The Irish Association of Pension Funds

Submission on

The Social Welfare and Pensions Bill 2012

(April 2012)

Background

In recent years the Irish Association of Pension Funds (IAPF) has made a number of submissions to the Department of Social Protection on the operation of the Funding Standard for defined benefit (DB) schemes. Some of these proposals have been implemented and some are still under consideration. All of the proposals have been made as a response to the increasingly difficult funding positions of DB schemes and have been an attempt to balance member security and the sustainability of DB schemes. The need to maintain this balance remains as critical as ever with the large majority of schemes continuing to experience very significant financial pressures.

In early 2010, the IAPF and the Society of Actuaries in Ireland proposed a removal of the link between the Funding Standard basis and annuities (which are used to value pensioner liabilities in assessing a DB scheme's funding position) priced off German bond yields. This proposal ultimately led to the development of the sovereign annuity concept, which has now been legislated for. It should be noted that this differs from the original proposal and that the circumstances in Ireland today are very different to those prevailing in early 2010 and this has impacted on Irish and EU Government bond yields generally.

In April 2011, the Department of Social Protection asked the IAPF and a number of other organisations to respond to a consultation paper "Proposed approach to Defined Benefit Pension Provision." Following a very short consultation period, the IAPF submitted our response and we, and the other representative bodies, met with the Minister, Department and Pensions Board officials to discuss our responses. We had subsequent discussions with the Pensions Board on simplifying the funding standard regime but have had no further discussions on the substantive issues contained in the original consultation.

In October 2011, the Department announced that the Government had approved a number of changes to DB provision to "help ensure its sustainability, enhance the security of member benefits and increase equity between members of schemes". The changes specified were:

- The existing funding standard would be restored for a three year period
- Risk reserves would be required "as a protection against future volatility in the financial markets"
- Revaluation of benefits would be changed to ensure equity between deferred and active members
- The priority order would be changed to allow for a better return to active and deferred members in a wind-up of a scheme in deficit

- The Pensions Board would be given the power to wind up schemes in certain limited circumstances.

The Pensions Board advised that it would publish guidance on the operation of the revised funding standard provision by the end of 2011.

Social Welfare and Pensions Bill 2012

On April 5th 2012 the Social Welfare and Pensions Bill 2012 ("the Bill") was published. This is a further step in reforming the funding standard.

However the Bill largely contains the enabling provisions and many of the actual changes will be introduced through regulation and Pensions Board or Actuarial guidance. As the Regulations and Guidance from the Pensions Board have not been published, that creates difficulty in analysing the impact of the provisions of the Bill, as in many cases it is not clear how they will operate in practice. Given the importance of the issues for DB schemes the IAPF wishes to make a number of points, albeit we are conscious that some of these may be dealt with in regulation or guidance. There are a number of substantive issues with the Bill as presently drafted.

Priority Order

One of the key changes announced in October 2011 as having been agreed by Government, was a proposed change to the operation of the priority order. This issue has been highlighted in all IAPF submissions on the Funding Standard in recent years. The priority order has been acknowledged by the Department as having the ability to give rise to significant inequities in the distribution of assets when an underfunded scheme is being wound-up. While we are aware that the Department intends to engage external advice and carry out further consultation on this issue, it was one of the key elements of reforming the Funding Standard and would go a long way to achieving equity between members and enhancing the sustainability of schemes. The absence of any provisions to deal with this issue will only continue uncertainty for schemes, trustees and members and will also lead to very adverse outcomes for active and deferred members.

Revaluation of Benefits

The proposals to allow schemes to apply a revaluation rate to deferred members that is consistent with the effective increase in active members' benefits are also not included in the Bill. Again, the announcement in October 2011 indicated these had been agreed.

The changes to the priority order and revaluation provisions were key changes which would alleviate some of the pressure defined benefit schemes are experiencing. Without these changes, it is hard to see how the Bill can achieve the previously stated objectives of ensuring sustainability and increasing equity among members.

Risk Reserves

The risk reserving requirement set out in the Bill is substantially different to what was proposed in the original consultation. The requirement in the Bill is that a scheme holds 15% of its liabilities as a reserve, less any Irish or other Member State Government Bonds, cash or assets that offer a similar degree of security, plus an amount sufficient to withstand a 0.5% fall in interest rates.

This reserving requirement does not appear to be a sustainability test to withstand an investment stress test, as was set out in the original consultation. It would also not necessarily be a protection against future volatility in the financial markets, as described in the announcement in October. Some of the greatest volatility in financial markets in recent years has been in EU member state bonds. And that is continuing at present. The reserving requirement ignores this volatility, by implying that all EU member state bonds are the least risky assets a scheme can hold. It also puts strong pressure on schemes to increase their holdings in these assets at a time when many of their investment advisers are unlikely to recommend such a course of action. While we recognise the general need to reduce risk in schemes over time, adopting an approach built on the basis that EU Government bonds and cash are non-risky, and everything else is, is far too simplistic and needs to be altered.

The Bill also gives the Minister the power to increase the reserving requirement to 50% of the liabilities and the impact of a 5% interest rate fall. The existence of such a power, without any indication of why it might be used, will be of great concern to sponsors of DB schemes as it could vastly increase the funding requirements for schemes without any advance warning.

It is not clear what assets would be considered to offer a similar degree of security to EU member State bonds or cash. Many schemes, for example, would hold non-EU sovereign bonds or corporate bonds that have a higher credit rating that some EU member State bonds. Schemes have also put strategies in place to match their liabilities e.g. using swap based LDI assets. There should be greater clarity on how these types of assets will be treated.

In the announcement in October 2011, it was estimated that the provision of risk reserves would add a further 10% to scheme funding requirements. It is not clear if this was based on

the type of reserving envisaged in the original consultation or what is now contained in the Bill. Presumably, the Department has completed a Regulatory Impact Analysis and this should be published. In any case, the Department needs to carefully consider that any increase in funding requirements, particularly one accompanied with such uncertainty and a strong requirement for schemes to hold assets they might not want to hold, is not conducive to the sustainability of defined benefit schemes. It is not clear that the reserving requirement enhances member security and will certainly not be enhanced if schemes are wound up as a result of these changes.

Sovereign Annuities/Bonds

There is also a difference in the treatment of schemes that hold sovereign bonds and those that purchase sovereign annuities. Where sovereign annuities are purchased, the annuity provider will have the ability to reduce a pension in payment if there is a default or restructure on the underlying bond. Where a scheme holds sovereign bonds as a liability match for pension payments, the scheme will not have the same ability to reduce benefits if there is a default or restructure on the underlying bond. That will force some schemes to purchase sovereign annuities where they would have otherwise continued to pay pensions from the scheme. This difference between sovereign bonds and sovereign annuities should be removed.

Simplification

Following on from the Consultation, the IAPF, Society of Actuaries in Ireland and Association of Pension Lawyers in Ireland had detailed discussions with the Pensions Board on simplifying the operation of the Funding Standard and Funding Proposals. There is nothing in the Bill that indicates that this issue will be addressed. For example, the requirement to now have two actuarial funding certificates can only complicate matters.

Provisions of the Bill

There are a number of specific provisions in the Bill which should be amended before it is passed.

As it is currently worded in the Bill, risk reserving will apply to AVC and DC assets held within a scheme. We assume this is unintended, as there is no logic in requiring schemes to hold risk reserved for DC assets.

It is unclear how the statement that schemes will have 11 years to meet the reserving requirements is actually catered for in the Bill.

Conclusion

The change in emphasis from the proposals outlined in the Consultation document published in April 2011 and the provisions contained in the Bill is disappointing. There has been no opportunity to fully consider the current proposals. However, the premise that holding any Euro Member State bonds automatically reduces risk is questionable. The absence of any guidance on how the provisions will actually be operated is disappointing and does not allow for proper consideration of the issues. We are concerned that the Bill does not contain any of the provisions that were intended to alleviate the pressure defined benefit schemes are under. Indeed, the decision to reduce the pre-retirement discount rate for calculating transfer values from 1st May 2012 only adds to the pressure.

At a time when many defined benefit schemes are experiencing very difficult circumstances, we are concerned that the Bill does not achieve the Government's objective, as stated in October 2011, of helping ensure sustainability of the DB system, enhancing the security of member benefits and increasing equity between members of schemes.