The Actuarial Profession
making financial sense of the future

Open Forum: Discounting pension cashflows for accounting valuations

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Pensions are different from insurance

Should that matter in accounting?

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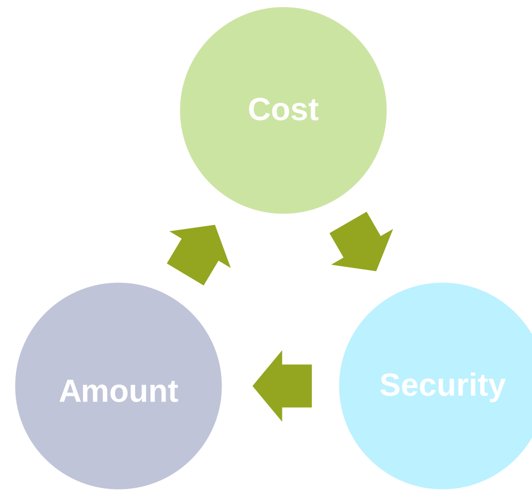
Context

Context is fundamentally different:

- Pension deal involves a balance between cost, security and amount of benefit,

- Greater social policy element to pensions than insurance; sponsors seek protection against political risk.

- *Balance usually struck at scheme level, and security may well be the balancing item*



Non-participating insurance is contract driven, with *security as an external feature* factored into the price of the product.

Should accounting recognise the different context?

Risk management

In pensions there is an implicit element of risk sharing, leading to a different risk appetite and different risk behaviors:

- Pension schemes more inclined to take investment risks which insurance companies might not entertain eg equities
- Pensions schemes may have more relaxed views on some guarantees and options
- Product design less aligned to risk management and more towards HR or social objectives (LPI, discretionary practices etc) – matching assets not always available
- Pension schemes have been more relaxed about data risks (eg marital status or spouses DOB rarely known) …. but changing

All raise some measurement issues, different from insurance

With-profits insurance

DB pensions have more synergy with ‘participating’ insurance contracts:

- Policyholders have paid a ‘bonus loading’ and are entitled to certain expectations

  …….cf expectations of members in a pension scheme (deferred pay)

- Risk appetite of with-profit funds is different

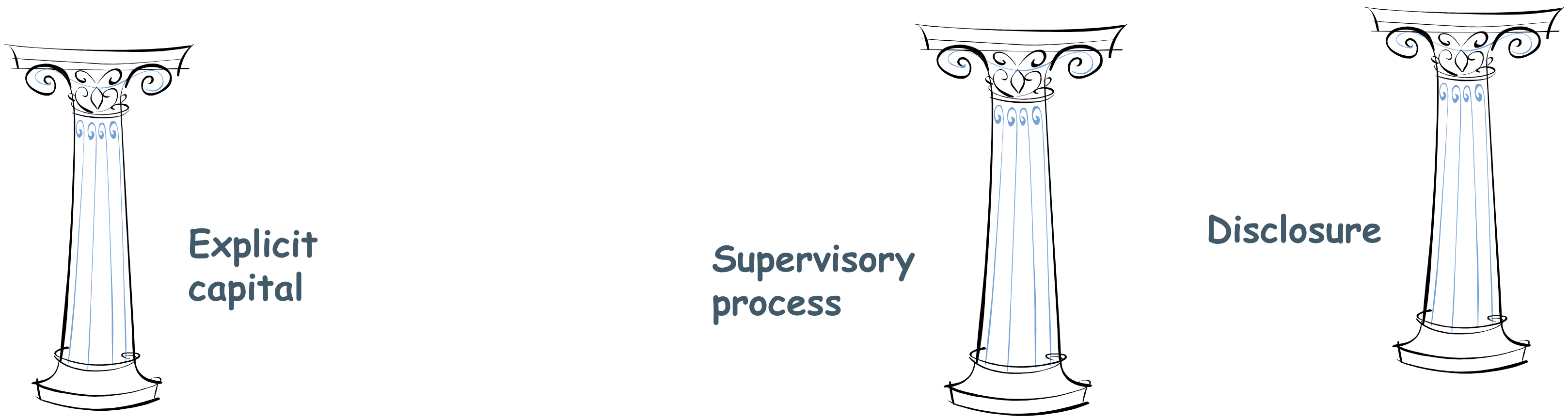
  …….cf pension funds (more risk taking, risk sharing)

- With-profit funds have concept of guaranteed and discretionary benefits (latter dependent on investment performance)

  …….cf discretionary and conditional benefits in pensions

Should accounting of pensions be more aligned with accounting of with-profits business?

Regulation



Insurance regime

- Primary focus on regulatory capital – effectively an insurance premium

  - Promoting desired behaviours via capital management through explicitly defined models, assumptions and tolerances

Pensions regime

- Primary focus on minimising risk of non-delivery through pro-active covenant management

  - Promoting right behaviours through arms length supervision, with checks and balances, sticks and carrots.

Management of 'own' credit risk is different; should accounting reflect this?

Solvency Capital

Nature and form of solvency capital is different; pensions have other non-cash capital:

- External security in the form of
  - Sponsor covenant
  - Contingent assets
  - Capital in independent external vehicles (eg PPF, PBGC, PSV)

- Governance (checks and balances, carrots and sticks to promote desired behaviors)
  - Regulatory powers; Regulatory oversight; Scheme governance ; Sponsor governance

- Disclosure (power to challenge undesirable behaviors and effect change)
  - To regulator; members; other stakeholders

Should some of this external capital be recognised in some form, eg higher discount rate?

Insurance accounting: Current (1)

Accounting requirements same as FSA statutory reporting requirements

- Technical provisions
  - Gross redemption yields on assets
    - eliminating credit risk
    - but not any premium arising from lack of marketability
    - 97½% of observed yields
  - Running yield on equities and property
    - Average of current dividend and earnings yield
    - but no allowance for future growth
  - No liability for future awards of bonus

Insurance accounting: Current (2)

In addition, for larger with profits funds,

- Enhanced Capital Requirement
  - Market consistent allowance for future returns on investment
    - Running yield, no allowance for capital growth
  - Stochastic approaches preferred
  - Demonstrate ability to treat customers fairly
    - In line with Principles and Policies of Financial Management
  - Market-consistent valuation of options and guarantees

If pensions have similarities with with-profits funds then ………….

Insurance regulation - where we might be going

Solvency II

- Technical provisions to be best estimate plus a risk margin
  - Can be interpreted as the amount another undertaking would require to take over the obligations
- Risk-free term structure of interest rates to be used
  - In general no regard to assets actually held
- Discussion over how risk-free rates should be determined
  - Reference rates
  - Term structure / re-investment risk
  - Default/downgrade risks
  - Strong argument from industry for an Illiquidity premium

Pensions are also illiquid, and investment strategies go beyond corporate bonds to equities, so …………

Will measurement of insurance contracts follow SII?

Revision of IFRS 4

- Long and twisting road to a standard for insurance contracts (still changing)
- Latest draft of IFRS (revised) proposes *fulfilment value*
  - Amount it would rationally pay at end of reporting period to be relieved of the present obligation
  - TPs include a risk margin
    - Risk margin = amount an insurer requires for bearing the uncertainty from having to fulfil the obligation
- Measurement (tentative)
  - Allow for probability weighted cash flows, and time value of money
  - Discount rate to capture characteristics of liability (not expected return on assets)
- Seems aligned with SII technical provisions (assuming fulfilment value embraces an illiquidity premium).

What lessons for pensions?

The bottom line – a personal view

- **When all is done and dusted we will still have different measures**
  - For insurance and pensions (most likely)
  - In pensions, for funding, accounting and solvency (definitely)

- **The differences will be a reflection of different levels of risk embedded in the respective discount rates**

- **Accounting measures are one-dimensional - they don’t tell you anything about risk. Shouldn’t they?**

This is the real communication gap