CAPITA

ACA Conference – 5 February 2016 – Seminar B10

Integrating investment and funding with covenant assessment – a debate on the gaps between theory and practice

1. Background

1.1 The Regulator has published three major documents in the last 18 months:

- a new Code of Practice on funding
- guidance on assessing and monitoring employer covenant
- guidance on integrated risk management

1.2 We are assuming that all present have a working knowledge of these documents.

1.3 We acknowledge the triangle linking covenant, investment and funding.

2. Investment and funding

2.1 The funding regulations say that the rates of interest used to discount future payments must be chosen prudently, taking into account the yield on assets held by the scheme and the anticipated future investment returns. Very few valuations are completed using unadjusted gilt yields.

- How visibly connected are discount rates to a scheme's investments?
- How easy do actuaries find it to set discount rates based on a scheme's current investment strategy?
- Do trustees have a clear view of future changes to their investment strategy?
- How easy is it to set discount rates appropriate to those future periods?

3. Covenant and funding

3.1 The funding regulations say that the assumptions must be chosen prudently taking into account an appropriate margin for adverse deviation. Covenant is not mentioned in the Act or in the Regulations. We know that the Regulator interprets this as meaning that higher margins should be used for weaker covenants.

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- 100% growth assets and minimal margins for the strongest covenant cases?
- Buy-out bases for the weakest covenant cases?
- What is appropriate for all the schemes in the middle?
- Can this be done formulaically or does it all depend on subjective judgement?

4. Covenant and investment

4.1 There is no regulatory instruction on investment. The Regulator provides some guidance.

- Very strong covenant cases can manage volatility and pursue high returns
- Very weak cases cannot manage volatility and should pursue lower returns
- What is appropriate for all the schemes in the middle?
- Can this be done formulaically or does it all depend on subjective judgement?
- How important are the allocations within the return-seeking and risk-reducing categories?

5. Theory and practice

5.1 The Regulator's model is a good model, but does it work in practice?

- Can we deal with the questions listed above?
- Covenant assessments might be valid for a couple of years. Funding plans need to cover several decades. Is it possible to integrate these?
- Are covenant assessments good enough in the first place?
- Can trustees and actuaries really plan future investment strategies?
- Is it right to block weak-covenant schemes from the possibility of high investment returns that might make all the difference to providing benefits in full?
- Do schemes in the middle of the covenant range get penalised twice – once for a restriction on return-seeking assets and again through margins in discount rates?
- Is it possible to construct worthwhile contingency plans?

5.2 The objective of the session is to share and debate opinions on what works in practice.

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