

Scheme Specific Funding

New regime 'triggers' changes to assumptions?

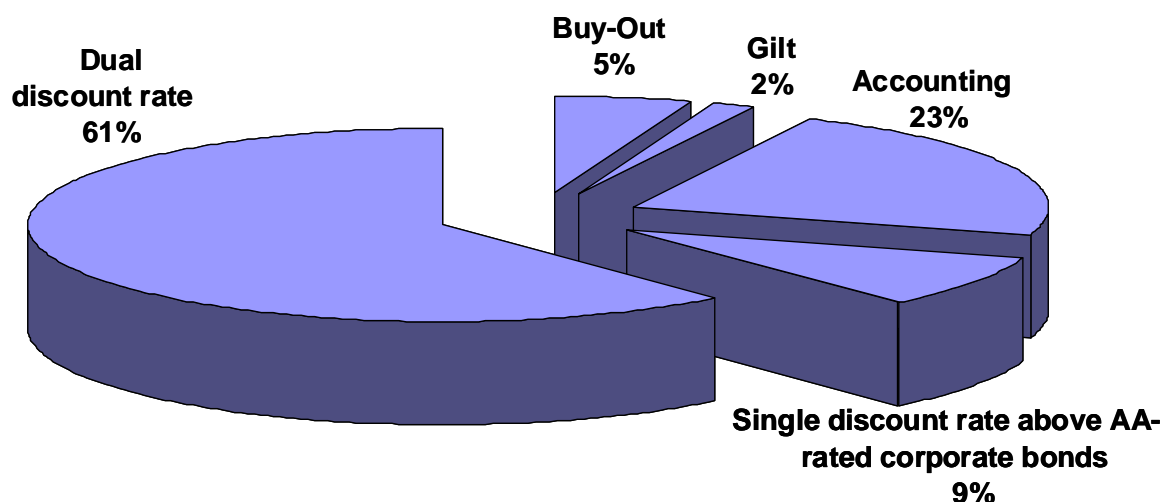
December 2006

In the next in our series of bulletins looking at the results of our survey into Scheme Specific Funding assumptions, we look at two of the key drivers for any valuation - discount rate and mortality – and particularly examine the extent to which they compare to one of the Regulator's trigger points.

Discount rates

One of the most critical assumptions for an actuarial valuation is the discount rate. Our survey shows that the approach to setting the discount rate generally falls into three categories:

1. Making allowance for outperformance of the investment portfolio over corporate bonds (70%), ie using an 'equity risk premium'.
2. Following IAS19 accounting standards, i.e. setting the discount rate by reference to the yield on AA rated corporate bonds (23%).
3. Using either a 'gilts basis' or 'buy-out' basis (7%).



It can be seen that the most common approach is to use a 'dual' discount rate, ie to adopt different rates pre and post retirement. Typically, though not universally, the equity risk premium is built into the pre-retirement rate.

A single discount rate above the accounting rate means that an equity risk premium has been built in for all future periods. This approach is becoming less common with the closure of schemes to new entrants.

Overall just under 60% of schemes would fail the Regulator's trigger based on discount rate alone. This is not dissimilar to the proportion suggested by the Regulator earlier this year.

The information in this document is based on UK legislation and practice. The Watson Wyatt commentary in this document is not intended to be comprehensive, nor to provide professional advice. It should not be treated as a substitute for professional advice on individual circumstances.

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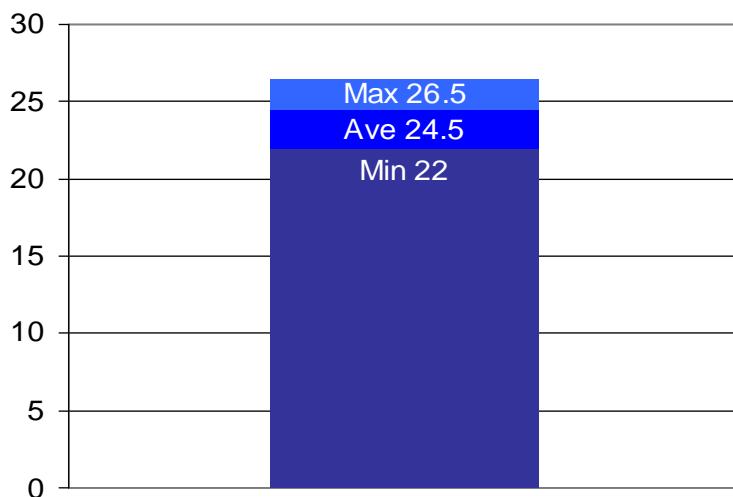
Further examination of the results reveals that:

- Schemes with stronger employers (as measured by the Dun and Bradstreet assessments) are tending to use higher discount rates, ie the trustees appear to be using weaker funding assumptions.
- The difference between the pre-retirement and post-retirement discount rates can be high, as much as 3% p.a. in some cases. This is higher than the typical spread we have seen in the past.
- Where a dual discount rate approach is being used, 60% are using a post-retirement discount rate of less than AA-rated corporate bonds, ie a stronger basis than the accounting standard once pensions are in payment. This means that the relative overall strength depends on the scheme maturity.
- As one might expect, there is a high correlation between the scheme's investment strategy and the pre-retirement discount rate, ie those schemes with a greater proportion of equities or return-seeking assets tend to have higher pre-retirement discount rates.
- We have seen some companies using contingent assets to help manage the outcome.

Mortality – improvements to life expectancy

A further key driver in a valuation is the mortality assumption, with many headlines hitting the press over the last year. Several highlights coming out of the survey are:

Life expectancy for a male pensioner currently aged 60



- The assumed average life expectancy for a male currently aged 60 has increased by nearly 2 years since the last valuation
- Almost all schemes have adopted the PM/FA92 series of tables
- 12% are using calendar year projections in the range 2003 to 2006 with no allowance for future improvements
- The remaining 88% have made some allowance for future improvements
- 30% have made allowance for future improvements based on “medium cohort”

How can we help?

Trustees are being encouraged by the Regulator to treat a deficit as a bank or unsecured creditor would when dealing with the company. Increasingly trustees wish to demonstrate that they have negotiated with the company on assumptions. It is therefore important for the company to be fully briefed when entering into a dialogue with the trustees.

If you would like to discuss any of the issues raised in this bulletin, for example on how your funding basis may compare to our survey data, or on negotiating with trustees, please call Steven Dicker on 0161 839 1600 or Andrew Reid on 020 7222 8033.