Defined Benefit Funding

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A paper jointly prepared by the Society of Actuaries in Ireland and the Irish Association of Pension Funds

December 2008

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1. Background:

Ministers are already aware of the problems currently being encountered by defined benefit pension funds. These are largely caused by the sharp decline in asset values over the last 12 months and a continuing rise in the cost of pension provision. This is a global issue and the OECD has estimated that €3.2 trillion has been wiped off the value of pension funds around the world between January and October 2008.

In Ireland, it is estimated that 90% of defined benefit schemes would not currently meet the funding standard. Furthermore, a significant number would not have sufficient assets to secure the pensioner liabilities in a wind-up. The current economic environment has greatly increased the likelihood of schemes winding up and not being able to pay full benefits.

While the long-term pension issues are currently being considered in the Green Paper process, the accelerating decline in assets and the current economic environment raise immediate concerns regarding insolvency of pension schemes that need to be addressed.

2. Why does the position need to be addressed now?

Pensions, like many parts of the economy, have suffered greatly in the current environment. As with other key areas such as the banking system, the problems involve looking at long-term viability while at the same time ensuring short-term survival.

The short-term position of defined benefit pension schemes is precarious for the following reasons:

- It is that estimated that 90% of schemes would fail the Minimum Funding Standard. While this itself is serious, what it does not show is the fact that the level at which assets cover accrued benefits for active and former employees is in many cases very low and in some cases now zero (because of the existing rules whereby pensioners are given priority in the event of a wind-up).
- There is no protection in place when a scheme with a deficit winds up.
- Schemes of solvent employers can also be wound-up in deficit with no protection in place.
- Employers, who are facing very large additional costs at a time of reduced profitability in their businesses, often do not have enough flexibility within the system to develop a workable plan to address their pension issues.

- Frustration with the existing flexibility could drive many employers to wind up schemes in circumstances where the alternative approach of carefully designed and correctly targeted support could ensure survival.

Private sector defined benefit schemes have approximately 250,000 active members. The combination of the above factors could mean we will witness the wind-up of pension schemes of both insolvent and solvent companies with potentially thousands of employees and former employees receiving only a fraction of their benefits or even no benefit at all.

The current position is unsustainable. The purpose of this paper is to put forward the key areas that need to be addressed, including an outline of what changes should be made in each area, in order to achieve:

- Greater flexibility to allow a pension scheme to develop a balanced plan to survive in the short term and achieve a more sustainable long term footing;
- Greater fairness and better security in the event of the wind-up of an insolvent employer;
- Greater fairness and better protection in the event of the wind-up of a scheme by a solvent employer.

3. What are the key issues to be addressed?

In aiming to remove weaknesses and difficulties in the current system in the event of (a)ongoing continuation of a scheme, (b)the wind-up of schemes of a solvent employer and (c)the wind-up of schemes of an insolvent employer, the following chart summarises the key issues that need to be addressed:

Sponsor struggling to sustain the scheme	**Scheme Wind-Up of a Solvent Sponsor**	**Scheme Wind-up of an Insolvent Sponsor**
Key issue Lack of options available	***Key issue*** Nothing to stop scheme abandonment	***Key issue*** Pensioner priority on wind-up
		Key issue No State protection

We have expanded below on the various scenarios and put forward proposals to address these.

4. <u>SPONSOR STRUGGLING TO SUSTAIN SCHEME</u>

Key Issue - ***Lack of options available***

The cost of defined benefit provision has increased greatly in recent years, due mainly to additional benefits conferred by legislation (e.g. preservation and revaluation) and the fact that people are living longer. In effect, the benefits being promised under the current model are becoming unaffordable for most employers.

There is currently a limited range of options available to employers, trustees and members as to how to address this issue. In recent years, many employers have put in place a combination of changes to address cost issues in their schemes, such as greatly increased employer contributions, increased member contributions and closure of schemes to new members. These measures to address cost issues have effectively already been used by many companies and therefore further options are required to address the new and even greater cost issues they now face. Greater flexibility is therefore needed or else, where a scheme cannot meet the Funding Standard or put a funding proposal in place, the Pensions Board will probably be forced to order the trustees to reduce the benefits. The current powers given to the Pensions Board under the Act are such that all benefit reductions must be suffered by employed members of the scheme.

Proposal:

There should be a mechanism to allow changes to benefits of active and deferred members in order to sustain the scheme

Because defined benefit provision has been getting more expensive the liabilities of schemes have risen dramatically in recent years. The recent severe falls in the value of the assets of schemes make it difficult to sustain any scheme in its current format.

The options available to scheme sponsors and trustees in such a position are limited. Continually increasing the contribution rates eventually becomes unsustainable and is also difficult in the current economic environment. If the contributions cannot be increased to a level sufficient to fund the benefits, then the benefits must be reduced. However, the trustees are restricted in how they can reduce benefits and cannot reduce accrued benefits. Reducing future accrual is an option but often is not sufficient to sustain the scheme. The Pensions Board can order the trustees to reduce benefits, albeit only those of employed members.

We believe that it is often possible for members, employers and trustees to agree reductions in benefit levels designed to ensure the sustainability and continuation of the scheme. However, it may not always be possible to get agreement, particularly where the agreement of individual members is required. Even where agreement is possible, it can be difficult to implement changes due to the protections provided in legislation.

We therefore propose that there should be some mechanism by which the trustees can be authorised to alter the benefits of active and deferred members (including accrued rights) where the employer and the members or their authorised trades unions have agreed this is necessary to allow the scheme to continue, or have agreed to be bound by the findings of an arbitration body.

We suggest that this could be done through one of the labour relations mechanisms of the State (such as the Labour Relations Commission or the National Implementation Body) in order to ensure there is appropriate scrutiny and balance in any proposals. However, it is important that whatever body has a role in this process has sufficient experience and expertise to fully consider the issues. With this in mind, it may be preferable for the Pensions Board to carry out this function through a revision of the power the Board currently has under Section 50 of the Pensions Act. This route may also be necessary as, if an employer debt provision is in place (see the next section), it is difficult to see how the trustees could determine that it is in the best interest of the members to reduce benefits. We also propose that the most appropriate benefit alterations would be to increase the age at which benefits become payable and/or to reduce the level of guaranteed pension increases in retirement payable under a scheme.

5. SCHEME WIND-UP: SOLVENT SPONSOR

Key issue - ***Nothing to stop sponsor abandoning scheme***

There are no provisions in Irish legislation requiring a solvent sponsoring employer that initiates a wind-up of a scheme to ensure that the scheme is brought to a level of full funding. In the UK, the deficit is a debt on the employer which can be enforced by the Pensions Regulator. However, it should be noted that the UK Government has just announced a review of the employer debt legislation.

With current funding levels, a wind-up of a scheme in deficit by an employer is likely to result in active and deferred members receiving much reduced benefits.

Proposal:

A debt on employer provision would be in place to prevent solvent employers completely walking away from pension commitments

We believe that a solvent employer should not be able to wind up a scheme without at least securing a specified level of benefits. This level of benefit could be the benefits which would be provided on wind-up if the scheme met the funding standard, or some part of these benefits. As such, a debt would be a contingent liability in the employer accounts, it would not adversely impact the balance sheet and hence it would not itself trigger employer insolvency. In the case of an insolvent employer, this would provide no added protection for members, but it would ensure that solvent employers could not walk away from their commitments.

Advantages

Provides greater security for members than they have at present
Discourages employers from abandoning schemes
Provides greater flexibility in funding for ongoing schemes

Disadvantages

Could be seen by employers as locking them into defined benefit provision
Could reduce flexibility of corporate restructuring such as mergers and acquisitions

6. SCHEME WIND-UP: INSOLVENT SPONSOR

Key Issue - *Pensioner priority on wind-up*

In the case of a scheme winding up where the sponsoring employer is insolvent, there is no further source of funds available to the scheme and the assets must be distributed among the members as legislated in the Pensions Act. Effectively, this is on the basis that the liabilities of pensions in payment are first settled and any remaining assets are then distributed to secure the liabilities of active and deferred members. All pensions in payment are equally protected, irrespective of the amount. Therefore, those in receipt of a relatively low level of pension would suffer the same percentage reduction as someone on a high pension if the assets were insufficient to secure the total amount.

Once the pensions have been secured and if the total amount of assets available is not sufficient to meet the total amount of liabilities, the active and deferred members will receive less than their entitlement. In some cases, there may be no assets remaining after the distribution to pensioners and the active and deferred members would receive nothing. While this has to date been an extremely rare event, the risks are higher in the current environment and clearly the impact could be very severe. Therefore, measures are required to be put in place to deal with this.

Defined benefit schemes operate on the basis of sharing of risk and pooling of assets. Intergenerational risk sharing has been the cornerstone of the success of defined benefit schemes and enables them to continue to provide the most likely means of members securing adequate pensions on retirement. Employers and employees who are contributing to defined benefit schemes today are seeing a rise in their contributions due to the increased cost of paying pensioners and falling asset values. While this could be viewed as a feature of intergenerational risk sharing, it is likely to be seen as inequitable by active and deferred members where those in receipt of pension have total protection at their expense in a wind-up situation. The level of protection currently provided to pensioners is not compatible with the concept of intergenerational risk sharing.

It is possible that active members who have increased their contributions and/or agreed to reductions in their benefits in order to sustain a scheme will receive no benefits on a subsequent scheme wind-up where the deficit is such that only the pensioner liabilities can be secured. In such a case, the active members have taken all the risk while the pensioners' benefits remain relatively secure.

Proposal

Pensioner priority on wind-up would be limited to a specified percentage of the pension currently in payment subject to a monetary minimum and maximum

Firstly, we propose that a specified percentage (e.g. 90%) of a pension currently in payment would replace the current priority given to pensions in payment under the legislation (benefits secured by additional voluntary contributions would continue to have first priority). There would be a monetary lower limit below which no pension would be reduced, and this could be set at a level of, say, 50% of Social Welfare pension (currently approximately €5,987.80 per annum). This, together with the Social Welfare pension that the individual would receive, should provide a reasonable level of protection (i.e. an income of approximately €17,963.40 per annum). In capital terms, securing 50% of the Social Welfare pension would currently cost in the region of €135,000 for a 65 year old male. There would also be a monetary upper limit on the amount protected (e.g. 200% of Social Welfare pension, currently approximately €23,951.20 per annum). In capital terms, securing 200% of the Social Welfare pension would currently cost in excess of €539,000 for a 65 year old male. This would ensure that those on relatively high pensions are limited in the level of protection in order to ensure a more proportionate distribution of the assets towards those who need them most.

Secondly, we propose that the first priority is restricted to the amount of current pension in payment (and any attaching contingent spouse's pension) and that any future increases in pension as may be guaranteed under the scheme rules should be de-prioritised as outlined below.

Once assets have been allocated for the newly constructed priority pensions, the remaining assets would then be used to secure the benefits of all members (actives, deferred and the non-priority component of the benefit of pensioners) on a pari passu basis. In allocating the assets, the liabilities would be calculated ignoring both any future revaluation for non-retired members and pension increases in retirement.

Once those assets have been allocated, any remaining assets would be used to secure some of the future revaluation and increases in retirement.

Advantages

Allows for a more equitable share out of the assets between pensioners and other members of the scheme in a wind-up
Provides more protection for pensioners with small pensions in the event of a wind up where there are insufficient assets to secure pensions in full
Achieves the overall aim of risk sharing and intergenerational support
Maintains a large element of protection for pensioners (in particularly those on lower level of benefit)
Active and deferred members close to retirement age will receive a greater share of the available assets in an insolvent wind-up than younger members due to the de-prioritisation of revaluation on preserved benefits

Disadvantages

Some pensioners are likely to lose income
Any pensioners with guaranteed increases will lose in real terms. This could be of significant value for those who have recently retired
Significantly reduced values on wind up for younger members due to de-prioritisation of revaluation on preserved benefits

Key Issue - *No State Protection*

Furthermore, where an employer insolvency leads to the wind-up of a scheme in deficit, there is no State protection in existence for those who could lose a significant part or all of their benefits. Based on the judgment of the European Court of Justice in the Robins case, the State has an obligation to ensure that members' pension entitlements are protected on an employer insolvency. In the Robins case, two of the claimants would only have received 20% and 49% of the benefits they were due and this was deemed by the Court of Justice not to fall within the definition of the word "protect".

In the UK, there is a Pension Protection Fund to which the assets of schemes that wind up in deficit due to employer insolvency are transferred. The Pension Protection Fund aims to provide all of the benefit for pensions (with the exception that lower increases may apply) and 90% of the benefit for active and deferred members, subject to a cap in benefit.

We do not consider that a Pension Protection Fund as operated in the UK would be viable in the smaller Irish market, but we recommend that further consideration be given to establishing a mechanism, e.g. using the State Insolvency Fund to provide greater protection to members of schemes who lose a significant part of their benefits due to employer insolvency.

Proposal:

A State Pension Purchase Scheme would be utilised for securing the pensioner liabilities where schemes wind up due to employer insolvency

Where schemes wind up due to employer insolvency, the State has, as evidenced by the Robins judgment, an obligation to protect pension entitlements. As a means of going some way towards satisfying this obligation, the State could offer annuities in return for the assets allocated to pensioners as part of the priority process. The benefit of this is that the State can cost pensions on a basis that does not include many of the costs that private sector annuity providers have to account for. This, in turn, would increase the amount of protection available to pensioners (by reducing or eliminating pensioner shortfalls, where these exist) and limit any reductions in their current payments. It would also increase the allocation to active and deferred members. The State's involvement would be limited to the acceptance of the allocated assets in return for an annuity based on a rate deemed appropriate by the State.

As the protection would only apply to schemes of insolvent employers that are winding up in deficit, the number of annuities provided should be limited, and would be minimal compared to the annuities currently provided by the State for social welfare pensioners and retired public servants. The State would always retain the option to set and adjust annuity rates in order to reflect the levels of risk as it deems appropriate. This also provides for intergenerational support. We would envisage State annuities being priced at a level currently of around 85% of commercial annuities. While the margin of 15% may not appear substantial and may rarely be called on, it would have a significant practical and beneficial impact on those cases where the State Pension Purchase Scheme is utilised due to the gearing effect of the priority order. This could, for example, improve a situation whereby active and deferred members are only due to receive 20% of their benefits to a level where even all of their benefits are covered. The level of improvement would be dependent upon the ratio of the pensioner liabilities to the total liabilities of the scheme.

Advantages

Increases amount of assets available for distribution to active and deferred members
Addresses, at least partially, the State's obligations under the Robins judgment
Only available in circumstances of employer insolvency and therefore limited risk to the State

Disadvantages

State could be pressured to go further and cover shortfalls
Only beneficial if State provides better annuity rates than commercial providers

7. CONCLUSION

This is a range of measures that the Irish Association of Pension Funds and the Society of Actuaries in Ireland are proposing. We believe that these issues should be tackled immediately, with longer term issues being dealt with under the Green Paper process, such as how the Funding Standard could be constructed to reflect such a system.

The measures form a package that deals with both the ongoing sustainability of defined benefit schemes and the immediate issue of the consequences of an underfunded scheme winding up. We have attempted to formulate a balanced approach that focuses on the central issues. This approach attempts to ensure a more equitable distribution of the assets of the scheme among all of the participants where a scheme winds up in deficit, reduce the risk of a solvent employer abandoning a scheme and allow more flexibility where trustees, sponsors and members wish to continue defined benefit provision. While the various measures involve commitment and contribution from all relevant parties, we believe ultimately that all parties would benefit if they result in the creation of a more stable overall approach.

It is important that the proposals are viewed as a package as they are all interdependent. Each proposal involves one of the parties in a scheme committing something that in the context of the overall set of proposals allows greater flexibility for schemes to continue in a sustainable format while increasing the overall protection to members of those schemes.

In summary, the issues we believe should be introduced are:

- There should be a mechanism to alter the benefit structures of active and deferred members in order to sustain the scheme;
- A debt on employer provision should be in place to prevent solvent employers abandoning their pension commitments;
- Pensioner priority on wind-up should be limited to a specified percentage of the pension currently in payment, subject to a monetary minimum and maximum;
- The State should offer a "not-for-profit" annuity system where schemes wind up in deficit and due to employer insolvency.

We believe that this package of measures would strengthen the provision of occupational pensions in Ireland and would mitigate the impact of the current financial crisis overall:

Members

The active and deferred members have more security in the event of a wind-up. Furthermore, the scheme itself is likely to be more sustainable, which increases their chances of still being in a defined benefit scheme at retirement, albeit with potentially lower benefits and/or benefits payable at a later date.

Employer debt would provide greater security to all members, including pensioners, as it would discourage an employer from winding-up the scheme and, in the event of abandonment by a solvent employer, pensions in payment and accrued pension rights can be better protected.

Some pensioners could suffer a drop in income in retirement in the event of a scheme wind-up following employer insolvency but this seems more equitable than the current position whereby they receive full protection irrespective of the level of benefit, potentially at the expense of active and deferred members. Pensioner members receiving small pensions achieve greater security over their core pension than is the case where very large pensions are afforded the same priority as small pensions.

Employers/Trustees

Employers and trade unions have more flexibility to negotiate and agree changes to the benefit structure that would make the scheme more sustainable and allow the trustees and sponsor to continue the scheme.

State

Having schemes that provide greater all-round security lessens the likelihood of the State being dragged into a wind-up situation where members lose significant entitlements. Allowing schemes to become more sustainable is also in the interest of the State as it ensures less reliance on the State for income support in retirement. A State Pension Purchase Scheme could go some way towards covering the State's potential liabilities under the Robins judgment.

Implementation issues

This paper deals with the proposals at a high level and does not examine the detailed implementation issues that are likely to arise. We do believe, however, that there are no insurmountable issues and that these proposals can be implemented in a manner that will assist the sustainability of defined benefit schemes and the protection provided to members of those schemes.