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Nadia Dabbagh-Hobrow
Secretary
SORP Working Party
c/o KPMG
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15 July 2014

Dear Ms Dabbagh-Hobrow

ACA RESPONSE TO THE PENSIONS RESEARCH ACCOUNTANTS GROUP CONSULTATION ON THE EXPOSURE DRAFT OF THE SORP: FINANCIAL REPORTS OF PENSION SCHEMES

We are writing on behalf of the Association of Consulting Actuaries (ACA), in response to your consultation on the above.

Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. Members of the Association are all qualified actuaries and all actuarial advice given by members is subject to the Actuaries' Code. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of defined benefit pension schemes.

The ACA is the representative body of consulting actuaries, whilst the Institute and Faculty of Actuaries is the professional body.

We welcome the opportunity to respond to the consultation. Our response below is focussed on a number of the particular issues on which comments were invited (annuities and investments). We also have comments on the treatment in the exposure draft of other pension assets which are gaining in popularity, namely longevity swaps and Special Purpose Vehicles (SPVs).

Annuities

We welcome the fact that FRS 102 directs pension schemes to provide a valuation of their annuity holdings. Annuity investments are a key part of the overall asset portfolio for a growing number of schemes, particularly those schemes where a significant proportion of a scheme's obligation to pay future benefits has been insured through a buy-in policy. Annuities are an important tool in pension scheme risk management and it is therefore important that users of the scheme's accounts are aware of the presence of annuity investments where material.

Our comments are therefore concentrated on the costs and practicalities of obtaining a valuation of annuity contracts. In our view the SORP could explicitly offer more flexibility around the actuarial assumptions used in their valuation.

Paragraph 3.12.19 of the Draft SORP notes that there are several actuarial bases possible for determining the present value of the benefit obligation covered by annuities and, by reference to FRS 102 28.15(b), the value of annuities themselves. We argue that it would be preferable to allow trustees a free choice of any reasonable basis for valuing annuities for the reasons set out below.

It is the order of magnitude of the annuity policy relative to the pension scheme as a whole which provides the most benefit to users of the accounts – i.e. whether only a small percentage of the obligation is matched by annuities, or almost the whole scheme.

The precise annuity valuation shown in the accounts does not, to our knowledge, have any specific use beyond the accounts themselves. This is not surprising since, at present, there is no requirement to include an annuity valuation at all. Even where annuities are given a non-nil value in accounts, Regulation 4(2) of the Occupational Pension Schemes (Scheme Funding) Regulations 2005 permits scheme actuaries to substitute their own valuation in place of the one shown in the accounts for the purpose of carrying out actuarial valuations under Part 3 of the Pensions Act 2004. Alternatively, Regulations 3(1)(c) and 3(4) allow the scheme actuary to exclude the value of both the annuities and the corresponding benefit obligation from Part 3 actuarial valuations.

The choice of actuarial basis is therefore somewhat secondary, at least as far as Part 3 actuarial valuations are concerned. This is in contrast to almost any other asset valuation shown in the pension scheme's accounts where the scheme actuary is compelled to use the value shown in the pension scheme's audited accounts. Given there is flexibility in the treatment of annuities for actuarial valuations we believe it would be reasonable to reflect a similar level of flexibility in the SORP. We suggest that 3.12.19 of the SORP provides a more general direction for the trustee to consider an appropriate basis for annuity valuation – perhaps taking the advice of the scheme actuary – and removing the example in that paragraph regarding the trustee's intention. Such intentions could be better expressed as part of the disclosure envisaged by 3.12.20.

There is also a timing issue with respect to using the scheme funding valuation basis as a suggested means of valuing annuities. Trustees have 7 months in which to produce audited accounts, but 15 months in which to complete a Part 3 actuarial valuation. In years where an actuarial valuation is taking place it will typically be the case that the funding basis will not have been agreed by the time that the scheme's accounts are signed. Any perceived benefit of using the funding basis, such as the scheme actuary not having to adjust the value of annuities as referenced in 3.12.20, would be negated.

As there is a cost involved in valuing annuities, we also suggest that 3.12.19 allows the possibility of an approximate or "roll-forward" calculation to be used where the trustee considers this appropriate. In which case, the disclosure in 3.12.20 should explain the method that has been used as well as the basis.

Given the flexibility we are suggesting, we support the requirement in 3.12.20 for disclosure of the basis used to place a value on the annuity, but this should be expanded with the additional disclosures we have noted earlier and also explain to which benefit obligations the annuities relate and any potential differences between the benefit obligation and the cash flow provided by the annuities (e.g. the benefit obligation may increase in line with CPI but the annuity cash flows may be linked to RPI). Furthermore we believe in some cases it may be possible and indeed reasonable to use the same annuity valuation as the employer, and therefore suggest that 3.12.21 is redrafted to allow for this possibility.

We agree with the stance taken in 3.12.22 that would allow trustees not to place a value on certain annuities on grounds of materiality. This may be particularly helpful for schemes with only a very small percentage of their assets in annuities as there can be practical difficulties in obtaining up-to-date information from the writers of annuities taken out many years ago. Therefore some schemes are likely to find it difficult to place any kind of reasonable value on these annuity holdings.

Finally on the topic of annuities and given the focus on credit risk in relation to investments generally, we suggest that the accounts include a disclosure of the credit risks the scheme is exposed to in respect of any buy-in contracts.

Investment risk disclosures

FRS 102 requires retirement benefit plans to 'disclose information that enables users of its financial statements to evaluate the nature and extent of credit risk and market risk arising from financial instruments', where market risk is further defined as interest rate risk, currency risk and other price risk. Trustees need to disclose the exposures to risk and how they arise, their objectives, policies and processes for managing the risk and methods used to measure the risk and any changes from the previous period.

Overall, we welcome the aim of the proposed draft SORP in helping trustees to have a good understanding of the underlying investment risks inherent in the pension scheme and to be transparent to members, sponsoring employers and regulators about how the trustees are managing those risks. However, we note that the draft as it currently stands places a large reliance on obtaining quite detailed data from schemes' investment managers.

We have experience with helping:

- Defined benefit ("DB") clients complete bespoke stress tests for the purpose of calculating the Pension Protection Fund ("PPF") levy (where a look-through at the underlying asset level and individual derivative level is needed); and

- Defined contribution (“DC”) clients to complete Office of National Statistics (“ONS”) surveys (for larger DC clients, where a look-through at the underlying asset level is required for non-life wrapped funds).

In our view, most investment managers do not have effective reporting systems at present to be able to provide the level of information suggested in the draft SORP in a format that will allow trustees to prepare the disclosures in an efficient manner. We note that PRAG has set up a working party with the Investment Management Association to discuss the draft SORP.

With more detailed risk and investment disclosures, higher advisor costs are likely to be incurred, particularly with more detailed reporting proposed for pooled funds. Although cost should not be a driver for good governance, we question the benefit of the detailed reporting proposed from the perspective of the readers of the accounts. In particular, the membership of most pension schemes will be less familiar with complex investments at the look-through level but may have a better understanding of the concept of pooled fund arrangements.

To meet the FRS 102 requirements, we would suggest trustees prepare a statement stating that the scheme is subject to investment risks and a brief summary of how those exposures have arisen and how the risks are appropriate, given the scheme’s circumstances and having taken professional advice. This would make reference to a scheme’s Statement of Investment Principles. To cover currency risks, we suggest that a statement on currency hedging policy should be included to explain how and why the trustees are managing currency risk.

We would suggest a reduced risk disclosure may be preferable to help with trustee governance. For DB schemes, this could be similar to that currently used for the Pensions Regulator Scheme Return, in order to reduce potential additional governance and costs for DB schemes. For the derivatives risk disclosure, we suggest a format similar to that used for the calculation of a bespoke stress test for PPF levy purposes could be used (although we note that not all trustees opt to carry out a bespoke stress test). The information would, therefore, be presented in a format that would be of interest to trustees, members and regulators. An example of a typical data request for the purpose of a bespoke PPF levy stress test is included in the appendix.

For DC Schemes, the proposal put forward in the draft SORP seems reasonable and we agree with recommendation that the ‘more significant member funds’ should be considered. We interpret this to be funds which hold the majority of member assets, although we would suggest that the final SORP provides clear direction on the definition of ‘significant’ to ensure consistency across pension schemes. For the majority of pension schemes, this is likely to include the default arrangement.

Pooled Funds

In understanding the level of disclosure required for pooled funds, the draft SORP suggests trustees consider whether they are investing in pooled funds to obtain direct exposure to market and credit risks (such as equities or credit, for example) or to obtain indirect market and credit risk exposure through the underlying investments of a fund that the trustees have chosen to invest it based on the mandate type (such as a hedge fund).

We believe this classification is subjective and could lead to discrepancies between pension schemes. Certain pooled funds, which have an absolute return focus, are inherently difficult to disclose at a look-through level. Our suggestion would be to use the same level of disclosures used for the Pensions Regulator's Scheme Return, which is also at a look through level. For the purposes of the Pension Regulator's Scheme Return, these funds are typically classified as 'hedge funds', if a look-through is not straight forward.

Fair value hierarchy

FRS 102 requires the use of a categorisation hierarchy for the estimation of fair value based upon the availability of quoted prices. The draft SORP provides further guidance on the categorisation.

We note that the draft SORP suggests that pooled fund assets falling into category (a) (defined by FRS 102 as those where there is a quoted price in an active market) are those that are priced and traded daily. The draft SORP categorises pooled fund assets trading weekly or monthly as category (b) (defined by FRS 102 as those where quoted prices are unavailable). We do not believe weekly traded pooled funds should be classified as category (b) as a quoted price is available and the underlying assets may not be illiquid (such as weekly traded equity pooled funds).

In addition, the draft SORP suggests that if a daily price is not available at the reporting date (which is a normal business day), then the investment would be valued under category (b) or (c). We do not agree with this approach as there may be good reason as to why a daily price is not available on the reporting day, such as a public holiday in a non-UK market. Depending on when certain dates fell in the calendar, there may be discrepancies in the fair value methodologies used for certain assets at different reporting dates.

The category (c) approach covers asset classes where the market is not active or the estimate of the fair value is not good. The draft SORP proposes two sub-categories based on whether observable or non-observable market data is used to value the category (c) assets and recommends that there are separate disclosures between the two sub-categories. The valuation techniques for the asset classes in this category will be driven in part by the nature of the asset class (for example, derivative pricing would be based on observable market data) however we do not see there would be additional benefit in creating separate disclosures within this category.

Concentration of investment

We note that the proposed risk disclosures under FRS 102 are more granular than currently presented in Audited Accounts. However, concentration within one pooled fund may no longer be transparent. We therefore believe that a note disclosing the concentration of investment is still valid as a high-level summary of the main investment exposures in the scheme.

Other comments

Outside of the specific areas in which PRAG has sought comments, we have the following comments on the treatment of longevity swaps and SPVs.

Longevity swaps

We note the requirement of FRS 102 28.15 for assets to be valued at fair value unless it is an insurance policy that exactly matches the amount and timing of some or all of the benefits payable under the plan. The approach set out in paragraph 3.12.24 of the exposure draft requires a market approach to assessing the fair value of a longevity swap based on market-based interest rates and current market views of longevity. This is consistent with the approach being suggested by some for the valuation of longevity swaps in the accounts of sponsoring entities under IAS 19 (see for example, KPMG's Pensions Accounting Survey 2014, p7).

However, we have some concerns over the use of this approach when placing a value on a longevity swap for the purpose of a pension scheme's accounts:

- Longevity swaps are purchased as a hedging instrument and should therefore remove (to the extent hedged) any variation at actuarial valuations in the difference between the scheme's assets and its technical provisions due to changes in assumed mortality as well as actual mortality. This will not be the case if the longevity swap on the asset side of the actuarial valuation is priced using market-based views of mortality whereas the technical provisions are calculated based on prudent mortality assumptions[1] chosen by the trustees. This is likely to result in actuarial assumptions for Part 3 actuarial valuations being modified (potentially by an explicit adjustment to the technical provisions) in an attempt to achieve consistency with the longevity swap fair value shown in the scheme's accounts. Alternatively, it may result in actuarial valuations appearing to retain a degree of volatility due to mortality risk when in practice it has been hedged, although this would not appear to be a logical outcome for funding purposes.

- To date there have been few longevity swap transactions by pension schemes. This therefore raises the question as to whether reliable market views of longevity can be obtained. Even where a pension scheme has access to the terms on which recent longevity swap transactions have been completed, it is not always clear to what extent the pricing of the swap reflects market-based interest rates and longevity versus how much relates to counterparty costs and profit margins. Furthermore, expected longevity will vary from scheme to scheme and therefore it is important not to be over-reliant on the longevity terms that other schemes may appear to have been able to secure.

- There is an inconsistency of approach between the treatment of a scheme which attempts to buy-in benefits synthetically using a "DIY" approach of interest, inflation and longevity

[1] The mortality assumptions used in Part 3 actuarial valuations are necessarily prudent due to regulation 5(4)(c) of the Occupational Pension Schemes (Scheme Funding) Regulations 2005 (SI 2005/3377)

swaps (all of which would be valued using market-based assumptions) and a scheme using a traditional annuity buy-in (which would be valued using assumptions determined by the trustee).

In addition, it is not clear whether a longevity swap transacted with no initial premium would have an initial fair value of zero under paragraph 3.12.24, if the fixed cash flows are expected to exceed the floating cash flows due to expense margins (using market rates of mortality in both cases). We suggest amending paragraph 3.12.24 to clarify that the initial fair value would be zero in this situation, assuming that is the intent (e.g. should there be greater consistency with the wording in IAS 19 and IFRS 13 that applies to the accounts of sponsoring entities).

To deal with the above points, particularly with regards to preserving the hedging characteristics of the swap, we would ask PRAG to consider including one or both of the following options in the SORP as a means of valuing a longevity swap, subject to being consistent with the definition of fair value in FRS 102:

(a) To allow trustees to make a mortality assumption for the purpose of valuing the longevity swap which is consistent with the trustees' view of longevity that was priced into the fixed leg of the swap when it was initially transacted. This assumption should then be adjusted to take account of subsequent changes in the mortality assumption used to calculate the scheme's technical provisions.

(b) In cases where the longevity swap has been written as an insurance contract, to allow the value of the swap to be determined using assumptions chosen by the trustees as per 28.15(b) of the exposure draft, noting that the fixed leg of the longevity swap will typically match the amount and timing of the benefit obligations that have been hedged by the swap.

SPVs

We believe the approach to valuing SPVs set out in paragraphs 3.12.25 to 31.12.31 of the exposure draft is reasonable.

It would be helpful however if the SORP could provide some guidance as to the frequency for full valuations of SPVs. For example, according to KPMG's 2014 survey: Asset Backed Funding for Pensions, property is an asset which backs the majority of existing SPVs. The same survey shows that SPVs are typically a significant proportion of scheme assets: 10% or more in almost half of cases. Guidance along the lines of exposure draft paragraph 3.12.24 (relating to the frequency of property valuations) would be helpful and we would suggest that the same frequency as actuarial valuations would be a suitable minimum. This would also be consistent with the position that the PPF is currently consulting upon that would base certification of SPVs around a detailed valuation at the same frequency as Section 179 valuations (ie at least once every three years).[2]

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[2] As per paragraph 9.2.14 of the Consultation on the second PPF Levy Triennium: 2015/16 to 2017/18 published by the Pension Protection Fund.

One area where we feel the exposure draft is lacking with regard to SPVs is in the area of disclosure. SPVs are bespoke arrangements and therefore we suggest that paragraph 3.12.31 is expanded to include disclosures of the payments that the pension scheme expects to receive from the SPV, the nature and relevance to the scheme of the assets held by the SPV and the main assumptions made when calculating the value of the SPV. This would be consistent with the approach taken by the Pensions Regulator in its November 2013 guidance titled "Asset-backed contributions" which requires reporting to members on the funding implications of SPVs (paragraph 49) and sets out the Regulator's approach of "unpacking" the SPVs to look at the underlying cashflows:

> "56. Where we consider that the valuation of the payment stream is material the regulator will 'unpack' the effect of the ABC [i.e. the SPV]. In other words, when considering the valuation and the scheme's funding plans, we will look behind the net present value attributed to the ABC and consider the aggregate funding stream provided under any recovery plan and the ABC. If the payment period under the ABC is longer (or more back-end loaded) than an appropriate recovery plan then we will ask trustees to explain how they have concluded the value of and access to the underlying asset justifies the extended period for the scheme to become fully funded."

It would also be helpful if the document in paragraph 3.11.7 (referring to PRAG guidance on accounting and valuing SPVs) could be incorporated into the SORP or the reference removed entirely. If this is not possible then, at the very least, guidance should be publicly available if referenced in the SORP.

We hope you find this response helpful. Please contact us if you wish to follow up any points.

Yours sincerely

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Appendix – Example of a data request for the Pensions Regulator Scheme Return and PPF Levy Bespoke Stress purposes

Physical assets

Equities
- UK quoted equity
- Overseas developed
- Overseas emerging
- Unquoted / Private equity

Property

Hedge Funds

Commodities

Fixed interest government bonds (including supra-national debt)
- Short maturity (0-5 yrs)
- Med maturity (5-15 yrs)
- Long maturity (15+ yrs)

Inflation-linked bonds (including inflation linked non-government bonds)
- Short maturity (0-5 yrs)
- Med maturity (5-15 yrs)
- Long maturity (15+ yrs)

Fixed interest non-government bonds (including ABS, MBS, FRNs and sub-sovereign debt)
- UK inv grade (0-15 year maturity)
- Overseas inv grade (0-10 year maturity)
- UK long-dated inv grade (15+ year maturity)
- Overseas long-dated inv grade (10+ year maturity)
- Global sub-inv grade (all maturities)

Cash

Annuities

Other (inc Insurance Funds) - please specify

Derivative market value (mark-to-market)

Total portfolio value

Total portfolio value

Total Portfolio Exposures
- **PV01**
- **IE01**
- **CDD01**

Interest Rate Derivative exposures

Interest rate swaps
- PV01

Inflation swaps
- PV01
- IE01

Gilt TRS / Gilt Futures
- PV01
- IE01

Asset swaps (derivatives only - excluding sensitivity of the physical assets)	
	PV01
	IE01
CDS	
	PV01
	CDD01
Repo	***Forward Gilt Exposure***
	PV01
	IE01
	Physical Gilt Exposure (included in "Physical Assets" tab)
	Market Value
	PV01
	IE01
Swaptions	
	Buyer
	Receiver/Payer
	Nominal/Real Rate/Inflation
	Strike date
	Swap Tenor
	Strike rate

Equity Derivative exposures

Equity future	
	Buyer
	Notional Economic Exposure at Calculation Date*
	Underlying Index
Equity TRS	
	Nominal
	Index at inception
	Index at valuation
Equity option	
	Buyer
	Put / Call
	Strike price
	Index at valuation
	Notional exposure at Calculation Date*

*** Economic Exposure at Inception adjusted in line with the relevant equity index return from the date of inception to the calculation date**