Institute and Faculty of Actuaries

Target end-states for defined benefit pension schemes

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Introductions

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Agenda

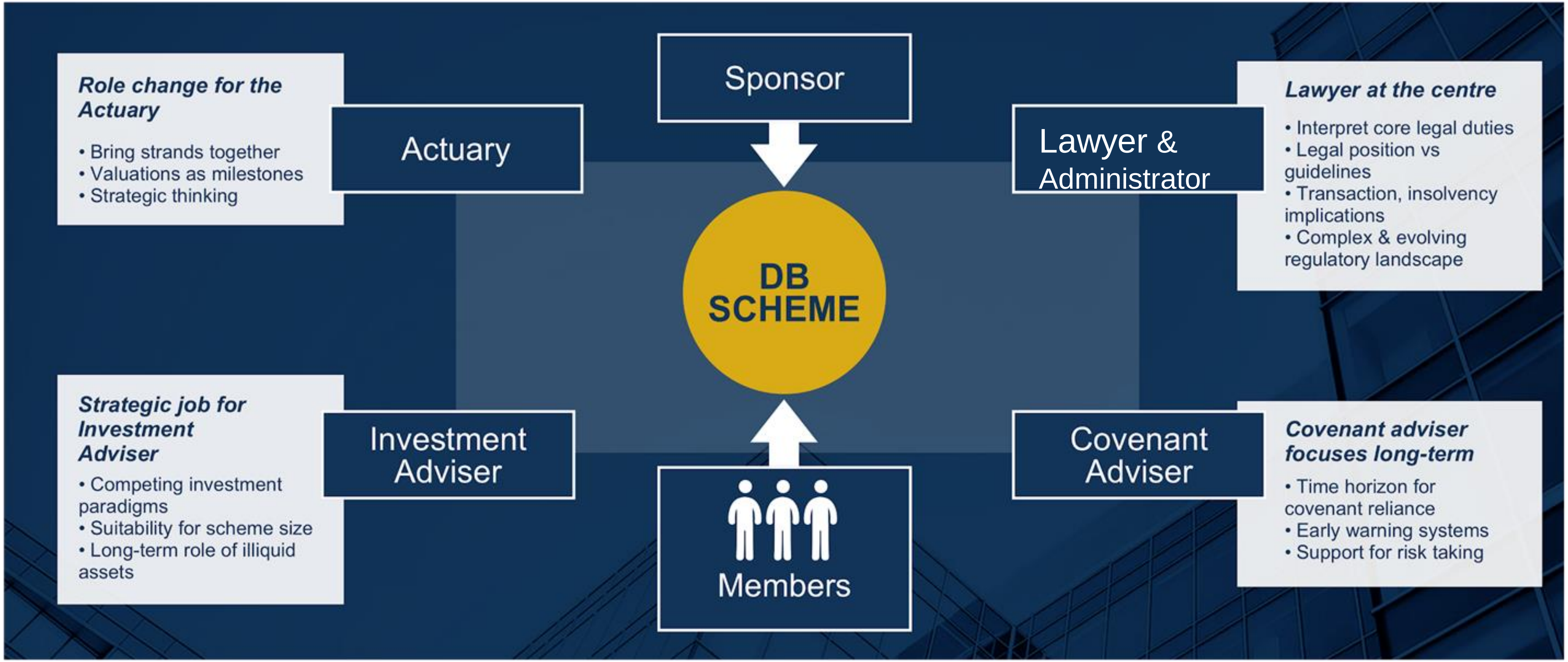
Today we will:

1. Overview the paper, recommendations and key themes emerging (40 minutes)
2. Address your questions
3. Hear your comments

The authors of the report on the target end-states for defined benefit pension scheme working party are: Adolfo Aponte, Dweenisha Caleechurn, Nigel Jones, Jane Kola, Rhian Littlewood, Dan Mikulskis, Kevin Wesbroom and Costas Yiasoumi

(Other working party members: Shyamal Bala, Mark Cliff, Richard Farr, Gareth Henty, Nick Johnson, Tom Lord, John Ralfe, and Martin Stafford)

The TES Journey



Strategic collaboration across domains is vital

What do we mean by a Target End-State (TES)?

The TES is the target stable state for a scheme such that when it achieves that state (providing it maintains it) member benefit entitlements will be met in full, with a high degree of certainty.

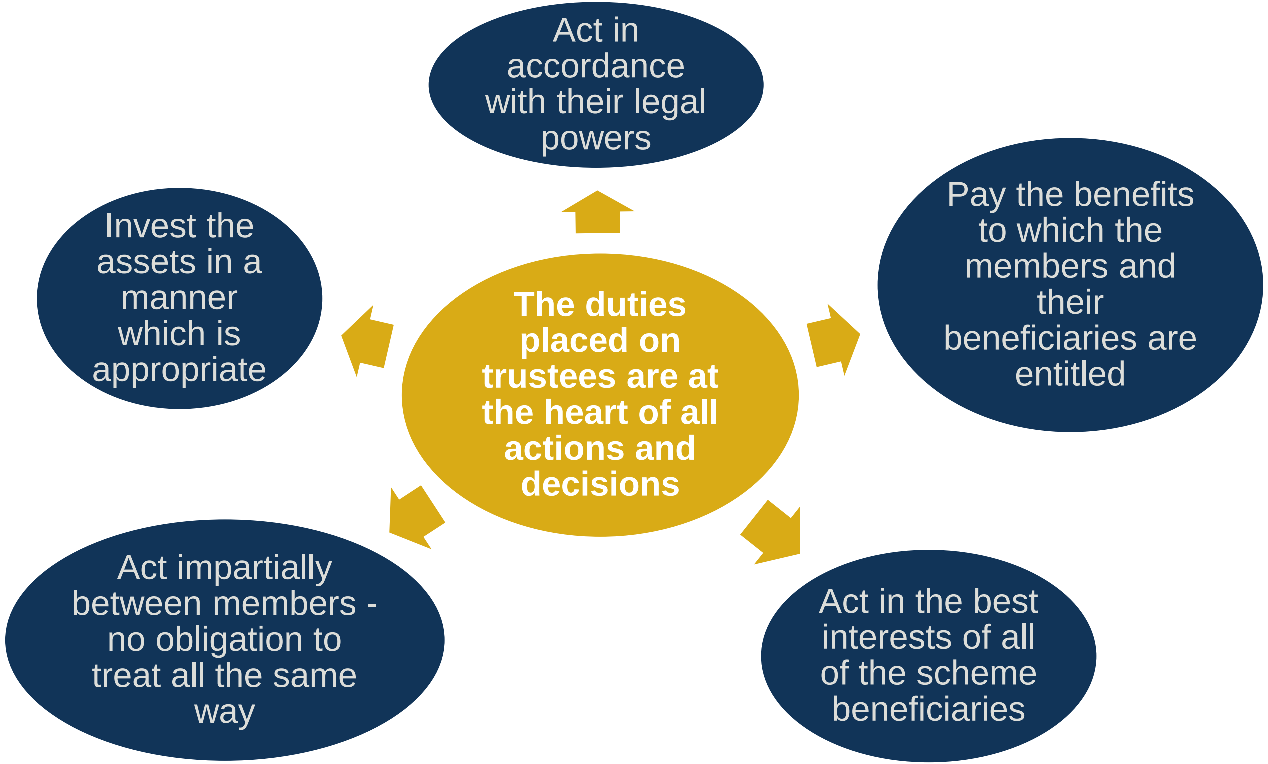
The three key TES

- **Low dependency**
- **Buyout**
- **Superfund transfer**

Two other end-states

- **PPF entry**
- **PPF+ buyout**

Putting the legal requirements at the start



A TES should be properly defined

1. Is the definition tangible?
2. Is it specific enough to help decision making?
3. Is it clear and unambiguous (or is it open to interpretation)?
4. Is it outcome focused (or funding focused)?
5. Is it prescriptive in terms of investment policy?
6. Is it objectively measurable?

The five steps to the TES

Step 1:	Use a long term IRM framework to identify which of the trio of TES are in play and the Journey Plans that would get the scheme to those TES.
Step 2	Understand any requirements, constraints or other factors that may impact the choice of TES.
Step 3	Model for different Member Outcomes under the TES in play in the event of the employer default.
Step 4	Eliminate any TES or Journey Plans that are not desirable.
Step 5	Determine the preferred TES from those remaining, after which the Journey Plan can be refined and a plan of action developed.

Poll #1

This house believes most trustee boards will adopt bare minimum statements of their long term objectives rather than more detailed and thoughtful statements that can be referenced for developing a detailed journey plan.

- **Strongly Agree (7%)**
- **Agree (42%)**
- **Disagree (47%)**
- **Strongly Disagree (4%)**

Low dependency – more than a discount rate

"*Low dependency means that funding and investment strategies are such that there is a low chance of requiring further employer support and, to the extent that such support is required, it is low relative to the size of the scheme*". [TPR 2020]

We set out:

1. A strong form of low dependency
2. A probabilistic approach to low dependency
3. A qualitative (weak form) of low dependency

… and the key considerations for assessing these

Are dynamic discount rates the answer?

Traditional discount rate

- Risk-free

plus

- Fixed margin

→

Dynamic discount rate

- Risk-free

plus

- Floating margin, adj. expected defaults

- Based on a buy-and-hold investment strategy where income matches benefit outflows
- Analogous to the approach insurers utilise

✓ "Floating margin" reduces funding volatility

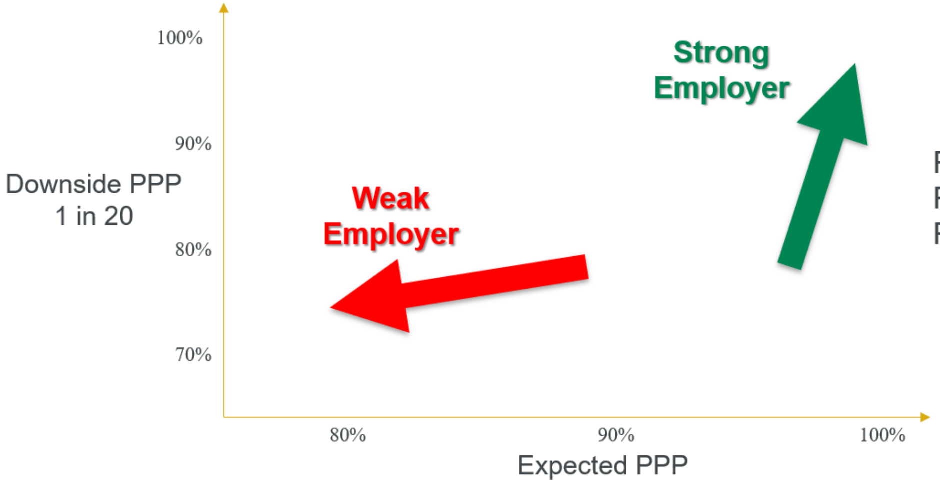
✓ Could result in a (much) higher best estimate discount rate than gilts *plus* 50 bps

Poll #2

TPR should accommodate dynamic discount rates higher than the proposed funding code levels, where a scheme has a well-hedged CDI strategy with much higher net yields.

- **Strongly Agree -** noting that an insurer might generate gilts + significantly more than 0.5% for a mature portfolio net of costs and defaults allowance **(24%)**
- **Agree -** TPR should accommodate dynamic discount rates that may periodically move above the funding code levels of gilts + 0.25% to 0.5%, but not ones that are materially higher on a permanent basis **(57%)**
- **Disagree (17%)**
- **Strongly Disagree (2%)**

Member outcomes - unexpected consequences of prudence



PPP = Proportion of Pensions Paid

Source: LCP

What do we mean by Member Outcomes?

- Example - Proportion of Pensions Paid ("PPP").
- Simple count of how many receive full pensions, or reflect severity of failure?
- Simple count, discounted, or weighted by liabilities - stochastic or deterministic?
- Look at scheme aggregate or analyse by categories – deferred vs pensioner?
- Industry standard measures needed?

Poll #3

Member outcomes analysis should become common place rather than relying on aggregate funding levels for advice (noting this will require model builds by advisers).

- Strongly Agree (11%)
- Agree (47%)
- Disagree (39%)
- Strongly Disagree (3%)

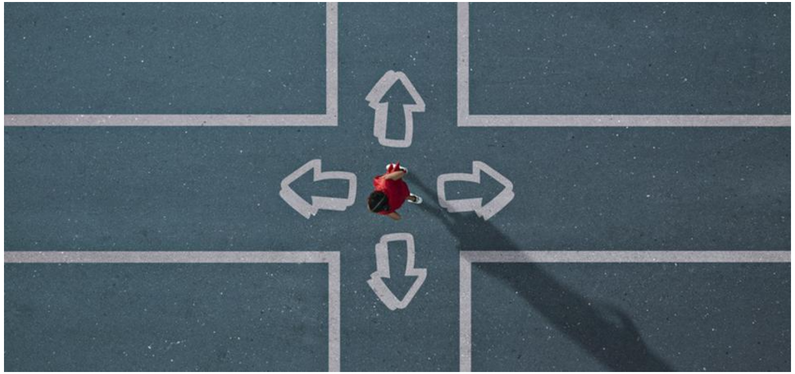
Superfunds – affordability vs security?

Members remain in the scheme

- E.g. relatively weak covenant and a funding shortfall against buyout
- Members retain exposure to the covenant and if it fails they will likely receive reduced benefits

Members transfer to superfund

- There remains a possibility of failure but that possibility might be lower
- It might also be that the benefit cutbacks on failure are lower



Source: gettyimages

It is all about member outcomes. Superfunds do not need insurer-like security so as to vastly improve member outcomes.

Developing a scheme's Plan B is essential

An event means the "Plan A" is no longer a suitable TES (e.g. covenant weakens meaning employer funding support becomes constrained)

Plan A: Buyout in 10 years	Plan B: Low-dependency
Based on the journey plan to the buyout TES, a partial pensioner buy-in results in an improvement in Member Outcomes	The partial pensioner buy-in constrains the investment strategy. Consequently projected Member Outcomes are not as good as they would have been otherwise

How much weight should be placed on the possibility that the Plan B becomes the primary way forward?

Poll #4

This house believes that most Trustees do not have sufficient Plan B/contingency planning around their target end state.

- Strongly Agree (28%)
- Agree (64%)
- Disagree (7%)
- Strongly Disagree (1%)

Stressed schemes – crisis, or well drilled scenario?

1. Stressed Schemes whose funding level is well below 100% against PPF
2. Stressed Schemes whose funding level is around 100% or better against PPF
3. Scheme(s) Without a Substantive Sponsor ("SWOSS")

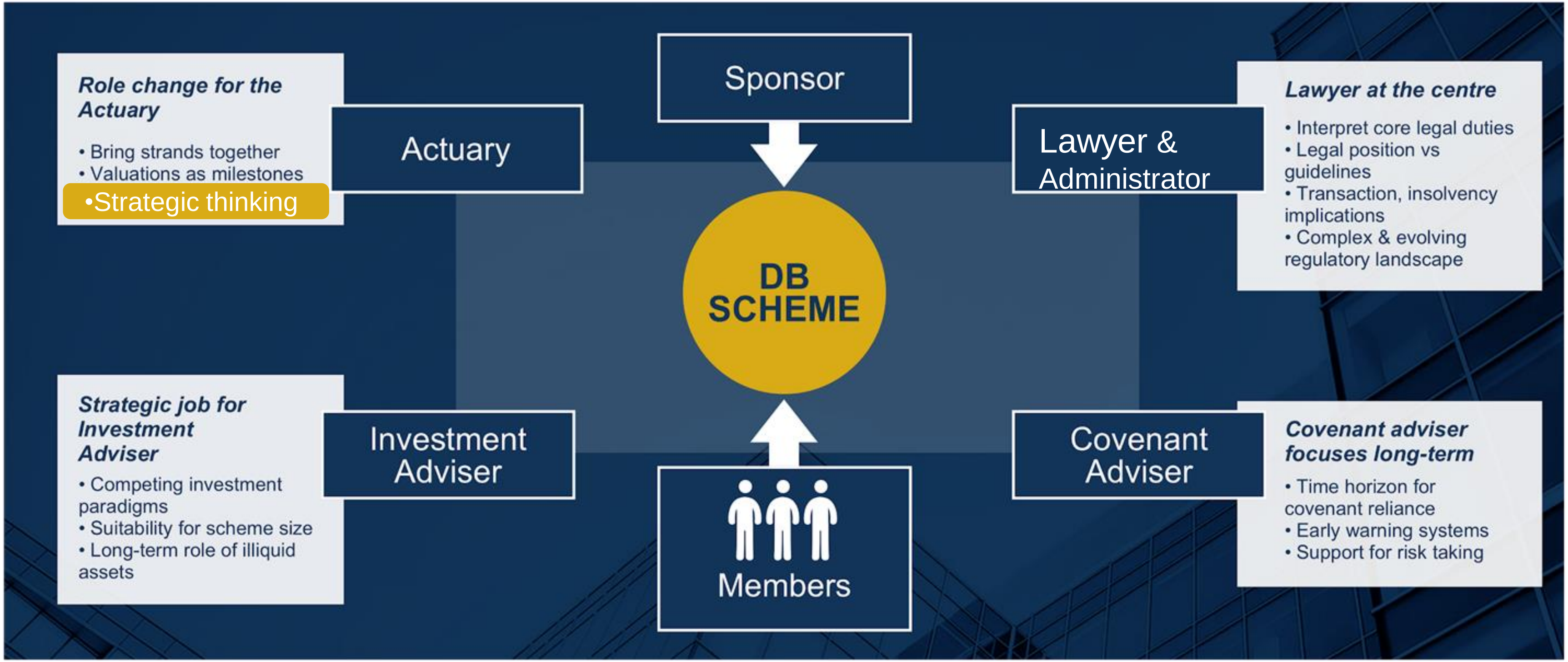
What should trustees do?

Poll #5

Increasing numbers of schemes are better funded than PPF. We need guidance from TPR for Trustees of such schemes than become insolvent.

- **Strongly Agree -** Current guidance doesn't look much beyond the PPF assessment process **(17%)**
-
- **Agree (53%)**
- **Disagree (27%)**
- **Strongly Disagree (3%)**

The TES Journey



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Questions

Comments

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Appendix - Summary of our eight recommendations

1. Actuaries should press trustee boards to take legal advice on their powers and on members' legal entitlements.
2. Schemes should define clearly what their TES means in practice, not adopt sanguine definitions.
3. The profession should sponsor research into the use of dynamic discount rates for technical provisions.
4. Strategy and journey plan is sometimes driven by an employer's financial statements. This can be sub-optimal to Member Outcomes. This is an area for further work by the profession and by TPR.
5. Schemes should develop and understand their Plan B in the event of employer distress or employer insolvency.
6. We recommend actuaries help clients focus on Member Outcomes.
7. Member Outcomes analysis is very dependent on assumptions and models. The actuarial should sponsor research into this area.
8. There is a need for clear and consistent legislation and/or detailed guidance on running a scheme as a SWOSS in the event of sponsor failure.

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