The Pensions Regulator Policy Team
Pensions Protection and Stewardship Division
Department for Work and Pensions
Caxton House
1st Floor
6-12 Tothill Street
London
SW1H 9NA

7 March 2013

Dear Sirs

Pensions and Growth – A call for evidence

Thank you for giving us the opportunity to respond to this call for evidence dated January 2013.

The Association of Professional Pension Trustees is an organisation of over 100 individuals who act as professional independent trustees to UK occupational schemes, some as sole practitioners and some working in firms of such practitioners. Our members represent a large number of mainly larger pension funds with combined assets of several hundred billion pounds.

The DWP Paper Pensions and Growth seeks views on the question of smoothing assets and liabilities in scheme funding valuations calls as well as on the possibility of introducing a new statutory objective for the Pensions Regulator to consider the long term affordability of deficit recovery plans to sponsoring employers. **We have responded separately to the latter point already: this response covers the issue of smoothing**.

We have considered this proposal from a Trustee perspective and in particular how it might affect the position of a Trustee in achieving agreement with sponsors on a recovery plan.

In summary this proposal has been put forward as a device to ease the funding burden on the sponsor and one in which lower contributions would be the result in the short term. This will leave the sponsors, it is claimed, better placed to invest and to attract immediate investment. No specification of how this alternative regime will operate has been put forward. The fact that no more detailed proposals emerged from earlier discussions indicate there are considerable difficulties in the design of such a proposal. No one proposal is likely to be suitable across the full range of sponsor and scheme circumstances, with regard to investment strategy, the weight of unfunded pension liabilities and the sponsor's covenant.

If smoothing were to have the impact of increasing discount rates, as those who advocate this approach clearly expect, then that can only occur if the resulting degree of prudence in the valuation will be lower (i.e. the degree of confidence that future experience will be no worse than the actuarial assumptions). In other words, in current circumstances, smoothing would actually be shorthand for a less prudent valuation methodology. It is not obvious why trustees and the Pensions Regulator would agree to this. If it was desired that they achieve this outcome, it could be done by simply permitting the adoption of less prudent or indeed deliberately speculative actuarial assumptions. This would be clearly in conflict with current Regulator guidance that (correctly in our view) argues that technical provisions should be set

in a prudent manner, even if the sponsor's ability to pay requires that the deficit recovery period is extended.

It has been claimed as a rationale for smoothing that current conditions in the gilt market are "abnormal". However, no observer knows how long the current climate of very low gilt yields will continue. Some academic studies (for example that of Reinhart and Sbrancia[1]) indicate that real interest rates have in the past been negative for many developed economies for very long periods – notably in the three decades following 1945 as governments dealt with very high levels of war debts. A methodology that assumes an inevitable reversion to more "normal" yield levels within the timeframe of a scheme's recovery plan is fundamentally flawed.

We are mindful of the considerable difficulty being caused for many schemes by the historically low level of interest rates and the need to operate the existing regime in a manner sensitive to those difficulties. But we consider that "smoothing" will not be the best approach to helping most sponsors cope with the problem.

The current regime incorporates a high degree of flexibility in terms of designing a recovery plan which encapsulates s a realistic strategy for the elimination of funding deficit tailored to the sponsor's circumstances. We believe the concerns of sponsors derive from a lack of confidence that the flexibility will be applied, and applied consistently, to the extent sponsors believe appropriate and necessary by the Pensions Regulator and therefore by trustees when negotiating a recovery plan.

There will be sponsors who will find it very difficult to eliminate funding deficits unless future investment conditions improve materially. The markets may of course improve to help them but possibly not within an acceptable time scale. In this situation it is important that the regulatory requirements do not induce an overreaction. It would be unfortunate if members were to lose benefits only to see markets ease and what had seemed unaffordable became affordable only a short time later. Their benefits would not be restored. On the other hand, it is not in anyone's interests for schemes which impose an unaffordable burden on their sponsors to remain open: that risks further damaging member confidence and burdening the PPF

The existing regime does however in our view include the flexibility which, if it continues to be utilised appropriately, will allow schemes in the large majority of cases to continue with contributions no more than what sponsors can reasonably afford. That may mean allowing

- recovery plans of longer duration; and/or
- with back loading of contributions; and/or
- best estimate type investment return assumptions in assessing the contributions.

The Regulator will be mindful of its responsibility to protect the PPF and will need to recognise that there will be some risk to the PPF with some schemes but no amount of smoothing is going to change that.

We undertook an on line survey of our membership's opinion and of those who responded

- Over 70% thought the existing regime sufficiently flexible to ensure regulation does not act as a material brake on investment and growth in the UK economy

---

[1] THE LIQUIDATION OF GOVERNMENT DEBT: Carmen M. Reinhart and M. Belen Sbrancia http://www.nber.org/papers/w16893

- Over 76% did not believe there is a coherent formula for smoothing which would materially improve sponsoring employers capacity to attract investment or to invest in the short term

- More than half thought the introduction of smoothing would make the process of agreeing a recovery plan more difficult.

In summary and to answer the questions raised.

Q1. What would be the effect of smoothing assets and liabilities in schemes undertaking valuations in 2013 and going forward? Would it materially improve the sponsoring employers' ability to attract investment or to invest in short term? If so, what evidence is there of this?

If contributions are set at a level which takes account of the sponsor's need to invest and/or attract investment then it matters not how that contribution level is derived. We believe there is sufficient flexibility in the current system which can and should be used to do just that.

Q2. Given that there is no one defined method for calculating scheme liabilities, how would you implement smoothing?

We are not offering a formula for smoothing. We doubt that a single formula can be found which would be appropriate to all schemes, given the diversity of investment strategies (including derivative strategies) and liability profiles of scheme.

Q3. What are the advantages and disadvantages of smoothing for sponsoring employers, scheme members and the Pension Protection Fund?

There are no advantages for smoothing as explained above (unless ones counts as advantage that "kicking the can down the road" by using an adjusted and lower measure of deficit can be a profitable strategy for sponsoring employers, or more correctly for the agents of sponsoring employers such as their directors and for those shareholders whose time horizon is short). There is a huge disadvantage in introducing a new regime just as the current regime is well understood by sponsors and trustees alike and is working reasonably well. A smoothing formula will either be too rigid to be helpful across the variety of sponsors' circumstances or be so flexible as to add a big layer of issues to be negotiated between trustee and sponsor further complicating the valuation process to no economic advantage.

Q4. Is the current regime flexible enough to ensure that defined-benefit pensions regulation does not act as a material brake on investment and growth for the UK economy?

Providing cash funding to Pension schemes is inevitably a brake on the economy, as is paying contractual salaries to employees and honouring contractual obligations to creditors including, via taxation, to the state. We need to ensure that regulation does not unnecessarily exacerbate the impact of pension liability. But equally, a mechanism that defers or eliminates the requirement for solvent sponsors to adequately fund their pension schemes is not an acceptable solution. It would be no more acceptable to scheme members than debt restructuring or default on contractual obligations would be acceptable to creditors or employees. The Regulator has signalled to sponsors and trustees that in exercising these functions it will recognise the particular difficulties, possibly temporary, that sponsors face at this time and will utilise the flexibility in the current regime sensitively.

Q5. Should a specific model of smoothing be introduced, the Government would welcome views as to what schemes, in terms of their valuation date, should be able to take advantage of the change.

We do not advocate the adoption of smoothing mechanisms so the question is irrelevant.

Yours sincerely

Rodney Jagelman
For the Council of the Association of Professional Pension Trustees