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ACA response to DSS/Treasury consultation – Security for Occupational Pensions

Introduction

- 1 In September 2000 the DSS and Treasury issued their consultation document 'Security for Occupational Pensions' to obtain views on the Minimum Funding Requirement (MFR) and on alternatives to the MFR in the light of the Actuaries' Report (issued in September 2000 by the Pensions Board of the Faculty and Institute of Actuaries). In November, Paul Myners' views on the MFR were released, where - amongst a range of proposals - he called for the abandonment of MFR.
- 2 The ACA has considered these three documents in detail in the light of our experience of advising sponsoring employers and Trustees of defined benefit schemes. The vast majority of the largest defined benefit schemes - over 95% - and most smaller schemes are advised by ACA members. We have consulted widely with our membership on this very important issue.
- 3 The MFR is used to determine: -
 - a. the minimum employer contribution rate which must be paid.
 - b. the underpin for individual cash equivalent transfer values.
 - c. the minimum assets in the scheme on a wind up of a scheme (subject to the employer's ability to pay) and in the event of fraud.

Promotion of pension provision should be priority

- 4 The ACA firmly believes that defined benefit pension schemes have played a major role in ensuring the retirement welfare of a large proportion of British pensioners. Successive governments have introduced requirements that make them even more beneficial for their members, which have been accepted by employers, even if not always with enthusiasm. The ACA believes that the government has recognised the importance of these arrangements.
- 5 This success has been achieved despite the fact that pension provision, in this manner, remains an entirely voluntary action by employers. The resultant cost of regulatory requirements, coupled with changed economic conditions make the continued provision of these arrangements by employers less likely, unless greater flexibility can be achieved in certain areas.

Reason why MFR should be removed

- 6** The concerns and failings of the current MFR have been set out in the documents in 1 above and we have not repeated them here in full.
- 7** We do not believe that the current MFR has added materially to the security of UK pension schemes but it has increased the cost of pension provision for all schemes as it is complex to calculate, track and understand. In particular MFR imposes a minimum contribution which an employer is required to pay and this loss of flexibility results in employers being less willing to sponsor defined benefit occupational pension schemes. We believe the real and potential loss of defined benefits for possibly tens and even hundreds of thousands of members exceeds the largely illusory protection afforded by MFR.
- 8** There is no one 'right' answer to the review of the MFR as any solution is a balance between security, affordability, benefit levels and investment flexibility. Where that balance lies is inevitably going to be a compromise.
- 9** There is a strong argument that the future for defined benefit pension schemes would be better if the minimum contribution requirements emerging from an MFR were removed.
- 10** The risk of removing the MFR is that there might be an unacceptable number of employers who would then be unable/unwilling to fund the benefits they had promised to an acceptable level resulting in the benefits not being delivered.

MFR to be replaced by Statement of Funding Principles (SFP)

- 11** Therefore, we believe that the current MFR should be abandoned as a means of providing a level of security for occupational pensions and replaced by a Statement of Funding Principles (SFP) similar in concept to the Statement of Investment Principles. The SFP would include a) the Schedule of Contributions agreed between the Trustees and the Employer and b) full disclosure of the funding position.
- 12** We believe that employers would prefer a SFP without a minimum contribution requirement but we recognise that a minimum contribution requirement may be considered necessary.
- 13** Without a minimum contribution requirement, the responsibility for ensuring security would be returned to the sole control of the Trustees and Employer. There should be mandatory guidelines on how the governance approach should be adopted coupled with full and detailed disclosure to members.
- 14** The Statement of Funding Principles would be prepared by the Trustees and Employer after taking the advice of the Scheme Actuary and would be updated after each valuation.
- 15** The main elements of the SFP would be
 - a.** A description of the long term funding target
 - b.** Details of the actuarial basis and allowance for discretionary benefits
 - c.** The ongoing funding level as at the valuation date (assets divided by value of accrued liabilities allowing for future salary increases)
 - d.** Disclosure of the funding level on the schemes transfer basis (which is the Statutory Transfer Basis if this is introduced (see paragraph 20)) as at the valuation date, together

with if it is below 100%, comments of when a 100% funding level is expected to be achieved.

- e. A copy of the Schedule of Contributions agreed between the Trustees and the Employer in accordance with the Scheme's Trust Deed and Rules. If it is decided that a minimum contribution requirement is necessary, an actuarial certificate will be required to confirm that the agreed contributions are above the minimum. A suitable minimum contribution requirement would be contributions which are expected to be sufficient to ensure that:
 - (i) if the funding level on the Statutory Transfer Basis is above 100%, the funding level remains above 100%
 - (ii) if the funding level on the Statutory Transfer Basis is below 100%, it would not decline and would rise to 100% over the average outstanding future working lifetime of the current active members (with suitable transition arrangements for mature schemes.
- f. Disclosure of the estimated wind up position as at the valuation date if the Employer had ceased to contribute to the fund
 - (i) For very large schemes (to be defined) this would require the Trustees to assess the sufficiency of the assets to fully cover the benefits on the assumption that the assets were invested in a matching portfolio of bonds.
 - (ii) For smaller schemes reference would need to be made to the estimated cost of buying out the benefits with an insurance company.
 - (iii) The Trustees/Actuary would need to make a realistic allowance for expenses.
 - (iv) For schemes where this disclosure would show that benefits could not be met in full a detailed disclosure of the proportion of benefits for each class of member which could be met.
 - (v) We believe that the disclosure should mirror the priority rules. This means that up to 2007 two disclosures would be required relating to the pre 2007 position and the post 2007 position,

16 This Statement of Funding Principles, even without a minimum contribution requirement, would provide some degree of security for occupational pension schemes members as: -

- (i) The Employer and/or the Trustees (according to their respective powers under the Scheme's Trust Deed and Rules) would demonstrate a funding plan with details of how the target could be attained
- (ii) The Schedule of Contributions agreed between the Employer and Trustees would ensure that both parties were aware of the agreed contributions and that action could be taken if the required level of contributions were not paid. Such action would include reporting to OPRA and disclosure to members
- (iii) The actual position on immediate wind up would be disclosed to members together with the implications on their benefits. This would give members the opportunity to negotiate with their sponsoring employer for greater security. If the

SFP also contained the minimum contribution requirement discussed in 15e) above then the absolute level of security would be similar to the current position, except in cases where employers were taking advantage of the longer period to recover from a less than 100% funding level on the transfer basis.

- 17 This procedure would enable the Employer and Trustees, if appropriate, to determine a funding plan appropriate to the individual scheme and not impose the inflexible regime of the current MFR.

Cash equivalent transfer values

- 18 Prior to April 1997 cash equivalent transfer values were determined by the Trustees of each scheme on the basis of actuarial advice and there was no statutory minimum transfer value basis. There was a wide variation in bases for the calculation of such transfer values. The Pensions Act 1995 introduced the MFR basis as the underpin for the calculation of any cash equivalent transfer value. The result of the legislation has been for transfer values generally to be calculated on the MFR basis and not on a more 'generous' basis.
- 19 We would prefer a minimum level of regulation and favour a return to the pre 1997 position. However, we recognise the political difficulty of removing the statutory basis.
- 20 If there was to be a statutory basis then we suggest that this Statutory Transfer Basis (STB) would be set by the Faculty/Institute of Actuaries and could be similar to the basis they have proposed for the revised MFR ie based on measures of yields on fixed interest markets wider than just gilt yields. This basis should be kept under review as, for example, the annual expenses of stakeholder/personal pension contracts are falling from 1.0% to perhaps 0.4% of the fund value. We suggest that consideration should be given to whether the strength of this basis is too high for a minimum transfer basis but at this stage we have not considered this option further.

Minimum assets in a scheme on wind up

- 21 Pension schemes are set up by a voluntary act of the Employer. The majority of pension schemes provided that the Employer could wind the scheme up at any time without being required to fund any deficit. Legislation in 1992 ensured that when a pension scheme is wound up (or partially wound up) the relevant employer has to contribute so that the assets are equal to the liabilities on the MFR basis. The provision of pension benefits with guaranteed increases in deferment and in payment at a time of low real returns is expensive. Ideally on wind up all members would receive their full accrued deferred benefit. At the current time the majority of schemes fall a long way short of having sufficient assets to meet this objective by buying-out the benefits with an insurance company. We believe that the current position, whereby the Employer has to meet any deficit up to the MFR, remains a reasonable balance. We believe that a statutory basis should be retained for calculating the 'debt on the employer' and the level of compensation for fraud.

This basis could be the STB discussed above. However we suggest that it would be appropriate to amend this basis so that the liability for pensions in payment was the full insurance cost of providing the benefit, for example, by the purchase of a non profit immediate annuity.

- 22** The MFR is complex to apply in practice on wind up, and the costs of compliance are usually met from the assets of the Fund. In the new environment where the STB will be linked to corporate bond yields we believe there are opportunities to simplify considerably the application of the debt without reducing the security of members' benefits.
- 23** We would support the Actuaries' proposal that further work is done to consider the priority order for different classes of beneficiaries on wind up both before and after April 2007.

Immediate Changes

- 24** As an interim proposal the Actuaries' report suggests change be made to the current basis. These interim changes were recommended by the Faculty and Institute of Actuaries nearly 2 years ago. If the implementation of the full review of the MFR is imminent there is no reason for the changes to be introduced in advance of the full MFR review. If the review is unlikely to be implemented for a year or more then we would support interim changes but believe that the 'proposed interim changes' should be reviewed to ensure they are appropriate to current market conditions.
- 25** The operation of the MFR as a funding standard results in complicated calculations for schemes that are close to 100% or below 100% MFR funded as the MFR position at the valuation date has to be approximately updated to the calculation date each year. The results of these additional calculations do not make a material difference to the security of members' benefits. We recommend that regulations are made without delay so that the minimum contribution rates are determined at the MFR effective date and that Schedules of Contributions do not have to be re-certified on an annual basis.

Conclusion

- 26** The ACA believes that the promotion of defined benefit occupational pensions is being seriously and adversely affected by the straight-jacket imposed by MFR. We believe it is essential to take early action in the interests of many thousands of scheme members, who otherwise over time may lose the benefits of these schemes because of the regulatory costs involved, with employers restricting scheme entry and in certain cases closing schemes.
- 27** We believe more employers will be prepared to retain defined benefit arrangements if MFR is abolished, and there is a chance more employees will be offered access to such schemes if this action is taken alongside further meaningful simplification of the legislation and regulations applying to such schemes.
- 28** The ACA would be delighted to meet with Ministers and DSS / Treasury officers to provide further assistance or to clarify any points within this submission.

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