The Irish Association of Pension Funds

New Funding Standard Guidelines - The Practical Implications

Agenda

- New Regulations – Brief Overview
- Risk Reserve Requirements
- Sovereign Annuities
- Sovereign Bonds
- Funding Implications
- Implications for Members
- Next Steps

New Regulations – Brief Overview

Risk Reserve

- 15% of liabilities less 15% of Cash and EU Sovereign bonds
- Increase in deficit if interest rates fell by 0.5%

Sovereign Annuities / Bonds

- Schemes can now buy sovereign annuities / sovereign bonds
  - Higher yields may lead to a material reduction in the pensioner liability
- BUT…
  - Sovereign default will be borne by members / scheme

New Regulations – Brief Overview

Investment Return

- Max. assumed investment return of 6.0% p.a.
  - 4.5% p.a. if Section 50

Contingent Assets & Employer Undertakings

- Further options around using contingent assets and / or employer undertakings to fund MFS deficit / Risk Reserve

Funding Period

- Schemes must meet MFS and Reserves by 2023
- Maximum funding period will reduce to 6 years by 2023
- Greater tolerance now with a new easier ‘On Track’ test

New Regulations – Announced but not enacted

<u>Pensioner Priority</u>

- Pensioner Priority in wind-up limited to 75% of pension, or €30,000 if lower

<u>Statutory Revaluation</u>

- Deferred pensions only revalued if active members' benefits increase

<u>Pensions Board Powers</u>

- Pensions Board will have power to wind up schemes in certain limited circumstances

RISK RESERVE REQUIREMENT
EXAMPLES

SCHEME LIABILITIES: €10m
SCHEME ASSETS: €5m

ALLOCATION TO BONDS/ CASH	RISK RESERVE
20%	€1.8m
40%	€1.6m
60%	€1.4m
80%	€1.2m
100%	€1.0m

SCHEME LIABILITIES: €10m
SCHEME ASSETS: €10m

ALLOCATION TO BONDS/ CASH	RISK RESERVE
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RISK RESERVE REQUIREMENT
ALLOWABLE ASSETS

TYPE	RISK RESERVE - 15% COMPONENT	RISK RESERVE - 0.5% COMPONENT	COMMENT
Eurozone Sovereign Bonds	✓	✓	Allowable
EU Sovereign Bonds	✓	✓	Allowable
Non EU Sovereign Bonds	✘	✓	No credit given as part of “15%”component
Non Sovereign Bonds	✘	✓	No credit given as part of “15%” component
Cash	✓	✘	No credit given as part of “0.5%” component

More relief as a result of holding peripheral EU debt (e.g. Greece) than high quality Non EU Sovereign debt (e.g. Canada)

SOVEREIGN ANNUITIES

- NTMA to issue “amortising bonds”, maturities of 10 – 35 yrs
  - Likely to be issued at a yield of 6% - 6.5%
- Insurers quoting 20-30% discounts to conventional annuities
- Current yield differentials suggest these discounts seem low
  - Does the discount give adequate compensation for the risk being passed to pensioners?

SOVEREIGN ANNUITIES – THE RISKS

If any delay or changes to the payments on the Sovereign bonds the impact will be will be passed through:

- **TO THE PENSIONER** if sovereign annuity purchased in pensioner name (buy out)

- **TO THE SCHEME ASSETS** (asset loss) if annuity purchased by Scheme (buy in)

SOVEREIGN ANNUITIES – CASHFLOW MATCHING PRINCIPLE

- Sovereign Bond restructuring could take many forms
  - **Scenario 1:** eg 30% reduction in all bond payments
    - Pension payments reduced by 30%
  - **Scenario 2:** eg bond payments ceased for 3 years
    - Pension payments cease for 3 years
- Scenario 2 highly undesirable from members’ point of view

SOVEREIGN BONDS

- Schemes could invest in sovereign bonds to get reduced pensioner liabilities if the following criteria are met:
  - Trustees take advice
  - Trustees formally resolve to use sovereign annuities in wind up
  - Trustees communicate this to members, representative unions
  - Confirm approach annually

SOVEREIGN BOND	MARKET DISCOUNT
Bonds backing available sovereign annuities	Discount available by purchasing sovereign annuity
Bonds with >3% yield over German	20% discount
Bonds with <3%	No discount

SOVEREIGN BONDS

- Required to have 100% EU bonds matching pensioner liabilities
- 20% reduction reduced to ONLY 5% by 2023
  - Significantly reduces impact for those looking at extended funding proposals
- May help better funded plans to meet MFS and avoid funding proposals

Implications for Schemes

Meets MFS	Funding Proposal in Place	No Funding Proposal in Place
• Consider Risk Reserve requirements. If not met, funding plan must be submitted after 2016.	• Funding plan can continue as is as long as it is "on track" • Risk reserves must be addressed at the end of funding proposal period	• Funding plan now required • If end date beyond 2016 then risk reserves must be addressed • Funding "ask" more onerous now than 2 years ago
COMMENT **Meeting the reserve requirement might be onerous but this is not immediately required**	**COMMENT** **No immediate requirement to act but begin to plan for risk reserves.**	**COMMENT** **Employers and Trustees need to evaluate options and decide on best course of action.** **Need to manage conflicts of interest**

Funding Implications – Sample Plan

DATE	MARCH 2011	MAY 2012 – No Risk Reserves	May 2012 – With Risk Reserves
Liabilities	€19.0m	€21.5m	€21.5m
Assets	€13.0m	€13.8m	€13.8m
Surplus/(Deficit)	(€6.0m)	(€7.7m)	(€7.7m)
Contribution Requirement*	1.0	1.6	1.9

** Annual rate required to fund deficit over a 10 year period*

- Contribution requirement has increased over the last year
  - Mainly due to falls in bond yields increasing liability value
- Introduction of “Risk Reserves” further increases contribution requirement (by c. 20%)

Funding Implications – Sample Plan

SCENARIO	With Risk Reserves	Sovereign Annuity	Sovereign Bond
	€m	€m	€m
Contribution Requirement*	1.9	1.4	1.7

** Annual rate required to fund deficit over a 10 year period*

- Purchasing sovereign annuities materially reduces contribution requirement (by c. 25%)
- Buying sovereign bonds has a much smaller impact

Implications – Scheme Members

Risk Reserves

- ✓ Reduces risk of Scheme falling into deficit in the future
- x May further exacerbate funding problems, leading to wind-up in deficit and cuts to members' benefits

Sovereign Annuities (buy-out)

- ✓ Improves security for Non-Pensioners
- x Exposes Pensioners to cuts in benefits

Sovereign Annuities (buy-in), Sovereign Bonds

- ✓ Avoids directly exposing Pensioners to benefit cuts
- x Risk of material deterioration in funding on sovereign default, potentially exposing Non-Pensioner members

Summary

WHAT ARE YOUR OPTIONS?

WHAT YOU NEED TO CONSIDER?

Risk Reserve →

- Optimal mix of growth & bond assets?
- More bonds to minimise reserves?
- Continue with growth assets and accept reserve?

Sovereign Annuities →

- Impact of this on future funding costs?
- Buy out or Buy in (where does risk lie)?
- Is price fair?

Sovereign Bonds →

- Do they help much?
- Are they worth the added risk and other onerous "must do's"?

Much stronger link between funding and investment policies under new Regulations

Next Steps

Seek actuarial advice on impact of risk reserves, role of sovereign annuities / bonds, contribution requirements	**July / August**
NTMA issue suitable sovereign bonds, Sovereign annuity products approved & launched by insurers	**Likely August / September at earliest**
Formulate proposal for discussion	**September**
Communication / consultation exercise with employees/unions	**October / November**
All parties seek independent legal / investment advice	**Throughout Process**
Finalise and submit agreed proposal	**December**

Most schemes that have not already done so need to submit funding proposals by December 2012