The Actuarial Profession
making financial sense of the future

4th Younger Members Convention
Funding Defined Benefit Pension Schemes

The City Hall, Cardiff, 5 December 2005

Funding Defined Benefit Pension Schemes

Agenda

- The debate at the Institute / Faculty Sessional meetings
- New Guidance Notes
- New Regulations
- New Pensions Regulator
- What does the future hold?

Institute / Faculty debate

A Critique of Current Advice

Funding Targets

- Use of discount rates in excess of gilt yields (but no allowance for extra risk)
- Smoothing adjustments (hiding mismatching risks)
- More risk implies fewer assets
- Strength of funding affected by assuming trustee still taking risk in 20 years
- Re-spreading of deficits means that the actual period of spreading is much longer than the period quoted (indeed the deficit may be spread indefinitely)

Adequacy and Affordability

- Pension debt already exists, markets can accommodate changing capital structures of firms / pension schemes
- We conclude that many current approaches risk giving the impression that a pension scheme is strongly funded with a low risk investment strategy when the reality is the opposite

Institute / Faculty debate

Principles for Funding Advice

1. Actuaries should use a solvency measure to value liabilities
2. Funding advice should disclose the broad impact of priority rules
3. Funding objectives should be well-defined
4. Funding targets should be described unambiguously in terms of solvency
5. Highlight if contributions are insufficient to maintain solvency
6. Reserve fully for options
7. Consider reliance to be placed on company covenant
8. Full disclosure of amortisation methods
9. Disclose projected solvency position at next valuation
10. Advise on contributions only up to next valuation

Institute / Faculty debate

Trustee Governance

- Trustees face many conflicts
- Trustees often have powers they choose not to use
- We believe that the trustee system is the primary source of governance failure

Company Incentives

- Pension accounting standards have distorted company incentives
- Analysts and shareholders do not fully understand pension risks
- Companies wish to avoid surpluses

Conflicts for Actuaries

- PCS states "*clients are entitled to assume that advice given by a member is unaffected by interests other than those of the client*"
- We support the proposed independent Actuarial Standards Board

Institute / Faculty debate

Findings

- Security is primary reason for funding
- Much better disclosure and analysis of solvency is required
- Pension liabilities are corporate debt and deficits are self-investment
- Creditworthy companies should favour a high level of funding and pension scheme investment in bonds
- Strong companies should fully fund pension schemes; weak companies should already have fully funded pension schemes

Actions

- We recommend Actuarial Profession should adopt our ten principles in GN9
- Much more care and thought to be given to the calculation and disclosure of solvency (particularly to members)

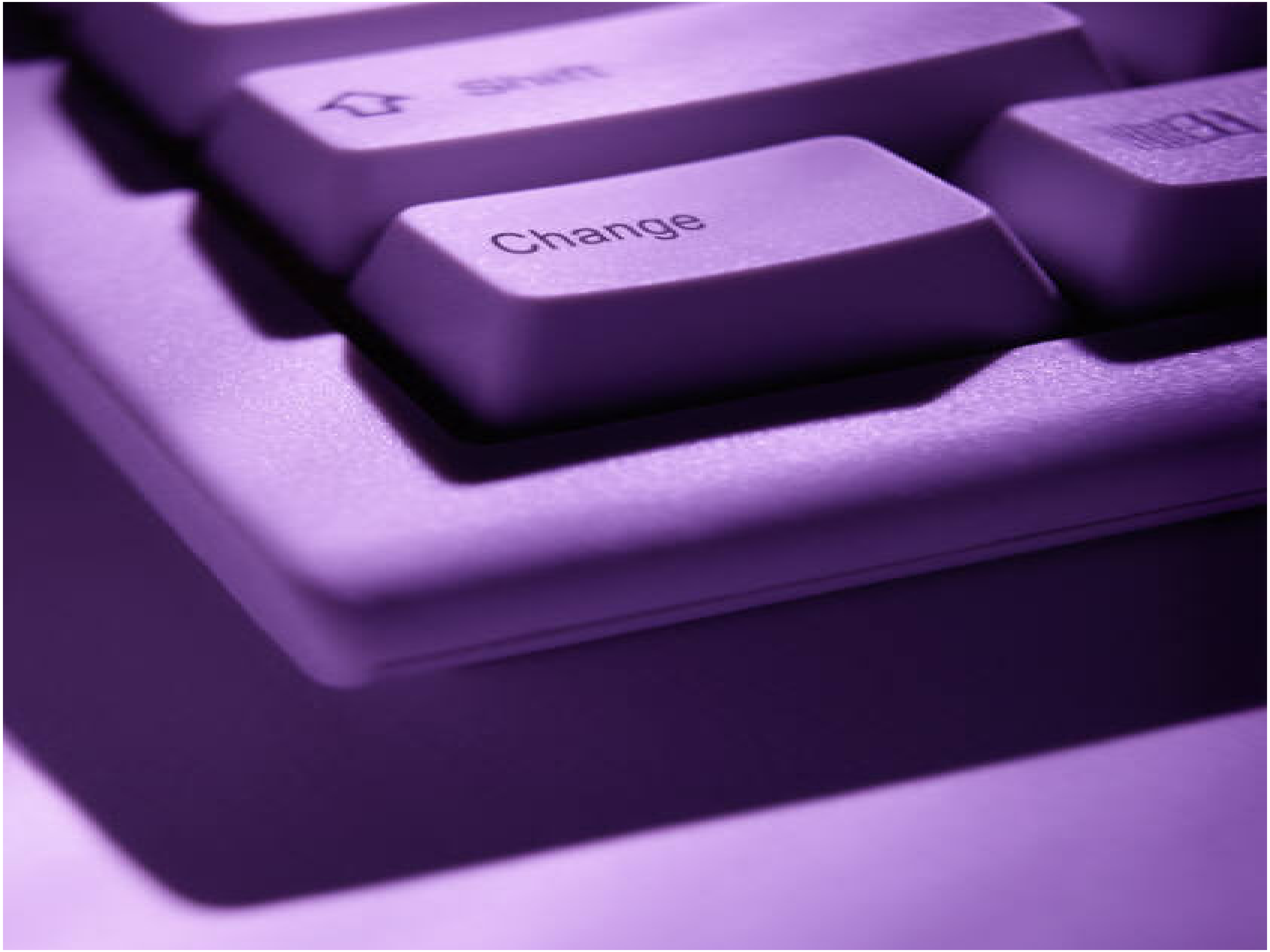
New Guidance Notes

EXD 55 (new GN9)

- Advice on evolving solvency position to be given sufficiently early to impact on development of funding objectives / strategy
- Disclose projected solvency position over at least 3 years
- Funding objectives should be well defined
- Funding advice should disclose the impact of priority rules
- Actuaries no longer to recommend a contribution rate
- Highlight assumptions on options
- Must comment on company covenant and risk of failure

Timetable

- Follow regulations
- End 2005 ?



Change


Trigger


Ask the Company to increase its contributions? I never heard that!
of interest?
ee any
Tell members the solvency level of the scheme? I don't think so!

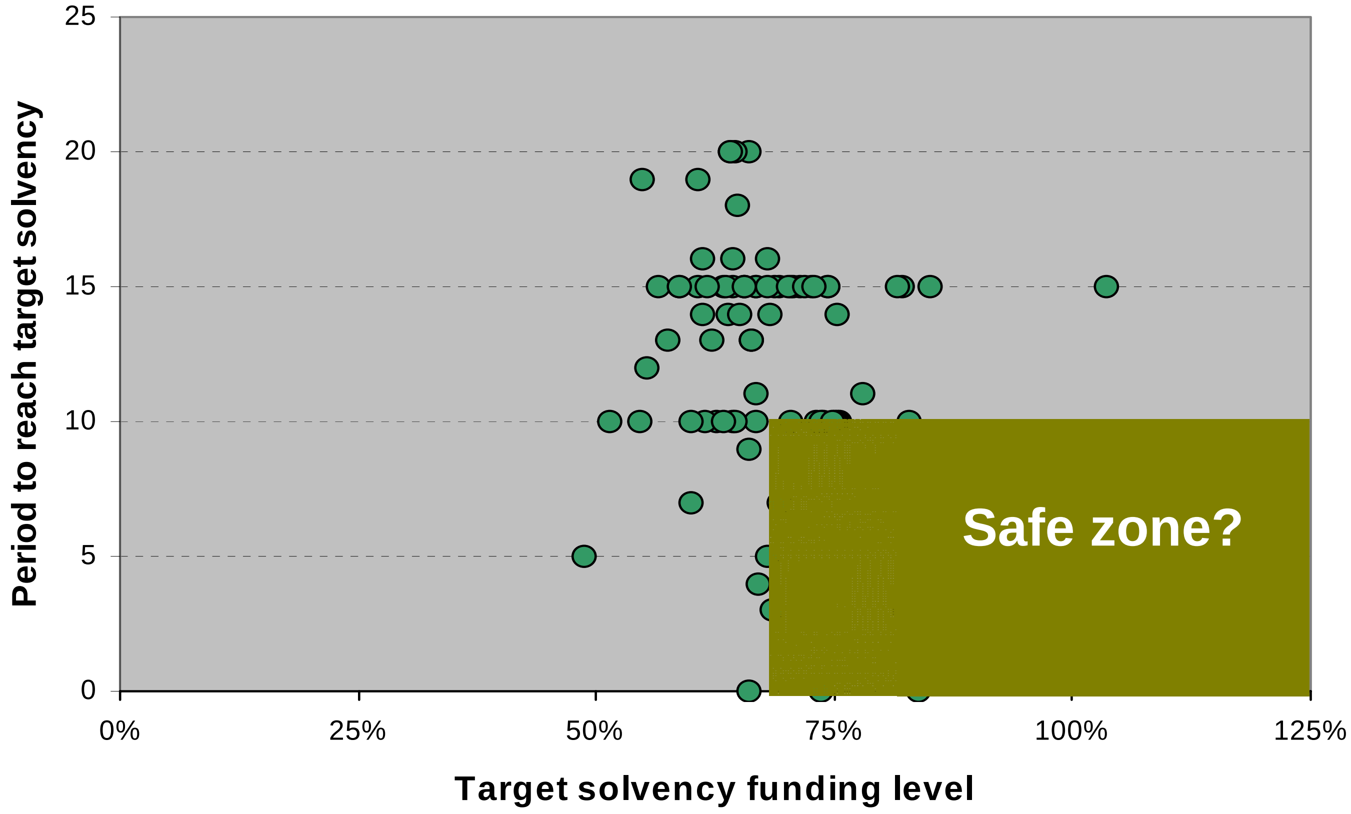
The Pensions Regulator

- *"A pension scheme in deficit should be treated in the same way as any other material unsecured creditor"*
- *"The pension scheme is a key company stakeholder. Trustees should be given access to information and decision makers; in return they should accept confidentiality responsibilities"*
- *"trustees should learn from the way a bank with a large unsecured loan would look to negotiate with a company"*
- *"[trustees] should monitor corporate activity and seek the employer's agreement to be given information at an early stage subject to the usual restrictions such as those on handling price-sensitive information"*

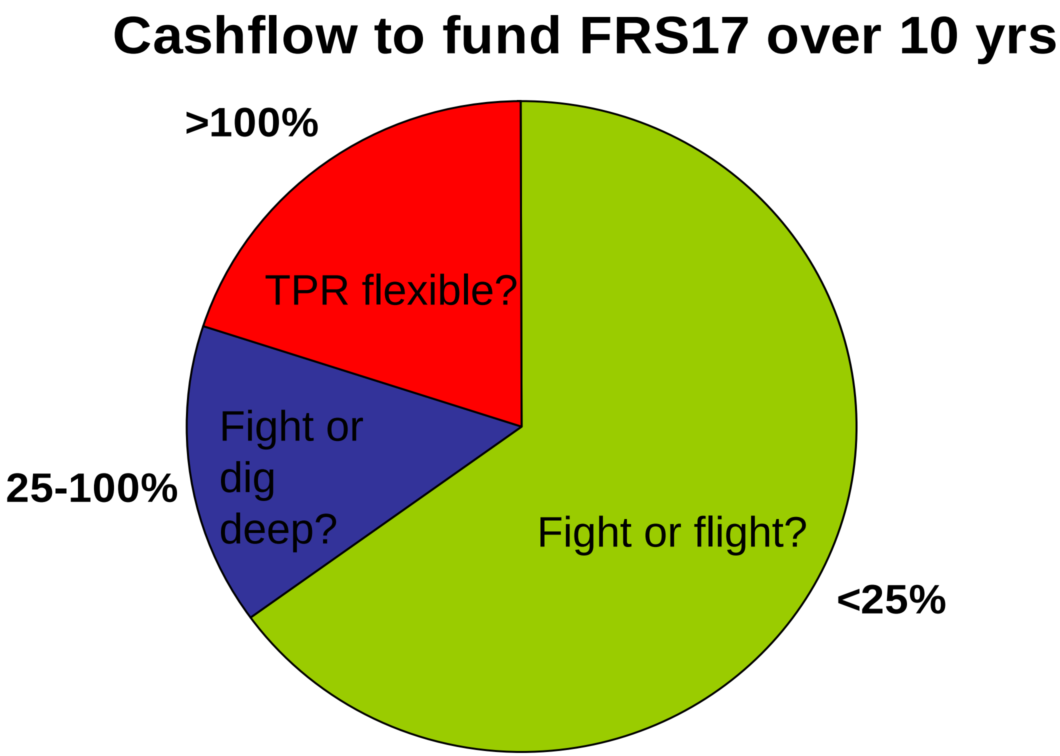
TPR supervision

- Triggers for intervention
  - 70-80% buyout target
  - >10 year spreading period (or less…)
- Scheme-specific trigger based on
  - Covenant/maturity
  - FRS17/PPF positions
- Recovery plan uncertainty
  - Pressure to reduce from 10 years
  - Allowance for investment performance

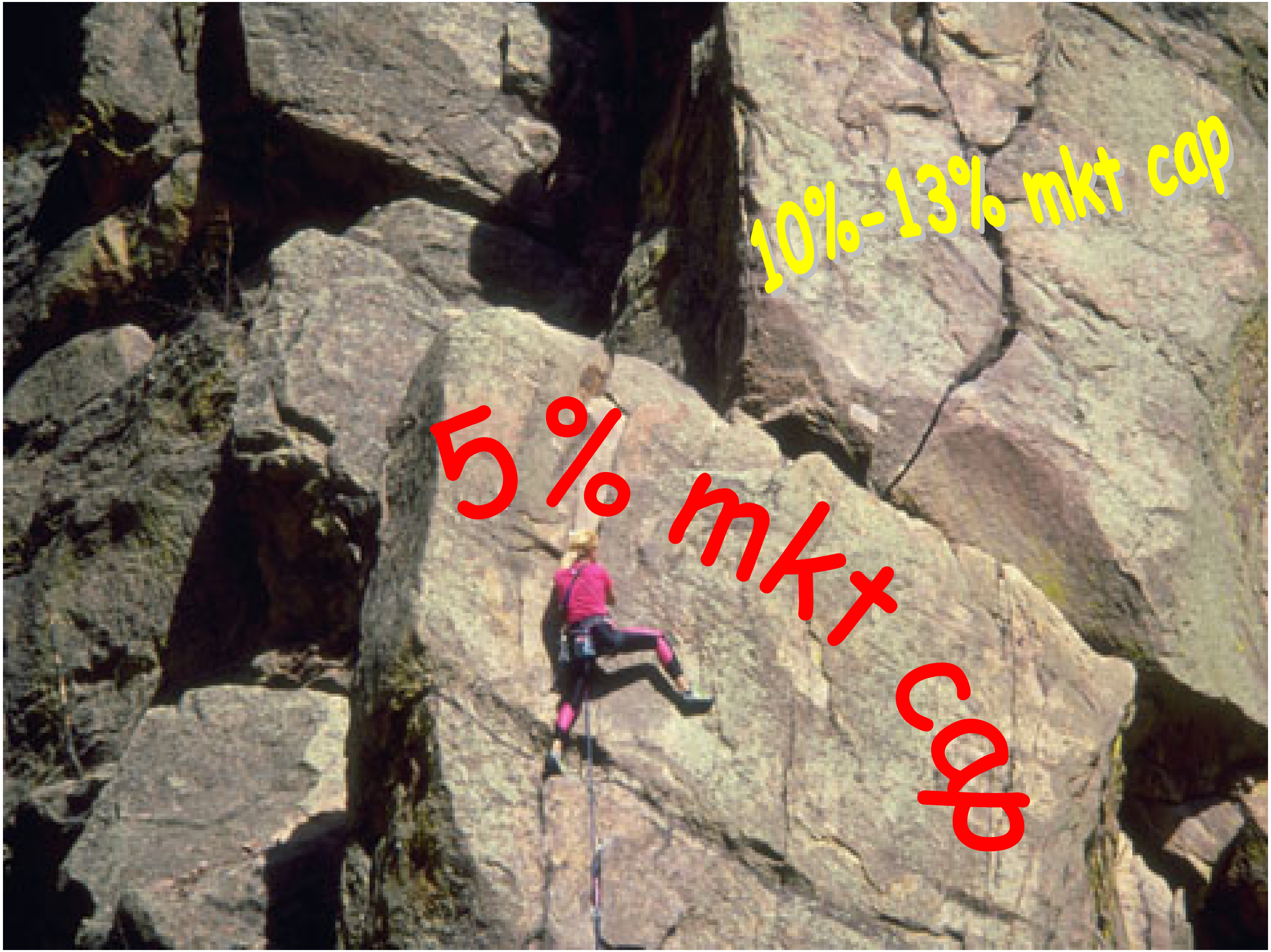
Pension Scheme Funding

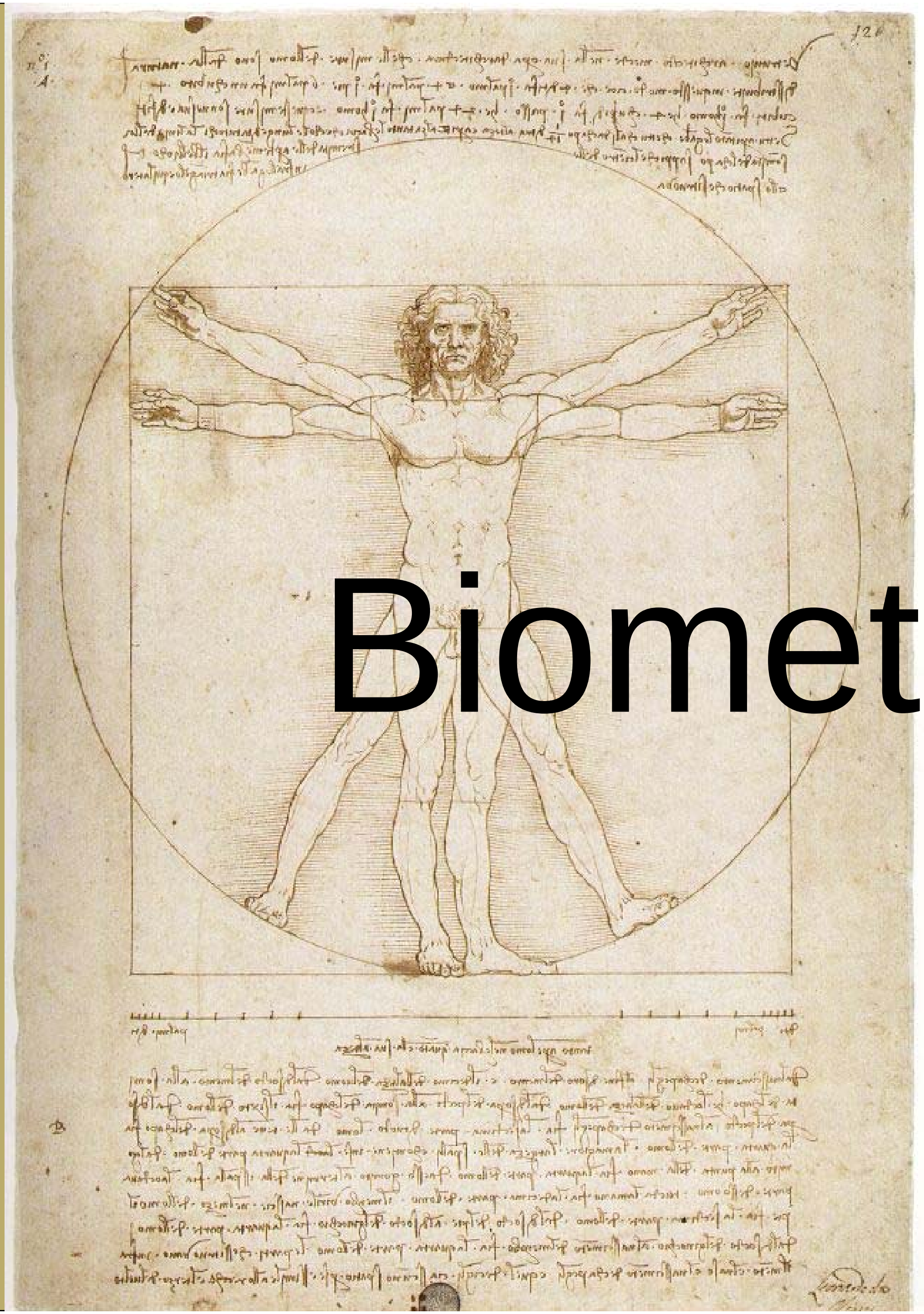


TPR’s impact analysis




£175 billion
£76 billion


10%-13% mkt cap
5% mkt cap



Biometrical risk

PPF next steps

- Early December – announce levies
  - Total levy
  - Scaling factor
    - PPF cheap capital?
  - Contingent assets
- New year
  - End of consultation
- 28 February = last date for contributions
- 31 March = L-Day

Trustee needs

Understand	Analyse	Decide
Regulation	Employer's position	Conflict management
Trustee powers	Employer risk vs funding/investment risk	Acceptable outcomes
Meaning of financial strength	Can't pay/won't pay	Independent advice

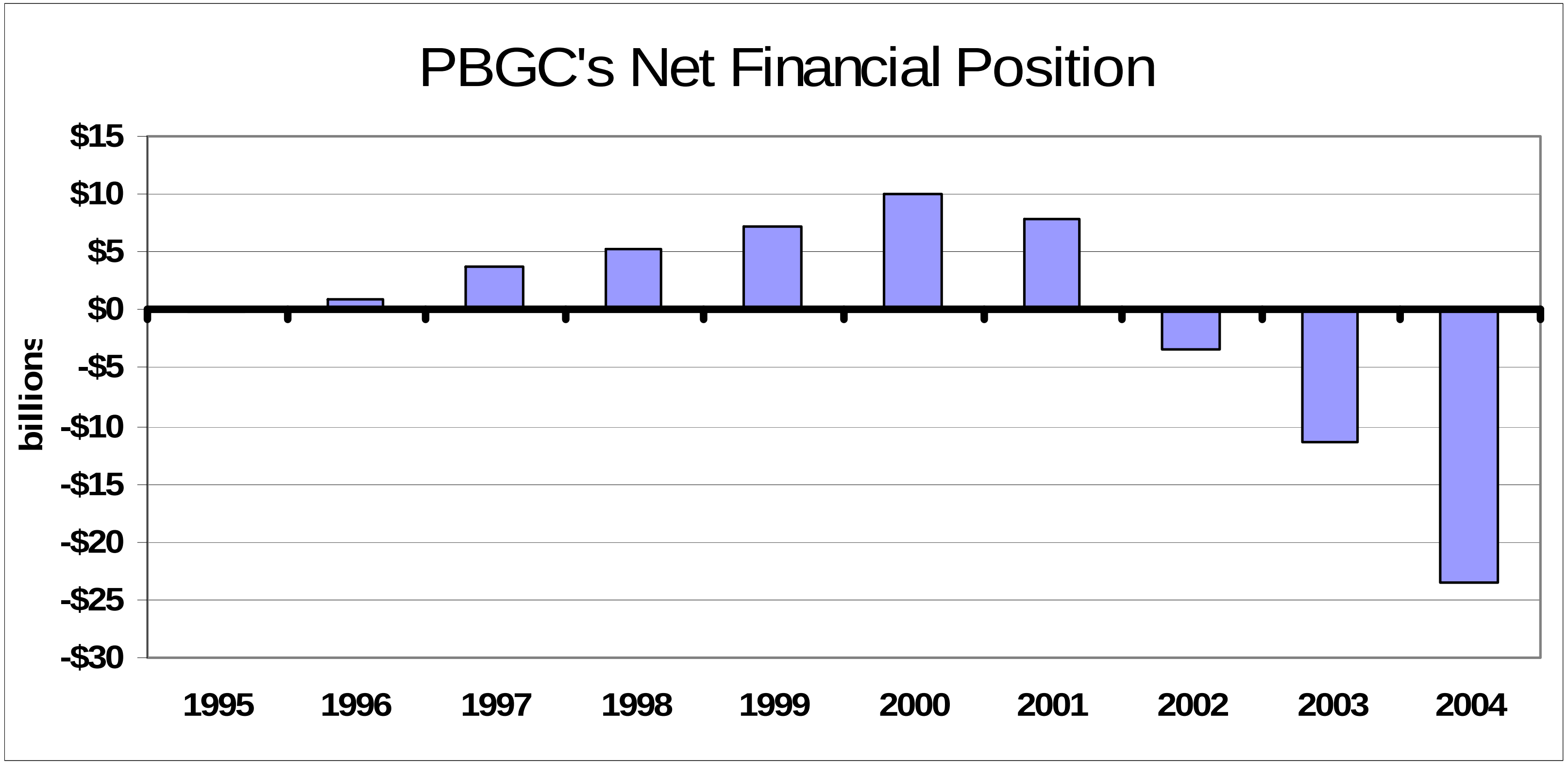
Company needs

Understand	Analyse	Decide
Regulation	Trustee's position	Conflict management
Trustee powers	Optimal funding strategy	Acceptable outcomes
Impact of pension scheme	Optimal level of investment risk	Independent advice
Tax issues		

Market Trends ?

- WH Smith Pension Fund
  - 94% LDI Fund + 6% Equity derivatives
- Ericsson / Marconi
  - Ericsson to pay £1.2bn in cash
    - Acquire bulk of Marconi's business (including 6700 employees)
    - Marconi shareholders to get £577million cash (275p per share)
    - Pension Scheme to get £185million
    - £490million to be placed in an escrow account to cover future pension liabilities
  - Remaining business to be renamed Telent
    - Unit servicing network, with profits of £37m on revenues of £336m
    - Left with the [£3bn] Marconi Pension Scheme
    - Left with net cash of ~£220million, largely required for legacy liabilities

Lessons from America




Trustees
Company

New GN9 (2020 ?)

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