Grant Thornton Pensions Advisory podcasts

4. Actuarial and Funding Issues: transcript

Hello and welcome to this series of Grant Thornton's Pensions Advisory podcasts.

In this edition, we will be looking specifically at Actuarial and Funding issues facing trustees and sponsors.

To make sense of these issues, I'm joined by my colleagues from the Pensions Advisory team, **Kevin Hollister** and **Zoe O'Donnell**, both of whom are very experienced pensions actuaries, who've worked for many years with employers and schemes.

Russell Kevin, my first question to you is a very simple one: how do you think the results from the next round of valuations are likely to look?

Kevin If we look back over the last three valuation cycles, so back over a period of nine years, what you're seeing over that period is funding deficits getting larger and larger, and funding positions getting worse and worse. There was an initial period of time where there was somewhat of a catch up on longevity assumptions, where these were brought into valuations and made the funding position worse and there's been a relentless fall in long-term yields over that time as well, so we've seen positions get worse and worse and worse. I think for the next set of funding valuations, the next valuations cycle, there's going to be no upside on that really, you're going to see a lot of schemes with either similar positions, despite large contributions being paid in, or funding positions getting even worse, deficits getting even larger. Again it's largely due to falling yields over the last three year period, that's really the main driver for the worsening positions, and many schemes are under-hedged on this key risk.

We're likely to see instances where recovery plans become more stretched, longer, possibly more back-end loaded and with more outperformance allowed for in asset returns over that recovery period. What you're actually starting to see is some type of gradual recognition, you're starting to see the first mentions in the press that maybe there are some schemes, where the hole is just too big that they can never really dig themselves out of the position that they're in.

Russell Zoe, what do you feel Trustees and Sponsors should focus on at upcoming valuations?

Zoe I think it's really important for them to be focusing on the potential range of outcomes that are faced by DB schemes. Consideration alone of the progression of the funding level just doesn't give them enough insight into the risks that are inherent. The problem with traditional modelling has been that it has not tended to focus enough on real-world economic scenarios and the integration of the employer covenant with that.

I think for most schemes the key consideration should start with the trustees and sponsor determining what their definition of success and failure is for the scheme. Generally for Trustees that will nearly always be when the scheme gets to a point where it doesn't rely on the employer covenant any longer, so some sort of self-sufficient or buy-out status. The trickier thing is for them to determine what is deemed a failure and that will vary widely across different schemes. Schemes where the employer is really cash-strapped, it could be something as simple as the current level of contributions increases by 10% over the next few years. Other schemes where they've got a sponsor with large pockets, it could be something completely different, for example not reaching buy-out or self-sufficiency within the next five years, but it will vary widely across schemes.

Kevin Of course you've got to look at the short-, medium- and long-term position of the employer to assess the covenant as well, but it really is that key definition of failure. As Zoe says, some small schemes can't absorb a small increase in contributions, whereas other may be absorb a multiple of the current level of contributions. So it's really key in your modelling to define those Success and Failure outcomes, and then once you know your definition of failure, which again as Zoe says could be markedly different across various groups of employers, you really need to optimise your investment and funding strategy to maximise those outcomes of success and minimise those outcomes where failure occurs. This is really in line with the regulator's message, a lot more thought really needs to be given to the integration of funding, investment and covenant in any modelling that is undertaken.

Russell But clearly there are some of the areas of risk and cost reduction likely to be investigated by Trustees and Sponsors?

Zoe There are many ways they can reduce their long-term cost and risk within the scheme. One of the key areas which the schemes might be considering, or it might be worthwhile for them to consider, is the possibility of some sort of transfer value exercise. These can take many forms, they can be an at-retirement exercise, they can be in bulk, they can be with an enhancement or without an enhancement, but the key consideration for the scheme with these is that there is the potential there for them to extinguish the liabilities of the scheme at a cost which is much lower than the cost of buying out. And that's the key consideration. A lot of times trustees will tend to compare the position with the current technical provisions basis and the funding level on that basis, however it is important they consider it against the buyout position, because ultimately extinguishing liabilities through a transfer value or buying out with an insurer, both achieve the same outcome but at very different costs.

Russell Aren't defined benefit pension schemes always the best solution for retirement benefits?

Kevin It's a great solution in order to build up retirement benefits, and if you look at a DB versus a DC plan, it's almost always going to be better to build up benefits within a DB plan. But when members actually come to take those benefits, sometimes the benefits from a DB plan can look very inflexible. If you take typical incomes from a DB plan, you'll get a pension at a set level and it will increase for the rest of your life, maybe at retirement or some other type of increase. But really if you look at spending patterns for those people in retirement what you tend to see is higher spending in the initial years as they want to treat themselves but then their spending tails off over the years as they become less active.

And as well you have the State Pension kicking in, so actually you are getting a much lower benefit in the early years and then a higher benefit with the state benefits included in the later years. Many members, if they really thought about it, would like to rearrange those benefits so they got higher benefits in the early years and lower benefits in the later years, or possibly even a flat benefit throughout their retirement. If you look at death benefits as well, the ability now, with quite favourable tax regimes, on how you can pass on your benefits to a spouse or other members of your family, can be very beneficial within the DC environment as well.

But what you really have to do is get the members engaged. You have to get the members engaged in looking at another alternative solution, an alternative outcome of benefits. Without them looking at that alternative outcome, when they got to get advice, any IFA is going to tell them to stick with the guaranteed benefits. So it's really getting the members thinking about what could be a different, an alternative set of benefits for me and how could a DC transfer value provide this? There are various ways you can get members engaged. You can look at tailored communications for members, members at different ages, members with different levels of benefits. You could offer them online tools for example, so they can go in and look at alternative provision for their retirement, but it's really that key thought of why do I want any benefits that are different to what the DB plan is offering that is going to get them engaged in the exercise

Zoe It's perhaps no coincidence that people in the Financial Services industry tend to have higher take up rate on these sorts of exercises, because they have given consideration to them alternative benefit structure than what is provided by the DB scheme.

Russell What about the annuity market, a steady amount of schemes seem to buy-in or buyout each year?

Zoe I think there will always be a steady stream of schemes who are fortunate enough to reach the point where they can go to full buyout in the market. Either they will be well funded enough, that they will have enough money within the scheme to do it. Or they will be backed by a sponsor with deep enough pockets who can fill the gap. Eventually the cost of going to full buyout will be outweighed by the potential risks that are inherent in continuing to run the scheme and the expenses of doing so. And ultimately that is the long term aim of most schemes, to get to the point where they can extinguish all liabilities with an insurer.

As an alternative to the buyout market, there is a buy-in market where it is more of an investment decision rather than a decision to extinguish the liabilities. And we've seen quite a lot of activity in this area, particularly for schemes with a significant proportion of their investment is held in gilts, and they can transfer those gilts, which are a good match for the liabilities, to an annuity which is an almost perfect match to the assets within the scheme.

Russell What does the typical gilts for annuities swap look like?

Kevin It's where a scheme sells its gilts that it is currently holding as a matching asset and goes and buys annuities with the proceeds of that sale. So essentially it trades a very good matching asset in gilts with a perfectly matching asset in annuities. Sometimes if market conditions are right and the appetite is there from insurers, you can actually pick up that annuity policy at a price which is at or lower than the cost of funding the benefits using the yields that you get on gilts.

We last year as an example a scheme with £40-50 million in gilts and traded a significant proportion of those gilts to buy an annuity policy. There was actually a bit of a pick-up for the scheme, the policy came in £2 million below the expected cost of funding those liabilities using that gilt portfolio.

Russell Any other examples where buy ins currently may make sense for a scheme?

Kevin Well, the enhanced annuity market has been growing over time. Typically it could an optimal scenario for smaller schemes where there's a large concentration of risk within certain members, so you may have 10% of the members are 40% of the liabilities for example. Now, in those cases, if there are any health issues with those larger members, overall if you look at the price of the annuity contract once those health issues are taken into consideration, then it can look quite favourable compared to what you've been funding on. Essentially there can some kind of hook up between the longevity assumptions used by the scheme and the actual longevity assumptions an insurer is willing to price on, once it knows that health information.

To be honest in that market, there are other factors at play with insurers trying to be as competitive as possible to increase their market share. It's no surprise given that their individual annuity market has probably decreased since the pensions freedoms came about, so they are trying to build their presence in the bulk annuity market and therefore there is some very competitive pricing

Russell Does this underwriting approach have any applications elsewhere?

Zoe What we've seen recently is that most schemes are using this sort of approach not to actually got to market, but to improve the accuracy of the assumptions being used for the funding valuations. It gives the trustees and the sponsor a better understanding of the life expectancy within the scheme. Traditionally schemes have used various different approaches to try and understand the longevity of the membership, from postcode analysis to occupation to regional analysis, but the best way to do it if you can get information on the membership's health background, it's obviously going to give them a more accurate rating than something which is based on postcode.

It's done using a similar process, a firm will write out to members and gather all the medical data the same way they would if they were going to market but it isn't actually used at the point of going to an insurer, it's used for internal scheme purposes basically.

Russell Do these exercises typically get a good response rate from members?

Zoe I think the key to the success of the exercise is the communication and I think as long as it's made clear to the members the purpose of the exercise, the fact that it's in the interests of the scheme that the exercise is proceeding, so that they can better fund and monitor the risks etc. within the scheme, I think members at that point are quite willing to provide feedback.

You're never going to get a 100% response in these cases, but if members feel they are doing something which potentially going to help something that is providing them with benefits, then you will get a reasonable amount that are quite willing to participate.

Both, thank you for your time and thanks for joining us. As usual you can find all the information you will need on this complex subject, including a transcript of this podcast, on our web pages at **http://www.grantthornton.co.uk/pensionsadvisory**

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