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15th February 2006

Mr M G S Farrell  
The Church of England Pensions Board  
29 Great Smith Street  
London  
SW1P 3PS

Dear Shaun

**Church of England Funded Pensions Scheme (“the Clergy Scheme”)  
Estimate funding position as at 31st December 2005**

You have asked for an update of the pension scheme position as part of the annual consultation on Stipend levels. I am pleased to write with the results of our calculations.

This letter also considers the potential impact of the new Scheme Funding requirements, which will apply for formal valuations in future.

**1. Recent valuations**

The last formal valuation of the Scheme was carried out as at 31st December 2003 and showed that the Scheme’s assets were some £91m below the Funding Target at that date. Our latest estimate of the Scheme’s funding position was carried out as at 30th November 2004 and this showed a broadly similar position.

**2. Estimated position at 31st December 2005**

As requested, we have estimated the position as at 31st December 2005.

**2.1. Method**

We have carried out an approximate calculation of the Funding Target as at 31st December 2005, by projecting forward the actuarial valuation as at 31st December 2003. We have then compared this with an estimated market value of assets as at 31st December 2005. This was calculated from the asset valuations provided by Betty Sanders as at 30th June 2005, which we have adjusted for contributions and market investment returns up to 31st December 2005.

In projecting forward the Funding Target, we have allowed for the further accrual of benefits, interest, and estimated payments out of the Scheme. We have also allowed for the

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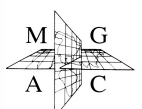
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known increases in the Pensionable Stipend supplied by Tony Williams in his email of 20th October 2005. We have assumed that all other experience has been in line with the actuarial valuation assumptions as set out in my report dated 26th October 2004.

We have then adjusted the Funding Target to allow for changes in market conditions.

Although this is an approximate calculation, I believe that this approach should provide a good indication of the overall picture.

## **2.2. Market conditions**

The main change in market conditions since 31st December 2003 has been a sustained fall in the real yield on index linked gilts, as shown by the table below:

<b>Assessment date</b>	<b>Real yield on index linked gilts</b>
31st December 2003	2.0% pa
30th November 2004	1.8% pa
31st December 2005	1.2% pa

The Funding Target and future service contribution rate anticipate future real returns from equities at the rate of 2% pa above the index-linked gilt yield.

Falling real yields on index-linked gilts increase both the Funding Target and the future service contribution rate, as the anticipated future investment returns are lower.

## **2.3. Results - Funding Target**

We estimate that the Scheme's assets were about £125m below the Funding Target as at 31st December 2005.

This represents some further deterioration from our latest estimate of £95 to £105m as at 30th November 2004. Although deficit contributions started from April 2005 (and we estimate some £6m has been paid since then) these would have done little more than cover the interest build up on the deficit.

The absolute investment return from equities was higher than expected, but the excess was not quite sufficient to cover the increase in the Funding Target due to falling gilt yields.

## **2.4. Results - future service contribution rate**

The reduction in gilt yields causes the future service contribution rate to increase from 28.9% to about 34%.

## **2.5. Results - deficit contributions**

The current deficit contribution is 4.5%, targeted to eliminate the deficit as at 31st December 2003 by 2018, ie 15 years from the valuation date.

To eliminate the increased deficit over a new 15 year period, with deficit contributions increasing from April 2007, would give a deficit contribution of 5.6%. Current “best” practice would be to retain the existing deficit contribution for the balance of the original period and then to add a new series of deficit contributions to remove the additional deficit. On this basis, the aggregate deficit contribution would need to increase to about 6.2% from April 2007, but would reduce to 1.7% from 2018 to 2020.

### **3. Pensioner mortality**

For the next formal valuation, we will want to analyse the recent pensioner mortality experience. In particular, we will want to consider whether it is appropriate to move to the most recent mortality tables that anticipate a faster increase in future life expectancy than the tables used at the last valuation - this is the “cohort effect” as discussed in the context of the other schemes.

The potential effect of such a move, we currently anticipate, would be to increase the Funding Target – and hence the shortfall – by up to £15m (this is a 4% rise), and the future service contribution rate by 1%. However, the analysis may suggest a smaller increase, or indeed no increase.

### **4. Scheme Funding under the Pensions Act 2004**

As you know, the Pensions Regulator has now published its code of practice on the new Scheme Funding requirements under the Pensions Act 2004.

The Regulator has also published a further consultation document on how it proposes to regulate schemes in relation to the new funding requirements. This provides information on the type of funding levels that might be expected in the future. In particular, the Regulator proposes a system of triggers to identify schemes that merit closer attention (but not necessarily intervention) in relation to their approach to scheme funding. The final provisions on this are not now expected until April 2006.

However, the current proposal is for two triggers:

- the first is on the “funding target” and refers, inter alia, to 70-80% of the amount that would be required to secure all the accrued benefits by purchasing annuities from an insurance company; and
- the second is on the period over which deficit contributions are to be paid to restore the assets to the funding target and refers to 10 years.

However, the triggers define when the Regulator may consider that the situation warrants a closer look; it does not follow that he would then decide to take further action. If he considers that the trustees have properly considered factors such as the strength of the employer’s covenant and the maturity of the Scheme, then it is expected he would do nothing.

Assessing the covenant of the various “employers” supporting this Scheme will not be a simple exercise!

The current Funding Target is materially below the “70-80%” of buy out - principally because of the level of future returns from equities that is anticipated. Also, the deficit correction period is 15 years. We have therefore considered the effect of moving closer to the Regulator’s triggers.

We have considered this by reference to both triggers:

- for the Funding Target, we have considered the effect of reducing the level of equity return that is anticipated, thus increasing the Funding Target. We have shown this in two stages: halving (ie to 1% pa) and then removing, but in both cases only in relation to the period after retirement; the latter stage gives a Funding Target that we estimate is within the range of 70-80% of buyout;
- for the deficit correction period, we have considered periods of 15 and 10 years.

	<b>Deficit from Funding Target £m</b>	<b>Approximate future service contribution</b>	<b>Deficit correction period</b>	<b>Approximate deficit contribution</b>	<b>Total contribution</b>
2003 valuation approach	125	34%	15 years	6%	40%
2003 valuation approach	125	34%	10 years	9%	43%
Halving the anticipated additional equity returns post retirement	170	37%	15 years	9%	46%
Halving the anticipated additional equity returns post retirement	170	37%	10 years	12%	49%
No anticipated additional equity returns post retirement	220	41%	15 years	12%	53%
No anticipated additional equity returns post retirement	220	41%	10 years	16%	57%

Clearly, the required rates of contribution become very high for the higher Funding Targets and shorter correction periods.

To the extent that the Scheme continues to invest 100% in equities, the move to a higher Funding Target essentially advances contributions, but does not necessarily increase the contributions that will be payable eventually. However, it does mean that the chance of the additional return from equity that is actually earned being less than the rate anticipated is reduced, so the chance of having to pay higher contributions in the future is reduced. Put another way, it means that there is more likely to be “good” news at a subsequent valuation than “bad” news.

## **5. Post 31st December 2005**

Since 31st December 2005, gilt yields have fallen further, causing the Funding Target to increase. Equity returns generally have not been sufficient to offset this, so the deficit will have increased again.

If these conditions persist, both the future service contribution and the deficit contribution resulting from the 2006 valuation will be higher than indicated above.

## **6. Conclusion**

Clearly the above comments about how the new scheme funding regime could impact on the contribution requirements will make depressing reading. It is very early in the new regime and it will inevitably be some time before we can be sure how it will operate in practice.

Please contact Aaron or me if you would like to discuss this further.

Yours sincerely

{Sent as an attachment to an e-mail on 15th February 2006 at 17:56}

M R Slack FIA  
*Partner*