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Issue 96: When is it ok to assume the earth is flat?

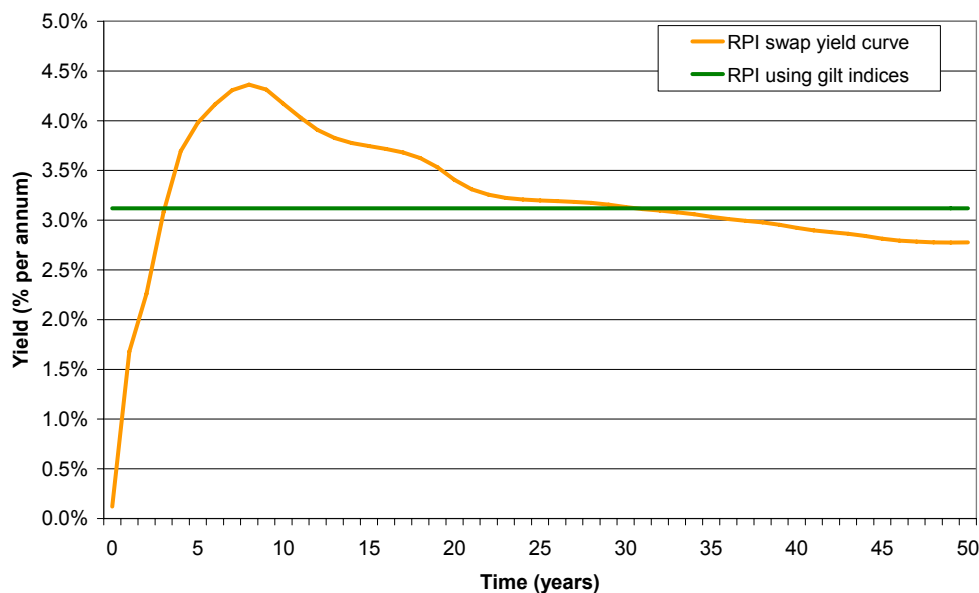
Over 2,000 years after Aristotle argued why the earth is not flat, similar discussions are taking place (sort of!) for actuarial valuations – with trustees and companies deciding on the merits of moving to a "yield curve" approach.

Although such a debate may seem esoteric in today's turbulent times, a yield curve approach can bring significant benefits, and so merits consideration. This edition of Spotlight considers the pros and cons of a yield curve approach as well as giving some ideas on how you can decide where the balance of advantage lies.

Background – Aristotle revisited

To estimate the benefits paid out of a scheme, assumptions need to be made for financial unknowns such as future inflation and future investment returns.

While actuaries have traditionally taken a simplified approach and used the same inflation assumption for all future years, the market's expectations for inflation vary 'year by year', as illustrated below.



Source: The orange line is the standard Hewitt curve for forward rates of zero coupon RPI swaps (based on the average of information supplied by counterparties). The green line is "break-even" inflation based on two long dated gilt indices. Figures correct at 20 February 2009.

The position regarding future investment returns is similar.

It is clear that using a single assumption for inflation and investment returns is a simplified approach in light of what market information is available, but should the more 'accurate' information be used?

Benefits of a yield curve approach

There are a number of benefits for using the 'year by year' information rather than an approximate approach:

- Greater 'accuracy'. Our studies show that the difference between using a yield curve approach and a simplified approach can easily be 5-10%, and that the difference changes from day to day.
- Making best use of Liability Driven Investment (LDI) strategies. For schemes that currently invest predominantly in asset classes that aim to match expected benefit payments (typically gilts and swaps), a yield curve approach provides a more stable funding measure.
- Future Proofing. Some schemes will adopt LDI strategies at some stage in the future. Adopting a yield curve approach now will avoid a valuation basis transition strain/gain at the time such a strategy is adopted.
- Decision making. If you're thinking of buying out longevity risks (e.g. through annuities or longevity swaps), a yield curve approach can give you a more accurate picture of the cost/benefit trade-off.
- Consistency with corporate accounting disclosures. The assumptions adopted for company accounting disclosures globally are becoming increasingly influenced by yield curve considerations.

When a simplified approach is better

In the same way that it is ok to assume that the world is flat if you only intend to travel 500 miles, it is sometimes ok to continue to adopt the simplified approach. Reasons not to adopt a yield curve approach include:

- Spurious accuracy. Yield curves may be considered over-the-top for schemes where there is significant uncertainty, e.g. if an equity led strategy is adopted.
- Cost. There may be additional complexity and cost, which should be understood and discussed at the outset.
- Herding. At present, the majority of valuations are carried out on a non-yield curve basis, although a tipping point may soon be reached.

Deciding where the balance of advantage lies for your scheme

- If you are in the process of matching your investments more closely to the benefit payments, then now may be the time to switch to a yield curve approach.
- If you think you will not be taking risks out of your pension scheme in the near future, and are generally looking to tighten your belt, then keeping a simplified approach may be the better approach for now.
- Whichever route you go down, we recommend that trustees and companies make a conscious decision on this at your next regular (or brought-forward) valuation.

Note as well that a variety of half-way houses also exist, which your consultant will be able to explain to you.

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