The Royal Bank of Scotland

Reality bites

There has been a raft of announcements, discussion papers and consultation initiatives affecting the UK pensions environment over the last few months. The RBS Pension Solutions Group highlights the key issues and considers their potential impact on markets and on pensions risk management

Government's deregulatory review

Recent legislation has allowed changes to be made to the minimum level of inflation protection required of defined benefit pension schemes. The *Pensions Act 2004* reduced the minimum permitted Retail Prices Index (RPI) indexation cap for pensions in payment from 5% to 2.5% (applied year-on-year). In addition, following the Department for Work and Pensions' consultation exercise in 2007, the government decided to reduce the RPI cap for the revaluation of deferred pensions from 5% to 2.5% (applied over the whole period rather than year-on-year) and to introduce statutory overrides to allow amendments to be made more easily to scheme rules so that these changes can be implemented. In all cases, the change only affects future benefit accrual, not past service benefits, and it seems highly unlikely that the government would risk any attempt to adjust past service benefits.

Figure 1 shows our estimates of how each of these three changes will affect the amount of inflation PV01 in new benefits accrued. The effect of the reduction in RPI exposure appears to be dramatic, reducing the inflation PV01 by more than 50% compared with pre-2005 benefit accrual. However, figure 2 puts this into context with the inflation PV01 of existing liabilities relating to past service, and shows that the amounts are not significant compared to the huge amount of existing unhedged inflation-linked liabilities. Given the large amount of pent-up demand for inflation protection of accrued liabilities, we therefore see little potential for any meaningful impact of these changes on the inflation market for many years.

Changes at the Pension Protection Fund

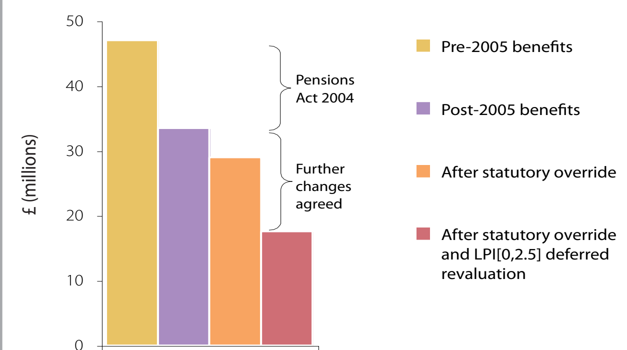
Over the last few months the Pension Protection Fund (PPF) has confirmed changes to its levy charge for 2008/09, as well as giving more details of how it sees the levy evolving in the coming years.

One of the core principles of the PPF is that it charges a levy proportional to the risk each scheme poses to the PPF. The original approach of only considering the size of the deficit and the probability of insolvency was acknowledged as too crude because fully funded schemes appeared to offer no risk. The reality is very different. The tail-risk scenario for the PPF is an environment of high company insolvencies in a systemic stress. In such a climate one expects to see weakness in equity markets and lower interest rates, both leading to the potential for deficits in previously well-funded schemes.

For 2008/09, the PPF is attempting to allow for this by increasing from 125% to 140% the funding threshold above which schemes can avoid paying the risk-based levy, effectively encouraging schemes to build a funding buffer.

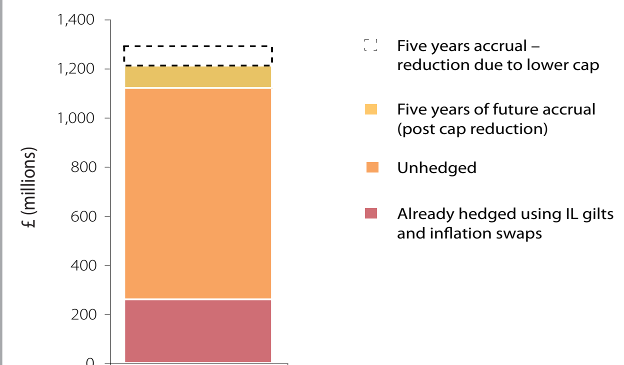
This is fairly simplistic because many schemes have significantly reduced their equity and rates risks, which means that the risk these

1 Estimated inflation PV01 of new accruals per annum in UK private sector DB schemes



Source: RBS Estimates

2 Estimated inflation PV01 of UK private sector DB liabilities (on swap basis)



Source: RBS Estimates

schemes pose to the PPF is lower. In the summer, the PPF will give further details on how it intends to adopt a more refined approach for calculating the 'long-term risk' each scheme poses. This will include an assessment of the impact of investment strategy risk on the PPF's overall risk.

The PPF is also toughening up its mortality assumptions, both for its own internal valuation and for the s179 valuation used to calculate levies. For the latter, it has moved to updated tables, medium cohort adjustment and 1% underpins on improvements. But the PPF has also increased the discount rate to be used by 30bp, and the net effect is likely to be a fall in s179 valuations, on average, by around 5%.

Consultation on longevity by The Pensions Regulator

The Pensions Regulator (TPR) has published a draft statement concerning the mortality assumptions used for funding purposes. This appears to be motivated by evidence showing that too many schemes are not giving enough thought to what a suitably prudent mortality assumption should be, and in particular are not making sufficient allowance for the clear trend in longevity improvements.

TPR's proposed trigger for scrutiny of assumptions is the use of anything less prudent than a long cohort assumption and/or lack of an underpin in improvements. This applies to all valuations from March 2007, so will affect many valuations that have been or are close to sign-off. We think this retrospective approach is quite aggressive and expect some pushback during the consultation.

If schemes shifted their assumptions to TPR's proposed trigger level, we expect that liabilities (for funding purposes) would increase by around 5–10% on average. This could imply a large increase in contribution rates for those schemes with modest deficits, e.g. a scheme that was 90% funded could see its deficit contributions increase by 50%.

It is possible that some schemes decided to allow for mortality improvements through use of a lower discount rate in the calculation of technical provisions. However, TPR has made it clear that important assumptions (such as mortality) should be estimated prudently rather than making compensating adjustments to other assumptions.

It is worth noting that shaving 30bp off the discount rate could easily have the same impact as the mortality shift described above. The discount rate is a difficult area of judgement because it is usually heavily dependent on the view on the equity risk premium. However, it is entirely possible that some schemes will move their mortality assumptions to a more prudent level, while increasing the discount rate to leave the technical provisions (and hence contributions) unchanged.

It would not surprise us if there was some knock-on effect to accounting figures too because it might become harder for companies to justify optimistic assumptions in their accounts. Companies might, however, justify different IAS19 mortality assumptions compared to those used for technical provisions on the basis that the accounting assumptions should be best estimate rather than prudent.

We see TPR's initiative as good news for buy-out companies and similar providers, whose solutions might not look as expensive relative to technical provisions as they did.

The Accounting Standards Board's discussion paper

The Accounting Standards Board's (ASB's) latest discussion paper on pensions includes the following ideas:

(i) Removal of allowance for future discretionary salary increases.
(ii) Removal of high-quality corporate bond credit risk premium from the discount rate.
(iii) Removal of smoothing and deferral methods, such as corridor approaches, when recognising changes in a scheme's financial position.
(iv) Showing the impact of the actual return on assets (rather than expected return) and changes in the discount rate as part of financing costs.

Point (i) would reduce liabilities for active members, and therefore have less impact on more mature schemes. Point (ii) is likely to be more material for most schemes, and the scope for increase in liability values depends on what is regarded as the 'risk-free' rate. Many commentators have assumed this to mean the curve derived from UK government bonds. However, there are good arguments for use of a swap curve or something intermediate between these two curves. Given the blow-out in AA spreads since mid-2007, the potential impact is large, though many might argue that end-2007 IAS19 deficit disclosures are artificially low due to the liquidity crisis.

Points (iii) and (iv) have not received as much attention, but we believe these have much more potential to influence the risk management of corporate pension schemes. Deficit volatility is already shown on balance sheets, but having it flow through the income statement in full would give unprecedented transparency to the true impact of pension risk. In addition, the move away from expected return would reduce the ability to flatter earnings through high equity allocations, which, in our experience, has been a major obstacle to diversification and efficient risk management.

The International ASB's discussion paper on this topic is imminent, but the timetable for implementation extends to 2011.

Our conclusions

Taking all the above together, there is a seemingly unstoppable trend towards presenting the true impact of pensions risks through:

- increased transparency;
- more accurate measurement by replacing optimistic assumptions with realistic/prudent assumptions;
- removal of advance credit for risk premiums in expected asset returns and discount rates; and
- removal of artificial smoothing mechanisms.

We would not be surprised if most of the proposals are accepted, though implementation of key accounting changes is many years away. Companies are likely to lobby hard against some of the proposals, particularly regarding the income statement volatility. Nevertheless, we believe these will result in increased contributions into pension schemes and add to the pressure to diversify and de-risk, whether through physical bonds, derivative structures, insurance company solutions or non-insurance buy-outs.

www.rbs.com/pensions

Paul Greenwood
Pension Solutions
T. +44 (0)20 7085 1037
E. paul.greenwood@rbs.com

Marcus Mollan
Pension Solutions
T. +44 (0)20 7085 6845
E. marcus.mollan@rbs.com

Guy Whitby-Smith
Pension Solutions
T. +44 (0)20 7085 0371
E. guy.whitby-smith@rbs.com

Udit Kapoor
Pension Solutions
T. +44 (0)20 7085 0759
E. udit.kapoor@rbs.com