Funding and the Sponsor Covenant

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Setting the scene

The raison d’être of pension schemes is

to provide security for benefit promises

Benefit security is derived from

1. the scheme’s *invested assets*,
2. the *sponsor covenant*—reliability of sponsor to meet scheme benefits if insufficient assets, and
3. the PPF (and other State compensation)

Pensions industry used to ignore sponsor covenant:

- Scheme governance was (and remains) weak
- Consequent commercial incentives for advisers

Primary force for change has been the Regulator

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Sponsor covenant recap

Exposure to the sponsor covenant is undesirable for members because it is

- a concentrated investment
- correlated with member remuneration

Actuarial Profession’s working party November 2005

- Actuarial role is *not* assessing the covenant itself, but *should* be able to advise on need and options
- Other than when academic, cannot continue to ignore the sponsor covenant in funding
- Actuarial advice and covenant assessment need to be combined—can’t ignore this interaction
- Distinguish ‘in distress’—not conventional funding

Benefit coverage (aka solvency)

Benefit coverage is the key funding measure

Why?

- Other measures are not falsifiable (which means that they contain little information)—market price is closest to falsifiable
- When the sponsor is in trouble, i.e. the only time that funding really matters, this is what counts
- Trustees need it to act on advice on the sponsor covenant (because it measures the real exposure to the sponsor covenant)
- Traditional opinion-based measures are prone to commercial pressure ('assumption shopping')—making an IOU of £20 appear as £10 is valuable

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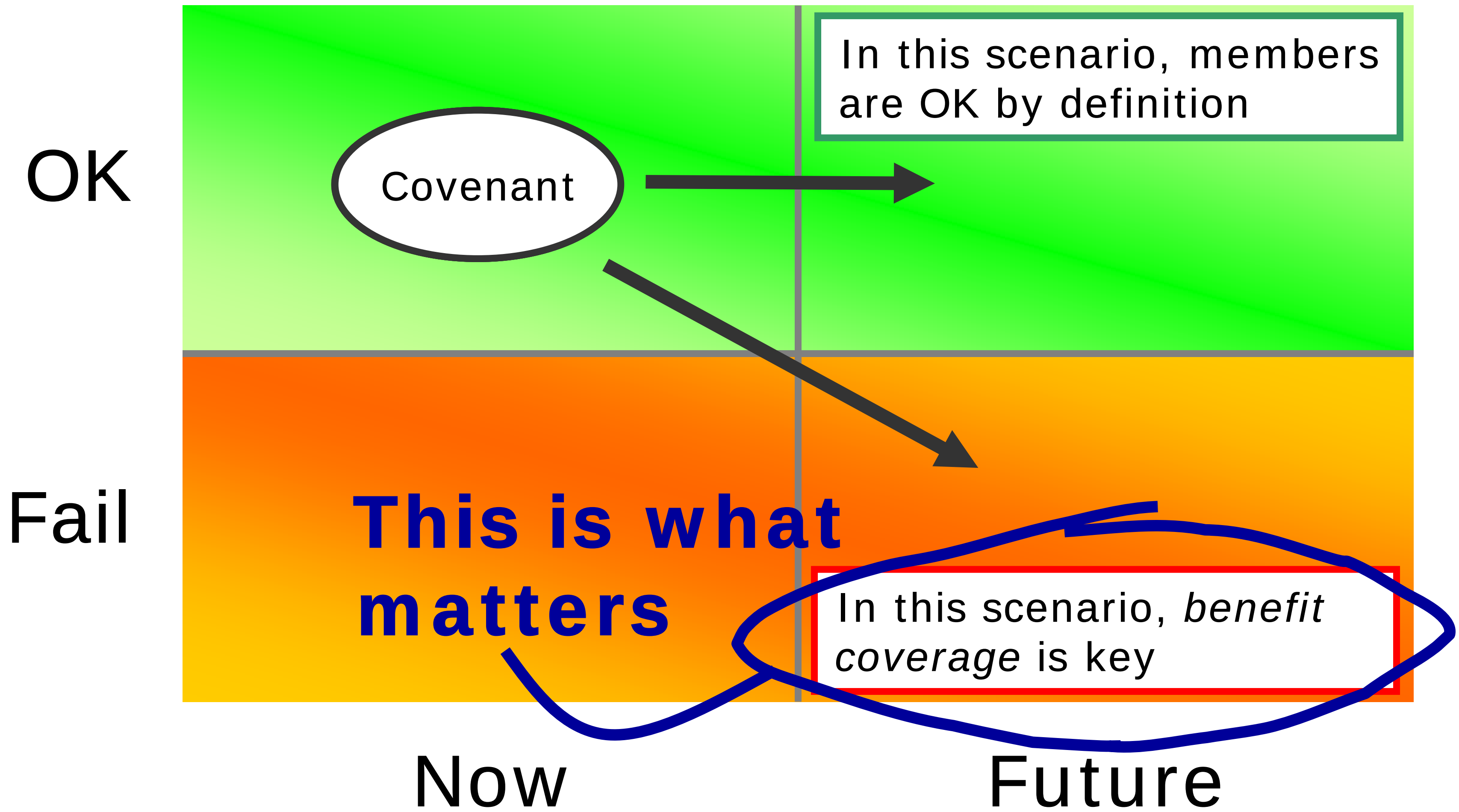
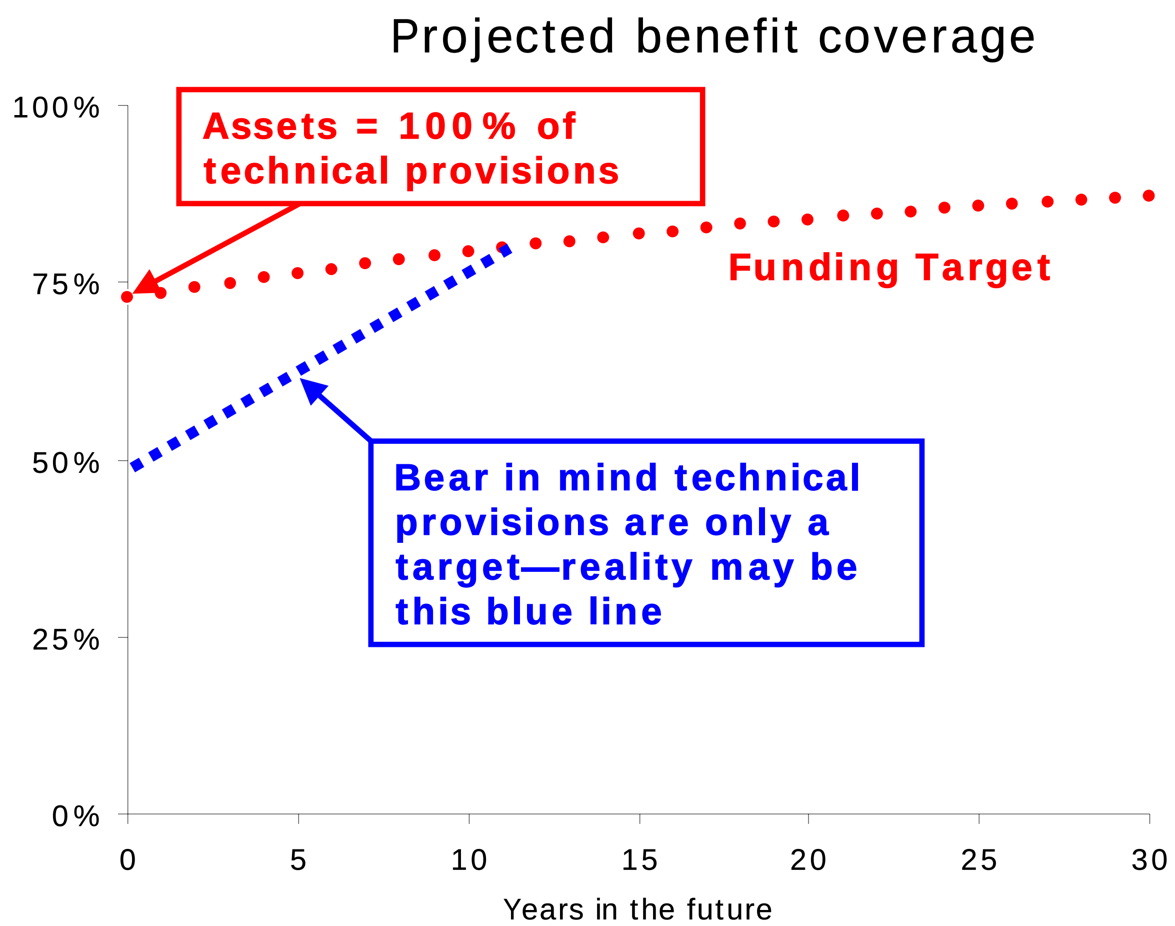
Sponsor covenant is binary

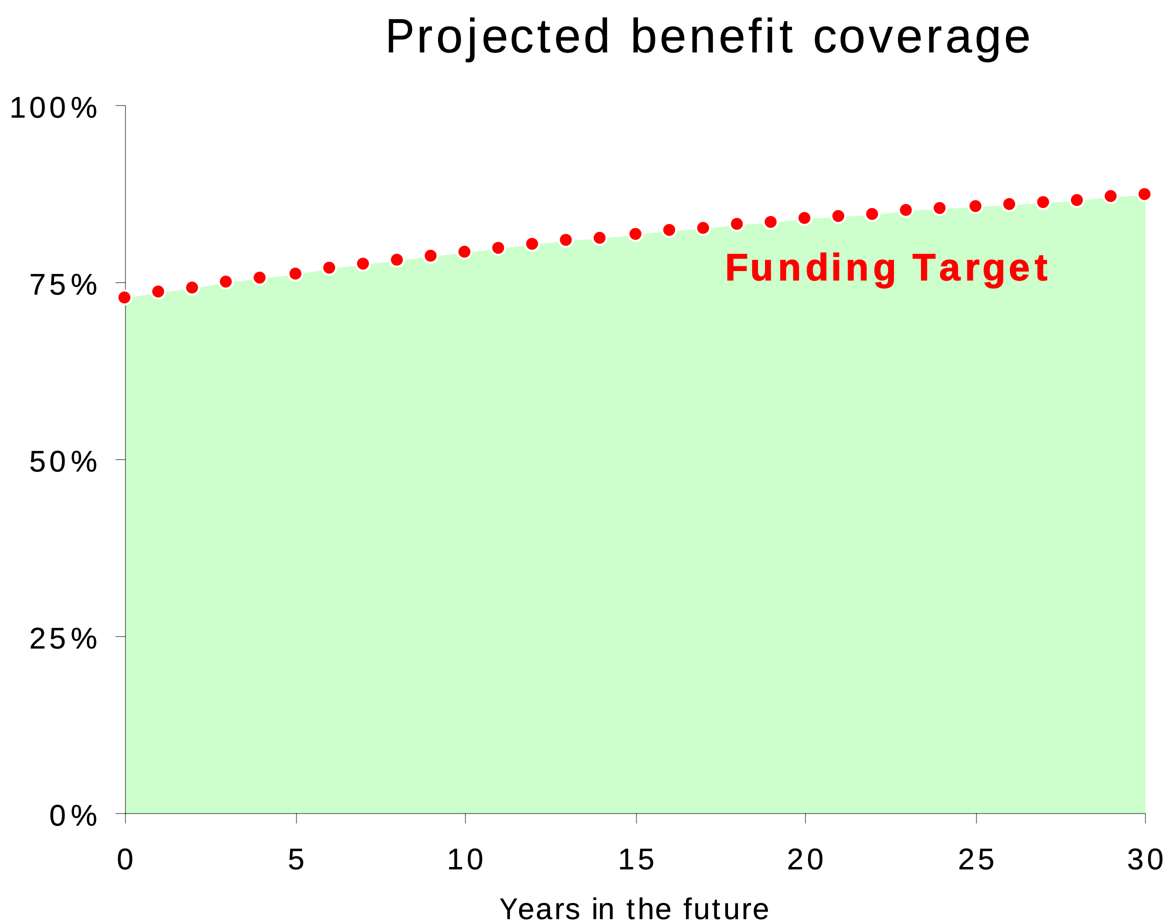


Sponsor covenant exposure



All graphs are illustrative

Sponsor covenant exposure



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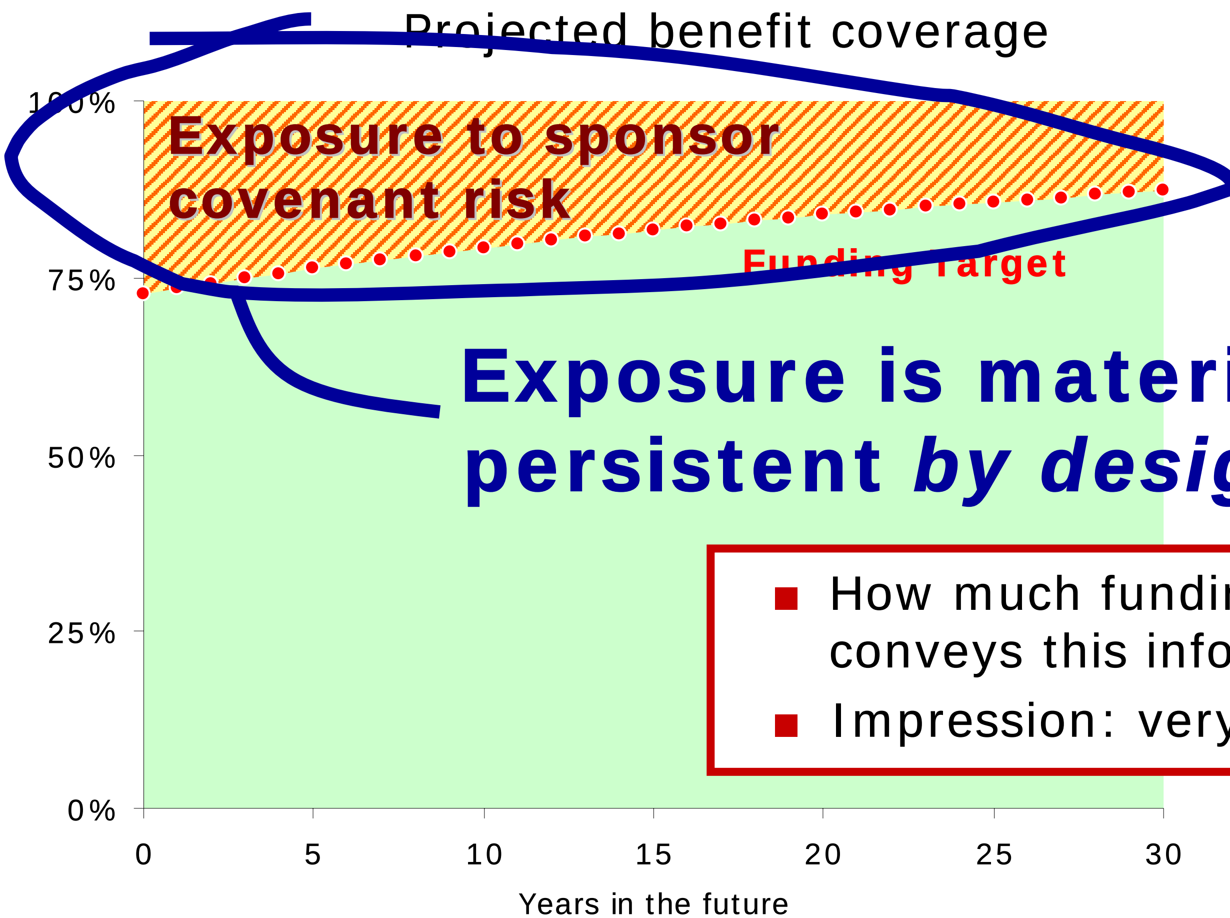
Sponsor covenant exposure

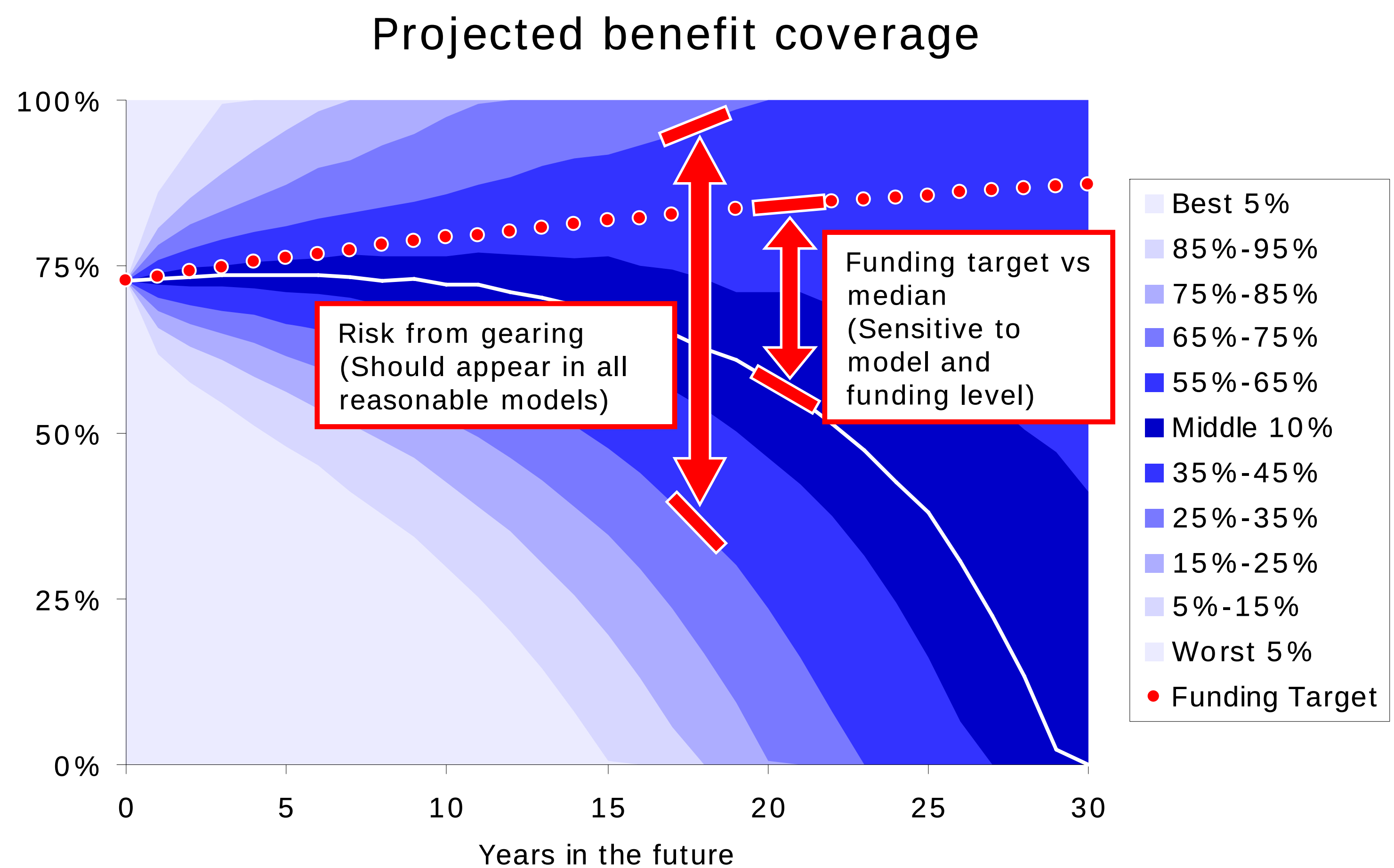


Exposure is material and persistent *by design*

- How much funding advice conveys this information?
- Impression: very little

All graphs are illustrative

Sponsor covenant exposure



Notes
1. Funding Target has same expected return as scheme assets.
2. Simple risk model—no allowance for yield curve or longevity risk.

All graphs are illustrative

Technical provisions

Technical provisions based on conventional funding

- create persistent exposure to the sponsor covenant *by design*
- hide risk
- should not be used to assess overall sponsor covenant risk

Run off plans

- Implicit run off plan in many cases is to wait for the last member to die—this can't be right
- Best practice is for trustees
  - to define their run off plan, *and*
  - to incorporate it in their technical provisions
- See 'Lessons from closure', Campbell et al, 2006)

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Taking account of the PPF

In theory, the PPF makes a big difference

Extreme case:

- Poorly funded scheme plus weak sponsor covenant means scheme ends up in PPF whatever
- One option is to run on as long as possible, because members benefit from
  - more accrual
  - more reaching NRA
  - optionality of a mismatched scheme investment strategy

Impression: actuaries do not advise on the impact of PPF on future benefit coverage

Topics for discussion

1. Funding advice that does not fully explain the future progression of the scheme’s exposure to the sponsor covenant is defective
2. It is inappropriate for technical provisions to be set to less than 100% benefit coverage forever
3. All pension schemes should have run off plans which are incorporated into their technical provisions
4. Actuaries should always give *quantitative* risk advice (including investment mismatch and longevity risk)

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4. Actuaries should always give *quantitative* risk advice (including investment mismatch and longevity risk)

5. PPF benefit coverage should appear in funding advice