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DEFINING AND PROTECTING THE PENSION PROMISE

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ABSTRACT

The 1993 Jubilee Lecture considered two fundamental questions addressed in the report of the Pension Law Review Committee: when an employee joins an occupational pension scheme, what should the law consider to be the fundamental pension promise; and how should that promise be protected? The factors affecting the employee's expectations are examined in the light of the pension promise, and the conclusion drawn that certain expectations relating to accrued rights should be protected by law, although the employer should be able to control its financial commitments as to future service. The status of surplus, in both an ongoing scheme and in the event of a wind-up, is also considered, and recommendations made as to the use of a surplus if not already dealt with by the scheme rules. The two principal forms of protection for the pension promise which were recommended by the Pension Law Review Committee are discussed; firstly, the introduction of a minimum solvency standard, backed up by tighter rules for the prompt payment of contributions and by enhanced monitoring and reporting requirements for scheme auditors and actuaries; and secondly, the setting up of a statutory compensation fund to cover a deficit in the event of fraud or theft, to be financed by a post-event levy on schemes.

KEYWORDS

Compensation; Discontinuance; Expectations; Occupational Pensions; Protection; Rights; Solvency; Surplus

It is a great privilege to have been invited to deliver this year's Jubilee Lecture to this distinguished Society here in Staple Inn, the home of wool merchants, lawyers and actuaries. But I appear before you with considerable trepidation. Until my Committee was set up I knew little of the actuarial world; indeed, I had hardly met any actuaries. And now I am confronting hundreds of them at a single sitting! Moreover, I had in my innocence assumed that actuaries were both unexciting and unexcitable. Nothing could be further from the truth! One has only to listen, for example, to the debate on such apparently uncontroversial matters as the minimum solvency standard to realise that beneath each actuary's breast lies a wildly beating heart!

I was interested to discover, on looking into the history of your various societies, that this is not new. The Institute of Actuaries was founded in the teeth of opposition from the Old Committee, who had opposed its establishment and declined all olive branches. The Actuaries' Club, which came into being some four months after the Institute, opposed it with unremitting hostility, which, since they were actuaries, they felt should be displayed over the conventional forty-year period! In turn the London members of the Institute so exhausted even the legendary patience of their Scottish brethren that the latter seceded and set up their own body, the Faculty of Actuaries. Your own Society, Mr Chairman, established as the Institute of Actuaries Students' Society, battled with its parent for years to dispense with the misleading label 'Student', and finally succeeded in its endeavours to become known as the Staple Inn Actuarial Society. So it has become clear to me that the life of the actuary is never, ever dull!

In the fourteen months in which my Committee was involved with occupational pensions I developed a great admiration for the skill and dedication of the actuarial profession, which not only submitted cogent evidence, but also responded most generously and informatively to our requests for further work on some of the more difficult actuarial considerations under discussion. Under our proposals the role of the actuary, already important, will be significantly enhanced.

My task tonight is to explore two fundamental questions addressed in our Report: when an employee joins an occupational pension scheme, what should the law consider to be the fundamental pension promise; and how should that promise be protected? These two questions came into sharp relief as the result of a series of cases in which pension funds lost the whole or a substantial part of their assets, placing at risk pensions earned over many years of work for the sponsoring employer. The Maxwell case, though the largest of these, was not isolated. There were many others, and public confidence in the integrity of pension schemes was severely shaken. The outcome was an investigation by the House of Commons Select Committee on Social Security, under the chairmanship of Mr Frank Field, whose Report led to the establishment of the Pension Law Review Committee. Our terms of reference were not limited to the loss of assets. They encompassed the entire field of occupational pensions. But two questions lay at the heart of our enquiry: are scheme members getting a fair deal? and are their rights adequately protected both in terms of legal definition and in terms of security?

1. Defining the Pension Promise

The Nature of the Pension Promise

When an employee joins an occupational pension scheme, what pension can he or she expect? At first sight the answer seems clear enough: in a money purchase scheme, a pension geared to the value of the contributions invested on behalf of the member; and in a final salary scheme, a pension based on the number of years of pensionable service and final pay on retirement. In the case of money purchase these expectations are for the most part realised, for the share of the fund invested for the member provides, not only the source, but the measure of the pension, so that full pre-funding is an inherent characteristic of the scheme. But the great majority of schemes, except for new schemes, are earnings-related, and in this type of scheme the apparent simplicity of the pension promise is deceptive. There are many reasons why this is so.

First, trust law, like contract law, is based to a high degree on freedom of will. The starting position of contract law is that the party making a promise may qualify it in any way he or she chooses. If, for example, I place a contract for the supply of services I am free to specify a string of conditions that have to be satisfied before the supplier of the services is entitled to be paid a penny; and I can reserve the right to amend the contract as I choose, or to terminate it altogether without notice. To ascertain the supplier's rights under the contract it is necessary to look at the total package. The benefit to which he is entitled is not an unqualified right to payment, but a prospective entitlement which is dependent on the fulfilment of the specified conditions and on my not exercising my right to amend the contract or bring it to an early termination. So also in trust law. The settlor, whether a patriarch in a family trust or an employer in a pension trust, has virtually complete liberty as to the terms of the trust. Thus there is nothing to stop an employer from reserving a power to reduce future pension entitlements, even as regards past service, or to declare those entitlements forfeited altogether—for example, because of misconduct by the scheme member—or to close the scheme to new members, freeze it as regards accrual of benefits or even wind it up altogether. Accordingly it is not only ancillary benefits, such as ill-health payments and payments to next of kin, that may be made discretionary; even the primary benefit, the pension itself, may to some extent be a discretionary benefit.

Secondly, there has been a great change in the duration of the employer–employee relationship. When earnings-related schemes first started, the typical pattern of employment was that the scheme member worked his way up through the firm from a junior post to a senior post and stayed with the firm for all his working life[(1)]. Vacancies were filled from within the firm rather than from outside, and pension schemes were structured to reward long service, and, conversely, to discourage early leaving. Hence labour was relatively immobile. That has long ceased to be true. Leaving on one side the particular problems caused by a recession, those who wish to move up the ladder commonly find that the easiest way of doing so is to move to new employment. Job stability has been replaced by job mobility. The average number of employers is six for a man and five for a woman[(2)]. So while final salary schemes are geared primarily to a pension based on earnings at normal retirement age, most scheme members are likely to leave early, with a deferred pension based on salary at time of leaving. Moreover, a substantial proportion of the workforce now takes early retirement[(3,4)], though in some cases on the basis of full pension rights.

Thirdly, expectations can be defeated by such factors as loss of one's job or insolvency of one's employer. Pensions, like pay, can become casualties of a recession. Where a scheme is fully funded scheme members are protected against the consequences of their employer's insolvency. But having set up a scheme, the employer is under no legal duty to fund it to any degree whatsoever except to the limited extent necessary to secure Inland Revenue approval for tax purposes or to provide the guaranteed minimum pension or (for money purchase) protected rights in a scheme contracted out of SERPS.

Pension expectations may therefore be frustrated by two entirely distinct factors. First, the pension promise itself may not be strong enough. Secondly, it may not be adequately secured. The strength of the pension promise involves questions as to the adequacy of its legal content and the precise relationship between the pension promise and the pension fund; the security for the pension promise turns on the sufficiency of the scheme assets to meet its liabilities. These are quite separate questions, the one involving legal entitlement and the legitimacy of freedom of trust, the other the level of funding and the freedom of the employer not to fund at all or to fund at below solvency level. I shall discuss each in turn.

The Strength of the Pension Promise

The typical occupational pension scheme involves a triangular relationship, in which the member's rights derive primarily from his or her status as a beneficiary of the scheme. The contract of employment usually contains no express promise by the employer to provide or fund a pension, but the courts have held that the relationship of employer and employee imposes certain duties on the employer as to the manner in which it exercises powers and discretions conferred by the trust deed(5).

The Protection of Expectations

Scheme members have not only rights, but expectations, which may or may not be well-founded. These expectations may include the following: that rights accrued by service will not be removed or reduced; that scheme improvements will be made as and when resources allow; that pensions will be based on actual or notional salary in the employment at the time of normal retirement age, even if they leave the scheme or the employment, voluntarily or involuntarily; that surplus in an ongoing scheme will be used, wholly or in part, to finance new benefits or improvements in benefit; and that on the winding up of the scheme any surplus will either be applied exclusively for the benefit of members or at least shared with the employer.

How far should these expectations be protected by the law? It is important not to lose sight of the fact that expectations, however reasonable, are not rights; they may or may not be realised. Once their realisation becomes legally protected they cease to be expectations and are converted into rights. Every such conversion has the effect of enlarging the employer's promise, of committing the employer to go beyond what it has actually undertaken. The crucial question to be addressed is how far it is legitimate to interfere with freedom of trust and to impose on the employer obligations it has not voluntarily assumed.

Those who favour retention of the *laissez-faire* principle in all its vigour argue that the establishment of a pension scheme is a voluntary act on the part of the employer, so that no expansion of the pension promise is justified. Since the employer does not have to provide a scheme at all, surely it must have complete freedom to set the terms of any scheme it chooses to provide. Though such a proposition still has its advocates, it is not dictated by either policy or logic. It is perfectly legitimate to insist that, if the employer does choose to set up a scheme, the bundle of benefits offered to employees as an integral part of the remuneration package should be legally protected and financially secured. The time has long past when the law can allow the *laissez-faire* principle unfettered dominion.

In the field of contract law the courts have long held that a party will not be allowed to rely on the small print of the contract to furnish something fundamentally different from what was held out as the offer. For example, a clause excluding the implied promise that goods shall answer their contract description will not entitle a person who has contracted to supply peas to deliver beans, or who has agreed to sell a motor car to deliver a vehicle incapable of being driven on the road(6,7). This common law rule has been reinforced by the Unfair Contract Terms Act 1977, which nullifies or subjects to the requirement of reasonableness clauses purporting to exclude or limit liability, including clauses in consumer contracts or standard-term contracts by which one party claims to be entitled:

(i) to render a contractual performance substantially different from that which was reasonably expected of him, or
(ii) in respect of the whole or any part of his contractual obligation, to render no performance at all(8).

Pension benefits should rank particularly high in the list of entitlements deserving of legal protection, for they are exceptionally long term in their maturity and are often the most valuable asset a scheme member possesses. My committee concluded that certain expectations were so fundamental that they should be elevated by statute to the status of rights. For this purpose we drew a distinction between accrued rights and benefits to be earned by future service. We considered that, whatever the scheme rules might provide, rights already accrued by service should, in principle, be inviolate and incapable of adverse amendment or forfeiture(9). For example, just as an employer could not properly reduce or extinguish a right to pay already earned, so also it should not be open to the employer or the trustees, in relation to past service, to amend the scheme rules retrospectively so as to reduce the accrual rate from one-sixtieth to one-eightieth or to reduce the amount of benefit payable to a member's surviving spouse or dependants. Similarly, while we saw no objection to the employer being able to deduct from a member's pension entitlement the sum required to compensate the employer for loss caused by the member's breach of duty to the employer, we could see no justification for a power to direct that the pension be forfeited altogether.

There are those who would no doubt argue that the power of forfeiture does not deprive a member of accrued rights, it merely sets an inherent limit on the quantum of those rights from the outset. But this argument is no more compelling than that of the car seller who contends that a clause in the contract of sale excluding all liability for defects means that his promise is to be construed not as an undertaking to sell a motor car, but merely as a promise to sell a collection of machinery which may or may not function as a motor car!

So we considered that only in exceptional cases and with the consent of the Pensions Regulator should accrued rights be capable of adverse amendment. But in relation to future service it was another matter. We regarded it as essential that the employer should be able to control its financial commitments as to future service, and should therefore continue to have the right to reduce benefits for future service, and to close, freeze or wind up schemes. Few employers would feel able to commit themselves to guaranteeing its workers lifelong employment, however desirable it might be to reward loyal service with job security. We felt that, by the same token, the employer could not be expected to continue schemes or to provide benefits for future service at the same level as for past service. An employer locked into a scheme for an indefinite period which it could no longer afford might feel compelled to reduce its liabilities by laying off workers or, in an extreme case, going into liquidation. *A fortiori*, the employer ought not to be expected to entrust scheme improvements to the unilateral decision of the trustees, for then the employer's future financial commitments would not only be totally outside its control, but also indeterminate in amount.

The Pension Promise and the Early Leaver

The gap between expectations and rights raises particular difficulties in the case of the early leaver. Under present law the deferred pension of an early leaver is based on salary at the time of leaving, revalued each year by the increase in the retail price index, with an upper limit of five per cent. It was put to us with some force that this is inconsistent with the pension promise, and leaves the early leaver severely disadvantaged compared with the scheme member who remains in the original employment until retirement and whose pension is therefore based on final salary applied to the entire period of service. It was argued that to base the early leaver's deferred pension on salary at time of leaving instead of on projected salary with the original employer at normal retirement age goes against the bargain made at the time the early leaver entered the employment. Moreover, so it is said, it is wrong in principle, and inimical to job mobility, to discriminate against the early leaver. The State has already recognised this by legislating for limited price indexation of deferred pensions. But that only goes part of the way; what is required is full earnings indexation.

This was one of the few issues on which there remained a divergence of view among members of the committee. Some felt these arguments to be persuasive, but the majority rejected them. In the view of the majority there never was a bargain with the first employer that the early leaver should get a pension based on employment to normal retirement age. The scheme documents make it perfectly clear that the pension is based on salary at the time of leaving, and the employer cannot reasonably be expected to treat the early leaver as if he or she had continued in the first employment up to normal retirement age. Limited price indexation is justifiable as maintaining the real value of the pension promise; earnings indexation, apart from involving a potentially huge financial commitment, would change the promise from that of a pension based on salary at actual leaving date to one based on salary at normal retirement date. If that was what scheme members want, then they should pay for it instead of seeking to burden the employer with a commitment the employer has never undertaken.

In the end, the committee was unanimous in its conclusion that, whatever the merits of the rival arguments, earnings indexation could not be recommended because of the serious risk that it would be seen to impose an unacceptable burden on employers and lead them to provide schemes at a less generous level or even to discontinue them altogether.

The Pension Promise and the Pension Fund

This brings me to the relationship between the pension promise and the pension fund. Pension schemes are established for the benefit of members. It is undoubtedly the case that members are beneficiaries of the trust established for their benefit. From this it seems but a short and logical step to conclude that the members own the pension fund. Even in the case of a money purchase scheme this is not strictly true, for members can draw their benefits only on retirement and in the form of a pension, whereas if they were truly co-owners they could terminate the pension trust and distribute the assets among themselves. But the perception of ownership is justified in the case of a money purchase scheme in the sense that the fund represents the measure of members' entitlements. This is not so in the case of a final salary scheme. The fund is the source of payment and the security for payment, but it is not the measure of members' entitlements. These are defined in the scheme documents by reference to years of service and final pay, and are not in any way determined by the size of the pension fund. To treat the members of a final salary scheme as owners of the fund would be to convert members' entitlements into whatever was the better of a final salary basis and a money purchase basis, which would be wholly inconsistent with the scheme documents.

In an ongoing scheme the fund belongs neither to the employer nor to the members. It is vested in the trustees and is to be applied for the benefit of members in accordance with the trust deed and scheme rules. It is only when the scheme is wound up that the rights of the beneficiaries to the assets comprising the fund crystallise. This is indisputably the law and has always been so. But I must emphasise that this is not simply a legal technicality, or an example of the law flouting reality. On the contrary, the law is simply reflecting, as it must, the pension promise as set out in the scheme documents, which is to provide a salary-related pension, not a pension based on a *pro rata* share of the value of the fund.

Surpluses

This leads on naturally to the question of surpluses. In an ongoing fund, as the courts have more than once pointed out, surplus is purely notional, being no more than the result of an actuarial calculation that, projected over a long term, the value of the assets at a particular point in time exceeds the value of the liabilities. Accordingly, insofar as surplus is identifiable at all, it tends to be ephemeral in character, for not only can values change from one year to the next, but even a modest change in an assumption, such as an assumed interest rate, may show a deficit instead of a surplus(10). If one were to suppose an immediate discontinuance, with the consequent need to value assets on a market value basis, the supposed surplus might well be found to have evaporated. I have already pointed out that the entire fund of an ongoing scheme belongs to the trustees and constitutes security for payment of existing and future benefits. Accordingly there is no distinct 'surplus' capable of independent ownership, whether by the employer or by the members. Had it not been for Inland Revenue rules, which require a surplus to be identified for tax purposes, it seems highly unlikely that surpluses would have assumed in the minds of scheme members the character of existing and identifiable assets.

Even on wind-up it may take time to demonstrate that a surplus exists, as where the trustees decide to deal with liabilities by retaining funds to meet them instead of purchasing annuities or deferred annuities. But it is the case that, once the assets of a scheme in winding up come to be distributed, a surplus in the true sense may be found to exist. We concluded that where the distribution of this was dealt with by the scheme rules, then those rules should be allowed to operate, without the need for enquiry as to the source of the surplus, for the scheme rules constitute the basis of the bargain between employer and members. It has, of course, been argued that in a contributory scheme surplus may result just as much from the members' contributions as from those of the employer. This may be true; indeed, one could make exactly the same argument for a non-contributory scheme, to which the members in effect contribute by a salary sacrifice. But in either case the argument, in my opinion, misses the point, which is that the members are being offered a package of rights under rules which expressly provide what is to happen to any surplus. Those rules are part and parcel of the deal, and compelling reasons would be needed to override them.

It is quite another matter where the scheme rules fail to deal with the application of surplus on winding up or prohibit any payment to the employer. Here we recommend that the surplus funds should be applied, first, to provide for limited price indexation of pensions, then to provide for scheme improvements up to the Inland Revenue limits, with any remaining surplus being dealt with at the trustees' discretion.

Maintaining the Reality of the Pension Promise

I have laid much stress on the importance of the principle that the pension promise is what is offered by the scheme rules, and that in an earnings-related scheme the sole purpose of the pension fund is to provide the source of payment and the security for payment, not to confer on scheme members ownership of the fund itself or of any surplus that may arise. But the other side of the coin is that the pension promise must be a real one, not merely an illusion, and that its content and limits must be clearly conveyed to scheme members, so that they know exactly where they stand.

Let me deal first with the reality of the pension promise. I have already identified certain expectations so fundamental in character that they should be converted into rights. These are that benefits accrued by service should not, save in the most exceptional circumstances and with the approval of the Pensions Regulator, be capable of adverse amendment or of forfeiture, even if this were permitted by the scheme rules. This is one case in which the law should protect the reality of the pension promise by overriding scheme rules. In effect, we are saying that the employer and the trustees should not be allowed to rely on the small print to diminish that which is presented to the scheme member as the fundamental core of his or her entitlements.

Another case relates to the surplus in an ongoing fund. If the fund is to serve as security for pension entitlements, the security must be a real one, not capable of being whittled away by scheme rules which allow payment to be made to the employer. The basic principle should be that the trust fund is inviolate and, whatever the scheme rules may say, should not be used for any purpose except the payment of benefits to scheme members. Of course, like any other principle, this should not be carried to extremes. Where there is a large surplus which is likely to continue for the indefinite future and the employer is willing to offer to share the surplus by providing significant scheme improvements, it would not be in the interests of scheme members to rule out a sensible arrangement by which excess funds are released to the parties' mutual advantage. But this should be very stringently controlled.

Under our recommendations it would not be sufficient that the scheme rules empowered the trustees to release surplus to the employer. Four other conditions would have to be satisfied. First, the scheme would have to provide (or be amended to provide) limited price indexation for past and future service. Only if there was still a surplus after making this provision would a payment be able to be made to the employer. Secondly, it would have to be shown that there was a surplus, not only on the basis of an actuarial valuation of assets and liabilities for an ongoing fund, but also on the more stringent discontinuance basis—in other words, that the proposed payment would not breach the statutory 100 per cent minimum solvency standard we have recommended. I say more of this a little later. Thirdly, the trustees would have to obtain written legal advice that the proposed payment was proper. Clearly a relevant factor here would be the presence or absence of a *quid pro quo* for scheme members in the form of improved benefits. Finally, the payment would have to receive the approval of the Regulator, who would have to be satisfied that members' rights remained fully secure and that contribution holidays would not eliminate the surplus within a reasonable period. Where the scheme rules prohibited payment to the employer, a fifth condition would have to be satisfied, namely notification of the proposal to the scheme members, who would be entitled to make representations to the Regulator, while the employer would have to state reasons why the Regulator should allow the payment. These conditions may seem stringent, but they are intended to reflect the fundamental principle that the trust fund should remain intact as security for members' entitlements and should not be seen as an asset of the employer.

2. Protecting the Pension Promise

Defining the pension promise so as to protect fundamental expectations that accrued rights will be maintained and the integrity of the pension fund preserved is one of the two main planks in our raft of proposals for pension law reform. The other is the financial protection of the pension promise, so far as this can be achieved. This protection takes two principal forms:

(1) a minimum solvency standard, buttressed by tighter rules for the prompt payment of contributions and by enhanced monitoring and reporting requirements for scheme auditors and scheme actuaries, and
(2) where the employer is insolvent and the scheme is in deficit, a statutory compensation scheme covering loss of assets through fraud, theft or other misappropriation.

(1) The Minimum Solvency Standard

The need for a Minimum Solvency Standard

As I have earlier pointed out, an employer is not obliged to fund a scheme at all except as a condition of contracting-out or for the purpose of securing Inland Revenue approval, and then only to a very limited extent. Many schemes are fully funded, but many are not. To the extent that a scheme is underfunded the pension promise is not secure and the protection afforded by setting up the scheme under trust is deficient. Despite the criticisms made of trust law, which are for the most part misconceived[(11)], the trust is a most efficient device for segregating the assets of the scheme from those of the employer. But the security given by the trust is only as strong as the adequacy of its assets to meet the scheme liabilities. There is little point in protecting the legal content of the pension promise if the promise itself is not underpinned by adequate security. Many of the schemes wound up in deficit in the United States of America owed their downfall to chronic underfunding.

We have therefore proposed that schemes should be fully funded at all times except where they are unapproved because they provide benefits in excess of Inland Revenue earnings limits or the earnings cap. By full funding we mean funding at a level sufficient to ensure that if at any time a scheme were to be discontinued the value of the assets would be not less than the value of the accrued liabilities. The proposals are directed primarily at earnings-related schemes, for money purchase schemes are by nature fully funded, members' entitlements being geared directly to the size of the fund. But even for money purchase schemes the funding requirements have a role to play, namely where assets are lost by fraud, theft or other misappropriation. Members of a money purchase scheme bear market risks; they should not also be expected to bear the risk of defalcations.

Under the regime we have proposed there would be two levels: the standard 100 per cent level and a lower, base level. Schemes would always have to target the 100 per cent level, but we recognised that market fluctuations might from time to time bring the value of the assets below that level. For these cases, and so long as the level did not fall below the base level of 90 per cent, the trustees would have to submit a business plan to the Regulator showing how the 100 per cent level would be restored within three years. The rules for the 90 per cent level would be more stringent. If the assets fell below 90 per cent of the liabilities the trustees would have to take steps to make good the shortfall within three months or such longer period as the Regulator might allow. The Regulator would have to be informed of any shortfall in either level as soon as the trustees became aware of it. Every scheme would have to have an Appointed Actuary, who would have to furnish a certificate of solvency to the 100 per cent standard and to update the certificate annually. These requirements would apply to all schemes, whether or not contracted out of SERPS.

The Problem of Funding for Discontinuance

The ideal solvency standard is one that ensures that, in the event of a final salary scheme being wound up, the assets will be sufficient to purchase non-profit annuities and deferred annuities for pensioners and deferred pensioners. Adherence to such a standard would ensure that the pension promise was maintained intact. For reasons which are well known this is no longer practicable. Insurers have become reluctant to quote at all for deferred annuities and could not even accommodate the demand for immediate annuities if a large and mature scheme were to be wound up. Where quotations are obtainable, the cost is usually extremely high. There are many reasons for these phenomena. They include the contraction in the amount of capital available relative to demand because of competition from other sources; the sharp fall in interest rates; the ever-increasing longevity of annuitants; and the strict solvency requirements life offices are now required to observe.

Other factors that have reduced or even reversed the margin between solvency on an ongoing basis and solvency on a discontinuance basis include the statutory revaluation of deferred pensions and the growing divergence between equity yields and yields on gilt-edged and index-linked stock. So schemes that are comfortably solvent on an ongoing basis, where assets are valued by discounting a projected long-term income stream and their adequacy tested by their ability to meet benefits as they fall due, might well find that, at times, their assets were wholly inadequate to meet the instant purchase of annuities and deferred annuities for its members. Even assuming that the insurance market was able to accommodate all the annuity and deferred annuity business required, the cost to an ongoing scheme of setting aside sufficient assets for the purpose could, in many cases, be met only by substantial increasing contributions or substantially reducing benefits.

How is the problem to be solved? We explored three avenues: the establishment of a central discontinuance fund able to take over the liabilities of schemes that would otherwise discontinue because of insolvency of the employer; the measuring of liabilities on a cash equivalents basis rather than on the cost of buying insurance contracts; and the creation of a new form of government security providing a closer match of deferred pension liabilities than is currently available on the market.

The Central Discontinuance Fund

The proposal for a central discontinuance fund (CDF) came primarily from two sources: Watsons and the Government Actuary. This was a constructive proposal for tackling a difficult problem and we examined it very seriously. The role of the CDF would be to take over the liabilities of discontinued schemes where the employer was insolvent and to operate as an ongoing fund with an equity-based investment strategy. A discontinued scheme would buy into the fund by paying a premium or transferring assets to a value equivalent to its liabilities. The liabilities would be assumed by the CDF only so far as covered by the premium, so that it was not intended as a compensation fund to bail out failed schemes.

The merit of this proposal, if it could be made to work, is twofold. First, the assets and liabilities on discontinued schemes would be valued on an ongoing basis, not on a discontinuance basis. Accordingly ongoing schemes would not have to fund for solvency on a discontinuance basis, but would simply have to satisfy the ongoing solvency test. Secondly, members of the discontinued scheme would receive the earnings-related pensions they had been promised instead of having to take a cash equivalent and in effect have their rights converted from final salary to money purchase.

When we probed these proposals it became clear that a number of significant hurdles would have to be overcome, including the basis of calculating the premium, the management of risk while adopting an equity-based investment strategy and the financing of any long-term deficit the CDF might incur. These problems were recognised by the proponents of the scheme, who understandably enough had in the limited time available to them been able only to depict the broad structure, without going into figures or other details. For example, we asked how the premium for buying into the CDF would be calculated. Presumably it would not be the same as the cash equivalent, which is based on fixed-interest and interest-linked gilts, whereas the CDF would be running an equity-based portfolio. We were told that this was an area which would need considerable research before the specific question could be answered. Then came the question of what would happen if the CDF ran into deficit. The answer to this was that the deficit, if not purely temporary, would be eliminated by a levy on all schemes or by a reduction in the promised benefits. So, while the CDF was not designed as a compensation scheme for under-funded discontinued schemes, there was a risk that solvent schemes would have to bail out the CDF if things went awry—for example, because it had paid too high a premium for the liabilities assumed or because its equity-based strategy had proved over-optimistic—or alternatively that scheme members would not receive their promised entitlements, a risk that the CDF was designed to avoid. We were told that levies, if they had to be made at all, should be insignificant. This reflected the concept that schemes buying into the CDF would pay, not only the value of the liabilities taken over, but also an additional sum by way of margin—in effect, a risk premium. Again, and quite understandably, no figures were available.

Both Watsons and the Government Actuary responded generously to our requests for further information on particular aspects, and I should like to reiterate the appreciation of their work we have already expressed in our Report. The Government Actuary provided us with some estimates of what he engagingly described as the probability of ruin, that is, of the CDF going into deficit. These estimates showed, as one would expect, that the probability of ruin increased with increases in the proportion of equities in the CDF portfolio and in the gross rate of investment return in the premium bases, and that the lower the risk of ruin acceptable to the trustees the higher the additional risk premium that would have to be charged if the CDF was not to modify its equity-based strategy.

It was accepted that much more work would need to be done on the mode of operation of the scheme, and in particular the computation of the premiums, the basis of the investment strategy and the handling of deficits. Unfortunately we as a committee had to work within a very tight time frame. We concluded that, in view of the difficulties I have just outlined, more concrete and detailed information would be needed before one could conclude that the scheme was workable without government support.

Cash Equivalents

Under the cash equivalents solution the assets of the ongoing fund would have to be sufficient to cover the cash equivalent of accrued liabilities, calculated on the same basis as a transfer value which excluded discretionary benefits. The cash equivalent could then be used to purchase pension rights elsewhere. The drawback of this method is, of course, that for funding purposes it assumes a change in the nature of the benefit from earnings-related to money purchase and thus runs counter to the whole philosophy of maintaining the reality of the pension promise(12). The advantage is that it provides a practical solution to the discontinuance problem and utilises a well-established method of valuing accrued rights.

This proposal has excited considerable debate within the actuarial profession.

Some have said that it could put many schemes into difficulty, particularly where there is a very sharp fall in the market or where the schemes are mature schemes with a preponderance of pensioners and deferred pensioners. Others have concluded that there should not be a serious problem. One exercise carried out indicated that schemes properly funded on an ongoing basis would have satisfied at least the 90 per cent level at all times except in 1974, when market values dropped very sharply, and that even then the 90 per cent level would have been restored within five months.

It is not for a mere lawyer untutored in these matters to become involved in the intricacies of actuarial debate. However, a few remarks of a general character may be apposite. First, many schemes fund, not only for accrued liabilities, but for pay increases and discretionary benefits. The minimum solvency standard we have proposed is confined to accrued legal liabilities, so that there is an in-built cushion to alleviate the problem. It may be that our proposals will lead to more benefits becoming discretionary. That is not necessarily a bad thing. Ongoing schemes will normally continue to pay such benefits, even though not having to fund for them. For those schemes that wind up, it is better for members to have a somewhat lower level of legal entitlement that is adequately secured than a promise of higher benefits which cannot be met.

Secondly, the Regulator would have a discretion to extend the time for making up a shortfall and would thus be able to take account of market conditions. Moreover, a cash injection is not the only way of meeting a shortfall. Where this is likely to be purely temporary, I see no reason why the Regulator should not be empowered to approve equivalent security, for example, a bond or standby credit. This would avoid both the need to realise investments to cover a short-term deficiency and the advent of an undesired surplus upon conditions returning to normal.

Thirdly, in the case of schemes with a substantial proportion of active members, there may be some merit in relaxing the basis of computation of the cash equivalent by predicating at least some degree of equity investment. That, I understand, is a matter which the actuarial profession is currently examining.

Fourthly, as regards schemes whose membership consists predominantly of pensioners and deferred pensioners, I would suggest that any difficulties such schemes might experience would not be due to our proposals, but rather to an existing mismatch of assets and liabilities. A scheme in which active members are in a minority, but which continues to have 80 per cent or more of its investments in equities, is surely making a rod for its own back.

There are those who argue that our proposals are based on a hypothesis which, in the typical case, will not occur; that most schemes will not discontinue and ought not to be made to fund for solvency on a discontinuance basis. This, if I may say so, misses the point of the exercise. A solvency standard is of little value if it fails to safeguard the member in the very eventuality for which the standard is designed. Our overriding concern was to ensure as far as possible that scheme members receive their benefits in full as and when these fall due. Those who have earned their pensions over a long period of work are surely entitled to expect no less. It is better, if necessary, to have slightly lower benefits that are properly secured than higher benefits that are inadequately funded. The discontinuance basis of solvency is therefore essential for the protection of scheme members. Clearly there are matters of detail to be worked out, and fine tuning to be done, and here the actuarial profession has a crucial role to play. I am confident that, as in the past, it will find a way of overcoming such difficulties as may arise.

(2) THE COMPENSATION FUND

Should there be a Compensation Scheme at all?

The measures I have earlier described—a full funding requirement, prompt payment of contributions, increased monitoring, the overall supervisory powers of the Regulator—should ensure that inadequacy of scheme assets to meet liabilities will be an infrequent occurrence, and that fraud or mismanagement is detected much earlier than it would be under the present regime. But in this uncertain world there can be no guarantees. In the words of the old actuarial adage, the only assumption that will always be correct is that all other assumptions will be wrong! So though we can reduce, we cannot eliminate, the possibility of scheme insolvency, whether through fraud, negligence or sheer bad luck. What safety net, if any, should be provided for scheme members faced with the loss of all or part of their pensions?

As on most issues, opinions were sharply divided. At one end were those who considered that there should be no compensation scheme at all; in the middle, a scheme limited to fraud and similar activity; at the other end, that there should be a compensation scheme covering all risks, on the basis that the hardship members suffer when a scheme becomes insolvent does not depend on the cause of the insolvency. There were some members of my committee who felt that a strong case could be made for this last point of view; but the majority considered that, while there should be a compensation scheme, it should be limited to loss caused by fraud[13], theft or other misappropriation of assets. That conclusion, which I believe reflects the preponderance of opinion on the part of those who gave evidence to us, was reached, not only because of the possible cost of covering all risks, including market risk, but because of the moral hazard involved. We saw no reason why schemes opting for a high-risk, high-return strategy should be bailed out by prudently run schemes that accepted lower returns in order to avoid undue risk. Members already enjoy a measure of protection in that the employer is by statute liable to make good a scheme deficit on the winding up of the scheme or of the employer. This protection will be reinforced by the minimum funding requirements and closer professional monitoring. We felt that any remaining market risk should be borne by the members, not by other schemes.

The compensation scheme would be administered by a Pensions Compensation Board. It would not cover loss of a surplus, only a deficit. Nor would it cover the entire deficit, only 90 per cent of the misappropriated assets (which for this purpose would include diverted contributions and pension payments) or 90 per cent of the scheme deficit, whichever was the less. This reflects our view, which is enshrined in all other compensation schemes, that every potential beneficiary should carry some element of risk and have some incentive to take a proper interest in the management of his or her scheme.

It would not be necessary for the Board to wait for a finding of fraud in criminal proceedings or civil litigation(14) before making a payment. That could take years—indeed, for various reasons, including the ill-health of the defendant, it might never happen at all—and we considered it vital that pensions should continue to be paid when due. Accordingly the Board would have authority, where satisfied that there was strong evidence of fraud, theft or other misappropriation and that the trustees were taking reasonable steps to recover the lost funds, to make interim compensation payments. These would be made to the scheme, not to individual members, and would be by way of a loan repayable out of recoveries, not by way of grant. The Board would have power to direct that payments be applied in an order of priority different from that prescribed by the scheme rules.

The scheme would be financed by a levy on schemes based, not on their actual assets, but on the assets they were required to hold to meet the 100 per cent minimum funding standard. This will avoid well-funded schemes having to subsidise underfunded schemes. The levy would be a post-event levy, not an advance levy. We did not see why schemes should part with money they could more profitably invest for their members in anticipation of events which might never occur. The Board would have power to borrow against projected levies in order to meet claims on the Compensation Fund.

We believe that adoption of these recommendations will go a long way to dispelling the anxiety of scheme members generated by the recent series of failed schemes. We think it unlikely that the compensation arrangements would be triggered very often or that they would involve the huge sums in issue in the Maxwell affair. But even if they did, any post-event levy would be quite small. If one assumed a worst case of, say, a £250 million claim, against total assets of £500 billion, we are talking of a levy of no more than 0·05 per cent of assets, surely an acceptable price to pay for pensions security. In practice, it is highly unlikely that we shall experience future claims which anywhere near approach this magnitude.

3. Conclusions

These, then, are our proposals for defining and protecting the pension promise. No doubt each individual recommendation is open to debate and criticism, but our proposals should be seen as an integrated package, each element of which is closely interrelated to the others. A number of commentators have rightly drawn attention to this, and have pointed out the importance of looking at the package as a whole, rather than seeking to unpick recommendations and thereby risk unravelling what was devised as a complete tapestry.

The actuarial profession will have a crucial role to play under our proposals. We hope they will continue to give our Report the support they have so far expressed in most generous terms, and thereby help to bring about a new and long-term regime for occupational pensions which will provide a fair balance of interests and much-needed security for scheme members. We must not only define the pension promise; we must give it reality.

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REFERENCES

(1) 'His' rather than 'his or her' because in those days women employees were the subject of severe discrimination in terms of type of work, promotion, pay and pension.
(2) BONE, M. *et al.* Retirement and Retirement Plans. Table 2.5. HMSO.
(3) HMSO (1993). Pension Law Reform: Report of the Pension Law Review Committee. §3.1.3. HMSO, Cm 2342-1. (heareafter cited as HMSO. (1993). Report.)
(4) ATKINSON, A. B. & SUTHERLAND, H. (1993). 'Two Nations in Early Retirement? The Case of Britain', in *Age, Work and Social Security*, edited by A. B. Atkinson & Martin Rein, 132. Macmillan Press.
(5) HMSO. (1993). Report. §4.2.13 and cases there cited.
(6) CHANTER *v* HOPKINS (1838). 4 M. & W. 399, *per* Lord Abinger at p. 404.
(7) KARSALES (HARROW) LTD. *v* WALLIS [1956]. 2 All E.R. 866.
(8) Unfair Contract Terms Act 1977, s. 3(2)*(b)*. The E.C. Unfair Contract Terms Directive 1993 is broader still.
(9) HMSO. (1993). Report. §§4.2.9–4.2.10, 4.6.13–4.6.15, 4.14.18 *et seq.*
(10) Graphically illustrated in LRT PENSION FUND TRUSTEE CO. LTD. V. HUTT (1993). Pensions Law Reports 227, where the judgment of Knox, J. states that it was estimated that a reduction of a half per cent in the assumed rate of future dividend growth would bring down the assessed value of the fund by £167 million and the past service surplus from £460 million to £293 million, a reduction of over 35 per cent.
(11) HMSO. (1993). Report. §§4.1.8–4.1.14.
(12) But this is purely for the purpose of calculating the minimum solvency standard. The trustees would still be under a duty to procure the promised final salary benefits on wind-up if the assets were sufficient.
(13) For those who seek a succinct definition of fraud I cannot improve on the celebrated Ambrose Bierce, who after writing his Enlarged Devil's Dictionary disappeared into Mexico some 80 years ago and was never seen again:
Fraud The life of commerce, the goal of religion, the bait of courtship and the basis of political power.
(14) Bierce defined litigation as a machine you go into as a pig and come out of as a sausage.