The Actuarial Profession
making financial sense of the future

Current Issues in Pensions - April 2013
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Funding in the current climate

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Overview

- Introduction
- Current areas of debate/contention
- Case studies
- Interactions with TPR

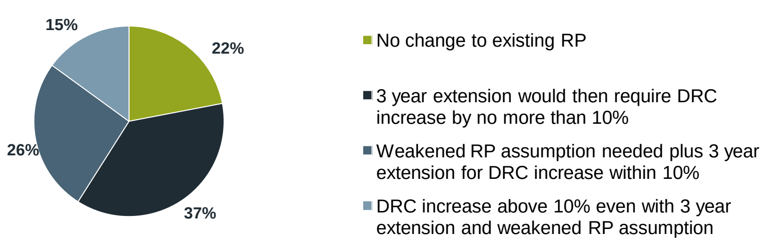
- Keen to hear your views / spark debate

Challenging times

- Market conditions have led to a higher deficit
- Results often not showing benefit of significant deficit contributions
- Employers do not want to see larger deficits and higher contribution requests…
- …and some trustees are scared to present them?

Not all bad news

- There is flexibility in the system
- Some schemes are coping fairly well



Source: The Pensions Regulator
'The Defined Benefit Regime – Evidence and Analysis' (October 2012).
Analysis relates to Tranche 7 (Sept 2011 – Sept 2012) valuations

Case Study 1

- Mature scheme, closed to accrual
- 2008 valuation
  - Weak covenant
  - Deficit of £100m; liabilities of £500m
  - Affordability constraint of £8m per annum

- Key question – how to set a suitable schedule of contributions?

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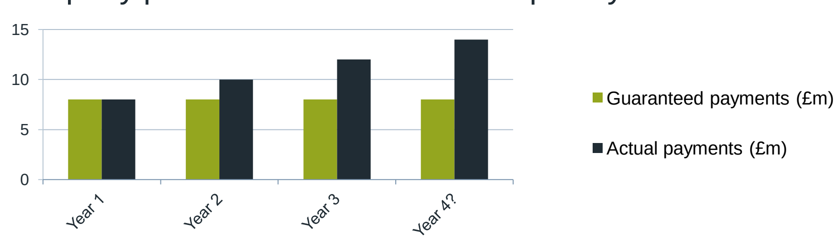
Case Study 1 (continued)

- Agreement of:
  - Fixed deficit contributions of £8m for 14 years
  - Additional £2m if disclosed EBIT trigger met
  - Additional pro rating if dividends increase above current level
- Company performed well over subsequent years



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Case Study 1 (continued)

- 2011 valuation
  - Stronger covenant
  - £90m deficit, £500m of liabilities
  - Trustees want higher fixed contributions
- Agreed on:
  - £16m per annum for 7 years
  - Plus more if any special dividends paid

Despite market conditions, now have a reduced deficit and a recovery plan due to end three years earlier than that agreed in 2008.

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Current Areas of Debate: Discount rates

- Trustee view:
  - Gilt yields lower but no guarantee they will rise
  - Generally reduced view of investment returns across all asset classes
  - Reasonable to retain previous ‘gilts plus’ approach
  - Larger deficit may simply mean a longer recovery plan if comfortable re affordability
  - But the figures look unpalatable…

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Current Areas of Debate: Discount rates (2)

- Employer view:
  - Lower gilt yields are irrelevant to expected equity returns
  - Looking at expected returns (eg. a ‘growth + RPI + risk premium’ argument) suggests a much higher discount rate
  - In any case, gilt reversion raises the prospect of trapped surplus if fund on the trustees’ proposed basis
  - Argue for much lower deficit and much lower contribution demands

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Case Study 2

- £130m liabilities, deficit around £45m
- Scheme much larger than Employer
- Using “gilts plus” assumptions
- Independent covenant assessment ‘moderate’

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Case Study 2 (continued)

- Employer argued that covenant ‘strong’
- Employer’s actuary proposes “equity returns basis”
- Trustees estimated company proposal to be in lowest 1% of bases
- Trustees rejected proposals
- Impasse until statutory deadline

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Case Study 2 (continued)

- Employer caved in…withdrew assumptions proposal
- Focused on cash contributions
- Deal still possible but outside of 15 months
- TPR currently awaiting resolution before commenting

Covenant and negotiation key factors

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Discuss

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Current Areas of Debate: Change of investment strategy

- Increasingly looking at different asset classes in pursuit of returns
- How should this affect valuation assumptions?
  - Lower volatility implies less downside risk hence higher margins over gilts?
  - Reduced upside potential means lower margins?
  - Don't forget expenses
- Long term or short term solution?

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Current Areas of Debate: Employer covenant

- Are trustees basing investment strategy on employer covenant?
- If cannot support downside risk then should they be pursuing this strategy?
- Increased pressure from sponsors for more/prolonged growth investment
- Often a cause for TPR queries (rather than inconsistency between strategy and returns)

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Discuss

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Other areas of debate

Inflation
(including RPI v CPI)

Flight paths
to buy-out / buy-in
(Secondary funding
targets?)

Mortality?

Others?

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TPR – current role in funding

- Continues to emphasise (and apply) flexibility and 'scheme specific' funding
- Continues to emphasise importance of assessing employer covenant and setting a funding plan accordingly
- Will continue to challenge cases that raise potential concerns
- If TPR would be concerned, perhaps trustees *should* think twice…

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TPR – evolving views

- Starting to work proactively – yet sometimes unwanted!
- Continues to adjust views based on experience and conditions
- 2013 valuation statement expected soon

Further questions or comments?

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

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