Department for Work & Pensions

Pensions and Growth

Whether to smooth assets and liabilities in scheme funding valuations

Whether to introduce a new statutory objective for the Pensions Regulator

A call for evidence

January 2013

Contents

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Executive Summary

1. Private sector defined-benefit occupational pensions remain a prominent feature in the United Kingdom's pension landscape, providing members with a much valued layer of financial security in later life. However, the cost of funding these pension promises is substantial as longevity continues to increase; returns on assets remain volatile; and the economic environment remains weak.
2. Of particular concern to some sponsoring employers and trustees alike is the recent period of historically low gilt yields which has affected the discounting applied in the calculation of long-term pension liabilities. 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.
3. Against this background, the Government is considering whether there is a need for -
   - legislation to explicitly allow the 'smoothing' of asset values and liabilities in funding valuations (i.e. averaging asset prices and discount rates over a longer period of time, instead of using current market spot rates) in order to counter the effects of the current economic situation.
   - a new objective for the Pensions Regulator to consider the long-term affordability of deficit recovery plans to sponsoring employers to add to the current recognition of this in the Pensions Regulator's Code of Practice.[1]
4. In considering whether changes to the funding regime are appropriate, the Government needs to weigh up impacts on:
   - Members - defined-benefit pension rights are obligations which cannot be altered once rights have accrued. The Government is committed to ensuring that members' interests are protected;
   - Sponsoring employers – the best security for a defined-benefit pension scheme and its members is a properly-funded scheme backed by a solvent, profitable sponsor. The Government recognises that for each scheme a balance needs to be struck between these two elements;
   - The Pension Protection Fund, which provides a safety net for members of pension schemes and is funded by a levy. The Government wants to ensure that it understands the potential impacts on the levy of any smoothing of assets and liabilities;
   - The wider economy - the Government wants to ensure that the protections in place for members within the defined-benefit pensions regulation system do not act as a brake on investment and growth.
5. The Chancellor of the Exchequer acknowledged that these complex issues needed further consideration in the Autumn Statement[2], when he announced that

[1] Pensions Regulator Code of Practice No. 3, February 2006, via: http://www.thepensionsregulator.gov.uk/docs/code-03-funding.pdf

the Department for Work and Pensions would consult on “providing the Pensions Regulator with a new statutory objective to consider the long-term affordability of deficit recovery plans to sponsoring employers” and “on whether to allow companies undergoing valuations in 2013 or later to smooth asset and liability values.”

6. Whilst the Government recognises that for sponsoring employers of defined-benefit pension schemes the current economic situation is a challenging one, it also recognises that opinions within the pensions industry differ on whether there is a case for change. This document is seeking therefore to gather views on:
    - whether the smoothing of assets and liabilities would be appropriate in schemes undertaking technical provisions (part 3) valuations, considering impacts on members, sponsoring employers and the Pension Protection Fund;
    - how smoothing might be applied;
    - whether a new statutory objective for the Pensions Regulator is necessary, or whether the appropriate considerations can be delivered under existing objectives, or alternatively whether other changes to the legislation are required.
7. The responses to this document will be used to inform whether there should be a new objective or duty for the Pensions Regulator. Any such changes will require primary legislation. The responses in relation to smoothing will be used to determine whether any change to legislation is appropriate and if so would form the basis for the options to be consulted on in a further consultation.
8. A full list of the questions posed in this document is contained in Chapter 6.

Next Steps

9. Due to the complexity of the issues involved, the Government has decided to launch this initial call for evidence to gather views on whether change is appropriate. The call for evidence is in two parts. The call for evidence on the new objective closes on **21 February 2013**. The call for evidence in relation to smoothing closes on **7 March 2013.**
10. Given the technical nature of pension valuations and the potential impacts of smoothing, feedback would be particularly welcome from trustees, sponsoring employers, actuaries and other pensions professionals. Members of the general public are also welcome to respond.
11. If the call for evidence prompts changes to legislation, the Government will bring forward more detailed proposals and implement any changes to legislation as soon as practicable in 2013.
12. Chapter 5 sets out the process in more detail.

[2] 5 December 2012 - written document

1 Introduction

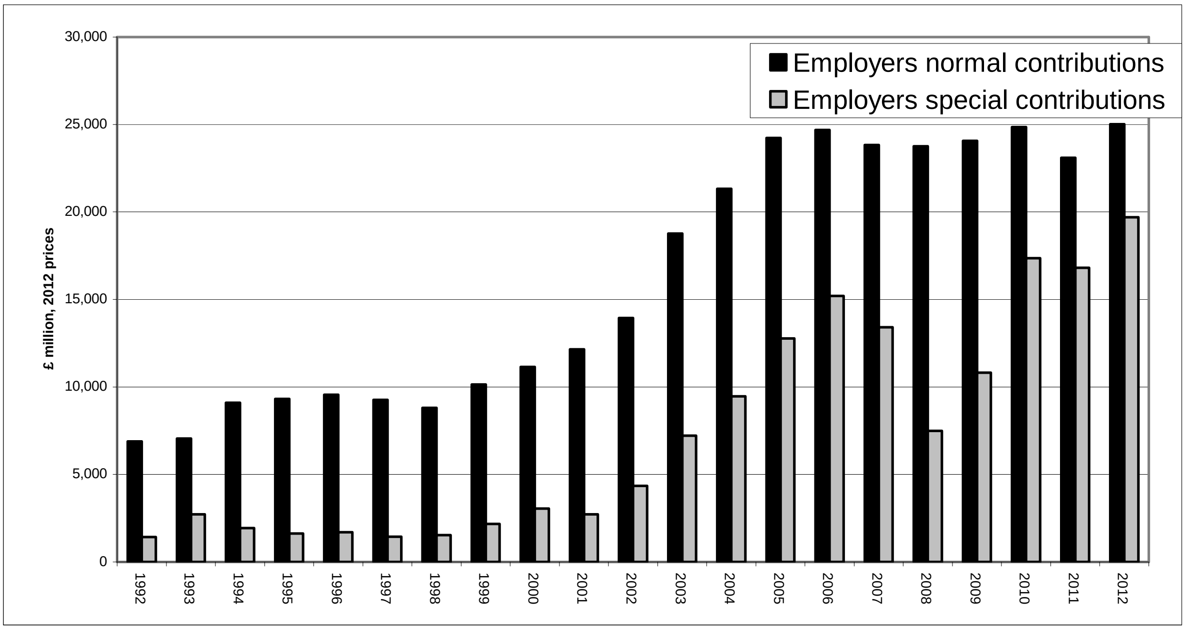
1. The Chancellor of the Exchequer explained in his Autumn Statement that “the Government is determined to ensure that defined-benefit pensions regulation does not act as a brake on investment and growth.” He said that “the Department for Work and Pensions would consult on providing the Pensions Regulator with a new statutory objective to consider the long-term affordability of deficit recovery plans to sponsoring employers.” Furthermore he said that “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.”
2. The purpose of this document is therefore to set out the background to the current position, to offer some initial analysis and to pose questions as to the most appropriate way forward.

2 Background

1. Despite the decline in the number of open private sector defined-benefit pension schemes in recent years, they still account for around £1.1 trillion of pension assets[3] and provide 12.1 million members[4] with a pension or a prospective pension.
2. Since 2000 we have seen an increase in the contributions made by sponsoring employers to meet their pension obligations. This is highlighted in the chart below, which shows how employer contributions made to fund accruing liabilities and repair deficits have increased since the early 2000s. It is worth noting however, that this data shows that special contributions reduced significantly in 2008 and 2009 during a period of economic downturn. The reasons for the increase in contributions since 2000 are numerous but can be related to three main areas.
3. Firstly, the replacement of the Minimum Funding Requirement (MFR) with Scheme Specific Funding (SSF). The former was generally a weaker standard than SSF has proven to be and as a result some schemes that were in surplus under MFR calculations (and took contribution holidays etc) would not have been so under SSF.
4. Secondly, the requirement for sponsoring employers to report the asset and liability position of the schemes in their accounts (using a set standard) created a level of volatility on the balance sheet of employers and in turn fuelled a desire from employers to hedge this volatility – resulting in an increased allocation of scheme assets from equities to bonds, whose expected lower return in comparison to equities raised the expected cost of funding.
5. Thirdly, economic and demographic changes meant that the poor performance of equities in the early 2000's, the significant increase in expected longevity (which became apparent in the early 2000s) and the fall in index-linked gilt yields since 1997 have affected both the assets and liabilities of scheme balance sheets.

[3] PPF 7800 Index, January 2013
[4] 2011 Occupational Pension Schemes Survey, Office for National Statistics

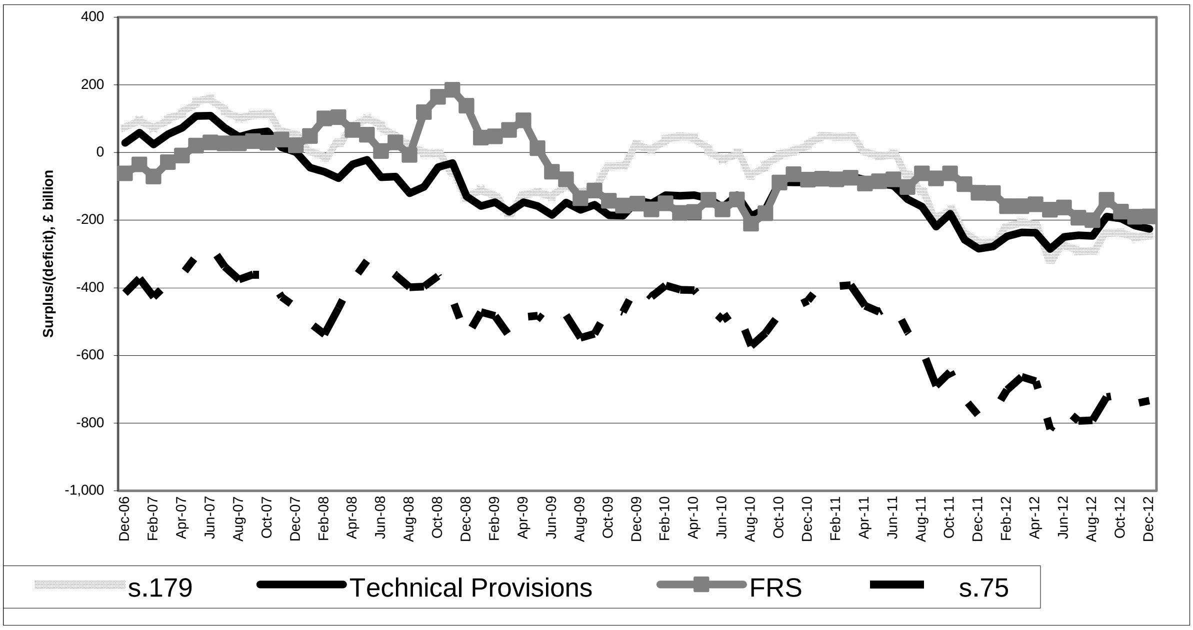
Chart 1: Employer contributions to pension funds – in constant prices terms



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

6. Despite these significantly increased contributions, schemes continue to be significantly in deficit, as shown in the chart below. The chart shows the position on a section 75 debt basis (that assumes liabilities are secured via the purchase of annuities), a technical provisions basis (the amount required under scheme funding legislation based, on an actuarial calculation, to meet a scheme's liabilities), an accounting FRS basis (the accepted standard that calculates pension liabilities on a company's balance sheet) and a section 179 (Pension Protection Fund level compensation) basis.

Chart 2: Aggregate Pension Scheme Surpluses or Deficits



Source: TPR approximations based on PPF7800 data

Notes:

1) Part 3 Technical Provisions: an estimate, made on actuarial principles, of the assets needed at any particular time to make provision for benefits already accrued under the scheme.

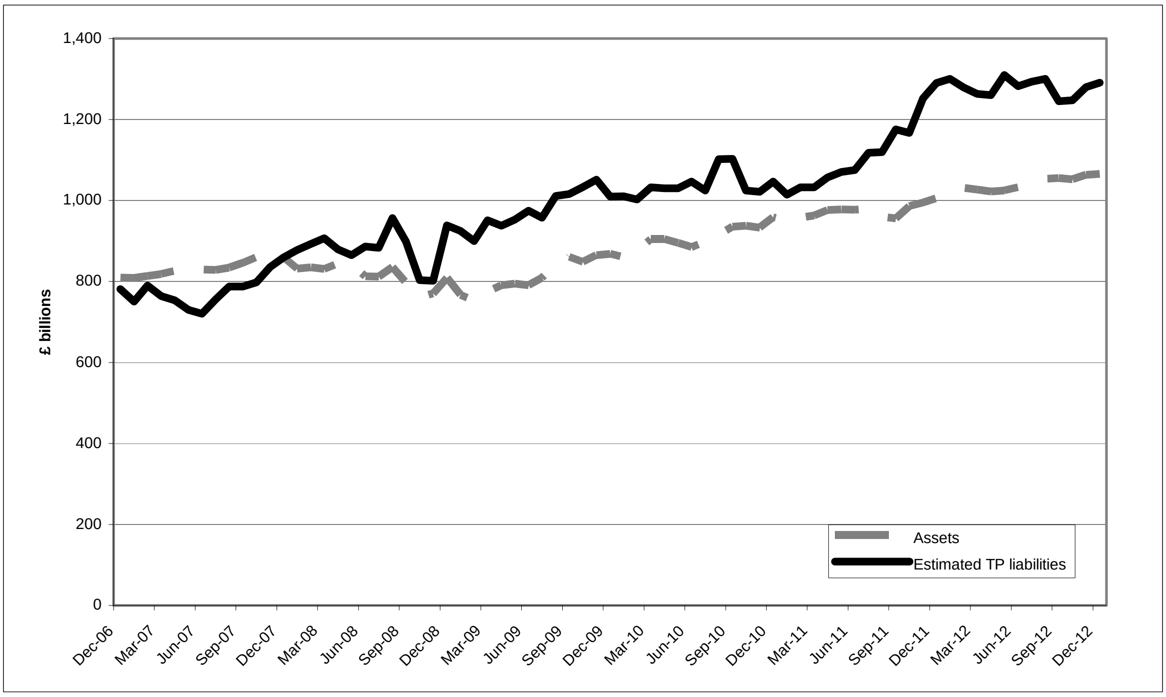
2) S179: this provides a broad measure of the cost of providing a pension equivalent to the PPF level of compensation.

3) S75: measures liabilities at or close to insurance buy-out prices.

4) FRS: a corporate accounting standard which measures pension liabilities for reporting in the sponsoring company's accounts. It is based on the prevailing yield on AA corporate bonds.

7. This increase in deficits has largely been a function of unmatched increases in measured liabilities, rather than falls in asset values, a point which is clear from chart 3, which shows that since the autumn of 2008, the estimated liabilities have grown faster than assets. This trend is particularly marked since the spring of 2011.

Chart 3: Value of assets and technical provision (part 3) liabilities

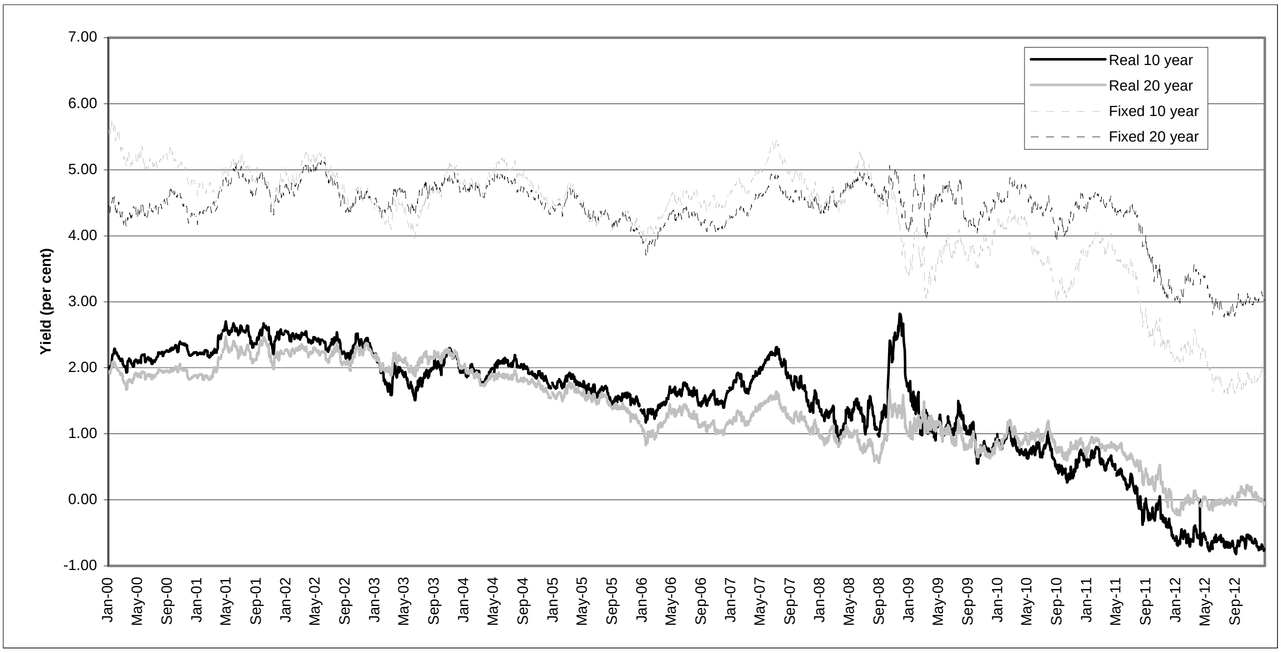


Source: TPR approximations based on PPF7800 data

8. A key reason for this marked growth in liabilities since 2008 is because gilt yields, which impact on the discount rates chosen by schemes to value their liabilities, have fallen to historic lows in the wake of the 2008 financial crisis. Lower gilt yields, by feeding through to lower discount rates, increase the present value of pension liabilities.

9. Chart 4 shows the 10 and 20 year fixed and real gilt yields since 2000. The yields on 'Fixed' gilts are specified in nominal terms (i.e. the yield includes the rate of inflation) and show the return on these assets implied by the current market price, whereas the real yields represent the yield on index-linked gilts *after* RPI inflation is taken account of – so a negative real yield means that after inflation, the asset is delivering a negative return at the current market price. This is a reflection of the sustained fall in nominal yields since 2008. Real yields are particularly relevant to DB schemes since their liabilities are linked to inflation, as a result of the rules on mandatory indexation and revaluation.

Chart 4: Yields on 10 and 20 year fixed and real gilts



Source: Bank of England

10. A number of reasons have been put forward as to why gilt yields have fallen to these historic lows, including the safe haven status of the UK in the wake of the Eurozone debt crisis, and since 2009, the impact of Quantitative Easing (QE). The Government believes that QE has been a necessary response to a difficult economic situation. In its absence, the UK economy would likely have been in a worse position. However, as the Bank of England notes[5] there have been some important distributional consequences of the policy.

11. The Bank's analysis finds that the impact of QE on pension schemes varied in relation to the different investment strategies taken. Any negative impact on gilt yields would be offset in part by strengthened equity and bond prices. However, for schemes already in deficit, and for those following an investment strategy, where the asset portfolio does not match the liability risk, a reduction in gilt yields would indeed result in an increase in pension deficits if the yield changes directly flow into the discount rates chosen for the next valuation. "The burden of these deficits is likely to fall on employers and future employees, rather than those coming up for retirement now".

12. The Government is concerned that this fall in gilt yields should not put a disproportionate financial strain on prudent sponsoring employers of defined-benefit schemes, who find themselves facing increased pension deficits and deficit repair contributions in order to meet their statutory funding objectives (see Chapter 3). At the same time, the Government wants to be careful that it does not inadvertently reward imprudent or reckless investment strategies.

[5] 'The Distributional Effects of Asset Purchases', Bank of England, July 2012.

13. In a time of challenging economic conditions, some sponsoring employers have raised concerns that high deficits would lead to high deficit repair contributions and may be diverting funds away from their investment and job creation plans, ultimately reducing their ability to generate economic growth. In addition some companies have suggested that high deficits are restricting their ability to raise finance, although there is little firm evidence to demonstrate this.

14. It is worth noting at this point that these concerns relate to deficits and contributions made by the sponsoring employer. It is not about avoiding or reducing the pension benefits that are due to members. The Government is committed to ensuring that protection for members is not undermined.

15. The Pensions Regulator's April Statement[6] emphasised the flexibility inherent in the current funding system (see Chapter 3) and recommended making use of the flexibilities available in agreeing recovery plans where employers faced affordability issues. However, 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. Ultimately, it is impossible to know and plan for accordingly when (if ever) a future rise in yields will occur and what a stabilised market will look like.

16. Despite the reassurance in the Statement a number of stakeholders representing schemes and sponsoring employers continued to express concern and to request that the Government looks at 'smoothing' the market-based assumptions used in pension funding valuations.

17. In response, the Government held informal discussions with a number of organisations and sponsoring employers over the summer of 2012 to help it understand these concerns. Whilst no consensus was achieved on whether smoothing was required or what form it might take, stakeholders agreed that the issue would benefit from wider discussion.

18. Some stakeholders asked whether the Government might also consider allowing schemes to apply smoothing in other measures, such as those used in the IAS19/FRS17[7] accounting standard. However, accounting standards are set independently by the Financial Reporting Council and not the Government and so are out of the scope of this document.

19. During the discussions on discount rates, additional issues were raised in respect of the Pension Regulator's statutory objectives, by stakeholders who felt that they focused on the protection of members' benefits and the protection of the Pension Protection Fund without any explicit regard to impact of the sponsoring employer. Whilst there is already recognition in the Pension Regulator's Code of Practice and guidance for trustees that the reasonable affordability of recovery plans for

[6] http://www.thepensionsregulator.gov.uk/doc-library/statements.aspx

[7] FRS17/IAS19 is the accepted standard that calculates pension liabilities on a company's balance sheet.

sponsors should be considered by trustees,[8] it was felt that there was a discussion to be had as to whether an explicit duty or objective would be appropriate.

[8] Pensions Regulator Code of Practice No. 3, February 2006, via: http://www.thepensionsregulator.gov.uk/docs/code-03-funding.pdf

3 Scheme Funding and the Discount Rate

Legislation

1. Private sector defined-benefit schemes are generally required to meet a statutory funding objective to have 'sufficient and appropriate assets to cover the scheme's technical provisions'.[9] These technical provisions are an estimate, made on actuarial principles, of the assets needed at any particular time to make provision for benefits already accrued under the scheme.'

Existing flexibilities within the scheme funding regime

2. Unlike the previous Minimum Funding Requirement (MFR) framework, there is no standard actuarial method and set of assumptions that must be used to determine a scheme's technical provisions beyond the requirement for economic and actuarial assumptions to be chosen prudently. Trustees have the freedom to decide on the actuarial method and assumptions appropriate for their scheme, within certain parameters, taking account of the scheme's specific circumstances, for example current and anticipated future membership profile, retirement age, investment policy, staff turnover, policy on future salary increases. Most notably schemes are free to take into account the investment strategy of the scheme and the ability of the sponsoring employer to underwrite risk in deciding on assumptions for discount rates.
3. Trustees are required to calculate the technical provisions using rates of interest chosen prudently, taking into account either or both: the yield on assets held by the scheme and the anticipated future investment returns; and the market yield on government or other high quality bonds.[10]
4. Ultimately, a partnership approach is required in deciding the actuarial method and assumptions to be used in funding calculations, with trustees and employers as decision-makers and the scheme actuary as a key adviser.
5. Full valuations must be obtained at least every three years to check whether the statutory funding objective is being met. These valuations form the basis for decisions about future contributions to the scheme, including whether a recovery plan is needed to restore funding to the level of the technical provisions. The majority of valuations require recovery plans to be put in place, which has been

[9] Part 3 of Pensions Act 2004, which transposes the requirements of Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provisions (the IORP Directive).
[10] Reg 5(4)(b) of the Scheme Funding Regulations (SI 2005/3377). The wording is very similar to Article 15 (4)(b) of the IORP Directive.

the case since the inception of scheme specific funding in 2005. Any recovery period must be finite and have an 'end date', indicating the period over which the shortfall is planned to be eliminated. However, flexibility is applied in determining such periods. Unlike the MFR, there is no prescribed period over which this must be done. Once again, it is for the trustees, in agreement with the employer, and after taking advice from their scheme actuary, to decide both what period is appropriate and the exact 'shape' of the recovery plan. The Pensions Regulator's Funding Defined Benefits Code of Practice[11] gives trustees guidance on the factors to be taken into account when drawing up a funding recovery plan, including affordability and the strength of the employer's covenant.

6. The Pensions Regulator's 2012 April Statement[12] recognised the difficulty that some sponsoring employers faced in funding their deficits in the current economic conditions. Whilst its statement highlighted the inherent flexibility in the current system, the Pensions Regulator also maintained "that the majority of schemes and employers will be able to manage their deficits within current plans or, if appropriate, by modest contribution increases and/or modest extensions to recovery plans. Therefore, for these schemes the question of needing to rely on increases to gilt yields beyond those implied by the market does not arise". [13] The Pensions Regulator recognised that there would be some employers who need some further flexibility but argued that, in regard to technical provisions, in its view "it would not be prudent to try to second guess market movements by assuming that gilt yields will inevitably improve in the near-term. Such assessments may turn out to be inaccurate and conceal important risks to the scheme's ability to meet its liabilities. Any strongly held views about future financial market conditions should therefore be accommodated in the recovery plan rather than the technical provisions where they are more clearly identified and mitigated should the assumption turn out to be false." [14]

7. The statement highlighted that where trustees choose to increase the asset outperformance in the discount rate to reflect assumed future market conditions, the Pensions Regulator will expect trustees to have examined the additional risk implications for members and be convinced that the employer could realistically support any higher levels of contributions required if the actual investment return falls short of that assumed.

8. In the Pension Regulator's view the use of the flexibilities in the system should mainly focus on the recovery plan. Whilst the overall deficit may increase as a result of the economic circumstances, the Pension Regulator's statement affirmed that the level of the contributions in respect of the deficit should be based on what is reasonably affordable for the sponsor. The statement also highlighted that

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[11] Pensions Regulator Code of Practice No. 3, February 2006, via: http://www.thepensionsregulator.gov.uk/docs/code-03-funding.pdf
[12] "Pension Scheme Funding in the current environment", April 2012, via: http://www.thepensionsregulator.gov.uk/docs/pension-scheme-funding-in-the-current-environment-statement-april-2012.pdf
[13] Ibid.
[14] Ibid.

where employers cannot afford contributions at previously agreed levels, or are unable to pay more in respect of a larger deficit, trustees may need to agree a longer recovery plan. The funding cycle provides the opportunity to regularly review the funding position and recovery plans.

9. In October 2012 the Pensions Regulator published evidence of how some of the flexibilities in the defined-benefit funding regime have been used by pension schemes and sponsoring employers. [15] They also published an analysis of the contributions required to keep schemes largely on track to previously agreed recovery plans.

10. This analysis demonstrated the existing flexibilities which individual schemes and employers have been able to use. Contributions as a percentage of liabilities (technical provisions) vary significantly from scheme to scheme, and the discount rates used by trustees vary significantly - assumptions for investment out-performance relative to gilts have varied from below zero to over 200 basis points, with the degree of outperformance increasing as gilt yields have fallen further. Recovery plan end dates for schemes in the current cycle increased by around 4.7 years in their last round of valuations three years ago. The current conditions are likely to mean that schemes undertaking valuations will use this flexibility again. If recovery plans extend by a further three years then on average the end date for recovery plans for these schemes will have moved from 2014 to late 2021**.**

11. In its analysis of contributions required, the Pensions Regulator assumed that employers would maintain the level of contributions already committed to recovery plans. This analysis found that:

   - about 25% of schemes would not need to amend their recovery plans;
   - about 30% of schemes would remain on track to meet their long-term liabilities with a three year extension to existing recovery plan subject to a 10% increase in deficit repair contributions;
   - about 20% of schemes would remain on track with a three-year extension to their recovery plan, subject to a 10% increase in deficit repair contributions and making use of further flexibilities in the funding regime, such as allowing for greater investment outperformance in their recovery plan;
   - about 25% of schemes would need to make larger deficit repair contribution increases or make maximum use of the flexibilities available in the funding framework because of the affordability challenges for the sponsoring employers.

12. Therefore for the majority of schemes, on average only modest changes to contributions would be required to remain on track. Nonetheless the analysis highlighted that there are clearly some schemes which will find the current economic situation a challenge and this is where flexibilities should be targeted.

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[15] "The defined-benefit regime: evidence and analysis", October 2012, via: http://www.thepensionsregulator.gov.uk/docs/the-defined-benefit-regime-evidence-and-analysis.pdf

13. Informal discussions with a limited number of employers, actuaries and others over the summer and autumn of 2012 highlighted the challenges facing pension schemes. Whilst some stakeholders appeared content with the existing flexibilities in the scheme funding regime, others wished to explore whether a temporary easement might be applied to 'smooth' the current low gilt yields, in order to mitigate their impact on the discount rate and resulting scheme deficits. Stakeholders were concerned that rising deficits are forcing some employers to make substantial additional contributions to their schemes, and this is potentially diverting funds away from business investment and ultimately, economic growth.

Smoothing

14. Although there is interest from a number of stakeholders in introducing some form of smoothing, discussions to date have failed to identify any consensus on the appropriate method. This document therefore seeks views on the extent to which smoothing should be explicitly allowed for in pension scheme valuations, appropriate methods of smoothing, and how best to apply a consistent approach across assets and liabilities.

15. Many stakeholders support the flexibilities in the current system of pension scheme funding which does not require trustees to choose discount rates based on gilts. There is some nervousness that specifying particular valuation methods, could result in a more rigid formulaic system and that the existing flexibilities would be curtailed. The following paragraphs seek to draw out some of the issues so that stakeholders can consider them when responding to this document.

16. The long term effect of adopting a consistent method of smoothing should be expected to be neutral as the effect is only to alter the timing of contributions into the scheme; the quantum of benefits owed to members remains unchanged. In the short term however the effect on cash flows into the scheme could be significant if, as some stakeholders have argued, the effect of smoothing the current gilt rate reduces current deficits and directly impacts on the amount of recovery contributions required. It has been suggested by some stakeholders that there could be significant reductions in both deficits and deficit contributions. Although there would be different impacts for individual schemes the total impact on all schemes due to undertake valuations could be significant.

17. The overall effect of introducing (explicitly) smoothing on aggregate pension liabilities would depend on whether trustees choose to use smoothing. Whether or not smoothing would be a preferred option depends on the scheme's and the sponsoring employer's circumstances. Schemes and sponsoring employers may choose not to smooth because:

    - locking in the current low yields (especially if the model of smoothing involved a lock in for more than one valuation – see below) would mean that schemes and employers could not benefit as quickly from a future rise in yields;

- if a scheme were to move into surplus as a result of smoothing and the cashflow into the scheme in contributions was therefore reduced, trustees may choose more risk adverse assumptions, which may in part or in whole counteract the effect of smoothing;
- in mature schemes a sponsoring employer may be trying to move a scheme to a low risk/self sufficiency status and thus smoothing might not be an attractive option.

18. The Pensions Regulator and others have noted that as the actual amount paid annually in recovery contributions should be based primarily on affordability rather than the level of the deficit, the impact on short term cash flows may therefore be limited. It is worth noting that other factors taken into account in determining the level of deficit repair contributions, such as the strength of the sponsoring employer's covenant will not be affected by smoothing.

Period used for smoothing

19. The longer the period over which smoothing takes place, the less volatile the movement in the liabilities and assets, but this also means that the valuation of assets and liabilities moves further from the related market rate for that particular scheme. For the majority of schemes, where the sponsoring employer remains solvent, the long term nature of their liabilities would mean that there is an in-built tolerance of short term volatility. However, where a scheme wind ups or enters the Pension Protection Fund (and liabilities and asset values crystallise), a significant deviation from the market rate may present disparities in the valuation required under these standards. Thus, where a scheme is fully funded on a smoothed technical provision basis, the loss to members and/or the Pension Protection Fund will increase at times when smoothed valuations understate market related deficits (as the case would be now) and reduce at times when smoothed valuation overstate market related deficits.

20. In considering the appropriate period for any smoothing it is useful to look at the reasons put forward for the current historically low rates and the extent of volatility. As discussed in paragraphs 9 and 10 of the Background section, the safe haven status of the UK in the wake of the Eurozone debt crisis and the impact of Quantitative Easing since 2009 are factors that are thought to have contributed to the fall in rates. Chart 4 (page 10) shows the particularly marked decline in nominal and real gilt yields over the last 2 years and rate volatility since the financial crisis peak in autumn 2008. Whilst any smoothing period is a matter of judgement this suggests arguments might be for made for periods from 2 to 5 years but there may be a case for shorter or even longer periods.

Treatment of assets

21. Another consideration and something that emerged during the informal discussions during the summer is the treatment of assets. Consistency would require that assets should be smoothed over the same period as the gilt rate in order to preserve the integrity of relevant funding calculations. The composition of

the asset portfolio will affect the net effect of any smoothing on the scheme's assets to liabilities. The Government believes that any form of smoothing would have to involve smoothing of assets as well as liabilities. However, it is recognised that there might be particular difficulties in assessing the value of some asset classes especially non UK asset classes.

Mandatory or Optional Smoothing

22. A further question is whether smoothing should be made mandatory for all schemes or be an option for trustees and sponsoring employers to consider when undertaking the valuation. The former might facilitate comparisons across schemes and an understanding of the total landscape. For many schemes, particularly those which have effective hedging strategies, smoothing may not be an attractive option. The scheme funding regime is inherently flexible and restricting that flexibility is not the intention. However, introducing an option carries the risk that schemes 'pick and choose' the most favourable option for them.

Locking in smoothing for more than one valuation cycle

23. If smoothing were to be used by schemes, should schemes, choosing that option, be required to apply the smoothed model for more than one valuation cycle in order to retain consistency? This could see schemes take longer to benefit from any upturn in gilt yields. However, if schemes used a different approach for different cycles it would make it difficult for trustees and sponsoring employers, and members, to compare the position of the scheme from one cycle to the next. Effectively allowing schemes to 'pick and choose' the method they use depending on the prevailing market conditions could undermine confidence in the entire scheme funding regime.

24. Given the range of factors that can be considered, it is too early to formulate a specific model for smoothing at this stage. However, the options for smoothing would consist of the factors demonstrated below. The Government would welcome your views and evidence as to which combination of factors would produce the most effective model, and how that model would be applied.

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

Implementation of smoothing

25. If the Government decides to bring forward a particular model of smoothing it would need legislation and therefore any changes would be subject to parliamentary approval. Any new legislation would need to be clear with respect to when the changes take effect and is an issue on which the Government would welcome views from respondents.

26. The clearest option would be for the legislation to apply to scheme valuations with effective dates after the introduction of the legislation. This would allow schemes currently undergoing valuations to continue with minimal disruption but be able to make use of these changes for subsequent valuations.

27. Alternatively, legislation could allow for scheme valuations with earlier effective dates to adopt a smoothing model. This could be advantageous to these schemes but could have the disadvantage of causing confusion and delays to valuations already underway and may add additional costs and burden for these schemes in adjusting or amending their current valuation basis.

28. Schemes are required to undertake a scheme specific funding valuation at least every three years. Currently the schemes required to carry out valuations divide evenly across the three years or tranches, with peaks of effective dates around December/January and March/April. The cut off date for introduction of a new approach to valuations may disrupt this by either causing some schemes to undertake out of sequence valuations or to delay the commencement or completion of a planned valuation.

Questions

29. It is evident from the feedback received to date from a number of stakeholders that there are differing opinions on the way forward. It is also clear that further insight is needed on the potential impacts on members and the Pension

Protection Fund, as well as sponsoring employers. The Government is interested therefore in your views on the following questions:

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?

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

- How should schemes calculate liabilities on a smoothed basis?
- Over what period of time should the smoothing occur?
- Would smoothing be a voluntary or mandatory requirement? Should there be any other restrictions applied to schemes if smoothing is used?
- Should schemes be locked into smoothing (if they choose to smooth) 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?

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

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?

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.

Please respond to these questions by 7 March 2013.

4 New Statutory Objective for the Pensions Regulator

1. The Chancellor of the Exchequer stated that the Government “is determined to ensure that defined-benefit pensions regulation does not act as a brake on investment and growth. The Department for Work and Pensions will consult on providing the Pensions Regulator with a new statutory objective to consider the long-term affordability of deficit recovery plans to sponsoring employers.”
2. The Pensions Regulator currently has five statutory objectives in exercising its functions. These are:
   - to protect the benefits under occupational pension schemes of, or in respect of, members of such schemes;
   - to protect the benefits under personal pension schemes, where direct payment arrangements exist or the scheme is a stakeholder pension;
   - to reduce the risk of situations arising which may lead to compensation being payable from the Pension Protection Fund;
   - to maximise compliance with the duties of automatic enrolment;
   - to promote, and to improve understanding of, the good administration of work-based pension schemes.
3. The argument for a new statutory objective is that the current objectives focus explicitly on protecting members and the Pension Protection Fund but do not explicitly require the Pensions Regulator to consider the long term affordability of deficit repair contributions to sponsoring employers of the pension schemes.
4. Representations have been made to the Department for Work and Pensions that an explicit statutory objective or duty which focussed on the sponsoring employers would have the effect of redressing the perceived imbalance.
5. On the other hand, there is an argument that implicitly in the Pensions Regulator’s Funding Defined Benefits Code of Practice[16] (which states that trustees should consider the affordability for the employer) and through operational practice, the Pensions Regulator already gives regard to the effect of deficit repair contributions on sponsoring employers. There is recognition that the best way for members’ benefits and the Pension Protection Fund to be protected in the longer term is a properly funded scheme backed by an ongoing sponsoring employer.
6. When considering whether to exercise its regulatory powers, legislation requires the Pensions Regulator to take into account those parties who are directly affected by the exercise of those powers. Where the regulatory power being

[16] Pensions Regulator Code of Practice No. 3, February 2006, via: http://www.thepensionsregulator.gov.uk/docs/code-03-funding.pdf

considered relates to how a scheme is funded the sponsoring employer would very likely be considered to be a directly affected party.

7. In addition, as a regulator, the Pensions Regulator is required to adhere to the better regulation and 'PACTT' principles.[17] These require that the Pensions Regulator, in exercising its functions, should have regard to the principles of transparency, accountability, proportionality and consistency. Also that regulated activity should be targeted only at cases where in which action is needed. If the Pensions Regulator fails to adhere to these principles, this can be used as evidence in a Judicial Review.

Questions

8. The Chancellor of the Exchequer stated that that the Department for Work and Pensions would consult on providing the Pensions Regulator with a new statutory objective – "to consider the long-term affordability of deficit recovery plans to sponsoring employers."
9. To implement an additional statutory objective for the Pensions Regulator will require primary legislation. The Government is seeking views on whether an additional objective or other amendments to the legislation are necessary.
10. The Government is interested in your views on the following questions:

Q6. What would be the advantages of a new statutory objective for the Pensions Regulator to consider the long term affordability of deficit recovery plans to sponsoring employers?

Q7. What would be the disadvantages in creating this further statutory objective for the Pensions Regulator?

Q8. Is the consideration of the long term affordability of deficit recovery plans to sponsoring employers already implicit in the existing objectives and requirements for the Pensions Regulator? If so, is this sufficient?

Q9. Are there other options (including legislation) which would ensure that the Pensions Regulator carries out its functions in a way which appropriately balances protection of members, the Pension Protection Fund and sponsoring employers?

Please respond to these questions by 21 February 2013.

[17] Reducing Administrative Burdens: Effective Inspection and Enforcement, Philip Hampton, March 2005.

5 About this call for evidence

This call for evidence is seeking views on –

- whether the smoothing of assets and liabilities would be appropriate in schemes undertaking valuations, considering impacts on members, sponsoring employers and the Pension Protection Fund;
- how smoothing might be applied;
- whether a new statutory objective for the Pensions Regulator is necessary, or whether the appropriate considerations can be delivered under existing objectives or through other means.

Given the technical nature of pension valuations and the potential impacts of smoothing, feedback would be particularly welcome from trustees, sponsoring employers, actuaries and other pensions professionals. Members of the general public are also welcome to respond.

This call for evidence applies to England, Wales and Scotland.

The document is available on the Department's website at:
http://www.dwp.gov.uk/consultations/2013

The evidence gathering period begins on 25 January 2013 and the part on the objective runs until 21 February 2013. The part on smoothing runs until 7 March 2013.

Impact Assessment

This document focuses on evidence gathering and does not contain detailed proposals. An Impact Assessment is not therefore necessary at this stage. Should more detailed proposals be brought forward the need for a formal Impact Assessment will be considered.

Whilst this document contains potential wording of an objective for the Pensions Regulator, the intention is for this objective to make explicit considerations already undertaken by the Pensions Regulator.

How to respond to this call for evidence

Please send your responses, preferably by email to:
pensionsregulator.dwpconsultation@dwp.gsi.gov.uk

Or by post to:

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

Please ensure your response on the objective reaches us by 21 February 2013.

Please ensure your response on smoothing reaches us by 7 March 2013.

When responding, please state whether you are doing so as an individual or representing the views of an organisation. If you are responding on behalf of an organisation, please make it clear who the organisation represents, and where applicable, how the views of members were assembled. We will acknowledge your response.

Queries about the content of this document

Please direct any queries about the subject matter of this document to:

Marc Swaby
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
marc.swaby@dwp.gsi.gov.uk

Freedom of information

The information you send us may need to be passed to colleagues within the Department for Work and Pensions, published in a summary of responses received and referred to in the published this report.

All information contained in your response, including personal information, may be subject to publication or disclosure if requested under the Freedom of Information Act 2000. By providing personal information for the purposes of the public consultation exercise, it is understood that you consent to its disclosure and publication. If this is not the case, you should limit any personal information provided, or remove it completely. If you want the information in your response to the consultation to be kept confidential, you should explain why as part of your response, although we cannot guarantee to do this.

To find out more about the general principles of Freedom of Information and how it is applied within DWP, please contact:

Central Freedom of Information Team
The Adelphi
1-11, John Adam Street
London WC2N 6HT

Freedom-of-information-request@dwp.gsi.gov.uk

The Central FoI team cannot advise on specific consultation exercises, only on Freedom of Information issues. More information about the Freedom of Information Act can be found at www.dwp.gov.uk/freedom-of-information

Consultation principles

This document is being conducted in line with the new Cabinet Office Consultation Principles. The key principles are:

- departments will follow a range of timescales rather than defaulting to a 12-week period, particularly where extensive engagement has occurred before;
- departments will need to give more thought to how they engage with and consult with those who are affected;
- consultation should be 'digital by default', but other forms should be used where these are needed to reach the groups affected by a policy; and
- the principles of the Compact between government and the voluntary and community sector will continue to be respected.

Feedback on the process

We value your feedback on how well we consult. If you have any comments on the process of this consultation (as opposed to the issues raised) please contact our Consultation Coordinator:

Elias Koufou
DWP Consultation Coordinator
2nd Floor
Caxton House
Tothill Street
London
SW1H 9NA

Phone 020 7449 7439

caxtonhouse.legislation@dwp.gsi.gov.uk

In particular, please tell us if you feel that the consultation does not satisfy the consultation criteria. Please also make any suggestions as to how the process of consultation could be improved further.

If you have any requirements that we need to meet to enable you to comment, please let us know.

We will aim to publish the Government response to the consultation and any next steps to be taken on http://www.dwp.gov.uk/consultations.

6 List of Questions

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?

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

- How should schemes calculate liabilities on a smoothed basis?
- Over what period of time should the smoothing occur?
- Would smoothing be a voluntary or mandatory requirement? Should there be any other restrictions applied to schemes if smoothing is used?
- Should schemes be locked into smoothing (if they choose to smooth) 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?

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

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?

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.

Please respond to questions 1- 5 by 7 March 2013.

Q6. What would be the advantages of a new statutory objective for the Pensions Regulator to consider the long term affordability of deficit recovery plans to sponsoring employers?

Q7. What would be the disadvantages in creating this further statutory objective for the Pensions Regulator?

Q8. Is the consideration of the long term affordability of deficit recovery plans to sponsoring employers already implicit in the existing objectives and requirements for the Pensions Regulator? If so, is this sufficient?

Q9. Are there other options (including legislation) which would ensure that the Pensions Regulator carries out its functions in a way which appropriately balances protection of members, the Pension Protection Fund and sponsoring employers?

Please respond to questions 6 to 9 by 21 February 2013.

7 Chart data

Full data sets for charts 1 to 4 featured in this document are available for download as Comma Separated Value (CSV) files:

- Chart 1: Employer contributions to pension funds – in constant prices terms (1KB) CSV file
- Chart 2: Aggregate Pension Scheme Surpluses or Deficits (2KB) CSV file
- Chart 3: Value of assets and technical provision (part 3) liabilities (2KB) CSV file
- Chart 4: Yields on 10 and 20 year fixed and real gilts (92KB) CSV file