Please reply to:

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The Hundred Group
of Finance Directors

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The Pensions Regulator Policy Team
Pensions Protection and Stewardship Division
Department for Work and Pensions
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Dear Sir or Madam,

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

I am writing on behalf of the Pensions Committee of the Hundred Group of Finance Directors with regard to the above-named call for evidence. I am responding by separate cover to the call for evidence on whether to introduce a new statutory objective for the Pensions Regulator.

The Hundred Group represents the views of the finance directors of FTSE 100 and several large UK private companies. Our member companies represent almost 90% of the market capitalisation of the FTSE 100, collectively employing over 7% of the UK workforce and in 2011 paid, or generated, taxes equivalent to 13% of total UK Government receipts. Our overall aim is to promote the competitiveness of the UK for UK businesses, particularly in the areas of tax, reporting, pensions, regulation, capital markets and corporate governance. While this letter expresses the views of The Hundred Group of Finance Directors as a whole, they are not necessarily those of our individual members or their respective employers.

We are sceptical of the merits of allowing the smoothing of assets and liabilities in scheme funding valuations. Flexibilities already exist within the legislative framework for such valuations, and attention should instead by focused on ensuring that sponsoring employers are able to take full advantage of those flexibilities.

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?

In carrying out a scheme funding valuation it is important that a consistent approach is taken to place a value on both the pension scheme's assets and liabilities. Recent market pressures, including the Bank of England's Quantitative Easing programme, have led to gilt yields reaching historic lows in the UK. For the majority of schemes, whose liabilities are not fully matched and who set their discount rates with reference to gilt yields, current conditions

will have served to place an artificially high value on their pension scheme liabilities and hence (in the vast majority of cases) their deficits. Reporting overstated pension scheme deficits can be detrimental to the UK economy as it can stifle the ability of companies to raise finance which in turn can inhibit investment in future growth, job creation and ultimately further pension scheme funding.

Whilst we do not believe that it is necessary to introduce smoothing, as such, we do think that greater emphasis needs to be placed on the ability of schemes to set their discount rates with reference to a prudent assessment of the expected return on the pension scheme's assets, as opposed to what appears to be the Pension Regulator's preferred approach of mechanically setting them with reference to gilt yields, irrespective of market conditions. This approach is allowed for in the scheme funding legislation and would, in our view, serve to place a more consistent value on a pension scheme's liabilities versus the market value of their assets.

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

- **How should schemes calculate liabilities on a smoothed basis?**
- **Over what period of time should the smoothing occur?**
- **Would smoothing be a voluntary or mandatory requirement? Should there be any other restrictions applied to schemes if smoothing is used?**
- **Should schemes be locked into smoothing (if they choose to smooth) for more than one valuation cycle or permanently? Would this make deficit repair contributions more counter cyclical to the wider economy in the longer term?**
- **How would you apply smoothing to assets?**
- **Would smoothing enable the breadth of differing scheme circumstances to be appropriately accounted for (e.g. schemes that have hedging/risk management strategies in place)?**
- **Should this be a permanent or temporary change?**

As indicated above, we would not implement smoothing for the purposes of funding valuations and therefore have not answered these questions.

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

The advantage of smoothing is that it might lead to a lower value being placed on the funding deficit for some pension schemes, and also, if applied for a reasonably long period, that it might lead to less volatility in the level of that deficit. However, any approach to smoothing would need to be properly designed to ensure that it is robust enough to work consistently irrespective of market conditions.

If it is not properly designed then this could give rise to a number of disadvantages. If introduced on a voluntary basis, then smoothing would be likely to lead to gaming of the system. If, on the other hand, it is introduced on a mandatory basis, then smoothing could impact unfairly on those schemes that have introduced hedging strategies. It would be likely to reduce transparency and increase complexity (and hence cost). Given that smoothing, if introduced at all, is not likely to be introduced immediately, it is likely that by the time it is in place, many schemes will already have got past the 'worst' dates for mark-to-market funding valuations (and so smoothing could have the paradoxical effect of giving worse values than anticipated on a pure mark-to-market basis).

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?

We believe that the current funding regime has the potential to be sufficiently flexible to ensure that it does not prevent growth for UK companies and the UK economy. However, as mentioned above, an overly prescriptive approach to funding valuations (especially in relation to setting the discount rate assumptions) could act to restrict growth and investment, even where the legislative regime in itself does not do so.

Some of the positions taken by the Pensions Regulator in its April statement can be interpreted in such a way. For example, the statement that 'the regulator views any increase in the asset outperformance assumed in the discount rate to reflect perceived market conditions as an increase in the reliance on the employer's covenant' does not derive from the legislative framework (where the concept of employer covenant is not even mentioned). Indeed this could be viewed as being contrary to the scheme funding legislation where greater flexibility is implied in setting discount rates with reference to "either or both...the yields on assets held by the scheme to fund future benefits and the anticipated future investment returns and the market redemption yields on government or other high quality bonds". Such statements from the Pensions Regulator may therefore be viewed as introducing an additional requirement for trustees that does not exist in the legislation.

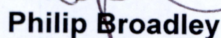
We would suggest instead that it would be beneficial for the DWP to engage with the Pensions Regulator to ensure that its regulation of DB funding does not act to inhibit companies' ability to invest in their businesses.

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 indicated above, we would not implement smoothing for the purposes of funding valuations and therefore have not answered this question.

I trust that these comments are useful.

Yours sincerely,



Philip Broadley
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The Hundred Group – Pensions Committee