

## Scheme-specific funding - nice idea but...

Francis Fernandes

Financial Markets Advisory, 30th November 2004



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## Agenda

- Statutory funding objective (SFO)
- Statement of funding principles (SFP)
- Valuation reporting
- Failure to reach agreement
- Future funding discussions
- Issues for trustees and employers



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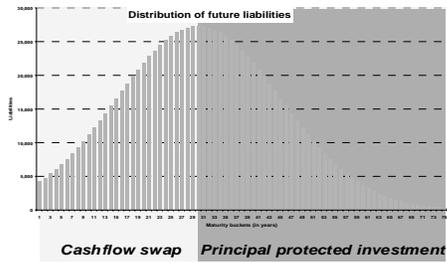
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### EU Directive - scheme liabilities



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### Statutory funding objective (SFO)

- Shortfall = assets - technical provisions
- Assets are sufficient and *appropriate*
- Technical provisions (TP) calculated in accordance with any "prescribed methods and assumptions"
- Actuarial certification within reasonable period
- Methods & assumptions for TP require agreement of employer

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### Statement of funding principles (SFP)

- Trustees' written policy for ensuring SFO is met
- Agreement of employer and advice of actuary
- SFP includes methods & assumptions for technical provisions and correction period
- Recovery plan - action to meet SFO in the event of shortfall and period for correction
- Schedules of contribution consistent with SFP - certified by actuary

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### Valuation reporting

- Actuarial valuations – at least every 3 years provided there are annual “actuarial reports”
- Actuarial reports - developments in technical provisions since last valuation
- Valuations against PPF as well...will impact risk-based levies
- More focus on solvency

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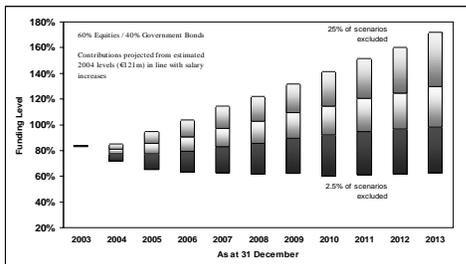
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### More focus on solvency



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### Failure to reach agreement

- Basis for PPF – buy-out
- Regulator: minimise calls on PPF
- Regulator power to set SFO and conts
- Consider new scheme...then extend
- Regulator sees recovery plans
- How tough will new regulator be?

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### An Illustration of the hit

#### Assets £1.7bn and payroll £500m

	Typical Funding basis	Buyout Basis
Technical Provisions	<b>£1.9bn</b>	<b>£3.1bn</b>
Future service rate	<b>10%</b>	<b>25%</b>
Deficit funding (pa)	<b>£14m</b>	<b>£100m</b>
Contribution rate (pa)	<b>£64m</b>	<b>£225m</b>

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### Possible view of new regulator

- Initially, pension schemes likely to be in deficit against SFO
- Trustees making large unsecured loans back to the sponsor
- While contributions by the sponsor may have increased, it is unlikely that the deficit will be removed in the **near** future
- So new regulator's powers could include forcing protection against some of the deficit as well as increased contributions
- Trustees can buy protection using credit default swaps (CDS)
  - Can be linked to the deficit at the time of insolvency or stress-test
- Might have some appeal for the sponsor
  - Potential reduction in the risk-based levy to the PPF
  - more flexibility over future funding

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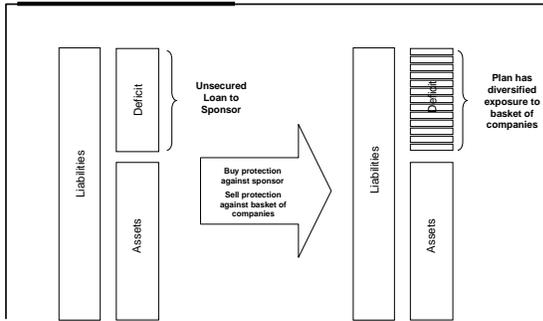
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### Buying protection against solvency deficits




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### Letter of credit

- Alternative approach is arranging a Letter of Credit facility
- Sponsor gets bank(s) to underwrite deficit in the event of employer insolvency
  - Actuary calculates the deficit on the solvency basis
  - Sponsor pays bank(s) to meet this deficit on certain "trigger" events
  - Position could be reviewed following each formal actuarial valuation
- Enables sponsor to continue to fund with flexibility on an "ongoing basis"
- Depends on size of deficit - but could weigh up contributions vs extent of protection
- Not a perfect match - but easier for trustees to understand than CDS
- Reduced risk-levy to PPF?

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### Issues for trustees and employers

- **Need detail urgently**
- **More focus on solvency**
- **How tough will regulator be?**
- **Future discussions on funding...new ideas?**
- **More bad news for DB schemes...have you warned clients?**

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