

SECURITY FOR OCCUPATIONAL PENSIONS

a consultation document

1. This consultation document seeks views on the Minimum Funding Requirement (MFR) that applies to most private sector defined benefit (DB) occupational pension schemes. It is issued in parallel with a report on the MFR from the Pensions Board of the Faculty and Institute of Actuaries. It also seeks views on alternatives to the MFR in the light of both the Actuaries' report and in the context of Paul Myners' review of institutional investment commissioned by the Chancellor of the Exchequer earlier this year.

2. Occupational pensions are important. About 4.5 million people already get pensions from private sector DB occupational pension schemes and about another 8.5 million people of working age have pension rights through such occupational schemes which will become payable in future. The Government is determined that all these scheme members – both pensioners and people still working – can have a high level of confidence that their pensions will be paid when they fall due.

3. To provide for their liabilities, defined benefit occupational pension schemes build up funds. These are subject to the Minimum Funding Requirement introduced under the Pensions Act 1995. Schemes whose assets fall below the minimum set by the MFR test have to make up the shortfall within prescribed time periods.

4. However, the MFR does not provide a *guarantee* that, in the event of an employer becoming insolvent, its pension scheme members' rights will be honoured in full. And there have been indications that the MFR also adversely influences the investment decisions of scheme managers. This could damage the longer term prospects for such schemes, which remain an important way of providing for retirement. Further to that in the last budget the Chancellor announced that he was asking Paul Myners to review the factors that influence institutional investment decisions. Responses to his review, for example from the National Association of Pension Funds (NAPF), suggest that the MFR has distorted investment decisions.

5. In March 1999 the Department of Social Security commissioned a report on the MFR from the Faculty and Institute of Actuaries, which is published alongside this consultation document. It contains proposals for reform and identifies a number of wider issues concerning the security and costs of defined benefit pensions. But it also suggests that the current MFR may

not be the most appropriate approach for the future. This document therefore seeks to explore these wider issues with a view to achieving security for defined benefit pensions from well-performing schemes. A number of options are put forward and the Government welcomes comments on the alternatives specifically discussed as well as other suggestions.

6. Paul Myners has also been asked for his views on the MFR and the possible alternatives as part of the consultation process. He will report at the time of the Pre-Budget Report. In order to allow time to reflect on his recommendations all other responses to this consultation document are invited by 31 January 2001. Please send them to:

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Further copies of this consultation paper are available on the following web-sites:

DSS: www.dss.gov.uk/publications/dss/2000/mfr/index.htm

HMT: www.hm-treasury.gov.uk/pub/html/reg/index.html

The Actuaries' report accompanying this consultation paper is available on:
www.actuaries.org.uk/pensions/mfr_index.html

The responses to this document may be made available to the public. If you do not wish your views to be made available in this way, please say so in your reply.

Department of Social Security
HM Treasury

September 2000

the importance of occupational pensions

7. DB occupational pensions have served successive generations of pensioners well. In the private sector there are some 38,000 such schemes and about 3,500 schemes which provide a mix of defined benefit and defined contribution. Their sizes range from very large to very small. Employers are under no obligation to set up occupational schemes. However, from 8 October 2001, those employing 5 or more people will have to provide employees with access to a defined contribution (DC) stakeholder scheme unless they provide an occupational scheme or they support a personal pension plan for employees. And most people in occupational schemes will be able to supplement their pension rights by topping up through a stakeholder scheme.

8. There will thus be a variety of ways in which people can save for their pensions. Different approaches will suit different people. If people have the opportunity to join an occupational pension scheme, they are usually best advised to do so because the employer makes a contribution. If they do not have that opportunity then a DC arrangement such as a stakeholder scheme will often provide the best fit.

9. The Government wants to help people understand their pension rights and appreciate the value of saving for pensions. In future, growing numbers of people with pensions will get a pension forecast each year bringing together their state and occupational pension rights. The Government's intention is that 15 million forecasts a year will be issued by 2005. This will help people gauge how well their prospective income in retirement is developing. Combined with the Government's new pension education material, this should help people make sensible informed decisions about their pensions.

existing protection for scheme members

10. Private sector occupational pension schemes are established under trust law and are run by trustees for the benefit of their members. So the normal fiduciary duties and disciplines for trustees apply.

11. In the case of DB schemes, scheme members' rights are usually defined in terms of formulae related to their earnings - for example in relation to members' final salaries and length

of service when they retire or leave the scheme. For these schemes, there is no intrinsic guarantee that the accumulated funds will be able to deliver members' pension rights. These rights are underpinned by the scheme's sponsoring employer, who must take action to make up any funding deficiency as it arises.

12. One of the additional disciplines introduced by the Pensions Act 1995, which came into force in April 1997, requires nearly all private sector DB schemes to make up any shortfalls, that emerge between their assets and a minimum level judged necessary to meet their obligations, within prescribed time periods to protect pensioners and other scheme members' rights. There is no equivalent requirement for DC schemes: in these, pensions are determined by the level of contributions paid in, how well the scheme's investments have performed, and what it costs to buy a pension when they retire. Whereas under-performance of investments by DB scheme funds usually leads to additional expense for the employer, in DC schemes it means that the scheme member has a lower pension.

13. The standard brought in for DB schemes in 1997 is known as the Minimum Funding Requirement or MFR. It is intended to provide protection for pensioners and other scheme members' rights by setting a benchmark for the acceptable level for the scheme's assets. With this floor in place, there is a reasonable chance that if the employer becomes insolvent, the pension scheme's assets will be able to meet the cost of paying out pensions for those already retired and provide for other scheme members' rights. It is not a solvency test as such and it is sometimes misunderstood to offer a more powerful guarantee about payment of pension rights than it actually delivers when a scheme winds up.

14. The previous Government set the objectives for this MFR test. The valuation method and assumptions for the MFR were then developed by the Faculty and Institute of Actuaries in 1995/1996 to meet the objectives set by Government. The test is intended to be carried out every 3 years and all schemes should have carried out a test by April 2001.

the MFR review

15. In March 1999, as part of the Government's overall strategy for pension provision the Pensions Board of the Faculty and Institute of Actuaries was asked to review the new MFR test. The terms of reference of the review are set out at Annex A.

16. The Government was and is determined that the long-term security of pensioners and the interests of other pension scheme members should be protected. It is right that the Government should look carefully at whether the MFR is working as was intended and ensure reliable methods are used to meet the key objectives. One aspect of the review was thus to explore alternative methods of delivering protection for scheme members and assess the effectiveness and reliability of those methods relative to the MFR.

17. In May 2000, the Pensions Board of the Faculty and Institute of Actuaries responded to the review remit with the report which is published alongside this document. The Government is very grateful to the Actuaries for their careful and thorough work, which included in-depth analysis and some far-reaching proposals and comments.

18. The Actuaries' report deals with the way in which the MFR is calculated, and the report's recommendations focus on certain specific features of the MFR calculation, in accordance with the terms of reference. In addition, the report identifies some wider issues about the operation of the MFR in practice, and in particular its ability to protect scheme members, including pensioners, in the way intended.

19. The Government believes that it is important to explore these wider issues to see whether there could be more effective or more reliable ways of protecting scheme members' rights. This consultation document is intended to launch a wide ranging consultation on the issues identified by the Actuaries' report.

how the current MFR works

20. The MFR is designed to underpin the employer's commitment to support the DB scheme it sponsors, so that in the event of the scheme having to cease, whether the employer is insolvent or not:

- scheme members who are already retired can expect their pensions to be paid in full;
- scheme members who are not yet retired have a reasonable expectation of receiving the value of their pension rights when they come to retire.

21. As the Actuaries' report identifies, the amount of reassurance the MFR can deliver is commonly misunderstood to be a good deal greater than it really is. Some people think the MFR test amounts to a full guarantee of scheme members' pension rights. It is not a solvency test. A funding requirement that gave full protection to members when their scheme ceased would lead to significantly higher costs than is the case under the MFR. The additional amount needed to bring schemes' funding to a full solvency level – a level at which they could buy out all their liabilities with annuities when discontinued – could be in the region of £50-100 billion.¹

22. The current MFR test works by comparing a scheme's assets and liabilities calculated in a specified way broadly as follows :

- the scheme's assets (gilts, equities and so on) are valued at market levels;
- the scheme's liabilities are divided between pensioners and those who have not yet retired and discounted to a capital value at different discount rates, broadly:
 - for pensions already in payment, the rate is the prevailing market yield on gilts (though for large schemes, some of these liabilities can be discounted using an assumed long term rate of return for UK equities);
 - for pension rights of scheme members not yet retired, the rate is broadly the assumed long term rate of return for UK equities before retirement and for gilts after retirement, adjusted by a 'market value adjustment' factor to reflect prevailing UK equity dividend yields. The rights are valued as if they had left service immediately.

23. If the scheme's assets are less than its liabilities in the terms of this test, the scheme is allowed one year to reach 90% of the MFR level and 5 years to reach 100%. In practice this normally means payment of additional contributions certified by the scheme actuary as being adequate to meet these targets.

¹ Figures based on very broad estimates made by the MFR Review working party of the actuarial profession looking at Solvency Insurance, using NAPF survey figures on minimum funding levels.

24. The NAPF in their response to the Myner's review, infer that the existence of the MFR, and the way it is calculated, may have made pension scheme trustees and their advisers more cautious about their investment decisions. They add that they believe that there is an inherent conflict between the MFR which imposes the risk of short term fluctuations in funding requirements, and the long term asset allocation to produce the best (financial) results for pension fund members.

This tension between the short term and long term considerations is also highlighted in the Actuaries' report. To the extent that this has happened, the effect might damage the long term interests of schemes, pensioners and other members. So the imposition of the test in the past years could also have caused some trustees to base their investment decisions on short term considerations. Funds must apply the test at least every 3 years although, in practice, many schemes do check their position more frequently and the scheme actuary must check the continued adequacy of the contributions being paid each year.

25. There is nothing in the way the MFR test works which formally requires any particular pension fund to invest in any particular way. A typical pension scheme might have about 75% of its assets invested in equities, about 20% in gilts and bonds, with the remainder in other assets, such as cash and property. But any scheme only just able to meet the MFR test will reduce the risks of failing the test in future by having an investment mix close to that implied by the MFR's calculations used to assess liabilities. In that way it will be more likely that the value of the scheme's assets and of the liabilities, as calculated under the MFR, will broadly move in line, thereby reducing the possibility of failing the test and the need for additional contributions to be made to the scheme. Schemes may be incentivised toward a more risk averse investment strategy than they might otherwise choose, to make the funds' performance against the MFR more consistent.

26. There is an indication that some pension schemes are becoming inclined to adopt this kind of strategy. To the extent that this happens, it will result in less diversification in investments and squeeze out investment in such assets as unlisted equities, foreign securities and physical assets such as property which are not used in working out liabilities calculated under the MFR. If these trends were to become widespread, it could mean lower investment returns in the long run, which may result in either lower pensions or higher contributions to the fund.

27. Some of these effects may be unavoidable. There is a natural tension between looking to schemes to invest their schemes' assets for the long term and at the same time requiring them to carry out regular valuations followed up by prompt action to restore any identified deficiencies. In their response to the Myners' review the NAPF commented that one of the consequences of

the MFR was that it favours the short-term equilibrium at the expense of the long term interests of members. The Government's objective is to protect the immediate interests of pensioners and other scheme members without damaging the longer-term prospects for current and future members.

the Actuaries' report

28. The Actuaries' report recognises these concerns, noting that in the event of the employer becoming insolvent, the current MFR test does not in practice deliver very much consistency over time in the level of protection of pension rights of scheme members who have not yet retired. The Actuaries' report discusses the extent to which the role of the MFR is understood by scheme members, trustees and employers. It notes wide misunderstanding of the effects it is designed to secure. The report then goes on to discuss the case for bringing home to scheme members the scale of the protection which the MFR can deliver, perhaps by disclosing to scheme members what benefits could be delivered should the scheme wind up.

29. The report also concludes that the current MFR formula is not a suitable approach for the future because of the difficulty of modelling returns on equities in assessing liabilities for pensions not yet in payment and of finding an objective way of allowing explicitly for variations in equity market prices using indicators of value such as dividend and earnings yields. The essence of the difficulty is having to predict long term equity returns for a statutory standard on the basis of prevailing market conditions.

30. If the MFR test is to survive in anything like its current form, the report recommends that, it should be redesigned. It recommends that liabilities for pensions in payment should be discounted using a composite index of gilts and corporate bonds while liabilities for pension rights not yet in payment should be discounted at a rate with a fixed premium of 1% per annum above this composite index. The premium was derived from a 2% per annum extra return less 1% per annum for the expenses of investing in an appropriate pensions vehicle and is broadly in line with assumptions underlying the current MFR. In this revised approach, there would be no explicit modelling of actual equity yields. Instead, the margin in the new discount rate would be an attempt to simulate over the long run the expected higher performance of assets other than gilts and corporate bonds, such as equities.

31. If this approach were adopted, there would be scope for adjusting the margin over the composite index for pensions not yet in payment. The Actuaries' report concentrates on the

principle of adopting this form of discounting, but leaves the actual size of the margin for further debate within the context of this broader consultation.

32. As the Actuaries' report explains, if it were possible to recast the MFR in the way described in paragraph 30, it would have the advantage that a fund which is able to meet the test would be able to offer its members a more consistent level of security for their pension rights. This is because the valuation methodology is more closely aligned to the costs of securing members' benefits on winding up. That is, a fund which could pass the recast MFR test would have a more consistent degree of assurance that it would be able to offer its members a certain minimum standard of underpinning for its commitment to pay their benefits.

33. This degree of consistency would be an advantage - although it would still amount to less than the guarantee of funding that many mistakenly believe the MFR provides. Even with this reservation, and as acknowledged in the Actuaries' report, it is achieved at the price of possibly imposing significant practical difficulties on pension schemes, their trustees and in turn their beneficiaries. These difficulties arise in two different ways but with similar consequences:

- funds which retain current levels of investment in equities will find that the results of the new MFR test are **more volatile**. In practice this may cause them to go for a higher average funding level to decrease the chance of failing the MFR test. So the short term cost of running a DB pension scheme may rise, and this in turn could lead to lower benefits in an effort to reduce costs. The report addresses this volatility by extending the periods within which deficits must be made up. Though this would help significantly, it is not clear that it would be fully effective;
- in practice, some funds may be inclined to take the **more risk averse** route of switching out of equities into corporate bonds and gilts. This would make a fund's performance against the MFR test more consistent, but at a price in terms of possible sub-optimal asset allocation for the fund. Past experience suggests that over a period the investment performance of the fund may be lower and thus the cost of running a DB pension scheme may rise. The additional demand for relatively scarce gilts and corporate bonds is likely to push up prices and drive down investment returns, with potential for a damaging spiral which could further push up the cost of operating a DB scheme. In this instance equity investments as well as unlisted securities might be squeezed out of funds' investment portfolios.

34. As acknowledged in the Actuaries' report, it is difficult to forecast with any meaningful precision what behavioural changes might occur if the proposals for revising the MFR in the report were implemented. For instance, extending the periods within which deficits must be made up might counteract the short term focus referred to in paragraph 27, leading to greater emphasis on long term investment policy with consequent greater diversification eg into overseas equities, property and unlisted securities. The scenario testing in the report offers some insight but there can be no certainty that recasting the MFR in this way would really deliver a more reliable level of security for pension scheme members' rights without substantial additional funding.

35. The potentially higher cost of funding in both the scenarios in paragraph 33 could prove difficult for some employers to meet despite the extended period which the Actuaries' report recommends for making good underfunding. This cost would fall on employers - provided of course that they remain willing to continue to offer DB occupational schemes. If employers were not able or willing to bear higher costs, the pensions available to scheme members in the future might well be reduced.

36. And still the reassurance provided by the MFR test would fall a long way short of the full guarantee that many people assume exists. It is also possible that higher costs would discourage firms from continuing to support DB schemes. If, instead, employers chose to support DC schemes of comparable quality, scheme members might be no worse off on average; but as the member would have to bear the investment risk there can be no confidence that this would be the case.

a wider debate

37. The Actuaries' report concludes that the current MFR, which relies on equity returns to value liabilities, cannot be made to work as a statutory standard. The report suggests an alternative way of valuing liabilities under the MFR, but also looks at other ways of providing protection for members.

38. It is important that scheme members are provided with a reasonable level of protection for their pension rights but without imposing unreasonable burdens which could threaten the future of defined benefit occupational schemes, and without creating adverse effects on investment behaviour. Before reaching a final view, the Government is therefore looking to

explore a more diverse range of ways in which scheme members' rights could be protected. A wide ranging debate should help evaluate other ways in which scheme members' rights could be underpinned.

39. In opening up debate in this way, the Government's purpose is to protect the interests of pensioners and other pension scheme members. It considers that the concerns identified by the Actuaries all deserve informed and thorough discussion among the various interest groups concerned. This was something which the Actuaries understandably were unable to do in preparing the report in view of the market sensitivity of any revision to the form of the MFR test. The Government is grateful to them for identifying the issues for wider debate.

40. In addition, in the Budget earlier this year, the Chancellor announced an investigation by Paul Myners into a range of policy issues relating to institutional investments generally. It will be important for these discussions to proceed in parallel and so help the Government reach consistent policy conclusions.

41. From the initial feedback on the Myners review consultation document, it is already clear that many people recognise the considerable overlap between the two sets of issues. The NAPF identified some of the same issues as the Actuaries' report, including the MFR's potential to create a bias toward short term considerations at the expense of pension fund members' long term interests. It went on to recommend replacement or at least significant restructuring of the MFR.

options for protecting pension rights

42. The Government wishes to explore a range of approaches to protecting pensioners' interests and securing other scheme members' pension rights. In seeking to achieve this it is important that any proposed measures do not damage the long-term future of defined benefit pensions or risk reducing the benefits that they provide. There are a number of ways in which these objectives could be addressed, ranging from amending the current MFR formula to abolishing it entirely and finding another structure, for example an insurance arrangement, through which to ensure security for pensions. It will be worth exploring how a combination of solutions would work, for example an amended MFR test coupled with insurance or supervision of schemes.

43. In considering **amending the MFR** itself, the weaknesses in the current calculation need to be recognised. As the Actuaries' report identifies, the current test fails to reflect equity price movements accurately, the benchmark by which it is intended that future liabilities for non-pensioners should be calculated. The Actuaries' proposed 1% premium above the composite index yield represents an approximation to long-term equity yields (less 1% for expenses), but using this as the discount rate might simply exacerbate the current supply-demand mismatch for gilts and bonds, increasing funding costs in the process. It might also create a greater divergence between a scheme's actual portfolio and one that would match the discounting applied to its liabilities, imposing greater volatility on a fund and also increasing the cost of providing a defined benefit pension scheme in order to provide a buffer against the volatility.

44. The Government therefore wants to investigate other objective ways to incorporate a measure of equity returns in discounting certain liabilities to avoid these potential problems. Possibilities include using returns measured over a period leading up to the relevant date, but other ideas are invited along with views on their likely consequences for investment behaviour, funding levels and costs to schemes.

45. The current MFR test seeks to provide security for pensions in the event of the discontinuance of the scheme but it might be in the longer-term interests of present and future scheme members to view the funding of a scheme on an **ongoing basis** for all scheme members. This is broadly how the Inland Revenue's Surplus Funds rules work and there are obvious administrative benefits at least to be gained from any alignment of the two. But there are issues surrounding whether a similar perspective is appropriate for a test aimed at ensuring adequate – as opposed to excessive – scheme funding. The Government recognises that this would imply a change in the underlying rationale for the funding test, particularly in respect of pensioner liabilities. It welcomes views on which measures would be suitable for a minimum funding requirement framed in this way, whether they should be combined with some other form of protection and the extent to which they would encourage a long term view to be taken in investment decisions.

46. Proposed revisions to the MFR need to be assessed not just in isolation but also in conjunction with other ways of protecting pensions. A revised funding requirement might require the support of supervision or insurance in order to meet the Government's objectives of security and affordability for defined benefit pensions. Equally, approaches such as insurance or a central discontinuance fund might necessitate the continued existence of a funding requirement in order to meet the objectives.

47. Among the possible alternatives to a funding requirement on its own is **prudential supervision** by a regulator. This would constitute a more proactive form of regulation than currently exists, but would enable funding to be monitored more regularly, perhaps reducing the impact of volatility in the adequacy of funding levels generated by short term market fluctuations. It would also allow the qualities of a scheme beyond simply its funding, for example its management, to be regulated and for the financial strength of the employer to be taken into account in the supervision process. But the additional administrative burden that supervision would bring cannot be ignored as this option would imply expanding the role of an existing regulator or creating a new one. The benefits of prudential supervision would have to be weighed against the difficulties and costs that this would bring. Whilst the required funding level of a scheme could be more sensitive to schemes' circumstances under this approach, prudential supervision is unlikely to eliminate the need for a funding requirement altogether.

48. A further option is **compulsory insurance**, either mutual or commercial terms. Such insurance would allow risks to be pooled across the sector, offering greater protection to scheme members than any individual scheme which is dependent on the health of its sponsoring employer, can provide.

49. **Compulsory commercial insurance** would also work with the grain of the market - an employer would be able to compare the upfront cost of improving the funding of its pension scheme against a reduced insurance premium. However, insurance brings with it the clear moral hazard of some employers neglecting their obligations in the knowledge that, in the event of their insolvency, their pension liabilities will still be met. Commercial insurance premiums would inevitably depend on employers' solvency and their schemes' funding levels but it is unclear whether, given the difficulties in assessing risks in this area, an insurance market could be developed or, if it were, be affordable. It is also uncertain whether the schemes most in need of insurance could obtain it or afford it. In view of the circumstances in which large-scale claims might be made on this insurance, it may also be necessary to address the case where insurance could not fully provide for all claims.

50. **Compulsory mutual insurance** would be one way forward if a compulsory commercial insurance market is not feasible, or only feasible for some schemes. This would require other defined benefit pension funds to stand behind the fund of an insolvent company in certain circumstances. Mutual insurance could operate with insurance premiums related to the extent of scheme underfunding and risk of insolvency of the sponsoring employer, paid into a central

fund, but the discipline generated is likely to be less than in a commercial regime. To mitigate moral hazard some form of funding requirement would probably have to accompany such an arrangement.

51. Again, the conditions in which the insurance would be put under most strain have to be contemplated. In an economic downturn, when a relatively large number of scheme failures might lead to greater claims on other struggling employers, a mutual insurance arrangement might not be able to carry the full cost. It would be inappropriate for the Government to act as guarantor, so reinsurance would probably be necessary. A market would need to develop and a means found of sharing the costs of this among diverse schemes. But there may also be a case for using mutual insurance more narrowly, perhaps for larger, similar schemes as an alternative to commercial insurance.

52. Similar issues arise with a **central discontinuance fund (CDF)**, where discontinued funds are pooled and run on as a single closed scheme. A major advantage of such an arrangement, particularly for smaller schemes, is that by running on as a closed scheme it typically costs less to deliver scheme benefits than to buy out guaranteed pensions with annuities, although smaller schemes can't generally do this alone. However, a CDF on its own would have only the investment returns from the funds transferred to it and would therefore be unlikely to deliver all benefits to members of discontinued schemes; unless additional funding could be secured benefit entitlements might have to be scaled down in some way. As with mutual insurance, any cost could fall on the remaining population of schemes, which would be charged a levy from time to time. But the levy would have to be affordable, and even if it were, there may be a need for an ultimate guarantor which could not be the Government.

53. There may also be further policy options worth exploration. The Government welcomes suggestions on them, particularly putting them in the context of its objectives and the potential obstacles identified in the above discussion of a number of alternatives. Equally, views on how the above alternatives could be used in combination, or on how they may be used for certain types of schemes, would be welcome.

54. For some of the policy options it is easy to see how the approach might be more suitable for larger schemes. It may therefore be desirable to develop a tiered policy in which smaller schemes would be subject to different requirements from larger ones, with the objective of providing consistent levels of reassurance to scheme members but through use of different operators. But this might increase burdens on small schemes relative to larger ones and

discourage growing employers from starting up DB schemes for their employees. Dealing with the interface between the different regimes and deciding where to draw the dividing line might also be complex.

55. Equally it might be possible to develop the existing distinction in treatment within a given fund between pensions in payment and pension rights for payment in future. For example, different funding standards could apply to them, or one set of liabilities could be compulsorily insured while the other is not. The Government would welcome views on how mixed approaches of these - or other - kinds might be developed.

56. One of the key recommendations in the Actuaries' report is for disclosure to members about the security of their benefits. Their concerns stem from the fact that the MFR is not a solvency test but that this is not always fully understood by members. The report recommends that there should be disclosure to members of, broadly, the extent to which their benefits could be secured by means of annuity purchase if the scheme were to wind up. This approach could be considered whatever policy is adopted. The Government would welcome views on this idea and how it might be achieved.

57. At Annex B is a list of questions which may help readers engage with these difficult issues. It is not intended to deter anyone from considering other associated issues, or generating alternative policy approaches. The Government welcomes constructive ideas with potential for helping secure the rights of all members of DB occupational pension schemes. Such ideas may cover a broad range of options and may lead to different blends of options to ensure security for pensioners and future pensioners at reasonable costs. In the light of the consultation the Government will seek to work up costed options and explore the regulatory impact.

updating the current MFR

58. Adjustments to the existing MFR could probably be implemented towards the end of 2001. However, any of the alternative ideas for underpinning the security of pensioners' and other members' rights in occupational pension schemes outlined in paragraphs 43 to 52 would require some time to implement. In the meantime it is important to keep the MFR up to date, while recognising its limitations and the Actuaries' report has recommended some limited interim changes to the existing MFR as set out in Annex C.

conclusion

59. The Government welcomes the report from the Pensions Board of the Faculty and Institute of Actuaries and seeks views on the considerations set out in this document. Paul Myners will also report at the time of the Pre-Budget Report before this consultation ends on 31 January 2001. In the meantime, the Government is considering whether to put in place some limited changes recommended in the Actuaries' report. The proposed changes are set out in Annex C. A regulatory impact assessment is attached at Annex D. The main purpose behind these changes is to keep pace with economic trends, and improving life expectancy in order that the level of protection afforded by the MFR is consistent with that originally envisaged.

Annex A: terms of reference for review of the MFR

Underlying objectives:

Benchmark funding level for salary related occupational pension schemes to protect members' accrued rights in the event of the sponsoring employer becoming insolvent.

Protection at a level to enable pensions in payment to continue in full (excluding future discretionary increases) and give non-pensioners a reasonable expectation of receiving benefits at a level that would have been paid if they had become deferred members and the scheme continued as an ongoing scheme.

“Reasonable expectation” means an “even chance” on transfer to an appropriate alternative pensions vehicle.

The benchmark funding level should be derived from an objective test which is independent of the circumstances of each scheme (except for gilt-matched schemes).

In most circumstances, meeting MFR should not require, in the long term, contributions which exceed the contributions produced by ongoing valuations for a scheme which is fully funded on the ongoing basis on reasonably prudent actuarial assumptions.

Analysis of existing valuation method against those objectives:

Consider the extent to which adjustments might be made to the existing valuation method (within the existing framework of primary legislation) so that it is better adapted to the objectives (e.g. whether it should also include assumptions about investment in overseas equities and property, and whether it takes proper account of capital growth).

Consider fundamental changes in approach which could achieve the underlying objectives and advise the DSS on these alternatives.

Other factors to take into account:

Variations in the valuation basis for schemes of different size/maturity and for insured schemes.

The effect of taking greater account of market values and capital growth compared with the greater reliance on long term rates of return (taking into account proposals from the Accounting Standards Board in relation to a more market based approach to accounting standards).

The desirability (or otherwise) of smoothing out volatility in outcomes and the means of achieving this.

Possible changes to the supporting structure of the MFR (eg the schedule of contributions and time limits for underfunded schemes).

Links between the MFR and minimum cash equivalent transfer values, deficiency calculation on wind-up/employer insolvency, solvency test for contracting-out, calculation of compensation.

Consideration of a central discontinuance fund/employer or scheme insurance/compensation with a levy.

Annex B: questions for feedback

Current MFR

1. How great a level of assurance does the MFR provide to the members of DB occupational schemes either in the immediate or long term? In the light of time limits allowed under the MFR for restoring underfunding is it expected that schemes will be better funded in future on winding up?
2. Does the current MFR affect pension schemes' investment decisions?
3. What problems have been found in using the current MFR? What would be required to make it work effectively?
4. In respect of the basis for the valuation of pensioner liabilities (paragraph 4.5.3 of the Actuaries' report) could an appropriate composite/gilt/bond index be devised? What problems might there be in the use of such an index?
5. In respect of members who are not yet pensioners, what would be the practical effect of introducing the alternative MFR approach together with the longer deficit correction period and the removal of annual certification, proposed in the Actuaries' report?
6. Are there any other ways in which the existing MFR could be redesigned to provide a more appropriate and reliable test which would secure scheme members' interests no less effectively?
7. Should all of the proposed interim changes be made to the current MFR test in advance of any changes arising from a wide ranging debate? Is the case stronger for some rather than others? If so, which? What effect would the increased funding requirements have on employers' willingness to continue to provide DB occupational pension schemes?

Other approaches

8. Would any of the approaches mentioned in paragraphs 43 to 52 work more effectively? If so how and why? How would their costs and benefits compare with existing arrangements?
9. Are there other ideas for providing protection for DB occupational scheme members' rights which should be considered?
10. Would it be better to develop a combination of the approaches in paragraphs 43 to 52?
11. Should there be different approaches for different sizes of schemes? Where should the dividing line be drawn?
12. Should the treatment of pensioners in DB schemes be changed to reflect developments in the defined contribution market? If so, how?
13. Are there any reasons why there should not be disclosure to members of the scheme's solvency position and of what this might mean should their scheme cease? How might such information be best communicated to members?
14. What might be the broader economic impact of the policy options discussed?

Annex C: interim changes to the current MFR

1. The Actuaries' report recommends some limited changes to the current MFR test to keep pace with economic and demographic trends. Further details of these changes are contained in the Actuaries' report (section 5.1). Broadly, they are as follows.

Mortality assumptions

2. People are expected to live longer than indicated by the statistics available at the time the MFR was introduced and it will consequently cost more to fund their pensions. The report recommends reducing the mortality rates to reflect an extra two years' longevity. This will produce an increase in MFR liabilities for both pensioners and members who have not yet retired, of about 6.5% for most schemes, and there will be a comparable increase in minimum individual transfer payments for all schemes.

Pension increases

3. The report also recommends an adjustment to the way in which MFR liabilities for pensioners are assessed. Since the MFR first came into operation, inflation and interest rates have declined. In order to maintain the original strength of the MFR test, the assumption as to the future level of pension increases needs to be adjusted to reflect the possibility that price levels may fall (in that event, the pension would not actually be reduced). The report indicates that the MFR liabilities for pensioners could increase by up to 3.5%, though the effect of this change will vary for different schemes.

Equity Market Value Adjustment

4. Under the MFR the calculation of liabilities for scheme members who have not yet retired is adjusted by an equity 'market value adjustment' (MVA) to reflect prevailing market dividend yields on the FT-SE Actuaries All-Share Index. Changing patterns of corporate activity and generally lower market dividend yields have significantly changed the relationship between the dividend yield and the capital value of the Index. To reflect this change, the report recommends that the reference yield for calculating the MVA should be revised from 3.25% to 3%. This will lead to a reduction in the MFR liabilities of 7.7%, for members who are more than 10 years younger than normal pension age, with more modest reductions for those closer to normal

pension age.

5. For schemes currently funded at the 100% level, the overall effect of these changes is expected to increase the assets which would have to be held by a typical scheme by up to 5% in order to maintain funding at the 100% level, but the precise impact would vary from scheme to scheme.

Annex D: regulatory impact assessment for interim changes to the current MFR

1. The Actuaries' report has proposed three changes to the current MFR test which are aimed at restoring it to the strength originally intended relative to current conditions. These are detailed in their report at section 5.1 and outlined in Annex C.

The changes are -

- a) adjusting the mortality assumptions to reflect increasing life expectancy (section 5.1.1);
- b) an adjustment to the way in which MFR liabilities for pensioners are assessed (section 5.1.2); and
- c) changing the equity market value adjustment (MVA) used in the calculation of liabilities for scheme members who have not yet retired (section 5.1.3).

Risk assessment

2. The MFR sets a minimum level at which most private sector defined benefit schemes should be funded. The Actuaries' report highlights, that in their view, that the MFR test is not currently providing the level of protection originally intended relative to current conditions. That could mean that a scheme fully funded under the MFR which winds up following employer insolvency may not be able to provide scheme members who have not retired with the same level of expectation of receiving their benefits when they come to retire, as was intended when the MFR was first established (see paragraph 20 of this discussion document). There is, therefore, a strong case for making interim changes to the current MFR test. These interim changes may have a small impact on the gilts market, particularly in respect of the investment strategy of those schemes which are already funded close to 100% MFR or who may become close to this level as a result of the changes.

Options

3. There are three possible options when considering the proposed changes:
- a) do nothing until the wide-ranging review of the MFR is completed;
 - b) bring in some of the changes but not all of them ; or
 - c) bring in all the changes together allowing time for changes to administrative systems.

Do nothing

4. The review of the MFR is likely to take some time and this option would prolong the period over which the level of protection provided by the MFR when the scheme winds up or the employer becomes insolvent would fall short of that originally intended. Actuaries would usually adjust the assumptions used in their ongoing funding valuations when they consider it appropriate to do so and the scheme's long term funding plans will be able to take these changes into account. However, there is no such flexibility in relation to the MFR, so it is important that the prescribed assumptions used for the MFR test are updated as soon as practicable where it is recognised that the level of protection for members is no longer as originally intended. Employers will, of course, have to face these costs in any event. Doing nothing simply extends the timescales within which members are exposed to an MFR test which does not provide a level of protection in line with that originally intended. If the MFR is not brought up to the level originally intended members will not receive the level of benefits the MFR is designed to protect when a scheme winds up fully funded on the MFR basis. It will also mean that minimum transfer values (which are calculated on the MFR basis), for those members who wish to transfer their rights out of the scheme, will be lower than they should be, though the actual transfer values could be higher than this minimum.

Bring in some of the changes

5. The Actuaries' report has recommended these changes because they consider that each is necessary to align the strength of the current test with that originally intended. As the Actuaries' report has identified, two of the changes, increased life expectancy and the adjustment to the calculation of pensioner liabilities, will have immediate costs for schemes. The adjustment to the MVA will be of benefit to schemes because it will reduce the amount of assets schemes have to hold in respect of members who have not yet retired. The overall capital cost of two of the changes, the increased life expectancy and the adjustment to the calculation of pensioner liabilities, will broadly be £3½bn spread over a five and a quarter year period. The saving produced by the MVA change will broadly be £1bn spread over the same period.

6. Introducing some of the changes and not others will not restore the MFR to its intended strength. For example only introducing the measures which have costs for schemes will mean that the MFR test would be too strong ie would require a higher level of assets to be held in respect of members who have not yet retired than was originally intended. It is appropriate that all factors which affect the level of funding under the MFR and which the Actuaries' report

considerations are necessary should be introduced at the same time. Furthermore, bringing all of these changes into effect at the same time, rather than piecemeal, should limit any difficulties which a succession of such changes might bring.

Bring in all the changes at the same time

7. Bringing in all the changes at once means that the MFR should be restored to the strength originally intended from a single date rather than introducing it in a series of stages. Generally schemes will be able to offset the increased costs for pensioners against the reduction in costs for those who have not retired. The changes could not be brought in immediately because of the due process of consultation within the actuarial profession which must be followed in order to make the necessary changes to professional actuarial guidance. Time will also be needed to allow for changes to computer systems. It is therefore unlikely that the changes will come into effect before the end of 2001.

Compliance costs

8. The cost for an individual scheme for the overall package of changes will vary depending on its membership profile and its current funding position. Those schemes which are already **well funded** under the MFR test **should not have to increase** their funding to meet the MFR as a consequence of these changes. However, those which are already underfunded on the MFR test, or are just slightly above it, may have to put more funds into the scheme.

9. However, for reasons explained above not all schemes will be affected to the same extent. For a typical scheme currently funded at the 100% level, the overall effect of the changes is to increase the assets which would have to be held by the scheme by up to 5% in order that the scheme continues to meet the MFR test after implementation of these changes. It is difficult to estimate with any certainty the overall cost of these changes because of the lack of detailed information about the current MFR position of schemes. Section 2.2.2 of the Actuaries' report refers to the latest available data collected by the Actuaries in respect of 586 schemes which have undertaken MFR valuations. On the basis of data on those schemes, a broad estimate of the total capital costs of these changes for those schemes already underfunded on the MFR test, or slightly above it, is that they will be in the region of £ 2 ½ billion (net of corporation tax)². However, employers will generally be expected to meet these costs over the periods allowed under the MFR

²The costs are presented net of Corporation Tax to allow comparison with the original MFR compliance cost assessment produced when the measure was introduced in the Pensions Act 1995.

for making good underfunding ie being funded to 90% by April 2003 and to 100% by April 2007. On the basis of those time limits and assuming the changes are introduced towards the end of 2001, it is estimated that the total overall effect of the changes will result in net additional contributions in the region of £700 million per year until April 2003 and in the region of £400 million a year thereafter to meet the target of 100% MFR funding by April 2007.

10. The estimates above reflect the costs needed, in the short term, to restore the MFR funding test to the strength originally intended. It is likely that these costs would be faced by schemes in any event because they reflect the funding required to pay the benefits promised under the scheme, although, in the absence of the MFR, they would normally be funded over a longer timescale. These changes will therefore be bringing forward costs that schemes would eventually face and require additional funds, within a relatively short period of time, to meet those costs.

11. It is estimated that the change to mortality assumptions will produce an increase in MFR liabilities for both pensioners and for members who have not yet retired of about 6.5% for most schemes. The increase may be different for very large schemes for which it is permitted to use mortality assumptions specific to the circumstances of the scheme. Some actuaries will already be taking improved mortality assumptions into account in their ongoing funding valuations so that the long-term funding of the scheme already reflects increased longevity. Broad estimates indicate a capital cost in the region of £ 2¾ billion for this change alone. The additional contributions needed to get schemes to 90% funding by April 2003 are estimated to be in the region of £800 million a year and about £500 million a year until April 2007 to get schemes to 100% MFR funding.

12. The change to the assumptions concerning the future level of pension increases to reflect the possibility that price levels may fall is likely to increase the MFR liabilities for pensioners by up to 3.5%. Costs will vary from scheme to scheme depending on the size of the pensioner liabilities and the current funding position of the scheme. Broad estimates indicate a capital cost in the region of £¾ billion. The additional contributions needed to get schemes to 90% funding by April 2003 are estimated to be in the region of £200 million a year and about £100 million a year until April 2007 to get schemes to 100% MFR funding.

13. The change to the MVA leads to a reduction in the MFR liabilities of 7.7%, for members who are more than 10 years from normal pension age, with more modest reductions for those closer to normal pension age. The effect on an individual scheme will depend on the size and age

distribution of the liabilities for those who have not yet retired and the current funding position of the scheme. Broad estimates are that the total savings are likely to be in the region of £1 billion. Spreading this over the same period as in paragraphs 11 and 12, for comparison purposes, indicates savings in contributions of about £300 million a year until April 2003 and roughly £200 million a year until April 2007.

Conclusion

In summary the overall effects are broadly estimated to be as follows:

Interim change	Total overall cost up to April 2007 for all employers who operate DB schemes	Additional contributions from 1 January 2002 to 5 April 2003	Additional contributions between 6 April 2003 and 5 April 2007
Life expectancy	£2¾ billion	£800 million a year	£500 million a year
Pension increases	£¾ billion	£200 million a year	£100 million a year
MVA adjustment	-£1 billion	-£300 million a year	-£200 million a year
Totals	£2½ billion	£700 million a year	£400 million a year

Effects on small employers and those running small schemes

14. The likely costs for small schemes will also depend on their membership profile and funding position. The data on which the costs have been estimated is not sufficiently detailed to indicate reliable costs for small schemes alone. According to the Actuaries' report in their sample of 586 schemes it was mostly the smaller and medium sized schemes which were likely to be funded at less than 100 % of the MFR level. It therefore seems more likely that small schemes rather than large schemes will face the additional costs indicated in the paragraphs above in complying with the MFR as a consequence of these measures. However, according to the Survey of Employers' Pension Provision 1998 (DSS Research Report No 123 forthcoming in 2000) only 2% of employers employing 19 people or less had a DB pension scheme.

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