A CENTRAL DISCONTINUANCE FUND FOR PENSION SCHEMES

J M Black, G Booth, D R Cooper, G A Devenney, G T Russell,
C G Singer, C M Stewart and A N Walton

Staple Inn Hall

20 October 1999

A CENTRAL DISCONTINUANCE FUND FOR PENSION SCHEMES

by J M Black, G Booth, D R Cooper, G A Devenney, G T Russell,
C G Singer, C M Stewart and A N Walton

Presented to the Staple Inn Actuarial Society, 20 October 1999

1. Introduction

1.1 In June 1998, the Technical Support and Research Committee of the Pensions Board set up a Working Party to investigate the arguments for and against the use of a Central Discontinuance Fund for UK pension schemes, under the following terms of reference:-

To attempt to define what a Central Discontinuance Fund is and what it is designed to cover.

To assess the risk covered under the insolvency of the company sponsoring the pension scheme, and look at the impact of the Pensions Act 1995.

To assess alternative ways of financing the risks and give a technical analysis of the alternatives.

To attempt to obtain input from a variety of organisations, including the NAPF, major employers, insurers, GAD and government departments.

1.2 The authors of this paper are the members of the Working Party. In addition, Mr P M Greenwood of the TS&RC attended most of our meetings and we gratefully acknowledge his help and guidance.

1.3 This paper to the SIAS consists of our report to the Technical Support and Research Committee, virtually without alteration. The matters dealt with from Section 2 onwards are as follows:-

2. The original proposal that a Central Discontinuance Fund should be created

3. The Pensions Act 1995

4. Risks faced by members of defined benefit pension schemes

5. What is a Central Discontinuance Fund, and how might it operate?

6. Consideration of long-term guarantees and uncertainties

7. Operation of a Central Discontinuance Fund in conjunction with a new Minimum Funding Requirement

8. Ensuring a sufficiency of assets at the time of discontinuance, and subsequently

9. The way forward

Appendix: Problems of small schemes in the Pensions Act 1995 environment

Addendum: Note on the operation of the P.B.G.C. in the U.S.A.

1.4 The Pensions Act 1995 introduced a raft of measures aimed at ensuring that defined benefit schemes would maintain a level of funding sufficient to enable the trustees to secure the members' accrued benefits if the scheme were to be discontinued. This meant the purchase of annuities for those already in receipt of pensions, and the payment of a fair actuarial value of the accrued rights of other members. If the assets available were less than this minimum funding requirement (MFR), the shortfall would be a debt due to the trustees from the employer. Unfortunately, this ranked only as an ordinary debt in bankruptcy proceedings, so that it was not likely to help much in the majority of cases. Moreover, even if the assets available corresponded to the prescribed MFR, they would still fall short of the actual cost of securing the accrued benefits, so that pensions in payment could only be secured by diminishing younger members' share of the assets. Therefore, although well intentioned, the 1995 provisions fell somewhat short of achieving their objective.

1.5 The basis for the new MFR reflected the fact that insurance companies' annuity reserves would be invested in gilts, whereas ongoing pension funds would prefer to invest largely in equities. Without the higher yield thus expected to be available, some doubt was expressed that employers would be able to continue to operate defined benefit schemes at the existing level. The main advantage seen for establishing a Central Discontinuance Fund (CDF) was that it would be set up as a pension scheme and, not being obliged to hold matching gilts, could adopt the same investment policy as any other pension scheme. The disadvantage was that, unless the benefits payable from the CDF could be guaranteed, the members' benefits would be considerably less secure than if annuities had been purchased. This is a serious obstacle as neither the generality of pension schemes, nor the government, has shown any willingness to stand as guarantor.

1.6 Another advantage seen for establishing a CDF was that it should give the opportunity to replace the existing MFR, based on fluctuating asset market values and with onerous requirements for the rapid elimination of deficiencies, with one based on a more traditional approach to the valuation of assets and liabilities, giving a stable contribution rate and with the terms of entry to the CDF calculated on a corresponding basis.

1.7 These and other aspects of the proposed introduction of a CDF are considered in the report that follows. In section 9 we give our view on a way forward which attempts to achieve a reasonable balance between the interests of members and plan sponsors.

2. The Original Proposal that a Central Discontinuance Fund should be created

2.1 In September 1992, the Pension Law Review Committee (the Goode Committee) invited submissions relating to its review of pension law. In separate submissions, R Watson & Sons and the Government Actuary suggested the creation of a Central Discontinuance Fund which would take over the assets and liabilities of defined benefit schemes winding up where the sponsoring employer had gone out of business and could therefore provide no further support. The following brief extracts from the two submissions give further information on what was being proposed:-

(a) Most scheme trust deeds provide for the liabilities of a closed scheme to be bought out by the purchase of insurance policies. (GA)

(b) Pension funds are increasingly invested almost entirely in equities and property, whereas insurance company buy-out terms will be based on the assumption of investment in fixed interest or index-linked securities. (GA)

(c) Imposition of a minimum funding standard based either on the purchase of appropriate annuity policies or running off the liabilities in a closed fund would seriously impact upon the pension costs and cash flow of UK companies. (Watsons)

(d) In most circumstances the level of funding in a matched investment policy is likely to lead to a fund in excess of that required to finance benefits through a CDF. (Watsons)

2.2 Clearly, what was being proposed for ongoing defined benefit schemes was a funding target lower than the cost of securing the members' accrued benefits on wind-up by the purchase of deferred and immediate annuities. For this lower amount of assets to be sufficient for a CDF to provide the same degree of security for the accrued benefits as buy-out, would thus require:-

(a) investment of the whole, or the major part, of the CDF in equities

(b) for the equities chosen to out-perform investment in matching fixed-interest or index-linked investments, and

(c) for some form of financial backing for the CDF to make up the shortfall if the investments were to under-perform. There were two suggestions on the nature this financial backing might take. One was that the government should stand as guarantor (and, as a quid pro quo, share in any profits) of the CDF. The other was for a statutory levy to be imposed on all continuing defined-benefit schemes.

2.3 The Pension Law Review Committee invited the Faculty and Institute to comment upon what was being proposed. A report from the Pensions Joint Committee on the concept of a Central Discontinuance Fund was sent to the PLRC on 2 March 1993. The Pensions Joint Committee's conclusion was that the concept might have some merit but it was suggested that a number of issues would need to be investigated by the PLRC before making any recommendations regarding the viability of a Central Discontinuance Fund. These included:-

(a) A CDF should cover only those schemes which were wound up without a continuing employer.

(b) The implications of using equity investments to back pensioner and deferred pensioner liabilities would have to be carefully thought through. The question of whether such a strategy would be appropriate was a crucial one.

(c) The CDF's premium basis would become a measure of discontinuance solvency. This might lead to incompatible solvency standards for solvent and insolvent employers.

(d) The provision of a Government guarantee or Government imposed compulsory levy (as opposed to an industry sponsored levy) would contrast with legislation which imposes strong solvency standards on insurance companies, and could be regarded as unfair competition.

(e) Many life offices were unwilling to quote for buy-outs, whether large, medium or small, and were unable to quote attractive terms relative to funding levels for ongoing benefits. There was a significant reinvestment risk associated with deferred annuities.

(f) In theory it would be possible to require disclosure of solvency relative to a buy-out basis but there were practical problems, particularly for the largest schemes.

(g) There were approximately 45 final salary pension schemes with assets of more than £1billion each, and the absorption of the assets and liabilities of any one scheme of this size into the insurance market would cause significant problems.

(h) In practice, the vast majority of schemes are able to demonstrate solvency on an ongoing basis. In any one year, it is only a relatively small number of schemes which will be wound up and thus be required to demonstrate solvency on a different basis.

2.4 The Pension Law Review Committee concluded that, although the establishment of a CDF had obvious attractions, there were also a number of disadvantages and difficulties, such as those pointed out by the Pensions Joint Committee. The PLRC's final word, in paragraph 4.4.41 of their report, was that:-

"It may be possible to resolve the difficulties outlined above, but on the basis of the evidence that we have seen we do not feel in a position to conclude that a central discontinuance fund represents a viable solution to the problem of funding for discontinuance. The uncertainties and risk arising from the necessary investment strategy and the potential size of the premiums needed to transfer into the CDF are such that in our view more concrete and detailed information would be necessary before one could conclude that the scheme was workable and sustainable without government support."

3. The Pensions Act 1995

3.1 Following the review of the law relating to the operation of occupational pension schemes, the Pensions Act 1995 was introduced, with supporting Regulations, and further support in Guidance Notes issued by the Faculty and Institute to deal with technical matters.

The provisions in the Act and Regulations were far-reaching but those aspects of most concern to the CDF Working Party are the following:-

(a) The prescription in S.56 of the Act of a minimum funding requirement (MFR) for ongoing schemes.

(b) The provision in S.57 of the Act that the contributions payable must be sufficient to ensure that the MFR will be met throughout the period of five years from the date of signing the contribution schedule or, where there is a deficiency not exceeding 10%, will be sufficient by the end of that period.

(c) The further provision in S.60 of the Act that, if the deficiency is greater than 10%, the excess must be eliminated within one year of the date of signing the contribution schedule.

(d) The provision in S.75 of the Act that, where a scheme is winding up and there is a deficiency when assets and liabilities are valued on the statutory MFR basis, the amount of the deficiency is to be treated as a debt due from the employer to the scheme.

(e) The provision in S.73 of the Act that, where a scheme is winding up, priority is to be given to securing those pensions currently in payment (but excluding future increases in those pensions) and any dependants' pensions which might be awarded later in respect of those pensioners.

3.2 The strategy of the then Government in introducing those measures was explained in the following words by Mr William Hague on 23 May 1995 during the Committee stage of the Pensions Bill:-

"The MFR will provide members with a reasonable assurance that, should the sponsoring employer become insolvent, the scheme will be able to deliver the relevant accrued rights. If the scheme is at least 100% funded on the statutory basis, pensioners can expect their pensions to continue to be met in full, while younger scheme members will be entitled to a fair actuarial value of their rights which they can transfer to another scheme or to a personal pension."

3.3 In point of fact, if a scheme is no more than 100% funded on the MFR basis, it is unlikely that younger members will receive a fair actuarial value of their rights. This is because the cost of purchasing immediate annuities for those already retired is, in the nature of things, greater than the MFR for those members, so that making those purchases will leave less than the fair actuarial value of the rights of younger members. At the time of writing, the MFR falls more than 10% short of the assets needed to purchase immediate annuities. Given that life offices must react quickly to changes in the market in matching gilts and bonds, and to intimations of improvements in pensioners' mortality, and having regard also to their need as commercial concerns to do better than break even on the business written, it should not be surprising if some shortfall compared with the cost of buy-out was the norm.

3.4 Unless the MFR were to be increased so as to approximate to the cost of buy-out for those already receiving pensions, and revised frequently so as to maintain that relationship, there will always be an element of unfairness in the present arrangements. That element may

be small if a scheme is 100% funded on the MFR basis, but could be large if the scheme were to be less than 100% funded on the MFR basis, and if the number of members already receiving pensions were to be disproportionately large.

3.5 The present arrangements may also be considered less than satisfactory by members close to retirement, who are much more security-conscious than younger members. Members of the Working Party with experience of scheme wind-ups report that, whereas many young members readily choose a transfer value representing what they are told is a fair actuarial value of their rights, older members, with less confidence about the future, would prefer to have the same preferential treatment as those already retired who have their accrued benefits secured by insurance policies.

3.6 At present, there are two sets of requirements which govern what happens on wind-up. One is in the scheme rules, which normally set the priority order (after meeting the expenses of winding-up) as (i) pensions in payment, contingent pensions, and those over pension age who have deferred retiring, (ii) GMPs, Protected Rights and EPBs, and (iii) other benefits of members under pension age who are not yet retired. To this we must now add the transitional priorities in the Pensions Act 1995, as follows:-

(a) Benefits in respect of members' voluntary contributions

(b) Benefits in payment (and benefits contingent on those) secured via an insurance policy taken out before 6 April 1997, including increases already made to those pensions.

(c) Benefits where entitlement has arisen (and benefits contingent on those) that are not secured via an insurance policy taken out before 6 April 1997, excluding any increases to those benefits when in payment.

(d) EPBs, GMPs, Protected Rights, and benefits accrued after 6 April 1997, in a contracted-out scheme where entitlement has not arisen, excluding any increases to those benefits when in payment.

(e) Returns of contributions due to members within 2 years.

(f) Increases to benefits in payment in respect of (c).

(g) Increases to benefits in payment in respect of (d).

(h) Benefits in excess of those in (d) to (g) where entitlement has not arisen.

3.7 The present arrangements go a long way towards securing current pensioners' accrued benefits in full although, as indicated above, this is often at the expense of younger members. For members of working age, a cash sum is substituted for a defined amount of benefit, which might be regarded as contrary to the intention of a defined benefit pension scheme. Furthermore, even accepting that the cash sum may properly be described as the fair actuarial value of the defined benefit, it is insufficient to purchase the defined benefit so that, a member who chooses not to take a transfer value, ends up by having purchased on his or her behalf a non-profit deferred annuity which guarantees a fixed pension significantly lower than the accrued benefit. This is because the "fair actuarial value" is based mainly on the likely

yield on equities, whereas deferred annuity premium rates, given the regulations applied to the conduct of life assurance business, are of necessity based on the yield on matching gilts and bonds.

3.8 For those deficiencies in the present arrangements to be eliminated altogether would mean adopting the market price of annuities from time to time as the MFR for persons already in receipt of pensions, and possibly also for members within about ten years of retirement age, and finding a way of absolving trustees from the residual obligation, or the perceived residual obligation, to secure deferred pensions by the purchase of non-profit deferred annuities as a last resort.

3.9 Even if the Minimum Funding Requirement were to be changed so as to eliminate those deficiencies, there would still be a risk that the assets available on discontinuance would be insufficient for the trustees to secure the accrued benefits. Given the volatility in market values of investments, this risk would remain whatever the Minimum Funding Requirement might be. It has been suggested that any such shortfall should be made good by a system of insurance. Such a system has been referred to by a variety of names, such as shortfall insurance, solvency insurance, insolvency insurance, or discontinuance insurance, all meaning much the same thing. It is common knowledge that there are difficulties in devising a workable system - for example, the Pension Benefits Guaranty Corporation in the USA tried some years ago, and are still trying to surmount difficulties in its operation - so we have approached this subject with caution. It is important to bear in mind that such a system would address only the matter of ensuring a sufficiency of assets at the point of discontinuance, and would not concern the ongoing security of benefits in payment under insurance contracts or from a Central Discontinuance Fund. We examine the subject of discontinuance insurance in section 8 of our report.

4. Risks faced by members of defined benefit pension schemes

4.1 Our terms of reference require us to assess the risk covered under the insolvency of the company sponsoring the pension scheme and look at the impact of the Pensions Act 1995. It will be apparent from what is written in section 3 of the report that the main risk faced by the members is that, as a result of the employer's insolvency, they will not receive their accrued pension rights in full. This could arise for a number of reasons, for example:-

(i) The inadequacy of the assets available when the scheme comes to be wound up, even if the present statutory minimum funding requirement has been met.

(ii) Where the assets are inadequate to secure all the accrued benefits by the purchase of immediate and deferred annuities, application of the priorities in Section 73 of the Act which leaves members of working age at a disadvantage.

4.2 However, a major risk to members of ongoing defined benefit pension schemes at the present time is that the administrative and financial burdens placed on such schemes by the Pensions Act 1995 regime are such that companies may decide to terminate the scheme and substitute money purchase or some other less costly arrangement in its place, to the disadvantage of the members. This is a particular problem for small schemes. One member of the Working Party who has direct experience of such schemes has prepared a "critique"

describing the problems of small schemes in the environment of the Pensions Act 1995. This is reproduced in full in an Appendix to the report. We would draw attention here to the following matters in particular:-

(i) Changes in the legislative background over the past twenty years have made small defined benefit schemes considerably less attractive to sponsoring employers. As a result, many have decided to switch to defined contribution schemes.

(ii) Some employers have moved towards funding on the MFR basis, a weaker funding basis than hitherto with fewer margins against volatility, and thus an increased risk of assets being insufficient in the event of winding up.

(iii) The nature of the assets of small schemes, many invested in insured with-profit or non-profit contracts, may not allow matching to the MFR liabilities, thus increasing the likely volatility of the contributions required.

(iv) The greater volatility in the operation of small schemes means that the time-scales for making good deficiencies are particularly onerous.

(v) The introduction of an MFR has heightened members' interest in the security of their pension rights, and may increase the risk that trustees are felt to be acting inappropriately if benefits have to be cut back on winding up.

4.3 Although the note in the Appendix relates particularly to small schemes, large schemes too have become increasingly concerned with the increased costs imposed progressively by changes in the legislation and falling interest rates, and many are consequently considering switching to money purchase or some other less costly arrangement. The question is whether funding ongoing schemes with a view to securing accrued benefits on wind-up in full at insurance company premium rates would place an unduly high pension cost on employers operating defined benefit schemes. Attention has been drawn in the Press to the predicament of members of money purchase schemes resulting from the volatility of the market values of equities in which their pensions savings are invested until retirement age approaches, and the fall in the amount of pension which can now be purchased on retirement. As all actuaries know, this fall is the inevitable consequence of falling interest rates, and improvements in mortality, recorded and anticipated, although journalistic comment, unhelpfully, frequently prefers to say that the cut in pensions is "unfair", or even "intolerable".

4.4 Defined benefit pension schemes are not immune to the effect of those changes in investment returns and mortality rates, but the impact falls on the employers financing those schemes rather than in uncertainty as to the benefits which might be received by the members, as happens in money purchase schemes. It has been suggested that, if employers are to be encouraged, or even enabled, to continue to operate defined benefit schemes, the whole of the burden of these changes should not be borne by employers. The proposition is that, so long as an employer remains in business and is therefore in a position to support the ongoing scheme financially, it is reasonable for the members to expect that the benefits promised in the rules will be paid in full, but that that promise should not be taken to extend beyond the time when the employer is in business. On the other hand, given the normal provisions in scheme rules relating to winding up, members may be forgiven for expecting that their accrued benefits will indeed be funded with a view to securing the benefits in full.

4.5 Not surprisingly, this matter has been the subject of debate in recent years. It is certainly an important matter to which further reference will have to be made in later sections of our report where we consider the possible establishment and operation of a Central Discontinuance Fund. If scheme members' present entitlements in winding up, or perceived entitlements, are to be changed in future, it will be essential for any changes to be made transparent, so that trustees, members, employers and other interested parties - not least the Government, which will have to be convinced of the merits of any proposal - fully understand the nature and implications of the changes. For example, an employer who decided that, in order to reduce costs, it would be necessary to reduce the pension fraction for future service from sixtieths to seventieths, would meet the transparency criterion. So would an employer who made the same change but who undertook to supplement pensions when in payment from seventieths to sixtieths so long as company profitability allowed. However, achievement of transparency in wind-up might become progressively more difficult the more radical the departures from the present strategy as outlined in paragraph 3.6.

4.6 As required by our terms of reference, in section 3 of our report we have drawn attention to inadequacies in the present Minimum Funding Requirement in relation to schemes winding up, but clearly the major issue at present is the impact of the MFR on ongoing schemes. If entry to a Central Discontinuance Fund is seen as a substitute for, or an alternative to, purchasing insurance contracts or paying members a fair actuarial value of their rights, the question of any changes which might be made to the present MFR is relevant to our work. If a Central Discontinuance Fund were to be established, then the terms on which different categories of member would be awarded full benefits in it would be in the nature of a Minimum Funding Requirement for ongoing schemes. On the other hand, if a new Minimum Funding Requirement tailored especially to meet the needs of ongoing schemes were to be put in place, the question of its compatibility with schemes' obligations on winding up would be important.

4.7 As far as we are aware, there are likely to be three possible valuation methods which might be under consideration as potential substitutes for the present MFR. The first would be to continue with the present approach, but modify the method in a way which avoided the present extreme volatility of the valuation results, possibly including also a revision of the prescribed time-scales for eliminating deficiencies up to 10%, and in excess of 10%.

4.8 The second would be to return to a traditional long-term funding method. This might follow the approach in the Pension Scheme Surpluses (Valuation) Regulations 1987 (SI 1987, No. 412), i.e. it might adopt the Projected Accrued Benefit Method of valuation for active members, and would value assets and liabilities by the prescribed method but using less stringent valuation assumptions. Another possible variation, having regard to the choice of wind-up benefits as the funding target for the present MFR, would be to substitute the Defined Accrued Benefit Method for active members.

4.9 The third possibility would be the introduction of a market-based approach to the valuation of assets and liabilities. There is growing support within the actuarial profession and the accountancy bodies for the use of such a method. The assets would, by definition, be taken at market values. The liabilities would be valued by reference to the current yields on fixed-interest and index-linked gilts, probably plus an equity risk premium in the case of

members of working age in respect of whom investment in equities would be the recommended investment strategy.

4.10 The presumption would be that, whatever the valuation method prescribed, the obligation of the trustees on winding up would still be to try to secure the benefits set out in the rules, adopting the priorities in the Pensions Act 1995 unless those were to be modified as part of the MFR review. A return to a traditional valuation method as mentioned above in paragraph 4.8 would be unlikely to produce a funding level which was synchronous with variations in market conditions which would underlie insurance company premium rates, but the volatility of the ongoing contribution rate would be greatly reduced. Whether the terms of entry to a Central Discontinuance Fund for retired members and members of working age could be made to correspond to the liabilities calculated by an ongoing valuation method is a matter for consideration.

4.11 Adoption of a market-based valuation method as outlined in paragraph 4.9 would have strong similarities to the present MFR, including volatility of the valuation results and the ongoing contribution rate. However, if the value placed on the deferred pensions for members of working age differed greatly from the present MFR, it might raise eyebrows if the new figure were also to be described as representing a “fair actuarial value” of the promised benefit.

5. What is a Central Discontinuance Fund, and how might it operate?

5.1 This question is central to our terms of reference. The intention is clearly to create a fund which would be legally constituted as a defined benefit pension scheme which would take on the assets and liabilities of schemes winding up because the employer had gone out of business and was consequently no longer able to provide financial support for the scheme. It would thus substitute for the present role of insurance companies as the pension providers for schemes winding up. As the Pension Law Review Committee concluded six years ago, creating a Central Discontinuance Fund has obvious attractions, but there are also a number of disadvantages and difficulties. In this section of our report, we explore the problems to be overcome if a Central Discontinuance Fund is to be established, as a preliminary to arriving at a conclusion on the best way forward.

European Law

5.2 Occupational Pension Schemes in the UK escape being classified as insurance companies because Section 3 of Article 2 of the First Life Directive exempts “operations carried out by organisations other than undertakings referred to in Article 1 [meaning broadly insurance companies] whose object is to provide benefits for employed or self-employed persons belonging to an undertaking or group of undertakings, or a trade or group of trades, in the event of death or survival or of discontinuance or curtailment of activity, whether or not the commitments arising from such operations are fully covered at all times by mathematical reserves”.

5.3 On the face of it, this would appear to rule out a Central Discontinuance Fund which took in former members of unconnected schemes. On the other hand, we do not see why there should be any objection in principle to schemes already exempted from the First Life

Directive co-operating to make suitable arrangements for securing the accrued benefits on discontinuance. They have a common interest as a group of schemes in making such arrangements as they can to that end. Clearly, this is a matter that must be gone into, but we thought it appropriate to continue our study on the basis that European Law would not present an insurmountable obstacle. However, the possibility of a Central Discontinuance Fund being operated as insurance business is referred to in section 7 of the report.

The Government as guarantor of a Central Discontinuance Fund

5.4 At the outset of our study, we thought it advisable to make an informal approach to officials at the Department of Social Security about the likely reaction of Ministers to the suggestion made six years ago that the Government might stand as financial guarantor of a Central Discontinuance Fund, on the understanding that such a fund would be operated on a basis intended to minimise the financial risk involved. We were informed that it would be safer to work on the assumption that it was not likely that Ministers would support the establishment of a Central Discontinuance Fund with Government involvement along those lines.

5.5 Since being so advised, we have given no further consideration to the idea of the Government providing financial backing, which leaves the other suggestion, that the Government might take powers to impose levies, if it proved necessary, on all ongoing defined benefit schemes in order to ensure that there would be no cut back in benefits payable from a Central Discontinuance Fund. The benefits would therefore be as secure as they would have been if insurance policies had been purchased. We are given to understand that employers sponsoring defined benefit schemes would be strongly opposed to a requirement that they should bear the financial risk of operating a Central Discontinuance Fund to support other schemes' members. We must take this objection seriously. However, so that our study would cover all the possibilities, we have not discarded the idea altogether. If a system of levies were to be part of a package in which a new MFR was brought in which eased significantly the current financial pressures on ongoing schemes, and enabled them to operate with a fairly regular annual pension cost which was no bigger than absolutely necessary, it seems possible that the idea might be more palatable to employers.

Eligibility

5.6 It has been suggested that access to a Central Discontinuance Fund should be limited to transfers of assets from trustees of schemes where the employer is no longer in business and an insolvency practitioner has been appointed. We agree with that view. So long as employers remain in business, we believe it to be their responsibility to finance the pension benefits promised to the members of the pension scheme (or perhaps the fair actuarial value of the promised benefits). If the employer sought to wind up the pension scheme, then the trustees should be able to require that sufficient assets should be provided for them to secure the promised benefits in full. This does not happen at present because of the inadequacy of the Minimum Funding Requirement in relation to the cost of buy-out. The "debt on the employer" provisions in Section 75 of the Act are well-intentioned but elimination of any insufficiency of assets only in relation to the Minimum Funding Requirement leads to the unsatisfactory situation which we have described above in section 3 of our report.

5.7 We believe there are nearly 50 schemes each with assets of more than £1 billion, and it has been suggested that they would have to be denied admission to the Central Discontinuance Fund, because the winding up of one such scheme would be more than the fund could swallow. Our first reaction to this is that, if a Central Discontinuance Fund is to be established, then access to the fund would have to be open to all schemes of whatever size where the employer was no longer in business. We return to this subject again later in the report.

5.8 It is important to bear in mind that if access to a Central Discontinuance Fund is to be restricted, it has to be decided what requirements should be imposed on those excluded from its operation. This aspect is considered in section 7 of the report.

Operating a Central Discontinuance Fund with guaranteed benefits with the present MFR

5.9 Before considering the impact of changes which might be made to the present MFR, we thought it would be useful to consider first what it would mean for scheme members and employers if a Central Discontinuance Fund were to be introduced with the present MFR still in place, or substantially unaltered.

5.10 For members of working age, the fair actuarial value of the member's accrued rights would, by definition, if appropriately invested, have been considered sufficient to produce an individual pension fund at the time of retirement which was at least as likely to produce a pension greater than that promised in the scheme as it was to produce a smaller pension. If the same amount were to be invested in a Central Discontinuance Fund in which the benefits were guaranteed, it follows that any levies payable by the guarantor would be likely to be small.

5.11 For those currently receiving pensions, the MFR value of the pension would probably fall short of the insurance cost, but the possibility of investing part of the monies transferred to the CDF in equities, and not wholly in gilts or bonds, would enable unreduced benefits to be awarded in the CDF. If the yield on equities was, as expected, higher than the yield on gilts, the risk of levies being required would not be high.

5.12 We have considered what the reaction of the insurance industry might be to directing the assets disposable on the winding up of defined benefit schemes to a Central Discontinuance Fund, and thus away from life assurers and, prior to retirement, from other pensions providers. It can be argued that there is nothing wrong in principle in such schemes co-operating with a view to making their own arrangements for securing the promised benefits when one of them has to be wound up, including guaranteeing the benefits from their own resources. They would not be competing in the open market for annuities, and insurers have benefited, and seem likely to continue to benefit, from Government promotion of money purchase pension schemes of various kinds. On the other hand, the guarantee would not be financed at the time of wind-up, but would be an ongoing obligation of other employers operating defined benefit schemes, many years after the event.

Operating a Central Discontinuance Fund without guaranteed benefits, with the present MFR

5.13 As already reported in paragraph 5.5, there are indications that employers sponsoring defined benefit schemes are likely to be strongly opposed to being obliged to pay levies to provide financial support for other scheme's members. We doubt if there is sufficient incentive for them to change their minds in the arrangements described in the immediately foregoing paragraphs, since they do not address the pressing problems faced by ongoing schemes, and we also doubt whether the Government would see sufficient reason to impose a system of levies. We have therefore considered the implications of introducing a Central Discontinuance Fund in which benefits were <u>not</u> guaranteed. This possibility is discussed in material published by the National Association of Pension Funds to which reference is made in section 7 of our report.

5.14 So far as members of working age are concerned, there would be no difference between the pensions accumulating in the Central Discontinuance Fund or with some other pension provider up to pension age. In the latter case, the pension purchased at, or within a few years after, the time of retirement, would reflect market conditions at the time of purchase, but would be guaranteed. It is uncertain how a Central Discontinuance Fund would operate. The amount of the deferred pension would not be guaranteed, but whether its non-guaranteed amount would be decided at the time of discontinuance, or at the time when the pension came into payment when there might be a switch to a matched investment policy, is a matter we have not heard discussed. No doubt those chosen to control the CDF's operations could be relied upon to act equitably but undoubtedly there would be a lack of transparency, unless the principles upon which it would operate were fully and publicly explained.

5.15 If members already receiving pensions were to suffer a cut in the amount currently payable, this would represent a significant departure from present practice. That might be inevitable, or it might be possible for only the size of future increases to be in doubt. It appears to us that the outcome is likely to be dependent upon the investment policy. With suitably matched investments, perhaps only future increases would be in doubt, but if (as suggested in paragraph 5.11) there was a significant equity content in the investments held, it might not be possible to limit the uncertainty to benefit increases. If a life office were operating such a system, it might take a cautious view, imposing a cut in the pension payable immediately and then hesitating to award increases until it was convinced that the gains from the investment in equities were sufficiently secure for it to be safe to do so. Such a strategy might be regarded as good insurance practice, but it would probably not be considered appropriate for a Central Discontinuance Fund. to take such a cautious view. In practice, it would be difficult to decide upon the size of pension increases it was safe to make. As before, there is no doubt those chosen to control the CDF's operations could be relied upon to act equitably, but the difficulty would remain, and a lack of transparency so far as the members were concerned.

5.16 It seems clear that if benefits after discontinuance are to be guaranteed, with the financial backing of employers sponsoring defined benefit schemes, then the creation of a separate fund for this purpose is inescapable. We are not certain that this would be necessary if the benefits were not guaranteed. Life offices would have the necessary expertise for such an operation, perhaps co-operating in a consortium of companies, but they would have to be subject to the same controls, and need for transparency, as would apply in a CDF so as to ensure equitable treatment of members, in particular in regard to the avoidance of undue caution, or the reverse, in the award of pension increases.

6. Consideration of long-term uncertainties and guarantees

6.1 Uncertainty concerning the return on investments in future is an inescapable factor in funding pension schemes and, the further into the future, the greater the uncertainty. We have seen how a fall in gilt yields can affected the purchase price of non-profit annuities for those retiring, with a similar effect on the costs of defined benefit schemes which match their liability for current pensions by investing in gilts. It is anticipated that gilt yields are likely to fall further before long. Until about fifty years ago the yield on Consols was in the region of 3% and a return to that level cannot be ruled out.

6.2 As regards investment in equities, it is said that the recent abolition of tax credits on UK equity dividends removes a strong incentive for companies to pay dividends and to finance themselves largely through equity, and that there is already evidence of some major companies rearranging their capital base. It is possible that this could lead to a situation like that in the USA where companies are more geared up with debt, their equity is more risky, and dividend distributions are more volatile. We are not predicting that this is what in fact will happen in the UK but those uncertainties cannot be ignored by individual investors and by schemes embarking upon long-term financial arrangements from which there might be no escape if circumstances were to change. Given also the current trend away from defined benefit pension provision and the consequent growing uncertainty as to the number of ongoing defined benefit schemes which there might be in the future, it is perhaps understandable why there are objections from the sponsors of such schemes to the proposition that they should be obliged to provide financial backing for a Central Discontinuance Fund in the very long term.

6.3 In the light of those uncertainties, in our discussions we have given consideration to the appropriateness, and prudence, of attempting to provide guarantees over a very long future period. This has led us to pose three questions:-

(i) Is it in the best interest of young members to envisage the purchase of non-profit deferred annuities on discontinuance? Given the uncertainties, including uncertainty about mortality improvements in the very long term, the cost of the guarantee can be seen to be considerable by comparing the buy-out cost with the fair actuarial value. Would it be in the members' interests, and therefore the public interest, to discourage the purchase of non-profit deferred annuities by the trustees of discontinuing schemes?

(ii) For members of pension age, and perhaps also for members close to pension age, the cost of the guarantee is not nearly so large. Should it not therefore be the aim to purchase non-profit annuities and deferred annuities for such members on discontinuance, and to fund accordingly?

(iii) In view of uncertainty concerning the very long term, would it be better to crystallise the position at the time of discontinuance, even if this meant cutting back the benefits secured, rather than envisage the possibility of a reduction in benefits at some later date?

6.4 We have already mentioned (in paragraphs 4.4 and 4.5) that many would reject the proposition in (ii) that the aim should be to secure guaranteed benefits for older members, on the grounds that it would impose too great a financial burden on ongoing schemes. This is one of the matters to be discussed in the next section of the report.

7. Operation of a Central Discontinuance Fund in conjunction with a new Minimum Funding Requirement

7.1 We would not expect the introduction of a Central Discontinuance Fund along the lines described in section 5 to satisfy employers finding difficulty in operating defined benefit pension schemes with the present Minimum Funding Requirement and time-scales for eliminating deficiencies still in place. The alternative would be to establish a Minimum

Funding Requirement which gives a stable regular pension cost, and to set premium rates for entry to, and for ongoing valuations, of the Central Discontinuance Fund on the same basis. The benefits payable from the CDF could either be guaranteed, with financial support from a system of levies, or not guaranteed but dependent upon the investment return and other experience factors.

7.2 The system proposed last year by the National Association of Pension Funds falls into this category. A paper outlining their proposals was sent to the Minister of State at the Department of Social Security and the NAPF kindly sent us a copy to assist our consideration of the subject. The NAPF's new Minimum Funding Requirement would be a "long-term funding standard.............based on an ongoing long-term basis..........set by the actuarial profession using typical actuarial assumptions".

"Such a long-term funding standard would be likely to be much less volatile than the MFR and should be compatible with the approaches to funding which are normally operated for pension schemes."

"The most damaging effect [of the present MFR] is likely to be the need for pension scheme assets to have a degree of matching with MFR liabilities. For many schemes this will mean a switch out of equities into bonds. Based on historic data, bonds return less than equities. The result will be either to exacerbate the move to DC [defined contributions], or an increase in employment costs. We believe that good employers are generally contributing to schemes at or close to their maximum tolerable level."

7.3 The NAPF paper proposes that, in order to avoid purchasing annuities on winding up, the assets and liabilities should be transferred into a Central Discontinuance Fund, or perhaps one of a number of competing funds. Their preferred solution would be for benefits awarded in the Central Discontinuance Fund to be guaranteed, but the CDF would not be responsible for making good any insufficiency of assets at the time of transfer. The CDF actuary would value the scheme's assets and liabilities and determine by how much the accrued benefits should be reduced on entry. It is not stated whether the new MFR basis would automatically follow the CDF actuary's basis, but that might be intended, in which case some regulation of that basis would probably be appropriate.

7.4 The NAPF paper also suggested, as an alternative, that the system of credit insurance in Germany might be worth examining, with a view to the possibility of its being adapted to fit the practice in the UK. A certain amount of information on the German system is readily available in J.I.A. 121, p.491 in the 1994 paper by D.C. Mason and others on *A consideration of Book Reserve Schemes.* Among the principal features of the PSV *(Pensions-Sicherungs-Verein*) are the following:-

(i) The PSV does not pay pensions. It reinsures them with a consortium of 74 insurance companies by paying single premiums when pensions come into payment.

(ii) For deferred pensions, the pension promised is recorded but there is no funding in advance. The system for them is apparently terminal funding.

(iii) The single premiums are calculated on the basis of 3% interest and, as the benefits do not qualify for post-retirement increases, the basis is guaranteed to generate substantial

profits. These are largely returned to the PSV. The element of insurance is therefore minimal in practice, and the insurance companies are said to regard this as experience-rated business.

7.5 If this system were to be adapted to fit UK practice, the most important change would probably be to institute advance funding for the deferred pensions. Such assets as were available at the time of discontinuance should be transferred to the “fund” for investment and the purchase of annuities. Those currently receiving pensions would have those pensions secured by the purchase of immediate annuities. In the case of younger members, their full pensions would be secured on reaching pension age. To the extent that the assets might be deemed from time to time to be inadequate, on a given basis, to cover the liabilities for deferred pensions after meeting the regular cost of purchasing pensions for those reaching pension age, levies would be imposed on all ongoing schemes to make good the deficiency.

7.6 Such a system would have the advantage that the need for levies would be determined at the time each member reached pension age and would not extend into the more distant future in the manner proposed for a Central Discontinuance Fund which guaranteed benefits. Another advantage is that, by ensuring a sufficiency of assets as each member reached pension age, there would be no need for a separate system for ensuring a sufficiency of assets at the time of discontinuance.

7.7 The system in Germany is in support of the book reserving system which operates there. If imported to the UK, it might be made to operate in support of any Minimum Funding Requirement which might be prescribed. The weaker the funding requirement, the higher the levies required. This would not meet the NAPF’s aim to abolish altogether the practice of purchasing annuities, but it would limit the cost of making such purchases to the small minority of schemes which actually wound up, and would not import it as a funding requirement for all ongoing schemes.

7.8 What is written above considers how the German system for securing accrued benefits might be adapted to fit UK practice. It might be more difficult to devise an acceptable system of levies to support that system. We return to that subject in section 8 of the report.

7.9 The NAPF’s proposal for a Central Discontinuance Fund suggests that the fund should not be open to schemes with assets exceeding £100 million which would have a realistic option of continuing on a closed basis, and that trustees of smaller schemes should have the option of purchasing annuities or applying to the Central Discontinuance Fund. We can foresee problems in attempting to introduce a system which would not be universal in its application, particularly one which guaranteed benefits supported by a system of levies. However, if benefits were not to be guaranteed, then there would be little difference between a large closed scheme running off its liabilities, and a Central Discontinuance Fund doing the same thing for smaller schemes, except that the latter would not be closed and in decline, because there would be a continuing inflow of new members from schemes winding up. If the Government were to set up a Central Discontinuance Fund without benefit guarantees, but with controls on its mode of operation, then it would probably be appropriate to apply the same controls to the operation of individual closed funds. This again raises the possibility of life offices, or a consortium of life offices, operating a Central Discontinuance Fund subject to the normal Insurance Companies Regulations. Correspondence between the controls applied to both would enable the Central Discontinuance Fund to take over a closed fund’s assets and liabilities when it became too small to operate independently.

7.10 As already mentioned in paragraph 5.6, we believe it would be proper to exclude from these arrangements any scheme discontinuances where the employer was still in business. In those circumstances, we believe it to be the employer's responsibility to finance the benefits promised, or the fair actuarial value of those benefits if appropriate. This would imply that, whatever changes might be made to the Minimum Funding Requirement for ongoing schemes, it would be necessary to retain something like the present MFR for such discontinuances. It would, in our view, be appropriate to substitute the cost of buy-out for pensions already in payment, and possibly also for those close to pension age, and the fair actuarial value for younger members.

7.11 The present MFR has relevance also for the calculation of transfer values, recoveries from the Compensation Fund, and perhaps for splitting the value of pension rights on divorce. The introduction of a new MFR on an ongoing valuation basis for ongoing schemes, while retaining a different wind-up basis for cases such as those mentioned in paragraph 7.10, might lead to complications. We recognise that these knock-on effects would require further consideration, but we have not at this stage considered what changes might be necessary. If the employer was no longer in business and an insolvency practitioner had been appointed then, for the purposes of Section 75 of the Act, it would be appropriate to apply the <u>new</u> MFR, assuming that this would also correspond to the entry terms for the award of unreduced benefits in the Central Discontinuance Fund.

7.12 There would therefore be in operation, at the same time, something like the present basis for use when an employer whose business was continuing wished to wind up a pension scheme, and a new MFR with a lower funding target for valuing ongoing schemes, which might, in the case of a guaranteed CDF, also set the terms for entry to a CDF when wind-up was the result of the employer's bankruptcy. It has been suggested that some schemes might continue to aim higher than the new MFR and thus have the option of securing the benefits by the purchase of annuities or the payment of a fair actuarial value of the accrued benefits in the traditional manner. However, it is likely that the majority would adopt the new MFR and anticipate securing the accrued benefits in the CDF at lower cost in the event of the employer's bankruptcy.

7.13 In section 3 of the report we set out some particulars of the provisions in scheme rules, and in Section 73 of the Act, which give preferential treatment to those already receiving pensions. If there is an insufficiency of assets at the time of discontinuance, securing their benefits by purchasing annuities comes first. There is no indication in the proposals we have seen for operating a Central Discontinuance Fund as to whether, or how, a similar preference would apply on entry to a CDF, or after entry if the award of increases to pensions and deferred pensions would be dependent upon investment profits. If a case is to be made for substituting a Central Discontinuance Fund, we believe it will be necessary to explain what is to happen to those preferences. This would be a radical change from traditional practice and would be of particular concern to members' representatives, and to the Government which was being invited to legislate for the change.

7.14 It may be that a change from the present system of priorities could be justified on the grounds of the unfairness to younger members, whose benefits are diminished in the interests of paying unreduced pensions to older members. We have already mentioned this in paragraph 3.7 of the report. Whether pensioners would still be given priority, or all members'

accrued benefits would be reduced proportionately, it is unlikely that the concept of younger members being entitled to expect to receive a fair cash equivalent of their accrued benefits could persist if the apportionment were to be on the basis of the ongoing valuation method proposed for the operation of the CDF. If the defined benefits of all members were to be secured in the CDF, this would not be a problem but, if younger members were to be allowed to take a cash payment instead, it would be difficult to know how to describe the amount paid. Even if the scheme's assets were 100% sufficient on the CDF basis, the cash payment would not be a fair actuarial value except on that basis.

7.15 At present, the prospect of large schemes running off as closed funds is frequently mentioned, without reference to what might happen in the longer term. Perhaps it would be possible for the members of a closed fund faced with terminating its operations to be admitted to the CDF on similar terms to those for schemes discontinuing.

8. Ensuring a sufficiency of assets at the time of discontinuance, and subsequently

8.1 In this section of the report we consider the situation where the employer is no longer in business and an insolvency practitioner has been appointed.

8.2 Section 75 of the Pensions Act 1995 specifies that, where a scheme is winding up and there is a deficiency when assets and liabilities are valued on the statutory MFR basis, the amount of the deficiency is to be treated as a debt due from the employer to the scheme. Unfortunately, this ranks as an ordinary debt and is given no preference, so there is little likelihood of the deficiency being made good in the majority of cases . The other possibility of making good a deficiency in such cases would be the introduction of a system of insurance, to which all ongoing defined benefit schemes would be required to contribute. We examine both aspects in this section of the report and also, if a Central Discontinuance Fund is substituted for insurance buy-out, the feasibility of ensuring a continuing sufficiency of assets to enable it to guarantee payment of the accrued benefits in full.

The debt-on-the-employer provisions in S.75 of the Act

8.3 Section 75(8) of the Act expressly states that the debt on the employer shall not be a preferential debt. It makes no distinction between a deficiency smaller than 10%, or a more serious underprovision which S.60 requires to be eliminated within one year. It is worth considering whether making good an underprovision, or a serious underprovision, in the pension fund should rank higher in winding up. In bankruptcy proceedings, it is common for two classes of preferential debtor to exist, namely, (i) the Government, in respect of unpaid taxes, national insurance, and customs and excise duties, and (ii) Banks.

8.4 If employers are suffering from difficult trading conditions, then to maintain their businesses they will need to raise money. If the money is raised through a bank, a covenant providing the bank with a preferential debt would normally be required. Alternatively, the employer could reduce contributions to the pension scheme, with our without the agreement of the trustees, to the legal minimum allowed under the MFR. If the scheme is already underfunded, but not seriously underfunded, compared with the legal minimum, then the ability to spread the employer's contributions required to reattain the legal minimum over a period of five years might be regarded as the employer taking a loan from the scheme. If such

financing is regarded as a quasi loan, then it can be argued that, on the insolvency of the employer, any debt vis a vis the statutory solvency level should be considered as ranking pari passu with any bank loans.

8.5 If this debt were to rank as a preferential debtor, then it is more likely than at present that money would be available to meet the trustees' claim in the bankruptcy proceedings, and consequently for the members' benefit. However, it must be remembered that this could lead to banks restricting the total amount they would be willing to lend to the employer, given that the total of the preferential loans would be split between two parties. It could be argued that this might cause employers to address impending insolvency at an earlier stage within the process, reducing the knock-on effect on other employers, the employees and the banks.

8.6 It may be considered that awarding the whole of the certified deficiency in the pension scheme the status of a preferential creditor would be to favour the members of the scheme to the detriment of other employees who are not members of the scheme, and other business creditors. In cases of misappropriation of assets, the compensation levy will only reimburse the scheme to 90% of the MFR level (although the Green Paper indicates that it is the Government's intention to raise this to 100% in respect of the liabilities for pensioner members and those within ten years of pension age.) Adopting a similar partial approach, perhaps it would be possible to award a Section 60 serious underprovision the status of preferential debtor, while leaving smaller deficiencies as ordinary debtors.

8.7 In point of fact, we are not optimistic that it would be possible to persuade the Government to award the status of preferential creditor even to a serious underprovision, which is a pity. It might be easier to extend the period for making good a serious underprovision from one year to five years, particularly if it could be combined with the kind of insurance arrangement considered below.

The insurance approach

8.8 The insurance approach to ensuring a sufficiency of assets at the time of discontinuance could have as its target the cost of purchasing immediate and deferred annuities for members of all ages, or substituting a "fair actuarial value" of the accrued benefits (calculated on a statutory basis) for members not yet receiving pensions. Members within ten years of pension age could be included in either category. Alternatively, the target could be the cost of securing unreduced pensions in a Central Discontinuance Fund, whether or not the CDF guaranteed that the pensions would continue to be paid in full in later years. This target would almost certainly be significantly lower than the cost of insuring the accrued pensions. The assets available would include any sums obtained by the trustees in the bankruptcy proceedings, in addition to the assets in the pension fund, whether those assets resulted from the operation of the present MFR or some different funding requirement.

8.9 We envisage that the operation of a system of "shortfall" insurance might be operated along the following lines. There appeared to be two possibilities:-

(i) The shortfall insurance would be regarded as a substitute for adding a solvency margin to the funding requirement. The insufficiency of assets would therefore be the difference between the assets actually available and an amount higher than that required to secure the accrued benefits, via life assurance or in a Central Discontinuance Fund as the case may be.

The sum at risk would reflect the shortfall at the time of the last valuation. Sponsoring employers would be required to pay annual levies into a receiving fund, possibly operating under the auspices of the present Compensation Fund. This fund could operate with a small working balance to even out the fluctuations in the annual levies which would be inevitable if they were to be related directly to the amounts necessary to secure the accrued benefits each year.

(ii) Alternatively, each sponsoring employer whose scheme's assets fell short of the amount necessary to secure the accrued benefits would be required to obtain cover in the general insurance market. The premiums would be expected to reflect both the sum at risk, and the relative probability of the company's bankruptcy, having regard to the class of business in which it was operating. An indication of the statistics available at Companies House which might assist in deriving a suitable rating system is given in Tables 7.1 and 7.2 of the paper on the German Book Reserve Method published in JIA 121, p. 491, to which reference has already been made above in paragraph 7.4. The conclusion of the authors of that paper was that, in their opinion, "a system of insolvency insurance could be devised at reasonable rates of premium" in the UK.

8.10 The main problem we foresaw with method (i) was that the cost of a single very large insolvency would fall on the generality of schemes which were paying levies because they did not have an excess of assets over liabilities in the fund. This could be remedied by increasing the yield from the levies, perhaps over a period or by increasing the solvency margin so as to bring more schemes into the frame for the payment of levies. While we could see the advantage this flexibility would give, we were uneasy that the system would have regard only to the scheme's finances, and there would be no link with the standing of the employer's business.

8.11 On the whole, we favoured the second approach, but were concerned at the number of small schemes which might be forced to seek commercial insurance cover. A possible alternative would be to combine the two approaches, setting a ceiling to the sum assured under the levy system, so that only large companies would be obliged to seek commercial insurance cover, for the excess sum at risk.

8.12 One of our members has been in discussion with colleagues in general insurance about the feasibility of a market being developed in the UK for this type of credit insurance. The response was not encouraging. It is common for insolvency to be the culmination of a long process of decline and it would be important to exclude any benefit improvements granted within a period of, say, three years prior to insolvency. This would be particularly important for private companies or small public companies with owner-directors, who would be in a strong position to influence benefits and funding levels. It might be difficult to avoid widespread abuse. Such insurance would be a major underwriting exercise, involving intense analysis of a company's financial health, and would only be appropriate for larger companies.

8.13 This response suggests that it might be necessary to consider combining the two approaches, as mentioned in the immediately preceding paragraph, or even abandon the idea of solvency insurance. We were approached by the Association of British Insurers on the subject of our study and we promised to write to them once our work had reached a stage of our being able to consult them on particular issues. We have not yet done so, but the

feasibility of general insurance cover for pension scheme deficiencies is clearly an issue on which it would be wise to consult the ABI at some stage.

8.14 Before attempting to design in detail the kind of scheme outlined above, it would be sensible to learn from the experience of other countries with somewhat similar schemes already in operation. From what we know of the German system, we don't believe it would be the best choice. Although each company covered holds a book reserve, the amount of assets actually recovered by the PSV from insolvent companies is very modest, so that the system there is able to levy premiums in proportion to the whole of the statutory book reserve, that being in effect the sum at risk.

8.15 It might be more informative to examine the experience of the Pension Benefits Guaranty Corporation in the USA. The early experience of that scheme stands as a warning to any country which launched a system of solvency insurance without due caution. We believe that the principal problem in the USA was that employers whose business was continuing were able to off-load their accrued pension obligations to the PBGC, however deficient the assets available in the scheme might have been in relation to those obligations. It is our information that that loophole has now been stopped, but that the system is still not watertight, and the levies imposed by the PBGC are gradually increasing as a consequence.

8.16 We believe it would be useful to try to discover what the factors are which are resulting in the gradual upward drift in the levies being imposed by the PBGC in the USA. We may surmise that it is in the nature of commercial concerns to seek a way around any rules that might be imposed, but information reaching us suggests that it is more than that, that there is still a legacy of the serious underfunding of pension schemes in the past which cannot be made good easily without doing damage to the companies sponsoring the underfunded schemes. One of our members has been studying the PBGC system and expects to present her findings shortly. This is unlikely to be before we submit our report, in which case we shall send it later as an addendum to our report. Serious underfunding of pension schemes is not a problem in the UK and, if we could devise a satisfactory system here, it would be a very useful instrument in the search for an approach which would reconcile the need of ongoing schemes for a user-friendly valuation method, with the need of schemes winding up to be able to secure the benefits in varying market conditions.

8.17 If a system of "shortfall" insurance were to be introduced, we believe it would have to be on a universal basis and, in particular, it would not be possible to exclude schemes above a certain size. All employers operating defined benefit schemes, whether closed schemes or schemes open to new entrants, would be required to pay premiums and all such schemes would be entitled to have any insufficiency of assets made good on winding up. It follows that the present practice of some trustees continuing to run their schemes as closed funds after the employer's bankruptcy, because that is what appeared to be in the best interests of the members in present conditions, would come to an end.

Guaranteeing benefits in a Central Discontinuance Fund

8.18 The form of insurance described in the foregoing paragraphs would be short-term in nature, in that claims and premiums would reflect the immediate needs from year to year, and would be risk-related. A different approach would be needed for a system of levies to ensure that a Central Discontinuance Fund was able continue to pay pensions without reduction. The

risk would not be related to particular companies so a system like that in Germany would probably be more appropriate, in which all employers operating defined benefit schemes would pay premiums proportionate to the scheme's assets. Some variation might be considered, but that would essentially be the most appropriate basis of the levies payable.

8.19 Nor would such insurance be short-term in nature. The need for the levies would arise long after the schemes the CDF members had come from had been discontinued, and would therefore be paid by a new generation of schemes. The length of the term would be shorter if members under age 65, or under 55, had not been admitted to the CDF but, either way, the obligation to pay levies would arise long after the event of the employer's bankruptcy had given rise to the award of pensions in the CDF. It is perhaps not surprising that the generality of employers operating defined benefit schemes would view askance the introduction of such a system. On the other hand, if it were to be combined with other measures as part of a package which included the introduction of a new MFR which met the needs of ongoing schemes, it might be viewed by them in a more favourable light .

Other countries' systems

8.20 In the time available to us, we have been unable to give as much consideration as we would have liked to the systems in operation in other countries. We have already commented upon the system in Germany (see paragraphs 7.4 to 7.8, 8.9 and 8.10 above). We have also drawn attention to the PBGC in the USA and we believe that it would be worth examining that system more closely. We have also considered the system in Finland and would offer the following comments.

8.21 In addition to the information in the paper *On the Solvency Requirements of the Finnish TEL Companies* by Jaakko Tuomikoski, published in Volume 5 of the Transactions of the 20th ICA held in Birmingham last year, we have been able to elicit further information from correspondence with a contact in Finland. However, it is clear that the National Guarantee System in Finland is designed to fit the pension arrangements there and would not translate easily to the situation in the UK.

8.22 The system of occupational pensions in Finland is seen there as part of the social security scheme. There are about 60 pensions institutions to which most employers and employed and self-employed persons are required by law to contribute. These are defined benefit schemes providing benefits as prescribed by the Government. If one of the pensions institutions gets into financial difficulties, the others are required to step in to secure the benefits of the members of the institution in difficulty. There is no escape. The risk is borne by future premium payers. In the UK, employers are not obliged to set up defined benefit schemes, and could switch to a less troublesome and less expensive money purchase alternative if the Government here were to impose unacceptable financial conditions now or in the future.

8.23 The pensions institutions in Finland are only partially funded, less than one-third funded, we believe, and the remainder pay-as-you-go. The funded element is considered important in the context of the national economy there, as is the selection of investments by the pensions institutions.

8.24 When Finland joined the EU, the entry agreement included an addendum to Article 4 of the First Life Assurance Directive, giving Finland the freedom to set its own solvency requirements for the pensions institutions. These requirements reflect the investment risks of each institution, having regard to the structure of its investment portfolio. Other stochastic risks are not taken into account.

8.25 The system in Finland is interesting but can only apply in a country where occupational pensions are subject to the degree of Government control which exists there. Such controls do not exist in the UK. However, one thing is common to both Germany and Finland. Occupational pensions are secured and guaranteed in the event of the failure of the company or the pensions institution.

9. The way forward

9.1 The idea of establishing a Central Discontinuance Fund was suggested to the Pension Law Review Committee six years ago. Ongoing pension schemes were able to benefit from the higher yields which had been available from investment in equities than in gilts and the purpose was, broadly, to extend that advantage beyond the time when a scheme had to be discontinued. A Central Discontinuance Fund, which would be able to include a significant holding of equities among its assets, would replace the existing arrangements for schemes winding up which involved the purchase of immediate and deferred annuities at prices which, of necessity, reflected gilt yields. It was intended that the benefits in the CDF would be guaranteed but, given a significant holding of equities, it was expected by those proposing the establishment of a CDF that the financial risk to the guarantor would be small.

9.2 The raft of measures introduced following the Pensions Act 1995 did not include the establishment of a Central Discontinuance Fund but, taken together, the financial and other requirements imposed have caused employers operating defined benefit schemes to review their arrangements. Some small schemes have already been closed and replaced by money purchase schemes, and employers with large schemes are also reviewing their position with a sense of urgency. In this new situation, the establishment of a Central Discontinuance Fund is seen by some as a measure which would facilitate a change from the present funding requirements to measures more in sympathy with the needs of employers financing ongoing defined benefit schemes. Our comments on funding relate principally to the Minimum Funding Requirement, details of which are found in GN27. We did not feel obliged to comment on other measures introduced, such as the related Schedule of Contributions, but we would observe here that this seems an unnecessarily complicated and burdensome requirement, especially in view of the stringent time-scales for eliminating funding deficiencies as set out in Sections 57 and 60 of the Act.

9.3 Some argue that the present Minimum Funding Requirement is unsatisfactory in its application to ongoing schemes. As described in section 3 of the report, it is also unsatisfactory when schemes have to wind up. Even if the MFR is met, the assets are insufficient to secure the accrued benefits and the result is that young members' interests suffer because priority is given to purchasing insurance contracts to secure pensions already in payment. However, the concept that the cash available to young members should represent a fair actuarial value of their accrued rights is not as effective as it might be because trustees

may, as a last resort, have to purchase non-profit deferred annuities for a residue of the members.

9.4 It is worth drawing attention to the fact that any incompatibility between the funding requirement and the assets required to secure the accrued benefits on discontinuance could, in principle, be met by a system of solvency insurance, if such a system could be devised. To be fully secure, the assets would have to be used to purchase insurance contracts. If they were paid as premiums to a Central Discontinuance Fund then, for equal security, it would be necessary to introduce also a system of levies to back the CDF’s promise.

9.5 The most expensive of those options would be for the premiums to the solvency insurance scheme to have to be sufficient to enable annuities to be purchased, albeit only for the small minority of schemes actually winding up. Note that, with this approach, the funding requirement for ongoing schemes could be changed to an extent which satisfied the wish of employers to have a lower, more stable, annual cost, which would more than offset the extra cost of the insurance premiums. It would be less expensive for the premiums to have to be sufficient only to secure entry to a Central Discontinuance Fund invested partly in equities but, for equal security to the annuity-purchase route, there would have to be a system of levies to support the operation of the CDF.

9.6 We would remind the Committee that this approach would be dependent upon being able to establish a satisfactory system of solvency insurance, and to overcome objections to such a system and to the accompanying system of levies. It would also require the participation of all schemes, in particular large schemes could not be excluded. We have examined these matters in section 8 of the report. We also examined in section 8 of the report the possibility of persuading the Government to award the status of preferential creditor to the debt due from the employer to the pension fund, but we did not hold out much hope that this would succeed.

9.7 We have considered how a new funding requirement more in tune with the needs of ongoing schemes might affect the calculation of transfer values, the splitting of the value of accrued pensions on divorce, and the calculation of the amount to be claimed from the Compensation Fund in the event of fraud. For the last of these, the liabilities as calculated on the new funding requirement would appear to be appropriate, so long as the new funding requirement was market-value based, so that the cash recovery would not take on a different value when it reached the valuation balance sheet. For the other two, we are not so certain. Use of the new funding requirement, even if market-value based, would produce values which reflected the special situation of the pension scheme, which could not be described as “fair actuarial values” in the open market in which the recipients of the cash sums would be investing the proceeds.

9.8 In view of the reported opposition to solvency insurance, and to a system of levies to support benefit guarantees in a Central Discontinuance Fund, and also the possibility that it might not prove to be practicable to devise acceptable systems, we have also considered how a CDF might operate if neither form of backing was available. In those circumstances, the precise nature of the new MFR would become important. If it were to be along the lines of the traditional ongoing funding methods in operation in past years, as envisaged by the NAPF then, with suitable assumptions, it could meet the requirements of ongoing schemes. The

question then would be whether the premium rates for admission to the CDF were on the same basis and could offer benefits proportionate to the level of funding.

9.9 As benefits in the CDF would not be guaranteed, the feasibility of introducing such a system would hinge on the benefit illustrations to be given to those admitted to the CDF, both to satisfy those representing the interests of pension scheme members, and the Government which would first have to be persuaded that they should support such changes by passing the appropriate legislation. The benefit illustrations would have to deal with both the starting pensions and the increments, or conceivably reductions, and take into account the installation of a strategy to determine how the award of increments in future would be derived from the performance of the investment in equities which would form a part of the portfolio. We have considered these difficulties without coming to a conclusion as to how they might be overcome. However, the benefit illustrations would be expected to impose constraints on the investment strategy to be adopted.

9.10 No doubt those uncertainties would be brought to light in discussions of such a system, but the other side of the argument would be to draw attention to the uncertainties in winding up with the present system, which is far from perfect. We have ourselves referred to these in paragraph 9.3 and in earlier parts of the report.

9.11 Another possibility, having regard to proposals currently under consideration elsewhere, would be to substitute the market-value approach to valuation. This approach would have the advantage, at the time of wind-up, that both assets and liabilities would reflect market values at the time, except that the value of the liabilities would reflect to some degree the yield on index-linked gilts, irrespective of the scheme's actual investments, so there would still be a degree of volatility in the valuation results, as with the present MFR.

9.12 Our conclusion is that there are a number of ways forward which might be considered, each with advantages and disadvantages. We have not considered detailed changes to the present MFR as this is the subject for a different working party. The first five of the possibilities mentioned below involve the setting up of a CDF and/or solvency insurance. The sixth does neither. With the first five, we envisage the present MFR being replaced by an ongoing valuation method (as suggested by those proposing the setting up of a CDF, and also now proposed in the recently issued terms of reference) which may, if appropriate, be used also for entry to the CDF. The sixth would probably involve retaining something like the present MFR, if members' benefits are to be reasonably secure in winding up.

9.13 In each case considered, the system would apply only where the sponsoring employer was no longer in business and an insolvency practitioner has been appointed. Other points which have general applicability to the options are given below:-

(i) It is intended that the benefits to be secured are the defined benefits under the scheme's Rules for both those in receipt of pensions as well as younger members. No allowance is to be made for any discretionary benefits.

(ii) If a CDF were to be established, the Trustees of the winding-up scheme of an insolvent employer would retain the option of buying-out the accrued liabilities with an insurance company.

(iii) If assets are insufficient at the time of winding-up (and the employer is insolvent) the first action for the Trustees will be to claim additional assets under the "debt on the employer" provisions in Sections 75 of the Act. In practice, however, we believe that this is unlikely to be a reliable source of additional funds for Trustees, not least because the debt is not high ranking and, unless that can be changed, the insolvent employer is unlikely to have sufficient assets by the time prior-ranking creditors have been paid.

(iv) With a new MFR, the present basis for calculating individual transfer values could be reviewed, for example, by breaking the present link with the MFR basis.

9.14 The options which we have considered are set out below. The first four involve setting up a CDF, either with or without benefits therein being guaranteed**.**

Option 1 – CDF with benefits guaranteed/no solvency insurance (i.e. as originally proposed to the PLRC)

Option 2 – CDF with benefits not guaranteed/no solvency insurance

Option 3 – CDF with benefits guaranteed/solvency insurance

Option 4 – CDF with benefits not guaranteed/solvency insurance

Option 5 – No CDF/solvency insurance

Option 6 – No CDF/no solvency insurance

Option 1 – CDF with benefits guaranteed/no solvency insurance

9.15 The main principles underlying this approach would be:-

(i) Once assets have been transferred to this form of CDF, the benefits are defined and guaranteed.

(ii) Trustees would be appointed as if the CDF were a form of special closed fund, albeit capable of receiving bulk transfers from other occupational schemes.

(iii) There would need to be a guarantor, such as the government or employers, with the potential for levies from time to time should the experience be adverse relative to the premium terms.

(iv) The Trustees of the CDF, and the Guarantor, would have freedom to establish their preferred investment policy, which could include equities.

9.16 *Advantages*

(i) In theory, this should be the lowest cost method of securing benefits for members of schemes where the employer has become insolvent.

(ii) Once secured, the benefits are guaranteed.

(iii) It provides a mechanism for large schemes to secure their liabilities without relying upon the capacity of the insurance market.

(iv) It would provide a mechanism for schemes which are 100% funded on the statutory solvency test to secure payment of the accrued benefits in full from the CDF.

9.17 *Disadvantages and difficulties*

(i) It may not be possible to set up a CDF which is exempt from the provisions of EU and UK Insurance regulations. If this is so, the CDF would effectively be classified as an insurance company.

(ii) Where schemes are underfunded on the statutory solvency basis, accrued benefits would have to be cut back at the time of discontinuance.

(iii) Employers are unlikely to wish to stand behind the guarantee. In particular, it would be solvent companies who would be financing the inadequate pension funding by insolvent companies.

(iv) The government is unlikely to accept the role of guarantor.

(v) As the terms of entry to the CDF would be likely to reflect investment of part of the funds in equities, the provision of guaranteed benefits with a guarantor (should one be found) might be regarded as unfair competition with insurance companies.

Option 2 -– CDF with benefits not guaranteed/no solvency insurance

9.18 The principal difference between this option and Option 1 is that the benefits, once transferred to the CDF, are not guaranteed. This has implications for the premium terms, the investment policy and inter-generational equity. In particular, we would expect such a CDF to operate a more matched investment policy even though, depending upon the mean-term of the liabilities transferred to it, there may still be a place for equity investment. Whilst the premium terms are likely to be higher than for Option 1, they would be expected to be lower than buy-out costs.

9.19 *Advantages*

(i) No need for a guarantor.

(ii) Individual employers are responsible for their own members and their underfunding costs are not transferred either to government or to other (solvent) employers.

(iii) It provides a mechanism for large schemes to secure their liabilities without relying upon the capacity of the insurance market.

(iv) It would provide a mechanism for schemes which are 100% funded on the statutory solvency test to purchase, nominally, 100% of the accrued benefits, but continued payment of those benefits in full would not be guaranteed.

9.20 *Disadvantages and difficulties*

(i) It may not be possible to set up a CDF which is exempt from the provisions of EU and UK Insurance regulations.

(ii) Where schemes are underfunded, accrued benefits would have to be cut back, and payment of that reduced amount would not be guaranteed in the CDF. It might rise above or fall below the amount nominally purchased.

(iii) The CDF Trustees may have to take difficult decisions on achieving a balance between maintaining a solvency margin and increasing or reducing benefits when actuarial surpluses and deficiencies are revealed from time to time.

Solvency insurance

9.21 With either Option 1 or 2, there is a chance that the benefits secured at the time of transfer would be less than 100% of the accrued benefits if the funding level is below the CDF premium required, as may be the case under normal experience fluctuations. We have therefore also considered some form of solvency insurance. We have examined this subject in section 8 of the report and have concluded that the system most likely to succeed would be that described in paragraph 8.9 (ii), in which each company carried its own risk, the premium reflecting the sum at risk and the company's prospects. The pros and cons of introducing such a system of solvency insurance are referred to below in the context of Options 3, 4 and 5.

Options 3, 4 and 5

9.22 It is worth noting that the funding threshold for the payment of insurance premiums, and the statutory minimum funding requirement, need not be the same. Thus, for example, under Option 5, solvency insurance would cover the gap between the actual funding level and the full cost of buy-out, and the MFR could be set below the buy-out cost.

9.23 With a system of solvency insurance in place, the only difference between Options 3, 4 and 5 is in the amount of the sum insured, the premium payable, and the quality of the guarantee of the eventual benefits. Only Options 3 and 5 guarantee the benefit payments after winding up.

9.24 Option 4 ensures a sufficiency of assets at the time of discontinuance, but does not guarantee the benefits payable subsequently from the CDF although, for the UK as a whole, it would cost relatively little to take the extra step and provide such a guarantee. We have put in Option 4 for completeness but we do not regard it as measuring up in comparison with Options 3 and 5 which do provide such a guarantee.

9.25 The *advantages* of solvency insurance are:-

(i) All members would have 100% of their benefits secured.

(ii) So long as there is a distinction between MFR and the funding level threshold for insurance, the costs would be small and good employers with well funded schemes would not incur further costs.

(iii) It could provide an incentive for boosting the funding position.

9.26 The *disadvantages and difficulties* of solvency insurance are:-

(i) There may not be an efficient market for the insurance.

(ii) Those employers most in need of solvency insurance will tend to find it most expensive thus exacerbating their commercial position.

(iii) Very large schemes which are not well funded may find it very difficult to obtain insurance.

(iv) It could cause potential economic instability as, presumably, insurance costs would rise in times of recession, just at the point when companies are under most pressure.

(v) Instead of boosting funding, some employers may be encouraged to cut benefits.

(vi) There may be scope for playing with the rules – for example, timing the valuation so as to be above the insurance threshold, seeking to underfund the scheme a year or two prior to bankruptcy (within statutory limits) etc.

Option 6 – No CDF/no solvency insurance

9.27 With neither a CDF nor solvency insurance, this leaves trustees in exactly the position they are in at present. If assets are insufficient at the point of wind-up, the only source of additional funds lies in the "debt-on-the-employer" provisions in the Act. Unless these provisions can be made more effective by awarding a higher priority to pension fund deficiencies, then only adequate funding will enable trustees to satisfy members' expectations that their benefits will be secured in full, or almost in full.

Conclusion

9.28 It has not been possible for the Working Party to support a single option unanimously. However, we are in general agreement with the comments which follow:-

(i) We believe that a system which avoids cross-subsidies is to be preferred, and would have the best chance of being generally accepted. Employers should stand behind the promises made to members while they are solvent and should not look to either the government or other employers to bail them out should they become insolvent. This points in the first place to ensuring adequate funding, and effective "debt-on-the-employer" provisions.

(ii) The level of security for members' benefits to be provided by the statutory minimum funding level is primarily a political decision. We believe that it is the actuarial profession's task to ensure that legislators understand the link between the level of security to be provided and the cost which the chosen level will impose on employers.

(iii) We believe that Option 1 is the one which best meets the main objectives of setting up a CDF. However, if it were to be deemed essential to avoid cross-subsidies in the payment of any levies to the CDF, it would be necessary for the Government to be involved as guarantor, rather than the generality of employers operating defined benefit schemes.

(iv) We would not favour either Option 3 or Option 4. With solvency insurance in place, we would see no necessity to set up a CDF, and would in that situation prefer Option 5 in which the present insurance buy-out approach would remain.

(v) If the Option 1 CDF proves not to be practicable, we see merits in the Option 2 approach, although the lack of benefit guarantee would need very careful communication and understanding

(v) Option 6, effectively the status quo, is the fall-back position. Its acceptability would depend critically on the changes which might be made to the MFR under the present review, and any reconsideration of the “debt-on-the-employer” provisions.

Next steps

9.29 We believe it would be prudent, before going much further in considering the various options, to:-

(i) seek legal advice on whether a CDF could be designed in such a way as to be exempt from EC and UK Insurance Regulations

(ii) request the ABI to nominate a panel of insurers to investigate the feasibility of rating for solvency insurance, the possible market in such insurance and sample premiums

APPENDIX

Problems of small schemes in the Pensions Act 1995 environment

This note describes the problems that small and medium sized schemes have experienced with the Minimum Funding Requirement and the Pensions Act 1995 (or may do in future). It relates to the second of the Working Party's terms of reference, namely:-

"To assess the risk covered under the insolvency of the company sponsoring the pension scheme and look at the impact of the Pensions Act 1995".

I have assumed that we are mainly concerned with scenarios where the company has become insolvent, as we have agreed that, where a company continues in business after discontinuing a Final Salary Scheme, it should be the employer's obligation to fund the benefits in full (whatever that may mean). I would also stress that this is based on my own experiences with small and medium sized schemes. It would be interesting to know whether others have had similar experiences.

Risk covered under the insolvency of the company sponsoring the pension scheme

I have assumed that the main risk to be considered under this heading is the risk that, as a result of the sponsoring employer's insolvency, the members if the pension scheme will not receive their accrued pension rights. The factors affecting this risk would appear to be:-

(a) The level of funding of the scheme on an "ongoing" basis,

(b) The probability that annuities will be purchased on discontinuance,

(c) The level and volatility of the cost of annuities on buy-out,

(d) The size of the company relative to the scheme,

(e) The basis of calculation of transfer values for non-retired members,

(f) The priority of any 'debt' on the employer relative to other debts.

A second issue relating to risk has occur to me. It is possible to envisage the case of an ongoing employer where a mature pension scheme exists that is large relative to the size of the company. As a result of the MFR an employer may not be able, or willing, to cope with the volatility of contribution rate that may occur. He therefore decides that the scheme should be wound up.

If, as we have previously suggested, the employer has an obligation, under the Trust Deed, to provide at least transfer values for non-retired members who wish to transfer, and to insure the benefits of those members who do not, it is also then possible that this event may lead to the employer becoming insolvent. This is obviously a secondary risk but one that may affect the use of a Central Discontinuance Fund if created.

The nature of smaller schemes

Before going on to consider the above risks and the impact that the Act has had on smaller schemes in particular, it is worth commenting on some of the main differences between small/medium schemes and large schemes :

Volatility

This is probably the main difference between large and small schemes and it covers a number of aspects:-

(a) The small size of membership with such schemes makes funding significantly more volatile. Membership changes, such as one member retiring or a significant number getting a pay rise greater than expected, can adversely affect the funding.

(b) Small or medium sized schemes are often sponsored by small or medium sized companies whose cash flow position is also volatile and who need, for survival and competitive reasons, a stable contribution rate.

(c) A medium sized scheme may well be a mature scheme invested in a unitised contract with a significant non-insured pensioner liability in comparison with the current company size. This leads to a gearing effect on the contribution rate and, in volatile market conditions, can significantly affect the scheme's ability to insure pensions in payment. This effect is worsened if an appropriate matching policy is not followed.

Assets

While large schemes (and some medium sized schemes) may be directly invested in stocks or invested via "Managed Funds", smaller schemes may be invested in insured conventional with-profit or non-profit contracts which have historically provided a smoothed lower-risk investment return.

Quality of advice/knowledge

Traditionally in small schemes, scheme actuaries and administrators are more remote from their clients than is likely to be the case in larger schemes. It is not uncommon in an insurance company for a Scheme Actuary to advise more than 50 schemes, compared to a consultancy where the norm may be 20 to 30 schemes, or even less. The result of this is that the Scheme Actuary may not be as aware of some of the decisions made by either the Trustee or Employer, and this may then lead to funding problems at a subsequent valuation or on winding up.

However, this aspect is not one-sided and it is probable, in my experience, that an employer or board of trustees spend less time on the running of the small/medium sized pension scheme than would be the case with a larger scheme. While this may not directly cause a problem it

does mean, due to a lack of understanding of possible consequences, that problems are more likely to arise that may lead to difficulties in funding or on winding up.

<u>Summary of differences between small and large schemes in the context of "Risk"</u>

I. As a result of the volatility involved in the funding of small schemes, the basis used to set contribution rates is likely in general to have been more conservative than that used to fund larger more stable schemes. This reduces the risk of members receiving less than their accrued rights on winding up.

II. As a result of the nature of small schemes it is unlikely that, on discontinuance, the scheme will continue with a closed fund. Therefore, as the purchase of annuities is more likely in the case of a small scheme, the security of a member's accrued rights is more at risk from the general level of, and fluctuations in, annuity costs than the member of a large scheme.

III. The volatility of the cash-flow position for small/medium sized employers means that, on average, it is more likely that a small employer sponsoring a small/medium sized pension fund will become insolvent. The risk that a member's accrued rights in a small scheme will not be met as a result of insolvency are therefore greater than for a member of a large scheme.

IV. Many of the smaller schemes will historically have been run by insurance companies. My experience suggests that historically many actuaries working for insurance companies will have based transfer value calculations, under GN11, on gilt yields, with perhaps lower reinvestment rates. Such a basis would have produced higher transfer values for non-retired members of small schemes relative to larger schemes, and on winding up would have therefore produced a higher "statutory debt" under GN19.

V. The changes in the legislative background over the past twenty years or so have made small defined benefit schemes considerably less attractive to sponsoring employers. As a result, many have decided to switch to defined contribution schemes. In such scenarios, active members will be offered full transfer values (due to statutory debt provisions) to any replacement arrangement. However, deferred members are unlikely to transfer and older active members may not be advised to transfer. Under current circumstances, annuities will have to be purchased for these members. If it is accepted that an ongoing employer should meet the cost of these annuities (plus any annuities for pensions in payment) in full, then there is a possibility that the cost may force a small employer into insolvency.

This is a greater risk where the scheme is of very significant size in comparison to the employer's business. Where such an event occurs, the normal approach is to reduce benefits for members to match the funds available (to avoid insolvency of the employer). This is an issue affecting small/medium schemes more than larger schemes and thereby increasing the risk that members of such schemes will not have their benefits met in full on wind-up of their scheme.

Impact of the Pensions Act 1995

Many of the problems that small and medium sized schemes have experienced as a result of the impact of the Pensions Act are similar to those of larger schemes. However, I have left it to others to cover these and confined my comments to issues related to small and medium sized schemes in the context of wind-ups.

(1) Increases in the volatility of contribution rates

Although, traditionally, smaller schemes may have been funded more conservatively than large schemes some employers, on seeing the difference between their funding levels and the MFR basis, have moved towards funding on the MFR basis. This has led to a weakening of funding bases, with fewer margins for volatility and, as a result, this action increases the risk of there being insufficient assets on wind-up.

The time-scales for recouping serious shortfalls under the MFR further increase the volatility of the pension scheme contributions.

The MFR has proved inadequate for small, medium and large schemes due to its assumed asset distribution of UK equity or fixed-interest investments. Many reasonably well funded schemes may have matched the equity exposure suggested by the MFR but, as they held overseas equity for diversification reasons, would have seen a reduction in funding levels due to the UK equity out-performance in the period to September 1998. The required asset distribution may well have been reasonable if the period to recoup MFR debts was long enough to let "diversification" of various asset classes work through in the long term. However, when combined with the fact that deficits have to be recouped quickly, this causes further problems.

Further, the nature of the assets of small schemes may not allow matching to the MFR liabilities. This again increases the volatility of the contributions. While in some situations it is possible to switch out of such assets, the terms available may not make this a desirable option.

An issue that may be related to this comes under the "quality of advice" heading. It is very likely that small and medium sized schemes have had considerably less discussion and information on asset-liability matching and volatility than larger schemes. As such, while larger schemes may be able to manage the risks they are running, smaller schemes may not understand these risks and are less likely to have taken action to manage them. Again, this increases the volatility of funding for small schemes to a greater level than large schemes.

While these issues can also pose problem for larger schemes, the level of volatility of the contribution rate in a large scheme in place before (and possible after) the legislative changes, was probably less. The increase to the level of volatility that already existed for small schemes, combined with the fact that smaller companies may in any case have cash flow problems, means that the impact on smaller schemes will be greater and may in some cases be the "straw that breaks the camel's back". The impact of this can either be to wind up the scheme and switch to money purchase - which tends to increase the risk that members'

benefits will not be met in full or, in some extreme cases, perhaps lead to the insolvency of the employer.

(2) Increases in employer costs

The additional complications introduced by the 1995 Pensions Act (Section 67 issues, the MFR, whistle-blowing responsibilities, etc) have increased the cost of administering schemes. In many instances these costs are scheme-related and not size-related. The effect of this is to increase the costs of small schemes significantly in comparison to larger schemes.

Benefits costs have increased due to the introduction of Limited Price Indexation (and possibly the Reference Test). Many smaller schemes made no allowance for increases to pensions in payment (discretionary or otherwise) and this requirement has therefore increased employers' costs. The effect of this may have been less for larger schemes which had already been funding for discretionary increases.

This has resulted in increased concern about costs (and hence long-term solvency of the company) and has led to a trend way from Final Salary to Money Purchase. This leads to more wind-ups and a greater risk to members of small and medium sized schemes.

(3) Gap between transfer values and annuity costs

In many cases small schemes have adopted a basis close to the MFR as the transfer value basis. In many cases, the effect of this has been to reduce the level of transfer values offered by such schemes.

At the same time, economic circumstances have increased the cost of annuities, This, combined with the decrease in levels of transfer values, means that the gap has probably increased more for smaller schemes than for larger.

The increase in buy-out costs in comparison with transfer values may mean that an employer switching to Money Purchase can now meet the statutory debt provisions more easily that before April 1997, but will be less able to buy out benefits via annuity policies for any members who do not transfer.

(4) Communication and trustee risk issues

Despite the "shortfall" between the MFR and the cost of buy-outs, the introduction of an MFR has heightened members' awareness of the security of their pension rights. In future, this may increase the risk that trustees are felt to be acting inappropriately when benefits are cut back.

While this may equally be true of small and large schemes, the level of understanding and quality of advice of issues may be greater in large schemes and this may help the trustees to communicate issues. Further, as set out above, the insolvency of companies running small and medium sized schemes is probably more likely than large companies running large schemes.

(5) Purchase of annuities at retirement

At present, many small schemes will already fully insure pensions in payment. On wind-up they are therefore in a better position than larger schemes which have to cover the extra cost of insuring pensions in payment over the ongoing/MFR cost.

Small and medium sized schemes that do not purchase annuities at retirement have similar issues with the difference between the MFR and buy-out costs as for larger schemes. However, the risk for smaller employers is that the liability as a proportion of their annual profits may be significantly greater, thus increasing the risk to members benefits .

ADDENDUM

to the report of the Central Discontinuance Fund Working Party

Note by Deborah Cooper on the operation of the Pension Benefits Guaranty Corporation in the U.S.A. (see paragraph 8.16 of the Report).

Background

The PBGC is a US Government Agency that guarantees defined benefit pension benefits for the participants and beneficiaries of insolvent companies with underfunded plans. It has assets of approximately $16 bn, held in two funds – the Trust Fund, which receives the assets of terminating pension funds, and the Revolving Fund, into which premiums are paid. Investment in the latter is more strictly regulated.

The PBGC covers about 42 million individuals in about 45,000 pension plans. Since it started in 1974, approximately 465,000 workers and pensioners in 2,510 terminated pension plans have had to rely on its provision. It pays benefits according to the rules of each individual pension plan up to limits set by law and in 1997 it paid out benefits of $824 million. Schemes participating in the PBGC pay a flat rate premium of $19 p.a. per individual covered, together with an additional variable rate of $9 per £1,000 unfunded vested benefits, up to a maximum $72 per participant.

The problem

Although the number of pension scheme terminations is falling, the net claim against the PBGC has been rising, since the unfunded liabilities per termination have increased and recoveries from employers are low. The estimated PBGC deficit was $2.9 bn in 1993. This figure ignores the cost of expected future terminations and so is likely to be an understatement.

Although in the US the great majority of pension schemes are well funded, there is a significant minority that are underfunded, possibly to as much as $53 billion. Fifty companies, fewer than 1% of the plans insured, account for more than 70% of the underfunding. The PBGC estimates that 25% of the underfunding is in respect of 'financially weak' companies. Underfunding tends to increase as companies enter financial difficulties, so the eventual exposure could be worse. Whilst the financial health of these 50 companies varies, it is arguable that the pension system effectively enables them to remain in business.

The PBGC's problems are partly structural, as a result of the difficulties in organising a guarantee program that avoids the risk of selection. The premium basis is only partly related to exposure, and unrelated to default risk, so it incorporates cross subsidies from well funded to poorly funded schemes, and introduces opportunities to select against the PBGC. In addition, the average premium rate per $1,000 is about $3.4. This is lower than the lending rate available from commercial lenders, which gives perverse financial incentives to employers with defined benefit pension schemes.

Premiums are the PBGC's only source of income. Insurance is mandatory for defined benefit schemes, and an increase in premiums commensurate with the liabilities could encourage employers to move to defined contribution provision. This would erode the premium base of the PBGC, and at the same time (probably) increase its level of risk.

When the PBGC was first started it was in a weaker position: employers did not have to be insolvent to make a claim; employers had control over funding levels; and premiums were not risk or exposure related. Since then, claims against the PBGC have been restricted to insolvent companies, funding requirements have been tightened, the premium basis partly reflects exposure, and the PBGC has a claim on the employer. However, difficulties still remain: some employers are still not funding their schemes to the minimum funding level; the minimum funding rules have not worked well in conjunction with the full funding limit; and bankrupt companies often have little net worth to recover. At the same time, issues critical to addressing risk and exposure, such as asset volatility, have not been addressed.

In addition, however, the PBGC also faces political difficulties, since Congress appears to view the PBGC as a means of subsidising employees and shareholders in certain industries, not solely a pensions insurance program.

What to do?

Some would suggest that the only solution is to move to a system of 'true' insurance, provided in the market place. The expectation is that new and innovative products would then emerge, perhaps permitting underfunding, since the employer would bear cost of the increased risk to scheme members, or with contract terms limiting employers discretion by excluding certain actions from cover. It is argued that the PBGC is not able to provide this service since it is a monopoly provider and so has no competitors to learn from and, since the scheme is mandatory, it has no information on consumer preference. Also, as a government organisation, it does not necessarily have access to appropriate data.

An advantage would be that the perceived 'transfer' function of the PBGC would be separated from the insurance function, so that government subsidy of inefficient industries would become more explicit.

The only other options available to the PBGC appear to be to reduce the level of benefits paid, or to ask for government support, since if it were to increase its premium level commensurate with the underlying risk, it might create a wholesale retreat to defined contribution schemes.