Protecting defined benefit pension schemes

ACA Sessional Meeting

26 April 2018

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White Paper proposals

1. Strengthen TPR powers
2. Improve scheme funding regime
3. Encourage consolidation

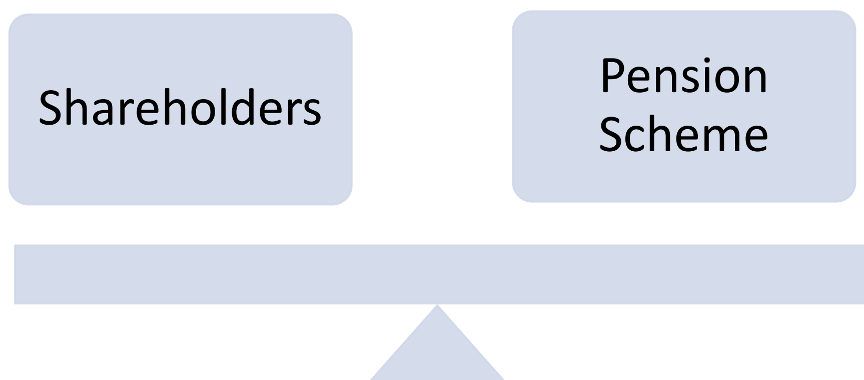
- Defining prudence (TPs)
- Defining appropriate (RPs)
- Setting a Long Term Objective (LTO)

Will focus on the last two proposals

Balancing interests?

DWP 2017 Green Paper: *"The UK DB funding regime is not designed to eliminate all risk to members' benefits.*

Rather it seeks to strike a reasonable balance between the demands on the employer and the security of member benefits, recognising that a strong, sustainable sponsoring employer is the best protection for a DB scheme."



Mood music has changed in last 12 months

Setting a clear line for "prudent" TPs

Main options

- Discount rate focus?
  - Gilts +?
  - Probability / confidence level – *unlikely?*
  - Other, e.g. AA yields?
- Other assumptions?
- Funding target – a % of:
  - Buy-out / solvency
  - Self sufficiency
  - PPF …. or IAS19/FRS17?

Some implications

- Back door MFR
- Behaviour impact - default to minimum
- Impact on investment
- Robustness over time?
- Interaction with LTO

Been here before ….. key issue of scheme specifics

Allowing for scheme specifics

Maturity

- Seems to be an obsession
- Is liquidity really an issue?
- Are the differences that stark?
  - Mature schemes are shrinking – less reliant on covenant
  - Immature schemes are growing
- Higher uncertainty over longer tail liabilities
- Role of insurance?

Covenant strength

- 4-box assessment pretty blunt
- Role of security / contingencies

Investment strategy

- Transparency short and long term
- Interaction with covenant

Benefit profile

- PPF drift / PPF haircut level
- Discretionary

What is an “appropriate” RP?

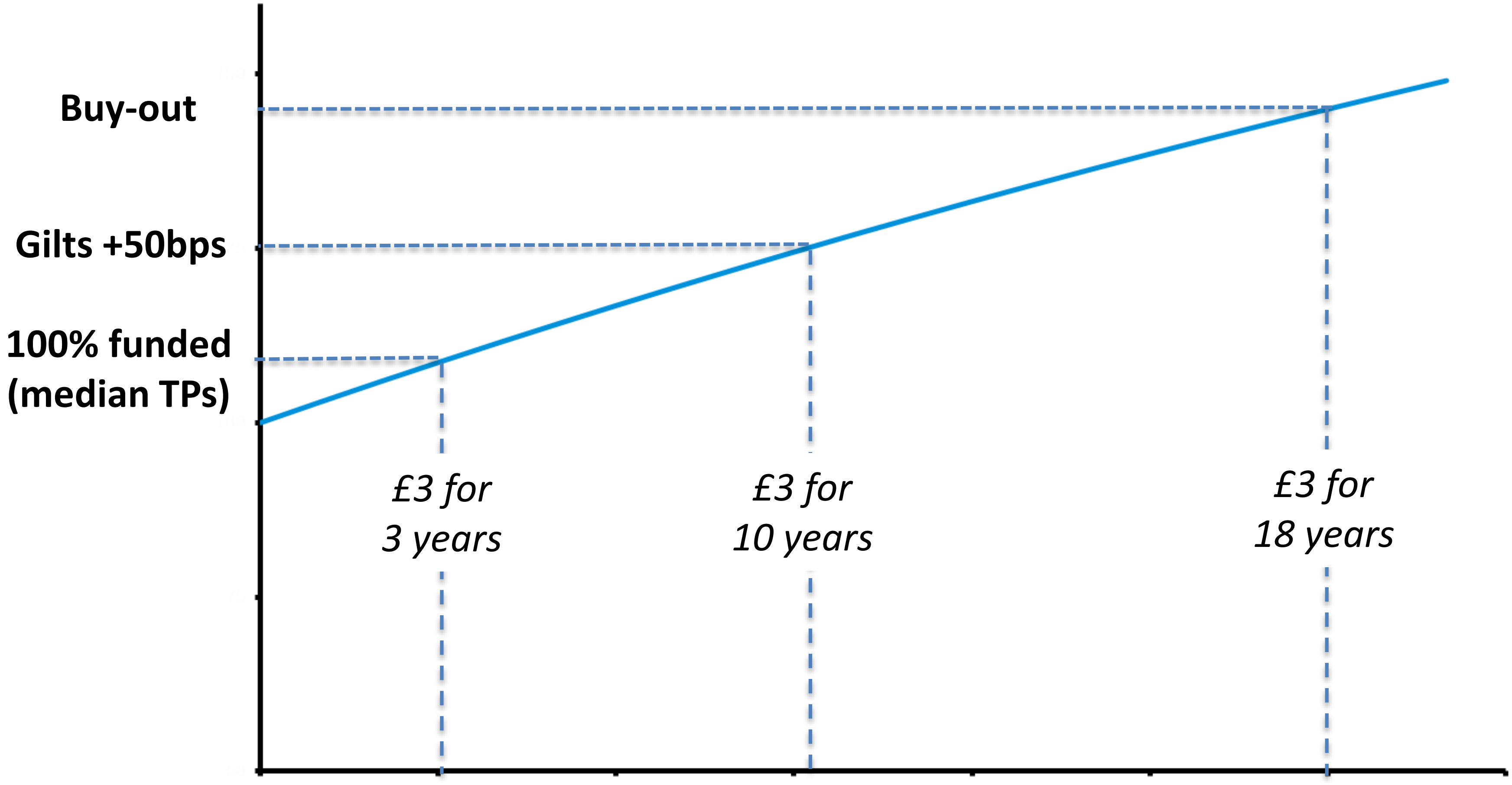
Areas to consider:

- Getting a ***fair*** share?
- Moving back towards as quick as reasonably affordable?
- Maximum recovery period?
- Level of back-end and front end loading?
- Investment strategy: balance of returns on DRCs vs investing in the business?

Some implications:

- Defining what is fair? Can it be measured?
- How does it take account of the sponsor’s multiple stakeholders?
- Impact on behaviour – previous ‘10 years trigger’ became a default
- How to take account of:
  - Wider support, contingent assets etc?
  - Contribution history / previous lump sum payments?
  - Relatively high levels of TPs prudence?

What is an “appropriate” RP?



Take account of the overall position

Setting a long-term objective

DWP 2018 White Paper: *"…ensuring a long-term view is considered when setting the statutory funding objective"*

Translated to:

- All schemes should have a long-term objective and journey plan
- Triennial valuations are staging posts towards achieving LTO embedded in the SFO
- Timeframe

White Paper examples of suitable LTOs:

- Self-sufficiency
- Buy-out (by a set time)
- Enter a consolidator vehicle (by an agreed time)
- Run-on with employer support (for open schemes)

Setting a long-term objective

Some implications:

- Potentially very wide range of answers
- Measurability – wide range of views
- Timeframe to achieve – flexibility to adjust over time?
- Relevance to stressed / deeply underfunded schemes?
- Consistency with Government policy on flexibility in the regime?

Hardening a long-term target - impact on behaviour:

- **Trustees:** pressure to take risk today in order to take less risk tomorrow
- **Members / press:** alarm over scale of shortfall
- **Investors and other stakeholders:** concern over viability / sustainability of sponsors
- Potential capital impact (for financial services) and accounting impact (e.g. IFRIC14)?

Encouraging consolidation

- Support for new ‘commercial’ consolidation vehicles
- …. as a more affordable way of risk transfer
- Benefit simplification - a missed opportunity?

Some of the implications (where covenant severed):

- More affordable = more risk
- Moral hazard risk
- Ensuring member outcomes improved / no worse (i.e. swapping covenant risk for scheme default risk)?
- Only available to those where capital plus assets > covenant?
- Restrictions over investments?
- PPF eligibility?
- Too big to fail risk?
- Superfund shareholders duties to members?
- Level playing field with bulk annuity market?

Other areas

- TPR to produce factsheet to raise greater public / member awareness of the different funding measures
- DB Chair's statement and improving member understanding
- Greater transparency on costs of managing DB schemes
- Improving governance and controls
- IRM and contingency plans

Questions