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CONSULTING ACTUARIES

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Dear Ms Brook

Consultation on Debt on Employer Regulations

I am writing on behalf of the Association of Consulting Actuaries in response to the consultation document issued by the Department for Work and Pensions dated August 2007 containing proposed amendments to the 2005 regulations.

Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. Members of the Association are all qualified actuaries and are subject to the code of professional conduct of the Faculty and the Institute of Actuaries. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of defined benefit pension schemes.

The ACA is the representative body for consulting actuaries, whilst the Faculty and Institute of Actuaries are the professional bodies.

We are supportive of the broad thrust of and intention behind the amendments. They contain several useful practical easements and clarifications. However, we have a number of comments on the detail, which are set out below. Key 'overview' comments are:

- The underlying principle should be that a debt event arises when an employer ceases his financial involvement with the scheme. Any attempt to define this explicitly by reference to the current membership is likely to cause problems.

- There is a danger that, whilst the legislation may contain options which in theory allow more flexibility for corporate transactions, these options may in practice not be available if the wording of the legislation encourages trustees to adopt a 'risk-averse' stance.

We expect that the consultation will give rise to a lot of comments about the detail and that the need for the DWP to give appropriate consideration to these comments will make it very difficult to achieve a December 2007 'in force' date. Whilst we are anxious to see these changes implemented as soon as possible, we believe that a further short delay would be preferable to amendments which retain technical flaws.

HMRC tax treatment

We are pleased to hear that you will be taking up with HMRC the question of corporation tax relief on guarantors' payments under approved withdrawal arrangements. The uncertainty over this tax treatment is a significant deterrent to entering into such an arrangement.

Role of trustees

Trustees clearly must have an important part to play in specifying the data to be used for the deficiency calculations, and the allowance to be made for expenses. It is less clear, though, what role the amended regulations would envisage the trustees should play in determining the actuarial (or accounting) approach to be used. Is it envisaged that they have a role, for example, in determining what assumptions are used to work out the annuity cost? But amended Regulation 5(7) still appears to make this estimate solely the responsibility of the actuary. (This is consistent with the Scheme Funding Regulations, where the actuary appears to be solely responsible for the solvency estimate.)

A 'joint' responsibility for the figures involving both the trustees and the actuary/auditor may indicate a significant change in approach. At present, we think most actuaries performing 'debt' calculations would see themselves primarily as discharging a regulatory function, rather than as 'advising' the trustees. The proposed new approach involving the trustees may suggest a shift towards a calculation which (whilst of course still being within the acceptable range of possibilities) tends to favour the trustees at the expense of the employer. In many cases there is not a unique, objective answer to what the deficiency is; the alternative valuation approach in Regulation 5(7)(b) and the facility to update earlier asset and liability values introduce options into the process which the trustees may consider should be exercised to their advantage.

Updating asset and liability figures

We agree that it should not be mandatory to have an audited asset value at the applicable time for debt calculations. (For the record, we do not believe that the current legislation requires one.) The ability to determine the asset value by updating last year's audited value is important to manage costs in multi-employer schemes (some of which have so many employers that cessation events are very frequent). We would like to see this ability extended to debt calculations more generally and not just restricted to cessation events. We would also suggest extending the maximum roll-forward period from 12 to 18 months, so that debt calculations at applicable times shortly after a scheme year end do not have to be delayed whilst that year's accounts are drawn up, and allowing an audited asset figure to be rolled backwards as well as forwards (this could be especially useful where an applicable time falls slightly before a scheme year end).

It is difficult to know what to make of the proposed facility to use an 'updated actuarial valuation'. Valuations are normally only produced once every three years and not every 12 months, so on the face of it the facility would only 'help' about one-third of the time. However, in practice actuaries would generally assume that they are required to come up with an answer which, in their professional judgement, is an adequate estimate of the 'annuity cost' at the applicable time, and would want to assess on a case-by-case basis the extent to which they can use previously-produced figures as a starting point rather than having to try to interpret what 'fits in' to a legislative provision such as that proposed by Amended Regulation 5(11). What we would ideally be looking for here is a general form of words under which it is clear that the actuary (and trustees) have acted in accordance with the legislative requirements if they have assessed the amount of a deficiency and/or resultant debt on an approximate basis which is reasonable in the circumstances, even where (it later transpires that) this is different from the amount that would have been produced had precise calculations (akin to a formal triennial valuation) been done.

Another option which we would like to see permitted for cessation events in multi-employer schemes is for the debt to be determined using an 'as at' date different from the 'applicable time' as currently defined. A maximum date difference of six months would generally allow trustees to use a scheme year end date (either the last one or the next one), if they considered it to be appropriate in the circumstances.

Estimate of annuity cost

We welcome the introduction of an 'alternative' estimation basis for the actuary (Amended Regulation 5(7)(b)), but do not think the changes deal with the whole current problem. There are two scenarios in which an actuary has difficulty with the current legislation – he may be unable to get a quote (because it isn't a 'real' case and no insurer is prepared to do the work), in which case the new provision *does* help, or he may consider that no buyout cost for the liabilities exists (because the scheme has uninsurable benefits or exceeds market capacity), in which case the new provision *does not* help (the regulations would need to allow the actuary to estimate something that wasn't specifically required to be "the cost of purchasing annuities"). We note that this problem does not arise under the Scheme Funding Regulations (i.e. the "such manner as the actuary considers appropriate" alternative covers both scenarios), and suggest adopting wording here which is closer to that in the Funding Regulations and which allows for an alternative to an estimate of the cost of purchasing annuities, rather than for an alternative estimate (to a cost based on the 'market') of the cost of purchasing annuities.

Default liability share

It is useful to have the clarification that the 'normal' basis of apportionment is to use actual pensionable service with each employer, and to have a 'default' fallback to a 'last employer' basis where the data are inadequate for this purpose. However, the proposed amendments appear to exclude the possibility (available under the current regulations) of using instead an apportionment basis set out in the scheme rules. Given that the 'last employer' basis may seem very unfair to one or more employers in some circumstances, and that the treatment of 'orphan' liabilities under either of the 'default' bases seems unfair to any newly-joining employer, we think that the Regulations should retain the current facility for the scheme rules to stipulate a liability share different from the 'default'. (It seems to us that 'apportionment shares' are not an adequate replacement for this facility, as they seem to be geared to specific debt calculations rather than to a basis set out for the scheme well before any actual 'applicable time' arises or is even expected.)

We note that, as with the current regulations, there is no facility for the debt to be reduced if there has been a bulk transfer to another scheme (whereas such a facility does exist for approved withdrawal arrangements and the proposed cessation agreements). We think that there should be such a facility. Presumably, a scheme apportionment arrangement could be set up which replicated the effect of a transfer deduction, but this seems to be a bit of a sledgehammer to crack a nut.

Definition of cessation event

The new definition's reference to 'active members' does add some clarity (in that it avoids the debate under the existing regulations as to whether or not 'employer' status is retained where there are, for example, prospective members) but does not entirely resolve uncertainty as there is room for debate as to whether a member who has ceased future accrual but continues to enjoy salary-linking on past service benefits is 'active'. But our view is that 'active membership' is not the right criterion to determine whether or not someone is still an 'employer'. The important point is whether or not the 'employer' is still standing behind the scheme, willing and able to make contributions to meet a deficit as and where necessary.

We also notice that the proposed amended definition has removed the rider "…at a time when at least one other person continues to employ…". This would have the effect of triggering a debt if all employers ceased to be employers at the same time – for example, if a scheme became closed to future accrual and even potentially in the run-up to a scheme merger. We do not believe that this would be appropriate (where the employers remain willing and able to make future contributions as and where necessary), and we are pleased that the Government has just (whilst we were finalising this response) announced that this was not its intention and that it will be reviewing the proposed amendments accordingly. We trust that the revised amending regulations will be suitably consulted upon (whether formally or informally) to help ensure that they do avoid unintended consequences of this type.

We support the introduction of the 12-month ‘grace’ period, during which a ceasing employer does not have to pay a debt if he intends to employ active members again. However, we would question the “not closed to new active members” requirement; on initial reading it just seems superfluous but on closer examination it actually seems to remove from the concession a situation which ought to be covered – one in which an employer temporarily ceases to have active members but shortly afterwards acquires such members by transfer of employment from another of the scheme’s employers. (We also note that this ‘grace’ period may not be required if a different definition of ‘employment-cessation event’, not specifically related to the membership, were to be used, as suggested in the overview comments.)

Apportionment arrangements
For the reason indicated above (under ‘default liability share’), we do not think that these are an adequate replacement for the current facility for a scheme’s rules to provide for an apportionment on a basis different from the default. Although new Regulation 6A(2)(b) specifically provides for a scheme apportionment arrangement to be made before the applicable time, it is unclear to us how to apply the tests in Regulation 6A(3)(b)&(c) in such circumstances. And, more generally, it is not clear to us how 6A(3)(b) and 6A(3)(c) work together, as the former may be read as implying that the scheme should be fully funded on the statutory funding objective immediately after the applicable time whereas the latter (with its reference to a recovery plan) suggests otherwise.

Regulation 6A(2)(a) requires that the trustees and departing employer are parties to the arrangement. Should it not be the case that *all* the employers are parties?

We note that Regulation 6A(2)(c) requires the arrangement to specify a *proportion* for determining the employer’s share of the total deficiency. Could not an *amount* be specified as an alternative? This latter option could save a lot of work in the calculation and certification process (see under ‘Actuarial certificates’ below).

Cessation agreements
We support the underlying principle, that a ‘withdrawal arrangement’ should be possible without Regulator involvement where the trustees are suitably satisfied as to the ongoing financial support for the scheme.

As with the apportionment arrangements, given that the trustees need to be satisfied as to the remaining employers' willingness to fund the scheme after the agreement, should not these other employers also be parties to the agreement?

Although the consultation document indicates that cessation agreements would be able to be made before or after the applicable time, this does not (unlike with the other options) appear to be reflected in the draft regulations themselves. We assume this is an oversight.

Also, although new Regulation 6C is clearly intended to govern the calculation of Amount A for the purpose of both cessation agreements and approved withdrawal arrangements, we note that Regulation 6B (unlike 7A) does not specifically refer to the 'immediate' amount of the departing employer's share as Amount A. Again, we assume this is just an oversight.

Approved withdrawal arrangements

We welcome the replacement of the 'more likely to be met' criterion, which has been very difficult to satisfy in many circumstances where a withdrawal arrangement would intuitively be a perfectly reasonable approach within the spirit of the legislation. The potential disadvantage is that the replacement provisions in themselves (Amended Schedule 1A, paragraph 2(4)(b)) give very little idea of the circumstances in which the Regulator would in practice grant its approval. However, we assume that this gap will be covered through guidance. Such guidance will not just be useful for cases where the parties specifically intend to seek Regulator approval, but will also be useful background for trustees when assessing whether or not to enter into a cessation agreement (without Regulator approval).

The facility for the Regulator to approve a lower 'Amount A' in limited circumstances is potentially useful, because any extra piece of flexibility generally is. Nevertheless, more clarity as to when the Regulator might use the power is necessary if this extra flexibility is to generate more benefit than 'angst'.

Actuarial certificates

The new (or revised) actuarial certificates are all expressed as giving the actuary's opinion as to the shortfall. However, the amending regulations give the trustees a joint role with the actuary in determining the amount of the liabilities, as well as clarifying that the asset value is down to the trustees in consultation with the auditor. We think that the wording of the certificate should be changed to reflect the fact that more people than the actuary are involved in determining the shortfall.

Furthermore, we note that, apart from identifying which of the four broad approaches has been used, the Schedule 1C certificate does not give any detail as to the underlying basis used for determining the employer's share of the debt. We think that it is important that such details are included with the certificate.

In the case of an apportionment share, if an amount rather than a proportion could be specified (see above) there would not necessarily have to be a determination and certification of the whole scheme shortfall for the scheme apportionment debt to be determined. In some circumstances, there would be no 'actuarial' calculation involved, rendering the actuarial certification unnecessary.

In the case of withdrawal arrangements and cessation agreements, the wording of Schedule 1C should reflect the fact that the figures will be determined on the scheme funding basis and not on a buyout basis. There is also no facility on the certificate to identify any 'relevant transfer deduction' – in line with our earlier comment on the need for the basis to be clear, we think that this is unsatisfactory. (Presumably the effect of any transfer deduction would just be swallowed up in the difference between the final figure in section 1 of the certificate and the figure quoted in section 2 of the certificate.)

Some of the above issues could be solved or lessened if the wording of the certificate was not so comprehensively prescribed and the actuary (and/or trustees) was able to amplify it as appropriate. Another important example of how the legislation (and in particular the certification wording) could usefully be made more flexible would be to permit the actuary to certify that the shortfall (and/or debt) is *no less than* a specified amount – in practice, trustees and employers would often be prepared to agree a pragmatic approach to a debt calculation which met this criterion.

Implications for other documents

There appear to be some inconsistencies between the proposals in these amending regulations and the draft 'clearance' guidance issued by the Pensions Regulator in September. The Regulator's guidance refers to the "insertion of an apportionment rule" as a 'Type A' event, whereas the draft amended regulations would appear to override scheme-specific apportionment rules. We assume that the DWP will liaise with the Regulator to ensure that the final regulations and guidance are consistent, and hope that the Regulator will not add requirements which in effect override the DWP's policy intention.

Amendments to the Employer Debt Regulations are likely to require amendments to actuarial Guidance Note GN19. We assume that the DWP has been liaising with the Board for Actuarial Standards (which is now responsible for GN19) in this regard.

Kind regards

Charles Young
Chairman
ACA Pension Schemes Committee