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Issue 1

Employer pensions alert

Tougher DB funding standard proposals: the final call to action for employers?

What you need to know

On 28 April 2011, the Inter-Departmental Implementation Group for the National Pensions Framework issued a consultation paper that sets out policy options for a reformed system of defined benefit (DB) pension benefit provision.

The paper proposes three options for the minimum funding standard and details of a suggested model for future DB pension provision.

Significant rise in required cash contributions and increased volatility for employers

Funding standard

The paper acknowledges that the current DB regulatory system is broken, with 75% of schemes at the last study failing the current Minimum Funding Standard (MFS) test. In addition, it recognises that many employers are at the limit of what they can afford to contribute to meet pension deficits.

The Implementation Group is not, however, advocating a relaxation in the MFS. Rather, they believe that deficits should, where necessary, be managed through once and for all scheme restructurings, with residual benefits funded to a much higher, more secure, level.

Three options have been put forward for comment:

Status quo: Maintenance of the status quo, but with adjustments to incorporate sovereign annuities[1]. However, the Implementation Group makes it clear that this option doesn't meet its intended objectives.

Incremental shift: Schemes would be required to hold an additional buffer above the current MFS liabilities to provide a buffer for a fall in equity values by 15% and a decrease in bond yields by 0.5%. It is expected that the risk reserves would add 10% to funding liabilities (although the exact figure will depend on the scheme make up). In addition, deficits would have to be funded over a maximum of eight years.

New approach: Liabilities would be measured using the yield on AAA bonds (technical provisions) and topped up by explicit risk reserves to be added against a fall in equity values by 20%, a decrease in bond yields by 1% and an increase of 0.5% in future inflation. This is essentially equivalent to an insurance company type reserving approach. Shortfalls below the level of the technical provisions would have to be funded over a maximum of 2 years, with any shortfall in the risk reserves met over five years. Overall, it's expected that this approach could increase funding liabilities by 50%.

The paper notes that on 31 March 2011, EIOPA, the EU body that supervises the regulation of pension schemes, published a paper that suggests that a standard close to the last option as being the EU's preferred approach.

New model for DB benefit provision

One of the key issues identified with the traditional final salary model of DB benefits is that the majority of the risks are borne by the employer. The proposed new model would aim to allow a more equitable sharing of risks, yet still give some certainty to members around core benefit expectations.

The model would identify a mix of core and discretionary benefits, with only the core level of benefits covered under the revised funding standard. The core level of benefits would be determined individually by each scheme.

[1]Sovereign annuities are a new class of annuity product where the payment is linked to and dependant on the payment of a specified euro government bond.

All benefits, whether to current employees, former employees or pensioners, would be increased equally but only to the extent that the scheme could afford it. Benefits would no longer be linked to final salaries at retirement as is the case for most DB schemes today.

Next steps

The consultation period will close on 22 May 2011, and announcements, including timescales for the reintroduction of the funding standard, are expected shortly thereafter.

Deloitte commentary

The proposals appear to be founded on a robust analysis of the deficiencies of the current MFS regime. However, what's clear is that there is no easy or quick fix for current DB deficits.

The proposals may provide employers and trustees with a more realistic assessment of the true cost of their DB pension liabilities. For many, it will also accelerate the "once and for all", robust decisions that are necessary. The Implementation Group itself appears to be expecting a high number of restructurings once the favoured test kicks in.

Whilst no doubt already far reaching, employers may also welcome the fact that the proposals don't in fact go further; for example, there is no mention of a legislative debt on the employer on wind up (c.f. the "Section 75" debt in the UK) or a mandatory requirement to hold insurance against the deficit.

Ultimately, whilst we welcome the ideas around the new DB model, they don't alter the fact that DC pension provision is now embedded as the preferred pensions solution and better fits the needs of the 21st century employer.

What do employers need to do?

The reintroduction of a potentially more robust and expensive funding standard will further delineate the roles and objectives of the employer and trustees. We therefore strongly advise that you take advice that is impartial and independent from the trustees.

Employers will need to understand how the proposals would impact on your future cashflow and therefore business plans.

We recommend that you review your pensions strategy with a view to arriving a durable and sustainable solution. This revised strategy should also take into account the recent tax changes to pensions and the other long term savings vehicles that are now available.

If you are undertaking a corporate transaction, you should ensure that the impact of the proposals is taken into account in any cashflow projections.

You should look out for the publication of the final announcements/ decisions.

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