



# Joint Colloquium of the IACA, PBSS and IAAHS Sections of the International Actuarial Association

Westin Copley Place Hotel, Boston, U.S.A. – 4-7 May 2008

## **“Trust and triggers”: The UK approach to the prudential regulation of occupational defined benefit pension plans**

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# Trust and triggers

- Defined benefit (DB) pensions in the UK
- The problem in 2003:
  - Familiar issues
  - Specific UK issues
- The legislative solution
- The regulatory challenge and insights
- The Pensions Regulator's approach – triggers not targets
- Impact on the market
- Comparisons with the 'solvency' approach
- Conclusions

# Defined benefit (DB) pensions in the UK

- 8,000 private sector occupational pension schemes
- 14 million members - under 4 million active
- Trust-based with employer and member nominated trustees investment responsibility
- Mandatory indexation and revaluation of benefits
- Employer “guarantee”
- Assets of around \$1,600 billion (2007 figures)
- Triennial valuations
- Great diversity in scheme size and funding levels

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# **The problem in 2003 – familiar issues**

- Perfect storm of falling asset prices and falling bond yields
- Increasing longevity
- Introduction of FRS17 (IAS 19) disclosed large deficits
- Flight from DB to DC, reducing employer interest in ‘legacy’ provision
- No consensus on how to measure liabilities

# **The problem in 2003 – specific UK issues**

- Prudential regulation limited to the ‘Minimum Funding Requirement’ (MFR)
- Limited role for the pensions supervisor (Opra)
- Role of trustees also limited
- High profile scheme failures, due to employer insolvency or walking away
- Made worse by a priority order on wind-up weighted against active and deferred members
- Need to implement the EU Pensions (IORP) Directive from September 2005

# The legislative solution

- From 2003, employer liable for full pensions debt, unless benefits bought out with regulated insurer
- Pensions Act 2004:
  - Created the Pension Protection Fund (PPF)
  - changed the priority order upon insolvency
  - Replaced Opra with a new risk-based regulator (TPR)
  - Scrapped the Minimum Funding Requirement (MFR)
  - Required triennial actuarial valuations of technical provisions to be based on ‘prudent’ assumptions chosen by the trustees
  - Instituted ‘concrete and realisable’ recovery plans to recover deficits
  - Trustees given a veto over funding targets and recovery plans
  - Came into force during 2005

# **The Pensions Regulator (TPR) established April 2005**

- Statutory objectives (Section 5 Of Pensions Act 2004) to:
  - Protect the benefits of members of work-based pensions
  - Reduce the risk of calls on the Pension Protection Fund
  - Promote good scheme administration
- Issued a code of practice on scheme funding
- Receives all recovery plans and obtains funding information through annual scheme returns
- Can challenge scheme funding targets that are not based on prudent assumptions or inappropriate recovery plans
- Can impose a solution where trustees and employers fail to agree
- Extended powers to replace or supplement trustee boards

# **TPR's role in enforcing the employer debt**

- ‘Moral hazard’ powers in the Pensions Act 2004 to protect the Pension Protection Fund:
  - Contribution notices
  - Financial Support Directions
- A duty on TPR to clear corporate transactions:
  - giving assurance that it would not use moral hazard powers
  - process is voluntary
  - has improved scheme funding relative towards IAS 19 levels, and sometimes beyond
  - raised awareness of the trustee role in relation to the employer debt

# **DB funding - the challenge for the Pensions Regulator**

- No statutory funding target - each scheme's target specific to its circumstances
- Recovery plans to be “as short as reasonably affordable” for the employer
- Limited constraints on how liabilities valued
- Key terms such as “prudent” and “reasonably affordable” not defined
- Limited evidence base...
- ... but a common view that funding levels were too low
- Risk of “liberty hall”
- Too many schemes to intervene in all of them
- Huge risks if challenges not addressed

# The evidence available to the Pensions Regulator

Research (notably from PWC) showed that:

- Minimum Funding Requirement and pre-existing scheme valuations commonly well below IAS 19
- Most employers could afford to restore funding to IAS 19 within 10 years
- Funding to IAS 19 would substantially reduce risks to the PPF
- The IAS 19 liabilities already affected share prices
- The impact of such a shift on the economy and financial markets would be limited

# The essence of the UK approach - moving from targets to trust

Two key insights:

- Insolvency risk is the most important risk for UK DB plans
- Trustees run the scheme – not the supervisor

One equation:

$$A + E \geq L(b/o)$$

A = scheme assets; E = employer covenant; L(b/o) = liabilities valued at cost of exit (buy-out by insurer)

# **Insolvency risk is the most important risk for UK DB plans**

- In the UK context the best security for scheme members is an ongoing scheme with an ongoing employer
- Scheme assets are just (one form of) collateral
- Employer insolvency risk is therefore the biggest risk to members (and the PPF):
  - outside trustees' control (so long as recovery plans are reasonably affordable)
  - difficult to quantify and highly scheme specific
  - affects how much investment risk a scheme can run
- There are well-developed approaches to addressing other scheme risks, notably investment and longevity

# Trustees run the scheme – not the supervisor

- Supervisor relies on commitment of the trustees...
- ... and the skill of the scheme actuary
- Fiduciary role should align with regulatory objectives
- Trustees are the front-line supervisors - they should know best
- Role of supervisor is to ensure that the system works, by:
  - helping to empower trustees, through information, guidance and direct help
  - not disempowering them - TPR uses its power to set funding targets as a last resort
  - strengthening the trustee board where necessary
  - encouraging actuaries to be effective in supporting the trustees
  - acting as a ‘referee not player’

# Moving the market

TPR needed to move pension plans towards:

- a shared understanding of its insights
- higher funding levels
- shorter (but reasonably affordable) recovery plans

TPR did this by:

- Consulting extensively on its approach
- Seminars, speeches and other communications

# The Pensions Regulator's approach - triggers not targets

- During 05/06 TPR developed a system to trigger regulatory intervention where:
  - Technical provisions valued below IAS 19 level or PPF insurance valuation level (S. 179)
  - Recovery plans longer than 10 years or back-end loaded
- Triggers are **not** targets – many schemes that trigger are not challenged
- Emphasis on trustees negotiating agreements with employers

# Risks to the approach

- Attitudes not changed
- Trustee conflicts of interest
- Actuary conflicts of interest
- Trustees not reviewing the employer covenant
- Trustees unwilling to challenge the employer
- Trustees relying on TPR to negotiate for them
- insufficient attention to mortality improvement
- Systemic risk

*Hence improving governance is key*

# Impact on the market

- The market has moved!
- Changes in trustee and actuarial attitudes
- Evidence (published in Sept 07) from first 1,292 recovery plans:
  - As expected, great diversity across schemes
  - Most schemes recognise making prudent assumptions for calculating technical provisions - with average TPs close to the IAS 19 level
  - Of the 70% of recovery plans that triggered, most needed only minimal TPR action (such as requesting further information/clarification)
  - In only 10% of cases has TPR concern about the plan led to regulatory intervention - TPR expect many of these to be resolved by agreement.
  - Over 80% of schemes are producing plans no longer than 10 years in length, with an average of 7.5 years
  - TPR hope that future recovery plans will take into account more recent arguments for strengthening mortality assumptions

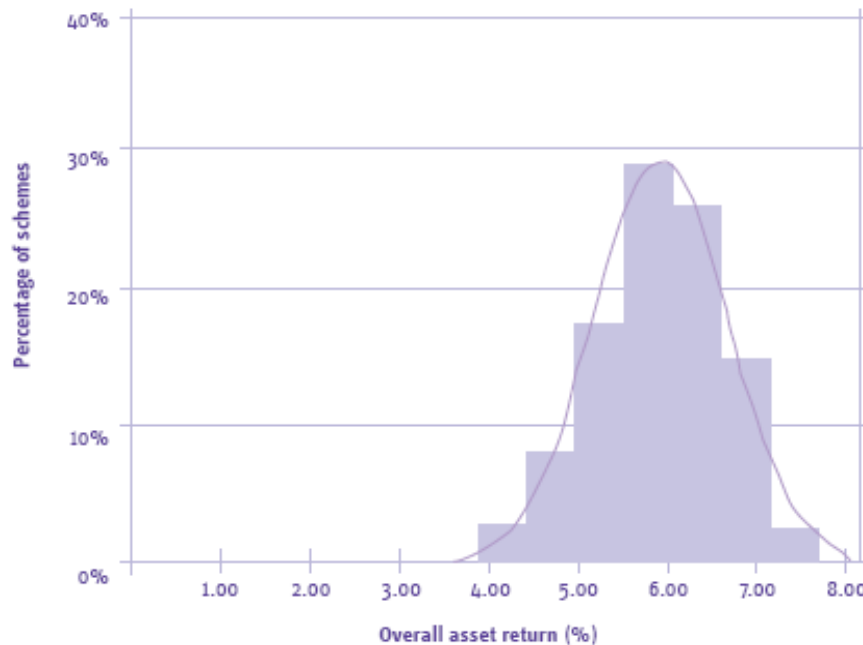
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# Spread of asset returns assumed

**Figure 2.4**

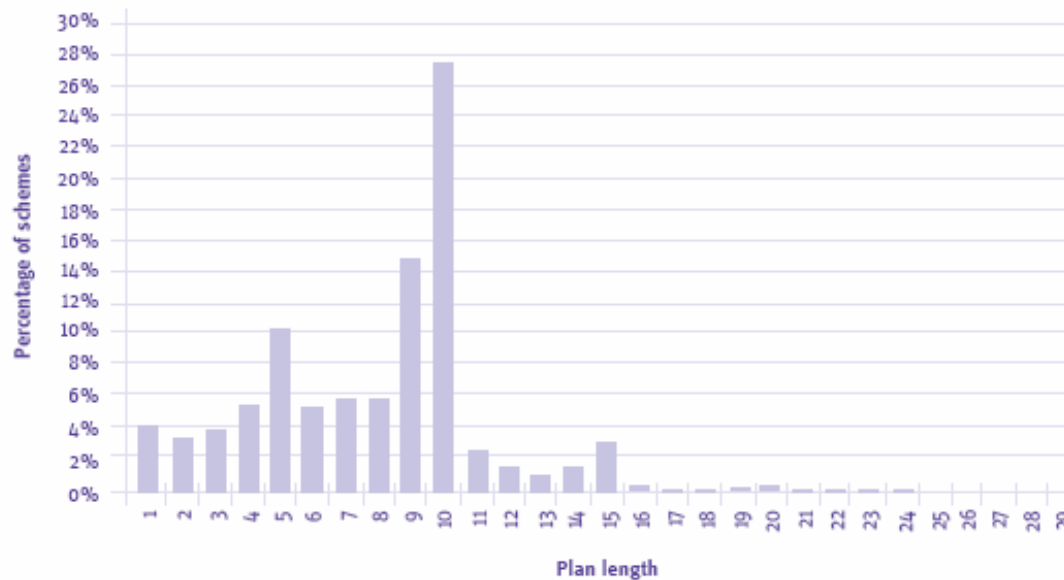
Distribution of overall asset return assumed for the length of the recovery plan



*Base: 1,182 schemes at 30 July 2007*

# Spread of recovery plan lengths

**Figure 2.3**  
Distribution of recovery plan length



*Base: 1,236 schemes as at 30 July 2007*

# How the UK compares

The 'solvency' approach	The UK approach
Rules for calculating technical provisions	Trustees choose own prudent assumptions - reflecting scheme specific nature of sponsor risk
Solvency buffers to keep funding above technical provisions (TPs)	Solvency risk included within concept of prudence – hence risk buffers within TPs
Supervisory focus on investment risk	Supervisory focus on sponsor and longevity risk
Pension plans intended to be self-financing regardless of sponsor position	Supervisory effort to maintain the sponsor link so far as possible – rely on the PPF upon insolvency
Maximum length for recovery plans	Recovery plan duration depends on reasonable affordability

# Conclusions

The UK approach gives sponsor risk centre stage:

- but, does not guarantee the full 'pensions promise'
- places reliance on trustees – requiring a focus on improving governance
- relies on a PPF that is exposed to systemic risk

It differs from the 'solvency' approach, which :

- seeks to make sponsor risk irrelevant
- relies on the supervisor being right - predicting the future on the basis of the past
- has a higher cost (at least in the short term) that may make it impracticable
- can dis-empower employers and trustees

Both approaches struggle with increasing longevity