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making financial sense of the future

D1 – Closed Pension Schemes

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What sort of pension scheme?

- Defined benefit, not defined contribution
  - (unless DC scheme pays pensions from fund…)
- Final salary, or career average
  - (though some points apply only to FS)
- Defined *pension* rather than *cash*
- Focus more on small to medium schemes

The life of a pension scheme

1st member joins

Last member joins

Last active member leaves

Benefits bought out

Last pensioner dies

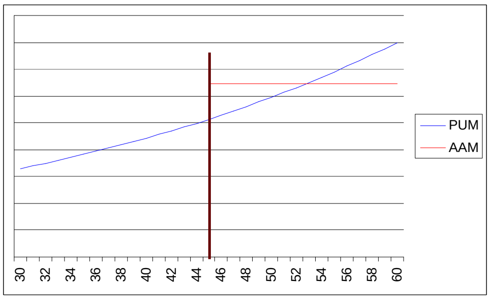
Issues to cover

From point of view of Trustees:

- Funding
  - with/without actives
- Investment
- Conflicts
- When to wind up
  - and how to prepare

Plus some thoughts relevant to the sponsor

Funding - method



Funding - method

For schemes closed to new entrants, not accrual:

- No real logic for AAM for funding a scheme
  - Used for benefit design
  - (unless used to add element of caution)
- PUM with 3 year control period much more sensible

Funding - assumptions

- No real logic for different strategy closed vs open, however, closed may imply:
  - More cautious investment strategy
  - More mature
  - More volatile
  - Sponsor less inclined to contribute
  - Scheme large compared to sponsor (e.g. in declining industry)
- These may have implications for funding

Dealing with deficits

- Term of liabilities still very long (for now)
- Might not have an "expected future working lifetime" any more
- No need to panic
  - But see comments on previous slide
- Over time, term of liabilities will reduce

Contribution rates

- No payroll or declining payroll
- No longer appropriate to express rates as % of salary
  - deficit payments
  - expenses
- Can still consider indexing with prices/salary growth

PPF Levy valuations/Priority orders

- Over time, PPF funding level will get worse
  - (all other things being equal)
- Proportionately more pensioners
  - Require 100% funding
- Same effect on priority coverage of non-pensioners
  - Consider impact of significant retirements
  - Note this affects transfer values etc too

Trustee discretions

- Closed scheme is more like a "share of fund" scheme
  - Depending upon attitude/existence of sponsor
- Giving to one member may be taking away from another
- Consider:
  - Early retirements, commutations
  - Transfers in, AVC conversions, etc
- …and impact on valuation

Investment

- Again, little reasons why closing in itself has immediate impact on strategy
- But, may be indicator of:
  - Increasing maturity
  - Lower employer covenant
  - Greater volatility to come
- Really, this section is about risk management

Risks faced

- Investment return
- Longevity
- Cost of buy-out
- Salary growth less important

- Over time, ability of scheme to manage adverse experience decreases

Mortality

- The smaller the population, the less able the scheme is to self-insure this
- Watch out in particular for one or two significant pensioners
- May want to buy out as many pensioners as can be afforded
  - or just the significant ones
  - need to consider impact on priorities/PPF
- Longevity bonds?
- Plan must be that eventually pensioners will be bought out

LDI – Liability Driven (Led) Investment

- One way of attempting to manage other risks
- Many different approaches
- Swaps to match liability cashflows
- Assets to return cash + x%

When LDI may be useful

- Sufficient size
- Sufficiently well-funded
- Mature
- Targeting buy out in n years

Other investment considerations

- Expectation of buy-out brings time horizon closer
  - (may still be quite far away)
- Risky investments only work over long-term
- Trustees must considered end goal to buy-out

Conflicts of interest

- Subject of another talk!
- If no active members:
  - less common ground between sponsor and trustees
- If no employees in scheme:
  - little incentive for trustees to continue running scheme
  - (if sponsor covenant not good)

Conflicts of interest

- Conflicts more likely to arise in closed scheme
- Between sponsor and trustees…
- …and their advisers
- Where do MNTs come from?

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When to wind up

- No more actives
  - What do rules say?
- How strong is sponsor?
- Can full buy-out be afforded?
  - How much of the buy-out debt would be recovered from the sponsor?

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Interaction with the PPF

(If no real prospect of any money from sponsor)

Insufficient assets to secure PPF benefits:

- Enter PPF straightaway?
- Risky investment strategy to attempt to beat PPF?
- Members better off by waiting anyway?

What if better funded than PPF?

What sort of guarantee is PPF, actually?

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Wind up is inevitable…

…only question is when.

- Trustees need to have a plan
  - Investment
  - Funding
  - Cost of ongoing expenses

GN29

(v6.0, 4.2 and A3.2)

- On receipt of information that scheme will discontinue or wind up…
- Scheme Actuary, or Trustee's Adviser must…
- ensure trustees are aware of the need to:
- take advice on financial and investment implications

Summary of trustee position

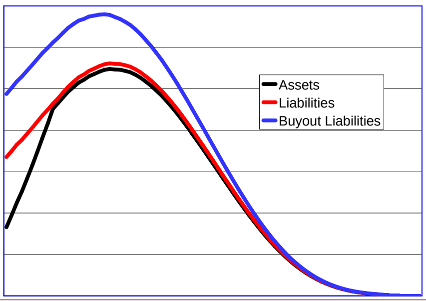
- Wind up is looming
  - may be a fair way off yet, though
- Plan needed
- Implications for
  - Funding
  - Investment
- Might mean less confidence in and cooperation with sponsor

Sponsor - funding

Once no more actives:

- Sponsor will probably want to buy out to minimise risk going forward
- BUT – at acceptable cost
- Best strategy will depend upon what can be afforded

Approaching buy out



Long-term uncertainty

- Biggest problem for sponsor is deferreds
  - Very long term
  - Lots of uncertainty
  - High cost of buy out
- May want to offer enhanced transfer values
- Third party willing to step in to provide guarantees?

Investment

From sponsor point of view:

- Very much dependant upon plan to buy out
- Similar issues as for trustees
- More emphasis on acceptable cost

Dealing with surpluses

- In closed scheme, sponsor less able to recover surplus if investments do well
  - Cannot be used to fund future accrual
- Big concern for sponsors
  - If being asked for large contributions now
- Use of options between trustee and sponsor?
  - Contingent asset in return?

Control

- Conflicts likely to arise with trustees
- May mean sponsor wants to step back from trustees
- However, will want to keep some control
  - How trustees exercise discretions etc

Expenses

- Employer will want to keep expenses to minimum
- Might be difficult if there is conflict with trustees

Two-tier work force

- Retrospective changes by Government
  - with no help from Lord Turner
- Force sponsors to target resources at these legacy schemes – at expense of current workers
- Gap will increase
- Employers will need to manage this

Summary for sponsors

- Large problem dealing with legacy issues
- Sponsors may not be sympathetic
  - May see problems as being created by legislation
- Likely to want least cost approach
- Aim to wind up when cost acceptable