International Actuarial Association: International pensions seminar

Protecting the Interests of Members of Private Pension Funds

The Minimum Funding Requirement in the UK   Peter Tompkins

A The Origin of Pension Funding

1 For most of the 20th century, the United Kingdom saw a significant expansion in the quantity of defined benefit pension provision made by employers, starting mainly with the public sector and moving gradually to large private corporations and ultimately most businesses other than those of a very small size.

2 The public sector generally provided a pension of 1/80th of final earnings for each year of employment and a lump sum of 3 times that; the private sector tended to provide pensions of 1/60th of earnings for each year of service. In both cases the effect was to build up over 40 years to replacement levels close to two-thirds of income before retirement.

3 The Government generally did not set up funds but promised to pay pensions out of future taxation. On the other hand, companies set aside funds and the authorities gave privileged tax status by exempting these funds from tax on their income or their gains. Pension funds thus became a useful tax shelter and so it was good sense for employers to fund their obligations to the separate trust, because of the tax benefits this bought. The authorities were more concerned to make sure that people did not put too much away and controls were introduced at various times to limit how large the funds could be.

B Funding not compulsory

4 One of the surprising elements of the funding regime in the UK is that it was voluntary. Employers did not have to set aside funds and indeed it was often the case that a company setting up a new pension plan might provide benefits which included benefits for service that an employee had already performed (for example if the company had until then had a practice of paying pensions which were discretionary but habitual.

5 To start the pension plan going they might, for example, create a plan with some assets in the holding company, for example company shares or loan stock, or the plan might simply be set up with a significant deficit between what it could afford and what it was intended to pay. Over a number of years the employer would tend to pay high enough

contributions to bring the plan up to a satisfactory level of funding, as the trustees would be concerned to see that funds eventually reach the plan.

C Contracting-out

6 In 1978 the UK introduced a partial privatisation of its state pension arrangements. The state benefits were from that time considerably increased with an earnings-related state pension, but those who had their own pension plans that did provide at least as good a benefit could "contract-out", which meant that the private plan provided a pension instead of the state.

7 The rules surrounding contracting-out were fiendishly complicated, but one in particular stands out for us. Actuaries were given the statutory responsibility of certifying that plans had enough assets to meet their liabilities for contracting-out. The authorities wanted to make sure that they would not be called upon to make good shortfalls if plans wound-up without enough assets to pay the benefits the state would have provided. The real reason for this was that the government gave rebates of social security contributions to allow people to belong to private plans instead.

8 Still, for plans that have been going for a long time, the contracting-out part was quite small, as it only began to be earned after April 1978. So it was still possible for a plan to be significantly underfunded compared with the cost of providing the benefits people might be expected to receive.

D Maxwell

9 In 1991, Mr Robert Maxwell, a media tycoon, was found to have defrauded the pension plans of his various businesses by using their assets to prop up failing parts of his media empire. At the end of the day, most of the pension plan participants did receive their benefits in one form or another, including the state picking up some of the cost of the benefits which would have been provided by the State were it not for contracting-out. But this scandal ensured close attention was given to pensions. The politicians of the day decided that there should be requirements for funding plans and that the voluntary approach which had existed up until then was not the right way to continue.

10 A committee headed by Roy Goode put together proposals which led in due course to legislation to provide for a minimum funding requirement (MFR). Initially this was

called the minimum solvency requirement (MSR), but the actuarial profession pointed out that the only way that the solvency could be guaranteed would be far too expensive for plans. This would involve having enough funds to buy-out inflexible fixed annuities for members of plans and deny the sponsors of plans the ability to have them invested in equities if they believed they would be likely to yield better returns over the long-term.

11 So after the debate in parliament the requirement was renamed a Minimum Funding Requirement and the profession helped the government to set a basis which at the time (1995) appeared to be an appropriate one to set as the minimum level of funding.

E Design of the MFR

12 The most difficult part of the process was the choice of a suitable basis for this MFR. At one extreme, one might have defined it entirely by reference to bonds, being the only investments which could strictly be defined as matching the liabilities as they fall due. At the other, employers and trustees wanted the freedom to invest in equities, which had and continued to be high performing assets. A compromise needed to be found and ultimately it was built around the following principles:

- for pensions in payment the liabilities should be assessed by reference to yields on either fixed interest or inflation-linked bonds, depending on the form of the liabilities; and
- for those yet to reach retirement age, the reference assets were to be UK equities.

13 A number of other features worth noting are:

- a blending took place for the 10 years before retirement to mimic a switch from equities into bonds over that period;
- mortality was set as a standard, to cover all plans, irrespective of the fact that different industries or regional groups do exhibit quite significant variations in mortality rates;
- expenses were allowed for, on a tapering scale starting at 4% for smaller plans and reducing to just over 2% for the largest plans.

14 One notable change negotiated during the passage of legislation was for very large plans where the liabilities for pensioners were more than £100 million, some of the pensioner liabilities could be accounted for by returns on equities rather than the returns on bonds.

15 The full set of financial assumptions specified was as follows:

	% per annum
Rate of inflation	4
Rate of salary growth	6
Effective rate of return on government bonds	8
Effective rate of return on equities – pre-MFR pension age	9
Effective rate of return on equities – post-MFR pension age	10
Rate of statutory pre-retirement revn for deferred benefits	4
Rate of LPI increase in payment (inflation up to 5%)	3.5

16 In order to allow the funding requirement to vary as the financial markets moved, a set of market value adjustments (MVAs) was designed to adjust the funding requirement as dividend yields on UK equities varied and as the value of fixed interest or inflation-linked bonds changes. For equities, the initial specification was that the MVA was the ratio of 4.25% to the gross dividend yield on UK equities as measured by the FTSE Actuaries All-Share index.

F What went wrong?

17 The MFR came into force on 6th April 1997 and 4 weeks later the government was overturned in an election, following which the very first act of the new government was to remove the tax privilege on investment income that pension plans had enjoyed for the previous three-quarters of a century. The MFR was immediately broken because pension plans could no longer receive the gross dividends, as they would bear tax at 20%.

18 After some months of discussion, the MFR was changed a year later, but the only alteration was to switch the MVA to be the ratio of 3.25% to the net dividend yield. The change was actually a bit more than would have been indicated by the loss of the 20% tax relief, but that was because dividend yields had already been declining quite sharply because of reduced payouts by companies, a trend which was to accelerate.

19 Over the ensuing 2 or 3 years, companies continued dividends and change their practice to include such novel approaches and share buy-backs, so much so that a complete overhaul of the MFR was called for, for the following reasons:

- The world did not exhibit the same kind of financial returns and parameters as were set out at the start and are shown in the table above, when inflation had fallen to around 2.5% and returns on government bonds were down below 5%.

- The stability of equity dividend payments was no longer a sensible basis on which to plan a measure of equity returns.
- There was a growing recognition that funding standards were best set by reference to more objective bond figures than by the suggestion that equities were a match for salary-related liabilities.
- Accounting standards were already moving to adopt bonds as the best measure of the cost of providing pensions.

20 Many other criticisms were levelled against the MFR regime, most notably:

- The fact that the asset mix was not something pension plans could actually match, in practical terms or indeed in relation to an available stock.
- The MFR calculation made no allowance for overseas investment and property investment.
- The complexity of scheduling contributions for employers to pay on an annual basis was both administratively costly and placed undue focus on the short-term.
- The mortality rates were already far too strong given increased life expectancy but most notably
- Pension funds which were 100% funded on the MFR might not have enough to pay benefits.

21 In the context of this, the profession was asked to review the MFR and come up with a proposed replacement.

G A new MFR?

22 The purpose of this paper is not to describe the whole of the current debate on the MFR, but the profession effectively reached the conclusion that the only sound funding test was one based on bonds, recognising the considerable growth in availability of corporate bonds and measuring the cost of providing for pensions against investment in corporate

bonds over the whole period before and after retirement. This was not to say that investments would have to be made in such assets, but the implication that any plan that was not so invested would exhibit considerable volatility against a corporate bond measure meant that the funding of final salary plans would become even less attractive.

23 The proposal was not accepted and the government decided instead to abolish the MFR completely and attempt to return to the status quo ante, with perhaps slightly more emphasis and responsibility placed on the actuary.

24 Their conclusion was that:

- There should be a new statutory duty of care by scheme actuaries to members
- Each scheme should have its own specific funding standard
- Employers should guarantee pension promises on winding-up
- Stronger protection for fraud

H What next?

25 We are currently in a period of considerable uncertainty, as the government has indicated its intention to remove the MFR, but this may take 3 or 4 years to achieve. Meanwhile, companies continue to cut or pass their dividends and actuaries continue to schedule MFR contribution levels, even though the regime is to go. Key questions for the profession are:

- What will the actuary's statutory "duty of care" be and how will this be defined?
- How will plans report on their solvency level? This is a subject the profession is very keen to promote in order that plan participants are not misled into a false sense of security.
- How will actuaries set valuation bases in the future, given the tension that could exist between employers and trustees?
- How will the new regime allow or encourage transfers between different types of pension arrangement and provide fair value for those leaving final salary pension plans?

26 It is a challenging time for the UK profession, who have been given considerable responsibility by the government to take a leading role in this area. Getting it right should ensure a high quality of member protection but failing to monitor solvency and provide adequate information to members of pension plans could leave the profession the subject of potentially serious criticism.

27 The profession will be interested to draw on experiences in other countries as we embark upon discussions with the government about the way in which our role is enhanced and developed over the months and years ahead.