GAD and the Government Actuary

1. The Government Actuary’s Department (GAD) was founded in 1919 and provides specialist advice across the public sector, modelling uncertainty across pensions, insurance, risk, social security and other areas. I became Government Actuary in August 2014, having previously been the Executive Director of the Pension Protection Fund (PPF) with responsibility for investments, actuarial and financial risk. I qualified as a Fellow of the Institute of Actuaries in 1982¹.

2. GAD provides actuarial analysis to all the main public service unfunded defined benefit (DB) pension schemes, such as those for the civil service, National Health Service, armed forces, police, fire service and teachers. GAD also provides advice to the trustees and sponsoring employers of a number of funded DB pension schemes which are subject to the pensions regulatory system and the requirements for scheme funding valuations under the Pensions Act 2004.

3. Additionally, GAD provides policy advice on a diverse range of both public service and private sector pensions issues to various government departments, including HM Treasury and the Department for Work and Pensions.

This submission

4. This submission is intended to provide some background information on the following areas:

   > how and why the existing framework for funding DB pensions operates as it currently does;
   > the balance of risks and affordability;
   > the difficulties of the conflicting objectives of The Pensions Regulator (TPR) to both protect the PPF and minimise adverse impact on growth of employers.

5. In summary, my view is that the current statutory funding framework for DB pension schemes does not need a major overhaul. The framework is not a prescriptive process, but allows for significant flexibility in handling the different objectives of the interacting parties involved in the funding process in order to reach mutually agreeable outcomes – although there is uncertainty around the extent to which this flexibility is currently being used.

6. This submission is not intended to summarise all of the relevant issues around the current framework, but to provide views based on GAD’s experience of the structure, and suggestions of the areas that the inquiry might like to explore further.

¹ As an actuary my work is governed by a number of profession standards issued by the Institute and Faculty of Actuaries and the Financial Reporting Council. The “GAD principles for actuarial quality” are a set of overarching principles that are applied to all work carried out by actuarial staff in a professional capacity within GAD. My work is also covered by the Civil Service code. This submission complies with all of these standards.
Funding valuations

7. A funding valuation for a DB pension scheme is a snapshot of the financial position of a scheme at a particular point in the time horizon of the lifetime of the scheme. It considers both how the level of scheme assets compares to the value of the liabilities that have been accrued at the valuation date – to establish the extent to which the scheme is currently ahead (in surplus) or behind (in deficit) its expected funding trajectory – and the expected cost of providing future benefits which may build up after the valuation date.

8. A funding valuation is a long-term assessment, recognising that pension scheme funding is a long-term activity – although it should be noted that it is difficult to be certain about various assumptions over that longer term.

9. Under the current funding regime, scheme trustees have the ultimate responsibility for funding decisions but are required to obtain advice from their scheme actuary and obtain the employer’s agreement. The trustees and employer must also agree to the level of future contributions payable to the scheme by the employer.

10. The actuarial assumptions used to value the scheme liabilities must be chosen prudently, allowing for an appropriate margin for adverse deviation. Trustees must consider the current position of the employer and future of the employer, as well as its covenant – the extent of the employer’s legal obligation and financial ability to support the scheme now and in the future – when considering the investment and funding risks being taken. This is because the future success of the employer is a key component in enabling the trustees to meet their key objective of paying promised benefits as they fall due.

Discount rates

11. Current UK funding legislation states that the discount rate used for valuing a scheme’s technical provisions must be chosen prudently, taking into account either or both of:

- the yield on assets held by the scheme to fund future benefits and the anticipated future investment returns;
- the market redemption yields on government or other high-quality bonds.

12. There is no single right answer to the question of what the discount rate should be for a specific scheme funding valuation at a particular date. Trustees are required to seek a funding outcome that reflects a reasonable balance between the need to pay the promised benefits and to minimise any adverse impact on the employer’s sustainable growth. They may use the flexibility available in setting discount rates to reach the balance that best suits the circumstances of the scheme and employer.

13. The prudence in the discount rate should be considered by reference to the likelihood and scale of the funding requirements which could emerge if the expected investment return is not achieved over the long-term. To that end, it may be considered appropriate to
benchmark the chosen discount rate against the “risk-free” rate (that is, typically, a discount rate set with reference to gilt yields), to establish the additional return that is being sought by the scheme in the long-term over and above this risk-free rate.

14. Although there is flexibility in the system, the latest information on scheme funding statistics published by the TPR² (see graph reproduced below) shows that discount rates adopted by DB pension schemes over the period since 2005 have closely tracked gilt yields, with a consistent gap of around 1% pa.

15. This graph shows that the average risk margin over gilts adopted in funding valuation discount rates has not generally increased over time, despite falling gilt yields, meaning that either valuation bases may have generally strengthened when considered against scheme’s actual investment strategies, or the investment strategies have become more cautious. As noted above, this need not necessarily be the case, and nothing in theory within the existing regime is preventing schemes from being more flexible in their approach to setting the discount rate or investment strategy.

16. It should be noted that this graph only shows the position for schemes with valuation dates up to September 2014. There have been significant further reductions in gilt yields in the two years since then, particularly during 2016, and it remains to be seen how this will have affected the position adopted for more recent funding valuations. It is advisable to keep a close watch on these developments as more information becomes available.

**Flexibility**

17. There is significant flexibility within the existing regime to affect the ultimate outcome from the employer’s perspective, in terms of future contribution requirements, both when setting the actuarial assumptions used to value the scheme’s technical provisions and when determining the recovery plan and resulting schedule of contributions.

18. Specifically, the actuarial valuation basis can either be somewhat weakened (for example by way of a higher discount rate, leading to a lower level of future employer contributions required) or strengthened (for example by way of a lower discount rate, leading to higher level of contributions required) – albeit within the constraints of retaining an appropriate overall level of prudence, for which there is generally a range of reasonable assumptions that could be made. Other assumptions which form part of the actuarial valuation basis can also be amended, within the overall bounds of prudence, which will affect the overall outcome, although changes to the discount rate typically have the greatest effect on the calculation of the scheme liabilities.

19. TPR’s Code of Practice on funding defined benefits states that recovery plans should be “appropriate”, and notes that whilst affordability of deficit contributions is a factor to consider, this does not mean that an employer should be expected to pay deficit contributions at a particular level simply because it would be able to afford to contribute at that level or because it has been paying them at that level in the past – trustees can use the flexibilities available in recovery plans to ensure that they are appropriately tailored to both scheme and employer circumstances.

**Affordability**

20. In the circumstances of recent falls in gilt yields, there is naturally significant debate about the affordability of DB pension schemes, with a number of stakeholders suggesting that maintaining the current level of benefits promised by DB pension schemes has become unaffordable to many employers. In practice there is no agreed definition of affordability, which makes this difficult to substantiate.

21. As discussed earlier, consideration of affordability issues is a key component of the current funding regime, and therefore affordability constraints should not in itself necessarily be a reason for any changes to the existing framework.

22. TPR noted in its 2016 annual funding statement\(^3\) that whilst deficits for many schemes have increased in recent years, the majority of employers are likely to be in a position to be able to maintain or increase contributions to their scheme. It further noted that the average ratio of deficit recovery contributions to dividends has declined over the last five years, with the median rate for FTSE350 companies falling from around 17% in 2010 to less than 10% in

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the latest data, meaning more than half of these companies paid out ten times or more to shareholders than to their DB pension scheme. It was noted that this is largely due to the significant increase in dividends over the period, without a similar increase in contributions.

23. However, a recent report by Barnett Waddingham on affordability issues for DB pension schemes operated by FTSE350 companies noted that the whilst deficit contributions relative to dividends has reduced on average in recent years, the position varies significantly for individual companies. Many companies have paid increased levels of deficit contributions and reduced dividends, whilst for companies that have reduced deficit contributions relative to dividends the average implied period for clearing pension deficits has reduced, suggesting that positive progress was being made to clear the deficit and significant up front contributions were potentially paid. This report also that noted that there are a significant number of companies currently paying deficit contributions at a level which is higher than their free cashflow – but conversely, stated that the median company could clear its entire DB accounting deficit using net cash generated from core activities within three months.

24. The Barnett Waddingham report also noted that the aggregate amount paid towards deficit contributions in 2015 (by FTSE350 companies with DB schemes) represented around one third of total contributions paid towards pension provision by those companies. This highlights issues of inter-generational fairness, whereby significant levels of contributions are being paid by companies towards legacy benefits (largely in respect of former employees), rather than being directed towards future pension provision for current staff.

25. However, it should be noted that the position may have changed to some extent in recent months after the vote to leave the EU, and it remains to be seen how the fall-out from this will affect DB pension scheme funding for UK companies in the short to medium term.

26. A number of changes have been suggested which might help to improve affordability of DB pension schemes for employers, particularly around benefit reduction – for example, introducing legislation to allow schemes to switch RPI-linked pension increases to CPI-linked increases. Whilst such measures would help to reduce costs for some employers, I would suggest that clear evidence of unaffordability needs to be examined to establish if there is a genuine necessity to go down this route – noting my earlier comments about the difficulties of defining affordability – bearing in mind that any measures to reduce liabilities for employers will result in reduced future benefits for pension scheme members, which would clearly not be welcomed by the affected individuals. The government might want to look at all the evidence in the round, and make an assessment of the trade-offs between employers, members, the PPF and the wider economy, before coming to any conclusions on whether intervention of this sort is desirable.

TPR objectives

27. TPR’s statutory objectives are set out in legislation. These include protecting the benefits of occupational pension scheme members, reducing the risk of situations arising which may lead to schemes entering the PPF, and minimising any adverse impact on the sustainable growth of an employer (in relation to the exercise of its scheme funding powers).

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28. These objectives might be considered somewhat irreconcilable – one way of avoiding schemes entering the PPF is for them to become better funded, requiring a greater level of employer contributions which could otherwise be directed towards employer’s business growth activities. However, avoiding employer insolvency – which can be supported by attempts to grow the business – is clearly another important way of ensuring continued sponsor support for the scheme and thus avoiding falling into the PPF.

29. Whilst the current funding framework is helpful to trustees in highlighting employers’ responsibilities in adequately funding their accrued DB pension liabilities, the objective around sustainable growth of employers – introduced in the Pensions Act 2014 – can sometimes make the trustees’ negotiating position in valuation discussions with employers more difficult. This objective can also make it harder for TPR to effectively intervene in cases where agreement cannot be reached between the respective parties. However, TPR has said that whilst trustees should take account of employers’ plans to invest for future growth, to the extent that this results in lower future scheme contributions than might have otherwise been the case, trustees should seek agreement to benefit from any positive employer growth which arises following such investment.

30. In practice, whilst covenant assessments can assist trustees in understanding the employer’s strength relative to the scheme, it can still be very difficult for trustees to establish whether an employer has a genuine need to reduce contributions to its scheme due to affordability issues, or whether it is trying to use the flexibilities within the regime to pay a lower level of contributions than might really be appropriate given the relevant circumstances.

31. These issues give TPR a very difficult role to balance trying to safeguard pension scheme security whilst also protecting employment and business viability. There is a danger that because TPR has to balance a diverse range of objectives, its ability to provide clear direction and guidance in some circumstances may be inhibited. Furthermore, whilst it has been suggested that TPR should be granted a wider range of powers, these conflicting objectives may make deciding how to use any such powers a challenging role.

Current environment

32. It is impossible to ascertain whether the current economic environment, with very low interest rates and arguably reduced future investment return expectations, is temporary or an indication of a long-term shift. This in turn makes it very difficult to establish whether an “exceptional approach” to scheme funding in the current environment is warranted, although any short-term change in approach should be considered against the risk that the current environment does persist over the long-term.

33. Whilst employers may generally welcome being able to pay lower levels of contributions to their DB schemes than the existing scheme funding regime requires, this would come at a cost of worse security for scheme members and an increased risk that promised benefits will not ultimately be met and that schemes might eventually fall into the PPF (with reduced benefits for members).

34. Ultimately, unless scheme benefits are reduced to some extent, the costs of promised DB pension provision have to be met somehow, and any changes to the funding regime are likely only to vary the pace of funding scheme benefit promises for employers. This may
simply push the cost to future generations of employee, or result in schemes which will never be capable of being fully funded by employers and lead to eventual entry to the PPF.

Concluding comments

35. In my view, there is currently a sufficient level of flexibility within the existing funding framework for DB schemes to enable the system to continue operating effectively, allowing for the different objectives of scheme members, trustees, and employers, even allowing for the current challenging market environment.

36. It does appear existing flexibilities are not necessarily being used as widely as they might be, and I would suggest that more work could be done to understand what is influencing behaviours. It might also be that some better communication of the regime – particularly to the public and the media – could be of benefit.

37. Whilst many employers have highlighted issues with affordability of DB schemes, the evidence surrounding this should be examined in detail. Any actions to address employer affordability are likely to result in a weakening of the current system, which could reduce the security of accrued benefits, placing members at increased risk of not receiving the full level of their promised benefits and increasing the risk of more schemes falling into the PPF.

38. Some areas which might be worthy of further consideration are set out below:

> Are there barriers in the existing funding regime flexibilities that prevent them from being used to a greater extent than at present?
> What evidence is there of affordability issues for employers sponsoring DB schemes?
> What steps could be taken to improve the operation of the existing regime without reducing the security of accrued benefits to scheme members?
> What effect have recent economic changes (for example the impact of Brexit and the current low levels of gilt yields) had on DB pension scheme funding issues which might supersede evidence currently available?
> To what extent are TPR’s apparently conflicting objectives restricting its communication of a clear purpose?

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