

MAL EBC Regulatory Update

17 May – 7 June 2010

What's My View? Dan DeKeizer

This month's Quarterly Report from Pension Capital Strategies (PCS) contained few positives for those interested in the long term health of company pension schemes. Most strikingly, whilst PCS pointed to significant increases in funding for pension fund deficits (£11.1bn last year, up £4bn on the previous year), the report highlighted the fact that this increased commitment from employers was balanced by a 15% decline in the overall employee pension provision. De La Rue is just the latest in a line of companies to look at the spiralling costs of funding their scheme deficit and has decided that closure is the only option.

In my opinion, this illustrates clearly the dangers of the skewed incentives that are at work within company pension schemes at the moment. The risks of any pension scheme are backed by the combination of existing assets and the promise of future funding from the employer covenant. When the adverse consequences of those risks, so dramatically evidenced in the last two years, come as a surprise to employers, schemes may close. If the protection of the employer covenant becomes essentially a one-sided bet, with the employer exposed to the downside of equity markets or longevity increases, but no realistic prospect of enjoying the upside, schemes may close. And if the only way to mitigate those future risks is through higher funding today, schemes may close. If we don't want defined benefit pension schemes to become a thing of the past, then this issue of conflicting incentives needs to be addressed.

So, how do we deal with this? Well, there are a range of different options that might usefully be explored by companies, scheme trustees and the regulators.

One positive move might be the voluntary application of the sort of risk management approaches developed by insurers and currently being codified under Solvency II to pension funds. Having a clear measure of the economic value of the employer covenant under stress scenarios could help improve funding efficiency and, by improving transparency, certainly helps build trust between trustees and employers.

Another approach would be for trustees and employers to explore more actively potential 'third way' options that might help better spread longevity and investment risk between employees and shareholders. Cap and pay arrangements that allow for greater cost sharing with the scheme members is one example. In the Netherlands, conditional indexing already allows greater flexibility for employers and fund trustees to balance funding needs against a company's financial constraints. Perhaps this is an approach that the Pensions Regulator could look at for the UK?

Failing that, there are third party insurance products in the market that already provide the potential for firms to neutralize the funding risk inherent in their schemes. Maybe examining these options in discussion with employers should be part of the standard covenant review process that trustees will be expected to carry out under the Pension Regulator's latest guidance?

Whatever approach is taken, it is clear from the PCS figures that fresh ideas are needed if we all want to continue to enjoy the personal and social benefits that come from strong defined benefit pension schemes. Beyond the ideas, though, it's my view that scheme sponsors and trustees need to change the nature of their conversations about pension risk and take concrete actions based on a shared view of the consequences of those risks.

Political update

Iain Duncan Smith MP speech

On 27 May, Work and Pensions Secretary, Iain Duncan Smith MP, delivered a speech in which he outlined the priorities of his Department. He asserted that the principles of "fairness, responsibility and social justice" will inform the Government's agenda for pensions and noted the policy to phase out the default retirement age, arguing that the "idea of someone being fired just because they turned 65 is nonsense".

Smith noted that people are living "longer and healthier lives", which has "huge implications" for the pensions regime. He argued that shifting demographics mean that there is a need to increase the pension age and also noted that the Government will end the rules requiring compulsory annuitisation at 75. Smith went on to state that from April 2011, the Government is triple-locking the value of the Basic State Pension so that it will rise by the minimum of prices, earnings or 2.5 per cent, whichever is higher.

He recognised that there is a need to encourage "greater personal saving" and pledged to encourage employers to provide high quality pensions for all their employees. He stated that he will work with employers, consumers and the industry to make automatic enrolment and increased pension saving a reality.

The full speech can be found here - <http://www.dwp.gov.uk/newsroom/ministers-speeches/2010/27-05-10.shtml>

Regulatory Announcements

FSA confirms annual funding requirement for 2010/11

On 28 May, the Financial Services Authority (FSA) confirmed its annual funding requirement for 2010/11. The budget sought to reflect that the FSA will be concentrating only on essential areas of work, including; the delivery of the credible deterrence philosophy; the policy reform programme, driven by the Turner Review, which forms the FSA's response to the financial crisis and covers critical issues such as reforms to liquidity and capital regimes; and ensuring delivery of the wider policy agenda mandated by the European Union, including Solvency II.

The annual funding requirement for 2010/11 is £454.7 million, up from £413.8 million in 2009/10. The increased cost of intensive supervision will be levied on those firms whose size and impact require the most regulation from the FSA.

The FSA's Business Plan is available here - http://www.fsa.gov.uk/pubs/plan/pb2010_11.pdf

FSA annual report 2009/10

On 10 June, the FSA published its Annual Report, outlining its performance against the priorities set out in its 2009/10 Business Plan and the FSA's statutory objectives. The report covers the FSA's regulation of the financial services sector from 1st April 2009 to 31st March 2010 and states that the main features of this year's programme have been:

- Substantial investment to create the capacity and capability needed to deliver the new 'intensive supervisory' approach.
- The creation of new, in-house analytical capability to provide sophisticated analytics in the areas of business models, accounting, and risk.
- Significant work to reform the regulatory framework in respect of capital and liquidity. This has involved the introduction of new local rules for liquidity and considerable input from the FSA in taking forward the global agenda for reforms to the capital rules.
- Further progress in improving the technology with which firms interact with and provide data to the FSA, culminating in the launch this year of an online system for standard notifications and applications which complements the capability to complete regulatory returns online, rolled out in 2008.

Commenting, Hector Sants (Chief Executive, FSA) said: "I believe the FSA is now a different and improved regulator both in respect of its philosophy and its ability to deliver that philosophy. It has demonstrated the characteristics that are essential to a successful regulator and proved to be an organisation capable of learning and adapting to an uncertain world."

The full report is available here http://www.fsa.gov.uk/pubs/annual/ar09_10/ar09_10.pdf

FSA consults on changes to the existing training and competence regime

The FSA has published proposals to strengthen its requirements on competence for individuals carrying out retail activities, while placing more emphasis on standards of ethical behaviour. The proposals will introduce a 30 month deadline for individuals to complete all modules of a qualification required for their role and will also remove some transitional provisions which allow individuals to operate without formal qualifications, due to the arrangements under their previous regulator.

Further proposals clarify how individuals carrying out approved persons roles should demonstrate a good standard of ethical behaviour. They will be expected to act in the interests of their client, avoiding consumer detriment and taking responsibility for their own level of competence.

The proposals seek to increase standards of professionalism across the industry, complementing the Retail Distribution Review plans and rules that are already in place for investment advice.

The consultation can be found here - http://www.fsa.gov.uk/pubs/cp/cp10_12.pdf

Jon Pain explains the FSA's approach to intensive supervision at the City & Financial Intensive Supervision conference

On 18 May, Jon Pain (Managing Director, Supervision, FSA) delivered a speech to the FSA City and Financial Intensive Supervision Conference. Pain discussed the FSA's "outcomes-based" approach to effective supervision and argued that there is a need to secure international consensus to deliver an enhanced prudential framework that "delivers a more resilient and robust banking sector". In addition, he called on the industry to "recognise that the world has changed" and asserted that it should not see the taxpayer as the "last resort". Pain also argued that the FSA needs to continue to increase its overall resource and to deliver a "cultural shift", where supervisors have a much "tougher role".

The full speech is available here -

http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2010/0518_jp.shtml

Other Announcements

Pensions Advisory Service - Rescue could hit annuity rates

On 17 May, the Pensions Advisory Service (PAS) reported that annuity providers have warned that UK retirees could receive a lower pension income from their annuities due to the eurozone's £617 billion financial rescue package. It noted that a sharp fall in annuity rates coincided with the UK's introduction of the European quantitative easing policy last year and that while the financial package announced by the European Central Bank did not confirm quantitative easing, many think it will inevitably have a longer term affect on European sovereign rates and, as a result, UK annuity rates.

Further details can be found here:

<http://www.pensionsadvisoryservice.org.uk/news/2010/may/rescue-could-hit-annuity-rates>

Pensions Advisory Service – NEST future in doubt

On 18 May, PAS stated that the new Department for Work and Pensions looks set to prioritise state pension reform over the National Employment Savings Trust (NEST). It noted that the Conservative and Liberal Democrat coalition's joint manifesto offered no certainty on NEST or reducing pension tax relief for high earners. In addition, PAS asserted that the appointments of Iain Duncan Smith MP as Secretary of State for Work and Pensions and

Steve Webb as Pensions Minister cast doubt on the future of NEST, with the latter having expressed reservations over the package, while the Conservatives are known to be dubious of NEST.

Pension Capital Strategies and JP Morgan Cazenove – Study predicts end of final salary pensions

On 19 May, Pension Capital Strategies and JP Morgan Cazenove published a report which looked at pension disclosures of FTSE 100 companies as at 31 March. It found that the total cost of providing the current year's pension obligations has fallen by 15 per cent over the past year. Commenting, PAS suggested that this indicates a decline in the number of employees who are earning final salary benefits PCS believes that the majority of FTSE 100 companies will cease DB pension provision to all employees within 2 to 3 years.

The full report can be found here -

<http://www.pensionstrategies.co.uk/MungoBlobs/pdfs/FINAL%20FTSE100%20Report%20May%202010.pdf>

De La Rue – Final salary scheme to close in 2013

On 24 May, De La Rue, the banknote printer, announced that it is to close its final salary scheme from 1 April 2013. Members will be moved to a money purchase pension arrangement although all final salary pension benefits earned up to 31 March 2013 will be protected. The company has decided to close the scheme in an attempt to address the scheme's growing deficit, which has increased from £56 million in 2006 to £204 million.

Further details can be found here -

http://www.delarue.com/Media/LatestNews/pre_statement/

Tate and Lyle – Company to Close Final Salary Scheme

On 27 May, Javed Ahmed, Chief Executive of Tate and Lyle, unveiled plans to close the company's final salary scheme to future accrual from April 2011. The group confirmed it will maintain its current pension plans in its other countries of operation. On full closure members will be offered access to the company's Stakeholder pension scheme.

Further details can be found here -

http://www.tateandlyle.com/InvestorRelations/ResultsandPresentations/Documents/2010/Results_for_Year_to_31_March_2010_PR.pdf

and here - <http://www.tateandlyle.presscentre.com/Press-releases/Tate-Lyle-Interim-Results-Announcement-2009-368.aspx>

OFT approves Willwriters Code of Practice

On 2 June, the Office of Fair Trading (OFT) announced that the Institute of Professional Willwriters (IPW) has achieved approval for its code of practice under the Consumer Code of Approval Scheme. The approval means that consumers using an IPW member to make a will are safe in the knowledge that code approved members operate to a higher standard of consumer protection than the law requires.

Further details on the Consumer Code of Approval Scheme can be found here - <http://www.oft.gov.uk/OFTwork/ccas/>

TPR - Regulator publishes record-keeping and wind-up guidance

On 2 June, The Pensions Regulator (TPR) published guidance on targets for member record-keeping, following a consultation earlier this year. In light of the wide support for the changes that were proposed, TPR has not made significant modifications to its initial proposals. TPR expects all schemes to measure their member records and, where necessary, have plans in place for improvement.

The final guidance includes: recommending specific targets for standards of common data; using regulatory powers to investigate standards within schemes including sampling schemes for data audit; potential enforcement action where there is a breach of legislation; setting a deadline of December 2012 for the resolution of outstanding data issues; and enhancing the education material on its website.

Poor standards of member record-keeping can lead to additional costs in areas such as administration, claims from members, buy-outs and wind-ups. Revised guidance on wind-ups was also published.

Further details can be found here - <http://www.thepensionsregulator.gov.uk/guidance/guidance-record-keeping.aspx>

The Pensions Regulator – Guidance on employer covenant

On 9 June, TPR published details of upcoming guidance and e-learning which aim to ensure that trustees improve their understanding of the support that a sponsoring employer provides for a scheme.

This statement set out the regulator's expectations of trustees in relation to employer covenant issues, and built on last year's focus on scheme funding and covenant. The regulator's research and casework experience has shown that whilst some schemes take a sound approach, for others improvement is still necessary.

The regulator also announced that it will publish a series of new guidance documents for consultation in the coming weeks. This will include:

- Guidance on monitoring employer support will provide more information on what trustees should do to measure and monitor employer covenant. It will also outline action trustees should take to strengthen scheme security if needed as a consequence of these assessments. It will provide guidance on how contingent assets and other arrangements can work alongside employer covenant to provide further safeguards.
- Guidance for trustees of multi-employer schemes will explain the importance of understanding who is legally responsible for supporting the liabilities in a multi-employer scheme; assessing the strength of the covenant supporting the scheme; and the options for mitigating the risk associated with the departure of an employer from the scheme. The guidance covers all the mechanisms which may apply when an employer departs a multi-employer scheme including the two alternative mechanisms introduced by the Department for Work and Pensions in April 2010.
- Following the focus on covenant issues, The Pensions Regulator will be producing revised guidance on transfer incentives, and other situations in which members are asked to consider substituting or converting their benefits. This will replace the current 'inducements' guidance and set out a principles-based approach to the issue.

Further details can be found here - <http://www.thepensionsregulator.gov.uk/docs/employer-support-DB-statement-june-2010.pdf>

Pension Policy Institute (PPI) briefing note – What could the Coalition Government mean for pensions policy?

On 3 June, the PPI published a briefing note outlining the Coalition Government's policies on pensions and older people, and highlighting what impact the new Coalition may have on pensions policy and provision for retirement.

The PPI stated that the Government has already made some important announcements on pensions policy, such as the decision to index BSP to the higher of earnings, prices or 2.5 per cent in 2011 and to support the introduction of auto-enrolment into private pensions.

However, it added that the Government's impact on pensions policy will be clearer once the results of the review on SPA changes and the commissions on public sector pensions and long-term care are announced and once any announcements are made regarding NEST, auto-enrolment and tax relief on pension contributions.

The PPI concluded that as a result of the new Government, we might expect some people to see greater freedoms and flexibilities in future around accessing pension wealth both in the run up to and during retirement.

The full briefing note can be found here –

https://www.pensionspolicyinstitute.org.uk/uploadeddocuments/Briefing%20Notes/PPI_Briefing_Note_56.pdf

Pension Protection Fund updates

PPF Bulletin

On 24 May, the Pension Protection Fund (PPF) published a new bulletin which noted that its independent steering group has published a paper setting out its ideas for the long-term future of the PPF levy. The PPF is now considering the ideas put forward by the steering group and looking at how they would work in practice. It will publish its thinking in the autumn.

In addition, the PPF announced that it has recruited seven Private Equity Secondary Managers to a panel for potential future investment. The successful managers are: Goldman Sachs; Hamilton Lane; Lexington Partners; LGT Capital; Partners Group; Pantheon Ventures and RREEF.

The full bulletin can be found here –

http://www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/ppf_bulletin_may_2010.pdf

New FAS webpage - Actuarial Factors

The Pension Protection Fund published the actuarial factors currently used to determine a member's entitlement under the Financial Assistance Scheme (FAS). The factors have been provided for information purposes only and should help trustees and administrators understand how FAS assistance is calculated. They will be reviewed from time to time and may be changed without notice.

Further details can be found here –

http://www.pensionprotectionfund.org.uk/FAS/info_pensions_professionals/Pages/InfoPensionsProfessionals.aspx