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Dear Louise

EXPOSURE DRAFT: PENSIONS

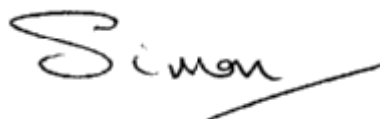
It was not my intention to comment on the Exposure Draft, but I have been struck by the differences of opinion relating to one aspect of the proposals and it occurred to me that a brief comment may be of assistance to the BAS.

I refer to the proposed requirement which now appears in paragraph E.4.2 of the Exposure Draft, essentially calling for a prudent estimate of a pension scheme's liabilities to be accompanied by a neutral estimate of the liabilities. This has proved to be contentious, with users of actuarial information calling for this information to be supplied and actuaries largely opposed to its provision.

It seems to me that there may be a simple misunderstanding at play here. The information that users are asking for seems to be an eminently sensible request, but it appears to have lost something in translation by the time it appeared in the consultation paper. As a result, the information being called for has the potential to mislead users of the information and those actuaries who can foresee the confusion are understandably concerned at the proposed requirement.

My submission (attached) is limited to this one point. I have not attempted to address the six questions set out in Section 7 of the consultation document.

Yours sincerely

A handwritten signature in black ink that reads "Simon" followed by a long horizontal stroke.

Simon Carne

COMMENT ON THE REQUIREMENT IN PARAGRAPH E.4.2

Summary

It seems to me that, as currently worded, the requirement in paragraph E.4.2 (calling for a prudent estimate of a pension scheme's liabilities to be accompanied by a neutral estimate of the liabilities) may not lead to the intended result. For reasons which I explain below, schemes which set higher levels of technical provisions may appear to be less prudent than schemes with lower technical provisions. Such an outcome would clearly be perverse and confusing. I am sure it is not what the BAS intends.

The crux of the problem is that the concept of "neutral assumptions" is not sufficiently narrowly defined to provide the comparison which I believe the BAS intends. To achieve the intended result, I believe the comparison needs to be made by reference to assumptions which are neutral *and independent of the assets*. Without that second condition, the neutral estimate of the liabilities would normally vary with the investment strategy.

An illustration of the problem

I think the simplest way to explain the problem is with an illustration of what could go wrong if the current wording is left unchanged. I have done my best to keep the example as simple as possible.

Two schemes have identical liabilities, but different assets. One scheme sets its technical provisions at 100 and the other scheme sets them at 90. The actuary to the scheme with technical provisions of 100 says the neutral estimate is 80, ie a prudence level of 125% (= 100/80).

If the same actuary advised the other scheme, the BAS might expect the actuary to say that the neutral estimate is still 80 (because the second scheme has the same liabilities). But in the circumstances I describe below that would *not* actually be a "neutral" estimate as currently defined by the BAS. The neutral estimate for the second scheme would almost certainly be less than 80, perhaps 60, making the prudence level 150% (= 90/60).

I explain the derivation of these figures below for those who wish to test my analysis. **The point of the example is that the first scheme has technical provisions of 100 and appears to be adopting 125% prudence, whereas the second scheme holds lower technical provisions for the same liabilities (only 90) and actually invests in more volatile assets (equities, not gilts), but declares itself to be more prudent (150%).** That is confusing and I am sure it is not what the BAS intends.

Derivation of the figures

Let us call the two pension schemes, A and B. They are identical except for the investment strategy. A is invested in gilts and B invested in equities.

Scheme A sets technical provisions at 100. For the neutral estimate, the actuary doesn't need to deduct much, if anything, to reflect neutrality in the discount rate, because gilt returns are pretty certain, but it deducts 20, say, to reflect neutrality in all the other uncertainties, making the neutral estimate 80.

Scheme B has identical liabilities, but the assets are invested in equities. For the technical provisions, TPR permits a *prudent* allowance for the extra return on equities. Given that a prudent estimate *without* an allowance for equities was 100 (see above), a prudent estimate with an allowance for equities is 90, say.

To assess the neutral estimate of the liabilities, the actuary needs to deduct (a) 20% to reflect neutrality in all the non-investment assumptions, exactly as for Scheme A, and (b) possibly something more to reflect a neutral estimate of the investment return.

Step (a) reduces the estimate to 72 (= 80% of 90) and step (b) might reduce the figure by another 20% or so, ie to around 60.

So Scheme A has technical provisions of 100 and appears to be adopting 125% prudence, whereas Scheme B holds lower technical provisions for the same liabilities (only 90) and invests in more volatile assets (equities, not gilts), but declares itself to be "150% prudent" (= 90/60).

Another way for the BAS to view this example is to think of it as the same scheme undergoing a change in investment strategy. Starting from an investment in equities, with technical provisions of 90 and prudence of 150%, the trustees ask the actuary to advise on the outcome of switching to an all-gilt strategy. The actuary re-does the sums, with the assumptions unchanged save for eliminating the extra return on equities, and advises that the technical provisions must go up from 90 to 100.

“Even more prudent,” says one of the trustees. “Yes and No”, says the actuary. “Your technical provisions have indeed gone up, but your prudence rating has dropped from 150% to 125%.”

How can this be?

This *isn't* a trick with numbers. And it isn't a special case. What is happening is that, as we switch from a scheme with equities to one without (or with a lower concentration in equities), the “neutral” assessment of the liabilities changes. Why? Because the quantification of the liabilities is dependent on the nature of the assets – see below. In order to avoid this, the requirement would need to call for a comparison with an estimate of the liabilities which was neutral *and independent of the assets*.

How can the investment strategy affect the quantification of the liabilities?

There are numerous references which support or explain why the investment strategy (might) affect the quantification of the liabilities:

- As the BAS says in paragraph 3.17 in the Analysis section of the Exposure Draft, if a discount rate is related to the future returns on scheme assets, its selection should take account of the trustees' investment strategy and anticipated changes in that strategy.
- TPR's *Funding Code* (paragraph 79) identifies the investment policy as a potential factor which may affect the assumptions used to determine the technical provisions.
- The fourth precept from the *BAS Conceptual Framework* tells us that the quantification of liabilities should be carried out using methods and assumptions that are consistent with the assets and consistent with the identified risks (which presumably includes the investment risks).

But even more crucial, perhaps, is the language of the Exposure Draft itself, when read in conjunction with the relevant legislation. The requirement in paragraph E.4.2 applies to information provided under Section 230(1)(c) and (d) of the Pensions Act 2004 (see paragraph E.4.1 of the Exposure Draft), in other words the *recovery plan* and the *schedule of contributions*. In the language of the *Conceptual Framework* (Precept 1 and Appendix A), these are both “plans” not “valuations”. The actuary is being asked to assess the level of contributions needed to meet the liabilities – an assessment which clearly cannot be made independently of the strategy for investing those contributions.

Fixing the problem

As a minimum, the phrase “the value of”, which appears twice in paragraph E.4.2, should be deleted. This will eliminate any suggestion that the role of the actuary in this context is one of “valuation”.

But this change, on its own, will not be enough to convert the calculation into one which is independent of the nature of the assets. The BAS will need to decide how it wishes to achieve that. There are a number of options which might be explored.