoothing for sponsoring employers, scheme members and the Pension Protection Fund?

Again this is entirely dependent, at least in the short-term, on how and when smoothing is implemented. Over the longer-term the impacts of smoothing should eventually balance out for those schemes that consistently use smoothing as an approach. If it was optional, and the approach could be switched on and off between valuations, then smoothing could create an opportunity for schemes and particularly employers to game the system and reduce the size of their deficits and recovery contributions on average.

However, the implementation of a mandatory smoothing system carries far greater risks both for pension schemes and the wider economy. It could backfire if implemented at the current time and have the opposite effect to the Chancellor's intended objectives. This is precisely why we did not come out in support of smoothing last year and argued for an alternative approach that allowed more flexibility through the temporary upward adjustment of gilts based discount rates. The most risky approach from the Pension Protection Fund's perspective would be if an optional smoothing approach was allowed that wasn't closely regulated as this would allow less scrupulous employers to game the system.

Question 4. Is the current regime flexible enough to ensure that defined-benefit pensions regulation does not act as a material brake on investment and growth for the UK economy?

In theory (and in legislative and regulatory terms), yes. However the experience of a significant number of schemes (whether the trustee, the scheme secretary, the employer, or another representative) suggests that the TPR's current stance is not seen as flexible enough for all schemes in practice. Just over 50% of those members we surveyed told us that they did not feel that TPR's guidance and practice around valuations is fully consistent with the flexibility in the legislative regime.

Question 5. Should a specific model of smoothing be introduced, the Government would welcome views as to what schemes, in terms of their valuation date, should be able to take advantage of the change.

It would put trustees in a disadvantageous position to unpick well advanced negotiations around deficit recovery plans and would increase the costs of the actuarial valuations. Given the current timetables, and that schemes with 2011/12 valuation dates are now very close to the end of their 15 month certification periods, any legislative or regulatory change announced now is unlikely to be of benefit. TPR should as a matter of priority issue a statement reiterating the full flexibility in the framework (around technical provisions *and* recovery plans) and should be transparent about the deficit recovery plans it is dealing with from 'tranche 7'.

Going forward, 'tranche 8', who are now beginning their valuation cycle, should be issued with a clear annual funding statement that again reiterates the full flexibility in the framework. This would be reinforced by an announcement that the Government intends to introduce a new statutory objective for TPR. However, TPR has already indicated it will not change its approach until that has happened. In which case, stronger action is likely to be required, including specific allowances within the regulations for schemes to make an additional upward adjustment to their discount rates where based on gilts. 50% of those members we surveyed told us that they would consider an upward adjustment to the discount rate if the Government or TPR gave reassurance that it is a prudent approach in the current low yield environment.

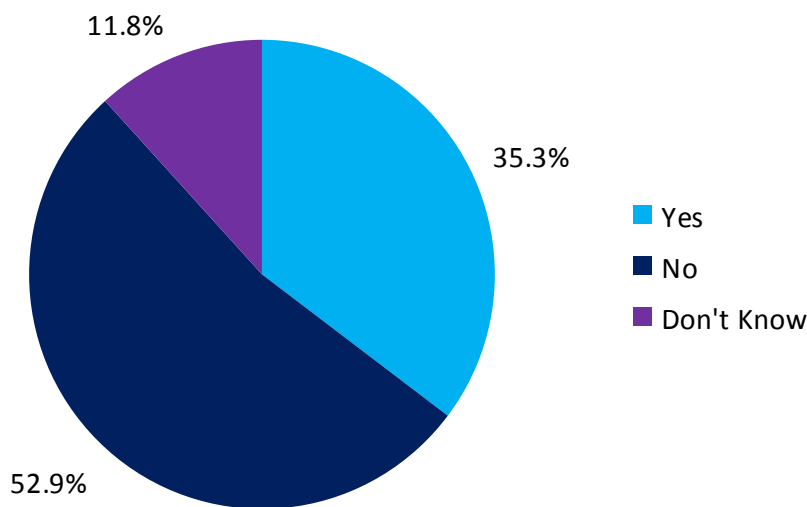
Conclusion

29. This consultation response responds to the second part of the DWP's Call for Evidence, on whether to introduce legislation to explicitly allow the 'smoothing' of asset values and liabilities in funding valuations in order to counter the effects of the current economic situation. The NAPF does not support the proposal to introduce smoothing though welcomes the Government's careful consideration of these issues and recognition of the challenges facing DB schemes in the current economic environment. We would like to see the full flexibility within the existing scheme specific regime exercised, including the flexibility around selecting discount rate assumptions for the technical provisions, though recognise that legislative or regulatory change may be needed if TPR is to change its behaviour and guidance on these issues.

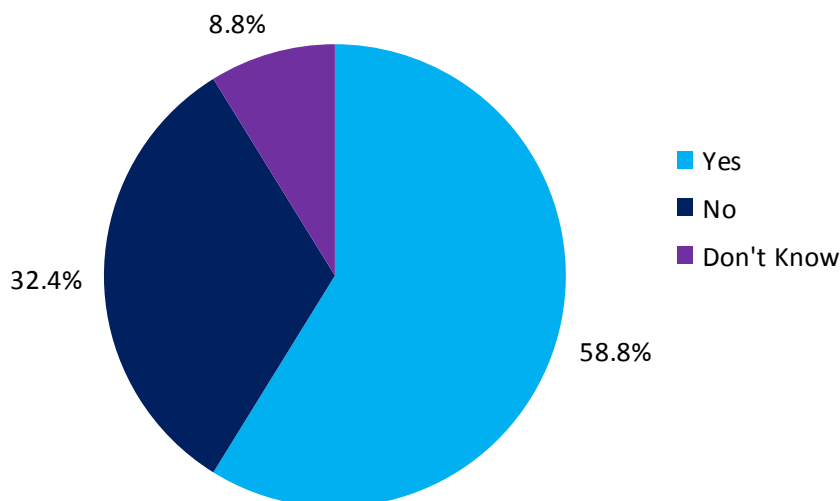
Annex A – Responses to an NAPF Survey with Members

The NAPF sought the views of its defined benefit pension fund members on the DWP consultation via an online poll. 34 respondents completed the poll. 8 described themselves as trustees, 14 as Scheme Secretary/Scheme Manager and 6 as employer representatives. The remaining respondents classified themselves as “other” pension fund representatives. The results of the poll are as follows:

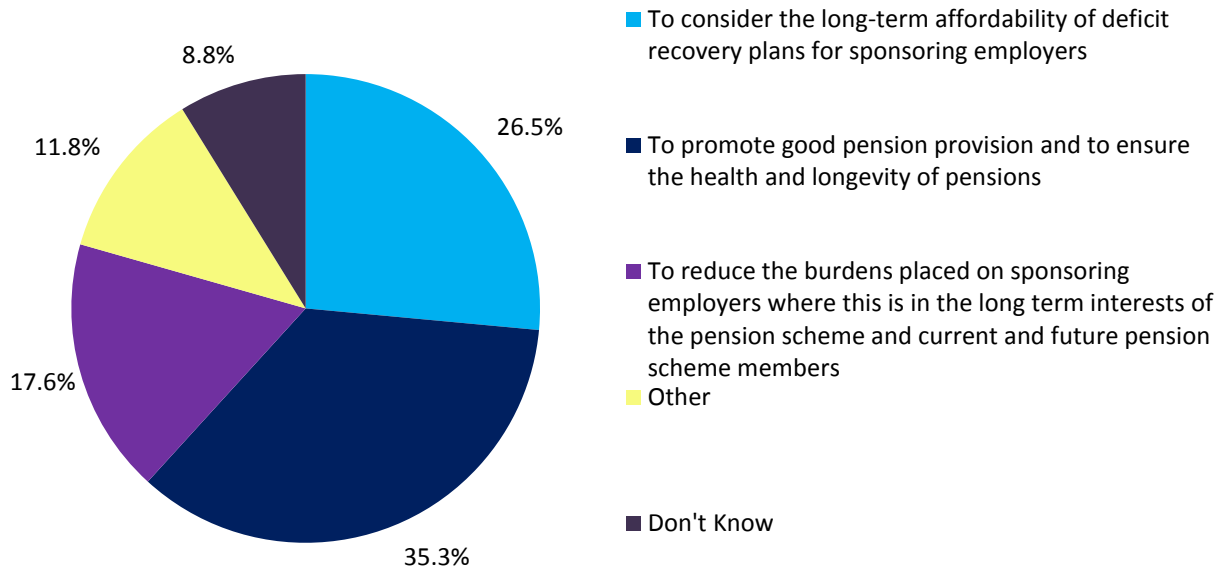
- 1. Do you feel that the Pension Regulator's guidance and practice around DB funding valuations is fully consistent with the flexibility in the legislative framework?**



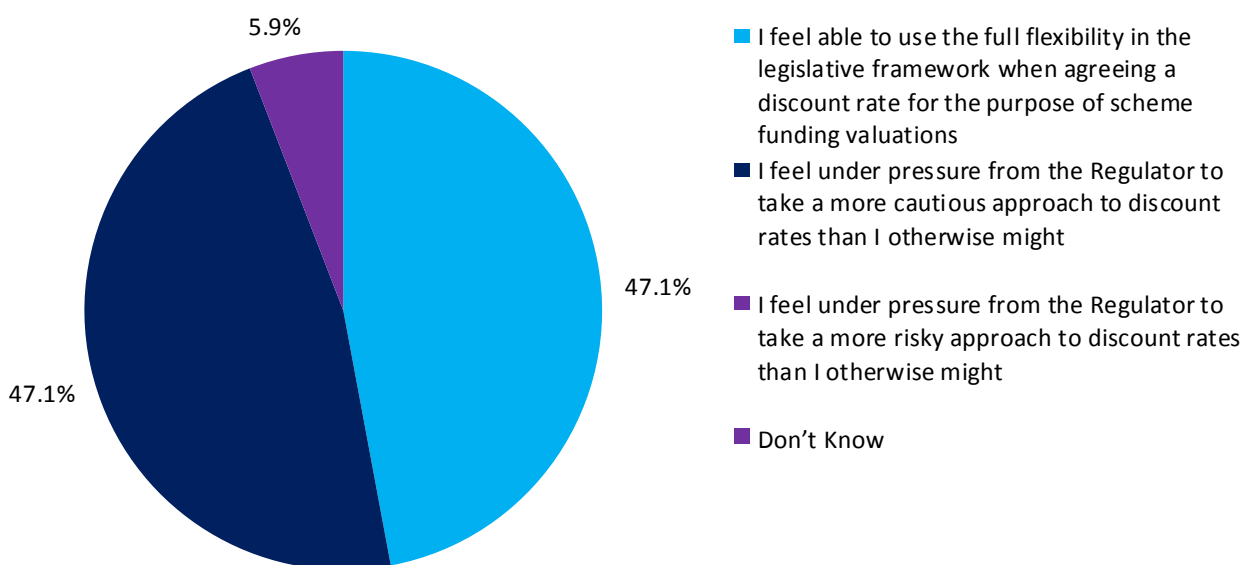
- 2. Do you think that the Pensions Regulator should be given a new statutory objective?**



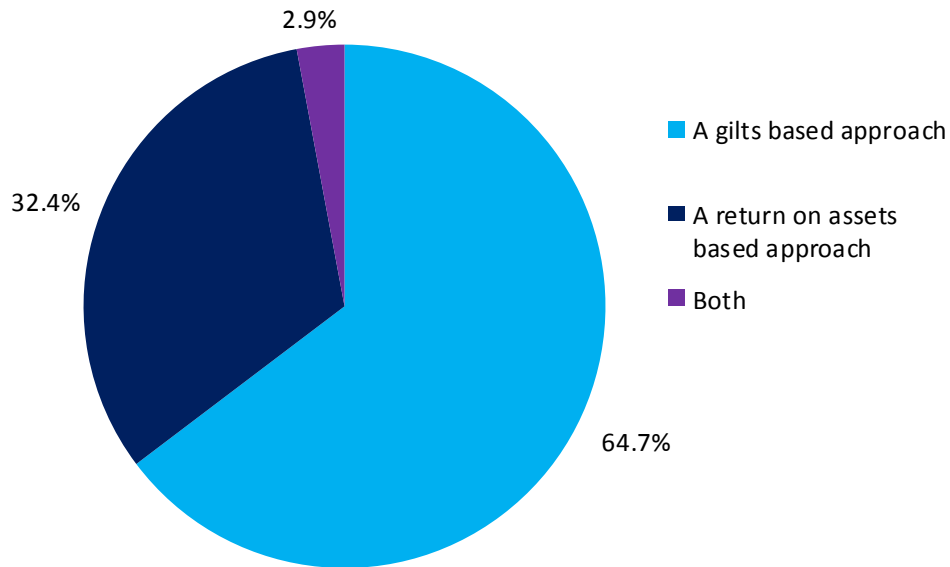
3. If the Pensions Regulator's objectives are amended, which of the following additional objectives would be the most appropriate?



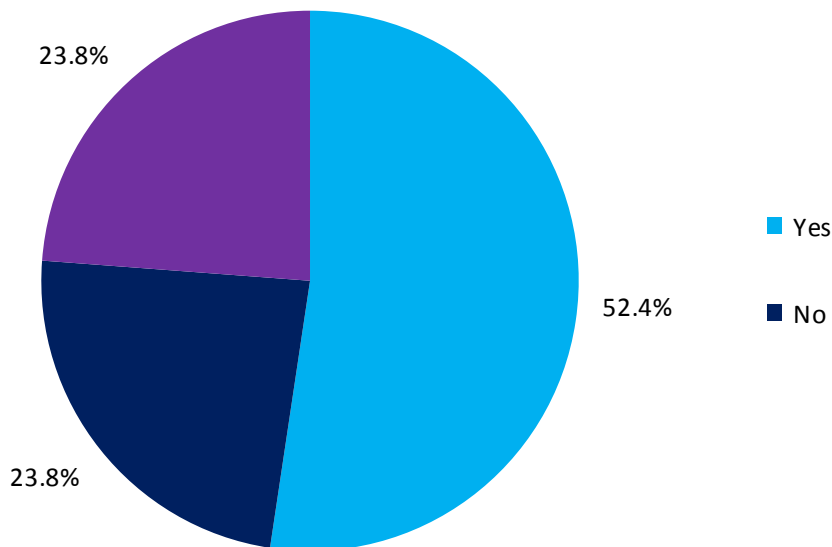
4. Which of the following best reflects your experience of dealing with the Pensions Regulator?



5. Which of the following best describes your current discount rate approach for triennial scheme funding valuations?

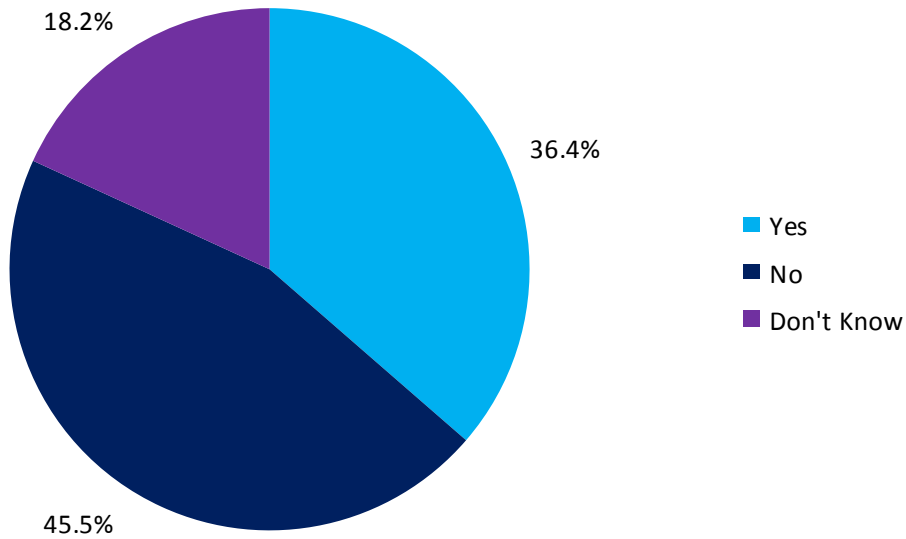


6. If you are currently going through a scheme valuation, would you consider using an upward adjustment to a gilts plus based approach to discount rates if the Government or the Pensions Regulator gave reassurance that it is a prudent approach in the current low yield environment?



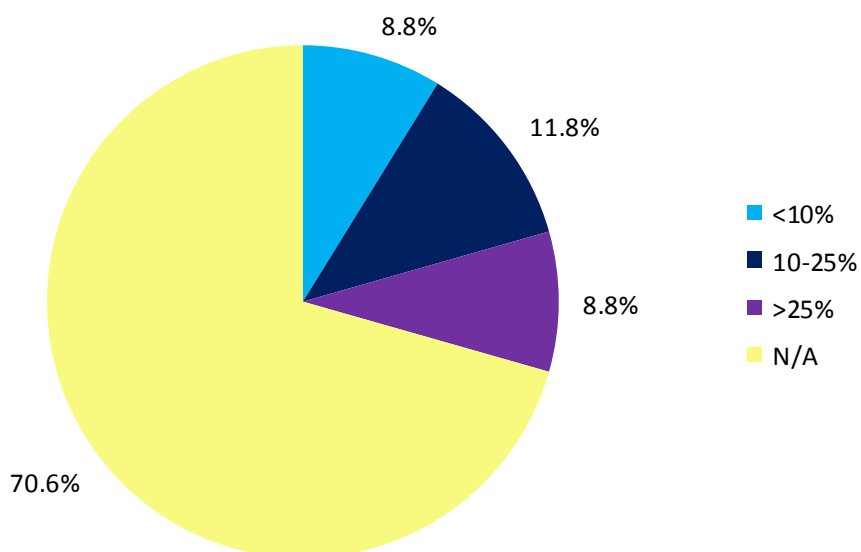
Base: 21 respondents. 13 respondents stated this question did not apply.

7. If you are currently going through a scheme valuation and the level of the deficit has increased since the last valuation, do you expect to be able to meet any increases in the level of the deficit through changes to the length of the recovery plan alone?

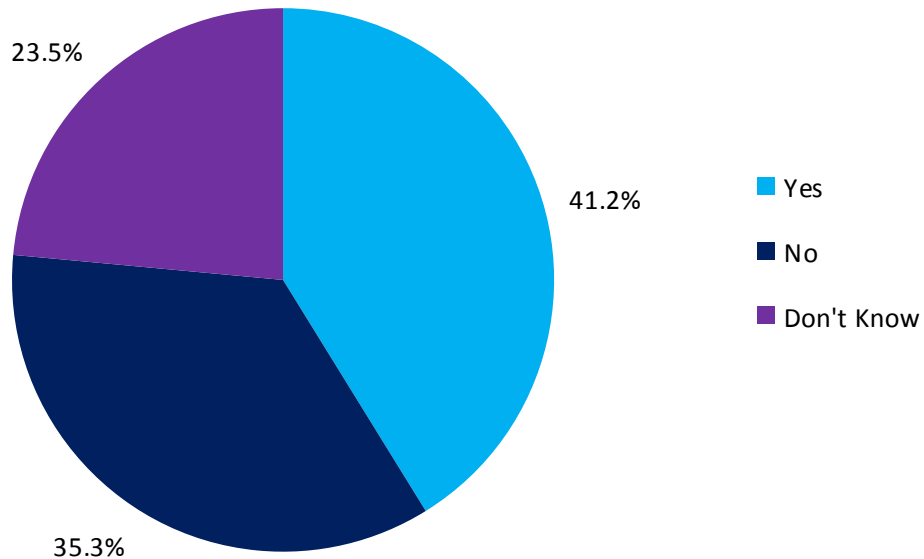


Base: 22 respondents. 12 respondents stated this question did not apply.

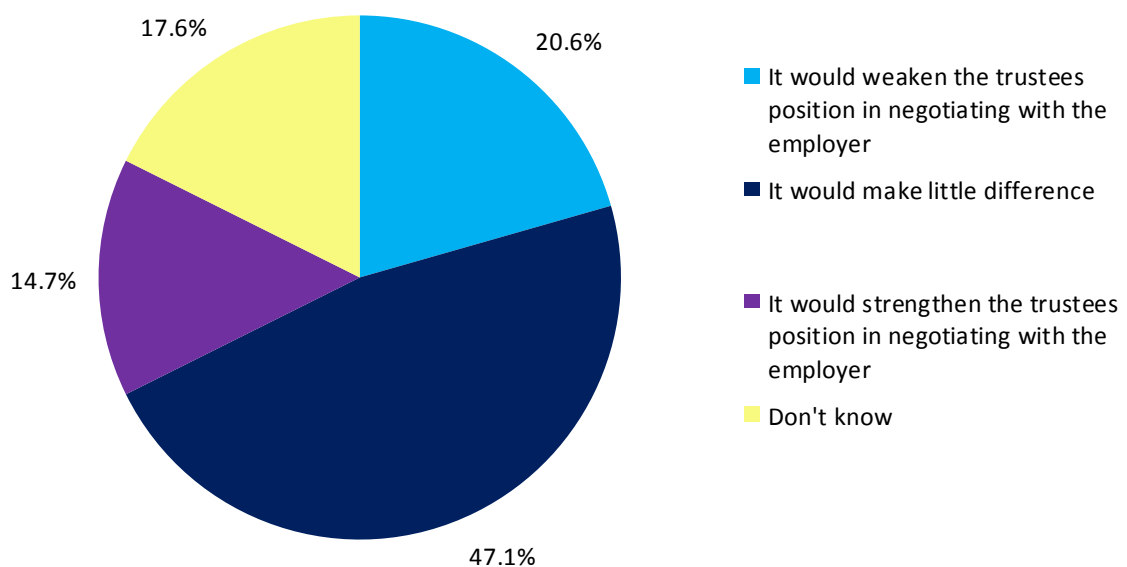
8. If answered No (b) to Question 7, how much do you expect sponsor deficit recovery contributions to increase by?



9. For future valuations (from mid-late 2013 onwards), would you consider switching to a smoothing approach to discount rates if the Government or the Pensions Regulator gave reassurance that it is a prudent approach in the current low yield environment?



10. If a smoothing approach to discount rates was an option in future, what impact do you think this would have on the trustee/employer discussions on agreeing a discount rate?



11. How important are the following considerations when considering your investment strategy?

