Proposed Approach to Defined Benefit Pension Provision
Consultation Paper

Section 1: Introduction, purpose and organisation of the Consultation

Introduction

This paper has been prepared by the Implementation Group of the National Pensions Framework[1]. Its purpose is to set out a number of policy options in relation to defined benefit (DB) pension provision. The views of key stakeholders such as representatives of employees, employers and the pensions industry are sought on these options on the basis of the questions set out at Section 7 of this document.

Background

The *National Pensions Framework* (NPF) was published in March 2010 and set out the plans for reform of the Irish pensions system. As regards defined DB pensions, the NPF recognised the difficulties facing DB schemes and emphasised its belief that "further measures must be put in place to ensure that regulatory provision underpins a realisable pension promise and provides that the funding levels required to achieve the core pension expectation of scheme members can be delivered". More specifically, the NPF committed to keep the funding standard under review and also set out a suggested new design for DB scheme restructuring.

Subsequently, in October 2010, it was announced that the work on the development of the new amended DB model suggested in the NPF would be expedited. It was indicated that, as part of its consideration, the Department would "look at issues regarding the governance of DB schemes, the basis for the funding standard (including areas such as risk management, smoothing out effects of changes in the bond markets and strategies for transitioning schemes to this new DB model)." It would also include a consultation with the pensions industry, employers and trade unions.

Structure of this paper

The structure of this paper is as follows. After this introductory section, Section 2 outlines the policy context, covering the evolution of DB pension provision over the last decade and summarising the policy and regulatory responses adopted to address some of the issues that arose. It also includes an analysis of the funding standard used to measure the solvency of DB

[1] The Implementation Group of the National Pensions Framework is composed of representatives of the Department of Social Protection, The Pensions Board, the Department of Finance, Department of the Taoiseach, The Office of the Revenue Commissioners and the Department of Enterprise, Jobs and Innovation.

schemes. Drawing on this analysis, Section 3 assesses the outlook for DB schemes on the basis of the current legislative and regulatory regime. Against this backdrop, Section 4 outlines the objectives or desirable features of a reformed DB system and following on from this Section 5 provides a description of the key features of an amended DB scheme design as previously described in the NPF. For clarity this is referred to as the "new DB model". Section 6 presents the options under consideration for the implementation of a revised approach to DB provision. The concluding Section 7 lists the questions on which responses are sought through this consultation process.

Consultation process and next steps

Respondents are asked to specifically address these questions in their responses which should be submitted to the Department of Social Protection (finbarr.hickey@welfare.ie) not later than Friday 20th May 2011. The Department will contact responding organisations to organise a seminar to discuss the issues raised in this paper and each organisation's submission.

Depending on the option chosen, if any, significant legislative amendments to the Pensions Act will be required. The Government will make a decision on this matter based on the advice of the Implementation Group and the results of this consultation.

The re-instatement of the funding standard deadline, which will be announced in the near future by the Pensions Board, will take account of the Government's decision.

Section 2: Context and difficulties encountered by DB schemes

Recent surveys of DB schemes indicate that approximately 75% of schemes do not have sufficient assets to meet the current funding standard. There are a number of reasons for this, in particular increases in longevity and investment losses since 2000. Although longer term investment returns have been positive, the surpluses accrued throughout the 1990s were substantially reduced through decreased contributions from employers and/or employees and through benefit improvements for some employees.

The Irish model of DB pension provision has tended to rely on increases in employer contributions where the scheme experience differed from that assumed. For many DB schemes, employer contributions are now at or above the maximum amount that is sustainable in the present economic climate. These schemes have no means of dealing with future deficits even after resolving the large current deficits: a number of scheme trustees have explicitly stated that they are relying on a relaxation of the funding standard to cope with future losses. However, the Group is of the strong view that relaxation of the funding standard will not resolve the deficits incurred and in some cases, schemes may have no other option but to engage with their members to restructure and reduce benefits.

Adverse scheme experience is inevitable from time to time and so it is important that schemes are robust enough to withstand negative times. However, in recent years, trustees have frequently operated their schemes on the basis of an assumption of a relatively narrow range of investment variation and long term pension cost stability. Neither of these conditions has been met: investment losses have been large, as a result of high equity holdings and volatile markets, and there has been a significant increase in life expectancy, which is expected to continue to improve. It is the Implementation Group's view that this approach should only be followed by trustees where there is strong employer commitment and resources and where the trustees and employer have together examined the range of possible outcomes and agreed and identified the necessary resources to meet them.

Policy and regulatory responses to DB difficulties and planned measures

In response to the difficulties confronting the DB sector since the significant downturn in financial markets since 2008, a number of measures have been taken to support schemes. These include the following:

- Increased flexibility to restructure benefits under Section 50 to allow deferred members' benefits and pensioners' post-retirement increases to be reduced;
- Introduction of the Pensions Insolvency Payments Scheme (PIPs);
- The role of the Pension Regulator was strengthened where an employer fails to remit pension scheme contributions deducted from an employee's salary to the trustees of the pension scheme.
- A separate and more serious criminal offence was created for failure on the part of an employer to remit pension contributions deducted from the salary or wages of an employee to the trustees of a pension scheme.
- Certain evidential presumptions were introduced to make evidence in connection with the prosecution of such offences more easily admissible in Court.
- Changes in wind-up priorities to remove the priority given to post-retirement increases for pensioners; and
- Introduction of sovereign annuities.

In addition to the above legislative response, extensions have been granted to deadlines for submission of recovery plans to the Pensions Board, initially by 6 months and with further subsequent extensions. This resulted in a situation where, by the end of November 2010, approximately 640 DB schemes out of a total of 1,212 were due to submit recovery plans to the Pensions Board for approval. As noted above, the re-instatement of the funding standard deadline, by the Pensions Board, will be announced in the near future, having regard to the Government's decision with regard to the options presented here.

In addition to the above, it is intended to introduce further changes designed to support schemes and to further strengthen the DB regulatory regime:

- The introduction of a statutory duty on employers to negotiate in good faith and to use their reasonable endeavours to agree a funding proposal[2]

- The introduction of a statutory mechanism that requires a DB scheme to wind-up where it is clear that even following benefit reductions a scheme will not be sustainable

- Amendments to the funding standard to take account of the purchase of sovereign bonds/annuities in respect of pension liabilities.

Other than the above, no other changes are planned that would affect the options open to trustees to deal with existing scheme deficits in respect of past service.

The Funding Standard

The funding standard sets out the minimum assets that DB schemes must hold and the steps to be taken if the assets of the scheme fall below the minimum**.** The funding standard measures scheme liabilities on a wind-up basis, such that it obliges schemes to aim to hold assets that would be sufficient to meet liabilities were the scheme wound up on the date of calculation.

Where a scheme meets the current funding standard, it may nonetheless not have enough assets to meet its obligations without further contributions for two reasons:

(a) The funding standard assumes an equity risk premium, i.e. that equities will earn more than bonds, and that this additional return can be assumed in allowing for future investment returns. However, this assumption may not be reliable in all cases. Although equities have historically tended to provide higher returns than bonds, there have been some periods of time over which this has not been true.

(b) The funding standard is a wind-up standard, and calculates the scheme liabilities on the assumption that the scheme is wound up on the date of the calculation. This assumes that, for final salary schemes, benefits will be revalued at no more than the statutory minimum rate. However, if the scheme is not wound up, it has been usually the case that average salary increases exceed the statutory minimum, and that further funding is needed.

[2] There is usually no legal obligation on employers to make good any deficit which exists in a scheme. There is also currently no legal obligation on employers to agree to a funding proposal. In order to apportion some of the funding burden which currently rests solely with the scheme trustees, the Pensions Act will be amended to incorporate a statutory duty to negotiate in good faith and to use reasonable endeavours to agree a funding proposal on both scheme trustees and employers. This duty is not intended to result in the imposition of a statutory obligation on the employer to pay additional contributions to the scheme.

Taken together, the two factors above mean that it should not be assumed that the current funding standard represents the true economic cost of benefits.

Section 3: Outlook for defined benefit

The above analysis leads to the conclusion that, on an assumption of a limit to employer contributions in most situations, many DB schemes will at some stage accumulate a deficit that will require a reduction of benefits under Section 50 of the Pensions Act. Section 50 was introduced to deal with exceptional situations and is not intended for, nor is it suitable to deal with, recurring scheme deficit problems. In practice, the effect on a DB system where schemes are subject to periodic Section 50 reductions to reflect investment or other losses is that not all members share the risk of these reductions. Rather the effect is that the reductions imposed are unpredictable, depending on the status of members and the operation of the benefit reduction process. As a result, some members may end up bearing a greater share of reductions (under current rules, these are members close to retirement) while others are to some extent exempt (pensioners).

Any system that incorporates regular reductions in benefits must be regarded as unsatisfactory. Furthermore, if the recent difficulties with the funding of DB schemes persist, it is likely that at some point in time schemes will face the prospect of winding up with what may be a substantial deficit. In these circumstances it is likely that scheme members (especially younger members and those close to retirement) may receive reduced level of benefits.

The analysis above has highlighted the fundamental issues facing schemes at present and the likelihood of continuing instability in the DB sector. By definition, a new DB model cannot address current scheme deficits. These can only be addressed through additional contributions, restructuring, Section 50 reductions and/or by scheme use of sovereign annuities (or the associated bonds). However, a necessary condition for any new DB system to succeed is that it should address the difficulties that have been identified

Section 4: Objectives of a new DB system

The primary aim of the proposed new DB model remains the same as the previous system, namely to provide pensions for members that are more secure and predictable than DC benefits. While this commitment could never be understood as an unconditional guarantee, it should, in the Implementation Group's view, enjoy a high degree of security. It also needs to ensure the future sustainability of DB schemes.

Ideally, any revised approach to DB provision should exhibit the following features:

- It needs to provide a 'promised' level of benefits to members that is reasonably predictable and that enjoys a high level of security,

- It needs to provide a greater degree of certainty for employers with regard to their contributions,

- It needs to be reasonably robust in the face of the economic cycle and downturns in financial markets, and

- It needs to have flexibility in its design and provide schemes trustees with adjustment options other than reliance on employer contributions.

Any new regulatory regime should provide stability; a reasonable expectation might be that there would be no major legislative or regulatory change for a period of 5 years[3].
In addition, post an initial scheme restructuring stage, future Section 50 type reductions should be rare.

Section 5: Possible design of a New DB model

The structure of pension benefits is a matter of negotiation between employers and employees. However, in order to achieve the above objectives, DB scheme design options that provide more flexibility are required, as is a balance between the level of security provided and acceptance of investment risk.

The design of a new model could consider or include the following components:

- Flexible benefits to cope with investment losses, increases in life expectancy or other adverse experience,

- All benefits (in respect of current employees, former employees, retired members and other beneficiaries) would be revalued annually and equally, but only to the extent that the scheme could afford it, and

- Contribution rates would be calculated on a basis incorporating revaluation of benefits in line with inflation, before and after retirement. However, only these core benefits granted plus revaluations to date would represent a scheme obligation.

The new DB model would provide for a mix of core and discretionary benefits, with the core benefits, (the level of which can be determined within each individual scheme), providing a greater level of certainty than is the case under the current DB system. It must be emphasised that the provision of benefits with greater certainty requires a tougher funding standard (see Section 6).

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[3] It should be noted that the EU Commission have recently launched a Call for Advice from EIOPA in respect of the review of the Directive 2003/41/EC (IORPS) Directive which may in time result in changes.

The mix of core and discretionary benefits gives schemes more flexibility to absorb losses and deal with volatility in an environment where increases in employer contributions are unlikely. This means that in years of negative investment returns, scheme trustees would have the flexibility to grant little or no revaluation, while in years of positive returns, trustees would seek to provide the revaluation that had not been paid in previous years.

A comparison between current DB designs and the structure described above would show that, for a given level of contribution, the new DB model would provide a lower level of benefit, and would maintain a significant level of ongoing reserves. These reserves would act as a risk buffer, allowing the scheme to sustain some level of equity investment if desired while providing security for the promised benefits.

It is important to emphasise that the adoption of such a model would not impact on the position of existing past service deficits.

Section 6: Options

Overview

Drawing on the above analysis and in particular the desired objectives set out at Section 4 and the design components in Section 5, the Implementation Group has developed a number of options for the implementation of a reformed DB system. The options target a number of policy areas including the funding standard and associated regulation, benefit levels and structures and scheme governance.

These five options are outlined in more detail below. By way of introduction these options can be characterised as follows:

Option	Outline
Option A	This is essentially a minimalist option; it involves the re-imposition of the funding standard modified only to take account of sovereign annuities/bonds and legislative change to facilitate adoption of the new DB model as a form of scheme design. While this option is included for the purposes of the consultation process, the retention of the status quo would not address the problems facing the current DB system as set out above.
Option B	This can be characterised as a further strengthening of the current solvency regime for DB schemes including new requirements aimed at encouraging improved risk management on the part of schemes. It also incorporates legislative change to facilitate the adoption of the new DB model as a form of scheme design. Under this option, the new solvency regime would be introduced after a lead in time of a number of years.
Option B1	This is identical to Option B but the changes to the solvency regime would be introduced in the short-term, i.e., from the beginning of 2012.
Option C	This involves the adoption of a new funding standard (to apply to past accrued and future benefits) as well as legislative change to facilitate the adoption of the new DB model as a form of scheme design.
Option C1	This is a variant of Option C; the proposed new funding standard would only apply in respect of future service.

Option A

As noted above, Option A takes a minimalist approach to the existing DB solvency framework, to include the following changes as outlined earlier in Section 2 as follows:

- The introduction of a statutory duty on employers to negotiate in good faith and to use their reasonable endeavours to agree a funding proposal
- The introduction of a statutory mechanism that requires a scheme to wind-up where it is clear that even following benefit reductions a scheme will not be sustainable and
- Amendments would be made to the funding standard to take account of the purchase of sovereign bonds/annuities in respect of pension liabilities.

In addition the following legislative change would be introduced:

- A mechanism to facilitate the operation of a discretionary revaluation system to be implemented by introducing a legislative change such that the revaluation rate required in respect of deferred members would not put them in a more favourable position than active members (see Option B below)

Options B and B1

Introduction

These options can be characterised as a further strengthening of the current solvency regime for DB schemes, in particular, with regard to the imposition of more robust criteria for funding proposals for DB schemes in deficit. They are also aimed at encouraging improved risk management.

As noted above, Options B and B1 differ only as regards the timing of their introduction. Under Option B, a lead-in time of about two years is envisaged for the changes to the solvency regime; whereas under Option B1 these would apply with more or less immediate effect. As this is the only difference as between the two options, the discussion below treats them as a single option.

Key elements

The main elements for this option include the following in addition to those already referred to in Section 2:

- The introduction of risk reserves to provide some protection against equity losses and interest rate movements. These would be in the form of the sustainability requirements currently applied to schemes restructuring under Section 50. The application of the Section 50 sustainability tests requires the scheme to withstand an investment stress test comprising an immediate fall in equity values of 15% and a simultaneous decrease in interest rates of 0.5 per cent. These would apply except where trustees have a legally enforceable guarantee from an employer to meet any deficit that arises.

- To facilitate the new DB model as a type of scheme design, introduce legislative change such that the revaluation rate required in respect of deferred members would not put them in a more favourable position than active members (currently the Pensions Act provides for the revaluation of deferred benefits by the lesser of the annual change in the Consumer Price Index or 4%)[4];

- For DB schemes in deficit with funding proposals the maximum allowable term for new funding proposals would be reduced to 8 years from the date of the most recent actuarial funding certificate (AFC). For schemes where an existing funding proposal of more than 8 years goes off-track but where the employer is willing to make such additional contributions as are required to ensure that the scheme meets the funding standard by the end of the term of that agreed funding proposal, the existing agreed term would stand. In addition, schemes would not be allowed to assume equity outperformance for funding proposal purposes.

It is important to emphasise that these changes would not impact on existing DB scheme deficits and such schemes would be expected to address these deficits within the confines of the existing regulatory provisions, including the changes outlined at Section 2 above. However, schemes could move to the new DB model for future service.

Option B - Financial and Funding Standard Impacts

The effect on a scheme's statutory funding position of this option would depend on the scheme's pensioner liabilities, the scheme's planned holdings of assets that require a risk reserve (thus the size of the risk reserve is determined by the trustees' investment policy) and whether the scheme avails of sovereign annuities/bonds. It can be estimated that the overall effect of this option would be to increase the level of the funding standard in the order of 10% - this assumes that most of the schemes' assets remain in equities, thus attracting a risk reserve, but offset by a reduction in the funding standard for pensioners. Schemes with no pensioners would face an increase in the funding standard to the full extent of the risk reserve requirement if they decide to retain the bulk of their assets in equities.

As regards the effects of this option on the contributions required to fund a recovery plan[5], the effect of allowing a shorter time period is to increase the contribution rate required significantly, albeit over the shorter time period. A contributory factor here is the elimination of the assumption of investment outperformance. Schemes which decide to take advantage of sovereign annuity/bond rates would not see so great an increase, but even for these schemes, the shorter time period can be expected to add to the annual cost of the funding proposal.

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[4] Note that schemes may need to change their rules so that revaluation of active member benefits is granted on a discretionary basis by trustees and not on an automatic (i.e., linked to salary) basis.

[5] As provided for in Section 49(3) of the Pensions Act.

Options C and C1

Introduction

The key feature of these options is a proposed significant revision of the funding standard; this is the main substantive difference compared with Option(s) B. Under Option C, a new funding standard would apply more or less with immediate effect to all benefits (i.e., benefits already accrued and to future benefits as they accrue over time).

Under Option C1, the new funding standard would apply only to future benefits (say after 1 January 2012); in this sense it can be understood as “drawing a line in the sand” and applying a more onerous solvency regime from an agreed point onwards.

A number of elements are common to the two approaches and are summarised below. Some specific aspects on how Option C1 would be implemented and its implications are discussed separately.

Key elements

While the central feature of this new option is the adoption of a new funding standard, it would also involve the change to revaluation rules as per Options A and B.

The key features of a new funding standard would be as follows[6]:

- Technical provisions: value of benefits discounted at risk free rates[7]

- Risk reserves[8]: provision would be made for mismatching risk, inflation risk and uninsured benefits risk. The proposed risk reserve requirement is one adequate to cover the following risks simultaneously:
  (i) A fall in equity values of 20%
  (ii) A change in interest rates of 1%
  (iii) An increase in expected inflation of 0.5%

- Recovery rules:
  (i) Where a scheme does not have enough assets to cover technical provisions requirements the position must be restored within 24 months

[6] As per Options A and B, the new funding standard would take account of sovereign annuities.
[7] Where a scheme adopted a new DB design, the funding standard would only apply to core benefits and revaluation benefits already granted.
[8] As per Option B, risk reserves would not be required where the employer provided a specific legally binding guarantee to meet any deficit that arises.

(ii) Where a scheme has assets to cover technical provisions, but does not have enough assets to cover technical provisions plus risk reserves, it must file a recovery plan projecting compliance within 5 years

(iii) Where a scheme fails to cover its technical reserves within 24 months, the Pensions Board will issue the equivalent of a Section 50 order.

The proposed new funding standard is explained in detail at Appendix 1. Under Option C where the standard is applied to all benefits including those already accrued, the effect of moving from the current funding standard to a bond-based funding standard with risk reserves would be increases in funding standard liability values of at least 50 per cent, and possibly more, depending on the parameters chosen. Reported funding levels would fall sharply as compared to the existing standard and most schemes would require major restructuring in the form of benefit reductions to comply with it.

The other changes outlined earlier at Section 2, namely the imposition of a negotiation requirement on employers and a wind-up requirement, also form part of this option (together with relevant revaluation change required to facilitate the New DB model). In addition, some changes in scheme oversight would be considered as part of this option. It would be important that The Pensions Board would be in a position to review aspects of scheme management including the setting of the revaluation rate, and the communication of this to scheme members. This could be accomplished through a mandatory reporting process imposing reporting obligations on the scheme actuary to the Board.

Option C1: implementation aspects

Under this variant, while future benefits would be accrued under the more secure bond-based basis, the standard would not be applied to benefits already accrued, i.e., before the specified cut-off date. These benefits would continue to be funded on the basis of the existing (and less secure) funding standard. Thus a dual funding standard regime would be in place; one in respect of past service, the other in respect of future service. The intention would be that there should be no cross-subsidisation between past and future benefits.

For this arrangement to work, a legal ring-fencing mechanism would be required to ensure a segregation of the assets in respect of benefits accrued under the “new” and “old” funding standards. This would be essential to safeguard new or future benefits in circumstances where a deficit existed in respect of past service benefits.

As regards past service benefits, the existing funding standard would continue to apply. Trustees and employers would be expected to fund for these benefits and meet any deficits in the normal way through the use of funding proposals and/or benefit reductions.

This option does not, of itself, force or require any action on the part of employers or trustees nor does it require any change in scheme design. However, the imposition of the new funding standard with its attendant cost implications might result in schemes reducing their future service benefits in order to satisfy the new standard. In this respect, it is likely that many schemes might consider the option of moving to the new DB model for future service (as the non-core, discretionary benefits would not be subject to the revised funding standard).

Option C1: impact on schemes

Assuming no change in scheme design or benefits structure, the immediate impact of a new funding standard is to increase substantially the measured cost of <u>future</u> benefits. As noted above, a possible consequence is that schemes would adopt the new DB model (with discretionary revaluation) for future service as a means of limiting the additional costs. It is considered highly likely that schemes would abandon "old DB" type benefits in respect of future service.

A new funding standard for future service would result in a dual regulatory regime for DB schemes. Schemes would be required to simultaneously meet two funding standards and two sets of legal obligations in terms of their respective funding obligations, for example, pre 31 December 2011 benefits and post 1 January 2012 benefits. Trustees would be required to administer their schemes on the basis of the relevant obligations that applied depending on the time of benefit accrual.

While there will still only be one scheme, one trust and one set of trustees, the existence of separate funds within the scheme could result in a substantial increase in regulatory burden and increased cost for existing schemes.

Section 7: Questions

As noted earlier, the Implementation Group wishes to obtain the views of interested parties on a number of issues or questions. These are set out below under a number of headings.

Analysis of current situation and outlook for DB

1. Is the analysis accepted that DB schemes, as currently organised, are too exposed to economic shocks?

2. Is it accepted that under the current DB structure most schemes are not in a position to provide a "promise" to their members that is reasonably predictable and enjoys a high level of security?

Objectives of a new DB system

In Section 4 of this paper, a number of desirable features or objectives of a new DB system were set out. The Implementation Group is interested in views as to how the various options set out in this paper rank in terms of these objectives.

3. A revised approach to DB provision should be one that provides a "promise" to scheme members that is reasonably predictable and that enjoys a high level of guarantee. Which of the options best advances this objective?

4. Any new approach to DB provision should be one that is robust in the face of economic difficulty and downturns in financial markets.

   a) Would the introduction of risk reserves and the new stipulations around recovery periods under Option B offer a sufficient protection for schemes in future?
   or

   b) Is it necessary to adopt Option C if schemes are to further enhance their security in the future?

5. A desirable feature of new DB system would be that of design flexibility meaning that scheme trustees could employ adjustment options other than reliance on employer contributions.

   a) Under all options, a legislative change to allow trustees greater discretion as regards the revaluation of deferred members' benefits is envisaged. Would this change significantly enhance flexibility in scheme management?

   b) Under both Options C, the revised funding standard would only apply to core benefits; other benefits would be discretionary. As the level of core benefits would be a matter for scheme-level determination, is it accepted that this option would significantly enhance flexibility?

6. Once the existing funding standard or a revised one is re-introduced/introduced respectively, a significant number of DB scheme restructurings including benefit reductions through the Section 50 process can be expected. However, following this period, it would be expected that future DB benefit reductions would be less common. Accepting that significant scheme restructuring in the near term is likely to be inevitable under any scenario, is there a view as to which of the options would reduce the need for benefit reductions in the future?

7. It is intended to bring a degree of policy and regulatory stability to the DB sector after the period of uncertainty of the last few crisis years.

    a) How likely is it that further major regulatory changes could be avoided over a medium-term timeframe if Option A, or either of Options B, which could be characterised as minimalist or incremental in nature, were to be adopted?

    b) Given the stated intention of the European Commission to examine the existing EU solvency framework as part of its review of the IORPS Directive, what is your view as to which of the options presented here is likely to conform best to any new EU standards?

    c) Would the adoption of Option C1, which would result in a dual funding standard regime in operation, of itself create a degree of uncertainty and instability?

8. Government policy aims to minimise the degree of regulatory and administrative burdens associated with new policy initiatives. Against this backdrop, views on the degree of additional regulatory and administrative burden associated with the options under consideration would be of interest. In particular, what would be the implications for schemes of the dual funding standard regime inherent in Option C1?

Preferred option

9. Taking account of your responses to the above, which of these options presented in this paper would your organisation prefer to see adopted?

Other options or issues

10. Does your organisation wish to propose another option or variant of the options presented above that would meet the objectives articulated for a new DB system?

As noted above, you are asked to submit your response to these questions to the Department of Social Protection (finbarr.hickey@welfare.ie) not later than Friday 20th May 2011.

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Appendix 1 – Proposed funding standard (Options C and C1)

Overview

The proposed new funding standard under Options C and C1 differs fundamentally from the current standard. The current standard uses the expected value of the promised benefits, i.e., the required reserve is calculated to have a 50/50 chance of being enough to provide the benefits.[9] The proposed standard would oblige schemes to hold enough reserves so that the risk that benefits cannot be provided would be much lower. The result will be a more demanding funding standard.

The proposed new funding standard comprises:

- Technical reserves, i.e., the estimated cost of providing the promised benefits
- Risk reserves – additional security against potential risks
- Recovery rules – what steps must be taken if the scheme has insufficient assets to cover its reserves.

Technical reserves

The technical reserves would be calculated as the value of benefits discounted at risk free rates, i.e., AAA rated, and using a prescribed mortality table. Where sovereign annuities are being used, the risk free rate would be modified to allow for the specific sovereign risk and the matching percentage.

It must also be decided whether to use the current rate or a smoothed average of recent rates. If a smoothed rate is used to calculate the value of the liabilities, they will be less volatile, and not move as sharply from month to month. The result will be that liabilities will be lower than assets when interest rates are falling, and will be higher when interest rates are rising. A significant disadvantage of a smoothed rate is that it is not possible to find assets that match it, i.e., that move in line with changes to a smoothed rate. Over the medium term, smoothed rates do not provide any identifiable advantage as a means of assessing scheme solvency. A further problem with using smoothed yields is that, in the event of a wind-up, the yields underlying the funding standard would differ from those available on annuities.

Even when a reference yield has been identified, it has to be decided whether to use a single, average rate or a rate that varies with the term. Given that Irish schemes are quite small, a term-related yield is probably over-complex: it is not especially practical anyway when there is not one single country being used for the reference yield. The result of

[9] The effect of recovery plans under section 49 is that the likelihood of a scheme being able to meet its commitments is arguably less than 50%.

using a single yield is that exact matching will not be possible, and therefore the funding standard regime should be reasonably tolerant of minor deficits.

Risk reserves

The obligation to maintain additional reserves above the technical reserves recognises that the scheme is subject to future risks and, whether these risks are deliberately taken or unavoidable, some reserve is appropriate to reduce the possibility that the risk will prevent the scheme from paying the promised benefits.

Among the risks that a DB scheme faces in respect of past service benefits are:

(a) Investment risk (or more specifically mismatch risk)

(b) Longevity risk

(c) Salary growth risk (where benefits are salary related)

(d) Inflation risk, where benefits are revalued by reference to CPI

(e) Expense risk – that the cost of running the scheme will reduce the resources available for benefits.

(f) Regulatory risk – that the funding standard will change

(g) Tax risk – that the assets of the scheme will face unanticipated taxes

(h) Operational risk – that losses will occur as a result of poor administration or management of the scheme

(i) Risk benefits – the risk that death or disability benefits are inadequately insured.

(j) Contribution risk – the risk that, where a funding recovery plan is in place, the contributions required are not made.

It has to be decided against which of these risks a reserve will be required, and then what reserve would be appropriate. The issue of independence or correlation of risks must also be considered. A specific reserve could be required against each one and/or a general reserve could be required.

The proposed approach is as follows:

(a) There should certainly be a reserve for investment risk, as this risk is within the control of the scheme trustees.

(b) A longevity risk reserve is probably impractical: however, both the funding standard and contribution calculations must make reasonable allowance for longevity improvements.

(c) There can be no objective basis for a salary risk reserve. Salary risk will only arise for final salary schemes, and will be a much lesser problem for career average or new DB schemes. In the event that pensionable salaries increase by more than anticipated, this will be an immediate challenge for trustees and the sponsoring employers, and should be dealt with through the recovery plan rules.

(d) The NTMA have indicated their willingness to issue bonds to match inflation risk. This risk is therefore a matchable risk and should be treated in the same way as investment risk.

(e) Expense risk is something for which future EU rules may require provision. However, as the general approach to Irish schemes is a wind-up rather than a going concern basis, an expense reserve is probably not necessary.

(f) It is not practical to require a reserve against regulatory risk.

(g) Similarly, there should be no obligations to reserve against tax except insofar as the tax is known.

(h) There is no practical basis for reserving against operational risk, so no reserve should be required.

(i) There should be an obligation to reserve in respect of uninsured risk benefits, if only to act as an incentive to insure them.

(j) It is not practical to reserve against loss of future contributions where the scheme is in recovery. If the contributions were not forthcoming, benefits would be reduced.

On the basis of the above analysis, a scheme would be obliged to hold reserves for mismatching risk, inflation risk, and uninsured benefits risk. There could be a requirement to hold a further general risk reserve, but this is not proposed.

There is no scientific basis for setting reserve requirements. Even where there is historical data available, there is no guarantee that future events will follow these trends. The following proposed reserving obligations represent an attempt to provide reserves against a one in ten year event.

The proposed risk reserve requirement is therefore a reserve that is adequate to cover the following risks simultaneously:

- A fall in equity values of 20%
- A decrease in interest rates of 1%
- An increase in expected inflation of 0.5%

In addition to the above, the scheme would be obliged to hold a reserve equal to the expected cost of uninsured benefits plus two standard deviations.

Recovery plans

The length of permitted recovery plans is an important determinant of the security of the benefits provided by defined benefit schemes. Lengthy recovery periods undermine the effect of the technical reserve and risk requirements as these obligations are in effect waived for the period of the plan.

Nonetheless, there are valid arguments against too short recovery periods:

- There will always be market volatility, and too short a report and recovery plan cycle will force schemes to react to market movements that may possibly correct themselves over a slightly longer period. However, it is important to distinguish between this point and a more general 'markets always recover' view.
- Where the recovery plan involves discussion between the trustees and the sponsoring employer, adequate time has to be allowed for negotiations.
- Short recovery periods are pro-cyclical, and oblige pension schemes to respond when markets are most likely to be low and when sponsors are least able to provide support.

The second and third points above are more relevant to schemes where the recovery plan is likely to incorporate additional contributions.

The following recovery rules are proposed:

(a) Schemes must report on their solvency within three months of the effective date of the actuarial certification.

(b) Where a scheme does not have enough assets to cover technical reserve requirements, the position must be restored within 24 months of the date of the actuarial certificate.

(c) Where a scheme does not have enough assets to cover technical reserve requirements plus risk reserves, it must file a recovery plan within 9 months of the effective date, and this plan must project compliance within 5 years of the date of the original certificate.

(d) The basis for all recovery plan calculations will be the same as for technical reserves.

(e) Where a scheme fails to cover its technical reserves within 24 months, the Pensions Board will issue the equivalent of a Section 50 order, subject to any comment by the scheme trustees. Should the Section 50 order not be acted upon, or should it not be possible to meet the technical reserves by this means, the scheme will be wound up.

(f) Any recovery plan to restore risk reserves will have to be assessed annually. If off-track, it will be up to the Pensions Board to decide whether to require a revision of the plan or to grant additional time.

Nonetheless, when a scheme does not recover its reserves within the specified time, it will be subject to benefit reductions or wind-up as in the case of a technical reserve shortfall.

ENDS