The Actuarial Profession

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Consultation Response

Department for Work and Pensions

Pensions and Growth: Whether to smooth assets and liabilities in scheme funding valuations

7 March 2013

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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

7 March 2013

Dear Sir/Madam

Pensions and Growth: Whether to smooth assets and liabilities in scheme funding valuations

The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to this call for evidence. This response has been drafted by some of our members working in Pensions following a series of regional meetings with around 200 pensions actuaries, who advise both trustees and employers, to discuss the call for evidence.

We note that the Chancellor of the Exchequer explained in the Autumn Statement that '...the Government is determined to ensure that defined-benefit pensions regulation does not act as a brake on investment and growth'. As the call for evidence document points out, there has been a significant increase in defined benefit (DB) pension contributions since the turn of the century. The public debate over the last six months has focussed on the view that DB pension contributions should at worst not increase, but preferably reduce from current levels. Our response is framed in light of that view; recognising that any change in approach to funding valuations that leads to increases in DB pension contributions would be unacceptable to many participants in that debate.

While there has been much commentary on the impact of falling gilt yields, there does not appear to be a consensus that the reduction in yields will be reversed in the near future. Indeed, there has been comment that yields could remain low for a sustained period of time. While the IFoA does not wish to comment on if, or when, yield reversion would take place, we do believe it is important to understand the consequences of yield reversion on pension scheme funding.

If yields remain low, the introduction of smoothing would, at best, introduce a delay in recognising the impact of such yields. While there could be a small temporary boost to funding levels, low yields would ultimately lead to lower funding levels. This would be the case whether smoothing were in place or not.

If yields were to increase, the introduction of smoothing would delay the benefit to funding levels, as the benefit of increased yields could not be taken into account immediately. This drag could lead to higher contributions than would otherwise be the case.

Q1. What would be the effect of smoothing assets and liabilities in schemes undertaking valuations in 2013 and going forward? Would it materially improve the sponsoring employers' ability to attract investment or to invest in short term? If so, what evidence is there of this?

The policy intention would suggest that Technical Provisions would be lower, although as we discussed in our introductory comments, the sustained period of low yields may not necessarily provide that result. As actuaries would not normally calculate assets and liabilities using inconsistent methodologies, smoothing would also affect the asset valuation. Depending on the mis-match within each scheme's investment strategy and the exact approach taken in using smoothing, the introduction of smoothing would have scheme specific outcomes for funding balance sheets. Depending on economic conditions, those outcomes may not always be lower funding deficits.

However, following through the implied policy intention, if smoothing were to produce lower funding deficits, there would not necessarily be an automatic change to contributions. For schemes with recovery plans already in place, trustees may wish the agreed contributions to continue. On a funding basis, lower deficits could lead to shorter recovery plans, rather than lower contributions. Given that trustees are already expected to consider what is reasonably affordable, without other changes to the employer's covenant, trustees may interpret reasonably affordable to mean that existing contributions continue.

Q2. Given that there is no one defined method for calculating scheme liabilities, how would you implement smoothing?

The IFoA agrees with the wording in the question that there is no single method that could be used for calculating liabilities; therefore, we do not wish to propose a single method in response to this question. However, there are some specific points that we believe are relevant to this question.

We believe that there should not be any compulsion if smoothing were to be introduced. The circumstances of individual schemes are so varied that a compulsory smoothing methodology could be detrimental to the management of those schemes. Specific examples where this would be the case are:

- Some schemes have implemented hedging strategies that depend on market valuations. Trustees and sponsors have agreed such strategies to manage risk. Any hindrance to managing these strategies, or implementing new hedging strategies, would be unwelcome.

- Some schemes have clear designed plans to progress toward the ultimate wind-up of schemes. As most private sector DB schemes have closed to new members, or to further accrual, these schemes will have maturing profiles. Consideration of such "flight paths" to wind-up is likely to be more common as DB schemes continue to mature.

  As ultimate wind-up will generally involve a transfer of liabilities to insurers, which will be calculated using market-consistent bases (i.e. not smoothed), the introduction of smoothing would be likely to reduce clarity around such options, thus, making it more difficult to secure members' benefits.

The IFoA recognises that introducing a voluntary regime for smoothing introduces a selection risk. There is a risk that valuation methodology could be selected on the grounds of what provides the best result, although trustees would have to justify the reason for change.

The IFoA believes there is justification in requiring schemes to "lock in" the consistent use of smoothing from valuation to valuation, but such a "lock-in" should not act to restrict the use of de-risking strategies. Regulations already require that changes to the method and assumptions must be justified by a change of legal, demographic or economic circumstances (regulation 5(4)(d)), so there may already be adequate protection against unwarranted changes to the trustees' smoothing policy, whilst allowing reasonable ones. Alternatively, additional guidance for trustees could be helpful in ensuring the policy intention is met.

Q3. What are the advantages and disadvantages of smoothing for sponsoring employers, scheme members and the Pension Protection Fund?

The IFoA's response to this question must be considered within the context of our response to question 1. Again, we would emphasise that the use of smoothing does not guarantee a reduction in DB pension contributions and that the practical effects of smoothing may be tempered by the Pensions Regulator's interpretation of affordability.

However, **if** smoothing were to be adopted and **if** DB pension contributions were to be reduced as a result, the following should be considered:

Employers

- Market-consistent valuations using market values of assets are much easier to understand. Introducing smoothing to valuations makes the communication of results more difficult and would be unlikely to encourage more engagement of members in pension matters.

- Employers benefit from a short term reduction in contributions offering the opportunity to invest, or grow the business, assuming those opportunities exist;

- There is no change to the calculation of pension scheme liabilities that appear in company accounts. In fact, reduced contributions would, over time, show increased deficits in those accounts.

Scheme members

- Theoretically, reducing contributions allows employers to invest and grow. If employers were stronger, there is more confidence in employers' covenants and a lower possibility of company default. Consequently, there would be greater likelihood across all schemes that benefits would be met in full, or at least up to PPF levels. In theory at least, a smaller number of schemes would fall into the PPF.

- Reduced contributions means less coverage of accrued liabilities. If employers were unable to meet benefits, lower funding of schemes from reduced contributions increases the risk for members that they would only receive PPF benefits.

- It should be noted that the changes in labour market flexibility mean that for many scheme members (deferred and pensioner), their only interest in the employer is that it remains in business and continues to pay sufficient contributions that will allow them to receive benefits.

Pension Protection Fund

The consequences for the PPF are much more difficult to determine, as there are a number of variables that would move independently of each other. However, the IFoA has identified the following general points:

- Reduced contributions would mean lower funding of schemes on PPF valuation bases. If sponsors of schemes were to default and the PPF took on responsibility for the payment of PPF level benefits, fewer assets would be available to meet those benefits. There is an under-funding risk for the PPF in respect of schemes that fall into the PPF, which could be increased by smoothing.

- It should be noted that stronger employers should be less likely to default, so if lower contributions strengthen employers, by means of more productive investment, there may be fewer schemes falling into the PPF.

- Reduced funding levels would increase schemes' levies, but this should be balanced against potential improvements in employers' covenants, which would reduce levies.

- If the net impact of weaker funding and stronger employers is an increase in calls on the PPF (and this impact is not at all clear), then this would also increase the PPF levy on remaining schemes.

Q4. Is the current regime flexible enough to ensure that defined-benefit pensions regulation does not act as a material brake on investment and growth for the UK economy?

The IFoA believes there is flexibility within the current legislative regime. However, as explained in our response of 21 February as to whether tPR should have a new statutory objective, we believe that tPR guidance and actions can serve to limit the flexibility otherwise available under the legislation.

Q5. Should a specific model of smoothing be introduced, the Government would welcome views as to what schemes, in terms of their valuation date, should be able to take advantage of the change.

As the call for evidence noted, most previous changes to pension legislation have been prospective. Simplicity would suggest that all schemes with signing dates after any regulations came into force could use smoothing.

If any changes were to be retrospective, there would be no benefit to employers to engage with trustees at this stage in determining valuation assumptions. The practical impact of this would be that more schemes would test the 15 month deadline for completing valuations. Increasing the number of uncompleted valuations could be an unnecessary distraction to tPR, unless it is prepared to accept a general delay for a limited time.

In summary, the IFoA does not believe that the introduction of smoothing for asset and liability valuations would necessarily provide the desired policy outcome. If you wish to discuss this response further, please contact Philip Doggart, Policy Manager at the IFoA (Philip.Doggart@actuaries.org.uk +44 (0) 131 2401 319).

Yours faithfully

Jane Curtis
Immediate Past President
The Institute and Faculty of Actuaries