Hundred Group - Pensions Working Party: Current funding issues

Executive summary and recommendations

The recent statement from the Pensions Regulator (TPR) on how it will regulate the funding of defined benefit pension schemes has been well received and should allow TPR to focus its resources on the schemes posing the greatest risk. However there are concerns that the use of IAS19/FRS 17 as a trigger, and for clearance, will drive behaviour in terms of both funding and investment.

Clearance of the Marconi – Ericsson transaction late in 2005 at a level well below buy out suggests that TPR may be prepared to allow the use of modern stochastic valuation techniques to set an appropriate lower level of security in such transactions. This in turn may allow new entrants into the pension termination market.

Although the threat of the use of the buy-out measure as a funding trigger has diminished, the working party wishes to discourage the use of the buy-out measure for funding and other purposes.

The working party would like surplus assets to be returned to employers sooner, more easily and with less tax penalty than currently applies, thus avoiding excessive use of contingent assets. Some scheme rules may restrict surplus refunds, and any change to the law is likely to take some time to implement. It would therefore be desirable if the tax treatment of contingent assets structures was aligned with that of pension schemes.

Background

Statement from the Pensions Regulator

On 4 May 2006, TPR published its statement on how it will regulate the funding of defined benefit pension schemes. It confirmed that it will look separately at the funding target, known as the *technical provisions*, and the time by which schemes in deficit aim to reach that target, the *recovery period*. If the triggers for either of these are failed, TPR will require the disclosure of more information and a dialogue involving secondary triggers.

TPR goes out of its way to state that the triggers are merely a resource allocation tool for its internal use to ensure that it doesn't demand superfluous information from schemes that already have adequate funding plans. They confirm this point by reminding trustees that they should not rely on the trigger mechanism to tell them whether they have been prudent. In establishing a prudent funding plan, Trustees need to take account of all the details of their own scheme, including the covenant of the employer and the nature of the assets and liabilities.

There will be twin triggers for the *technical provisions*. One will be the IAS19/FRS17 liability, where the directors choose the assumptions, after taking actuarial advice. The other trigger is the value of liabilities used for calculating the risk-based levy to the Pension Protection Fund (the 'Section 179 liability'). Mature schemes with weak sponsors will trigger towards the higher of the two, with immature schemes having stronger sponsors triggering around the lower.

The *recovery period* will trigger if it is longer than ten years, or if the contributions are either significantly backend loaded or assume an inappropriate level of investment return.

The main changes from the consultation document are:

- The relegation of the buyout measure from being a trigger in its own right, at the 70% to 80% level, to providing a sense check on the *technical provision* triggers. This change was made because of the difficulty of defining the amount of the buyout liability and due to fear that the trigger would be set too high for many schemes.
- Clarification that the triggers are not targets, and
- Discussion of the consequences of the difficulty the employer faces in recovering unneeded surpluses from schemes.

Although the Regulator had confirmed that the points identified are intended as triggers not targets, they may influence behaviour. In addition, IAS19/FRS17 is still used by the Regulator in the context of clearance. Concerns remain that the choice of IAS19/FRS17 will drive behaviour in terms of both funding and investment.

Subject to the concern about the use of IAS19/FRS17, the statement from the Pensions Regulator (TPR) on how it will regulate the funding of defined benefit pension schemes has been well received and we believe it should allow TPR to focus its resources on the schemes posing the greatest risk.

Marconi / Ericsson clearance

Until the clearance of the sale of the bulk of the Marconi business to Ericsson, many people assumed that, if funds were available, TPR would insist that they be used to provide security for members of a pension scheme up to the level of security provided by an insurance company (expressed as covering 199 out of 200 outcomes). However, TPR gave clearance for about £600 million to be returned to Marconi shareholders by way of a special dividend, on condition that just under £200 million was paid into the pension scheme, with nearly £500 million placed in an escrow account. Even if the whole of the escrow was treated as a pension asset, the assets would have covered only around 85% of the notional cost of securing the benefits with an insurance company. Stochastic techniques suggest this lower level of assets will be adequate in nineteen out of twenty outcomes. Such techniques have shed new light on the level of security provided in different scenarios and their use seems likely to grow.

Legislative focus on buy-out

The two developments above, covering clearance and funding triggers, suggest that the regulatory focus on buyout may be reducing. However it remains in determination of Section 75 debts, covering partial or complete termination, and there are suggestions that an accounting disclosure of the buyout position may be required in future. In addition there may be a risk that the Basle II solvency requirements for insurance companies may feed through into pension schemes, perhaps initially for financial services companies.

The imperfections of the buyout market are well-known, and have been thrown into sharper focus by the gyrations of the bond markets in recent months. Although that market is changing, with a number of new entrants seeking FSA approval, this alone would not ease the excess potential demand over supply for bonds. Indeed it could make it worse as the requirements for insurers to match their liabilities are greater than those for pension schemes. What would significantly ease the

pressure is if any of these new entrants chose to operate under the supervision of TPR, when they would hope to take on pension liabilities on terms similar to those underlying the Marconi clearance.

Although the threat of the use of the buy-out measure as a funding trigger has diminished, the working party wishes to discourage the use of the buy-out measure for funding and other purposes because it is based on a significant imbalance between supply and demand

Spreading of tax relief for large contributions

There is a tension between DWP's/Regulator's aim to boost funding levels as quickly as companies can reasonably afford and the Revenue's desire to spread tax relief where contributions exceed twice what was paid in the previous year. It seems fundamentally wrong that contributions required by Trustees, with the backing of legislation, may not attract immediate tax relief.

Consideration of a safety valve

To some extent, the concern over the short-term risk being carried by trustees in the event of the insolvency of the employer may be mitigated by the use of contingent assets such as property, a parent company guarantee or letter of credit. TPR has recently published guidance on the role that such assets can play in scheme funding. Whilst they provide a solution to some situations, suitable assets may not always be available and these arrangements will be complex and costly for both employers to set up and for trustees to monitor.

Of course, such solutions would be less in demand were it possible for assets within pension schemes to be returned to employers in a timely manner and with fewer legal hurdles when they were unlikely to be needed by the scheme. One of the key causes of tension between employers and trustees over pace of funding could be ameliorated if employers had confidence that overpaid contributions would revert to the employer, and not remain locked within the pension scheme where they can be used only for the benefit of the remaining members. The Regulator has had discussions with DWP about this issue, who have confirmed that they intend to keep the situation under review as the new requirements for the funding of defined benefit schemes are put into practice, and will consider the need for consultation on changes to current legislation in due course.

The working party would like surplus assets to be returned to employers sooner and with less tax penalty than currently applies, thus avoiding excessive use of contingent assets. If schemes were in surplus, any discussion on this issue would be difficult, but given current levels of funding, now would be an excellent time to debate the merits of a change in the law.

Some scheme rules may restrict surplus refunds, and any change to the law is likely to take some time to implement. It would therefore be desirable if the tax treatment of contingent assets structures was aligned with that of pension schemes.

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