GET READY FOR A WIND UP

JUST BECAUSE YOUR FIRM'S DEFINED BENEFIT SCHEME HAS CLOSED TO NEW MEMBERS DOESN'T MEAN YOU CAN JUST FORGET ABOUT IT, SAYS **TONY CUNNINGHAM**.

Recent research carried out by the Association of Consulting Actuaries revealed that more than 60% of UK pension schemes are now closed to new entrants. UK finance directors who have closed their defined benefit (DB) schemes need to keep an eye on the closed scheme left behind because it will not simply go away or die quietly. This article explains why final salary schemes that are closed to new entrants are very different from open schemes, and why they need to be looked at carefully, soon after closure. It also highlights that, because closed schemes are different, their financing should be managed in a new way.

THE PROBLEMS. Before considering closed schemes, one needs to appreciate why so many schemes have closed to new entrants. In terms of financing, what have been the key problems over the past 10 years or so? You may be surprised by how much the cost of final salary schemes have increased, possibly by as much as 50%, without any voluntary changes to the arrangements having been introduced by the employer, over the period. The problems include:

- **mortality –** (or more precisely, the lack of it!) – as life expectancy continues to increase, the costs of providing final salary pensions have increased;
- **falling real yields –** index-linked gilt yields have fallen close to 2% and the outlook is for real yields to remain low as the supply of gilts continues to dry up; and
- **low price inflation –** which increases the value placed on guaranteed pension increases, such as the LPI (the guarantee is, in effect, full inflation-proofing because the level of increase will always be price inflation itself so long as the outlook for inflation is well below the 5% cap).

Naturally, we also have to look at the state of the equities markets, which after two disappointing years, have witnessed a further fall of 20% this year. The future outlook for equity returns remains uncertain. It is necessary to decide not only at what point you think the equity market will stabilise but also at what rate you think equities will begin to grow again from that point. Where pension funds are invested heavily in equities, this has important implications for the costs that are borne by employers in financing expensive defined benefit promises.

Where schemes are closed to new entrants none of the above problems go away, but the ability to deal with them without increasing cost still further may be reduced. "What's so different about a closed DB scheme?" I am often asked. Read on to find out.

WHY ARE CLOSED DB SCHEMES SO DIFFERENT. The first point is that as soon as the scheme is closed to new entrants there is a recognition that the contribution tap from the employer is being shut off – not immediately, but at some point, as there will be no new entrants coming into the scheme to replace those who have retired. Therefore, the ability of the company to smooth experience over future generations is reduced.

Once a scheme is closed to new entrants, its ability to regenerate and rejuvenate following adverse periods is going to be lost, because at some point the number of active members within the scheme is going to fall to zero. This will make it harder for the company to manage its expense, not just managing any deficits, but also the ability to potentially take benefit from any surpluses.

CLOCK TICKING TO WIND UP. Once the scheme is closed to new entrants, you have set the alarm clock ticking for wind up. What does this mean? I believe that, once a scheme is closed, there is very little that can be done to the scheme in the future, apart from ultimately buying out the benefits at some point from an insurance company and removing the risk altogether.

Therefore, as soon as the scheme is closed, the trustees and the employer need to sit down and determine exactly what their objectives are. It is crucial not to just consider what the investment strategy of the scheme is now but also how it will change over time.

In terms of financing the scheme, you need to realise that anticipated extra returns from the equity holdings in the scheme today will not continue forever. The reality is that, as the scheme matures, the objective to move towards buy-out comes nearer. Therefore, more bonds will be required to match the buy-out position and, therefore the holdings in equities will fall, probably quite rapidly over the next 10 to 15 years. One of the consequences of closing the

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scheme to new entrants is that, initially, you see a reduction in the active members, reflecting the staff turnover experienced by the company. However, following an initial period of potentially significant reduction, the decline can suddenly tail off. Why is this? It is largely reflecting the fact that staff turnover is generally concentrated in the younger shorter service staff. As such, while initially turnover is coming from the closed DB plan, it may not be long before most is coming from your new defined contribution (DC) plan.

Consequently, your DC plan grows slowly, while your DB plan refuses to go away. In addition, because the initial leavers were at the younger end of the membership profile, the average age of those left may increase faster than year for year (that is, after five years, you may find your average age has gone up by seven years, but, despite, say, 20% a year turnover, you may still have 60% of your DB members), increasing the per capita cost, but with increasingly less time to ride out adverse experience.

FINANCING CLOSED DB SCHEMES. Recognising that the dynamics of the pension scheme have changed, there are still essentially only two important questions that need to be answered: (i) How much are we likely to need to hold today to meet the future cashflow requirements? (ii) What is the probability that current assets/future planned contributions will be sufficient?

This is where so-called ‘stochastic’ actuarial valuations are important. Not only can they communicate the contribution and funding uncertainty to both employer and trustees, they can also quantify the level of actuarial prudence that is built into the contribution rate. Stochastic valuations are based on economic models and use the best estimate of what the future cashflows are going to be, while recognising the uncertainty attaching to the estimate. The stochastic valuation also takes into account the consequences of a changing investment mix over time, an essential feature when considering a closed scheme.

The strength of this approach for a closed scheme is the fact that we can reasonably estimate all the future cashflows that will ever take place from the scheme. For a closed scheme, we can picture how the payments out will grow as more and more members retire, pension payments reach a peak and then fall away as the retired pensioners die. Eventually, all the pension payments will fall to zero, as there are no more pensioners. Therefore, the valuation process is relatively straightforward:

- estimate all the cashflows that will ever arise from the scheme;
- compare the present value of these, for any given expected future investment return, with the assets the scheme has today; and
- then decide how to meet the difference over the future, perhaps by a level contribution over the next 20 years or as a one-off capital payment at some future date.

The key to a stochastic valuation is that it models the range of expected returns from the assets, allowing for the impact of the investment principles on the future asset mix. This enables the company and trustees to identify how much, if any, prudence is built into the estimate of the future contribution rate. This is important, as the company has less flexibility, and time, in the new environment to ride out tough times. As industries decline, it is possible that the pension scheme can become much larger than the net asset value of the company itself. Consequently, the company flexibility in being able to meet short-term shortfalls with a cash injection becomes much more restricted.

MORE FOCUS ON SOLVENCY. So far the discussion of the stochastic valuation has concentrated on the employer’s perspective, that is, what rate of contribution is it likely to have to pay in order to meet the particular exit strategy chosen, perhaps buy-out in 25 years’ time. But, as far as the trustees are concerned, once the scheme is closed to new entrants, they want to be sure that there is an adequate degree of security likely to attach to the members’ benefits throughout the wind-down period. In effect, they will be concerned about what is the buy-out solvency from one year to the next?

Although MFR is likely to be abolished, it may be that its replacement, a scheme-specific funding requirement, will actually be more stringent. One proposal mooted by the government is that the actuary might also have a statutory duty of care to members and this may mean that the actuary actually becomes even more prudent than before (yes, it is possible). Coupled with the statutory duty of care to members, it is possible that we may see actuaries increasingly focussed on buy-out solvency, as is already found in much of mainland Europe.

From the trustees’ point of view, they need to act in the best interests of members. This means looking at not just the security for the whole scheme but also the security for the different levels of priority on winding up. If trustees are acting in the best interests of all members, they must be mindful of the way in which the solvency level for the lowest priority may move over time. Stochastic valuations help in understanding how this might be affected by different investment and contribution strategies.

THE WAY AHEAD. The key item to recognise is that closed DB schemes are different. You cannot divorce the financing strategy from the investment strategy. The fact that most schemes, after they close, become more focused on wind-up at some point in the future needs to be taken into account, as does the accompanying reality that the investment strategy will shift towards bonds to reflect this feature.

This latter point needs to be clearly allowed for when deciding upon the financing strategy for the scheme. A stochastic actuarial approach will give more meaningful information on precisely how this new environment will impact on the future investment strategy and the likely range of demands on company finances. This is a reality that financial directors and trustees cannot afford to ignore. It needs to be considered soon after the scheme is closed. If you wait too long, you may find you no longer have the ability to manoeuvre out of a problem.

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