The Actuarial Profession
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Pensions, benefits and social security colloquium 2011

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Capital Requirements and the Role of the Sponsor

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Capital Requirements and the Role of the Sponsor

- Trustee perspective
- Employer perspective
- Issues for the Financial Advisor
- Issues for the Corporate Treasurer

Trustee perspective

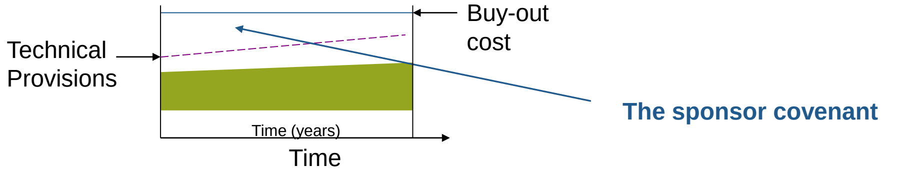
- Reliance on sponsor covenant
- How to assess covenant and mitigate a weak covenant
- How does it impact on funding assumptions?
- How does it impact on investment strategy?

Reliance on sponsor covenant

- The equivalent of capital for an insurance contract
- The “Solvency II” debate has clarified this concept, but may lead to calls for quantification
- “Missing capital” is **at least** the gap between current funding and self-sufficiency

Sponsor covenant risk

•Almost all schemes have some exposure to the sponsor covenant
•The sponsor covenant operates in lieu of solvency capital



Reliance on sponsor covenant

- The equivalent of capital for an insurance contract
- "Missing capital" is **at least** the gap between current funding and self-sufficiency
- May not need to be precisely valued
- **If insufficient, cannot easily be remedied**

How to assess covenant and mitigate a weak covenant

- Well understood methodology
  - **On an ongoing basis**: effectively the employer's ability to generate cash and to direct this towards ongoing requirements and deficit repair
  - **In the downside**: effectively the scheme's ability to secure benefits out of insolvency process
- Regulatory guidance
- Various forms of mitigation have been used
- Issues vary case by case

How does it impact on funding assumptions?

- Current approaches are crude
- More sophistication should be achievable
- The issue is where the assumptions should lie between prudent best estimate and self-sufficiency

How does it impact on investment strategy?

- Typically assumptions are driven from the actual or intended asset allocation
- Asset allocation itself is usually driven by sponsors' risk appetite, and not often properly integrated with Enterprise Risk Management .....
- .....whereas Trustees/ Plan administrators should be pushing for close liability hedging
- Conflicting agendas need to be reconciled

Employer perspective

- Risk exposure – current and future
- Mitigation – benefit reduction, scheme closure etc
- Risk reduction – investment (inflation, interest, equity); longevity; operational

Risk exposure

- Current and future
- Inevitable maturing of the scheme
- Acceptance that pensions are a “legacy liability” demands a planned route to self-sufficiency

Mitigation – benefit reduction, scheme closure etc

- Restriction of discretionary benefits
- Closure of schemes to new entrants
- Closure of schemes to future accrual
- Renegotiation of terms, retirement age etc
- Enhanced transfer value offers

Risk reduction

- Investment hedging
  - Inflation swaps
  - Interest rate swaps
  - Equity alternatives
- Longevity hedging
- Operational risk addressed through better governance

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Issues for the Financial Advisor

- Risk of employer default – how to model it?
  - Various approaches exist – but for different purposes
- Relative value of cash, promised cash and contingent assets
  - Need to move beyond "time value of money" and think more like bankers
- Overall risk assessment – how to combine sponsor risk, investment risk, longevity risk
  - Current approaches are simplistic or simplified

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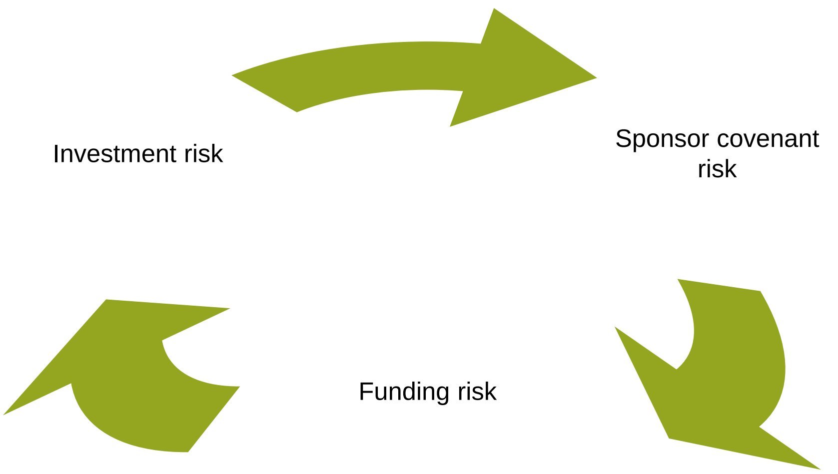
How to combine sponsor risk, investment risk, longevity risk



Issues for the Corporate Treasurer

- How to optimise the situation?
- Value for money for money spent on deficit reduction vs. risk reduction vs. investment in the business
  – Needs an “internal rate of return” to be calculated – not easy!
- De-risking – buy-in, buy-out, hedging
  – Covered in the second part of the session
- Economic vs. actuarial cost of de-risking
  – Non-actuarial considerations include market perception, share price, credit rating, management focus

Conclusion

- A more holistic approach is needed by both Trustees and Sponsors