Dear Sir or Madam

CALL FOR EVIDENCE ON PROPOSALS TO ALLOW THE SMOOTHING OF ASSETS AND LIABILITIES IN SCHEME FUNDING VALUATIONS

The ICAS Pensions Committee welcomes the opportunity to comment on the DWP’s call for evidence on whether to allow the smoothing of assets and liabilities in scheme funding valuations for defined benefit pension schemes.

We would not support the introduction of smoothing in scheme funding valuations on the grounds that there is sufficient flexibility within existing Regulations, which, if exercised would mitigate the impact on sponsoring employers from short-term changes in market conditions such as the current fall in gilt yields. The Occupational Pension Schemes (Scheme Funding) Regulations 2005 provide flexibility on the selection of interest rates used to discount future payments in the calculation of technical provisions. While the DWP’s call for evidence acknowledges this flexibility, current practice is constrained, in part, by concerns that The Pensions Regulator (TPR) will challenge technical provision calculations which discount future payments on anything other than market redemption yields on government or other high-quality bonds. Challenging TPR on this matter is expensive and time-consuming as it would require pension trustees to seek and consider additional professional advice.

We appreciate that TPR’s statement in April 2012 offers a degree of flexibility to sponsoring employers in relation to recovery plans with regard to strongly held views about future market conditions on the grounds that any incorrect assumptions are more easily mitigated. However, this approach fails to support pension trustees in applying the flexibility which currently exists within the law.

Under the 2005 Regulations, technical provisions do not need to be calculated using the market redemption yield on government or other high-quality bonds. Under Regulation 5(4)(b) the principles to be followed in calculating the technical provisions specify that the rates of interest used to discount future payments of benefits must be chosen prudently, taking into account either or both:

(i) the yield on assets held by the scheme to fund future benefits and the anticipated future investment returns, and
(ii) the market redemption yields on government or other high-quality bonds.
The first of the two approaches permits the use of long-term funding assumptions which are prudently established. As the run off period for defined benefit pension schemes is normally decades, it would not seem appropriate to adjust assumptions in the short-term, i.e. to use smoothing in response to short-term changes in the gilts market. At present, the gilts market is distorted by quantitative easing and there is a mismatch between supply and demand, with demand outstripping supply. Gilt rates are too low, therefore it makes sense for slightly higher rates to be assumed.

Using the first approach available under the 2005 Regulations, technical provisions could be established by using a method which is more appropriate to the circumstances of defined benefit pension schemes. Using a discount rate based on gilts is appropriate if a scheme is being bought out in short order but if a scheme has an employer covenant with a long run off period then option one under the 2005 Regulations offers an appropriate alternative.

We believe that there are a number of barriers to using option one which would need to be addressed before pension trustees can use the flexibility available to them under the law. We also believe that other benefits may arise from removing these barriers.

Existing arrangements seem to favour a compromise position as TPR is under resourced and is focusing on the affordability of recovery plan payments to the sponsoring employer. However, less expensive recovery plans devised from technical provisions based on method one would assume higher discount rates based on better investment returns. This in turn could increase investment in the economy and divert funds into DC schemes and auto-enrolment activity.

TPR’s approach to trustee knowledge and understanding (TKU) through the production of detailed codes of practice and regulatory guidance means that trustees never need to read the regulations. We believe that there would be some merit in a change of approach from TPR which would encourage pension trustees to refer to, or read, the 2005 Regulations and other key legislation.

Actuarial advice can also be a barrier to using option one. Actuaries are advising their clients that if they select a figure which is different from the gilts-based rate, then TPR will take issue with this. Therefore, while we understand why actuaries are taking this approach, actuarial advice appears to favour the giving of consistent rather than tailored flexible advice based on professional judgement. A change in approach from the TPR could encourage the actuarial profession to provide more flexible advice.

The DWP’s call for evidence, paragraph 13, refers to there being little firm evidence which demonstrates sponsoring employers concerns that high deficit repair contributions may be diverting funds away from their investment and job creation plans. However, the Pension Corporation’s findings on this topic have been reported in the press and on its website and it may be helpful for the DWP to consider these finding in more detail. By way of headlines, the Pensions Corporation estimates that since quantitative easing started in the UK in 2009, British companies have sunk £135 billion into defined benefit pension schemes and the cost to HM Treasury in lost tax revenues from this action is estimated to be about £30 billion.

We would be happy to discuss our views with you in more detail.

Yours faithfully

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