

REVIEW OF THE MINIMUM FUNDING REQUIREMENT

EXECUTIVE SUMMARY

1. Introduction

This review has been carried out for the DSS by the Pensions Board of the Faculty and Institute of Actuaries.

2. Reasons for the Review

There are a number of concerns which have been raised by employers, trustees and actuaries about the current MFR. The principal concerns are:

- it has led employers and trustees to pay too much regard to short term market conditions, instead of focusing on long term funding and investment policy
- it appears to have created some extra demand in the long end of the gilts market, which may have contributed to the depression of yields
- the dividend yield is no longer a reliable measure of "value" for UK equities – this is partly due to the abolition of tax credits on UK dividends in the July 1997 Budget, which has changed companies' behaviour over profit distribution, and partly because investors are willing to value shares on future long term expectations, despite the absence of dividends or profits
- there are technical problems:
 - for schemes which try to match their assets to their MFR liabilities
 - for certain types of insured schemes
 - with the rigid and mechanical rules for setting minimum contributions
- there is a large and worrying gap between the level of security which the MFR test actually delivers and the public's perception of what it will deliver

3. Terms of Reference

The terms of reference for the review set out the Government's objectives for the MFR test. The key objectives are:

- for pensioners:
 - " protection at a level to enable pensions in payment to continue in full (excluding future discretionary increases) ... "

- for non pensioners:
 - " ... a reasonable expectation of receiving benefits at a level that would have been paid if they had become deferred members and the scheme continued as an ongoing scheme."
- the test should be objective and independent of the circumstances of each scheme

4. A Revised MFR Test

- The Government sets the objectives for the MFR test and ultimately decides the strength of the test. (For this purpose, "strength" means the level of benefits to be secured, coupled with the degree of certainty that a scheme which is 100% funded on the MFR test will be able to secure those benefits.) The actuarial profession provides advice on the best way to meet the Government's objectives and achieve the desired strength. Our proposed new basis for the MFR test is our best solution, which meets the terms of reference set by the Government.
- We have excluded all methods which do not focus on members' security. The security that matters to members is the security for their accrued benefits in the event of the insolvency of their employer.
- We have reasserted the need for the MFR test to be related to the cost of buying out benefits in the event of the scheme winding up.
- We recommend that, in addition to the MFR test, there should be a security measure which is clearly disclosed to members.** This security measure would indicate the level of cover achieved against a stronger test, designed to give all members a very high chance of receiving their accrued benefits on winding up. The MFR test, to which statutory controls apply, gives pensioners a very high chance and non pensioners a "reasonable expectation" of achieving their benefits, in accordance with the objectives set by Government. Members would be informed that the MFR test differs from a true security test and does not give 100% security, as they currently believe.
- We have concluded that valuation methods which depend on equity returns, and thus allow the value of liabilities to move in line with equity markets, cannot be made to work for a mandatory standard.** The assumptions required are highly subjective and their use requires the exercise of judgement, which cannot be "hard coded" into a statutory test. We have been unable to find an objective way of allowing explicitly for variations in equity market prices using "indicators of value", such as dividend or earnings yields. **We have therefore proposed a test based solely on bond yields, with an explicit allowance for the excess expected return from investments other than bonds, such as equities, through a risk based addition to the discount rate for valuing non pensioners' liabilities.** This risk based addition is designed to meet the "reasonable expectation" objective in the terms of reference.

- f) **We propose that the bond yield should be derived from a new composite index, comprising fixed interest gilts and investment grade fixed interest corporate bonds.** By including a large range of gilts and corporate bonds, the aim is to reduce as far as possible the impact of demand from pension funds on narrow segments of the gilt and corporate bond markets. **The proposed risk based addition to the discount rate for valuing non pensioner liabilities is 1% pa, net of expenses.** This is equivalent, in current conditions, to an expected "real" return in excess of price inflation of around 4.5% pa before expenses, incorporating expected returns from future income and capital growth in equities.
- g) We recognise that there are some important issues still to be addressed regarding the construction of the proposed new composite index. We have been unable to discuss our proposals with actuaries and others working in investment markets, due to the market sensitivity of this review. We have therefore analysed a number of key issues which we have identified, for wider consideration.
- h) The new test is designed to be of a similar strength to the current test. We have carried out backtesting which shows that, for most of the period since 1983, the new test would have been easier to meet than the current test for a typical scheme. However, under the economic conditions prevailing between August 1998 and November 1999, the new test would have been harder to meet.
- i) The backtesting also clearly shows that, for a scheme which was always 100% funded on the current MFR test, the level of security for members' benefits was highly variable. On the other hand, if a scheme had been 100% funded on the proposed new MFR test, the level of security for members' benefits would have been much more stable. On these grounds, the proposed new test is much better at delivering the Government's objectives.
- j) For a typical scheme which holds significant equity investments, the actual level of members' security will vary over time. This is because, with such an investment strategy in place, the MFR funding level will vary. The MFR funding level under the new test is potentially more volatile than under the current test for a typical scheme which holds significant equity investments. **We discuss a range of alternative ways of reducing this volatility, or its impact on contributions, and conclude that the best solution is for the MFR deficit correction periods to be extended.**
- k) It is difficult to predict the impact that our proposed new test will have on investment markets. The use of a corporate bond and gilt based measurement for MFR might increase the incentives for schemes to invest in those assets, rather than equities. However, extension of the deficit correction period and other recommended measures should shift the emphasis from short term to longer term investment considerations.

5. Other Aspects of the MFR Test

- a) We recognise that the proposed change to the MFR test will require extensive consultation with other parties involved in pension provision, which will inevitably

take some time. In the meantime, **we make recommendations for interim changes to the current MFR basis covering:**

- **mortality assumptions**
- **assumptions for pension increases**
- **the equity market value adjustment factor**

The impact of these changes for schemes will be to worsen slightly the funding level against the MFR for a typical scheme, although not all schemes will be affected equally.

- b) **We recommend a simplified and less mechanical approach to setting minimum contributions**, giving greater responsibility to scheme actuaries, subject to professional guidance. **We recommend abolishing the requirement for annual recertification.**
- c) **We recommend the introduction of a formal mechanism for a regular review of the assumptions underlying the new MFR test.**
- d) **We recommend continuation of the current position in relation to minimum transfer values and debt on the employer**, but with simplification in the way in which the regulations for the debt on the employer work in practice.

6. Framework in which MFR Operates

We discuss in some detail possible changes to the framework in which MFR operates. We outline how members' security could be protected by the introduction of a Central Discontinuance Fund with a guarantor of last resort or by the introduction of compulsory commercial solvency insurance. Either of these would need to work alongside an amended MFR test. We also discuss the way in which winding up operates in practice and how this might be adapted and simplified to provide a more acceptable and practical distribution of assets.

7. Funding and Investment Policy for Pensions in Payment

- a) We refer to very recent changes proposed by Government for occupational defined contribution schemes, removing the requirement to provide automatic increases to pensions in payment and giving the option of an investment linked annuity instead.
- b) We highlight changes to the priority order on winding up already contained in legislation and discuss the implications for the Government's objectives for the MFR test.
- c) We look at defined benefits and the relationship between discretionary and automatic increases in benefits, from a historical perspective.

- d) We consider the demographic effects of members retiring earlier and living longer and the impact on investment policy, in terms of continued investment in equities into retirement. We touch very briefly on the issue of future supply and demand for gilts and corporate bonds.
- e) Finally, we give some initial thoughts as to how the MFR test might be modified if the objectives for the test were to be changed by the Government in the light of these developments.