Trustee Accelerator Programme, Unit 3
5 December 2024

Trainer: Joe Moore (JM) - Aon

Topics

- DB Scheme Design
- Asset classes
- Risk and return (inc Mansion House)
- Issues associated with overseas investment
- Other asset types
- LDI
- Actuarial valuations
- Funding methods

Summary

The meeting commenced with an introduction to the speaker, who discussed defined benefit (DB) pension schemes. The speaker highlighted the key features of DB schemes, contrasting them with defined contribution (DC) schemes, particularly noting that the risk lies primarily with the employer in DB schemes. Various types of DB schemes were explained, including final salary and career average revalued earnings (CARE) schemes, with examples illustrating how pensions are calculated. The discussion then shifted to investment strategies for DB schemes, emphasising the importance of asset allocation and the role of trustees in setting investment strategies. The speaker outlined different asset classes, including equities and bonds, and their relevance to pension schemes. The advantages of equities as long-term investments were discussed, alongside the stability offered by bonds for matching liabilities.

The conversation also touched on the complexities of liability-driven investment (LDI) and the use of derivatives to manage risks associated with interest rates and inflation. The speaker addressed questions regarding investment options available for DB versus DC schemes, noting that while there are no strict rules, practical considerations often dictate the choices made. The meeting concluded with a discussion on actuarial valuations and the importance of understanding demographic factors in pension planning. Overall, the session provided a comprehensive overview of DB pension schemes, their design, investment strategies, and regulatory considerations.

Key Points

Introduction to Defined Benefit Pension Schemes

The session began with an introduction to defined benefit (DB) pension schemes, highlighting their structure and how they differ from defined contribution (DC) schemes. In DB schemes, the pension amount is predetermined based on a member's earnings and years of service, placing the financial risk primarily on the employer. This contrasts with DC schemes, where the investment risk is borne by the employee. The speaker emphasised the importance of understanding these differences for effective pension management.

Types of Defined Benefit Schemes

The speaker outlined various types of DB schemes, including final salary and career average revalued earnings (CARE) schemes. Final salary schemes calculate pensions based on the salary at retirement, while CARE schemes consider average earnings over a member's career, adjusted for inflation. The discussion highlighted how these structures impact retirement income and the importance of understanding them for both members and trustees.

Investment Strategies for DB Schemes

The discussion shifted to investment strategies for DB schemes, focusing on the role of trustees in setting investment policies. The speaker explained the importance of asset allocation, including equities, bonds, and property, and how these investments must align with the scheme's liabilities. The need for diversification to mitigate risks was also emphasised.

Understanding Bonds and Their Role

Bonds were discussed as a key investment class for DB schemes, particularly government bonds and corporate bonds. The speaker explained how bonds provide regular income and are generally less volatile than equities, making them suitable for matching liabilities as schemes mature. The importance of understanding bond yields and their sensitivity to interest rates was also highlighted.

The Importance of Actuarial Valuations

Actuarial valuations were identified as crucial for assessing the financial health of DB schemes. These valuations determine the scheme's liabilities relative to its assets and involve various assumptions about future financial conditions and demographic factors. The speaker stressed that regular valuations help ensure that pension obligations can be met.

Regulatory Framework and Compliance

The regulatory framework governing DB schemes was discussed, including the responsibilities of trustees under the Pensions Act 95. The speaker outlined the need for compliance with statutory funding objectives and the preparation of necessary documentation such as the Statement of Investment Principles and schedules of contributions.

Challenges Facing Defined Benefit Schemes

The discussion highlighted several challenges facing DB schemes, including increasing longevity risk and market volatility. The speaker noted that as members live longer, pension funds must ensure they have sufficient assets to meet ongoing obligations. Additionally, economic fluctuations can impact investment returns, necessitating proactive management strategies.

Future Trends in Pension Scheme Management

The session concluded with a discussion on future trends in pension scheme management, including the potential shift towards more sophisticated investment solutions in DC schemes. The speaker suggested that as providers develop new products that offer both guarantees and flexibility, there may be a convergence between DB and DC strategies.

Actions

- Donna will organise a session with the bulk purchase annuity team within Standard Life to provide more information on this topic.
- Lisa will arrange a session with the PMI qualifications team to answer any questions on the exams.

Questions

Question	Description	Answered?	Answer Summary
Were DB schemes designed to incentivise long-term employment with one employer?	The speaker is asking if defined benefit (DB) schemes were created as a tool to encourage employees to stay with one employer for an extended period.	yes	Yes, DB schemes were indeed designed as part of the total reward package to attract and retain employees by offering a secure pension payable for life.

Is the total accrued pension the annual benefit the member is entitled to?	The speaker seeks clarification on whether the figures shown in the third column represent the annual pension benefit that a member is entitled to receive for life.	yes	Yes, the figures in the third column represent the annual pension payable for life from the point of retirement.
Can bonds or gilts be redeemed before maturity?	The speaker is asking if it is possible to redeem the value of bonds or gilts before their maturity date or if one must adhere to the original contract terms.	yes	Yes, bonds can be redeemed before maturity. They can be traded in the market just like equities, allowing investors to sell them if they believe they are overvalued or need liquidity.
Do longer-term bonds offer better rates?	The speaker is asking if bonds with longer durations, such as 10 years instead of 5 years, typically offer better rates and if they are more attractive to pension companies due to their long-term nature.	yes	Yes, longer-term bonds generally offer better rates due to a term premium. Pension schemes often seek long-dated bonds because they match their long-term liabilities.
Does the value of government bonds depend on interest rates or sterling value?	The speaker is asking if the value of government bonds is influenced solely by interest rates or if it can also be affected by the value of sterling, referencing the impact of political events on bond markets.	yes	Yes, while underlying interest rates primarily influence government bond values, confidence in government policy can also affect bond yields and values, as seen during political events like the Liz Truss mini-budget.

Why use liability-driven investments instead of simpler index-linked investments?	The speaker is questioning why trustees would choose complex liability-driven investments (LDI) involving derivatives and swaps over simpler index-linked investments that seem less complex.	yes	Affordability and leveraging are key reasons. LDIs allow trustees to gain more inflation and interest rate protection without committing all assets, which is crucial for schemes not fully funded.