Funding Standard Review

Submission by the Society of Actuaries in Ireland

June 2006

The Society welcomes the opportunity to comment on the Pensions Board's review of the funding standard.[1] Our responses to the questions posed by the Board are set out below. We would be happy to discuss our response in more detail with the Pensions Board if required.

We note and welcome that the Board is separately examining whether changes could be made to the current certification requirements in order to make contribution rates less volatile and to reduce the burden and cost of compliance.

We emphasise also the need to ensure that scheme members are made fully aware of the funding position of their scheme and of the benefits that they could actually expect to receive if the scheme were to be wound up.

Question 1 ***Which of the following does your organisation prefer***

- ☐ *No change to the current standard*
- ☐ *Option A*
- ☐ *Option B*
- ☐ *Option C*

Please explain the reasons for your preference.

Of the options presented, the Society's preference is no change to the current standard. Our view is that it remains appropriate to base the funding standard on the obligations of the scheme in the event of its winding-up.

We believe, however, that changes could be made to other areas of legislation that would increase the assets available if a scheme does have to wind up and would reduce the cost of providing members' entitlements. We recommend a fundamental review of the requirements in the event of a scheme winding-up. We also welcome the Board's proposal to investigate the use of contingent assets (such as letters of credit, securitised assets, etc).

Review of requirements in the event of a scheme winding up

We believe the review of the requirements in the event of a scheme winding up should include:

- how the assets are distributed (the statutory wind-up priorities), so as to share any shortfall more equitably between active and retired members, and
- the possibility of providing benefits other than 100% guaranteed annuities for pensioners.

[1] A copy of the Board's letter to the Society in relation to the review is attached as Appendix 1.

Statutory wind-up priorities

Whilst acknowledging the potentially vulnerable financial position of retired members, the Society believes that the current wind-up priorities are unfair and provide a disproportionately high level of protection to pensioners, particularly when compared to older or long-serving active members. As we have previously proposed, we believe consideration should be given to some "levelling up" i.e. giving the same priority as pensioners' benefits to an element of the benefit entitlements of other classes of members, in particular for those approaching normal retirement age.

We also believe that benefit entitlements for those who have taken early retirement should be treated on the same basis as benefit entitlements for active and deferred members until the members concerned reach normal retirement age. This would have the benefit of facilitating individuals who wish to retire early from underfunded schemes, while protecting those schemes from further deterioration in their funding position.

The priority level of pension increases and deferred pension revaluation, and the distribution between older and younger active members, could also be reviewed. A further alternative option would be to give priority to a basic minimum amount of benefit for all classes of members, ahead of the current priorities.

Alternatives to 100% guaranteed annuities for pensioners

We suggest giving serious consideration to possible alternatives to the requirement to secure pensioners' benefits by purchasing matching guaranteed annuities in the event of a scheme winding up. Trustees could be invested with the power to secure the pensioner liabilities in alternative formats, which could include:

- the substitution of a higher amount of level pension for a pension with guaranteed increases
- the substitution of an annuity that carries a limited level of investment risk for a guaranteed annuity, or
- converting pensions in payment to lump sum transfer values which could be invested in ARFs.

To the extent that the substitute benefits could be provided at lower cost, it would enable a higher proportion of the benefit entitlements for active and deferred members to be met, in the event of the scheme being underfunded on wind-up. The substitute benefits could also have attractions for the pensioners concerned.

We believe, however, that the ARF alternative should only be available to trustees in respect of pension benefits in excess of a specified threshold that is considered adequate, from a public policy perspective, to ensure an appropriate level of income security.

It would also be important to ensure that all concerned understand clearly the trade-offs involved in any of the above benefit substitutes e.g. in the case of the ARF alternative, the trade-off for pensioners is between flexibility and control of capital on the one hand, and income security on the other.

Review of the treatment of contingent assets

Rather than weaken the funding standard, we would prefer that the focus should be on considering more flexible ways for employers to meet their funding standard obligations. In particular, bearing in mind that the majority of schemes do not wind up, we are interested in exploring the possibilities for meeting funding standard liabilities partly with contingent assets, rather than having to match liabilities in full with assets held under the scheme trust. This would help to address, in particular, the situation in which a scheme is fully funded on an ongoing basis but does not meet the funding standard. In this situation, it would provide an alternative to the payment of contributions that will only be required if the scheme winds up, but, once paid into the scheme, cannot be recovered by the employer for many years, if ever.

We appreciate that there are many significant issues in relation to the use of contingent assets, and that legal and other expert advice will be required in this area. We believe, however, that the Board should actively consider this, and should develop published guidelines for schemes wishing to consider the use of contingent assets.

Basis for valuing pensioner benefits

We believe that the basis for valuing pensioner benefits for the purpose of the funding standard should continue to reflect what would actually happen if the scheme had to wind up, and we are therefore not in favour of option B as outlined. There are, however, practical difficulties associated with the use of quoted market annuity rates, for example:

- Access to market quotations (only one annuity provider offers an online quotation system)
- Lack of transparency as to the basis underlying quoted rates, which causes practical difficulties in valuing liabilities for large numbers of pensioners
- Changes to quoted annuity rates may lag changes in bond yields.

It may therefore be appropriate to consider introducing a prescribed basis which would generally reflect the basis on which annuities are priced.

Question 2 ***Is there an alternative approach to the funding standard that your organisation would favour? If so, please describe in as much detail as possible, including your views on the effect it would have on defined benefit schemes that meet the standard and those that do not.***

Other than as outlined in response to question 4, the Society does not favour an alternative approach to the funding standard. We have, however, identified in response to question 1 associated issues which we believe merit consideration.

Question 3 ***If the funding standard is separated from winding-up entitlements, i.e. options B1 or B2, would you favour a mandatory employer debt on scheme wind-up of the shortfall relative to the winding-up entitlements? Please give the reasons for your views.***

The Society does not support separation of the funding standard from wind-up entitlements, nor would we favour a mandatory employer debt on scheme wind-up.

We believe that it could prove difficult in practice to introduce a mandatory employer debt, and we note also that the introduction of the measure could prompt a rush to wind up schemes before the debt provision took effect. In addition, there will be cases where the employer is insolvent and few, if any, assets would be available to meet the debt.

We are in favour, however, of measures to enable employers to meet part of the obligation through the use of contingent assets.

Question 4 ***Would your organisation favour the adoption of options B or C voluntarily in conjunction with a voluntary employer debt.***

The Society would support the adoption of option C voluntarily in conjunction with a voluntary employer debt in respect of the wind-up liabilities. This is similar to Option F outlined in the Society's submission to the 2004 review of the funding standard. We note that:

- If this approach were adopted, there should continue to be a requirement to disclose the discontinuance position fully and clearly to members.
- We believe that, within an ongoing funding standard, the valuation of pensioner liabilities should continue to be bond-based, with appropriate allowance for mortality improvements.
- The trustees would need to be independent of the employer and would need to agree to the adoption of an ongoing standard in conjunction with the employer debt.
- The financial soundness of the employer is an issue in determining whether a debt on the employer is of value. However, it is reasonable to presume that the trustees will take this into account in deciding whether to agree to the discontinuance deficit being made good over a longer period.
- We envisage that a minority of schemes would be in a position to avail of this alternative option.

Summary

In summary, our views are as follows:

- the funding standard should continue to be a wind-up standard, *but*
- there should be a fundamental review of what happens on wind-up, and
- we are interested in exploring the possibilities for meeting funding standard liabilities partly with contingent assets, rather than having to match liabilities in full with assets held under the scheme trust.

We also emphasise the need to ensure that scheme members are made fully aware of the benefits that they could actually expect to receive if the scheme were wound up.