Funding defined benefit pension schemes

David Morton reports on the Faculty sessional meeting on 21 March.

The paper, 'Funding defined benefit pension schemes', which was produced by Charles Cowling, Tim Gordon, and Cliff Speed, and the discussion on the night serve to highlight the difference in opinion that exists in the debate on how the funding target of defined benefit (DB) pension schemes should be derived. The debate centred around the appropriateness of what some might call traditional pension scheme funding techniques, which take advance credit for expected future investment return, and techniques which do not, eg funding targets which are related to scheme solvency, as proposed by the authors.

A key question in this debate, which was raised by Donald Campbell in his opening comments, is 'how do we create sustainable, affordable, pension schemes in the UK, and what role should the profession play in achieving this?'

To an extent, the sustainability of DB pension schemes is likely to come down to the approach that individual actuaries, and the profession in general, take to calculating and presenting funding levels and estimated future pension costs.

From outside the profession, and indeed from within it, it can – and does – appear strange that the value of a defined benefit can change dramatically, even to the extent that a deficit can become a surplus, simply by changing the underlying assumptions; 'Actuarial magic' one contributor called it.

It was clear from the debate that the contributors felt that it is important that actuarial funding advice is transparent, and that we ensure that sponsoring employers not only have a clear understanding of the cost of the benefits which have already been accrued, but also the cost of the benefits which will be accrued by their employees in the future. It is clearly also essential that sponsoring employers understand the variability of those costs and the risks involved in providing the chosen level of benefit.

There was general agreement that, as part of this process, more focus was required on the solvency funding level of DB pension schemes. However, there was substantial debate on whether a solvency-type approach, as advocated by the authors, was the appropriate primary measure when setting funding targets for ongoing schemes.

There was a clear concern among some of the contributors that the wholesale adoption of funding targets which are linked to scheme solvency would greatly hasten the demise of the remaining DB schemes. It was also noted that it did not appear practical to expect that solvency funding levels would be returned to 100% in the near future, given the current large deficits.

One commentator noted that there was an entrenched belief by sponsors and trustees in equity investment and a continued expectation of future returns in excess of those on bonds. He felt that by focusing on the solvency funding level the authors were implicitly encouraging a much larger investment in gilts and bonds which would ultimately increase the cost of benefit provision.

Some speakers agreed with the authors, however, that it was possible to target a solvency funding level of less than 100%, at least in the short term, and that presenting the results on a solvency basis would reduce confusion among members and lay people and may also serve to introduce a greater degree of consistency between actuaries.

Several contributors noted that trustees were increasingly focusing on the solvency funding level of their schemes and were looking in greater detail at the covenant of their sponsoring employer. This is an area where actuaries may be expected to play a larger role than they have in the past in order to advise trustees on what constitutes a reasonable level of contributions. In this regard, an apparent anomaly was highlighted in that stronger employers would be asked to make higher contributions than weaker employers, simply because they had the ability to do so.

Based on the number and diversity of opinions expressed at the meeting, it seems clear that this is a debate which will continue for some time to come. However, it also seems clear that change is coming in one form or another. The deputy chairman of the Pensions Board confirmed this when he said that the board has for some time now been working on implementing changes that are consistent with many of the recommendations in the paper. If you have an opinion to put forward, now is undoubtedly the time to speak up.