SOCIETY OF ACTUARIES

Article from:

International News

August 2010 – Issue No.51

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Combined Investment and Funding

The Holy Grail?

By Norbert Fullerton

Not long ago it was acceptable for defined benefit (DB) pension scheme trustees to consider funding and investment solutions separately. Typically, pension fund trustees spend a lot of time with their actuary discussing assumptions and finalising a triennial valuation. After the valuation, they might review the fund's investment strategy and, just maybe, alter their portfolio. Often, they realised that any changes to the investment strategy would have to be small, to avoid invalidating the valuation results and agreed funding plan. While there was often a desire to reduce investment risk, there was generally no appetite to re-open the funding debate. So, the sponsor and trustees shook hands and waited for three years to repeat this process.

Those days are now gone. Rising deficits, weakened company covenants and a more risky investment world have led trustees and sponsors to look for ways to manage the finances of their pension funds more effectively.

Some sponsors in the United Kingdom and North America have made tough decisions such as closing their private (corporate) DB pension funds to new members and reviewing the design of future benefits. While this reduces future risks and costs, many realise that there is still a large 'legacy' built up that has to be carefully managed.

Many sponsors and pension fund trustees say they have found the "Holy Grail." They now integrate their funding and investment decisions while at the same time take account of the strength of the sponsor's covenant. This way, they say, all parties can better understand the risks facing the pension fund and make holistic funding and investment decisions. In practice, this means that pension fund trustees and sponsors should only agree to a funding plan with full knowledge of the amount of risk required to achieve it.

THE POWER OF INTEGRATION

Corporate pension fund trustees and sponsors often have different views on how pension funds should be invested and funded. What is important, however, is that both parties should agree to run their pension funds with a long-term business plan, in a similar way to other big organisations.

Applying an integrated approach provides a robust and informed framework, placing all parties in a strong position when negotiating a combined funding, investment and covenant package. Handling negotiations well is very important for any sponsor or trustee group because the outcome directly affects benefit security and the sponsor's cost of providing future pension benefits.

This approach also helps to develop a clear map or journey plan of how the funding position and investment strategy might evolve over time. Certainly, no one answer fits all when it comes to finding ways to reduce risks of rising deficits or sponsors' costs. However, this approach leads to greater clarity when choosing appropriate actions, including:

- **Investment** – for example, switching from growth to liability-matching assets, diversifying growth assets and using derivative instruments (such as swaps) to better hedge interest rates and inflation.

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- **Funding** – set prudent funding targets and agree a robust deficit recovery plan that is reasonably affordable by the sponsor.
- **Covenant** – identify appropriate arrangements for improving the sponsor covenant, such as escrow accounts, parent company guarantees and so on.

Figure 1: The Benefits of the Integrated Funding and Investment Approach.

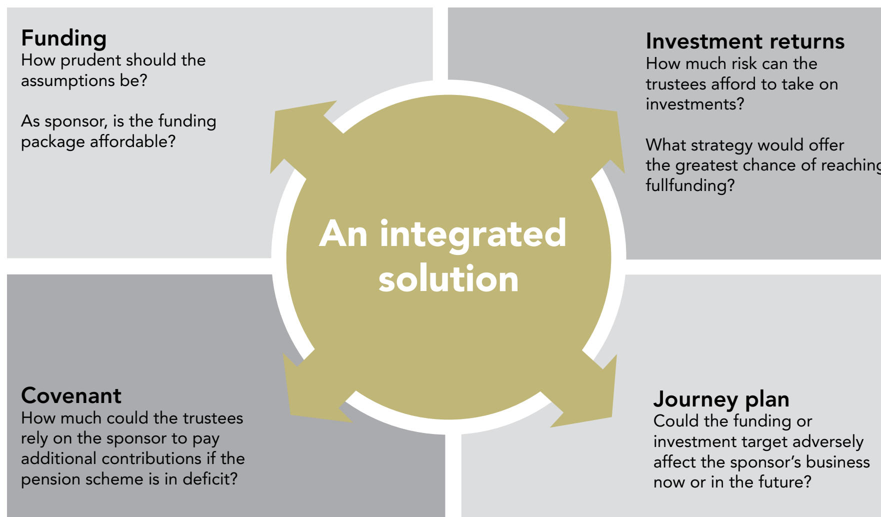
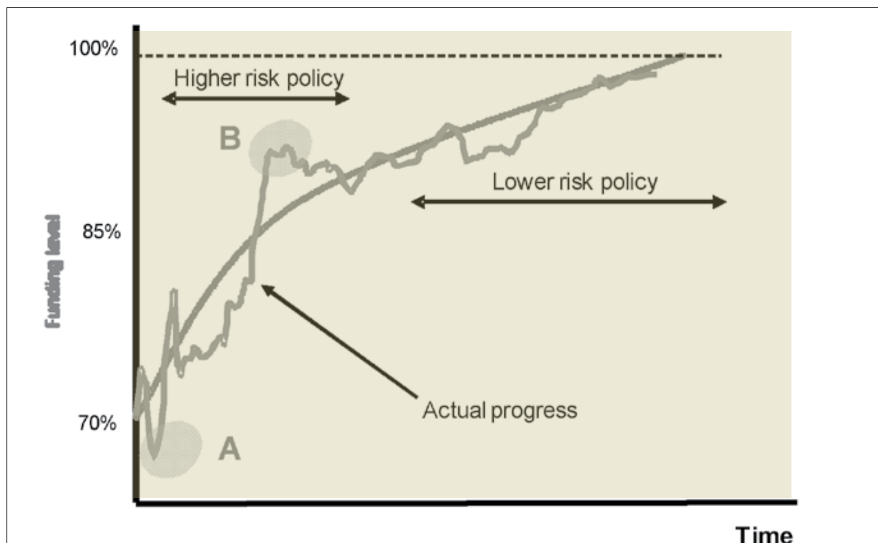


Figure 2: Consider decisions along the journey plan, monitor and take action.



- **Dynamic risk management** – avoid losses that could compromise the sponsor's business, or look for attractive opportunities to lock into good outcomes when the fund is ahead of its journey plan.
- **Liability management** – such as, changing future benefits, trivially commuting members' benefits or carrying out early retirement exercises.
- **Longevity risk management** – for example, purchasing annuities or using longevity swaps.

FINDING THE RIGHT PACKAGE

A DB pension fund's deficit can be considered a debt due from the sponsor. Therefore, pension fund trustees should take account of the quality of the sponsor's covenant (the ability and willingness to support the fund) when making funding and investment decisions.

Sponsors, on the other hand, have competing demands and constraints on their capital and cash flow. It is a high priority, therefore, for them to agree with DB pension fund trustees a recovery plan, technical provisions and investment strategy that result in reasonably affordable contributions, both now and over time.

As shown in figure 1, considering financing, investment and the covenant together enables trustees and sponsors to decide on:

- how much investment risk they could take now and in the future
- the degree of prudence they should apply to their valuation assumptions
- a reasonable time to recover any deficits
- the level of contributions that are affordable, and
- a framework for designing a journey plan.

> "...the journey plan should include a strategy for how to react if events turn out materially better or worse than expected."

HOW COULD THIS WORK IN PRACTICE?

First, pension fund trustees and sponsors need to determine the level of funding they are ultimately targeting. With many DB pension funds running huge deficits, closed to new members and, in some cases, future accrual, many trustees and sponsors are targeting a point when their pension funds will no longer need to rely on high investment returns or the sponsor's capital resources.

Having defined this target, a range of suitable packages of investment return targets and sponsor contributions could then be analysed. Stochastic models, where appropriate, can then provide the parties with a greater understanding of the possible variability of funding levels over time, the timescales needed to reach full funding, and the probability of significant increases to sponsor contributions in the future.

Once pension fund trustees and their sponsor agree a suitable package, they have begun a journey (see figure 2). This journey should be monitored, with the parties regularly keeping track of how the pension fund develops over time. This may include regular updates of the financial position, the level of risk in the investment portfolio, the strength of the company's covenant, and so on.

At a basic level, a journey plan involves setting the level of contributions and investment returns required at the outset to achieve the desired funding target. However, the journey plan should also include a strategy for how to react if events turn out materially better or worse than expected. If the pension fund is **ahead** of the journey plan (point B), then there may be opportunities to choose from a range of de-risking solutions and still achieve the long-term objectives.

If the fund falls **behind** the journey plan (point A), this raises a number of questions. For example, at what point would an increased pension fund deficit have a detrimental impact on the sponsor's business and what protection might be needed to prevent this? At what point, if there were a deficit and the sponsor became insolvent, would the pension fund trustees not be able to recover enough money after the sponsor pays its creditors?

WHAT NEXT?

If you have an upcoming funding valuation, or opportunity to review sponsor contributions or the fund's investments, it would be worthwhile adopting an integrated approach outlined above. Doing this will ensure you make informed decisions relating to the funding assumptions, investment strategy, a deficit recovery plan, and the design of a journey plan; in other words, you will achieve the pension fund's crucial objectives in an effective and efficient manner. ☐