

The Actuarial Profession
making financial sense of the future

Pensions Conference 2011
Mark Rowlinson, First Actuarial LLP

Schrödinger's pension fund

© 2010 The Actuarial Profession • www.actuaries.org.uk

Question

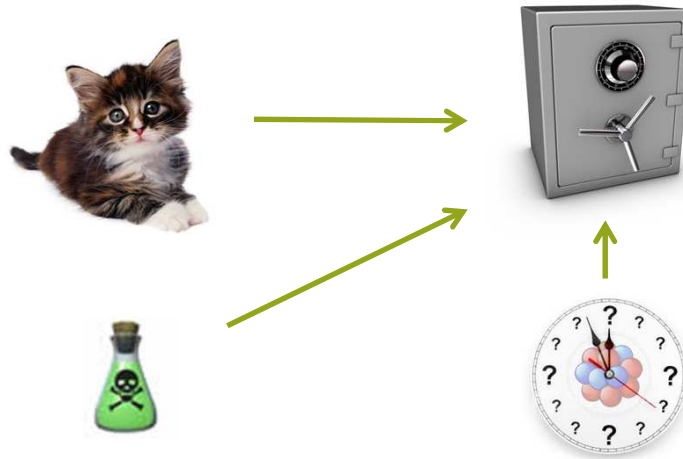
Who thinks that the current funding
framework has got it about right?



© 2010 The Actuarial Profession • www.actuaries.org.uk

1

Schrödinger's Cat



© 2010 The Actuarial Profession • www.actuaries.org.uk

2

Schrödinger's Cat

- Leave the box for a while then ask the question:

Is the cat dead or alive?



© 2010 The Actuarial Profession • www.actuaries.org.uk

3

Schrödinger's Cat

- Cat is dead and alive at the same time (zombie..?)
- Nonsense?
- Schrödinger thought so - intended as a "reductio ad absurdum"
- Shows how bizarre the world of quantum mechanics is.



© 2010 The Actuarial Profession • www.actuaries.org.uk

4

Put an employer in a box

Employer



Is the employer ongoing or insolvent?

© 2010 The Actuarial Profession • www.actuaries.org.uk

5

Put an employer with a pension fund in a box



What funding target is required?

© 2010 The Actuarial Profession • www.actuaries.org.uk

6

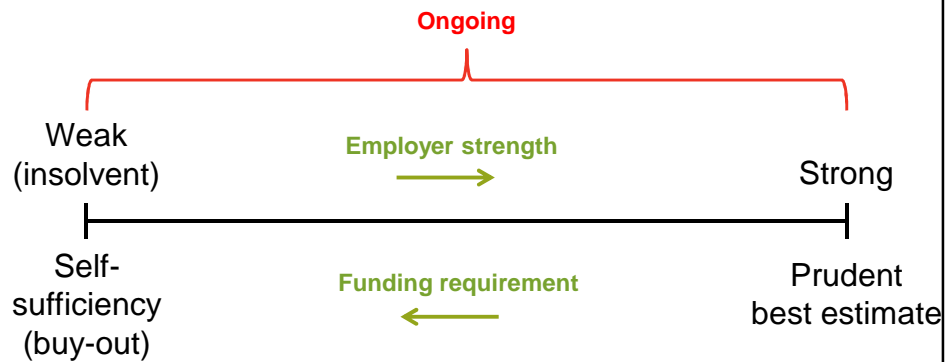
What funding target is required?

- Money comes from the employer so state of employer is crucial
- Employer insolvent:
 - Need buy-out
- Employer ongoing:
 - Best estimate makes sense

© 2010 The Actuarial Profession • www.actuaries.org.uk

7

SFO funding regime/Employer covenant



© 2010 The Actuarial Profession • www.actuaries.org.uk

8

Starting again – a new framework

- State of employer key to amount of money needed
- Only 2 possible approaches to start from
- Need to consider requirements of **key** stakeholders:
 - Members
 - Employer

© 2010 The Actuarial Profession • www.actuaries.org.uk

9

Option 1 – assume insolvent

- Insolvent employer => buy-out funding target
- Ensures money available to buy-out full benefits
- Very good for member security
- From the employer's perspective buy-out very unattractive
 - Huge opportunity cost of tying up cash
 - Ultimately very expensive
- Initially looks like “the answer” – security of benefits is most important
- Is this where we are slowly heading?

© 2010 The Actuarial Profession • www.actuaries.org.uk

10

But....

- Is it really good for members?
 - Cost results in lower pay/employer prospects
 - Member value < employer cost
 - Same cost gives high probability of higher DC pension
- If this is “the answer” then the question would never have been asked.
 - DB inefficient and is not provided if funding target too high
- Even SFO regime need to “over egg” has led to bigger reductions and more closures that might have occurred

© 2010 The Actuarial Profession • www.actuaries.org.uk

11

Option 2 – assume ongoing

- Ongoing employer => best estimate funding target
- Funded in line with expected cost so no opportunity cost
- Employer can provide:
 - Valued benefit
 - Cost effectively
- Some big issues to overcome....

© 2010 The Actuarial Profession • www.actuaries.org.uk

12

Issues with best estimate

- Considering needs of the 2 key stakeholders the big issues are:
- Employer:
 - may be cost effective but stability of cost still potentially a big issue
 - taking on risk
- Members:
 - Valued benefit but what about security?

© 2010 The Actuarial Profession • www.actuaries.org.uk

13

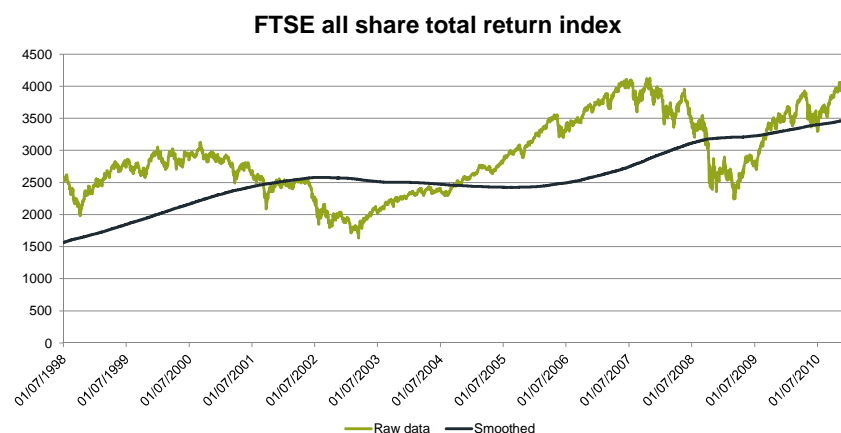
Prudence

- What is prudence?
- A dictionary definition:
 - 1. discreet or cautious in managing one's activities; circumspect
 - 2. practical and careful in providing for the future
 - 3. exercising good judgment or common sense
- Contrary to how we've come to think of prudence it doesn't necessarily mean bias

© 2010 The Actuarial Profession • www.actuaries.org.uk

14

Smoothing is prudent



© 2010 The Actuarial Profession • www.actuaries.org.uk

15

Benefit security

- We already have a solution for this:

the PPF

PPF – why it works

- Charges appropriate levies to reflect risk
- Pays compensation when an employer folds
- Can manage risk via levy rises and in worst case benefit reductions
- Invests for the long term – not run as an insurer
- Cost effective solution since:
 - Not all employers will fold
 - Employers fold at different times

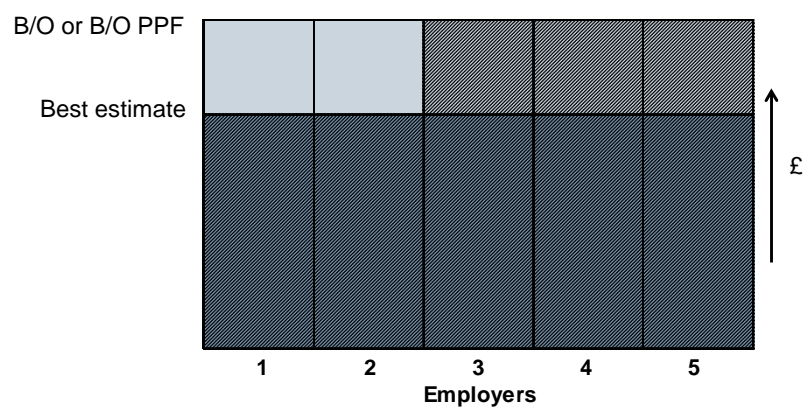
PPF cost effectiveness – example



© 2010 The Actuarial Profession • www.actuaries.org.uk

18

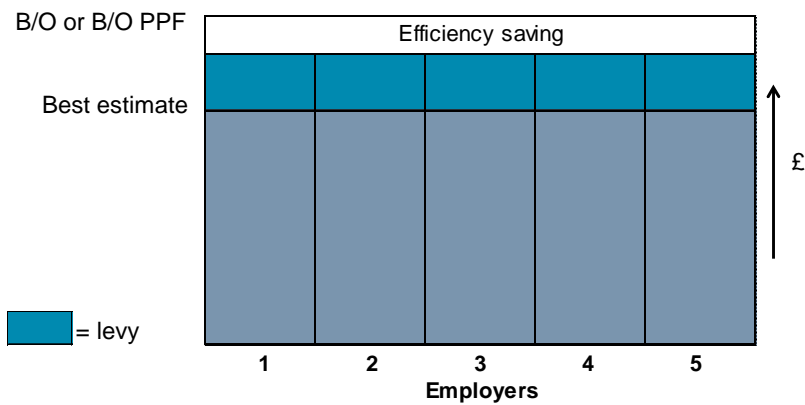
PPF cost effectiveness – example



© 2010 The Actuarial Profession • www.actuaries.org.uk

19

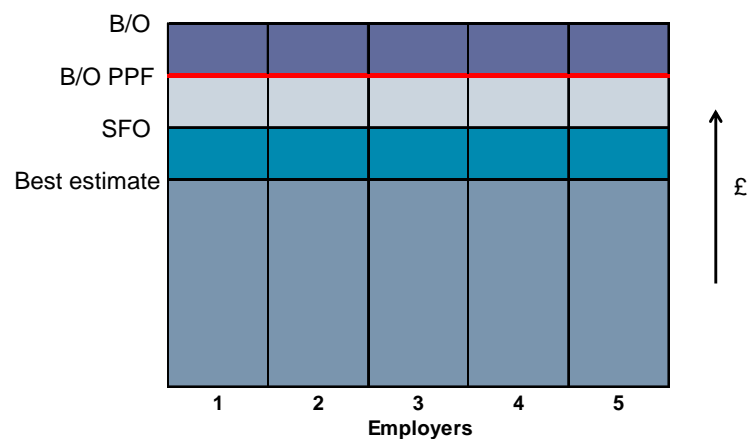
PPF cost effectiveness – example



© 2010 The Actuarial Profession • www.actuaries.org.uk

20

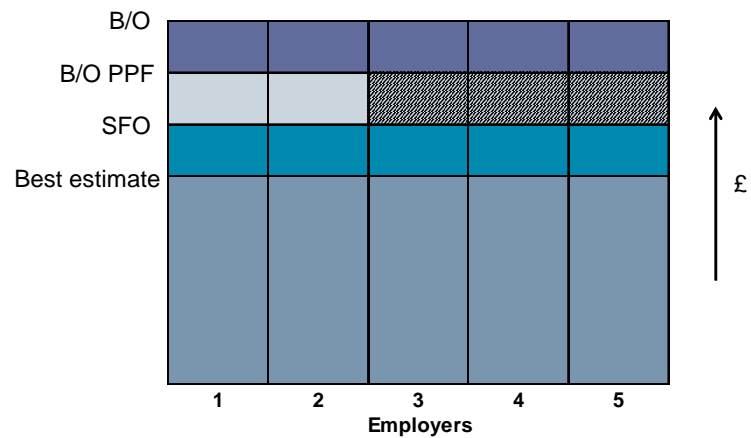
PPF cost effectiveness – current position



© 2010 The Actuarial Profession • www.actuaries.org.uk

21

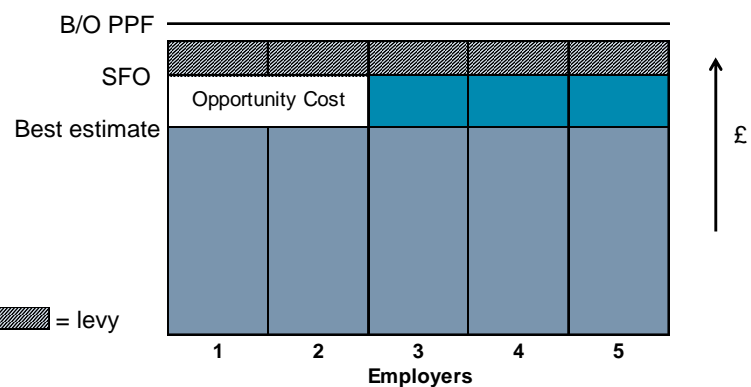
PPF cost effectiveness – current position



© 2010 The Actuarial Profession • www.actuaries.org.uk

22

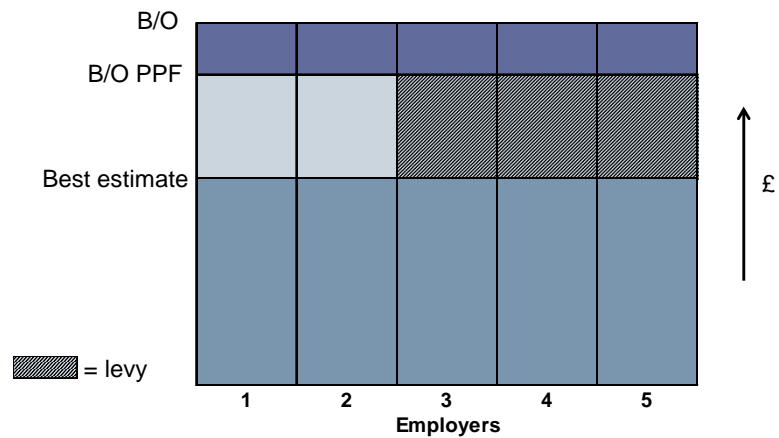
PPF cost effectiveness – current position



© 2010 The Actuarial Profession • www.actuaries.org.uk

23

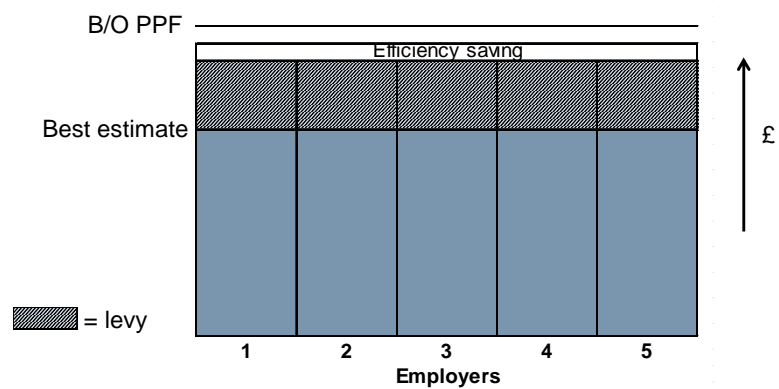
PPF cost effectiveness – fund to best estimate



© 2010 The Actuarial Profession • www.actuaries.org.uk

24

PPF cost effectiveness – fund to best estimate



© 2010 The Actuarial Profession • www.actuaries.org.uk

25

Problem with the current PPF

- They only have one vision of the future:
 - a world with no (private) DB pension schemes
- Will be right if continue as we are with increasing prudence, mark to market accounting/funding volatility etc.
- Funding regime increases insolvencies as weakest employers have both:
 - higher levies to pay
 - higher funding costs
- Run too much like an insurance company

© 2010 The Actuarial Profession • www.actuaries.org.uk

26

PPF cost effectiveness – more efficient PPF?



© 2010 The Actuarial Profession • www.actuaries.org.uk

27

PPF plus

- Private sector covenant insurance?
- More costly but perhaps more flexibility available
- How about a choice of compensation level
 - Perhaps with a statutory minimum of 50%
- Insurance asset recognition? End mark to market accounting by the back door!

© 2010 The Actuarial Profession • www.actuaries.org.uk

28

Alternative view of SFO regime

- Funding regime designed to:
 - primarily protect the PPF
 - help ensure scheme's are funded to guarantee reasonable proportion of benefit.
- Accept this as an approach but it's:
 - Inefficient
 - Opaque
 - Puts a disproportionate cost on weaker smaller employers.

© 2010 The Actuarial Profession • www.actuaries.org.uk

29

Summary: my proposed framework

- Fund to best estimate
- Invest for the long-term
- Smooth assets and liabilities
- Use PPF (or equivalent) to provide security funded by appropriate levies (insurance premiums)
- PPF to act less like an insurer in approach to reflect its nature

© 2010 The Actuarial Profession • www.actuaries.org.uk

30

Question

Who thinks that the current funding framework has got it about right?



© 2010 The Actuarial Profession • www.actuaries.org.uk

31

Question (risky!)

Who thinks my proposed framework is better?



© 2010 The Actuarial Profession • www.actuaries.org.uk

32

Question – does it matter?

Who thinks it doesn't matter – DB is dead and there is nothing we can do about it?!



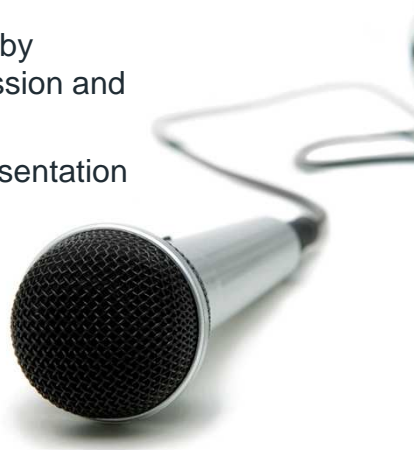
© 2010 The Actuarial Profession • www.actuaries.org.uk

33

Questions or comments?

Expressions of individual views by members of the Actuarial Profession and its staff are encouraged.

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



© 2010 The Actuarial Profession • www.actuaries.org.uk

34

Contact me

- Email: mark.rowlinson@firstactuarial.co.uk
- Twitter: @markjrowlinson
- LinkedIn: <http://uk.linkedin.com/in/markrowlinson>

© 2010 The Actuarial Profession • www.actuaries.org.uk

35

Support me to raise money for the Royal Marines

- My just giving page: www.justgiving.com/mark-rowlinson
- Commando spirit: www.commandospirit.com

