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THE ACTUARY IN PENSIONS—THE GROWING CHALLENGE

JOINT ACTUARIAL CONVENTION,
HARROGATE, 16–18 SEPTEMBER 1991

THE 4th residential Actuarial Convention, Harrogate, 16–18 September 1991, was arranged jointly by the Institute and the Faculty. The programme was very wide-ranging, covering individual and group pension topics.

Topical pension issues were discussed in 80 meetings (workshops and open meetings) and this article summarises many of the important issues raised. Of course with such a broad spectrum of subjects, there will inevitably be some overlap of the subject matter between the headings used below. Detailed Proceedings have been published, so the reader should refer to these for more information. The topics discussed have been summarised under the following main headings:

—Legislation and Pension Scheme Design,
—Unapproved Arrangements,
—Accounting Standards,
—Pension Products,
—Funding and Valuations,
—Investment,
—Relations with the Public,
—International, and
—Miscellaneous Subjects.

The Faculty President, Mr Alistair Neill, in his opening address, gave his own thoughts on some of the important topics that were to be discussed, identifying some current issues which gave him particular cause for concern.

He felt that the sex equality issue, started by the 'Barber' case (see Appendix) 16 months earlier (May 1990), had not been dealt with satisfactorily under our legal system, and was still leading to an unsatisfactory degree of uncertainty in pension scheme benefits. He was not happy with some aspects of the 1990 Social Security Act (SSA90—see Appendix) and noted that parts of the Act had been postponed until the 'Barber' issue was resolved. His view was that the possibility of increased liabilities for increases to pensions in payment was an unacceptable additional financial burden on employers. He also mentioned the proposed new European Pensions Directive which, it now seemed, would cover only investment matters.

He questioned why pension schemes had such a wide variety of different benefit structures, which introduced complexity instead of the desired simplicity. Referring to the final salary *v* average revalued salary *v* money purchase debate, he concluded that perhaps the final salary scheme was the best that we could do.

He raised questions such as: How do privately invested money purchase schemes work, given the prospect of negative investment returns in some periods? Why are there so many funding methods for final salary type pension schemes? How should pension benefits be divided on divorce? Why was the mortality experience of private pension schemes, particularly mortality in retirement, not published as it is for insured schemes?

The President pointed out what he regarded as inadequacies of trust law and called for legislation, a Pensions Act, to clarify the responsibilities and rights of employers, trustees, members and advisers such as actuaries and investment managers. He welcomed the professional responsibilities given to actuaries for pension scheme financial matters, which he saw as preferable to an increase in the number of rules. Finally, he regarded the area of assets as being very important, and an area where actuaries should have increasing influence.

LEGISLATION AND PENSION SCHEME DESIGN

Two major issues dominated many discussions, namely, the repercussions of 'Barber' and the Social Security Act 1990. A summary of the 'Barber' sex-equality issue and the main provisions of relevant legislation are given in the Appendix.

(a) *'Barber'*

Sex discrimination and other areas of discrimination in pension schemes were key areas of concern following the uncertainty caused by the 'Barber' case decision by the European Court in May 1990. What the Government would do in respect of the State Scheme was not known and, until that was clarified, occupational pension schemes, especially defined benefit schemes, were likely to wait before taking appropriate action.

The main difficulties were the cost of retrospection before May 1990, and associated potential administrative difficulties with different benefits operating for different periods. Unisex transfer and annuity rates, equality of contribution rates for money purchase schemes and difficulties with individual-member transfer values (GN11) were other matters that were covered.

(b) *Social Security Act 1990 (SSA90)*

It was felt that the increase in cost of final salary schemes, resulting from partial inflation proofing of pensions under this legislation, would lead small or medium-sized companies to reconsider the future of their schemes, and inevitably some would switch to money purchase schemes, to the possible detriment of pension provision for employees (especially older employees). The imposition of regulations forcing surplus to be spent on past service escalation, was considered to be a contentious issue for employers. The increase in cost of providing partial inflation proofing of future pension accruals seemed unlikely to be offset by a reduction in future accrual rates, because employers would find such a change difficult to explain or justify. An increase in the member contribution rate was a possibility.

On winding-up, any shortfall in assets will become a debt of the employer, and it was agreed that this was also an undesirable feature in legislation relating to pension schemes. Other requirements of the Act, such as revaluation, self-investment, registration and the Ombudsman, were not seen as being of great significance financially.

Many participants felt that, while the increased complexity of pension scheme regulations would not deter large companies from continuing their final salary schemes, the increased costs and complexity might make smaller employers have second thoughts.

(c) *Review of 1993–98 Contracting-out Rebate*

The Government Actuary's quinquennial review of the 1993–98 National Insurance contributions rebate for contracting-out was not, unfortunately, published in time for the conference. However, there was a useful discussion on the make-up of the rebate and possible future changes. The theoretical desirability of age-related rebates (because individuals could now elect to contract out via personal pensions) was balanced against the need for a system which was practicable for final salary and group money purchase schemes to administer. It was felt that the administration of group pension schemes would be very difficult with an age-related formula for the rebate.

Given the forthcoming General Election in 1992 and the uncertainties as to how State Pension Ages might change, it was thought that there might be a case for an interim solution, followed by a further review of contracting-out terms in 1994–95.

(d) *Other Recent Legislation*

The recent Occupational Pension Schemes (Preservation of Benefit) Regulations 1991 and the operation of the new actuarial guidance note (GN16) dealt with accrued rights transfers between occupational pension schemes without members' consent. The regulations dealt with the rights and 'expectations' of members transferring to a new scheme. The treatment of discretionary benefits was an area of difficulty, as was the possibility of differences in interpretation between the Guidance Note and the regulations. The new actuarial certificate had been used in relatively few cases so far, and difficulties in interpretation could lead to revisions to clarify matters in 1992. In the meantime, it was suggested that any actuaries signing to allow transfer of benefits without member consent under these regulations should proceed with due care in this very difficult area.

It was agreed that removal of compulsory pension scheme membership in 1988 had not yet had any real impact on final salary pension scheme finances.

It was noted that under the Finance Act 1986 (FA86) Surplus Regulations (see Appendix) the Inland Revenue was not permitting pension schemes to make allowance for liabilities that might be imposed in future as a result of the 'SSA90' and 'Barber'.

(e) *Other Sessions*

The commercial area of purchase and sale agreements was described as a minefield because of 'Barber', 'LPI', SSAP24 (the new U.K. accounting standard) and unapproved arrangement (see below) considerations. It was agreed that the SSAP24 'best estimate' basis was an appropriate starting point for negotiations between purchaser and vendor, but that there was justification for deviation from this basis. Areas such as discretionary benefits had caused difficulties, and extreme care needed to be taken with unfunded arrangements.

It was agreed that, for smaller employers, the simplicity and lower level of regulation currently favoured defined contribution schemes. A further problem associated with compulsory limited price indexation of pensions in payment under the Social Security Act 1990 was that it could disturb the financial balance in pension schemes with final salary or money purchase underpins.

Discussions were held on the latest LAUTRO rules on illustrations. The issues discussed included commission and expense disclosure, regular premiums versus single premiums and reduction in yield figures. It was agreed that the rules had undoubtedly affected product design for individual pension products.

UNAPPROVED ARRANGEMENTS

This new topic resulted from the Finance Act 1989 (FA89). On 14 March 1989 the Government imposed a ceiling on pensionable earnings (called the 'cap') in approved pension schemes. The 'cap', £60,000 at the outset, was applicable to new pension schemes immediately, and new members of existing schemes from 1 June 1989. The intention of this legislation was to limit tax relief for pension benefits for the highly paid, but the proposal to limit the indexation of the 'cap' each year to price inflation, rather than earnings inflation, meant that, in due course, it would affect a considerable number of people. It was questioned why companies should compensate highly paid individuals for a tax change over which they had no control. However, the legislation introduced inequities between new and existing employees, which might have an adverse effect on recruitment. It was also suggested that taxing both investment income and the pensions paid was unreasonable. This was double taxation. Experience to date had been that many employers had continued to promise final salary benefits to employees affected by the 'cap'. There were very few unapproved schemes, because it had been possible instead to enhance normal scheme benefits within FA89 limits.

It was stated that the current tax regime made it very difficult to provide funded unapproved final salary pension benefits in a coherent way. The majority of employers continued to provide such benefits by adopting unfunded unapproved arrangements, but the poorer security of such arrangements for members seemed unsatisfactory. It was suggested that there was no one solution which would satisfy all members affected by the 'cap'. A negotiated package of benefits, to avoid the complications of unapproved schemes, might be a desirable alternative at the current time.

ACCOUNTING STANDARDS

SSAP24, supported by an actuarial guidance note (GN17), sets out the principles for determining pension cost in company accounts. Following initial problems in interpretation, co-operation between actuaries, clients and accountants had resulted in a satisfactory application of the standard, although it was suggested that disclosure requirements could be improved. The standard had led to more realistic assumptions being used for funding purposes. Since many accounting firms now employed actuaries, some interesting cross-comparisons were being made on pension cost calculations.

The US FAS87 accounting standard has, as its main objective, consistency from company to company in accounting for pension costs. It was a more rigid standard than SSAP24, which could cause problems in advising clients.

There is no required accounting standard for medical benefits in the UK, but SSAP24 may be applied optionally for post-retirement benefits. In the USA FAS106 now applies, and this had imposed an enormous financial burden on companies in respect of unfunded post-retirement medical benefits.

PENSION PRODUCTS

The poor profit margins for Group Risk business in the U.K. were highlighted. It was thought that, in the past, this had resulted from competitive pressure to obtain the associated pension business. It was agreed that sound rating and underwriting practices were required in order to be profitable, but that the opening of the European market in 1992 might increase competitive pressures. As regards Group PHI business, the very bad results for many Life Offices had led to the market moving to a sounder costing basis for that business.

A discussion on Dread Disease cover agreed that group schemes were rare because it was not yet a standard part of employee benefits, except perhaps for senior executive categories. It was accepted that AIDS was unlikely to be included in this type of cover in the foreseeable future. Group Medical and Health business had suffered from an erratic growth in premiums over the previous 8 years. Recently there had been a switch from individual to group cover.

Personal Pensions were first introduced in 1988, and the merits of using them to contract out of the State scheme were discussed. The timing of contracting back in was seen as a difficult area. The variety of individual products such as free-standing AVCs, Section 32 policies, executive pension plans and Personal Pensions had made the market complex and led to administration difficulties, as had the current sex equality issues, including the unequal State pension ages.

The future of Section 32 policies was discussed, and it was questioned whether this type of policy would decline in importance following the introduction of Personal Pensions. It was agreed that the very large market in transfer values from individual leavers and from discontinuance of occupational schemes meant that there was significant potential for business for both types of policy.

The greater flexibility of the unitised with-profits concept for individual pension plans compared with traditional reversionary bonus policies was discussed. The need to be more open on expenses, to have flexibility in contributions and to switch between unit-linked and with-profits funds were all factors accelerating the trend towards unitised policies in recent years. The financial difficulties in smoothing returns were discussed, as were the market practice on terminal bonuses and market value adjustment factors on early termination.

The immediate annuity market was having difficulty with sex equality issues. The market did not, in general, offer unisex rates. The trend towards providing escalation on pensions had not led to a significant increase in escalating annuities for individual pension policies, because of the disincentive of lower initial payments.

FUNDING AND VALUATIONS

Appropriate actuarial assumptions and methods were discussed in the light of changes in the economic and demographic situation. It was generally agreed that demographic elements should normally be best estimates, and appropriate margins should be included in the economic elements. The possibility of separate valuations for SSAP24 (the U.K. accounting standard), FAS87 (the U.S.A. accounting standard), FA86 (taxation of excessive surplus), SSA90 (LPI on past service out of surplus) as well as asset allocation and normal funding purposes, could cause difficulties of presentation and cost. It was agreed that discussion with the client on the degree of security required by the trustees and the company, and possibly the company's cash flow position, would help formulate an appropriate funding basis. Alternative bases could then be considered to meet statutory or accounting requirements. Although, in the past, it could be argued that conservative actuarial bases and methods had contributed to pension scheme surpluses, it was noted that, in future, the SSA90 provision for LPI increases could reduce surpluses, which could lead to underfunding if investment returns were then to fall. There was, therefore, a continuing need for prudence.

In current investment conditions (relatively low long-term fixed-interest yields) some schemes which had been 100% funded on a past-service basis (allowing for future salary increases) could be insolvent on a wind-up basis. Low market values and high dividend yields had exacerbated this problem, and some actuaries had used conservative dividend growth assumptions to get the right balance for the funding levels and funding rates.

The results of a survey of the current practice of members of ABI, ACA and

SPC on funding methods were discussed. Of the 5 standard methods used in the past only the Projected Unit Method was still in general use. The change was mainly attributed to SSAP24; however, it was recognised that the actuary needed to continue to use his judgement to choose the right method for the particular circumstances of each scheme.

The impact on actuarial methods and assumptions of the abolition of compulsory membership in 1988 was examined. Although the short-term trend has been for the average age of members of small schemes to increase, because many young employees were not joining, it was not yet evident whether this trend would continue. Most actuaries did not yet appear to have changed their assumptions, preferring to wait and let things settle.

Difficulties on pension scheme issues existed because many of the detailed regulations for SSA90 had not yet been published, and because of SSAP24 and FA86. Objections were raised to the compulsory use of surplus to increase benefits as required by SSA90. It was felt that the definition of surplus proposed in the recent exposure draft (EXD8) could lead actuaries to use conservative assumptions in order to reduce the chance of having to spend surplus on LPI for past service. There were strong feelings against having to award LPI increases in respect of past service, because it appeared that final salary schemes were being penalised when compared to money purchase and personal pension schemes.

The implications of the 'Barber' judgment on solvency valuations were discussed, especially in relation to small schemes. An important point was made in relation to OPB Certificate A, where the cost of the independent trustee to be appointed in winding up under SSA90 could be large in relation to the assets of a small scheme. How should this be allowed for in our solvency calculations?

The relationship between actuarial discounted values of assets and market values was discussed, including the problem of explaining away the writing up of the asset value to above market value. This problem would be exacerbated when the need to define surplus under SSA90 came into effect.

INVESTMENT

Asset/liability modelling was considered suitable for very large pension schemes as a means of researching appropriate investment policy. It was stated that, now that pension schemes had very large assets and liabilities from past service, there was a need for a more detailed analysis of both assets and liabilities. The models did not aim to provide definitive investment strategy recommendations, but assisted in the development of an appropriate investment policy and a performance measurement benchmark. It was suggested that any agreed long-term investment strategy resulting from the analysis should leave scope for short-term tactical opportunities. One speaker stated that in the U.S.A. and Australia asset/liability modelling had changed investment patterns, by making pension fund clients aware that increasing the fund's exposure to equity investments was not necessarily increasing the risk.

The importance of the risk/reward relationship and the need for an appropriate measure of risk were discussed. The steady improvement of stochastic techniques to help restore the actuarial contribution to the analysis of appropriate assets and liabilities and the choice of sensible performance benchmarks were highlighted. It was agreed that the next decade would be a very exciting period for asset/liability modelling.

In the past 2 years there had been an active interest in 'derivative' securities like futures and options. It was agreed that they were playing an increasing role, and that the necessary tax changes to accommodate them had now been made, as had the means of reporting and measuring their impact.

Several important questions were raised. How do you decide on a shortlist of managers? What regard should be paid to past performance? Should investment management be split between managers? How should the final decision be made? How should performance be measured? When should the decision be reviewed? Continuity in personnel and above average performance over at least 5 years was considered important, but equally relevant was the performance in the light of the guidelines put forward by the Trustees. It was wondered whether fees should be partly performance related.

The topical issue of indexed funds was considered. They were regarded as a challenge to traditional balanced management. In the U.S.A. a core of indexed funds and satellite specialist funds had helped diversification and reduced costs. It was thought that up to 30% of U.S. assets were in indexed funds, but it was agreed that the U.K. has a long way to go to reach that total. The discussion centred on the proper role for an indexed fund within a structured fund management approach.

RELATIONS WITH THE PUBLIC

Our need to continue to work hard at our communication with the press and clients was stressed. We should be open in giving advice, and take pains to help reconcile the different, possibly conflicting, interests of our clients. It was noted that the press required quick, telephoned responses rather than official press releases of public relations committees, and, to be more influential, it was suggested that we must, as a profession, take action to communicate effectively, avoiding too much technical jargon. The concept of a Public Relations specialist for our profession was endorsed. It was suggested that the wide range of views in the profession meant that it was not possible to give a single view of any one topic.

Several difficult questions were posed. Could a single actuary advise employers, trustees and members with their different interests? Do we communicate the different funding alternatives to all parties? Do we advise the Trustees of all options open to them? How clear was it who we were advising? The new and existing responsibilities for actuaries under legislation and accounting standards mean that we must consider actions that addressed correctly all of these issues.

Compliance with the Financial Services Act and the practical implications of that Act for actuaries in pensions were discussed. The compliance procedures for different advisers with IMRO, FIMBRA or those covered by the Institute of Actuaries as a Recognised Professional Body (RPB) were considered. It was felt that the costs of the Act were disproportionate to the marginal improvements in client service and protection.

INTERNATIONAL

The pensions situation in the EC and the concept of a pan-European pension fund (i.e. where a pension fund in one country could have members in other EC countries) were discussed. Since there were different benefit levels, different methods of pension provision and different legislative requirements, it was concluded that such an arrangement was a long way off. It seemed, however, possible to improve the situation for migrant workers.

Problems with the EC Social Charter had resulted in the July 1991 draft of the EC Pensions Directive being more of an investment directive than one concerning pensions. The establishment of a basic code of conduct for member actuarial associations in the EC was being considered as were education and training. It was agreed that there were many important questions still to be resolved on codes of conduct, signing powers, disciplinary procedures, etc., and that the U.K. actuarial profession ought to be proactive in formulating future policy.

On occupational pensions the EC was still considering how it could best prevent pension issues from impeding the freedom of movement of employees. Since harmonisation of social security benefits had not proved to be possible, a community consensus about desirable social security policies and a statement of guiding principles were being developed. Some doubt was cast on the future of final salary schemes which were at present predominant in Europe. It was felt that the biggest growth area for money purchase schemes would be Eastern Europe, because Governments there wanted to introduce pension schemes quickly. A number of participants felt that money purchase schemes in the U.K. and Europe would continue to grow in number until reaching a plateau towards the start of the next century.

Country profiles for Germany, France and the U.S.A. were considered. In Germany there had been immense changes during the year following the reunification of East and West after a 40-year division. There was now an agreed policy on social security benefits, as well as on pension and medical benefits. The paper on France included a description of the French pension system, and the discussion centred on the Government review of their pension system in April 1991. In the U.S.A., current issues in employee benefits arising from recent regulations in retirement programmes were discussed. One of their main problems was the lack of a co-ordinated national pensions policy. Also, the recent accounting standard for post-retirement medical benefits (FAS106), as stated in the section on accounting standards above, would be a very important issue in the coming years.

Off-shore pension schemes for international employees were considered. The difficulties of identifying social security benefits for such employees meant that specialist knowledge was required to advise on all aspects of their pension provision.

In Australia and New Zealand occupational pensions operate in a taxed environment, and their experience gave a valuable insight into future possibilities elsewhere in the world.

MISCELLANEOUS SUBJECTS

The specialist subject of pensions litigation covers advice on compensation for personal injury or fatal accident, unfair dismissal and breach of contract, as well as sale and purchase agreements and difficulties with schemes merging and winding up. It was agreed that solicitors and actuaries needed to work closely in these areas.

The important and growing problems of pensions and divorce were raised. The equitable apportionment of joint assets on divorce was seen to be the main problem. Since the occupational pension benefit was a very significant financial factor, and given the unfortunate growth in the number of divorces, it was felt that actuarial advice would be increasingly sought by the legal profession. Scottish law already deals with the subject of divorce, so it would be useful to watch developments there.

The long-term problem of AIDS, and its effects on employment and benefit provision, are important matters for the actuarial profession. The unreliability of current statistics on AIDS testing and the lack of AIDS cover under Group Dread Disease products were discussed.

Continuing Care Retirement Communities have been a feature of the provision for the elderly in the U.S.A. for over 25 years, but, because of the cost involved, had been restricted to the middle and upper social classes. In considering whether such schemes would also become a feature in the U.K. actuarial work on financial projections, impaired life mortality and funding for individuals would be important factors.

The final session consisted of a panel of distinguished actuaries responding to a variety of questions submitted by participants during the Convention. Topics as diverse as solving the current sex equality problem and the likely nature and availability of actuarial work in the 1990s were discussed. On the latter topic, the panel felt that there would be greater involvement in investment and general insurance work, but fewer jobs in pensions and life assurance.

APPENDIX

The 'Barber' Case

The case involved Mr Barber, a 52-year-old man who was made compulsorily redundant and was entitled to a deferred pension and a lump sum severance payment. A woman doing the same job and made redundant at the same age would have been entitled to an immediate early retirement pension and a smaller lump sum.

The case centred on whether Mr Barber had been discriminated against on the grounds that a woman would have received greater benefits in similar circumstances. Eventual referal to the European Court of Justice essentially found in Mr Barber's favour. The ruling was a complex one, and gave rise to the questions of retrospection (i.e. whether it applies only to benefits accruing after 17 May 1990 (the date of the judgment) or to all benefits in respect of retirements after 17 May 1990).

Social Security Act 1990

This Act received Royal Assent on 13 July 1990, and introduced measures aimed at further protecting members' benefits from occupational pension schemes. Many of the regulations have yet to be published, but the main provisions of the Act were as follows:

(1) *Increase of Pensions in Payment*
 (a) Pensions (in excess of any GMP) in respect of service after a day to be appointed, are to be increased each year in line with the Retail Prices Index, or by 5% if lower. This is referred to as Limited Price Indexation, or LPI.
 (b) Pensions (in excess of any GMP) in respect of earlier service are to be increased similarly if there are surplus assets in the fund. The definition of surplus for this purpose, in an ongoing scheme, has not yet been decided. In winding up, it will be clear whether or not there are surplus assets.

(2) *Revaluation of Pensions in Deferment*
 (a) Early leavers: Those leaving on or after 1 January 1991 are to have their deferred pensions (in excess of any GMP) revalued in line with LPI.
 (b) Winding up: Deferred pensions (in excess of any GMP) awarded in schemes winding up after 1 January 1991 are to be revalued in line with LPI.

(3) *Other Provisions Relating to Winding Up*
 (a) If the scheme's assets are insufficient to secure LPI in deferment and in payment, then, after a day to be appointed, the shortfall is to be a charge on the employer's assets.

(b) If, from 12 November 1990, winding up is caused by the employer's insolvency, an Independent Trustee is to be appointed to oversee the disposal of the scheme's assets.

(4) *Other Provisions*

(a) A Pensions Ombudsman was established on 1 October 1990 to give legal redress to members or beneficiaries for disputes after 18 July 1990.
(b) A pension scheme registry was established which will assist members in tracing the Trustees of their previous pension scheme.
(c) The Government will be increasing funding for the Occupational Pensions Advisory Service (OPAS), whose aim is to assist in resolving disputes between members and their schemes.
(d) A 5% limit on self-investment.

Finance Act 1986

Regulations made under this Act laid down rules for dealing with excessive pension scheme surpluses. Under the regulations, if the value of the assets of a scheme exceed 105% of the value of the liabilities calculated on a prescribed (conservative) basis, then it is necessary to take action to reduce the surplus if the full tax exempt status of the scheme is to be retained. The provisions of this Act were incorporated in the Income and Corporation Taxes Act 1988.

J. R. Cook