



The Actuarial Profession

making financial sense of the future

Consultation Response Department for Work and Pensions

Pensions and Growth: Whether to introduce a new statutory objective for the Pensions Regulator

21 February 2013

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

The Pensions Regulator Policy Team
Pensions Protection and Stewardship Division
Department for Work and Pensions
Caxton House
1st Floor
6-12 Tothill Street
London SW1H 9NA

21 February 2013

Dear Sir/Madam

Pensions and Growth: Whether to introduce a new statutory objective for the Pensions Regulator

The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to comment on the possible introduction of a new statutory objective for the Pensions Regulator (tPR). The IFoA notes the Chancellor of the Exchequer's explanation in the Autumn Statement that '...the Government is determined to ensure that defined benefit pensions regulation does not act as a brake on economic growth'.

A tension currently exists between the level of security achieved in relation to benefits promised under UK defined benefit pension plans and any desire to limit the impact of plans on employers. Any change which would make contributions to pension plans less onerous – whether a weakening of funding targets, allowing deficits to be eliminated over a longer period, or allowing the investment policy to involve greater risk in exchange for higher expected returns – will tend to reduce the level of security for members' benefits (i.e. will increase the risk of pension plans not providing all of their promised benefits). Any requirement to set contributions at the maximum level affordable will minimise the risk in pension plans, but could constrain companies in how they use their resources, with an inevitable impact on investment. If such a requirement were made, the weighing of these tensions would need to be considered when deciding what security should be provided to pension plans.

Some considerations of how the regime currently works are as follows:

- The legislation, as set out in the Pensions Act 2004 and related regulations, provides adequate flexibility for trustees and sponsors to agree appropriate "scheme specific funding" targets and deficit repair plans (although see the comments below about the Statutory Funding Objective)
- Practical constraints mean it is impossible to require a company to pay higher contributions to a pension scheme than it can afford. Indeed pushing for the maximum affordable in the short term is probably counter-productive if the result is to increase the risk of medium term insolvency.
- Our members have suggested that the legislation does provide for flexibility but this has not always been implemented as anticipated.

As noted in the call for evidence, the Scheme Specific Funding regime has proved to be a stronger standard than the MFR, even though this was not envisaged in the Impact Assessment. However, there is evidence to suggest the new regime has not provided the increased flexibility also envisaged. This does not mean, however, that tPR's

approach is necessarily inappropriate. Indeed, although the legislation, in general, envisaged tPR acting in a balanced role between trustees and sponsors, tPR's objectives are concerned with reducing risk, in particular:

- To protect the benefits of members of work-based pension schemes
- To reduce the risk of situations arising which may lead to compensation being payable from the Pension Protection Fund (PPF).

These explicit objectives encourage tPR to reduce risk to the minimum practical level, within the legislative and practical constraints.

Alternatively, a new objective that made consideration of wider economic issues more explicit may support tPR in its role whilst also promoting future investment by easing the focus on reducing pension risk to very low levels. A potential implication of introducing more flexibility in the operation of the Scheme Specific Funding regime may be that this increases the risk of larger shortfalls when a sponsor does become insolvent (although such insolvencies may be less frequent).

Q6. What would be the advantages of a new statutory objective for the Pensions Regulator to consider the long term affordability of deficit recovery plans to sponsoring employers?

We believe that contributions are already limited by practical circumstances to the maximum reasonably affordable. We would therefore expect only a limited impact (if any) from imposing a new statutory objective worded in this way. In the long term, consideration should be given to whether members' benefits are better protected by strengthening the employer covenant or by contributions to the pension scheme.

Q7. What would be the disadvantages in creating this further statutory objective for the Pensions Regulator?

Contributions are already limited by circumstances to the maximum reasonably affordable, which is reflected in tPR's guidance to Trustees. We therefore believe that there would be few, if any, disadvantages to introducing such an objective, other than (as noted above) its limited impact. Indeed, the greatest drawback might be that it gives the appearance of doing something while actually changing nothing. If there is a view that strong action needs to be taken, introducing such an objective would be a distraction and would delay any real change.

Q8. Is the consideration of the long-term affordability of deficit recovery plans to sponsoring employers already implicit in the existing objectives and requirements for the Pensions Regulator? If so, is this sufficient?

As noted above, we believe that although only loosely implicit in the existing objectives (it is in the members' interest to have a viable employer), it already acts as an inevitable practical constraint. It is reflected in tPR's guidance to trustees.

We believe that applying this constraint to contributions does not avoid an impact on company investments. Our members have suggested that under tPR's current objectives, contributions are seen as more affordable if a company has no solid plans to invest in the near term. As a result this has been interpreted to suggest that cashflow not yet set aside for investment is available to the pension scheme and can be included in the Recovery Plan. Such circumstances may not reflect the investment strategy of firms and as a result may curtail wider economic growth.

The knowledge that all reasonably affordable cash is expected to be paid to the pension scheme also discourages unsecured loans to the company and the injection of additional equity into the company. This may result in the a situation where a firm is discouraged from paying (additional) dividends to equity investors, even following additional equity investment.

Q9. Are there any other options (including legislation) which would ensure that the Pensions Regulator carries out its functions in a way that appropriately balances protection of members, the Pension Protection Fund and sponsoring employers?

It may be argued that allowing companies to retain more of their cashflow for potential future investment makes the company stronger in the long term and will reduce the risk of insolvency. We are not in a position to comment on this. However, it is possible that even if it is true that the number of company insolvencies reduces, it is likely that the average pensions deficit at the time of insolvency might be higher (because of the consequential lower funding level).

If tPR were to interpret the current legislation with greater flexibility, there may be no requirement to introduce a new objective.

A number of examples of reduced flexibility in the regulatory regime are set out below:

- The legislation appears to provide flexibility as to the period over which trustees and companies agree that deficits will be eliminated. Indeed, the Impact Assessment issued with the Pensions Bill envisaged that this flexibility would allow deficit recovery periods to be longer under the Scheme Specific Funding regime than the 10 years allowed under the previous MFR legislation.

However, tPR appears to have interpreted the Statutory Funding Objective, which provides that the scheme must have sufficient and appropriate assets to cover its technical provisions, to mean that deficits must be eliminated as quickly as reasonably affordable. tPR's public statements have emphasised this flexibility to agree longer recovery plans and occasionally to make contributions reasonably affordable.

The legislation would appear to allow a strong sponsor to repair a deficit slowly, providing time to wait and see whether market movements reverse and eliminate at least part of the deficit themselves – in effect a form of smoothing, applied to the contributions rather than the valuation measure. tPR does not appear to allow this and expects deficits to be repaired quickly by strong employers (or at least, for trustees to seek alternative security otherwise).

Allowing recovery plans to be longer than the minimum period (based on reasonably affordable contributions) will increase risk (the sponsor could fail in the meantime) but the increase in risk might be limited if the flexibility were restricted to stronger employers. However, an objective, measurable and robust definition of what constitutes a strong employer would be needed to make such a restriction workable. This is an example where tPR's approach reduces risk, but with implications for company finances and where increased flexibility would have to be balanced against increased risk. tPR could ideally weigh the risks of insolvency against the potential advantages of allowing the pension contributions to be invested to strengthen covenant.

- The legislation requires the valuation discount rate to be chosen prudently, taking account of either or both of:
 - a) the anticipated future returns on the assets held to fund future benefits
 - b) the market redemption yields on government or other high quality bonds

There is a perception that tPR discourages any approach other than setting discount rates at the yields on gilts plus a fixed margin. Furthermore, it has seemed to favour this approach over alternatives whereby schemes reflect the variation over time in expected investment returns relative to bond yields, which effectively eliminates use of the first approach (other than as represented by some arbitrary fixed margin above the gilt yield). This automatically limits the flexibility afforded by the legislation. Using a discount rate linked to gilt yields causes the surplus/deficit of assets relative to liabilities and, therefore, deficit contributions to be more volatile than using a discount rate which reflects movements in expected returns

relative to bonds. An approach which allows discount rates to follow investment returns can be interpreted as placing more reliance on the sponsor covenant. This highlights again the tension where increased flexibility would have to be balanced against the view of increased risk.

- The legislation does not restrict pension scheme investment strategy. Indeed, the Impact Assessment issued with the Pensions Bill envisaged that the increased flexibility around technical provisions and recovery plans would allow pension schemes to revert to investing more in equities because the impact of market fluctuations would not feed through as directly into deficit contributions. However, tPR's approach as illustrated above means that market fluctuations feed through even more directly into deficit contributions than under the MFR. Some commentators have suggested that this may have been one of the factors contributing to pension schemes directing their investments away from equities and towards bonds in recent years. Furthermore, tPR has at times required trustees to restrict investment risk having regard to the sponsor covenant and to create and implement plans to de-risk over a reasonable timeframe. This approach is expected to reduce the risks to members over time, but has also reduced the supply of funds available for investment in equities. Increased flexibility around investment strategy would have to be balanced against increased risk while considering possible outperformance.

In general, we believe the legislation allows greater flexibility than currently observed. However, if the government does wish to introduce an additional objective it will need to ensure that the impact is not constrained by the legislation. However, as noted above, the Statutory Funding Objective has been interpreted to mean that deficits must be eliminated as quickly as reasonably affordable – this may as a result, negatively impact investment and growth.

The Government might therefore need to encourage even greater flexibility within the regime or alternatively, seek to amend this aspect of the legislation. We note that other EU countries do not appear to have had problems allowing flexibility in the length of Recovery Plans under the IORP Directive – in some cases even for cross-border plans.

We hope our response will contribute to an outcome where defined benefit pension schemes cannot take the blame for slowing investment growth in the future. If you wish to discuss this response further, please contact Philip Duggart, Policy Manager at the IFoA (email: Philip.Duggart@actuaries.org.uk, phone: +44 (0)131 240 1319).

Yours faithfully



Jane Curtis
Immediate Past President
The Institute and Faculty of Actuaries