The Irish Association of Pension Funds

Submission on

The Proposed Approach to Defined Benefit Pension Provision Consultation Paper

(May 2011)

1. Introduction and Summary

1.1 This document represents the response of The Irish Association of Pensions Funds to the consultation document on the Proposed Approach to Defined Benefit Pension Provision.

1.2 The objectives of the review of the operation of DB schemes are critically important as they will shape any changes that emerge. While some objectives of the Implementation Group's review of DB schemes are set out, there appear to us to be conflicting objectives. In Section 2, we have commented further on this and have elaborated on objectives we believe should also underlie any new model.

1.3 **The Government must ensure that any changes are made on a basis which would not in fact threaten the provision of benefits and in particular would not trigger the wind up of schemes which are currently viable.** It is essential that a full and detailed Impact Analysis is carried out before any changes are introduced. Some of the options set out have the potential to damage the level and security of pension for members. The impact of each potential course of action needs to be fully understood before any changes are introduced and we call on the Implementation Group and Government to carry out this analysis before proceeding.

1.4 The Implementation Group's review represented an opportunity to carry out a full review of the operation and funding of DB schemes. The paper however starts from the premise that large parts of the existing system, with some adjustments, should continue. Many elements of the existing system are not even considered such as the requirement to reserve for pensioners based on annuity pricing and the priority afforded to pensioners on wind-up. In our view the existing regulatory regime is not fit for purpose and a broader review of the operation and funding of DB schemes should have taken place.

1.5 We believe the consultation process should have been extended beyond "the pensions industry, employers and trade unions". The changes proposed will impact on employers, trustees and scheme members. Not all of these stakeholders are represented by the organisations consulted with and many of those would also have availed of the opportunity to give their views. Those views, from stakeholders directly impacted by the proposals would be of immense value to the Implementation Group.

Furthermore, the timescale given to respond on such a fundamental issue is very challenging and disappointing. It is difficult to gather views within a large membership based association in such a short time period. As the paper took from October until the end of April to produce, asking for responses within a 3 week time period makes providing a fully considered response difficult.

1.6 It is disappointing that no steps have been put forward to reduce the level of regulatory and administrative burden associated with the existing system. Simple practical measures could be introduced to cut down on the work involved in submitting Funding Proposals, applying for Section 49 extension periods and Section 50 orders. Changes in these areas could more than offset additional work arising from changes to the DB system.

SUMMARY OF KEY ELEMENTS OF IAPF'S RESPONSE

1.7 In our view, the existing funding system is not fit for purpose and should be overhauled for the following reasons:

- The use of an annuity standard for pensioners requires companies to build up reserves in their DB schemes which may never be used. Companies will seriously question the wisdom of this which may in turn threaten the continuation of DB provision.
- Due to the existence of the priority ruling for pensioners on wind-up, it is not possible to operate a system which provides a high level of security for all members while also maintaining cash funding at a level that is reasonable.
- Requiring companies with viable schemes to build up cash reserves to cover market fluctuations and to have sufficient assets to cover wind up liabilities at all times, even though they do not intend winding up, will actually reduce rather than increase the security of members' benefits.

1.8 <u>Alternative</u>

As an alternative, we would propose the following system:

1. The requirement to reserve using annuity pricing for pensioners should be removed. To our knowledge no other European Country requires reserving at this level.

2. To maintain the link to a wind-up standard, the rules should be changed to allow ARFs to be bought for existing pensioners. It may be advisable to set a minimum pension level up to which an annuity would have to be purchased, but the trustees would have the option of applying the value[1] of a pensioner's benefit over and above this minimum level to an Approved Retirement Fund.

3. The priority rule applying to pensioners should be changed. Even if it is not possible to do so for existing pensioners, a legislative change should be introduced which would result in all retirees after the effective date of the legislation ranking equally with active and deferred members.

If instead of the above system, Option B were chosen, we still believe it is critical item 3 above is introduced. In addition,

4. Some of the existing excessive regulatory requirements associated with the Minimum Funding Standard should be removed. These include, the application process including the asset test for Section 49 extensions, the linking of a funding proposal to the conditions on the date it is signed and the need to review funding proposals so regularly.

[1] The value could be determined based on prescribed actuarial assumptions

2 Objectives of a Restructured DB Regime

2.1 The Objectives set out in the Consultation Paper:

The consultation paper contains some commentary on the objectives of the review. Page 5 of the consultation document states that:

"The primary aim of the proposed new DB model remains the same as the previous system, namely to provide pensions for members that are more secure and predictable than DC benefits."

The document also goes on to state that DB commitments should *"enjoy a high degree of security"* and that the new DB model *"needs to ensure the future sustainability of DB schemes". The features of a new DB model are also outlined.*

2.2 IAPF's Views on the Objectives of a Restructured DB Model:

When considering what objectives should underlie a restructured DB model, the following are key factors that we believe should be taken into account:

- Provision of pensions is voluntary. Consequently, any measures which make it more difficult to fund and operate pension schemes are ultimately likely to threaten, not improve, the security of pension benefits
- Requiring employers to build up reserves in pension schemes which may never be usable (either through reserving based on annuity prices or requiring explicit additional reserves to be maintained) will act as a strong deterrent to continuing with DB schemes and will thus threaten the security of members' benefits
- It is not unreasonable for pension schemes to have modest deficits from time to time particularly given the fluctuations in markets, interest rates, etc that take place. The existence of the priority ruling for pensioners however exacerbates the impact on individuals in the event of an actual wind-up and creates the potential for individuals to suffer disproportionately and severely.[2]
- The existing legislative and regulatory regime is very cumbersome and contains unnecessary features that make it difficult to operate a DB scheme. For example, the requirement that funding proposals reflect up to date conditions on the day they are signed, means that plans negotiated and agreed between the various stakeholders in a scheme, can unravel in a matter of weeks. This alienates the goodwill of employers to address pension deficits.

Having regard to the above factors, we would propose that the objectives of a restructured DB Model as outlined in Section 2.1 should be as follows (our proposed changes to the consultation document's objectives are outlined in bold):

[2] This very important issue receives no mention in the consultation paper and should be addressed in the review

- *"It needs to provide a 'promised' level of benefits to members that is reasonably predictable and that enjoys a high level of security ,* ***while not threatening the willingness of employers to provide benefits,***
- *It needs to provide a greater degree of certainty for employers with regard to their contributions* ***while limiting the build up of reserves which may never be utilised,***
- *It needs to be reasonably robust in the face of the economic cycle and downturns in financial markets* ***by avoiding the prospect for individual categories of members bearing disproportionately severe hits on their benefits****, and*
- *It needs to have flexibility in its design and provide scheme trustees with adjustment options other than reliance on employer contributions"*
- ***It needs to avoid a scenario where large scale wind-ups and ceasing of DB accrual, take place in response to the legislative changes***

It is also worth noting that even as things stand, private sector DB schemes are arguably far less exposed to economic shocks than public sector schemes. Public sector schemes are generally unfunded[3], very large in size and fully exposed to projected adverse demographic shifts and fiscal inability to pay. In our view this is a far more pressing issue for the Government to address.

2.3 Possible Reaction of Schemes:

As highlighted in the introduction, it is essential that an independent impact analysis be carried out on the potential fallout of each of the various options.

For example, if schemes are forced by the measures proposed in the consultation paper to overhaul their benefits in respect of future service, the vast majority will not avail of the model of a lower core DB benefit with discretionary benefits on top. Given the cost of operating such a scheme, many will switch to DC for future accrual and/or will seek to wind up their DB schemes altogether. It is important that this be assessed particularly as the primary objective involves "providing benefits that are more secure and predictable than DC benefits".

Many schemes are currently working within the current regime. The reason many funding proposals have not been submitted is that trustees are awaiting the introduction of sovereign annuities and details of the review of the funding standard. We are aware of many schemes that have restructured benefits following discussions between employers, unions and members.

In summary, changes should not be introduced which may give rise to significant and potentially widespread adverse and unintended consequences for members.

[3] In fact in the current economic crisis, we have seen whatever funding does exist being largely sold off and used for other purposes

3 Proposals Relating to Dealing With Deficits

3.1 Proposals Relating to Accrued Benefits:

The paper sets out certain proposals for dealing with accrued benefits which we understand may be introduced regardless of whether options A, B, C or any alternatives are introduced. These proposals do not appear to be covered by the questions in section 7 of the consultation paper and are therefore addressed here.

3.2 Statutory Duty on Employers to Negotiate in Good Faith:

The paper proposes "the introduction of a statutory duty on employers to negotiate in good faith and to use their reasonable endeavours to agree a funding proposal" It is very difficult to see how this provision could be implemented and whether it has any practical impact. It may be helpful to trustees who are not getting any response from employers but it would appear to be impossible to determine whether someone is negotiating in good faith.

3.3. Statutory Mechanism Requiring a Wind Up Of a DB Scheme in Certain Circumstances:

The paper sets out a proposal for "The introduction of a statutory mechanism that requires a DB scheme to wind-up where it is clear that even following benefit reductions a scheme will not be sustainable". We understand this would only apply in very limited circumstances. However we would welcome clarification of the circumstances in which this aspect of the legislation would apply to ensure it would only apply in very exceptional circumstances.

3.4 Sovereign Annuities:

The consultation paper refers to amendments to the funding standard to take account of the purchase of sovereign bonds/annuities in respect of pensioner liabilities. The fact that no sovereign annuities are available and there is no detail on how the availability of these annuities and sovereign bonds will impact on the funding standard is one of the main issues preventing schemes from progressing funding proposals.

This is a key component of any new DB system. While it provides welcome flexibility, we believe the use of sovereign bonds/annuities should be limited to avoid over exposure of members to sovereign risk.

This is of particular concern, given that at the time of writing, trustees could invest in bonds with very high yields (and consequent risk of default), exposing pensioners to high levels of risk. Without some restrictions on the use of sovereign bonds/annuities, it is self evident that the primary objective of proving a high level of security to members' benefits will not be achieved.

4 Responses to Specific Questions Raised

Analysis of current situation and outlook for DB

Q1. Is the analysis accepted that DB schemes, as currently organised, are too exposed to economic shocks?

We would accept that **individual members** in schemes can be too exposed to economic shocks. This however is due primarily to the priority ruling that exists in legislation which favours existing pensioners. If this priority ruling did not exist, the exposure to economic shocks at the scheme level would be acceptable for the following reasons:

(a) To completely protect from economic shocks is probably not possible and certainly unaffordable. We have just come through one of the biggest economic shocks and pension schemes continue to pay pensions. There is no pension system that could have coped with the shocks of the last decade and schemes in countries such as the UK and Netherlands are facing similar pressures. However, schemes are restructuring to ensure sustainability and have not needed taxpayer bail-outs.

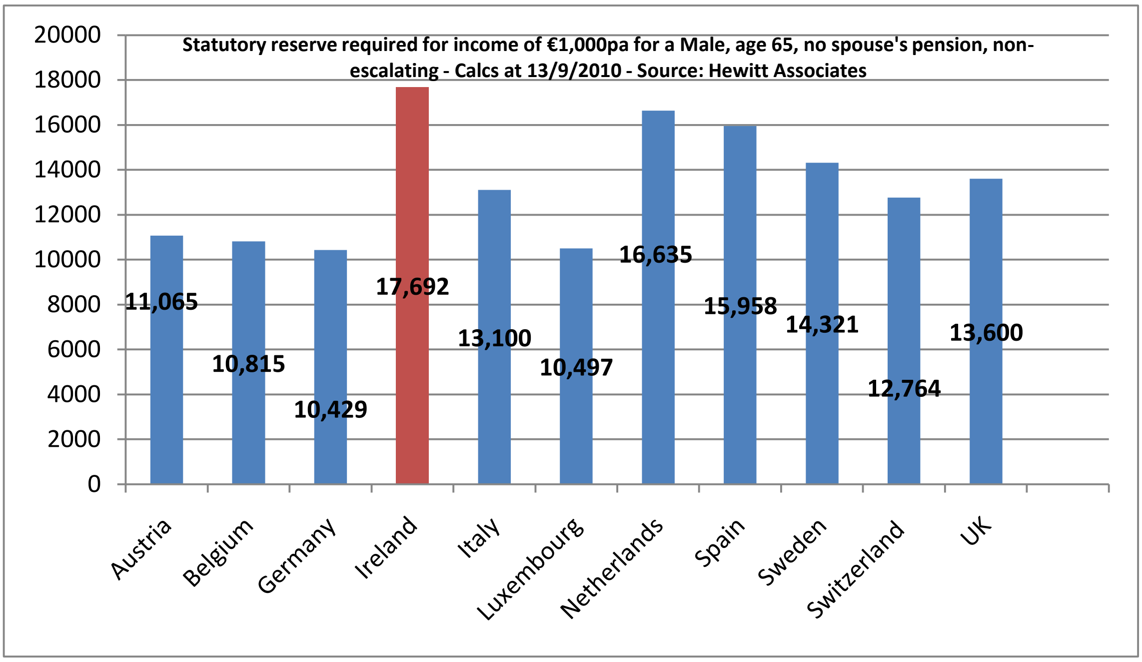
(b) As highlighted in our introduction, in a voluntary system, increasing the level of protection by placing increased cash funding demands on employers will in fact reduce protection for members. Being exposed to some risk provided it is proportionate, is therefore in members' interests

(c) The removal of the "gearing" effect against active and deferred members caused by the pensioner priority rule would spread adverse financial experience more evenly and avoid individual members being heavily exposed to economic shocks as they are at present.

Q2 Is it accepted that under the current DB structure most schemes are not in a position to provide a "promise" to their members that is reasonably predictable and enjoys a high level of security?

We believe that most schemes do provide benefits that are reasonably predictable and funding to a wind-up standard together with the covenant of an employer does provide security. There needs to be a realisation that the promise can be adjusted **(within reason)** to reflect economic and financial circumstances. This is no different to other aspects of an individual's remuneration and benefits.

Ireland has the highest reserving requirements of any country in Europe in relation to the cash reserves required for pensioners as the following table illustrates:



As a large majority of schemes are closed to new entrants, the reserving basis for pensioners will become even more of a dominant feature of DB schemes. This provides a good level of security in a context where pension provision is voluntary. If the level of security were to be increased **the Government must ensure that this is on a basis which would not in fact threaten the provision of benefits and in particular would not trigger the wind up of schemes which are currently viable.** Security could be enhanced by encouraging further the de-risking of schemes. We believe it is also worth exploring options such as voluntary debt on the employer as alternatives to requiring high cash reserves in schemes.

Objectives of a new DB system

Q3. A revised approach to DB provision should be one that provides a "promise" to scheme members that is reasonably predictable and that enjoys a high level of guarantee. Which of the options best advances this objective?

While the question posed does not seek views on the objectives of a new DB model, we have commented in detail in section 2 of our response, on what we believe should be the objectives of a new DB system.

In assessing the effectiveness of any DB system, it is critical to consider what the possible reaction of employers and schemes will be following its introduction. In the context of the options put forward in the paper, we believe the key question that arises is whether a Government decision to raise the bar on cash funding will improve or reduce the security of members' pension benefits. **Our view is that increasing the requirement for cash funding, is on balance likely to have unintended consequences and act against members' interests. It will result in some members no longer receiving benefits which they would otherwise have received, thus reducing the security of their benefits.**

We would therefore call on the implementation group and Government to confirm it has carried out a detailed impact analysis of its proposals on pension schemes and to publish this analysis.

To provide a more predictable promise and a higher level of guarantee, would require a more fundamental change to the system and this is addressed further in question 10.

Q4 Any new approach to DB provision should be one that is robust in the face of economic difficulty and downturns in financial markets.

a) Would the introduction of risk reserves and the new stipulations around recovery periods under Option B offer a sufficient protection for schemes in future?

or

b) Is it necessary to adopt Option C if schemes are to further enhance their security in the future? Adopting Option C raises the funding requirements by so much that it is not feasible for benefits to be provided on that basis.

Option C in our opinion, would give rise to the widespread destruction of DB schemes with many members suffering as a result.

The proposals in Option B would strengthen the level of cash reserves in some schemes but would give rise to other schemes taking action which is to the detriment of members. **The Implementation Group and Government have an absolute responsibility to minimise adverse impacts on members of any changes (for example the wind up of schemes in deficit which would not otherwise take place).** In order to minimise the impact on members, certain variants would be required and these are addressed in Question 10.

Q5. A desirable feature of new DB system would be that of design flexibility meaning that scheme trustees could employ adjustment options other than reliance on employer contributions.

a) Under all options, a legislative change to allow trustees greater discretion as regards the revaluation of deferred members' benefits is envisaged. Would this change significantly enhance flexibility in scheme management?

This change would provide greater flexibility and would be welcomed. The link to capping statutory revaluation at the level of "revaluation" applying to active members would in our view be fair and equitable. The practical implementation of this would need to be thought through carefully.

We note that if revaluation is provided for under a Scheme's rules, this would require a Section 50 application to be made to make this discretionary. Whether or not revaluation is incorporated into a scheme's rules tends to be mainly reflective of legal drafting practices and should not therefore have a bearing on whether discretionary revaluation can apply in one scheme and not another. We would favour an overriding provision in legislation which would allow this measure to be introduced in all schemes.

b) <u>Under both Options C, the revised funding standard would only apply to core benefits; other benefits would be discretionary. As the level of core benefits would be a matter for scheme-level determination, is it accepted that this option would significantly enhance flexibility?</u>

In our opinion, if either of the two options under C are introduced, very few if any schemes will continue to provide future accrual of benefits on a DB basis. The issue of enhanced flexibility would not arise.

<u>Q6. Once the existing funding standard or a revised one is re-introduced/introduced respectively, a significant number of DB scheme restructurings including benefit reductions through the Section 50 process can be expected. However, following this period, it would be expected that future DB benefit reductions would be less common. Accepting that significant scheme restructuring in the near term is likely to be inevitable under any scenario, is there a view as to which of the options would reduce the need for benefit reductions in the future?</u>

We would agree that many schemes are restructuring benefits although the proportion of these that involve Section 50 is relatively small. Section 50 has mainly been confined to some but not all of those schemes that provide pension increases under the Scheme rules.

We would agree that benefit restructuring is largely inevitable under any scenario. This is currently taking place in many schemes arising from discussions between the various stakeholders. It is necessary to emphasise that some of the options, if introduced, could give rise to very material and widespread changes in benefits as well as scheme closures and wind-ups in the short term which would not otherwise have occurred.

It is not unreasonable that changes in benefits should occur. For example, if people are living longer, it should be possible to increase retirement ages. Furthermore, employers will always wish to retain the flexibility to change benefits in respect to future service. In relation to benefit changes it is our view therefore that:

- Changes should not be introduced now which will trigger widespread benefit changes which would not otherwise have occurred.
- There should be less likelihood of changes affecting accrued benefits and if such changes are required they should be equitable across all members. In this regard we would favour:

    (a) Increased emphasis on risk management by trustees and
    (b) The removal of the priority afforded to pensioners at least in respect of all future retirements

- It should remain possible for employers to have the flexibility in discussion/negotiation with their employees, to alter the benefits for future service

<u>Q7. It is intended to bring a degree of policy and regulatory stability to the DB sector after the period of uncertainty of the last few crisis years.</u>

a) <u>How likely is it that further major regulatory changes could be avoided over a medium-term timeframe if Option A, or either of Options B, which could be characterised as minimalist or incremental in nature, were to be adopted?</u>

While the changes under Option A may be described as minimalist, the existing regime is anything but, as it places onerous regulatory (including funding) requirements on employers and trustees.

The changes under option B are not in our view minimalist.

One of the factors which heightens calls for changes under the current regime is the over-emphasis on financial conditions on a given day e.g. the date a funding proposal is signed. This can create unnecessary pressures in the system. A very good example of this was the position in August and September 2010 when despite relatively steady investment markets throughout the year, sharp falls in long term interest rates caused mayhem for companies and trustees in dealing with their funding proposals. Some limited smoothing of the date on which funding proposals are prepared and annually reviewed would be helpful and would reduce calls for legislative change.

The decision to levy the assets of pension funds and the continuing uncertainty regarding the maximum benefits that can be accrued and tax relief on contributions only further undermine the considerable goodwill employers display towards pension provision.

b) <u>Given the stated intention of the European Commission to examine the existing EU solvency framework as part of its review of the IORPS Directive, what is your view as to which of the options presented here is likely to conform best to any new EU standards?</u>

In the absence of the framework it is difficult to comment. We strongly believe that applying Solvency II like provisions to DB schemes is utterly inappropriate and are making representations through the EFRP on this point. Private pension provision is generally provided as a social contract between employers and employees often with trade union involvement. This is the main factor that distinguishes it from insurance contacts which are financial products bought by customers from insurers. The intentions of the Commission are extremely unclear at this point in time and there have been recent indications that they are moving away from a Solvency II approach.

c) <u>Would the adoption of Option C1, which would result in a dual funding standard regime in operation, of itself create a degree of uncertainty and instability?</u>

Yes, as we have already highlighted, Option C will only result in the destruction of defined benefit provision.

<u>Q8. Government policy aims to minimise the degree of regulatory and administrative burdens associated with new policy initiatives. Against this backdrop, views on the degree of additional regulatory and administrative burden associated with the options under consideration would be of interest. In particular, what would be the implications for schemes of the dual funding standard regime inherent in Option C1?</u>

It is disappointing that no steps have been put forward to reduce the level of regulatory and administrative burden associated with the existing system. Simple practical measures could be introduced to cut down on the work involved in submitting Funding Proposals, applying for Section 49 extension periods and Section 50 orders. Changes in these areas could more than offset additional work arising from changes to the DB system.

As already outlined, we believe very few schemes would continue to provide DB future service accrual under option C so the question is largely academic. For the very few that might continue to provide DB benefits for future accrual, the burden would clearly be greatly increased.

Preferred option

Q9. Taking account of your responses to the above, which of these options presented in this paper would your organisation prefer to see adopted?

We would prefer an overhaul of the system along the lines outlined in question 10 below. Failing this, the only option that can be considered is a modified version of Option B but subject to the variations set out in response to question 10.

Other options or issues

Q10. Does your organisation wish to propose another option or variant of the options presented above that would meet the objectives articulated for a new DB system?

In our view, the existing funding system is not fit for purpose and should be overhauled for the following reasons:

- The use of an annuity standard for pensioners coupled with the potential for additional reserves under some of the options, requires companies to build up reserves in their DB schemes which may never be used. Companies will seriously question the wisdom of this which may in turn threaten the continuation of DB provision.
- Due to the existence of the priority ruling for pensioners on wind-up, it is not possible to operate a system which provides a high level of security for all members while also maintaining cash funding at a level that is reasonable.
- Requiring companies with viable schemes to build up cash reserves to cover market fluctuations and **to have sufficient assets to cover wind up liabilities at all times, even though they do not intend winding up,** will actually reduce rather than increase the security of members' benefits.
- The regulatory and administrative costs of operating DB schemes will act as a deterrent to providing DB benefits.
- It is important to minimise adverse and unintended consequences for scheme members and DB provision.

Alternative

As an alternative, we would propose the following system:

1. The requirement to reserve using annuity pricing for pensioners should be broken. To our knowledge no other European Country requires reserving at this level.
2. To maintain the link to a wind-up standard, the rules should be changed to allow ARFs to be bought for existing pensioners. It may be advisable to set a minimum pension level up to which an annuity would have to be purchased, but the trustees would have the option of applying the value[4] of a pensioner's benefit over and above this minimum level to an Approved Retirement Fund.
3. The priority rule applying to pensioners should be changed. Even if it is not possible to do so for existing pensioners, a legislative change should be introduced which would result in all retirees after the effective date of the legislation ranking equally with active and deferred members.

If Option B were chosen, we still believe it is critical item 3 above is introduced. In addition,

4. Some of the existing excessive regulatory requirements associated with the Minimum Funding Standard should be removed. These include, the application process including the asset test for Section 49 extensions, the linking of a funding proposal to the conditions on the date it is signed and the need to review funding proposals so regularly.

[4] The value could be determined based on prescribed actuarial assumptions

5 Contact Information

We look forward to the opportunity of meeting with the implementation group to discuss our response.

If you have any queries on the document, please contact Maurice Whyms or Jerry Moriarty using the contact details below:

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