iapf
the voice of Irish pensions

Review of the Funding Standard

Response to the Consultation Document on the Review of the Funding Standard

September 2004

Contents		**Page**

Table of contents

1 Executive Summary

This document is the formal response of the Irish Association of Pension Funds to the Consultation Document issued by the Pensions Board entitled Review of the Funding Standard dated July 2004.

The Irish Association of Pension Funds (IAPF) was established in 1973 and is a non-profit, non-commercial organisation. Our members provide retirement security to over 200,000 employees, pay pensions to nearly 70,000 people and are responsible for some €50 billion in retirement savings.

The IAPF would welcome the opportunity of discussing the contents of this submission with the Pensions Board at an oral hearing.

1.1 Responses sought

The Pensions Board has sought responses to the following questions:

1.1.1 Should the standard be based on advanced funding?

The Pensions Board specifically requested that respondents cover whether the standard should be based on advanced funding rather than exit funding or other approaches. IAPF believes that the standard should be based by reference to advanced funding of the benefit promises made.

The additional security which advanced funding provides to the member's entitlements is preferable and more easily understood by scheme members. The alternative of an exit funding based standard would potentially undermine the "comfort" provided by the defined benefit promise.

As stated by the Pensions Board the international experience of exit funding arrangements would tend to suggest that they cannot provide a satisfactory level of security to members (unless advance funding is also required) without a State back-up guarantee. The possible combination of advanced funding together with an insolvency guarantee fund should be explored further.

As stated later in this document, a less onerous funding standard test, combined with exit funding mechanisms (such as a State backed annuity scheme and a voluntary lien on employer assets) could provide comparable levels of security for members' benefits to that provided by the existing standard. This combination could also reduce the possible disincentive to employers to continue sponsoring funding defined benefit schemes.

The IAPF believes that an environment where defined benefit schemes are maturing, forcing such schemes to fund at a rate higher than necessary on an ongoing basis will detract from national competitiveness by requiring companies to utilise capital in an inefficient manner. It may also act as hurdle to a policy objective of enhancing defined contribution adequacy if companies' overall pension spend is weighted towards inefficient funding of annuity costs where the purchase of annuities is not anticipated.

IAPF expect that over a period of 15 years or more there will be a very significant shift in the maturity and profile of Irish pension schemes with a dramatic increase in the weighting of liabilities towards pensioner liabilities. We believe that the inefficiencies, in terms of capital utilisation, of requiring employers to reserve assets on an annuity cost basis where there is no expectation or intention that annuities will be purchased to discharge these liabilities present very significant public policy issues which must be addressed in this review of the funding standard.

1.1.2 If so, should the level of the current funding standard be reduced?

The IAPF recognises that defined benefit schemes in Ireland vary considerably in size and maturity and that a "one size fits all" approach may not therefore be feasible. The IAPF therefore believes that the current standard, including an extended funding period for scheme deficiencies and the valuing the scheme's liabilities for pensioners by reference to annuity costs and active and deferred members on a long term basis, could continue and be disclosed to members. Failure to meet the standard would require the preparation of a funding proposal.

However, IAPF would argue that schemes could be allowed (under S.49(3) of the Pensions Act) to prepare a funding proposal designed to meet a revised standard which operates on a going concern type approach. This would remove the requirement for a scheme's pensioner liabilities to be measured against annuity costs and value the scheme's liabilities for active and deferred members on a long term basis that anticipates the returns that might be expected from a mixed portfolio containing a significant proportion of equities. Guidance as to the methodology and assumptions to be used should be specified by the Society of Actuaries in Ireland for use by Scheme Actuaries.

The usage of a long term ongoing funding approach should be linked to an exit funding mechanism, such as a voluntary "lien on employer assets" and a "nil cost" State backed annuity purchase scheme in cases of corporate insolvency.

1.1.3 If so, by approximately how much?

The IAPF believes that the current standard, including the amendments outlined above, could continue if schemes were permitted to submit a funding proposal based on a going concern type approach and incorporating alternate mechanisms or commitments for enhancing member security.

1.1.4 If it is changed, should the funding standard follow the current structure or require a minimum fixed benefit per member?

The IAPF believes that the revised funding standard should follow the current structure rather than a minimum fixed benefit per member.

1.1.5 If the standard follows the current structure, should the changes be made to the pensioner standard, to the active deferred member standard or to both?

The IAPF believes that changes, subject to guidance issued by the Society of Actuaries in Ireland, should be made to the method for valuing the entitlements of pensioner, active and deferred members.

1.1.6 How do respondents view the Board's preferred option?

The IAPF believes that the current standard, including the amendments outlined above, could continue if schemes were permitted to submit a funding proposal based on a going concern type approach and incorporating alternate mechanisms or commitments for enhancing member security.

Additional comments are provided later in this report.

1.1.7 Wind up priorities

Based on the proposed approach favoured by the IAPF, the IAPF believes the current wind up priority ranking to be appropriate. The IAPF recognises that there are a number of arguments which can be put forward justifying a higher priority ranking for actives with long service, older members etc. IAPF recognises that significant amendments introduced in this area would lead to additional complexity.

The one area where the IAPF believe a change should be made is in the area of the value placed on pensioner liabilities in the event of a scheme wind up. The IAPF believes that the value placed on such liabilities should be first and foremost the actuarial valuation of pensions in payment on an ongoing valuation basis. Subsequent priorities would cover active and deferred members, with any balance of assets remaining after these liabilities have been discharged, being used to meet the additional cost of securing annuity contracts for pensioners. The rationale for such an approach is that it treats all scheme members on a consistent basis by valuing their entitlements under the scheme based on their economic cost as determined by reference to the valuation basis. The IAPF suggest that, in the context of adopting such an approach, it would seem logical, on wind-up, to make available to pensioners the option to transfer the value of their benefits to an ARF or a State backed annuity purchase scheme.

The consultation document also identifies the possibility that pension increases could be treated separately in the wind-up priorities. One possible route in this regard would be to allow greater flexibility as regards the speed at which pension increases are to be funded in the case of a scheme in deficit , including perhaps the proviso that the core benefit entitlements are met over the "normal" 3½ year period.

1.1.8 Early retirements from underfunded schemes

The IAPF believes that the provisions of the Social Welfare (Miscellaneous Provisions) Act 2003 should be extended to enable trustees to withhold consent to the payment of Early Retirement pensions to reduce Early Retirement pensions to a level dictated by the active solvency level in order to protect the remaining members against anti-selection.

The IAPF again urges that trustees be given the power to withhold consent to the payment of early retirement benefits in circumstances of scheme insolvency and that trustees may agree alternative early retirement provisions whereby, for example, early retirement pensions can be paid but would not attract priority until the member reaches normal pension age in the event of wind up prior to normal pension date.

1.1.9 Lien on Employer Assets

To avoid the potential duplication of calculations and increased compliance cost, any calculation of a shortfall should be consistent with the revised funding standard. The potential introduction of a statutory debt for pension scheme shortfalls, combined with a wind up funding standard, would be likely to discourage the continued provision of defined benefit pension schemes and should not be pursued.

The IAPF believes that the ability for schemes to prepare a funding proposal based on a long term ongoing funding approach should be linked to an exit funding mechanism, such as a voluntary "lien on employer assets" and a "nil cost" State backed annuity purchase scheme in circumstances of corporate insolvency.

1.1.10 A pension protection fund

The IAPF agrees with the Pensions Board that the issue of a pension protection arrangement to top-up benefits when a scheme winds-up with a shortfall should be explored further. Comparable arrangements are currently in place in the UK and US and the potential provision of a guarantor of last resort would provide pension scheme members with an additional safety net in the event of the insolvency of a sponsoring employer.

The IAPF does not believe that such a fund should result in more well funded schemes subsidising weaker funded schemes and has proposed in this document that a State backed annuity purchase fund be created on a "nil cost" basis.

2 Response from the IAPF

2.1 Purpose of the Funding Standard

At the outset, we feel it is worth stating that we appreciate the underlying rationale behind the adoption of the current funding standard and that we are fully supportive of that rationale. However, we also believe that, in the recent environment of falling interest rates and volatile investment markets, a lack of flexibility in the application of the standard may lead inadvertently to the undermining of the position of members of defined benefit schemes.

IAPF understand that the funding standard as it was originally enacted and the time constraints on funding proposals presented a threat to the level of benefits in some schemes. We were therefore supportive of the interim measures introduced last year to safeguard active members of these schemes from reductions in benefits that may be contemplated due to the impact of the original funding standard framework. These measures were introduced as a short term measure pending the review of the funding standard.

For many pension schemes the original funding standard basis could give rise to a situation whereby short term solvency considerations require the employer to make additional substantial contributions to the scheme over the short term.

Employers facing such a scenario may have no option but to discontinue their defined benefit pension scheme with a consequent shifting of risk from the employer to the scheme members. Alternatively, employers may seek to reduce benefits for members to a level which would make their schemes affordable on the funding standard basis regardless of whether or not the existing benefits are affordable on a long term funding basis.

The IAPF believe that it is not in the long term interests of members of defined benefit pension schemes that the funding standard should have such an impact.

The IAPF believes that an environment where defined benefit schemes are maturing, forcing such schemes to fund at a rate higher than necessary on an ongoing basis will detract from national competitiveness by requiring companies to utilise capital in an inefficient manner. It may also act as hurdle to a policy objective of enhancing defined contribution adequacy if companies' overall pension spend is weighted towards inefficient funding of annuity costs where the purchase of annuities are not anticipated.

2.2 European Union IORPs Directive

The revised standard should be reasonably robust so as to cope with changes in economic circumstances and should comply with the European Union IORPs Directive to avoid the need for subsequent corrective legislation.

2.3 Objectives of the Funding Standard

The IAPF believe that the funding standard should attempt to balance two objectives:

- The safeguarding of the benefits that members have accrued to date; and
- To avoid discouraging defined benefit provision.

The funding standard should aim to ensure that defined benefit schemes, sponsors and members are able to provide a reasonable level of security for benefits accrued to date. This should, of course, be balanced against the constraints and cost implications it may create for sponsoring employers and members.

The IAPF believe that no funding standard can provide absolute security to all members as it would be likely to place excessive demands on sponsors of defined benefit scheme and hence potentially lead to the end of defined benefit scheme provision. However, IAPF support efforts to ensure that adequate disclosure of relevant scheme information (including solvency and funding approach) is in place for the benefit of members.

2.4 A long-term standard

The IAPF believes that any change to the funding standard should be a long-term change as defined benefit schemes are very long-term arrangements and need stability in order to plan and invest to reflect their long-term commitments.

As outlined at our meetings with you last year, defined benefit pension schemes operate on the basis of pooling risks across a group of members. Most schemes operate on the basis that long term considerations take priority over short term issues. The great majority of defined benefit pension schemes have liabilities that will emerge over an extended future period of time and the investment strategy followed for the majority of these schemes reflects this fact. It is the ability of pension funds to take a long term view that has allowed them to invest a significant proportion of the assets in equities, thereby allowing access to the higher potential returns achievable from this form of investment.

The type of long term return that is available from equity investment has enabled many employers to afford the provision of relatively generous defined benefit pensions. Without access to equities, many employers would no longer be able to afford to provide the level of benefits that has been enjoyed by members in the past.

2.5 A going concern versus wind up approach

We believe that the purpose of the funding standard should be to provide a financial "health check" on the status of the fund **as a going concern**. By their nature, long term investments are volatile in the short term and this can lead to a situation whereby a defined benefit pension scheme, although remaining on target to meet its long term objectives, can become technically insolvent on a short term basis. Under the normal ebb and flow associated with long term investment strategies, this technical insolvency can be corrected over time.

The funding standard as it currently operates concentrates on the position if the scheme were to be wound up at the effective date of the actuarial funding certificate. It therefore focuses on the situation at a point in time rather than the long term nature of the pension fund.

The IAPF therefore believes that the current standard, including an extended funding period for scheme deficiencies and the valuing the scheme's liabilities for pensioners by reference to annuity costs and active and deferred members on a long term basis, could continue and be disclosed to members. Failure to meet the standard would require the preparation of a funding proposal.

However, IAPF would argue that schemes could be allowed to prepare a funding proposal designed to meet a revised standard which operates on a going concern type approach. This would remove the requirement for a scheme's pensioner liabilities to be measured against annuity costs and value the scheme's liabilities for active and deferred members on a long term basis that anticipates the returns that might be expected from a mixed portfolio containing a significant proportion of equities.

A revised standard which contains less of an emphasis on the 'wind-up' focus of the current funding standard would be preferable. The IAPF believe that the Society of Actuaries in Ireland could specify a framework of actuarial methods and assumptions that would have to be used to assess the funding position of schemes on an ongoing approach, for the purposes of calculating the scheme's statutory liabilities. The specified assumptions would have to be reviewed on a regular basis.

The IAPF would also support the testing, by the Scheme Actuary, of the sensitivity of the scheme's funding position to various alternative assumptions.

2.6 Impact on scheme's investment policy

The format and impact of any revised funding standard should avoid potential distortions/imbalances in investment markets and the investment freedom of trustees/sponsoring employers. If the funding standard is too restrictive, and particularly if the time allowed to restore full funding is short, the standard will potentially impact and constrain the investment policies of schemes. The IAPF believes that schemes should be capable of funding the benefits promised based on the long term economic cost of such benefits.

2.7 Advanced or exit funding

The Pensions Board specifically requested that respondents cover whether the standard should be based on advanced funding rather than exit funding or other approach. IAPF believes that the standard should be based by reference to advanced funding of the benefit promises made.

The additional security which advanced funding provides to the member's entitlements is preferable and more easily understood by scheme members. The alternative of an exit funding based standard would potentially undermine the "comfort" provided by the defined benefit promise.

As stated by the Pensions Board the international experience of exit funding arrangements would tend to suggest that they cannot provide a satisfactory level of security to members (unless advance funding is also required) without a State back-up guarantee.

The usage of an advance funding approach on an ongoing basis could be linked to an exit funding mechanism, such as a voluntary "lien on employer assets" and a State backed annuity purchase scheme in circumstances of corporate insolvency.

2.8 State backed annuity purchase scheme

The IAPF believe that there is merit in the State providing a vehicle to take on, in rare incidences, pensioner liabilities in return for the payment of a capital amount based on the actuarial value of such benefits on an ongoing basis.

A State backed annuity purchase scheme would enable the Board propose an advance funding system on a discontinuance basis but with the flexibility to allow employers elect (with trustee and Pensions Board consent where the best interests of the members dictate) an ongoing funding approach with additional security such as a voluntary lien on employer assets. The State backed scheme would then provide an additional safety net in instances where involuntary insolvent wind-ups occur and where the employer has insufficient assets to satisfy the difference in assets between the ongoing liability in respect of pensioners and the annuity cost for such purchase.

Under this framework the State could agree to accept assets at the ongoing valuation rate in exchange for the payment of the pension to the member and this would allow the State at a no cost basis to provide the protection necessary in order to underpin the defined benefit system.

In this environment it would also be possible to envisage that in insolvent wind up pensioners could be offered the option of transferring their benefits to an ARF at the actuarial valuation or ongoing value of those liabilities rather than the annuity cost. This may well suit some pensioners and would also relieve the position regarding the funding of deferred members and active employees. It is probable that the system, in such circumstances, would have to also be amended to allow ARF options for pensioners on solvent wind up to ensure that the range of options available for members of an insolvent wind up is freely available to all, i.e., that pensioners on insolvent wind up are not preferred.

The advantages of a proposal in this regard are to allow employers to elect to fund schemes on an ongoing basis. In return, it is proposed that employers' commitment to continue to fund such schemes is underpinned by a voluntary assumption by the corporate entity of a "lien on employer assets". This lien would apply in circumstances where the scheme is subsequently wound up and has insufficient assets to secure annuities for pensioner liabilities.

In addition the current funding standard framework would not require a significant alteration as the existing funding standard would remain in place and an ongoing funding standard would merely be an option for the trustee / employer election subject to Pensions Board consent under Section 49(3).

The establishment of a State backed annuity purchase scheme can be supported by the following arguments.

- It will only apply in the event of involuntary insolvent wind-ups (i.e., where the employer has gone into liquidation) and where there are insufficient corporate assets to satisfy the "lien on employer assets". The incidence of such events could reasonably be expected to be low.

- It would not necessarily require any substantial State funding and therefore as an alternative to a pension protection fund, avoid the imposition of levies on either the taxpayer or the pensions system.

- It would operate on a basis where, on the insolvent liquidation of a sponsoring employer, an insolvent scheme would transfer to a State backed fund the actuarial equivalent (calculated on an ongoing basis) of the pensioner liability.

- The fund could be invested on an ongoing basis with an equity/bond mix and should not be subject to EU Life Directive regulations or IORP's investment principles. As such the fund ought to be able over the long term to satisfy the pension liabilities from the assets paid into the fund.

- The incidences of involuntary insolvent wind-ups are unlikely to be materially significant (in terms of the number of such occurrences arising).

- There are numerous third party administrators who would be willing to operate a pensions payroll system, thus eliminating any administrative burden on the State. Costs associated with this administration would be included in the actuarial basis for determining the costs of benefits.

- Equally, the investment of the fund's assets could be managed by private sector trustee and investment manager appointments to further eliminate administrative burden on the State, or otherwise by the NTMA using the NPRF. Costs associated with this operation and investment management fees would be included in the actuarial basis for determining the costs of benefits.

- The existence of such a scheme may be seen to prefer members of defined benefit schemes. As such, it may be appropriate to simultaneously recommend the extension of the ARF regime to all defined contribution members.

3 Comments from the IAPF

In addition to the responses in Section 2 above which address the issues on which the Board sought specific responses, the IAPF would offer the following additional comments for the Board's consideration.

1 The IAPF believe that the standard should value the scheme's liabilities for active and deferred members on a long term basis that anticipates the returns that might be expected from a mixed portfolio containing a significant proportion of equities. This would also include ending the requirement to value pensioner liabilities by way of annuities for the purposes of the standard.

2 Where a funding proposal is required, the standard should continue to provide scheme trustees with the flexibility to fund the shortfall over an extended period of time and, where there are sound logical reasons for doing so, including periods in excess of 10 years. In the UK where the Minimum Funding Standard is set at a significantly lower level a period of 16 years has been adopted. Where all parties, employer, trustees and members are in agreement, longer extensions could be considered. Following the Social Welfare Act, 2003 this is now a matter of Pensions Board policy and would not require legislative or statutory amendment.

3 Section 50 of the Pensions Act should be amended to alter the situation now prevailing where members in active employment are expected to shoulder the burden of the deficit attributable to all members (including active, deferred and pensioner liabilities). The proposed amendment should allow the Pensions Board direct a reduction in the benefits of all members, including those of deferred members and pensioners as appropriate.

4 Where a plan fails the Funding Standard and an employer is considering a reduction in benefits so as to restore solvency, there should be a requirement to make a submission to the Pensions Board under Section 49(3) setting out the best funding proposal that can be agreed by the employer and the trustees without reducing benefits. Clearly, the employers ability to meet the long term funding rate would be critical to any consideration of such circumstances.

5 The provisions contained in the Pensions (Amendment) Act 2002 for the inclusion of annual actuarial statements in annual reports should be reviewed as it has placed an additional compliance burden on defined benefit schemes. Perhaps a confirmation statement from the Scheme Actuary could be included referring to the previous actuarial funding certificate, any funding proposal in place together with a statement that the trustees will monitor the funding position of the scheme in consultation with the Scheme Actuary.

6 An amendment be made to the Pensions Act in the Social Welfare Act 2004 to allow trustees to compulsorily purchase buy-out bonds at active solvency level for members who opt out.

7 Broader guidelines to be introduced for Industry Wide schemes, as they do not pose the same risk of corporate insolvency and redundancies co-incident with scheme insolvency and wind-up.

Section 48 could be amended in respect of industry wide multi employer schemes (other than "sectionalised schemes") to enable partial wind up to apply at active solvency levels for active and deferred members where the participating employer has terminated its liability to contribute. As it presently stands, the law does not allow for this to occur with the effect that the viability of some such schemes is in serious doubt as past service deficits relevant to the liabilities of deferred members employed by the employer whose participation has ceased, increases the burden on the remaining participating employers and employees to an unsustainable level.

As many such schemes operate on a basis where the contribution rate is apportioned between employees and employers, the impact effects employee contribution rates and employer contribution rates and in many circumstances it may not be in the interest of members to continue such schemes when the employee contribution rate exceeds the rate which might otherwise represent value for money. This becomes increasingly the case as employer and employee contribution rates are increased to meet the past service deficit applicable to the deferred members whose participation has ceased.

8 The IAPF would agree with the Pensions Boards suggestion that the provisions of the last year's Social Welfare Act should be extended to enable trustees to address Early Retirement Pensions in the context of the active solvency level in order to protect the remaining members against anti-selection.

The IAPF would again urge that trustees be given the power to withhold consent to the payment of early retirement benefits in circumstances of scheme insolvency. Trustees should also be capable of agreeing alternative early retirement provisions whereby, for example, early retirement pensions can be paid but would not attract priority until the member reaches normal pension age in the event of wind up prior to normal pension date.

9 The IAPF believes that Section 49(3) should be amended to incorporate the impact of interest rate movements, as they are effectively the same as changes in investment market conditions.

10 Consideration might also be given to extending the ARF option for securing pensions on insolvent wind-ups or for enabling early retirements on a share of fund basis. This could be considered together with the revision, by the Society of Actuaries in Ireland, of the assumptions underlying the calculation of liabilities under the funding standard.