‘Scheme specific funding’ in the UK

Introduction

Defined benefit (DB) pension schemes provide a promise that the members will receive a specified level of pension irrespective of the cost of providing that pension. For tax reasons, and to give better security to members, the majority of UK DB pension schemes are funded; assets of the company are set aside (by contributing into a separate trust) for the sole purpose of paying the promised benefits to members.

This Editorial looks only at funded DB pension schemes, and discusses the debate that has been running for some time about how well funded such schemes should be. It is not possible to know in advance how much money is needed within a scheme to pay for the benefits promised. There are many uncertainties (or risks) about the pension payable to an individual:

- *When will the pension commence?* This will depend upon when the individual decides to retire.
- *How much will the pension be?* While the benefit is defined, it is not normally possible to be certain in advance what the level of pension will be, as pensions are often linked to future salary levels or linked to inflation in some way.
- *For how long will the pension be paid?* For the life of the individual (and possibly their spouse/dependant).

With a large population, it is possible to

make assumptions about the average retirement age, salary growth and longevity, but that is not the subject of this paper. The important point to note is that these risks exist, and cannot be eliminated completely.

The main risk in UK schemes, namely investment risk, is considered in some detail in this paper, as it is fundamental to the question of scheme funding. Once the amounts and timings of future pensions payments have been estimated, those payments must be discounted back to a present value to establish the amount of money needed currently. Depending upon why the calculation is necessary, it might be compared with the question: ‘how much money is needed now so that, when added to the expected investment return, there is sufficient to meet all of the payments in full?’ The practice in the UK has generally been to set the amount of money needed to equal:

$$\text{Pension payments promised} - \text{Future investment return expected}$$

For this reason, the expected future investment return is a key variable in determining funding and investment risk is a key issue faced by schemes: if the investment return is less than expected, then there is not enough money. Many people believe that this approach is flawed, and that allowance for non-guaranteed investment returns should not be included in the above equation.

The role of actuaries and the actuarial profession

Arguably the most reliable measure of guaranteed (or risk-free) investment returns is the return available on UK Government loan stock. However, pension schemes have historically invested quite heavily in equities, which many scheme sponsors and other commentators believe will achieve higher investment returns than the risk-free rate in the long run (backed up by long-term experience to date in the UK and other developed equity markets). Actuaries have been heavily involved in scheme funding; not just performing the calculations, but also advising on the assumptions to use and making recommendations about the level of contributions required.

Until quite recently, actuaries have generally made allowances for the expected long-term equity outperformance when setting the required level of funding. In deciding how much outperformance to allow for, the assumption has generally been made that equity returns will be higher when markets appear historically low and vice versa. This has the impact of smoothing out some of the equity market volatility from the funding calculations. For example, if equity markets fall, then the assets held fall, but the expected future investment return increases which reduces the required calculated funding. Thus there is not necessarily a need for additional contributions following market fluctuations.

The smoothing mechanism above depended upon having a reliable method of deciding how 'high' or 'low' equity markets are at any particular time. This was normally done by looking at the dividend yield on a basket of stocks. The dividend yield is calculated on any particular day as dividends paid over the previous year, divided by market value

on that date. The numerator of the equation (dividends paid over the year) moves gradually over time, as companies change the level of dividends, and so any fundamental changes in markets should be reflected in funding levels. However, day to day fluctuations in price go directly into the denominator, cancelling out asset fluctuations.

In 1997 the tax treatment of UK dividend payments changed, which sent a shock into the dividend yield calculation with which the actuaries' traditional methods could not cope. Moreover, a number of other factors such as the trend towards globalisation, different dividend practices in different regions, and the debate among actuaries as to whether or not allowance for equity outperformance is reasonable (which is touched on below), obliged actuaries to move away from this system, and equity market volatility is no longer smoothed to such an extent, if at all.

The above gives a very brief and simplified summary of the way many actuaries carried out funding calculations in the past. Meanwhile the Actuarial Profession was involved with the inception of the Minimum Funding Requirement (MFR) in 1997. This was a funding test brought in by the Government in an attempt to increase member security by ensuring that all schemes were funded in excess of the same minimum level. If a scheme were not sufficiently funded, then there were tight deadlines for correcting any deficit by additional employer contributions.

The assumptions to be used for calculating the MFR were agreed by the Government but set out in one of the Actuarial Profession's guidance notes. These assumptions, which were based on the dividend yield method mentioned above, then proved very hard to keep up to date as the methodology became defunct, and estimates of longevity

changed quickly. The MFR swiftly became discredited, opening up the debate about whether there should be a funding standard and, if so, what level of funding should be required, and who should take these decisions.

The general consensus is that MFR was too inflexible and in particular it was a mistake to have a 'one-size-fits-all' test. The Actuarial Profession remains clear in its belief that setting minimum funding levels and thus setting the balance between the need for member security and affordability is a job for the Government.

Pensions are expensive

DB pensions are costing more than most employers expected, and more than many employers are willing to pay. There are a number of reasons for this:

- people are living longer, and retiring earlier;
- low inflation means that yields are low, which increases the cost of pensions;
- over time, successive governments have added various statutory extras to the pension promises made. For example, any pension earned since 1997 must increase in payment; early leavers have protection that they never used to have.

There has been a practice in the UK (helped along by the surpluses in pension schemes in the 1990s) of granting generous early retirement benefits as a way of managing redundancies, but now employers are realising that the benefits provided are actually very costly, and that perhaps there are more efficient ways of rewarding their staff. If there were a cheaper benefit on which employees placed a higher value, then that would be a better option.

On the other hand the problems

outlined above do not just affect occupational pension provision — there is a general shortage of pension coverage. Pensions are costing more, but people cannot afford to save more, and so the amount of pension expected reduces. The Government would like to encourage occupational pensions provision to help spread that burden.

There is an increased need for pensions, but employers are put off by both the absolute cost and also the fact that they do not see that pensions provide value for money. One way to help with this problem is to achieve higher returns on the pension scheme's assets, but this means investing in more volatile assets.

Protecting members

Members of DB pension schemes know what level of benefit to expect when they retire. If experience within the scheme has been poor, and that benefit actually costs more than expected, then that strain is borne by the employer. This only works if the employer is around to put in any extra money.

For a long time UK DB schemes worked well on a 'with-profits' principle. The schemes invested heavily in volatile assets — equities, for example — but a portion of the benefit (such as the pension increases) was often discretionary, meaning that there was a safety valve. Thus if investment returns were poor, the pension increases, which had never been guaranteed, were not paid. In better years, increases were paid. This safety valve has now largely been removed by legislation which effectively required most of the discretionary element of benefits to become guaranteed.

In the extreme case of a company not

being able to afford its pension benefits, it would have been able to cease its liability to pay contributions to the pension scheme and the assets in the scheme would be used to provide pensions to members — unfortunately with benefit cutbacks in most cases. Good employers (and bearing in mind that providing pensions is voluntary, this encompasses most employers who set up DB schemes) would hope to keep such cutbacks to a minimum in the worst scenarios by funding their pension scheme prudently. This safety valve (of being able to cut-back benefits in the worst case scenario) was also removed a few years ago. Companies must now guarantee to meet all pension promises, even if this drives the company into insolvency. Interestingly, this change was made with retrospective effect in that it applies to benefit promises made before the legislation was changed.

Over the long term, equities have outperformed the less volatile assets, reducing the cost of benefits. Employers have been able to manage the volatility because of the long-term nature of the benefit promises: a few bad years do not matter that much when the majority of the benefit payments will be made many years into the future. In the meantime one can expect to have some good years to make up for the bad.

This system works while the scheme has a long-term future. When forced to look at the short-term position, however, the system can fall down. There are a number of snapshot tests that companies have to put their pension schemes through now (such as the new UK accounting standard, FRS17) which have brought this concern to the attention of many finance directors. However, in the case of a scheme wind-up, this short-term problem is crystallised, and will often affect benefits significantly.

The UK pension market is fairly mature, with a number of schemes looking to close and then be wound up, in which case all of the benefits will be secured elsewhere. The benefits that can be secured will depend upon the assets of the scheme at the date of the wind-up, and if the assets are invested in equities, for example, and equities have performed badly recently, it may well be that full benefits cannot be purchased.

The effect can be quite drastic, but it is amplified by the impact of the 'priority orders' which allocate first pick of the assets to particular classes of members. Historically, trustees would have allocated the funds available according to the scheme's own priority rule, which may have favoured pensioners to some extent, but would have had some flexibility especially over discretionary benefits such as pension increases. However this was replaced by a statutory priority order which, until very recently, required that the first priority in UK schemes would be to secure benefits for pensioners fully, including future increases (which had now become guaranteed benefits).

In an example scheme with £90m of assets and a £100m cost of securing full benefits for all members, one may at first sight think that everyone would get 90 per cent of benefits; while this is not ideal, neither is it a cause for great alarm. However, if the scheme is very mature (as many are), the vast majority of the membership might be pensioners. For the sake of this example, assume the cost of securing benefits for pensioners would be £90m — this is the first call on the assets and uses them all up. This leaves no assets for any of the remaining members, including any that due to retire tomorrow. This is much more alarming, and there have been a number of sad stories of members in this sort of position.

To combat this problem, there has been a slight change in the statutory priority order, but this only eases the problem slightly. The main response has instead been a raft of new legislation aimed at increasing the protection for members' benefits. If there is any shortfall on wind-up, that amount becomes a debt due from the employer (in many cases this would be an impossible figure). If there is no employer left to pay the debt, then the new Pension Protection Fund (PPF), similar to the Pension Benefit Guarantee Corporation in the USA, will step in to provide benefits up to set limits in return for a levy which is paid by all (non-Government) pension schemes.

All of this increases the cost of DB pensions further, and increases the dichotomy between DB schemes, which are moving towards being 100 per cent guaranteed — whatever happens, and defined contribution (DC) schemes which have little guarantee at all. Many observers would rather see a trend towards a middle ground, with affordable pensions with an achievable level of guarantee that gives the member a good chance of knowing what to expect, but accepting that a 100 per cent guarantee is not affordable.

The role of the Government

As discussed above, the Government is looking to encourage occupational provision to help meet the perceived lack in overall pensions coverage. The Government also claims to support DB pension provision, but the political message at the moment is that DB schemes must be as fully protected as possible, thus pushing the cost of DB to unaffordable levels and making DC the only sensible option.

In the UK DC schemes generally provide significantly lower benefits than

DB schemes. This is not necessary: the main driver for moving to DC has been to reduce the risk to the employer, but many employers have opted to reduce costs at the same time. This is perhaps because it is harder for an employee to judge how much pension they will receive from a DC scheme (which just provides whatever pension can be purchased from the accumulated pot of contributions paid on behalf of the member). Even if DC schemes did provide the same level of benefit as DB schemes they would not be as helpful in solving the Government's issues about pensions coverage. DB schemes smooth out volatility, and provide all members with a targeted level of benefit. In DC schemes there will be winners and losers relative to the target benefits, as volatility is passed on to the members: some will get more than they need, while others will not get enough, falling back on the State provision.

The Pensions Act 2004 is being implemented gradually with most elements due in by April 2006. This will significantly increase the protection for members of DB schemes, and therefore the cost to employers of providing those benefits.

As well as the introduction of the PPF mentioned above, the Government has introduced a new Pensions Regulator with increased powers to police pension schemes with complementary aims of protecting members and of reducing claims on the PPF, by making sure that schemes are so well-funded that they do not need it.

Scheme specific funding

The other major part of the Pensions Act 2004 is the introduction of the new regime of 'scheme specific funding' (SSF), which was originally intended as a replacement for the MFR. One of the

major criticisms of the MFR was that it was too inflexible and did not adequately recognise the circumstances of each particular scheme. Hence the name for the replacement — the intention of the new regime is to provide a framework for a funding standard flexible enough to take account of the specific circumstances of the scheme.

Even before the first proposals for SSF were drawn up, the goalposts were being moved by a number of external influences. The EU Pensions Directive has rules which EU member states must adopt relating to pension schemes, including a funding standard, but it has been hard for the Government to shoehorn the scheme specific proposals into a form which also passes the EU test, and whether they have been successful has yet to be tested in Court.

The outcome of this is that we have a rather strange definition:

Every scheme is subject to a requirement ('the statutory funding objective') that it must have sufficient and appropriate assets to cover its technical provisions.

What does this mean? 'Technical provisions' is a new definition for the UK, and is actually just lifted straight from the EU Directive. Unhelpfully, the Act goes on to clarify that, 'A scheme's "technical provisions" means the amount required, on an actuarial calculation, to make provision for the scheme's liabilities'.

This is a slightly circular definition, leaving no-one wiser about what is meant. The key uncertainty is whether or not it is permissible to take credit for expected future equity (or other) outperformance to reduce the figure calculated as 'sufficient and appropriate to cover' the technical provisions.

There are a number of parties with an interest in these calculations, who might therefore be expected to have some

input into this question, and these are addressed in turn.

The Government

The Government has made the legislation and has an interest in the level of pension provided by companies as discussed above. It also has a political interest in keeping everyone happy, which in the current climate appears to mean increasing the level of protection within DB schemes, but at the same time not appearing to have increased the costs to employers (which is not possible, as discussed above).

These are conflicting objectives — on the one hand, the Government wants to encourage occupational, and in particular DB provision, without overly burdening employers. This would imply allowing volatile equity investment, and for advance credit to be taken for expected outperformance within the calculations. Indeed the draft regulations which will implement the SSF regime state that when determining the rate at which liabilities should be discounted, trustees can take into account, 'the yield on the assets held by the scheme to fund future benefits, and the anticipated future returns on those assets'.

On the other hand, we have seen above how this can cause problems with security of members' benefits, particularly on wind-up. Even with the PPF in place, if a scheme makes an allowance for equity outperformance in its funding, it is likely that on the particular day on which the scheme winds up there will be insufficient assets. While the PPF will provide some protection, it will not provide full benefits. In fact the PPF may itself scale back benefits in the future if it runs into funding problems, but it remains to be seen whether this will actually happen.

On top of this, the Government is

under pressure to show that the PPF will not cost more than its estimates. One way to achieve that is to make sure that the PPF is not needed, by imposing strict funding rules on schemes.

Therefore the Government would like funding to be as strong as possible, taking little if any credit for expected future outperformance. The Government has published some example statements of funding principles for trustees to use as a guide; none of these show allowance for expected outperformance, even though it would be allowed in theory by the draft Regulations.

Trustees

In the UK, pension schemes are set up under trust, looked after by the board of trustees, which, in theory, is an independent body from the sponsoring company. In practice many trustees also have company positions, and need to take care to manage any conflicts of interest if they arise. Trustees have significant new responsibilities under SSF. It is the trustees who set the funding principles, and they are therefore open to criticism in the future if things go wrong. This may imply that trustees will want a higher level of funding than previously, and will be less inclined to take account of expected future outperformance.

In setting their funding principles, however, trustees must take advice from the Scheme Actuary, and agree the principles with the employer. If the trustees cannot agree with the employer, then the new Pensions Regulator will get involved, and would have the power to set the funding principles itself, among other things.

Actuaries and the Actuarial Profession

The Actuarial Profession in the UK has the opportunity to set out guidance to its

members, which would limit the advice that can be given to trustees when setting funding principles. It has chosen not to do so, as it believes that the decision is one for Government, not for the profession.

Individual actuaries will therefore have to make their own choices when advising the trustees, and will themselves have more responsibility than previously, because the trustees will be relying on the advice when setting their principles. This again implies a stronger funding test than previously. However, it is also likely that employers will want to take their own separate advice, and this advice will be pushing in the opposite direction. Note that this need for extra advice will in itself increase the costs of DB provision.

Many actuaries now believe it is inappropriate to take advance credit for investment outperformance because it may well not materialise.

Employers

Employers will on the whole be looking to keep down costs; otherwise DB provision ceases to become a viable option. It might seem that this is just a question of cash-flow timing: a stronger funding standard now means more money in now, but less money later. However, as the trustees control the investment decision, in general trustees with more money now will take fewer investment risks; they do not need to take risks to have enough money to pay the benefits so they will not do so. Therefore, the opportunity for expected outperformance will be lost by the scheme, and the actual cost will increase.

If an employer has to pay sufficient money into a scheme to guarantee benefits, it is better to pay that money into a DC scheme rather than a DB one. The point of DB is that the risks can be

managed by the employer better than by any individual. If the money paid is sufficient to eliminate the risks, then DC is equally as good, but with a lower cost of compliance. Employers will not provide DB benefits unless they are allowed to take investment risk, and take advance credit for it.

In the meantime, faced with trustees asking for higher contribution rates, employers are going to have to say to trustees that there is a limit to what they can pay, and in many cases prove to the trustees that their financial covenant backs up that statement.

The Regulator

The Regulator has made it clear that it does not want to get involved in arguments between the trustees and the employer, and that they should work hard to resolve their differences between themselves. However, in many cases the trustees and employer may both be bound by their conflicting responsibilities, and unable to reach agreement, so it is likely that the Regulator will have to step in more frequently than it currently hopes.

It will be interesting to see what approach the Regulator takes when it does step in, because it will then be placed in the position of trying to implement the Government's conflicting desires. On the one hand the Regulator is responsible for making sure benefits are secure and schemes do not fall into the PPF. On the other, the Regulator will not want to be seen to be bringing down companies with crippling pensions costs.

Conclusions

There is a lot of uncertainty in the UK DB pensions market at the moment. Employers with DB schemes cannot currently get out of them because the cost of securing benefits on wind-up is unaffordable, and is now a debt payable by the employer. However, the majority of schemes are now closed to new members if not to future accrual of benefits, and any increase in the funding requirements will hasten the trend away from DB.

Adequate pensions are expensive to provide. The only way to achieve the pensions that society in the UK expects, and at the price that the UK is prepared to pay, is to take some investment risk. DB schemes help members manage that risk by passing some of that risk on to companies, but employers cannot be expected to shoulder the full responsibility. DC schemes keep virtually all the risk with the member, and as such do not work so well to fill the gap in pension provision.

The new SSF regime in the UK is attempting to walk the line between protecting members and allowing schemes to take risks, by not actually saying which side it is favouring. The regime came into force in September 2005, but will not affect many schemes until their next actuarial valuation (which could be up to three years away). The true impact of SSF remains to be seen, but this Editorial hopes to have given a flavour of the difficult discussions ahead.

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