Improved funding positions offer opportunities to consider longer-term objectives

Aon's **Jay Harvey** discusses how the improved funding positions many schemes currently enjoy will affect their long-term targets

Trustees and sponsors of many defined benefit (DB) schemes will be considering the results of spring 2018 valuations over the coming months. For many, those results will be easier to navigate than previous valuations, giving an opportunity to look longer term.

Improving funding positions

Many valuations in 2015 highlighted the fact that schemes were behind with their funding plans. That resulted in often difficult conversations about how to deal with that position, and whether funding plans, contributions and timescales should be reconsidered. Three years on, according to our own data, schemes are likely to be looking at improved funding positions in many cases, and the conversations are set to be very different.

On the liability side of the equation, lower discount rates are likely to have increased liabilities. In part, this is caused by falling gilt yields (yields at 31 March 2018 were around 0.5% pa lower than at 31 March 2015, looking at market data and indices), but more widely it reflects lower expectations for future investment returns on a range of asset classes. The chart right shows how gilt yields and expected returns have fallen from 2015 to 2018. The result is that the value of liabilities is likely to have increased irrespective of the valuation methodology used, including more cashflow-driven methodologies.

On the asset side, however, returns have been fuelled by a sustained period of good returns from equities and other growth assets. In many cases, that will have more than offset the liability increase, leading to an improved funding position. As an additional bonus, the changes to mortality projections in the past three years may have reduced liabilities by up to around 5% depending on the assumption used at the previous valuation, according to Aon calculations. The net effect for most schemes is, therefore, that they will be ahead of their recovery plan.

There will, of course, be variations around this depending on individual circumstances, but for a typical scheme that is ahead of (or even in line with) their plan, the discussions are likely to be very different to 2015. Rather than higher contributions and longer recovery plans, we expect discussions to be around possible asset de-risking (if triggers haven't kicked in already), requests from sponsors for contribution reductions (perhaps hard for trustees to stomach, but may be right in some cases) or a revised plan for reaching full funding earlier than expected.

Looking longer term

However, as well as simply dealing with the technical provisions, 2018 is an opportunity for trustees and sponsors to consider in more detail their longer-term objectives. Specifically, what happens beyond 100% funding on the technical provisions basis; what does long-term investment strategy look like (eg, preference for equity vs credit risk); how to deal with ever-increasing benefit cashflows, and at what stage bulk annuities make sense for the scheme.

For the increasing number of schemes that are very close to (or possibly over) 100% funded on their technical provisions basis, a question that needs to be addressed is how any longer-term objective links to their formal valuation.

One approach is to maintain the technical provisions largely as they are, noting that going forward the scheme is likely to be 'over-funded'. The formal valuation and member communication would be more straightforward. Negotiation of technical provisions assumptions becomes less important, as it does not drive contributions. Care needs to be taken that discount rates remain achievable by the assets, but this should be largely a formality. And both trustees and sponsor know that the 'real' long-term target may be something else.

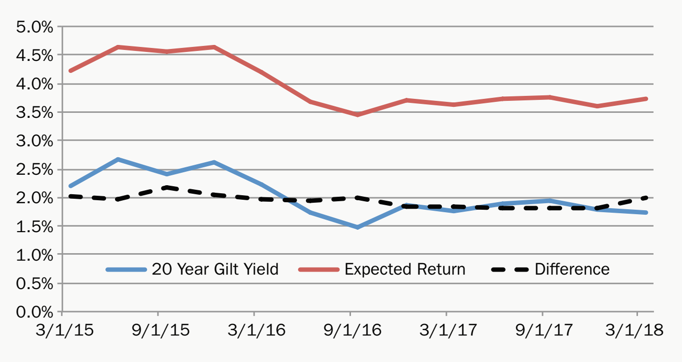
Alternatively, the long-term target could be reflected in a new and tougher set of technical provisions. The indications in the recent DWP consultation on the government's White Paper on *Protecting Defined Benefit Pension Schemes* suggest this is the direction we should expect to see encouraged, and it arguably makes for a much clearer and more robust decision-making framework. But that approach brings other implications. First, by moving the goalposts a new deficit emerges, just when members thought the scheme was fully funded. It may also put pressure on the sponsor for further contributions, at a time when they (and their shareholders) thought they were fully funded.

It is not clear at this stage which of these approaches will become most prevalent.

Broadly on track

With recovery plans broadly on track or ahead in many cases according to Aon's own data, 2018 valuations will afford trustees and sponsors the opportunity to look beyond full funding on the technical provisions basis. This opportunity should be grasped, with formal valuations being more straightforward than in previous years, and funding conversations focused on long-term strategy and objectives rather than on assumptions and discount rate methodologies.

Chart: Falling gilt yields and expected returns



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