The Actuarial Profession
making financial sense of the future

Current Issues in Pensions
Donald Duval , Malcolm Paul

This House believes that the Current Funding Regime is Not Fit for Purpose

Format

- Introduction – Chair
- For the Motion – Donald Duval
- Against the Motion – Malcolm Paul
- Open Discussion
- Summary – Malcolm Paul
- Summary – Donald Duval
- THE VOTE

Donald Duval

The Current Funding Regime is Not Fit for Purpose

Or rather, how tPR interprets makes it not fit for purpose

tPR has an unhealthy obsession with Gilts …

Advice on assumptions

79. The following matters relating to the assumptions

should be covered by actuarial advice and discussed with the employer:

…..

the current price of UK government securities and the information this provides about the expected return on investments which are low risk in relation to the liabilities;

…..

the trustees' investment policy and the extent to which the expected returns on, and the risks associated with, actual investments held should be reflected in assumptions about investment returns;

Equity out-performance

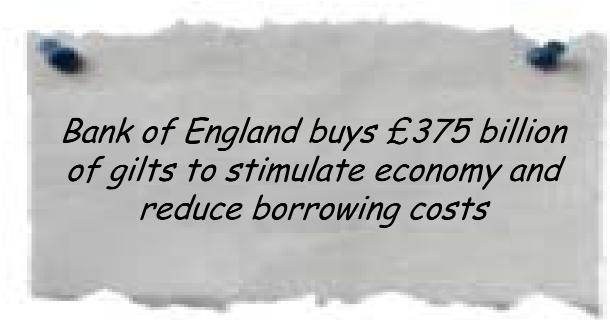
92. Prudent assumptions could allow for some degree of out-performance of scheme assets relative to bonds depending on the specific circumstances of the scheme.

i.e. the "gilts plus" mentality

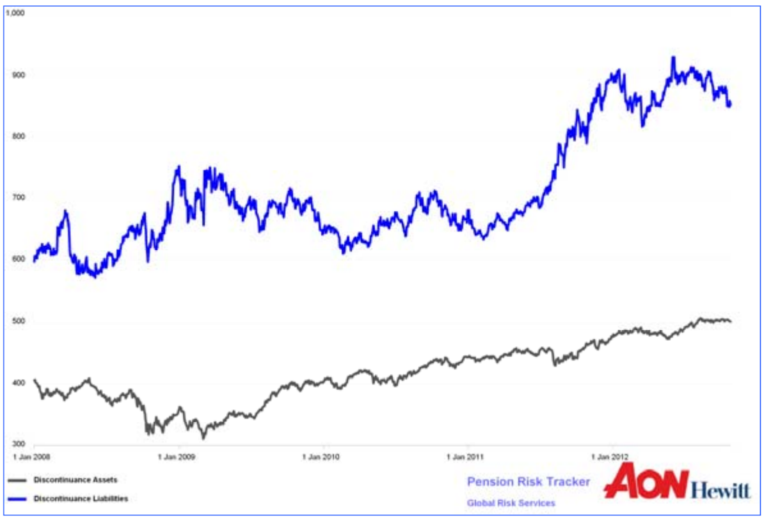
And we all know gilts are distorted …


Pension scheme funding in the current environment

4. Long dated index-linked gilt yields are at an all time low due to a combination of economic factors driving down their yields. These include supply and demand issues and the perception of UK bonds as a safe haven, as well as the Bank of England's quantitative easing (QE) programme.



So liabilities are out of control ….



Have liabilities increased from £600 bn to £900 bn – or is this just a distorted measurement tool?

This makes a difference in the real world


The Telegraph

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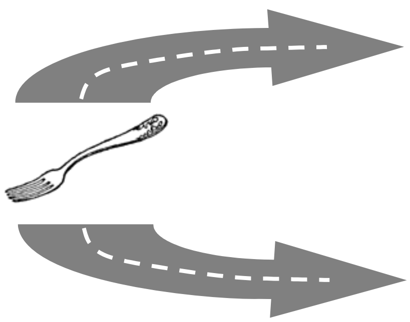
Smiths Group warns Bank of England's money printing is hindering investment

Smiths Group, the FTSE 100 engineering and technology company, has warned the Bank of England's quantitative easing programme is forcing it to pump money into its pension pot that could otherwise be spent on investment and shareholder dividends.

QE having the exact opposite of its desired effect !

Plenty of ways to deal with Low Gilt Yields



Technical Provisions

Gilts plus rather more

Recovery Plan

Allow for gilt reversion

*20. **Any strongly held views about future financial market conditions should therefore be accommodated in the recovery plan (rather than the technical provisions)** where they are more clearly identified and mitigated should the assumption turn out to be false.*

But Technical Provisions matter …

- Firstly, huge jumps in the deficit can ‘**spook**’ sponsors and trustees, prompting them to question whether they can continue to support the scheme;
- Secondly, where details of the valuation are in the public domain, this can then damage corporate **credit-ratings**, with all the consequences that brings; and
- Finally, the size of the scheme deficit does have a real bite, to the extent that any recovery plan subsequently agreed to fill the deficit leads to **higher sponsor contributions** into the scheme than would otherwise have been the case.

CBI lobbies for cut in cost of pensions

Financial Times

The UK Treasury should persuade the Pensions Regulator to use a higher discount rate than that prevailing on gilts currently when calculating liabilities for final-salary retirement schemes, in order to facilitate reduced contribution and insurance costs for employers, the Confederation of British Industry has said.

Jim Bligh, head of labour market policy at the CBI, said that the employers' body is also seeking an amendment to the Pensions Act of 2004 so that the pension watchdog is mandated to make "promoting growth" as one of its policy objectives.

Finally, the CBI is lobbying with the Treasury to convince the Pension Protection Fund to include the period before record-low interest rates took effect in its calculation of premiums that each scheme must pay, Bligh revealed.

The biggest issue is Inertia …

- Use the same “Gilts plus” as last valuation
  - Trustees and anchoring
  - Actuaries and anchoring
  - tPR and anchoring

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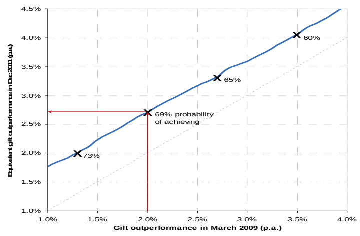
July 22, 2012 4:43 am

Lobby for ‘smoothing’ gathers pace in UK

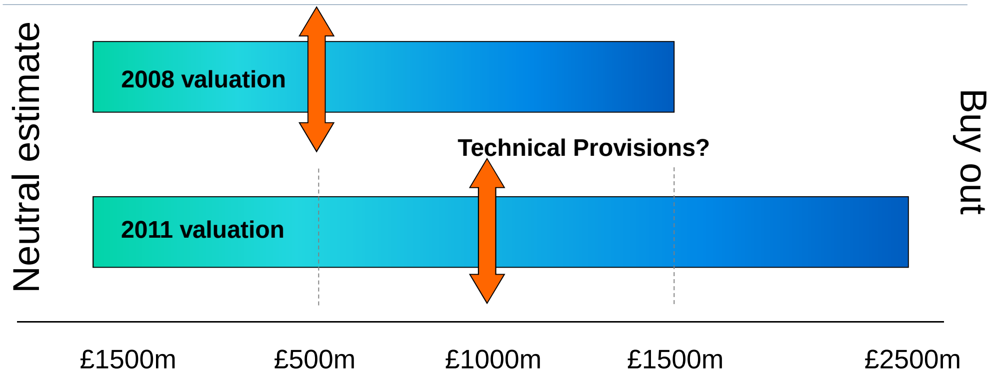
More than six in 10 UK pension scheme trustees would like to see the Pensions Regulator give them additional flexibility to iron out short-term market movements when calculating their scheme's funding level.

The growing calls from trustees and a number of industry bodies for so-called "smoothing" follows recent relaxations of pension scheme funding regulations in Europe and the US.



We need explicit recognition that these are exceptional times, that have an adverse impact on our current approach to valuing liabilities

Inertia leads to extra prudence



Relative to Best Estimate – this is an Extra £500m of (unwarranted) prudence

Everybody else is doing it …

The Moving Ahead for Progress in the 21st Century Act (MAP-21) is a funding and authorization bill to govern United States **federal surface transportation spending**. It was passed by Congress on June 29, 2012, and President Barack Obama signed it on July 6

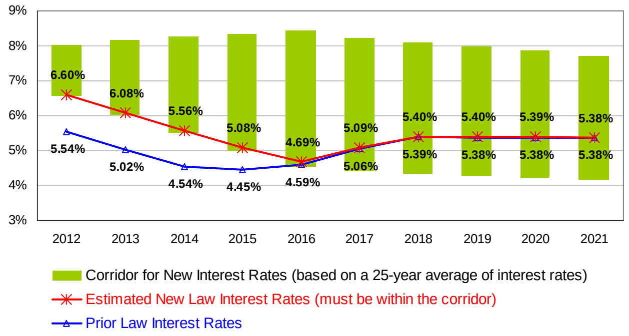
Several unrelated provisions were attached to the bill: A one-year extension of federal **student loan** rates through June 30, 2013; a five-year reauthorization of the national **flood insurance** program through 2017; and a one-year extension to the Secure Rural Schools Act, which compensates rural counties for loss of revenue caused by **reduced timber harvest** on federal lands.

MAP-21 is funded without increasing transportation user fees. (The federal gas tax was last raised in 1993). Instead, funds were generated through the following measures:

….

Change the interest rate that pension plans use to measure their liabilities….

Theory (?) and Practice



Estimated Projected Interest Rates Assuming May, 2012 Rates Rise 100 Basis Points in 2015

"We expect that near-term cash contribution requirements could decline by 30% or more for some plans through 2015 compared to the requirements under the prior law"

And all the others ….

Sweden

Finansinspektionen consults on a "temporary floor" on discount rates

Netherlands

An Ultimate Forward Rate of 4.2% in line with Solvency II

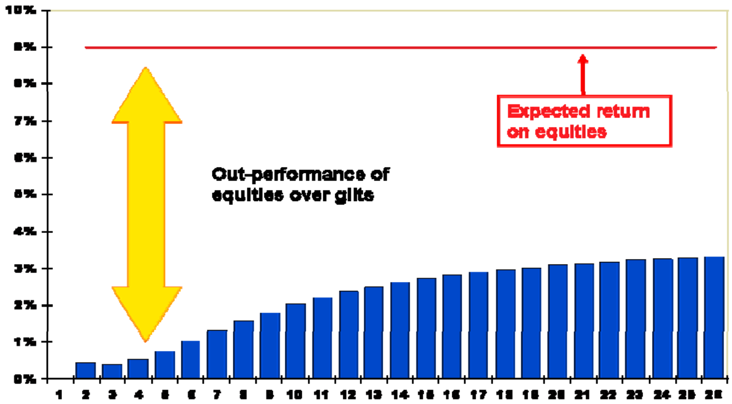
Denmark

Pension funds and insurers use "normal market conditions" of 4.2% UFR

UK

"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"

Realistic Recovery Plans ??



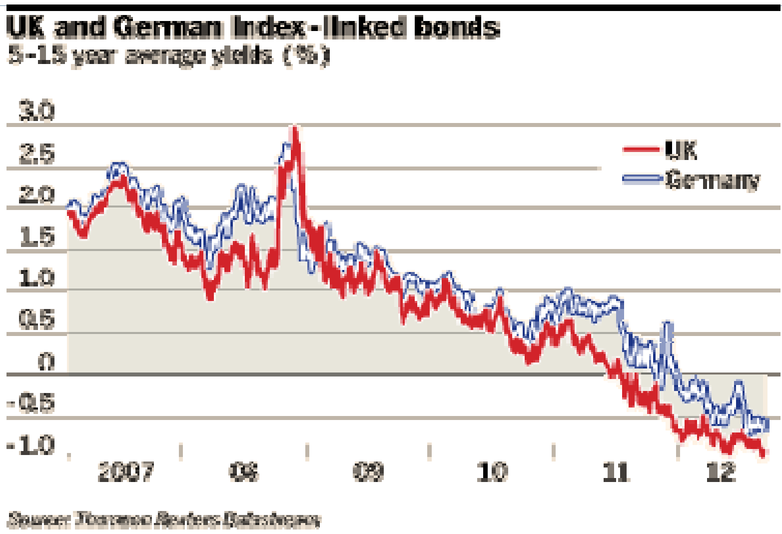
"We have a huge deficit but are paying no (extra) contributions since everything will come good in the end…"

Malcolm Paul

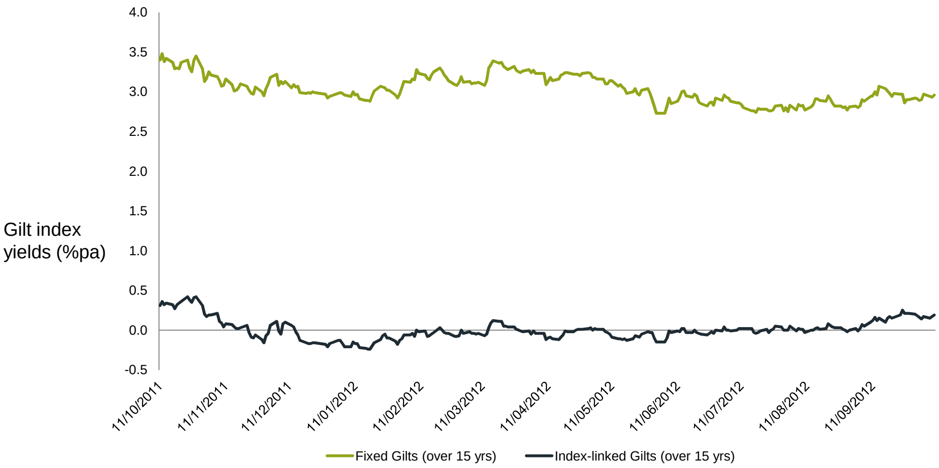
The Current Funding Regime IS fit for purpose …

… if only actuaries use their judgement

Is QE just part of a longer-term trend …



Would smoothing help ?



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Do we really want to follow the US example … ?

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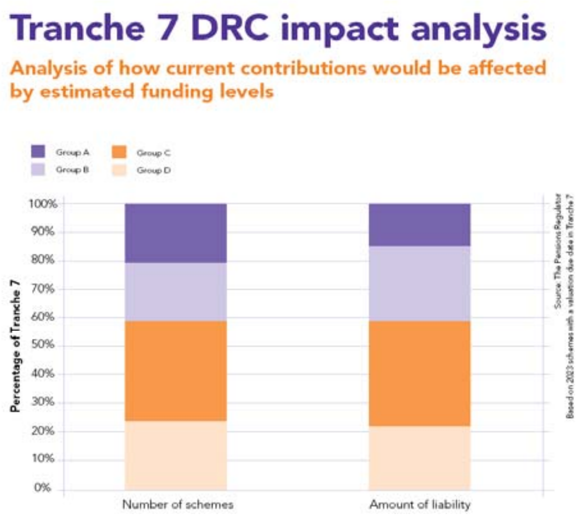
The Pensions Regulator's views



•Group A: DRC increase above 10% even with a 3yr extension and weakened recovery plan assumption
•Group B: DRC increase contained to 10% if 3yr extension applied, but only through weakened recovery plan assumption
•Group C: DRC increase contained to 10% if 3yr extension applied
•Group D: No need to amend recovery plan

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The Regulator's three categories ....

A significant majority?

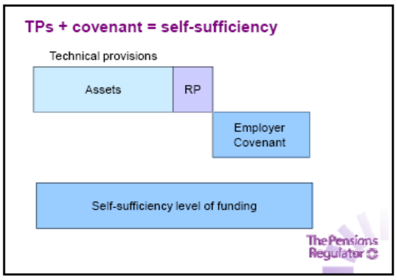
The squeezed middle?

Low security schemes

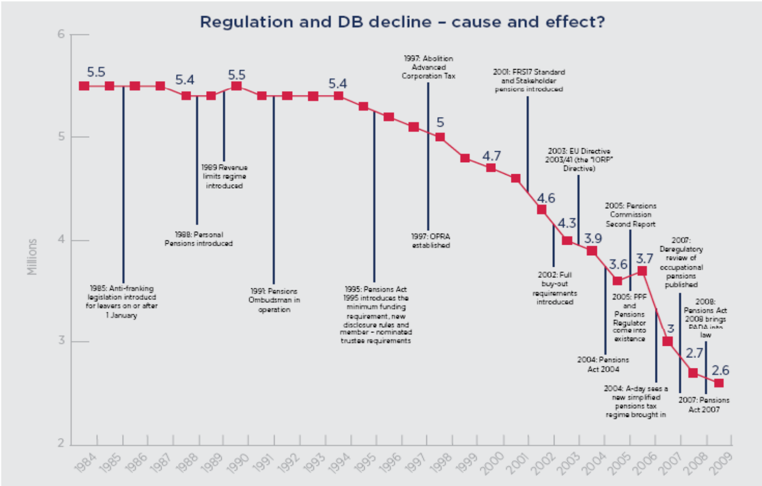
What is the purpose of funding?

Technical Provisions should depend on covenant

- Eg tPR view that Technical Provisions + Employer Covenant = Self-sufficiency
- Self-sufficiency will be based on gilt or swap yields
- Hence margins over gilts or swaps should not depend on expected returns



Where are Pension Schemes today?



NAPF: Fit for the future

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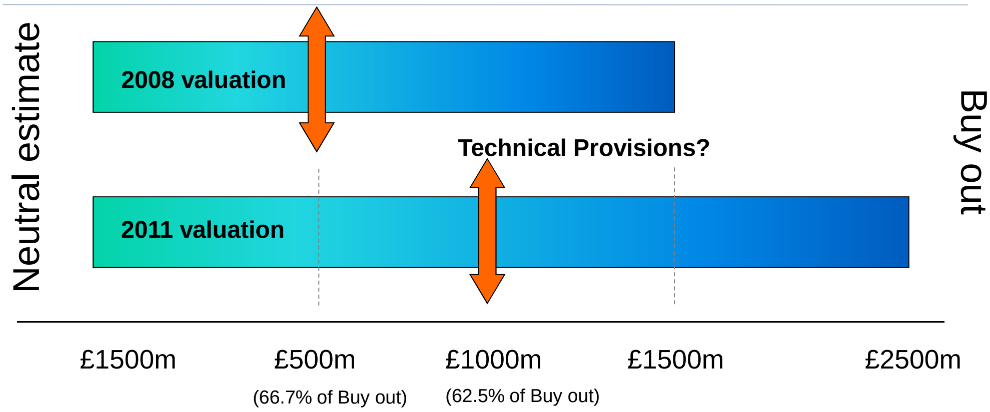
Not extra prudence – but less!



This is an extra £500m reliance on sponsor covenant – and a 4 percentage point reduction in solvency target

tPR has a *healthy* obsession with Gilts …

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 ongoing 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.

These are sound actuarial principles

THE VOTE

This House believes that the Current Funding Regime is Not Fit for Purpose

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 presenters.

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