



The Funding Standard & Approaches to Funding Defined Benefit Schemes

Philip Shier
President

Society of Actuaries in Ireland



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Introduction

- Society's submission to Green Paper
- Focus on adequacy, sustainability and security
- Today I will consider security of defined benefit pension schemes
- Background of falling equity markets, economic recession, make the timing of any changes a challenge



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Why fund in advance?

- To provide some security for members so that they do not have to rely totally on the employer's willingness and ability to pay promised benefits when due
- To enable the employer to spread the cost of providing pensions over the working lifetimes of the members



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But in reality....

- The security of active members' benefits is still largely dependent on the employer covenant
- Employers have to make significant additional contributions from time to time to meet funding standard requirements



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When a pension scheme was set up

- The objective was to pay members' retirement (and death) benefits when they fall due
- Schemes were established on the basis of long term assumptions to meet this objective
- Actuaries could smooth out bad (and good) experience so that the long term costs would be relatively stable



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But...

- The long term assumptions turned out to be wrong – especially longevity
- There is now a greater demand for transparency (partly driven by accounting standards)
- The minimum funding standard reduces the flexibility for smoothing out costs over the longer term



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Do we need a funding standard?

- Yes!
 - To ensure that assets are held to back the benefits promised to members
 - To provide protection for members in the event of wind-up
 - To comply with EU requirements



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What type of standard?

- Could be based on long term funding objectives – but might not provide adequate protection if scheme were to wind-up
- Solvency or discontinuance test – focus on ability to meet accrued benefits but may be inconsistent with long term funding objectives



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Position of the Society of Actuaries in Ireland

- The approach to be adopted is a public policy issue
- We support the current discontinuance test approach as the most appropriate way to protect members
- But we have concerns about the way in which the standard currently operates



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The current system..

- Over-promises and under-funds
- Exposes members (especially current employees) to far greater risks than are commonly understood
- Places the majority of the risk on current employees
- Limits the capacity of trustees to address the issues



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Risk exposure in defined benefit schemes

- Pensioners generally well protected
- By contrast, current employees (and deferred pensioners) have lower priority, and transfer values are calculated on “optimistic” assessment of fund growth
- Current system characterised by equity-based investment and funding policies, long recovery periods and little regard to strength of employer covenant



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A geared equity investment?

- DB scheme with €100m assets and €100m liabilities (€50m pensioners, €50m actives) so meets the funding standard
- Assets fall to €75m so only 75% coverage in total
- Pensions must be secured first, leaving €25m assets for actives – coverage for them is now only 50%



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UK Model

- Funding policies must be approved by The Pensions Regulator taking an objective measure of employer strength
- Pension Protection Fund - levies based on funding level and employer strength
- Debt on employer legislation
- Greater powers and duties of Trustees



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Dutch Model

- Greater collaboration between pensioners, employees and employers
- Lower “core” benefit with “conditional” pension and pre retirement increases.
- Minimum funding requirements on “economic basis” for core benefits
- Margins reflect investment strategy with trigger points for action (> 100%)
- Contribution rates set in anticipation of paying indexation



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Society's proposal

- Introduce more rigorous approach (i.e. similar to Dutch model)
- Permit reduced core benefits (while targeting higher benefits under a lighter funding regime)
- Remove wind-up priority afforded to current pensioners
- Consider introduction of debt on employer legislation and protection fund



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EU requirements

- Variety of different approaches in Europe, compliant with IORP Directive
- Desire for harmonisation and “level playing field”
- Solvency II framework being championed by some – resisted for the time being
- (Lack of) security for pension promises in Ireland may be difficult to support



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