The Actuarial Profession making thanda sense of the future

Incorporating Sponsor Covenant Risk into Actuarial Advice

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Whether to incorporate?

- New methodology for Actuaries
 - Basic theory exists
 - Counterparty credit risk / default risk
 - Basel II / capital requirement regulations
- Difficulties with long-term nature of pensions
 Market doesn't exist?

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Fair value principle

- A fair value is defined as
 - "The value at which an arms-length transaction involving willing, knowledgeable counterparties would take place"
- It involves modelling how a market would value the asset or liability
- <u>http://www.actuaries.org.uk/files/pdf/sessional/s</u> m20050425.pdf

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- Does this just mean higher contributions?
- Yes, we can solve for the contribution amount such that PVfc (allowing for default) = deficit
 - i.e. economic value of promise = deficit
 - Promise would be worth £100m

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Implications for advice

- Traditional advice: £20m p.a. Promise not worth the deficit
- "Account" for sponsor default: £27.1m p.a.

 - Economically equal to deficit
 Too much? / Not enough?
 Unless insurance is actually purchased
- What can actuaries do? Need to understand who benefits from default

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Who benefits?

- Consider a simple company
 - £250m of assets
 - Pension fund with £100m deficit
- How are the shareholders affected
 - With matching assets in the pension fund?
 - With mis-matching assets in the pension fund? See Appendix for details

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Opportunities

- Innovation involvement in the discussions on structuring of company assets to back the promise
- Modelling all this is difficult but not impossible Not an excuse for ignoring the problem
 Education about the principles would be a start
- If actuaries don't someone else will
 - The market M & A
 - The regulator
 - Investment banks / ratings companies

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Appendix - Risky assets

- Including mis-matched and therefore risky assets in the pension fund can have a significant impact on the value of the promise
- If trustees and the company are going to take these risks the actuary has a responsibility to explain the economics which result from the decision

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