Pension Liabilities for Life Actuaries

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Pension liabilities

- Pension liabilities are just annuities.
- increases are either
  - Fixed
  - Inflation linked (with caps and collars)
  - Different increases in deferment and payment

Since 2005 the PPF has provided a limited second level of protection;

- £25k cap for non-pensioners
- 90% protection for non-pensioners

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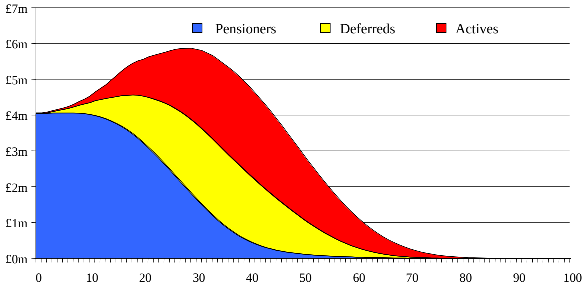
Typical pension scheme cashflows



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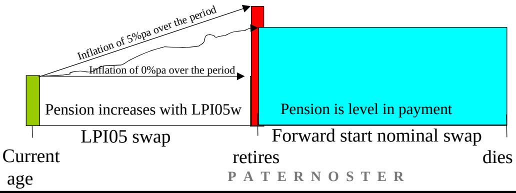
Increases and hedging

- In payment can be covered by
  - Bond portfolios, or
  - Cash and swaps.

Deferred pensions can be harder



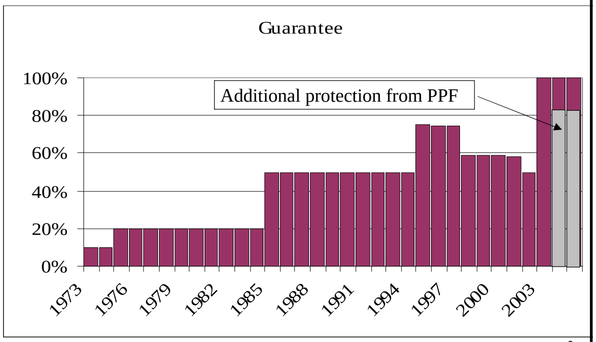
Other complications

- Commutation usually on unfavourable terms (mis-selling?)
- Transfer values out of scheme (mis-selling?)
- Contingent benefits
- Early/late/ill health retirements
- Guarantee periods
- Death benefits

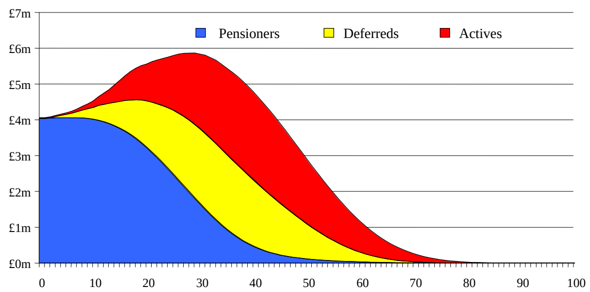
Legislation (re-)defines the liabilities

- Social Security Act 1985 - introduced revaluation in deferment
- Social Security Act 1990 - extended revaluation in deferment to all service
  - Debt on the Employer legislation
- Pensions Act 1995 - LPI increases for future service
  - MFR
  - Debt on the employer at the MFR level
- 1998 and 2002 - changes that reduce the MFR liabilities
- June 2003 - Debt on employer becomes buy-out cost
- April 2005 - PPF and tPR provide additional protection

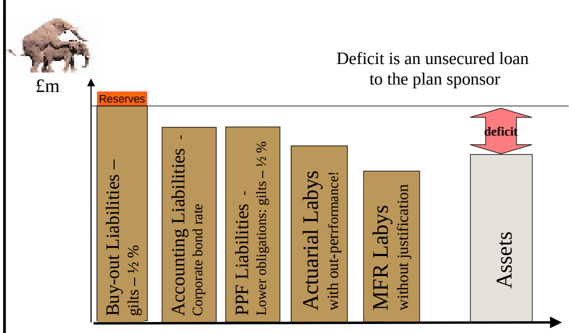
Legislation (re-)defines the liabilities



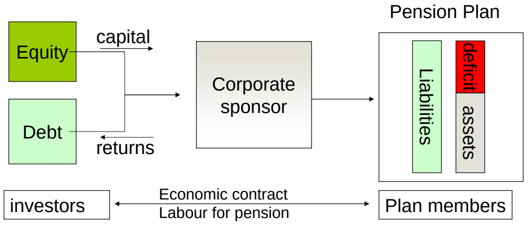
What is the liability?



What is the liability?



Pension scheme in the corporate structure



- Pension plan deficits are
  - a source of capital to the sponsor
  - a loan by plan members to the sponsor - why do this?

Impact of the PPF

1. The leveraged buy-out, overseas parent
   Poorly funded scheme FL << PPF liability.
   CEO with benefits over £25k pa, 10 yrs to NPA
   What is the value of new accrual?

2. Poorly funded, weak sponsor
   Addressing the deficit likely to trigger insolvency.
   Company can probably not afford the cost of accrual.
   What should the trustees do?

FRS17/IAS19 liabilities: future salaries are not a current liability

- Liability = present obligation arising from past events
- Legal obligation is accrued benefits (ie excluding future salary increases)
- Future salary growth is not a liability on the B/S
- Cost of employment includes salary, new pension accrual, and real increases in accrued pension promise
- Pensionable real salary increases represent the issue of a new bond
- Accruals concept make provision for expense incurred when receive benefit relating to that expense [check]

FRS17/IAS19 liabilities: future salaries are a current liability

- General rule for all provisions (IAS37)

  Amt recognised as a provision shall be the best estimate of the expenditure required to settle present obligation

  "future events that may affect the amount required to settle an obligation shall be reflected in the amount of the provision"

- Contrast a final salary and a current salary (re-valued) promise
- Accounts prepared on an on-going concern basis, hence buy-out inappropriate

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Lessons from closure: Campbell et al

- See table p27 table 1
- Reserves and values of annuities of a Life company

FSA requirements for Life companies

- DB scheme of a Life Co is exempt from ICA
- Pen scheme deficit not on realistic Balance Sheet
- Expected payments into the pension scheme over the next 5 years

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Lessons from closure

- Solvent in 90 s & benefit improvements
- Now insolvent, reduced accrual, increased p/h er premiums aim for solvency in 15yrs
- Shortfalls hampering corporate transactions
- Credit ratings subject to regular fluctuations
- Key decisions on funding and investment made by those with little specialist expertise
- Surrender values below mark-to-market
- Until recently on wind-up a non-pensioner could get nothing
- Now compensation scheme in place, but inadequate and lacking in transparency

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