A technical response to commentary on asset projections

The analysis by Dr Marsh and the blog by Dr Otsuka are both based on the erroneous premise that setting contributions which are adequate on average over 20 years is sufficient to fund the scheme.

To be clear: planning for contributions that are adequate on average over time is a **necessary condition** for an acceptable valuation, but it is emphatically ***not*** a **sufficient condition**. The reason for this comes down to **risk**. It is the trustee's duty to ensure that valuation is robust and can adequately withstand adverse investment outcomes that may materialise in any of the next 20 years. Risk has many dimensions, and the valuation must be acceptably robust in how it manages each of them.

Because of the trustee's belief in interest rate reversion – namely, that gilt yields *will* return to levels last seen in 2014, and *sooner* than is currently priced into the market – the required contribution rates, although initially higher than present, are expected to fall over time.

The proposal from Dr Marsh to set one average contribution rate is effectively backend-loading the task of meeting the cost of pensions accruing between now and 2037. In other words, current active members would today be accruing benefits that cost more than the contributions that are being paid. (And, on the flip-side, future members would be accruing benefits which cost less.)

The lower initial contributions that Dr Marsh's proposal would involve increase the short-term risk in the funding position at a time when the reliance on the employers' covenant is already higher than their stated risk appetite.

Let us make this last point more concrete: the reliance on the employers' covenant measured in terms of the self-sufficiency deficit at the time of the valuation was £22bn, which is **much higher** than the employers' stated long-term risk appetite of £10bn.

The trustee and the employers believe this position is manageable, given the strength of the covenant as confirmed by PwC, provided that, over time, reliance can be effectively managed towards £10bn.

However, there are potential scenarios that could put a significant strain on this. Specifically, as discussed in the Technical Provisions consultation, if interest rates do not rise as expected by 2020 this will increase short-term reliance by c.£4bn. Additionally, a 10% downward correction in asset markets would increase short-term reliance by c.£6bn. If both were to happen together the increase would amount to £10bn on top of the current level of reliance. A further analysis of value-at-risk (VaR), which takes account of the probabilities of movements in asset prices, shows that over a three-year period there is a 5% (or one in twenty) chance of a much greater increase in reliance of £26bn.

Higher contributions do not remove, but can mitigate this short-term risk. The total combined contribution increase for employers and members proposed for the current benefits is 11.4% of salary, or c.£900 million per year. In the absence of other agreed contingency arrangements which would help to manage the short-term risks, this increase is necessary. Moreover, the increase is sufficient to cover the current cost of benefits as they accrue. As a result the increase takes a meaningful step towards reducing both the current level of reliance on the employers' covenant and the associated short-term risks.

A contribution rate calculated as an average over 20 years is simply not sufficient for this purpose.

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