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Pensions Conference 2013

Another objective for the Regulator – what will it mean for actuaries?

Charles Cowling

Agenda

- Where are pension schemes today?
- What has the Regulator been saying?
- What is the new objective?
- What does it mean for us?

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Where are Pension Schemes today?

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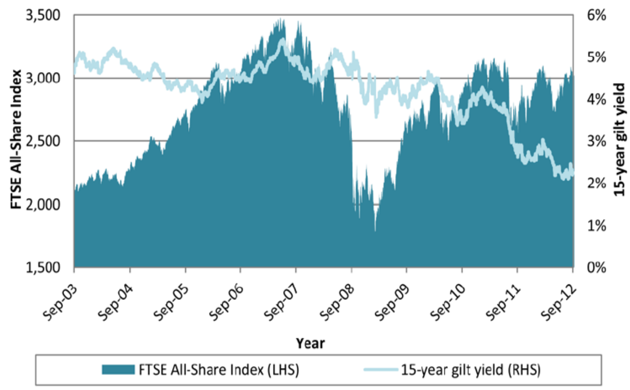
Where are Pension Schemes today?

Chart 5.3 | Movements in stock markets and gilt yields



Source: Bloomberg

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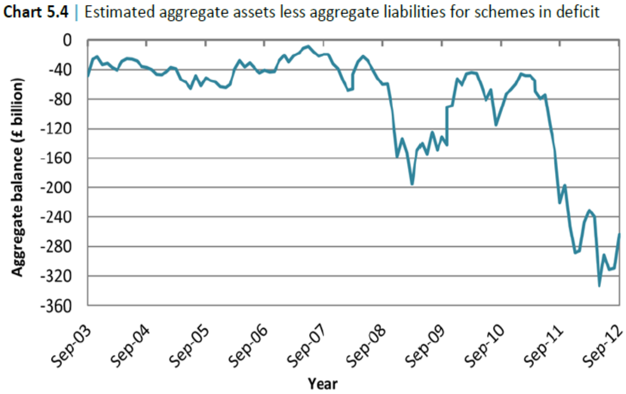
Where are Pension Schemes today?

Chart 5.4 | Estimated aggregate assets less aggregate liabilities for schemes in deficit



Source: PPF / The Pensions Regulator

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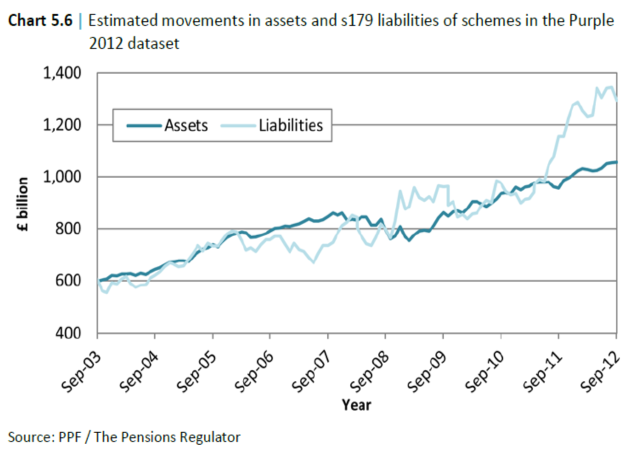
Where are Pension Schemes today?



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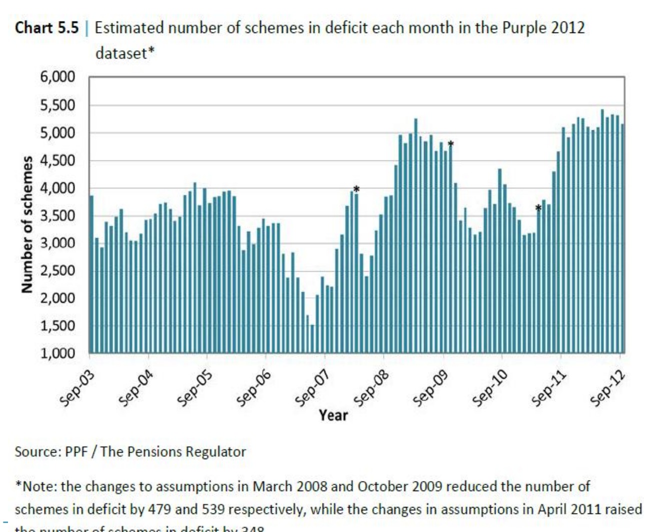
Where are Pension Schemes today?



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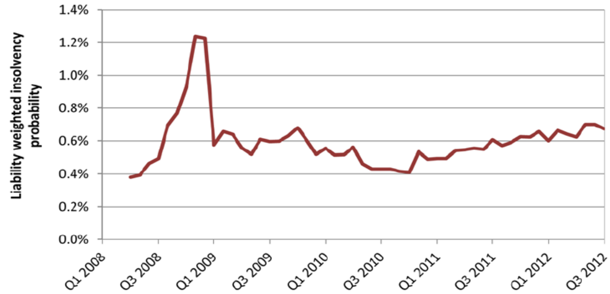
Where are Pension Schemes today?

Chart 6.2 | Liability-weighted insolvency probability* of the PPF's 500 largest scheme exposures**



Source: PPF / The Pensions Regulator

* Where available, the insolvency probabilities have been derived from credit ratings, including market-implied ratings, supplied by Moody's and Fitch. Market-implied ratings are constructed on the basis of information from the equity, bond and credit default swap markets. For pension fund sponsors who do not have publicly quoted equities or bonds and are not rated by ratings agencies, Dun & Bradstreet (D&B) failure scores are used. Around 35 per cent of the insolvency probabilities are derived from D&B failure scores.

**Largest scheme exposures in terms of scheme underfunding adjusted for volatility of assets.

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Where are Pension Schemes today?

Table 3.1 | Distribution of schemes by status

Percentage of schemes	Extended Purple 2007	Purple 2008	Purple 2009	Purple 2010	Purple 2011	Purple 2012
Open	36%	31%	27%	18%	16%	14%
Closed to new members	45%	50%	52%	58%	58%	57%
Closed to future accruals	16%	17%	19%	21%	24%	26%
Winding up	2%	2%	2%	2%	2%	2%
Total	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

Source: PPF / The Pensions Regulator

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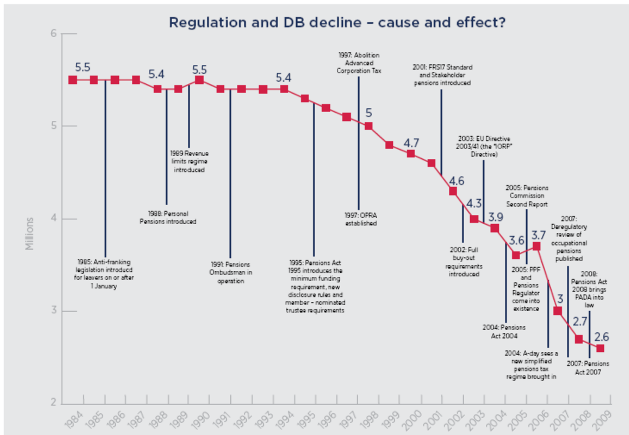
Where are Pension Schemes today?



NAPF: Fit for the future

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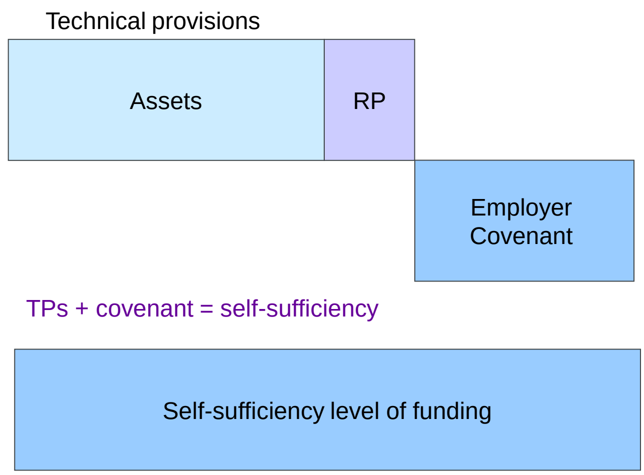
The Pensions Regulator's views



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The Pensions Regulator's views April 2012 statement

- It is a requirement for trustees to calculate technical provisions based on prudent assumptions in relation to their assessment of the employer covenant. This duty applies irrespective of the deficit it may reveal.
- In the regulator's view, investment outperformance should be measured relative to the kind of near-risk free return that would be assumed were the scheme to adopt a substantially hedged investment strategy.
- We do not consider smoothing of the discount rate to be consistent with the legislative requirement to value assets on a mark-to-market basis. We consider asset and liability measures should be consistent.
- Irrespective of the current economic climate, recovery plans should usually be based on what is reasonably affordable without compromising the employer's long term ability to support the scheme. In the vast majority of situations, a strong and on going sponsoring employer is the best support for a scheme.
- As a starting point, we expect the current level of deficit repair contributions to be maintained in real terms, unless there is a demonstrable change in the employer's ability to meet them.

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TPR views - Michael O'Higgins, Chairman, tPR

Professional Pension Show, 3rd October, 2012

"I believe the right balance is being struck in the funding framework"

"Schemes should be looking to maintain deficit recovery contributions in real terms."

"It's our view that the majority of schemes are in a position to make either little or no adjustments to their current plans."

"A significant minority of schemes will find themselves under particular strain and members' benefits will be at greater risk. These schemes may need to make the maximum use of the flexibility in the system to help them through… However, schemes and sponsors need to recognise the challenge and cannot afford to take disproportionate risks with members' benefits."

"The best support for a DB pension is a properly funded scheme supported by a strong employer. While we believe contributions should be made where they are affordable, we do not want trustees to be 'recklessly prudent' in the valuation assumptions they make and in their negotiation with employers. There will be occasions when the right thing to do for the employer and the scheme will be to *invest in the growth of the sponsoring company* rather than making higher pension contributions."

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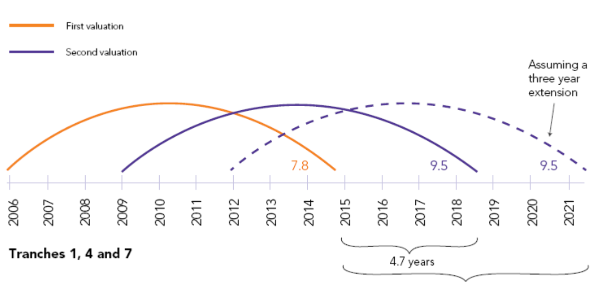
The Pensions Regulator's views October 2012 paper

Schemes have used the flexibility available in setting recovery plan lengths

Average recovery plan length by funding cycle



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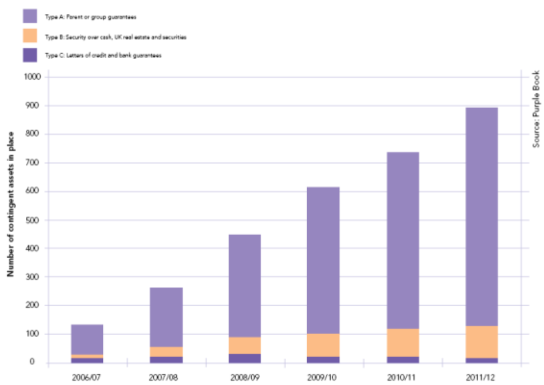
The Pensions Regulator's views October 2012 paper

Alternative forms of support

Schemes have used the option of contingent assets as well as cash contributions



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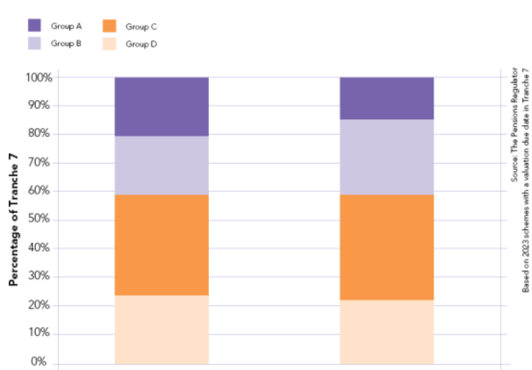
The Pensions Regulator's views October 2012 paper

Tranche 7 DRC impact analysis

Analysis of how current contributions would be affected by estimated funding levels



- Group A: DRC increase above 10% even with a three year extension and weakened recovery plan assumption
- Group B: DRC increase contained to 10% if three year extension applied, but only through weakened recovery plan assumption
- Group C: DRC increase contained to 10% if three year extension applied
- Group D: No need to amend recovery plan.

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The Pensions Regulator's views October 2012 paper

Most schemes will be able to continue with previously agreed plans, or will need to make only slight adjustments. But others will find it extremely tough and will need to make maximum use of the flexibility the system affords. We're working proactively with schemes to understand how we find a way through these difficult cases.

tPR, 10 October, 2012

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Background - UK Government Consultation Pensions and Growth

- Issued 25 January 2013
- Whether to smooth assets and liabilities in scheme funding valuations
- Response by 7 March 2013

- Whether to introduce a new statutory objective for the UK Pensions Regulator
- Response by 21 February 2013

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UK Actuaries Survey (2012)

- 134 of the 151 actuaries who responded to our questionnaire think the current pension funding legislation contains ample flexibility … but that there needs to be more flexibility from the Pensions Regulator
- 100 think interest rates will revert to higher levels than implied by current market yields … but there is a wide range of views about “normal” levels and when interest rates might return to them
- 34 think such reversion should be anticipated in funding calculations
- 13 think interest rates should be smoothed

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What the UK Profession said

- Would not wish to see a regime that permitted arbitrary discount rates that obscure the cost of pension promises
- Smoothing raises concerns
- Vital that all stakeholders work together to ensure all the intended flexibility in the regime is readily available to schemes
- Consistency of asset and liability valuations is important
- Any explicit adjustment to discount rates for the difficult current conditions should be tested against expected returns

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Budget Statement – 20 March 2013

- Smoothing ditched
- Focus on sustainable growth of employers
- The Pensions Regulator will have to take into account employers' growth prospects when considering DB valuations
- Precise wording of new objective yet to be set down

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The Pensions Regulator's views May 2013 statement

- Trustees may need to make greater use of the flexibilities available than needed for their preceding valuations.
- Trustees can use the flexibility available in setting the discount rates. The assumptions made for the relative returns of different asset classes may rise or fall from preceding valuations.
- As a starting point, trustees should consider whether the current level of contributions can be maintained.
- Trustees should allow for an appropriate level of risk to be taken that is neither overly prudent nor overly optimistic.
- We are moving away from setting triggers focused on individual items such as technical provisions and continue to evolve a suite of risk factors as part of our filter mechanism.

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Implications

- Popular with employers (possibly)
- Potential for higher tax revenues for Government
- Lower funding targets ➔ lower security for defined pension benefits
- Failures may be less frequent but more severe.
- Catastrophic claim more likely ➔ a corresponding increase to PPF levies
- A weakened UK regime may increase the likelihood of a European funding standard to protect the security of members' benefits… BUT … EU has postponed / shelved new "Solvency II" rules
- Failure of employers / trustees to agree more likely? Delays?
- Unaffordable benefits may accrue for longer
- **We still need to comply with the TASs**

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Possible outcomes

- More covenant analysis work
- Weaker assumptions for Technical Provisions ?
- Longer Recovery Plans ?
- More flexibility generally ?
- More responsibility on Trustees / Scheme Actuaries ?

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Predictions

- The Pensions Regulator will not ditch basic framework / principles
- New objective will not be allowed as an excuse to reduce funding below already agreed / signed Recovery Plans
- Many employers that most need relief on DB pension funding are not "growth" employers
- The Pensions Regulator will need convincing that all stakeholders are sharing similar pain (so no holding back pension funding whilst dividends to shareholders get a generous increase)
- May have only limited impact overall

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Does it change anything ?

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Discount Rate Framework

"Matching"

- "Matching" (i.e. "Market Consistent") using discount rates consistent with current market value of assets that replicate the future economic behaviour of the liabilities
- Transactions, avoiding arbitrage
- Adequacy of assets, knowing that these can secure assets in market if perfect matching can be achieved

"Budgeting"

- "Budgeting" using discount rates consistent with the expected future returns on the assets held to provide for the cash flows as they fall due
- Planning, based on assumed rates of return
- Funding, where market transactions or market comparisons are neither required nor anticipated

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A plea for transparency

- Main difference between matching and budgeting is extent to which advance credit is being taken of a favourable outcome from an investment view which might or might not come good
  - Magnitude of view; and
  - How much of it is being credited for in advance (i.e. level of prudence)
- Matching and Budgeting should produce essentially same answer if 'expected' relates to matching / replicating portfolio
- How do any differences affect different interested parties?
- And is this clear to them?

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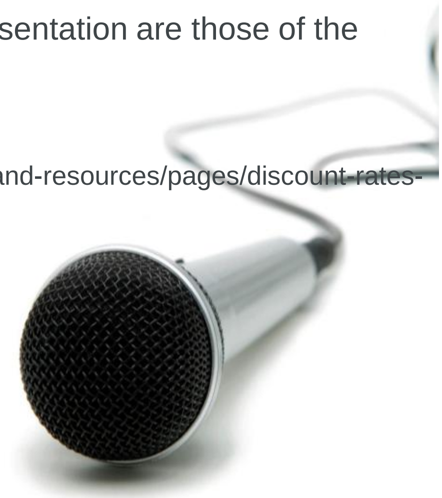
Questions or comments?

The views expressed in this presentation are those of the presenter.

http://www.actuaries.org.uk/research-and-resources/pages/discount-rates-project



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