

1 Background

Investment markets have been extremely volatile during 2011, and particularly so since July.

Scheme funding positions have been put under pressure during this period and trustees of defined benefit schemes need to be mindful of their duties in such an environment.

2 What drives funding levels?

There are three key financial variables driving scheme funding levels – the discount rate, expectations for future price inflation and investment performance.

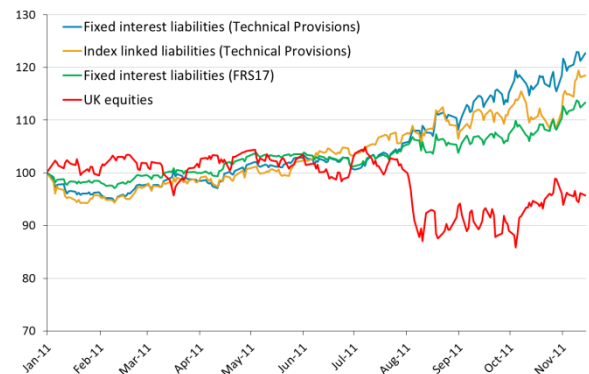
Discount rates are generally determined with reference to the market yields available on gilts or high quality corporate bonds. The lower the yields available in the market, the lower the discount rate typically used, and the higher the valuation placed on a scheme's liabilities. This is equivalent to saying that, when bond prices increase, so does the value of a scheme's liabilities.

Inflation expectations are also derived from the market price of investments, principally inflation-linked bonds.

Bond markets, and gilt markets in particular, have performed strongly during 2011, being seen as safe haven assets in the current climate. This has put significant upwards pressure on liability valuations.

The year to date has been very difficult for equity markets, with a range of difficulties threatening the global economy.

The chart below illustrates the typical growth in pension scheme liabilities resulting from market movements since the start of the year, and contrasts it with the total return on UK equities. Given the dependence on equity investment that many schemes have, market movements are likely to have had a significant impact on funding levels during this period.



Source: FTSE, iBoxx; rebased to 100 at 1 January 2011

3 Trustees' responsibilities

Trustees are expected to be aware of the factors that affect the solvency of their schemes and to consider whether any steps are necessary to protect members' benefits as market conditions change. This would be expected to be of particular importance if the trustees have concerns regarding the strength of the employer covenant.

Such steps might include:

- Undertaking an updated funding assessment;
- Seeking additional funding from the employer;
- Reviewing the Scheme's investment strategy;
- Reviewing the level of reductions being applied to transfer values;
- Considering whether any other discretionary policies need to be reviewed, e.g. early retirement policy.

In the first instance, trustees should speak to their Scheme Actuary to discuss the position and consider what, if any, actions might need to be taken in their own schemes' cases.

Please contact your usual consultant if you have any queries regarding this update.

BBS Consultants & Actuaries Ltd
December 2011