Quattro Pensions
CONSULTING ACTUARIES
news bulletin

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In short...

- There is no reason (either in Legislation, or in logic) to automatically set all discount rates on a Gilts + basis
- It matters! Employers are being strangled, and Trustees are making investment decisions, directly as a result of the choice of discount rate.
- If a scheme is an on-going, long-term, entity, it makes more sense to consider the expected return on the assets you will actually hold.

Discount rates: over-prudent?

The Government's Green Paper on DB Pensions raises the question of whether the scheme funding regime needs an overhaul. Part of the debate reflects an argument that has been brewing for several years – how to set discount rates.

It has become standard industry practice to set discount rates on a "Gilts+" basis. Certainly, the Regulator has always given a very strong steer that it thinks this is how it should be done.

However, the existing Legislation already permits different approaches, and nowhere in Legislation is there any demand for a Gilts + approach or even a particular emphasis on gilts. Instead, Legislation states only that the discount rate needs to be prudent having considered each of three things: gilts, bonds, and the expected return on the scheme's assets.

There have always been some dissenting voices (ours included!) but it seems more and more people are now becoming brave enough to speak out against the accepted Gilts-based approach. Here, we look at the flaws in the Gilts+ approach. But first, an obvious question: does it even matter?

Does it even matter?

A scheme's benefits are not affected by the arbitrary way we choose to value them – your pensioners still expect their pension next month, regardless of actuarial assumptions! So does it matter what those assumptions are?

Our answer to this is that it definitely does matter, because the reported funding position can drive decision making:

- Sponsors may make business decisions influenced by the reported scheme deficit. In the extreme, a pension scheme deficit can strangle the sponsor to the point of insolvency.
- Sponsors may decide to close their scheme based on the size of its deficit.
- Employers decide how much they can pay to a DC scheme for future generations based in part on what they need to pay to fund the DB scheme deficit.

- Trustees make investment decisions according to the way scheme liabilities are measured. The recent trend towards so-called "LDI investing" for example, where assets are linked directly to changes in interest rates, is a direct result of schemes measuring liabilities by reference to gilt yields. If it were not for deficits being based on a Gilts+ basis, would it really be sensible to borrow money to invest at a guaranteed negative real return?

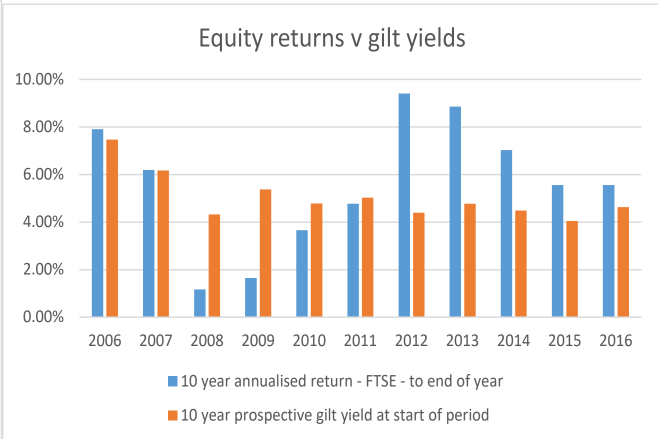
If gilt yields fall, are the expected returns on all asset classes lower?

We'll look at just one asset class here: equities. We have heard three arguments to support the idea that a lower gilt yield (corresponding to a higher gilt price) means that you should also reduce your expected return on equities:

1. The supply and demand principle affects asset prices in the same way as for commodities, so if equities become expensive people will buy gilts in preference, and vice versa, until the market reaches an efficient fair value between the two.
2. An equity is a right to a future dividend income stream, so a lower interest rate should push up its capital value, and vice versa.
3. Interest rates reflect the health of an economy generally – a low interest environment implies low asset returns.

Each of the arguments would imply some correlation between gilt yields and equities. Has there been such a correlation historically?

The first graph below compares the historic real returns on UK equities to UK gilt returns. The second graph compares 10 year gilt yields in recent years and compares to UK equity performance over the following 10 year period.



What we see is a poor correlation between gilt yields and equity performance. Gilt yields have not historically been a good indicator of the prospective returns on equities.

And going forward, do we believe the "supply and demand" argument when the Bank of England has recently purchased about 30% of all gilts, and insurance companies mop up a large proportion of the rest? Or does the existence of such "forced" buyers in the market distort the fair value of gilts?

Is it true that a fall in the gilt yield increases a scheme's deficit – when changes in gilt prices affect neither the benefits to be paid to members nor the prospective return on assets held?

In short, if a scheme invests a significant proportion of its assets in something other than gilts, why should the gilt yield form the basis of pension scheme funding decisions?

We should still use gilts as the basis, because one day most schemes will need to wind-up…

This can make sense for schemes where wind up in the short term is a realistic target. But for the majority of schemes wind-up is a distant dream, and over the 20 years or so before the scheme will realistically be able to afford it a large proportion of the liabilities will be discharged through payments of pensions each year, deaths, and transfers.

Of course, if the trustees are concerned about solvency of the employer, or want to target buyout short term, or want to buy gilts, or already actually hold a large proportion of gilts, then it makes sense that gilts frame the choice of discount rate. But in ongoing cases, the point is that the funding plan should reflect what you are trying to achieve, and the assets you are going to hold, rather than being automatically marked to today's gilt yields.

Is there any better alternative to a Gilts+ discount rate?

In most cases it makes more sense to reflect the expected return on the actual assets a scheme holds (and intends to hold) than to reference today's price on an asset that the scheme has no intention of buying at today's price. This approach is already permitted by the existing Legislation.

Typically, scheme liabilities have a strong link to inflation and hold assets that are expected to deliver real returns long-term, so it is often more sensible to frame the discount rate as a margin above inflation. This would then introduce a stabilising effect on the funding level, removing the volatility that is introduced by using a Gilts+ basis.

Note that there is still a legislative (and common sense) requirement for prudence – we are not advocating a reckless approach to scheme funding – but in many cases, the Gilts+ mechanism has no grounding in logic or legislation and is in many cases strangling employers unnecessarily, and forcing trustees into investment strategies they might not otherwise consider sensible.

Do we need discount rates at all?

A more radical suggestion would be to abandon discount rates entirely – instead of condensing information about the scheme into a single number (the deficit), why not consider a cashflow projection of both asset income and benefit outgo? If this approach were taken to company accounting for example, together with disclosure of what assets were held and what contributions the trustees had asked an employer to pay, this would give a reader of those accounts far more information than the current disclosures required by FRS / IAS accounting regulations.

Although this approach is sensible, it does still require an answer to the question of how to project asset income. Asking about future investment returns should really be the same as asking how to set a discount rate – but few investment consultants would automatically project scheme assets by some arbitrary small margin above gilts.

But isn't the expected return approach more subjective, and less secure?

Most actuarial valuations are subjective. You can argue that any estimate of cost less than the buyout cost of benefits is a fudge. If security is our only issue then we should be targeting buyout, nothing less, as soon as possible. But if what we want is a stable and sustainable long-term funding plan, aiming to pay members over time without killing the golden goose that is the sponsor, and providing an environment for sensible investment strategies and good quality schemes for future generations, we must move away from the idolatry of gilts.