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Also referred to by Philip Coggan in the *Financial Times*

Quantifying FRS17 Volatility

One of the biggest concerns in the run up to FRS17 being introduced has been the expectation of significant volatility being demonstrated. As yet, we doubt that many people have developed that much of a quantitative “feel” for the magnitude of volatility that they will see in their FRS17 liabilities, particularly for active and deferred members. Accordingly, at Jagger & Associates, we have been trying to devise a measure which will enable our clients to do this, and which can be readily compared with the actual return achieved on a scheme’s assets, to identify how the surplus/deficit position under FRS17 is likely to have evolved.

It became clear early on to us that a single-figure statistic would not be very useful for schemes in general, since it was too dependent on assumptions about the scheme structure and average age of the liabilities involved. So, what we have come up with is an **age-by-age change indicator** – for each £1 of accrued pension at any given age, we compare its FRS17 value 12 months ago (the “start” point) with the value now (the “end” point), i.e. allowing for the change in corporate bond yields, earnings growth and so on. This method can be adapted for deferreds as well as actives, and can be applied for any scheme-specific level of pension increases.

The indicator’s change is thus the yardstick against which to measure your scheme’s asset return – simply estimate the average future term to retirement of your scheme’s active membership (weighted by accrued pension) and read off from the chart the corresponding change indicator’s value. To get the debate on volatility magnitude started, we have produced the results for the 12 months for each month end up to the end of August 2001. The deferreds’ results are very similar to those for actives, so we have not pursued them further here.

The chart gives just the actives’ results, using the latest 12 months period. The actives’ results are shown below for pensions with no increases and with RPI increases – in either case, what can be seen is that the fall in corporate bond margins has fed through to dramatic increases.



For example, a scheme with an average future term to retirement of 15 years will have seen its FRS17 active liabilities rise by about 27% over the 12 months to 31 August 2001 - compare this with a return from corporates of +13% and from UK Equities of *minus* 17%. The liabilities have outstripped these assets by 14% and 44% respectively!

Yes, scheme-specific factors may mean these figures require adaptation in a particular case, but they are nevertheless a valid start point from which to begin to face up to the magnitude of the reported balance sheet volatility coming towards the UK’s pension schemes and employers.

Simon Jagger
Director & Actuary