



A Response to the DWP’s Discussion Paper: *Payments to the Employer (the “surplus” rules)*

This is a formal response to the questions posed within this discussion paper. As the paper was not widely distributed, it quotes extensively from it and these quotations are italicised.

By way of preamble, we should recognise that it is a prerogative of government to define what is and what is not a liability, but across branches of government there should be consistency of definition. By the same token we should also recognise that the question at the heart of this issue is one of use of corporate funds, rather than recognition of those funds as sponsor assets; the current accounting standards, FRS17 and IAS19, allow the recognition of all surpluses for an ongoing scheme. As there is some confusion of terminology, we shall elaborate on this. If a company intends to maintain the scheme and discharge its liabilities through that mechanism, the scheme is ongoing. It has nothing to do with the status with respect to member benefit accruals.

The accounting treatment is correct – it recognises the best estimate of the liability (best estimate is alternately known as the technical provision). There are though many other issues surrounding pension accounting, which are not relevant here. Prior to insolvency company and scheme should recognise only this best estimate. In this regard, requirements for “prudent” valuation such as those contained in the Pensions Act 2004 are misguided and bias the liability estimate and raise costs redundantly. In plain English, company and scheme accounts should recognise only the best estimate of liabilities as long as the business and scheme is ongoing.

There is a potential difficulty for the scheme with this arrangement in that post insolvency it faces a long time until all liabilities are discharged and much risk and uncertainty in that period. The scheme is an orphan with no further recourse to its parent. Existing legislation recognises this and defines the debt on employer (the S75 value) effectively as the cost of full annuitisation and termination of the scheme, a materially higher sum than the best estimate of liabilities.

This problem is optimally addressed by indemnity assurance. It is not resolved by the presence of a compensation fund such as the PPF.



Reverting to the Discussion Paper:

Option 1 – Clarification of the members’ interest requirement

We would welcome views on whether clarification of the extent of the “members’ interest” requirement in section 37 of the Pensions Act 1995 would be helpful.

This issue arises from a misunderstanding of the effect of this legislation, and is best dealt with by guidance.

In fact it is almost always in the members’ interest to return any surplus in excess of the best estimate of the liabilities of the company. This lowers the insolvency likelihood of the company, the primary determinant of risk to members. Only in exceptional circumstances, where the expected (post tax) return on assets employed in the business is lower than the expected return on assets in the scheme fund, could this not prove the case.

Further there are material differences of interest across classes of member; for example current employees’ interests extend also to their employment benefits while for pensioners in payment the interest is the more limited future receipts of pension.

Option 2 – Sharing payments between employers and scheme members.

We would welcome views on the introduction of such an arrangement.

The suggestion is that any surplus could be shared between sponsor and members. This is pure folly; it would raise further the cost of DB pension provision to the employer. It would also provide incentives for employers to insist on indulgence in overly conservative investment strategies to the harm of the wider economy. It would lower Exchequer tax receipts. It would also serve as a further disincentive to the provision of DB by employers, contrary to stated Government policy.

There are two cases to be considered; the first is surplus arising from revision of an assumption - that is error correction, and the second is surplus arising from risk realisation, for example good investment performance. In both cases however such sharing rules would, by their asymmetry, penalise the sponsor employer.



Option 3 – Lowering the full buy-out threshold

We would welcome views on whether consideration should be given to lowering the current threshold for consideration of payments to a level between a scheme's technical provisions and its estimated full buy out (sic) level and, if so, what that level should be.

The Government rejection of the earlier reviewers' (Lewin and Sweeney) recommendation that surplus to the technical provision level should be considered for return to the employer was flawed. Any surplus in excess of the level of technical provision should be considered.

The following discussion is contained in the paper:

It was felt that such a change, even if it required the agreement of a scheme's trustees, could significantly weaken protection for scheme members (particularly as recent stock market volatility has highlighted the risk of sharp fluctuations in assessed scheme funding levels).

There are two distinct issues in this discussion. The first issue is whether members' protection is weakened by the return of surplus to the sponsor, an action which strengthens the sponsor and reduces the likelihood of insolvency – the prime determinant of risk to members' security. This is a rightly a matter for consideration by trustees, in the light of circumstances prevailing. The second issue is the value relevance of an assessed scheme funding level at any point in time to the scheme's ultimate liabilities. This is low to the point of being an irrelevance for the overwhelming majority of schemes.

It must be said that this appears to be another instance of inchoate conservatism with added motivation coming from the presence and conflicts arising from the existence of the PPF as a government-sponsored enterprise.

The discussion continues with:

Other relevant factors, such as the strength of a sponsoring employer's covenant, may also change significantly over relatively short periods of time.

The sponsor covenant does not usually change rapidly, though there are industries, such as finance, where this may sometimes be the case. There really is a fundamental question here: Should there be solidarity in distress between pension scheme and sponsor employer? The modern theory of corporate finance, as encapsulated in the Bank of



England's "London Approach", would suggest strongly that the pension scheme should return any surplus prior to insolvency and those associated costs where no rescue or turn-around was achieved. It is possible that lawsuits from other creditors and perhaps even shareholders of the employer will develop from this aspect.

The problem actually only arises because the benefits offered by the PPF are less than the full benefits of members of insolvent employers, and the PPF has no natural involvement in corporate finance. Indemnity assurance fully resolves such difficulties, and would encourage the return of surplus in most cases.

Option 4 – lower threshold for open schemes only

We would welcome views on the possibility of restricting a lower threshold to those schemes which remain open to new members.

This is not a good idea as it restricts further the freedom of action of the sponsor employer, which will raise scheme costs. The ability to limit future accrual, through for example closure to new members, is one of the few ways in which sponsor employers may effectively manage the cost exposure of the benefits offered. This is a valuable option to the sponsor – any action which destroys the value of this option is counter-productive.

In any case an explicit lower threshold is unnecessary - everything else being equal, a scheme open to new entrants can legitimately justify lower technical provisions than one that is closed to new entrants.

Option 5 – Encouraging trustees and employers to agree in advance

We would welcome views on the extent to which concerns about the current rules could be addressed through greater use of the current framework for trustees and employers to discuss and agree the circumstances in which payments will be authorised

If it were possible to determine all possible future events and assign probabilities to them. the world would be fully predetermined and none of the pensions legislation - which of course is risk based - would be necessary. Such agreements could only be partial.

If a scheme is funded to buy-out level, return of all surpluses is in the members' interest. The more difficult area occurs, as noted earlier, when the scheme is funded at levels



between buy-out and technical provisions (or best estimate) – here the matter is rightly considered by trustees in the light of circumstances prevailing. The consideration is not trivial – lowering of insolvency likelihood and increase in some member interests versus benefits receivable in insolvency.

Option 6 – Schemes which do not provide for payments to the employer

We would welcome views as to whether consideration should be given to allowing trustees to consider a payment to the employer if the statutory “surplus” rules are satisfied – even where the rules do not allow such payments.

This form of rule is unusual; there presumably was historically sound reason for its introduction into a private contract. Of course that reason may now be otiose, but of course variation to scheme rules, the contract, in this circumstance is already possible. In general, government intervention in private contracts is not justified without the usual preconditions for regulation being satisfied and it is far from obvious that any of these circumstances have arisen or even could.

Option 7 – Market Solutions

We would welcome views about the extent to which such developments are capable of satisfying concerns about the operation of the current provisions.

Contingent assets do to an extent alleviate this surplus return problem. However, only full private sector indemnity assurance resolves fully all of these issues – it would also remove all risk for assured schemes from the PPF. However, the current contingent asset rules and documentation do not admit directly such indemnities and considerable contortions as to form, which do not enhance member security, are required to gain recognition as a contingent asset.

The indemnity offered is that necessary to complement scheme assets in order to procure individual annuities in the amount of every member’s full pension entitlement at the time of sponsor insolvency.

The indemnity assurance to be offered by BrightonRock will encourage the return of any surplus in excess of funding to the level of technical provisions, regardless of the state of sponsor finances and insolvency likelihood. For schemes funded in excess of 115% it will reduce its premiums payable to a nominal sum, precisely to make evident to schemes and sponsors that with funding at these levels that BrightonRock faces no risk of loss,



even with insurance provisions and costs as high as they are likely to be under Solvency 2.

The indemnity assurance policy is an asset of the scheme in addition to any role as a contingent asset for regulatory purposes. This admits the possibility for scheme funding, ex that asset, to be materially less than 100% of technical provisions, lowering pension costs to the sponsor significantly.

The position of BrightonRock with respect to scheme deficits relative to technical provisions is that these are claims upon the employer which crystallise with insolvency. These do not differ fundamentally from any other claim on a company, of which there are many others contained in the insurance and investment portfolios of BrightonRock.

These aspects are all best dealt with by private contract between the Indemnity Assuror, scheme trustees and sponsor employer.

This discussion paper has in fact just highlighted the design flaws inherent to the current regulatory architecture and makes even more surprising the reluctance evident to accept private sector indemnity assurance as delivering cost-effective member pension security.

Con Keating

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September 2008