Editorial: MFR — Past and future?

History

In September 1993, the Pensions Law Review Committee chaired by Professor Roy Goode reported on the findings of its Inquiry, having been asked by the UK Government to perform a comprehensive review of the law relating to occupational pensions. One of its recommendations was the establishment of a Minimum Solvency Requirement (MSR).

The Minimum Solvency Requirement would be that each scheme should hold sufficient assets to cover its discontinuance liabilities measured in a prescribed way. The measurement of liabilities should be based on the cost of purchasing annuities in respect of current pensioners and associated survivors' benefits, and on cash equivalents for the benefits related to active members and deferred pensioners. The cash equivalents would be calculated on a basis laid down in legislation and/or associated professional guidance and this was intended to take account of returns on equities as well as on bonds. The MSR would take no account of any discretionary benefits; the discontinuance liabilities would be based only on entitlements.

The Government accepted this recommendation and proceeded to consult on the details of its implementation. Lobbying by companies with large pension schemes resulted in an amendment to the original proposals, in that schemes with relatively large pensioner liabilities (in excess of £100m) would be allowed to measure those liabilities partly by reference to expected returns on equities. This easement was justified on the grounds that large pension schemes were likely to continue as closed schemes, rather than purchase annuities, in the event of discontinuance and they might continue to invest partly in equities to cover these liabilities. The actuarial profession lobbied for a change of name, from Minimum Solvency Requirement to Minimum Funding Requirement (MFR), and the Government duly acceded to this request.

The actuarial profession was asked to produce a guidance note to cover the details of the calculations and it required further guidance from the Government as to its policy intentions. In particular, the Government indicated that the cash equivalents should be sufficient to give a reasonable expectation (taken to mean a 50 per cent chance) of providing equivalent benefits if invested through a personal pension scheme (an individual defined contribution arrangement). The professional guidance was duly issued as GN27: Retirement Benefit Schemes — Minimum Funding Requirement. Various amendments have been made to the guidance which is now in its fifth version.

The MFR test

The valuation of liabilities for the MFR takes account of investment conditions at the time of the valuation. The value of the pensioner liabilities, which is intended to approximate to the cost of

buying annuities, is based on the yield on Government bonds ('gilts') as at the valuation date, these being fixed-interest or index-linked as appropriate to the liabilities. For schemes with a large pensioner liability, the liability above £100m or that which applies to payments more than 12 years from the valuation date, whichever is less, is calculated on the basis of expected equity returns.

For active members and deferred members more than ten years from their 'normal pension age', the liabilities are based entirely on the expected return on equities. For those within ten years of normal pension age, a mixture of equity returns and gilt returns is used, such that for those at normal pension age it is entirely the gilt return that prevails. Special provisions apply where a scheme follows a gilts-matching policy as defined in the regulations, so that the value of the liabilities approximately matches that of the matching gilts portfolio.

At the time the MFR was introduced, the assumptions used to provide the expected return on equities implied equity dividend growth of about 1.5 per cent per year above price inflation. Subsequent amendments have effectively increased that assumed rate of dividend increase to about 2.5 per cent per year in excess of price inflation. While the original 1.5 per cent per year may have been considered a rather cautious 'best estimate', the current implied 2.5 per cent per year would be considered by many to be at the top end of the range of possible best estimates. What is most interesting is that the implied rate of dividend increase has changed so much, when dividend cover at 31st March, 1997 was almost identical to that on 31st March, 2001. It is hard to see the justification for such a change in these circumstances. For active members and deferred pensioners allowance is made for the expenses within personal pensions to reduce the effective yield on equities by 1 per cent per year. This represents a very broad brush which might be appropriate when considering a scheme's overall funding level, but is hard to justify when the same measure is also used for calculating minimum transfer values! (In the UK, deferred pensioners have the right to require a transfer value to be paid from the pension scheme to another pension arrangement of their choosing.)

It will be clear from the above that, although assets are taken into account at market value, the approach to MFR for non-pensioners is the traditional UK actuarial approach of a dividend discount model. This model, which is the subject of derision from some actuaries who would appear to be confused financial economists, is based on the premise that the return obtained on equity shares comprises dividends paid plus eventual sale proceeds. It would be hard to take serious issue with such a premise — the real area for debate relates to how one would make assumptions about the future dividends payable or the future sale proceeds. Suffice it to say that a broad range of different views exist as to the likely rate of increase of dividends and the likely eventual sale proceeds. This merely reflects the fact that nobody knows what equity returns will be over the next year, or indeed ten, 20 or 30 years. Indeed, those who object to such methods would normally claim that the returns to be expected on the assets held by the scheme are irrelevant — perhaps trustees should keep the money under their mattresses!

The MFR result gives rise to a minimum contribution, based on the same assumptions, amortising any deficit over five years (or until 2001 if longer). Special provisions apply where the MFR funding level is less than 90 per cent.

Myners

In 2000 the Treasury asked a further committee, chaired by Paul Myners, to investigate possible distortions in the way in which institutions invest. Despite the almost total lack of influence of MFR upon investment strategy, Paul Myners saw fit to take the opportunity to recommend the abolition of the MFR. Such a recommendation was seized upon eagerly by the Treasury, despite the relevant legislation having emanated from the Department of Social Security (now the Department for Work and Pensions) rather than from the Treasury. It was hopeful that the abolition would help its aims of persuading pension funds to invest more in equity, in particular private equity, or venture capital. Although the Government has accepted this recommendation it has not, at the time of writing, announced the date of the MFR's demise and has given, along with Myners, only vague hints as to what might replace it. It is ironic that the main change in asset allocation since the announcement has been a shift into bonds rather than into venture capital. Meanwhile, the Government is considering extending the period for amortising deficits to ten years and relaxing the requirements relating to funding levels less than 90 per cent.

The information available so far on the replacement for MFR does not give much comfort that the Government is prepared to bite the bullet on pension scheme funding.

Long term or short term?

The basic problem with funding targets is that long-term targets are incompatible with short-term targets. A long-term funding target is based on a presumption that the scheme will continue, whereas a short-term target is based on providing the accrued benefits if a scheme were to wind up immediately. Twenty years ago there was no problem because a long-term funding target would have provided sufficient assets on a winding-up to provide the benefits which had been promised. However, a series of legislative and other changes in the UK, including bringing in revaluation of deferred pensions, full vesting after two years' pensionable service and guaranteed pension increases, has resulted in the situation where a normal long-term funding target is insufficient to provide the winding-up benefits.

The basic question to be answered is therefore whether funding should be aimed at covering winding-up benefits at all times or, alternatively, can it reasonably be based on a presumption of a continuing scheme, except where this is obviously incorrect? If it is to be the former, then funding targets will need to be based on bond yields and most will need to be increased substantially. The additional funding which this would entail would result in many companies reducing the retirement benefits which they are providing. If a long-term funding target is adopted then, when schemes wind up, it will be expected that the assets will be insufficient to guarantee the accrued benefits.

For the MFR, the issue was fudged by adopting a short-term funding target (ie, based on winding up), but incorporating long-term measures by aiming only at a transfer value for non-pensioners. Since the transfer value (or cash equivalent) was based in most cases on assumed equity returns, the end result was a curious mixture of short-term and long-term funding targets.

The new proposals

The Government has stated that it intends the new arrangements to be based on long-term scheme-specific

funding targets. At first sight, therefore, the Government appears to have taken a decisive stance that security on winding up must take a back seat. However, the courage of its convictions appears to be strictly limited and it has stated that the new funding targets will be accompanied by a statutory duty of care on the actuary in respect of scheme members. This would suggest that the actuary might be held responsible if the funding arrangements result in insufficient assets on winding up. First impressions are that the Government has fudged the issue once more, but this time in a far more subtle and pernicious way.

Will this statutory duty of care effectively lead actuaries to use methods and assumptions which masquerade as long-term funding plans, but are actually more like funding for winding up? Without clear guidance from Government, or from the actuarial profession (which the Government is trying to avoid) the imposition of this duty combined with natural conservatism may well lead many actuaries down this road. Even if it does not, how prudent should the new scheme-specific funding target be? Very few pension schemes are currently funded on a 'best estimate' long-term basis. There is certainly good reason why they might not be, not least because it is impossible to match the liabilities with appropriate investments. A cautious assumption about future investment returns could be considered as providing an implicit mismatching reserve within the fund. This would be appropriate whatever investment strategy is being pursued, since there are significant risks associated with all strategies.

If a best-estimate basis is inappropriate, how big a margin of prudence should be included? Perhaps it should be such that the experience of the scheme might be expected to be better than the assumptions with a probability of 75 per cent, say. For equity returns, this might equate to a reduction of the order of 1 per cent per annum, which in turn might increase the relevant liabilities by 20–30 per cent. The likelihood of the Government specifying what it requires is small indeed. That would require it to have a clear view on the purpose of funding, and hence the principles to be followed, something which it has shown great reluctance to provide. We await the future with interest and trepidation.

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