THE FUTURE OF PENSION SCHEME FUNDING

A NEW APPROACH TO PENSION VALUATIONS

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AGENDA

- Backdrop
- The new approach in practice
- Case study
- Joining it all up (IRM)

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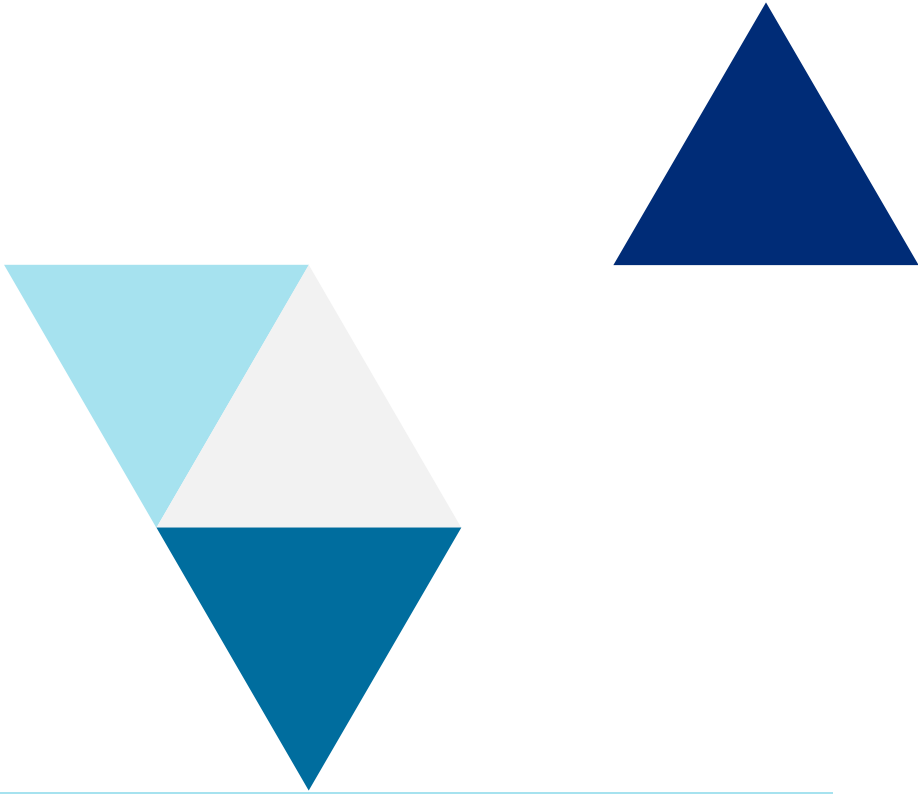
BACKDROP



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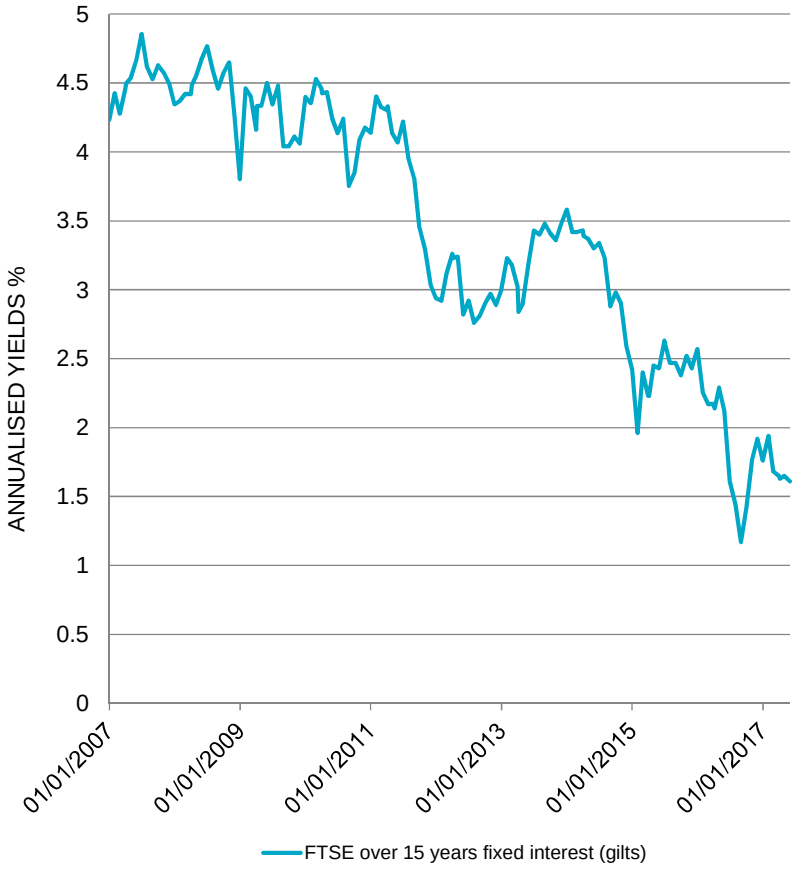
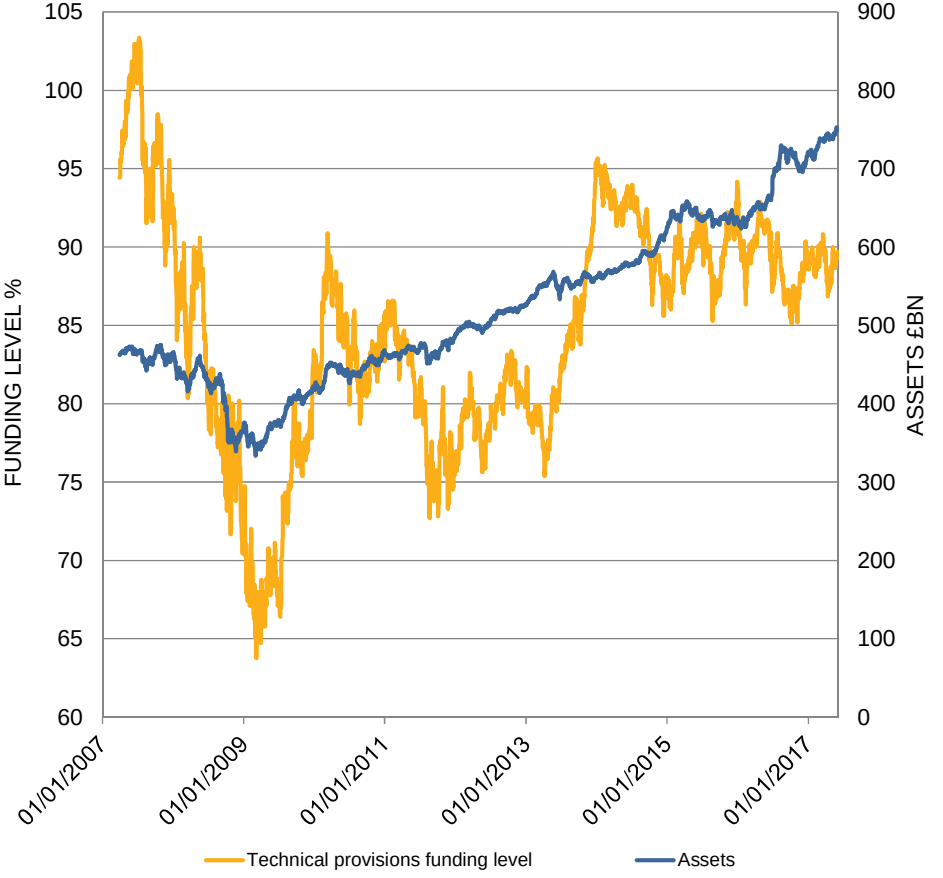
BACKDROP

- Evolution of gilt yields 2007 to 2017



- Evolution of FTSE 350 Technical Provisions and assets from 2007 to 2017



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SOME KEY QUESTIONS BEING RAISED

- Our scheme is under pressure, how should this be resolved securely and cost effectively?
- We have a well established valuation process, how should this be modified within the IRM* context?
- There is so so much uncertainty, how do we proceed from here?
- We know our sponsor will not agree to increasing deficit contributions, what do we do?

*IRM: Integrated Risk Management

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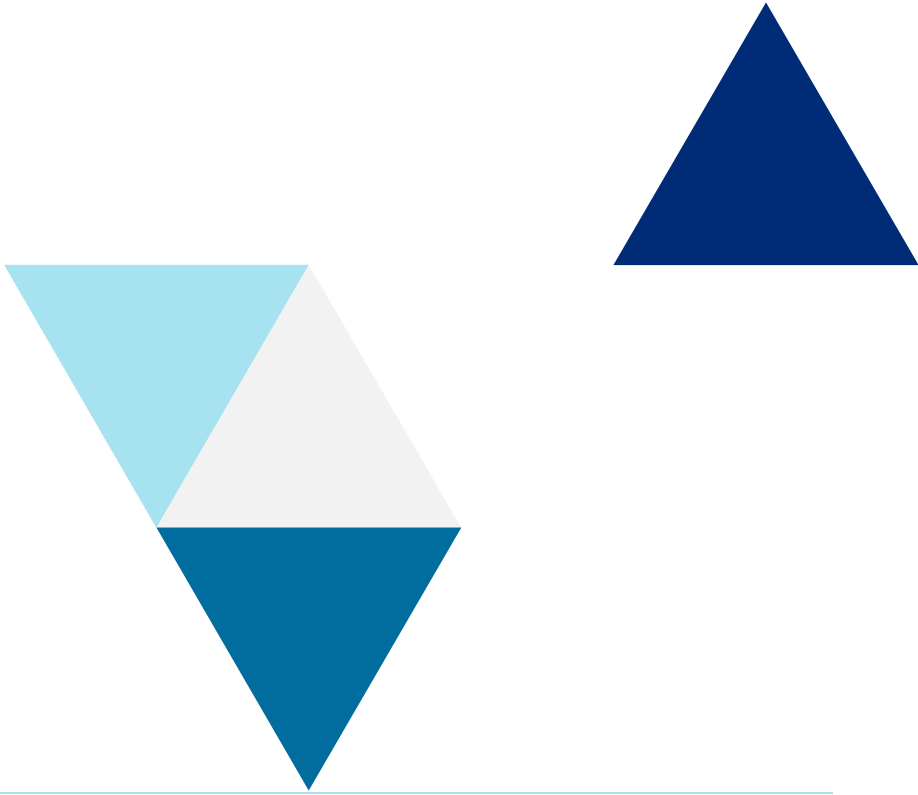
NEW APPROACH IN PRACTICE



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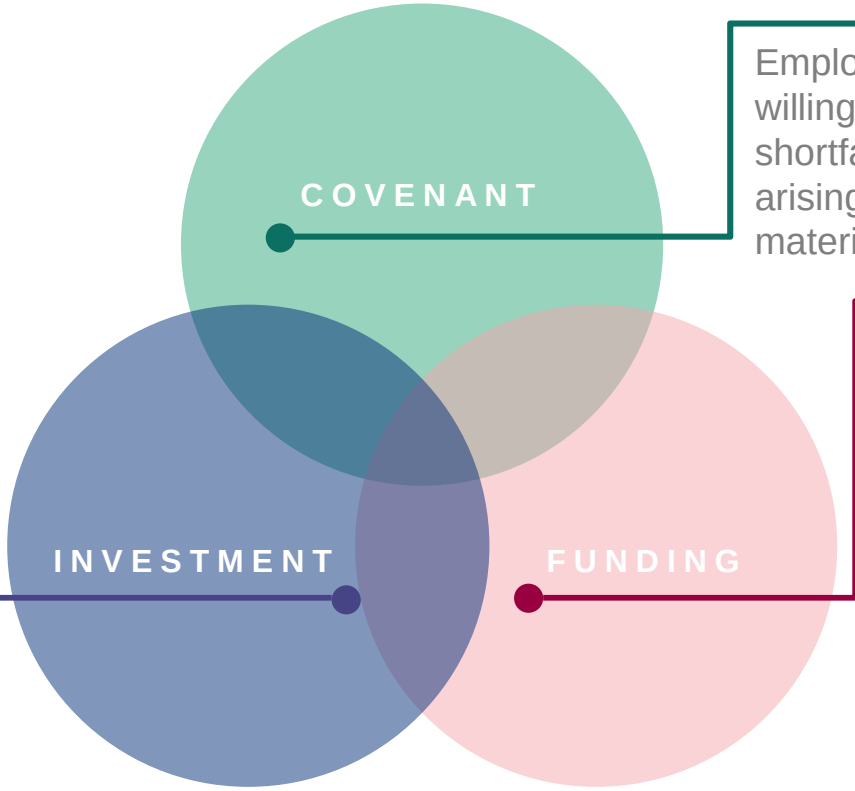
INTEGRATED FINANCIAL MANAGEMENT
FINDING THE BALANCED OUTCOME



Employer is able and willing to meet the shortfall contributions arising from adverse risks materialising.

The level of investment risk is appropriate to the circumstances of the scheme and the employer.

The investment return is optimised for the acceptable level of risk.

There is a clear risk management plan which is reflected in the funding arrangements.

The Technical Provisions are sufficiently prudent.

The shortfall contributions represent a reasonable balance between the need to pay promised benefits and minimising any adverse impact on the employer's sustainable growth.

Full funding is attained over an appropriate period with sufficient likelihood.

Contingency arrangements exist which address worsening / improving funding developments

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ACTUARIAL VALUATION
ALTERNATIVE APPROACH

What's new?

Assesses the funding requirements without having to rely only on the traditional discount rate approach.

How does it work?

A stochastic analysis of the projected ability of a scheme's assets to meet members' benefits payments – funding and investment viewed through an alternative lens.

Its advantages?

Provides transparency of:-

1. The extent to which scheme assets are projected to be sufficient to enable members' benefits payments to be met, based on a chosen investment strategy.
2. How the likelihood of success is projected to change if the level of investment risk is progressively reduced by investing increasingly in income generating assets.
3. The level of prudence in the trustees' funding principles measured against the likelihood of meeting future benefit payments to members rather than the discounted value of the liabilities.
4. Risks and reliance on covenant, enabling enhanced integrated risk management.

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ALTERNATIVE VALUATION APPROACH
FUNDING REGULATION ALIGNMENT

Key requirements

1. Trustees' key objective is to pay promised benefits as they fall due.

2. Trustees should seek a funding outcome that reflects a reasonable balance between the need to pay promised benefits and minimising any adverse impact on an employer's sustainable growth.

3. Technical provisions should be calculated using assumptions that have been chosen prudently, taking into account the degree to which the employer covenant can support a range of likely adverse outcomes.

4. Discount rates must be evidence based taking into account either: the yield on assets held by the scheme to fund future benefits and the anticipated future investment returns; and/or the market redemption yields on government or high quality bonds.

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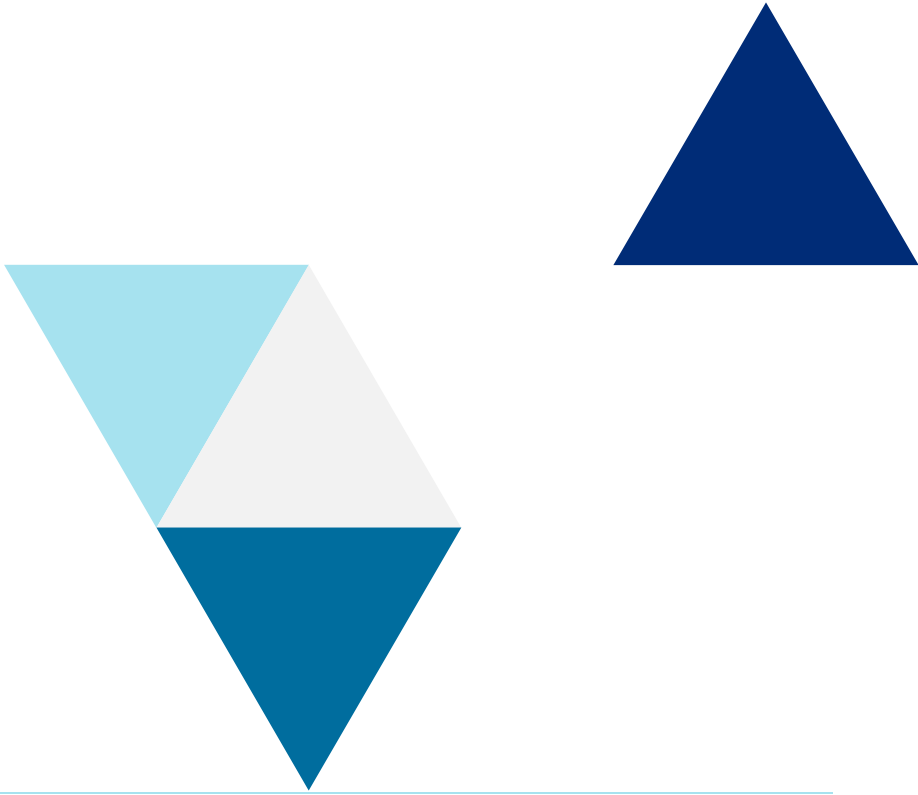
CASE STUDY



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ALTERNATIVE VALUATION APPROACH
CASE STUDY ILLUSTRATION

STEP 1: DETERMINE THE PROFILE OF BENEFIT PAYMENTS TO MEMBERS

STEP 2: MODEL THE SCHEME'S ASSET INCOME AND COMPARE WITH THE BENEFIT PAYMENTS

STEP 3: SHORTFALLS TO BE MET FROM THE ASSETS AND CONTRIBUTIONS, SUPPORTED BY THE COVENANT

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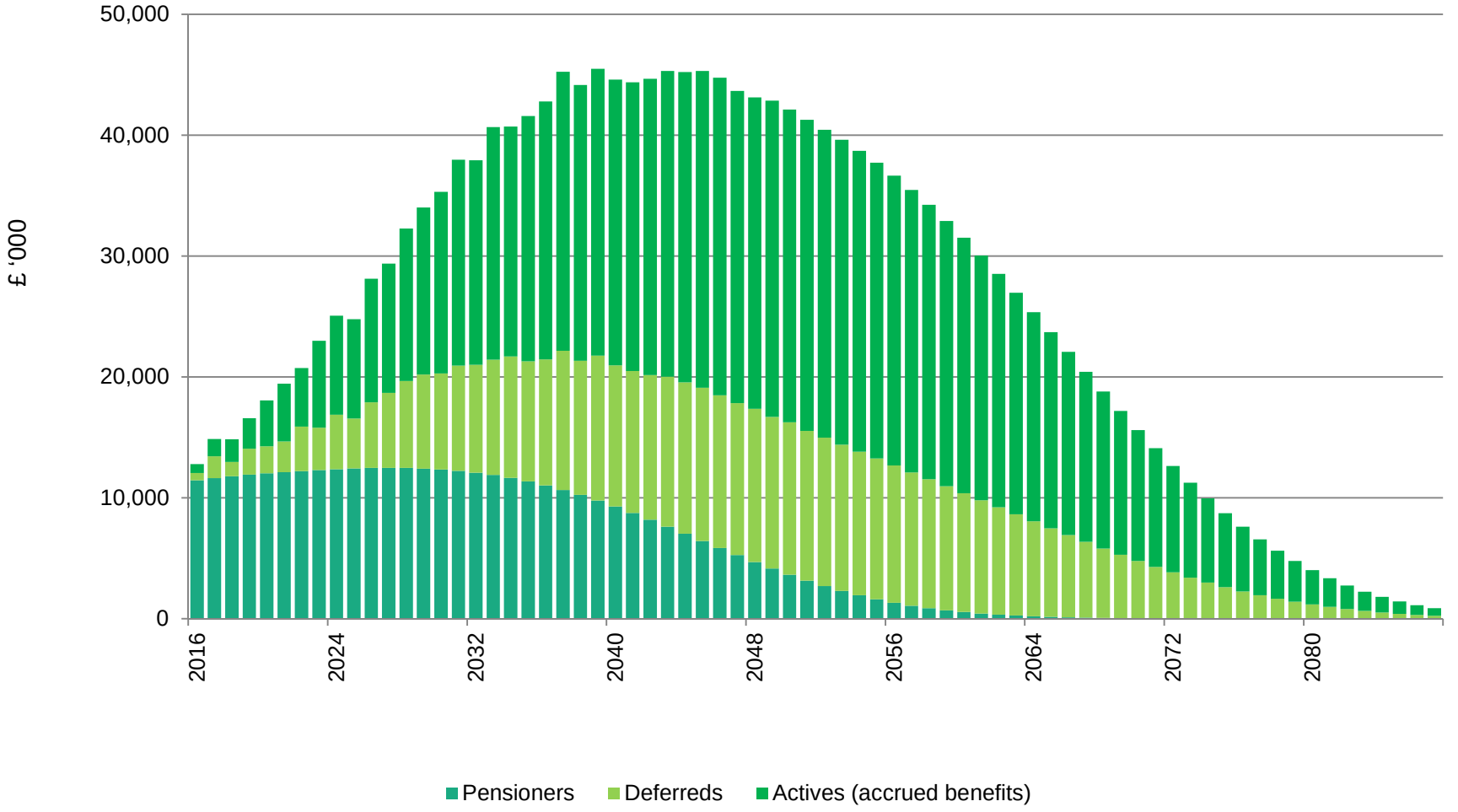
PROJECTED BENEFIT PAYMENTS



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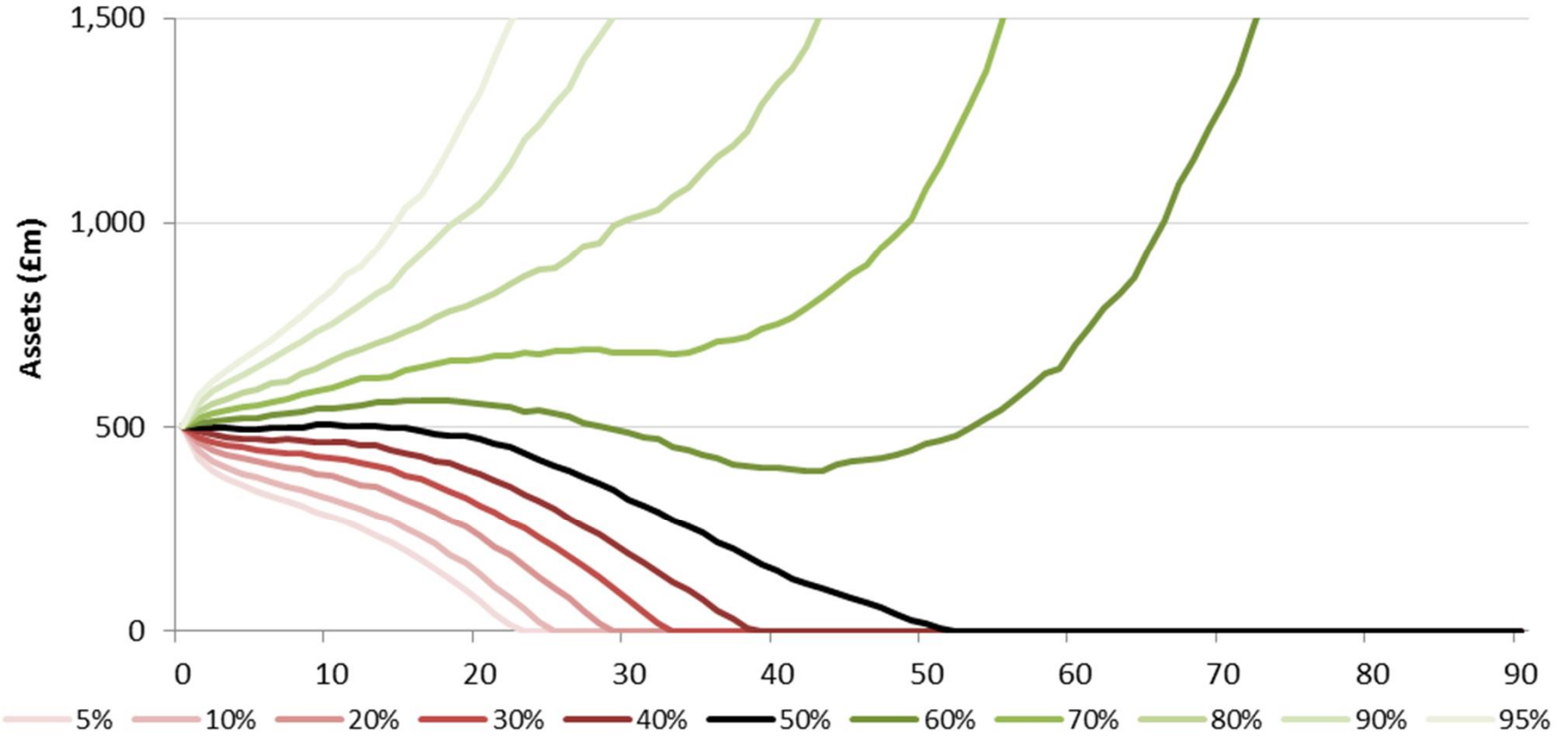
ASSET PROJECTION

Current investment strategy: 60% growth assets



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CONSIDER THE COVENANT

The strength of the Company's covenant support for the Scheme is the foundation of the integrated approach to risk management. In particular, the covenant has to underwrite the risks within the funding and investment strategies.

CONSIDERATION	DESCRIPTION	STRATEGIC IMPACT
Short term solvency risk	What is the risk that the employer will become insolvent leaving the Scheme with no sponsor? In that event, what assets would the Trustees be able to call on to secure the benefits?	If this risk is too great, the Trustees should consider reducing short term investment risk and/or securing greater funding or contingent assets.
Medium term cashflow risk	What level of additional contributions would be intolerable to the Company?	Funding and investment strategy should be designed to limit the possibility of a funding requirement in excess of this.
Covenant visibility	Particularly if the covenant is currently viewed as strong or positive, is there a time period beyond which this becomes significantly less certain.	It makes sense for the Trustees to target some form of risk reduction over this period. The period could be extended as and when greater visibility is achieved.

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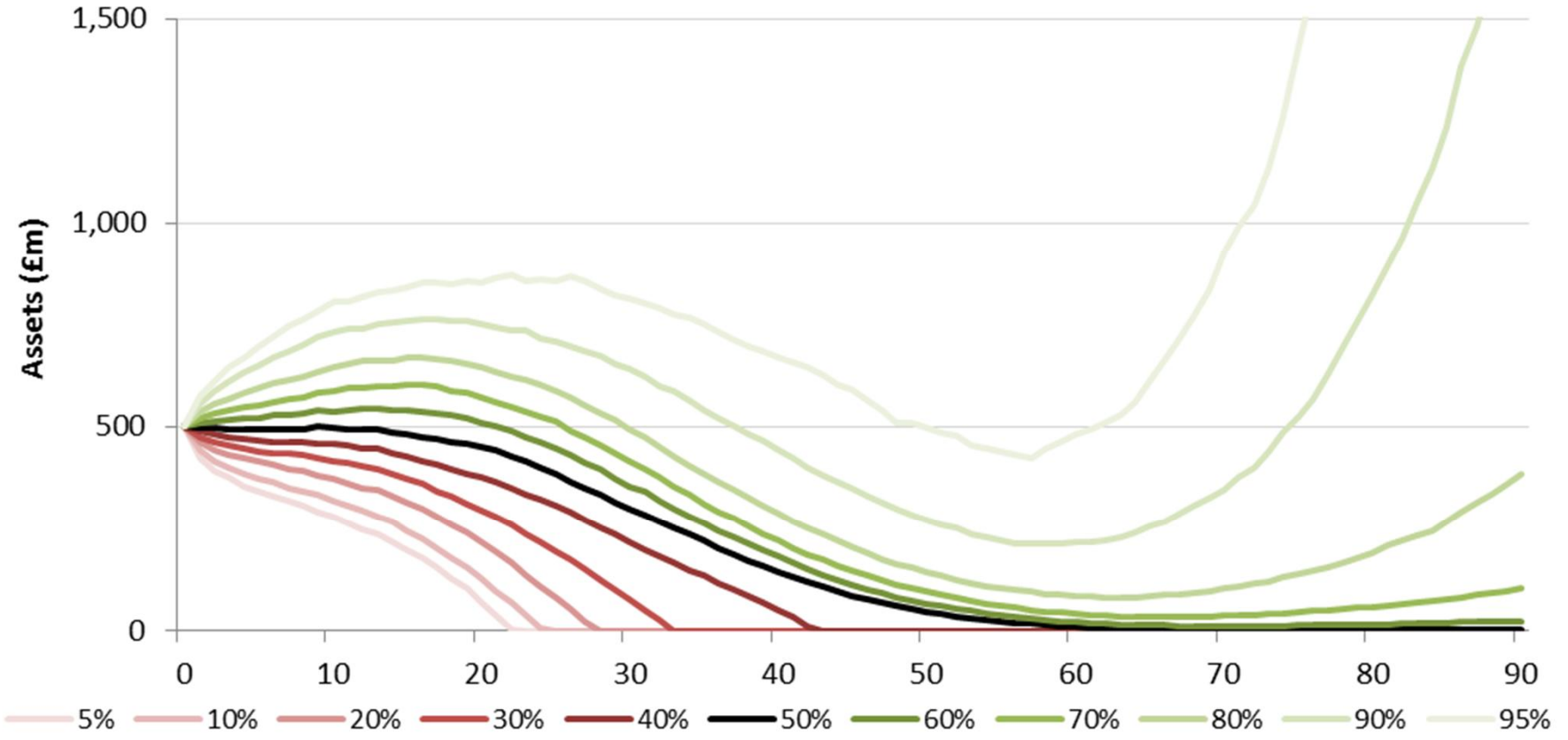
DYNAMIC INVESTMENT STRATEGY
ASSET PROJECTION

DYNAMIC INVESTMENT STRATEGY: CAPTURING UPSIDE OPPORTUNITIES



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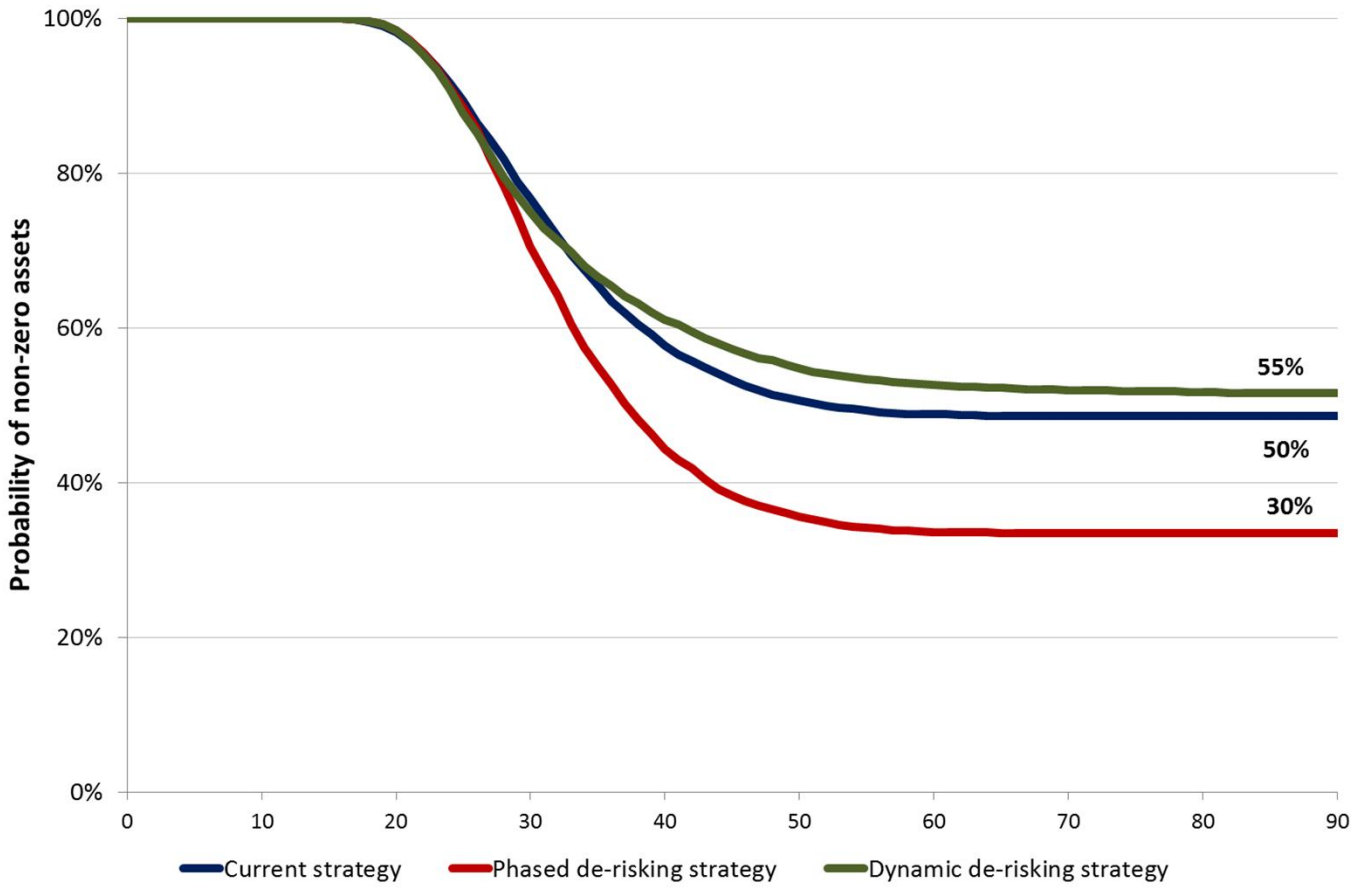
DYNAMIC INVESTMENT STRATEGY
PROBABILITY OF LONG TERM SUCCESS

PROBABILITY OF NON-ZERO ASSETS



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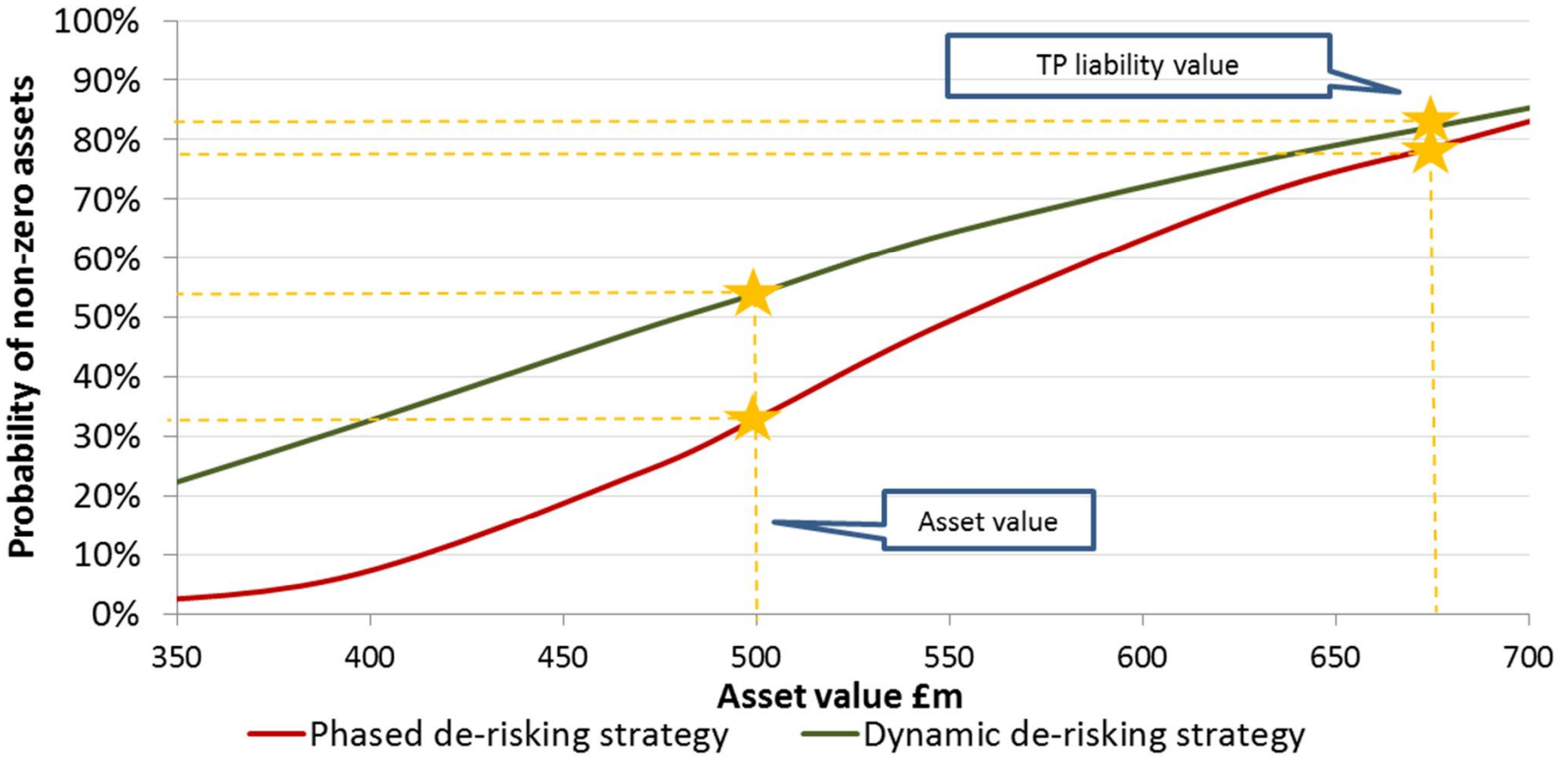
DYNAMIC INVESTMENT STRATEGY
LONG TERM SUCCESS

LONG TERM ASSET PROJECTION



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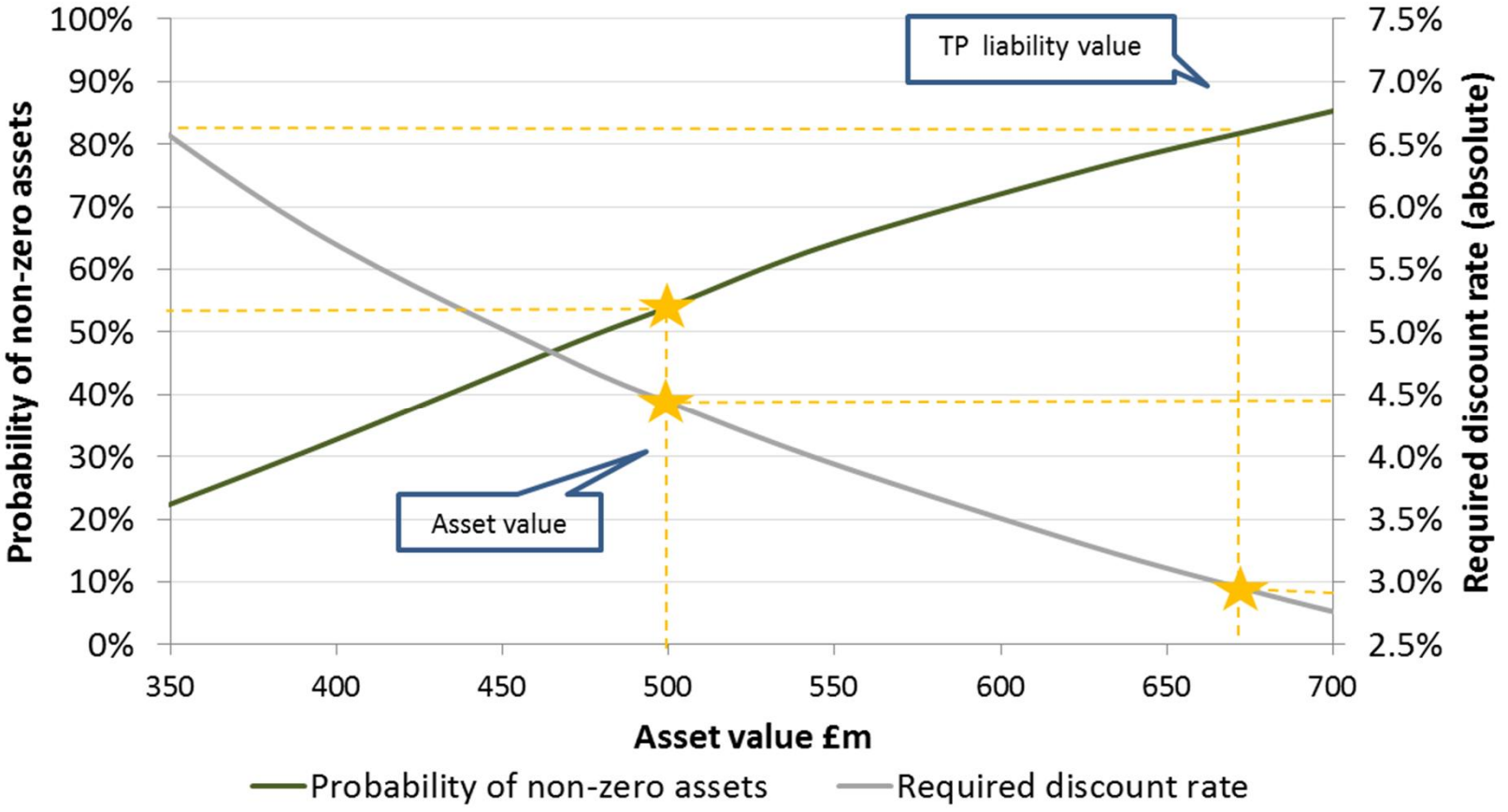
STATUTORY DISCOUNT RATE



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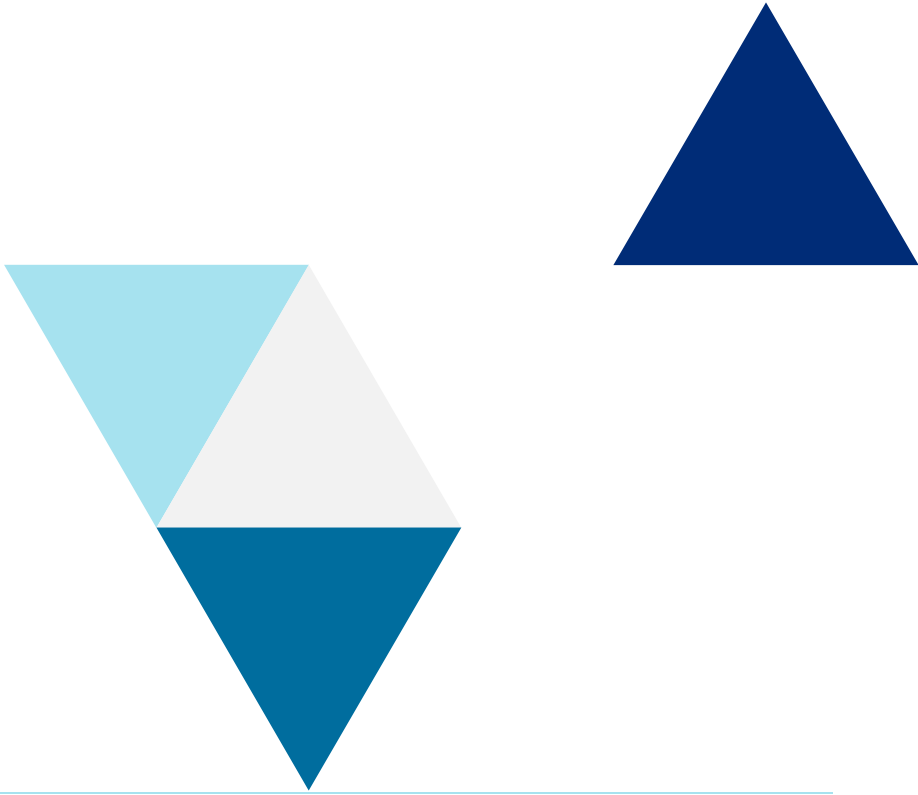
JOINING IT ALL UP – INTEGRATED RISK MANAGEMENT



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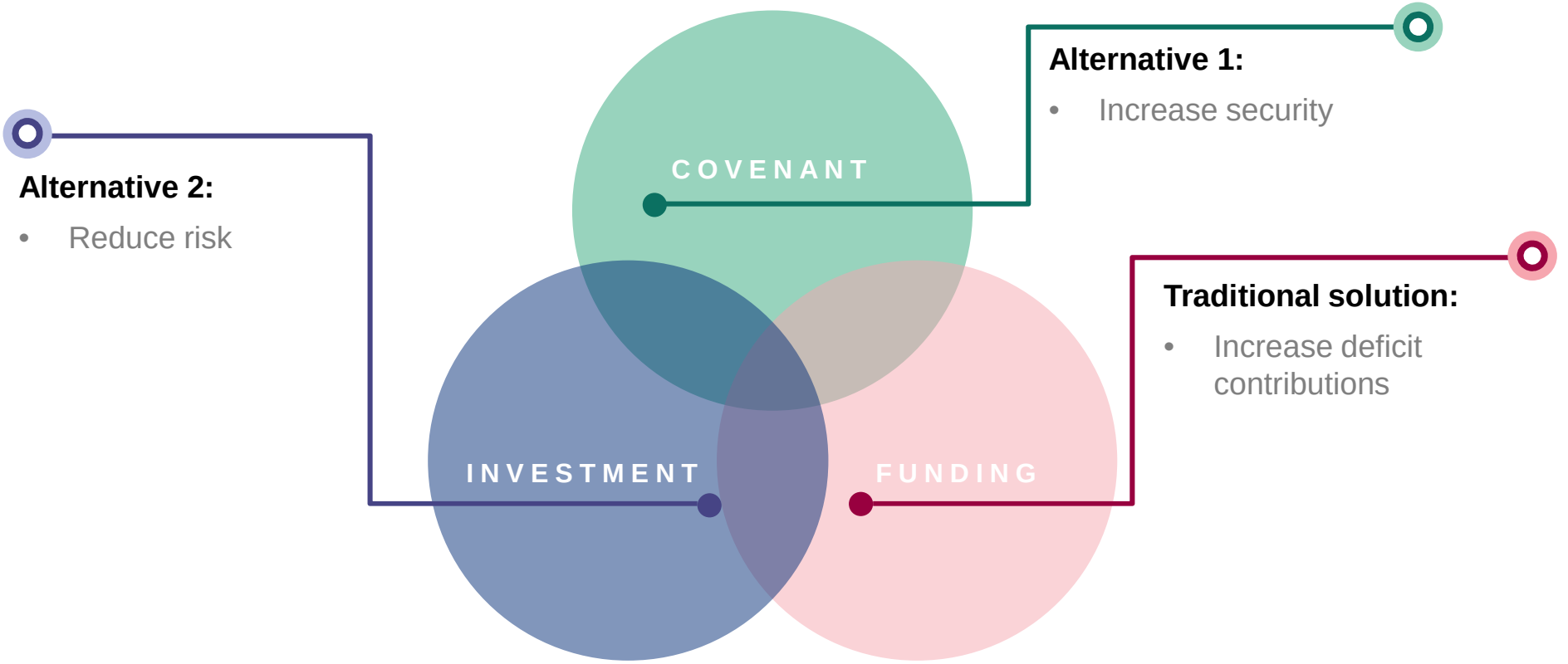
VALUATIONS IN ACTION IN AN IRM FRAMEWORK
FINDING OPTIMAL SOLUTIONS

EXAMPLE ISSUE: INCREASED DEFICIT



Alternative 1:
- Increase security

Alternative 2:
- Reduce risk

Traditional solution:
- Increase deficit contributions

Alternative 3: Create robust mitigation plan (e.g. contingent recovery plan)

Alternative 4: Strengthen governance (Trustee structure and relationship with sponsor)

Alternative 5: Combination of the above, etc. etc.

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VALUATIONS *SUPPORT* AN IRM PROCESS …..NOT THE OTHER WAY AROUND

TRADITIONAL:

VALUATION	INVESTMENT REVIEW	BUSINESS AS USUAL	. . .
YEAR 1	YEAR 2	YEAR 3	

Move from here….to here

CONTINUUM

IRM PROCESS:

IRM DEEP REVIEW	**IRM EXECUTION**	. . .
• OBJECTIVE SETTING • RISK ANALYSIS • COMPANY CONSULTATION • INVESTMENT & FUNDING* STRATEGY • STRATEGIC PLAN • ETC..	• MONITOR • ACTIONS • PERIODIC REVIEW	

*Statutory valuation elements completed once every 3 years

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QUESTIONS?

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QUESTIONS

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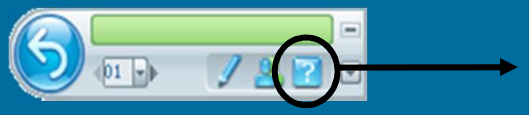

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