

Certain comments on Draft Position Paper

By John Walton — December 11, 2003

Para 44. Suggest add at end-

“ A dissenting view is that a scheme is fully funded when the actuary expects it to be able to meet all liabilities as they fall due, given no change in the policy of the employer, provided that there is also adequate provision for the risk of the market value of assets being insufficient in the event of premature wind-up of the scheme*. This could be called the “going concern” basis. This allows for risks arising from premature wind-up to be reinsured and for the funding level then to be based on an actuarial (that is, income based) valuation# of the scheme’s assets, so that the scheme is regarded as fully funded when the actuarial values of assets and liabilities are equal, and the extent of under- or overfunding is then measured from the comparison between assets an liabilities when both have actuarial values . ”

New footnotes

- * This can be called provision for the insolvency risk. See section 2.8 of Exposure Draft 51 (EXD51) of the UK actuarial profession, headed “solvency”, issued on 10 June 2003, and a separate paper issued at the same time entitled “A Review of Principles for Measuring Solvency under Guidance Note No. 9”.
- # Actuarial values of assets are arrived at in the same way as actuarial values of liabilities, that is by discounting to the present estimates of income and outgoings in the long-term, using the same discount rate for assets as that for liabilities. Actuarial values of assets are less volatile than market values, and in consequence, it seems, could be used as the basis of the actuarial estimates of the current service cost to the employer of the scheme (though this not what is recommended in FRS 17, which applies long term assumptions of the rate of return on assets to their current market value).

Paragraph 60. Suggest add at end-

“ On the dissenting view (see paragraph 44), the employer does not have an effective liability to the fund at the accounting date when the scheme is fully funded on the actuarial basis of valuation of assets and the risk of shortfall on premature wind-up is reinsured. Under- or overfunding measures the difference between assets and liabilities when both are valued on an actuarial basis.

The employer’s apparent liability to a scheme which is fully funded on this basis is measured by the shortfall of assets at market values to actuarial values; this is also a reasonable estimate of the employer’s potential claim on the reinsurer, if there had been premature wind-up at the same date of such a scheme. However, as this is regarded, when there is no wind-up, as only a contingent asset of the employer and a contingent liability of the reinsurer, further consideration is needed of recording in SNA. Options are: to regard the shortfall of assets at market values to actuarial values, being amounts potentially claimable, as an actual asset of the employer; to attribute these short-term elements of deficit or surplus to the employees; or to leave a short-term element of net worth with the fund, which will tend to average out to zero over a number of years.

A similar distinction between short-term and structural elements of deficit or surplus would be made in the case of schemes which are under- or overfunded on the fully actuarial basis.”

Paragraph 124 (before) – suggest the heading might read
“bankruptcies, mergers and acquisitions”

Paragraph 126. Suggest add at end-

“ The agency does not cover underfunding on the “going concern” basis, that is when the fund remains in being and is actuarially sound. Part of the cover when there is premature wind-up reflects a possible shortfall of assets at market value to their actuarial value, and this amount will tend to average to zero over a number of years. The other part of the cover when there is premature wind up reflects underfunding in a more structural sense, that is when the actuarial value of assets falls short of the actuarial value of liabilities. The former element, measured by the difference between actuarial and markets values of assets will attract a low premium and the question whether effectively it should be regarded as a liability or asset of the employer needs further consideration (see paragraph 60). ”

Comments on Draft Position Paper : Output

December 11, 2003

Para 96. Suggest add at end-

In SNA93, there has been some ambiguity about output measurement in the case of defined benefits funds. If the fund can have a net worth, is it analogous to a mutual life insurance company, where some funds are kept as liabilities (second line “reserves”) which are not distributed to policy-holders? Because this is so, a mutual insurance company generates an operating surplus, which is usually undistributed. If so, could a defined benefits pension fund with a net worth have an operating surplus, in the sense of an allocation out of income which is not part of technical provisions?

At first sight, the proposals of the EDG clarify this matter; if a defined benefits autonomous pension fund cannot have a net worth, its total service charge (output) can be measured directly as the sum of costs, in the same way as for a defined contributions fund. The usual top down formula for measuring the output of a life insurance enterprise would give the same result, because all surpluses are allocated to technical (or actuarial) provisions; and it does not matter, then, if holding gains and losses are included in the formula, in total, as both credits and debits, or are excluded. This depends however on a convention that the service charge is incurred entirely for the benefit of the members of the scheme (the present and future pensioners) and so is associated in its entirety with the technical provisions; when an overfunded scheme carries another liability which is an asset of the employer, this does not imply that the employer is a consumer of part of the service charge (and likewise for those assets of an underfunded scheme, which are liabilities of the employer).

Care is needed about the treatment in accounting sources of the management costs of an autonomous defined benefits pension scheme; in SNA93 and in the proposed SNA these are costs of the scheme, as an IU in S.125, so that the current service costs of the employer, plus employee contributions, should be sufficient to cover them. In employer accounts, however, these costs may be charged directly to the operating account of the employer as either intermediate consumption or labour costs which are associated with mainstream production, and not included within the current service costs to the employer of running the pension fund; for instance, in the UK, FRS 17 is not explicit about this.

NB. The above text uses the terms technical provisions and actuarial provisions (rather than reserves), in line with the report of the Task Force on the measurement of the production of non-life insurance services (and paragraph 41 of the DPP)