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DWP Call for Evidence

ACA Sessional, 28th February 2013

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DWP "call for evidence" January 2013

- Whether to smooth assets and liabilities in scheme funding valuations (7 March)
- Whether to introduce a new statutory objective for the Pensions Regulator (21 Feb)

Agenda - smoothing

- (Brief!) summary of call for evidence
- Some comparisons from other countries
- Some voices
- Some graphs
- Your thoughts, comments and questions

The underlying premise

"Some commentators have stated that rising deficits are forcing some employers to make substantial additional contributions to schemes, which is diverting funds away from business investment and ultimately, economic growth."

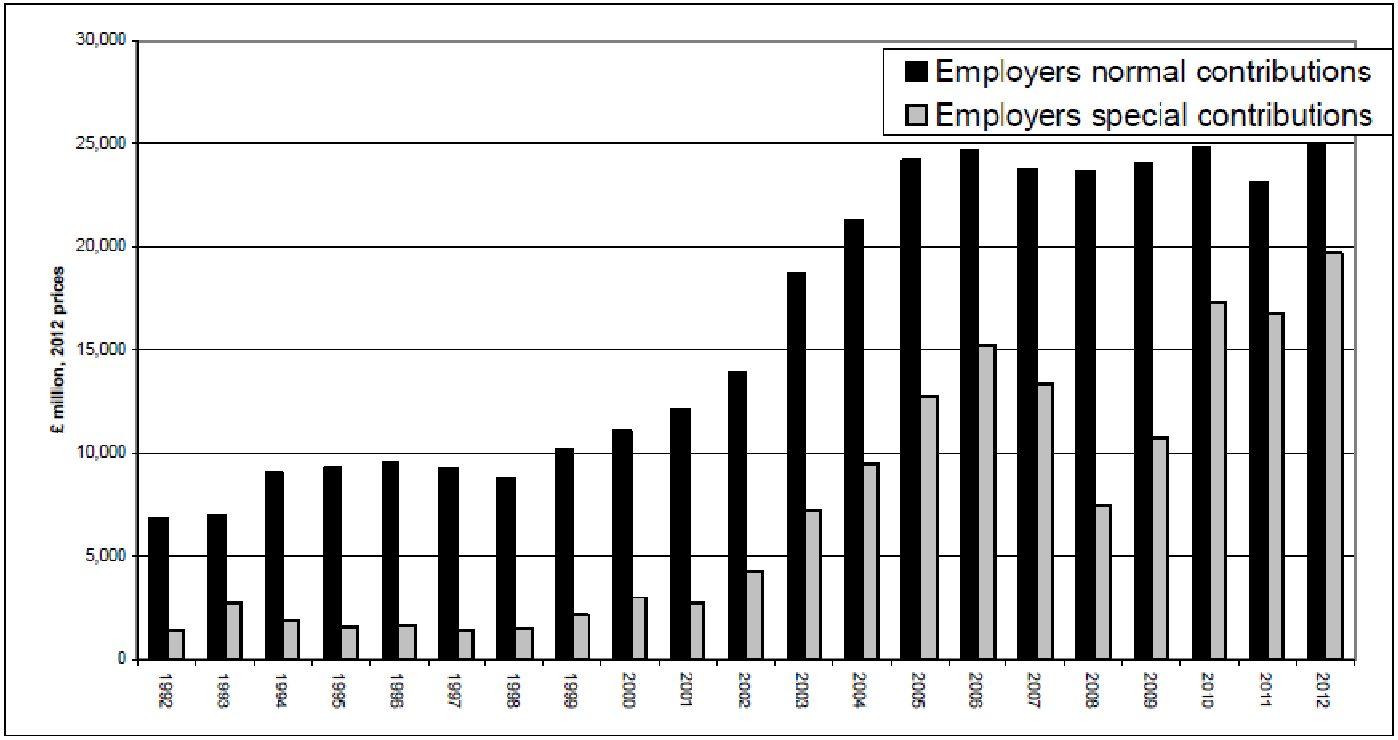
DWP Call for evidence, Jan 2013

"The Government also recognises that volatility in measures of pension scheme deficits can make it hard for companies to manage their investment plans and attract external funding. DWP will also consult on whether to allow companies undergoing valuation in 2013 or later to smooth asset and liability values."

Chancellor's Autumn Statement, 2012

Running fast to stand still

Chart 1: Employer contributions to pension funds – in constant prices terms



Source: Office for National Statistics
Notes: Data for Q4 2012 is not yet published so has been estimated based on Q4 2011 to Q3 2012 data

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Low yields – but for how long?

- QE ↔ UK Gov now owns c.30% of gilts
- Euro crisis is hardly “over and done with”
- The spectre of Japan
- Cheap fuel in short supply
- Aging, dependent population

The Pensions Regulator has been clear that in its opinion trustees should not anticipate changes in market conditions by smoothing discount rates in technical provisions to reflect a belief that markets are artificially distorted.

Our flexible friend

- Basis scheme-specific (c.f. Solvency II)
- Prudent discount rate ↔ investment strategy
- Beliefs about asset returns ↔ recovery plan
- Freedom to take account of employer strength
- Recovery plan period / shape not prescribed

Note, a prudent discount rate has to take into account <u>either or both</u>
- **Yield on scheme assets**
- **Yield on gilts or other high grade bonds**

Nowhere does it say that discount rates must be 100% correlated to gilts

October 2012 Statement

- Variation in investment outperformance assumption
  - From Gilts less a deduction
  - To Gilts plus over 200 bps
- Recovery plans are increasing
  - Average end-date pushing out from 2014 towards 2021

• No need to amend their recovery plans	25%
• 3 year extension plus 10% increase in contributions	30%
• As above, but also tweaking the asset return assumption	20%
• The rest	25%

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Smoothing – whether?

- Impact ought to be long-term neutral
  - But would PPF levies go up?
  - And what about schemes that move out of deficit altogether?
- May well increase the discount rate now…
  - But decreases it once gilts come off the boil
- Interplay with a matching strategy
- Interplay with a “crystallisation event”
  - Entering wind-up
  - M&A bulk tvs
  - Debt on the employer

Smoothing – how?

- Longer period means greater volatility damping
  - But increases disconnect with markets
- The flipside: asset smoothing
  - Could be tricky for some classes eg SPVs
- Multiple valuation cycles
  - When should you (be allowed to) revert to mark-to-market?

"Arguments might be for made for periods from 2 to 5 years but there may be a case for shorter or even longer periods."

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Some comparisons from other countries

Source: the NAPF Call for Action

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USA

For schemes which have yet to adopt mark-to-market…

- Method was to discount on 2 year average AA bonds
- Introduced a corridor and a 25 year smoothed rate:
  - disregard rates 10% outside 25 year smoothed average
  - corridor widens over time
    - 10% corridor in 2012
    - 30% corridor by 2016 (in effect reverting to the 2 yr average)

Sweden

- Introduced a temporary floor for the discount rate
  - Insurers
  - Occupational pension funds
- The floor is proposed to apply for one year only

Holland

- Introduced a 3-month average interest rate
- Also adjusted the yield curve for at the long end
  - Does not affect maturities up to 20 years
  - For longer maturities, the market interest rates will be adjusted gradually over a period of 40 years using the Ultimate Forward Rate (UFR) of 4.2%.

- Denmark also has an Ultimate Forward Rate of 4.2%

Some voices

NAPF

Press release, 17 October 2012

"Many funds base their discount rates on gilt yields, which have been heavily skewed by £375bn of QE over the last three years"

"The UK is well behind the curve on this. Other countries have given pension funds breathing space to adapt to their low gilt environments. It's time we caught up."

Health warning: "more prescriptive regimes … could be seen to pave the way towards Solvency II"

(CBI's preference was for smoothing)

tPR

- “does not consider smoothing the discount rate to be consistent with the legislative requirement to value assets on a mark-to-market basis”
- “it would not be prudent to try to second guess market movements by assuming that gilts will inevitably improve in the near term”

Chairman, tPR

Reckless Prudence

"While we believe contributions should be made where they are affordable we do not want trustees to be recklessly prudent in the valuation assumptions they make or in their negotiations with employers.

"There will be occasions where the right thing to do for the employer and the scheme will be to invest in the sponsoring company rather than requiring them to make higher pension contributions."

Michael O'Higgins' speech at Professional Pensions show 2012

Deputy Governor, Bank of England

For a pension scheme starting in balance, the impact of QE had been broadly neutral, with positive movements in assets broadly matching the movement in liabilities

NAPF Local Authority Conference, May 2012

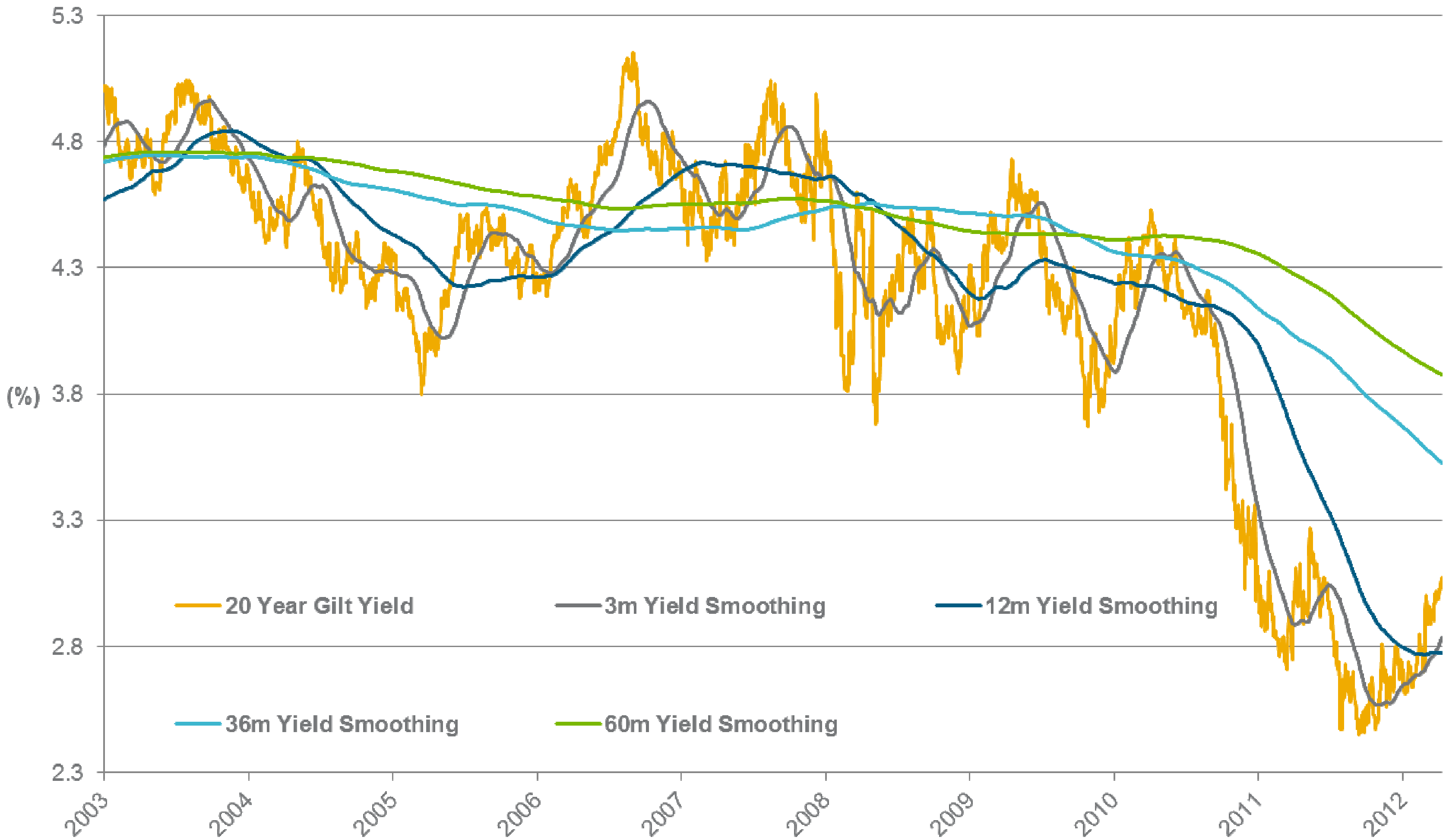
Independent commentators

- A number of others commentators now voicing concerns with current methods, eg
  - Con Keating and others
    - critique of the “mixed attribute” nature of the current system
    - assets and liabilities are not consistent
    - http://www.futureofpensions.org/resources/Keep+your+lid+on-Final.pdf
  - Norma Cohen
    - Questioned the whole paradigm of growth and equity risk premia
    - FT article, 23rd November 2012

Some graphs

Yield Smoothing

20 yr gilts with smoothing over various periods



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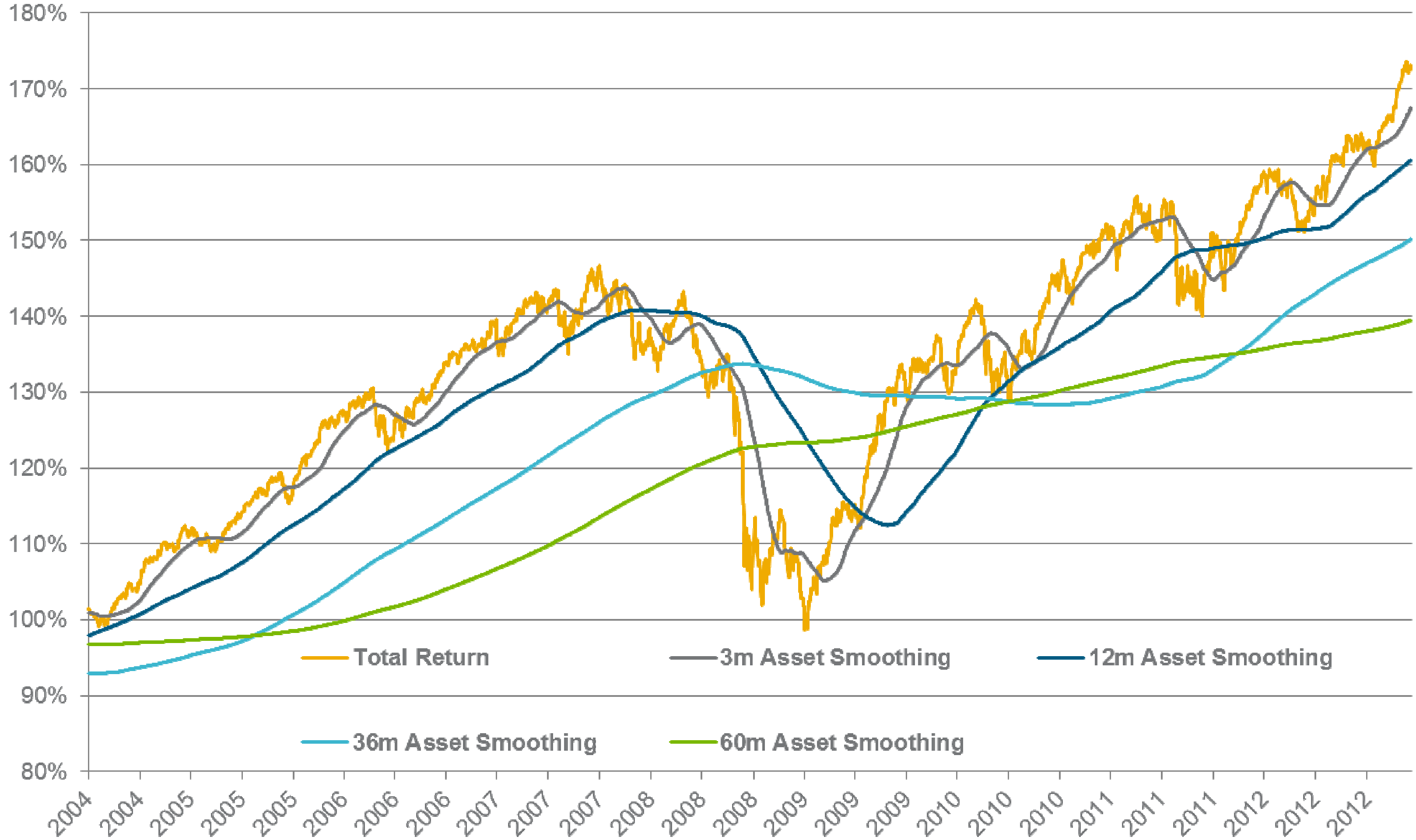
Asset Smoothing

Equity: 30%UK, 30% O'seas. Bonds: 20% Corporate, 5% Gilt, 15% ILG. Yearly rebalancing.



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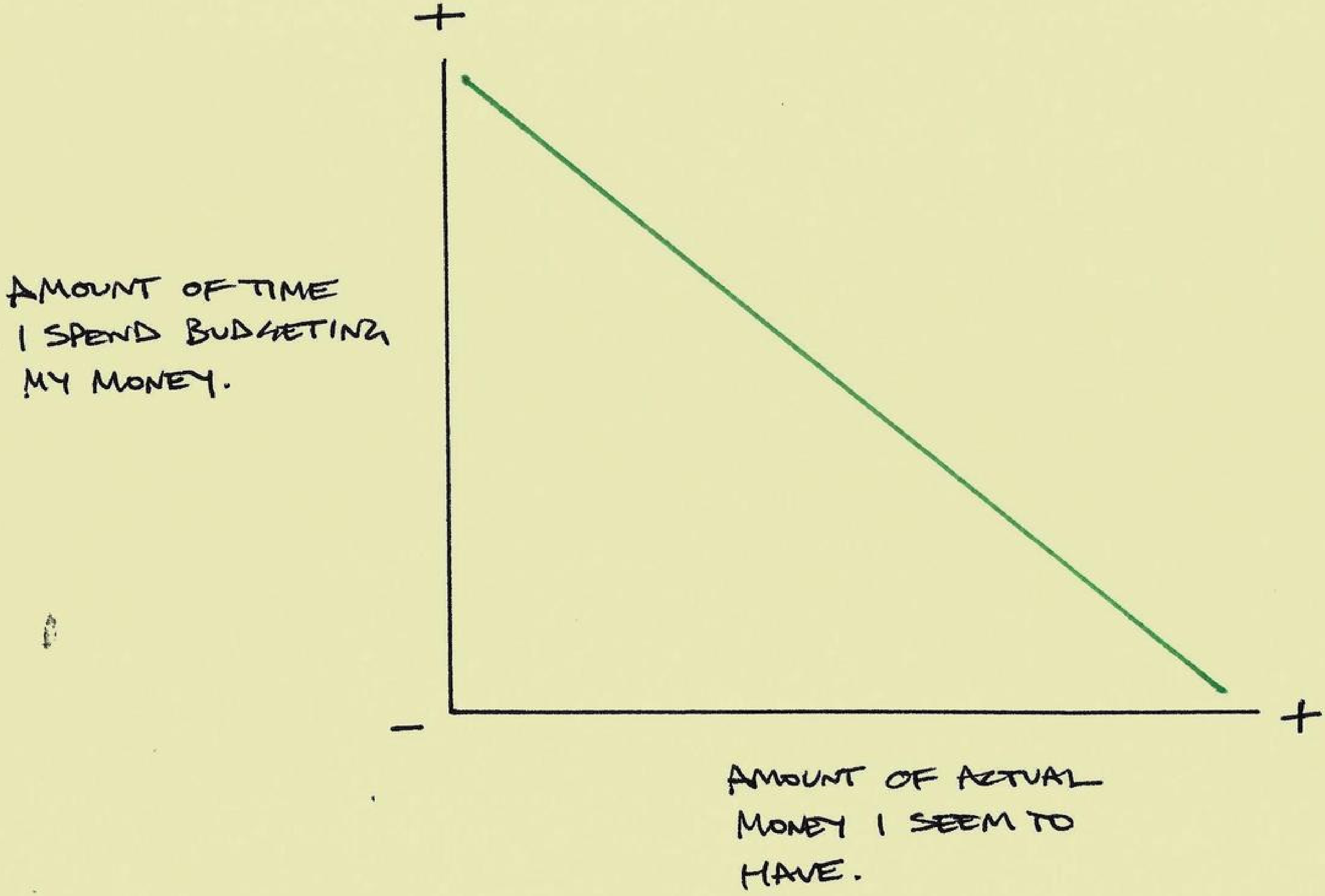
Be careful what you wish for…

- 3 year smoothing currently increases yield by c.50 bps
  - Perhaps reducing liabilities by 10%, say
- 3 year smoothing currently reduces my assets
  - Reduction is c.15%

Note, this smoothing is very different from the “discounted dividend” method that was commonly used before mark-to-market


+
AMOUNT OF TIME I SPEND BUDGETING MY MONEY.
−
+
AMOUNT OF ACTUAL MONEY I SEEM TO HAVE.

Your thoughts, comments and questions

Questions on “whether”

1 What would be the effect of smoothing …? Would it materially improve the sponsoring employers’ ability to attract investment … in short term?

3 What are the advantages and disadvantages of smoothing for [various stakeholders]?

4 Is the current regime flexible enough … not to act as a material brake on investment and growth?

5 What schemes, in terms of their valuation date, should be able to take advantage of the change?

Question on “how”

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

- How should schemes calculate liabilities?
- Over what period of time should the smoothing occur?
- Would smoothing be a voluntary or mandatory requirement?
- Should there be any other restrictions … if smoothing is used?
- Should schemes be locked into smoothing for more than one valuation cycle or permanently? Would this make deficit repair contributions more counter cyclical to the wider economy in the longer term?
- How would you apply smoothing to assets?
- Would smoothing enable the breadth of differing scheme circumstances to be appropriately accounted for (e.g. schemes that have hedging/risk management strategies in place)?
- Should this be a permanent or temporary change?

Smooth summary

Chart 5: Possible Factors in a Model for Smoothing.

Description	Period considered for smoothing	Mandatory/ Optional	Requirement to remain with smoothing model for more than one valuation cycle?	Smoothing of assets as well as liabilities
Option 1	2 years	Y/N	Y/N	Y/N
Option 2	3 years	Y/N	Y/N	Y/N
Option 3	5 years	Y/N	Y/N	Y/N