Institute and Faculty of Actuaries

Sessional Funding defined benefit pension schemes – An integrated risk management approach

13 November 2017

Institute and Faculty of Actuaries

Chair’s Welcome

Marian Elliott, Deloitte

13 November 2017

Institute and Faculty of Actuaries

Funding Defined Benefit Pension Schemes

An integrated risk management approach

Charles Cowling, Hannah Fisher, Jignesh Sheth, Murray Wright

13 November 2017

What is the purpose of funding?

Create a plan to finance a long term obligation

There are **two** very different objectives

Provide security for members' benefits

Institute and Faculty of Actuaries

Binary outcomes

6,000 Remaining Schemes

Full benefits for members

PPF level benefits or PPF+

Institute and Faculty of Actuaries

Default risk and impact on members

Probability of default within 30 years and estimated member losses

Covenant	Probability of default	Estimated benefit losses
Strong (CG1)	6%	11%
Tending to Strong (CG2)	20%	14%
Tending to weak (CG3)	40%	16%
Weak (CG4)	65%	19%

Source: PLSA taskforce

Institute and Faculty of Actuaries

Integrated Risk Management

Institute and Faculty of Actuaries

Introduction

to the research

Regulatory Framework for Funding

- A look back to the MFR
  - A transfer value to replicate benefits for active and deferred members
  - Annuities for pensioners
  - 5 year recovery plans with 1 year to get to 90% funded
- What would the MFR look like today?
- What has the move to scheme specific funding achieved?

Institute and Faculty of Actuaries

How are funding assumptions linked to strength of covenant?

Nominal discount rate by covenant

Covenant	Valuation tranche 7 Sep 11 – Sep 12	Valuation tranche 8 Sep 12 – Sep 13	Valuation tranche 9 Sep 13 – Sep 14	Valuation tranche 10 Sep 14 – Sep 15
Strong (CG1)	4.34%	4.13%	4.64%	3.46%
Tending to Strong (CG2)	4.32%	4.18%	4.51%	3.50%
Tending to weak (CG3)	4.29%	4.11%	4.49%	3.50%
Weak (CG4)	4.16%	3.95%	4.32%	3.43%

Source: The Pensions Regulator

Institute and Faculty of Actuaries

How are funding assumptions linked to strength of covenant?

Nominal discount rate distribution

	Valuation tranche 1 Sep 05 – Sep 06	**Valuation tranche 4** Sep 08 – Sep 09	**Valuation tranche 7** Sep 11 – Sep 12	**Valuation tranche 10** Sep 14 – Sep 15
Upper quartile	5.55%	5.73%	4.66%	3.84%
Median	5.23%	5.38%	4.31%	3.47%
Lower quartile	4.99%	5.00%	3.94%	3.10%
Inter-quartile range	0.56%	0.73%	0.72%	0.74%

Source: The Pensions Regulator

Institute and Faculty of Actuaries

How are funding assumptions linked to strength of covenant?

Ratio of TPs to buyout liabilities

Covenant	Valuation tranche 10 Sep 14 – Sep 15
Strong (CG1)	67.6%
Tending to Strong (CG2)	70.1%
Tending to weak (CG3)	68.0%
Weak (CG4)	74.7%

Distribution of return seeking assets

Covenant	Valuation tranche 10 Sep 14 – Sep 15
Strong (CG1)	59%
Tending to Strong (CG2)	57%
Tending to weak (CG3)	58%
Weak (CG4)	55%

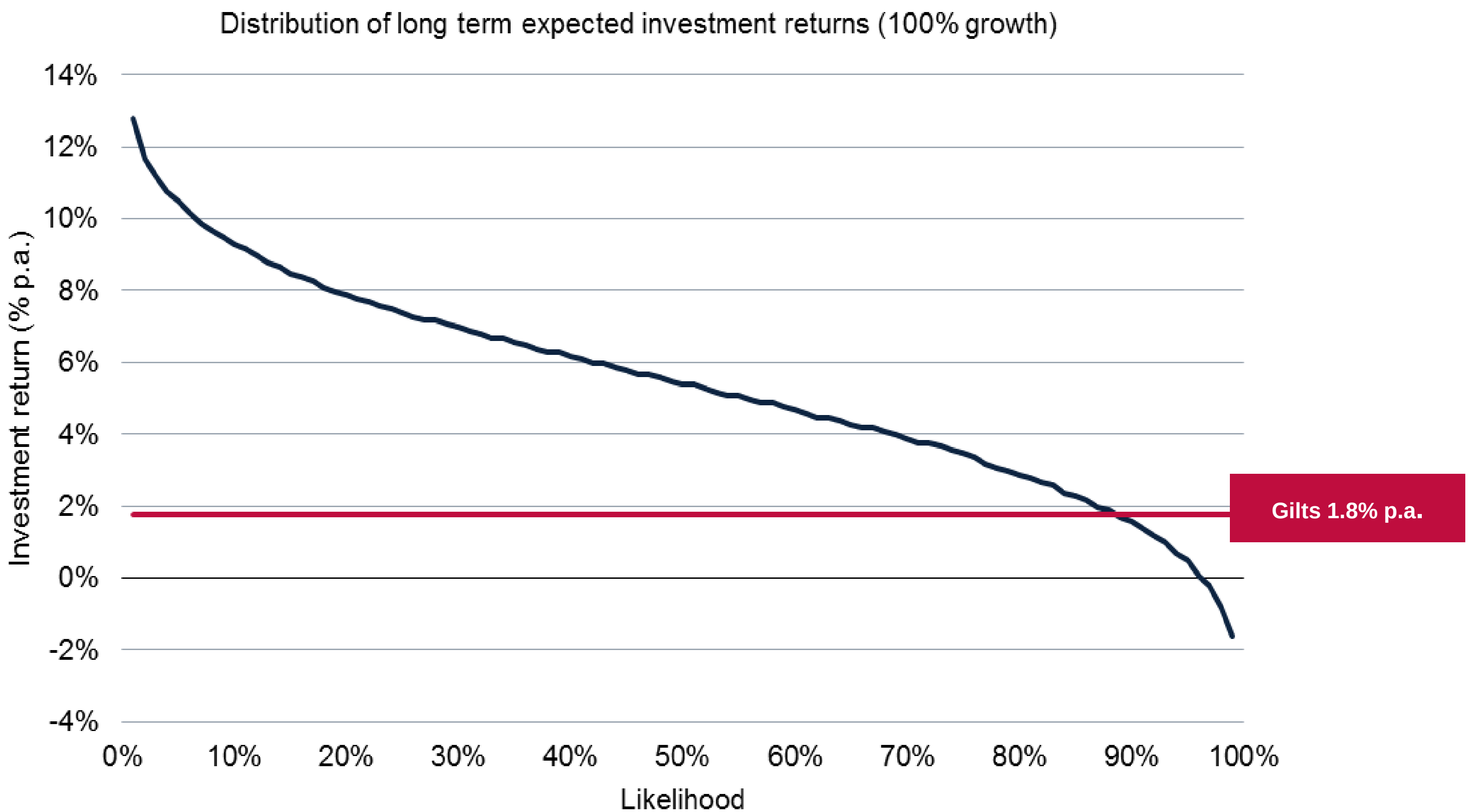
Source: The Pensions Regulator

Institute and Faculty of Actuaries

Commentary on investment aspects

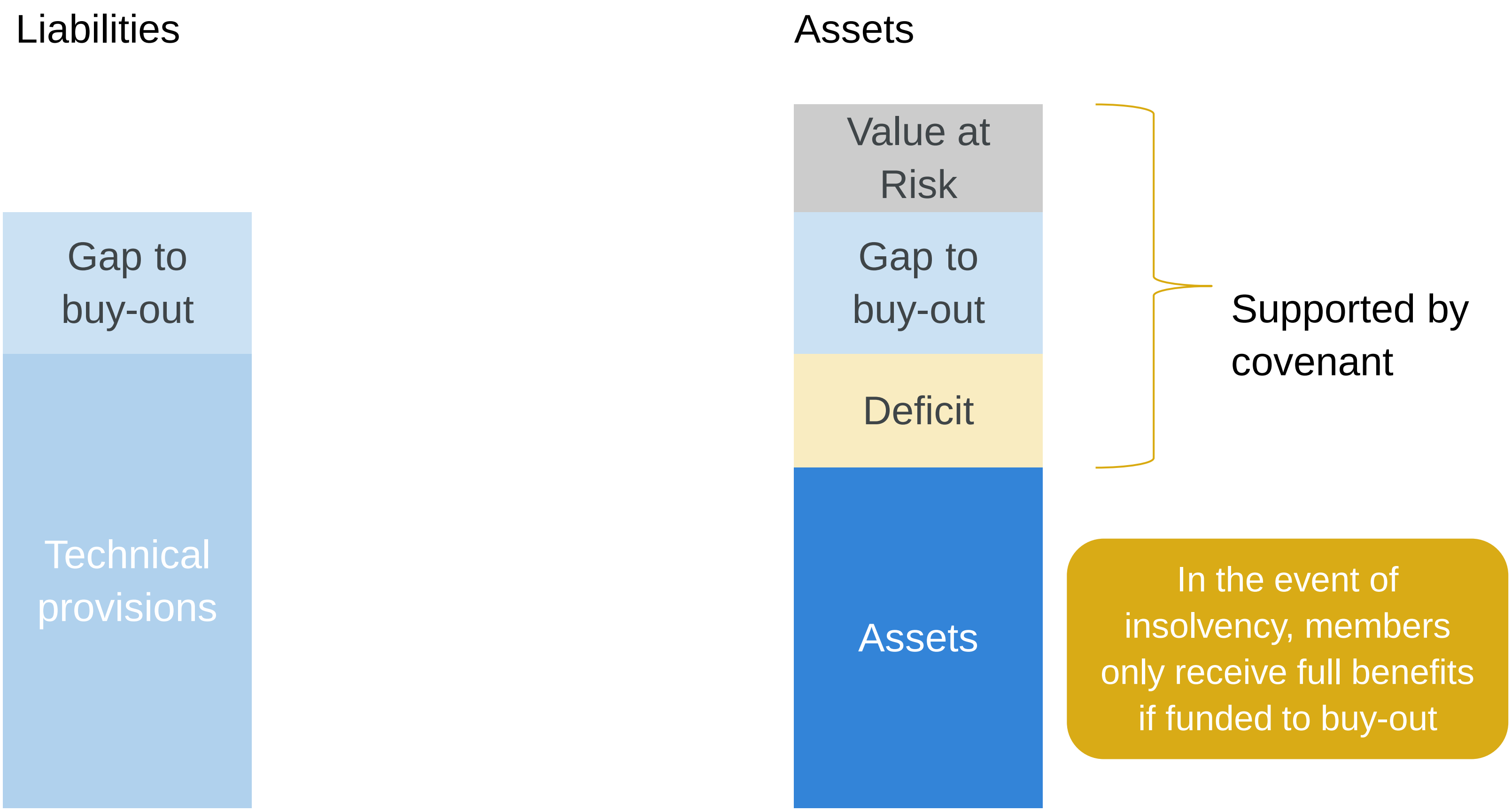
Institute and Faculty of Actuaries

Consider investment strategy



Institute and Faculty of Actuaries

Covenant support



Source: Illustrative only

The proposed framework

Institute and Faculty of Actuaries

Sessional Paper

Our challenge was:

- How to establish a funding framework with an obvious link to the strength of the employer covenant?
- How to ensure that there is transparency, understanding and agreement on the level of risk being run within the pension scheme?

Institute and Faculty of Actuaries

Funding objective

First need to consider the Funding Objective

Funding **Objective**

- Meeting benefits as they fall due
- Build up pension fund to provide a high likelihood of delivering members' benefits in full with minimal reliance on employer covenant
- Full settlement of liabilities / no reliance on employer covenant

Institute and Faculty of Actuaries

Examine employer covenant

Strong
CG1

Tending to strong
CG2

Tending to weak
CG3

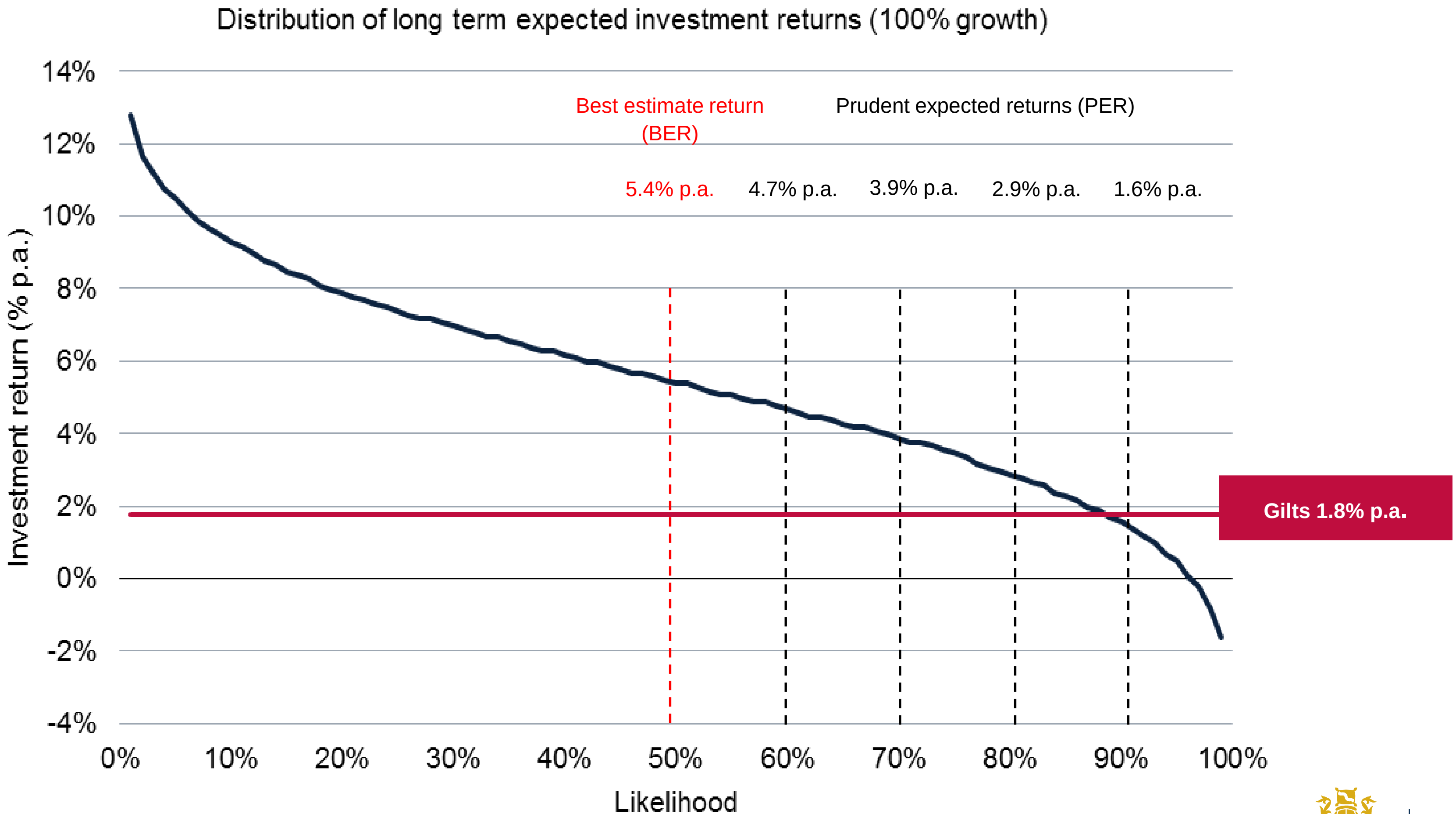
Weak
CG4

Link funding to employer covenant

Covenant	Funding
Strong CG1	60% confidence
Tending to strong CG2	70% confidence
Tending to weak CG3	80% confidence
Weak CG4	90% confidence

Institute and Faculty of Actuaries

Set discount rates



Institute and Faculty of Actuaries

Recovery Plan

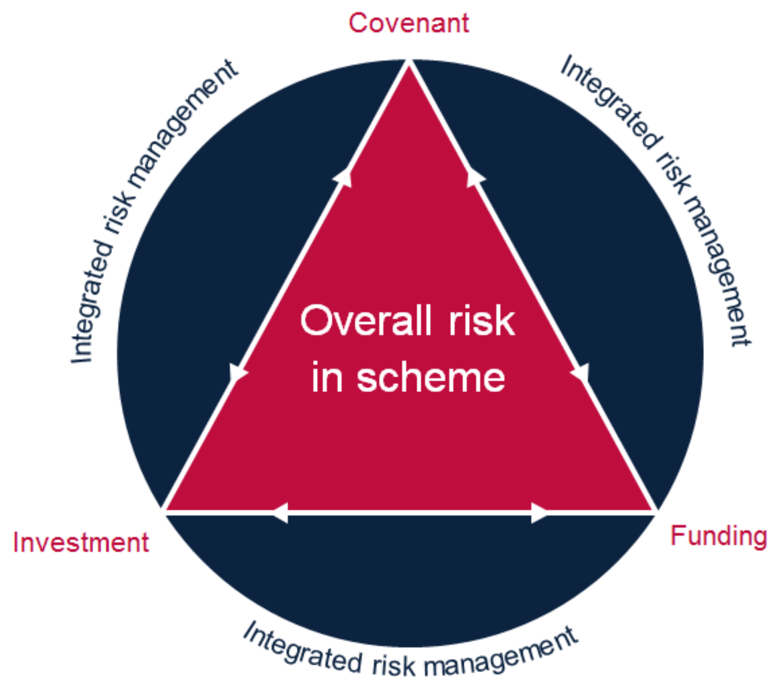
- Best estimate investment returns
- Link between recovery plan length and affordability

Strong affordability	• 5 years
Moderate affordability	• 10 years
Weak affordability	• 15 years

Institute and Faculty of Actuaries

Review for robustness

- Can the employer manage the level of risk implied?
  - Analysis over the inter-valuation period and to the end of the recovery plan
- If not, step back to objectives / covenant assessment / investment strategy



Institute and Faculty of Actuaries

Sessional Paper

Our challenge was:

- How to establish a funding framework with an obvious link to the strength of the employer covenant?
- How to ensure that there is transparency, understanding and agreement on the level of risk being run within the pension scheme?

Institute and Faculty of Actuaries

Institute and Faculty of Actuaries

Opener

Stephen Rees, Capita

13 November 2017

Questions

Comments

The views expressed in this [publication/presentation] are those of invited contributors and not necessarily those of the IFoA. The IFoA do not endorse any of the views stated, nor any claims or representations made in this [publication/presentation] and accept no responsibility or liability to any person for loss or damage suffered as a consequence of their placing reliance upon any view, claim or representation made in this [publication/presentation].

The information and expressions of opinion contained in this publication are not intended to be a comprehensive study, nor to provide actuarial advice or advice of any nature and should not be treated as a substitute for specific advice concerning individual situations. On no account may any part of this [publication/presentation] be reproduced without the written permission of the IFoA [*or authors, in the case of non-IFoA research*].

Institute and Faculty of Actuaries

Institute
and Faculty
of Actuaries

Closer

Cliff Speed, TPT

13 November 2017

Funding defined benefit pension schemes

Issues

- Financing a long term obligation
- Providing security

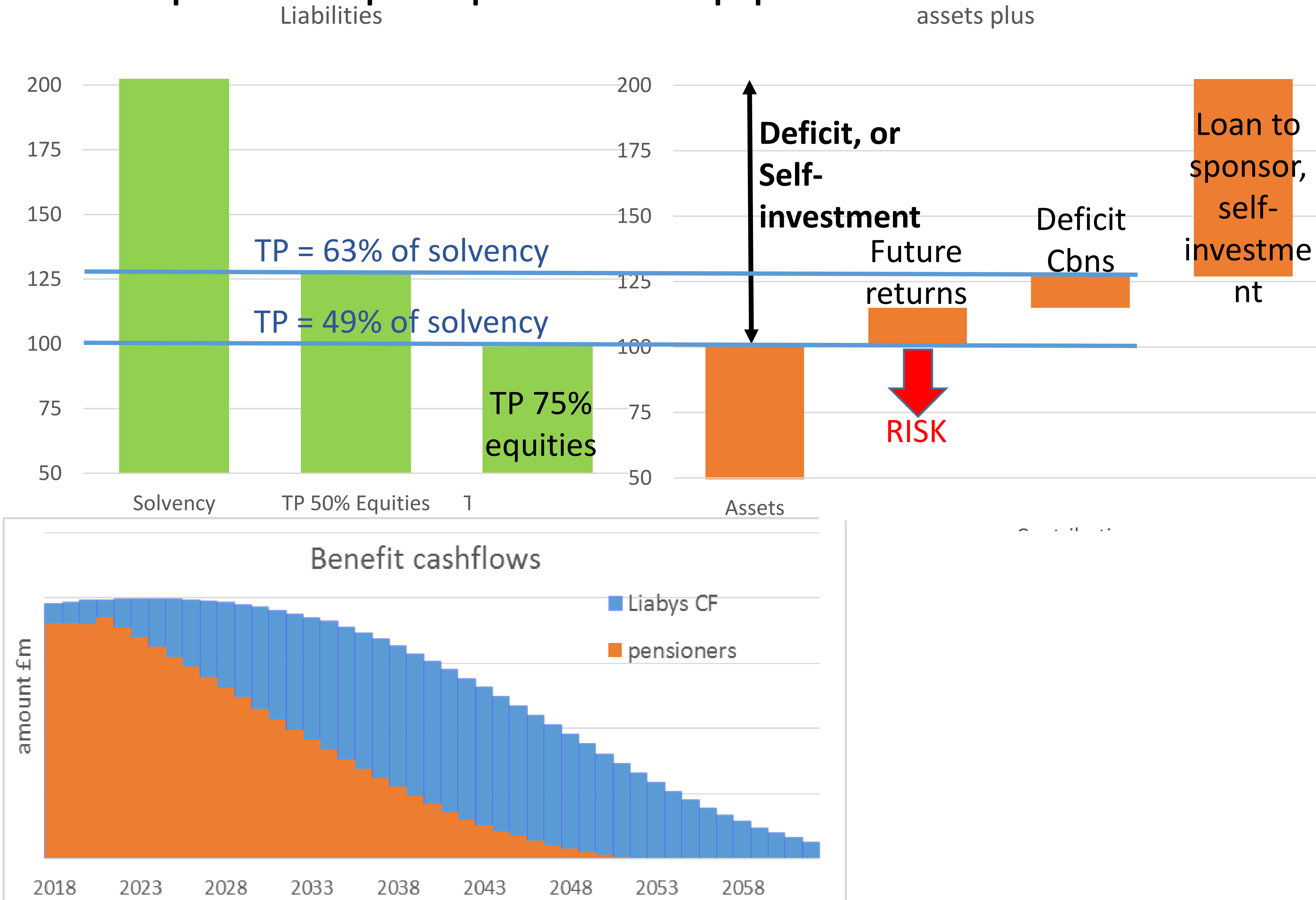
Challenge

- A funding framework that links to the employer covenant

Recommendations

- A better minimum funding standard would be one linked to a matching calculation
- A more transparent and therefore fairer approach would be a funding target which is an agreed percentage of the buy-out basis
- Funding objective should be clearly stated and understood and the self-investment, currently and at the target funding objective, should be transparently communicated to members.

Example of proposed approach



Funding defined benefit pension schemes

- This paper has much to commend it.
- The regulatory framework does not encourage good practice.
- “Experience is the name we give to our mistakes”.
- Could the profession be bolder in setting out a coherent framework?

Institute and Faculty of Actuaries

Institute and Faculty of Actuaries

Thank you for attending

13 November 2017