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Fast forward

If accurate, timely actuarial valuations within 24 hours were a reality, what would be the implications for the actuarial industry? asks Richard Lowe

The words 'fast' and 'actuarial valuation' have rarely been uttered in the same breath. The practice has always been a slow, time-consuming and laborious one, especially when much of the underlying pension scheme data is derived from paper records.

That said, there has been a general move to more frequent actuarial reporting. Many schemes now go beyond the regulatory minimum of a triennial formal valuation with annual updates. Some call on quarterly updates from their actuarial consultants, but these are not accurate valuations in themselves so much as projections based on the same set of assumptions – or 'roll-forwards' as they are known.

It should come as a surprise, then, to learn that one company claims it can provide full formal valuations on a monthly basis. And not only that – it can deliver it within 24 hours direct to a pension manager's computer.

The natural reaction to this assertion is one of cynicism, and Pensions First has met a lot of this since unveiling its new service, PFaroe, which it says does exactly that described above. If quarterly updates are simply roll-forwards based on potentially outdated assumptions, then surely monthly valuations deliverable by the next day are equally inaccurate, if not more so?

This is the very criticism raised by most actuarial consultants who are aware of Pensions First's new product. For example, Antony Barker, managing director at Pension Capital Strategies, says that if the service can be turned around within such a short time period it must be based on assumptions. He adds that the 24-hour tag is a good headline-grabber, but any consultant could deliver this, because it is nothing more than updating calculations.

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Deborah Cooper, principal at Mercer, echoes these sentiments, saying her consultancy could produce update calculations in 24 hours if clients wanted it. "But all you are doing is repeating a set of calculations over again and again," she says. "There are all sorts of different things that affect the pension scheme that you won't be able to capture."

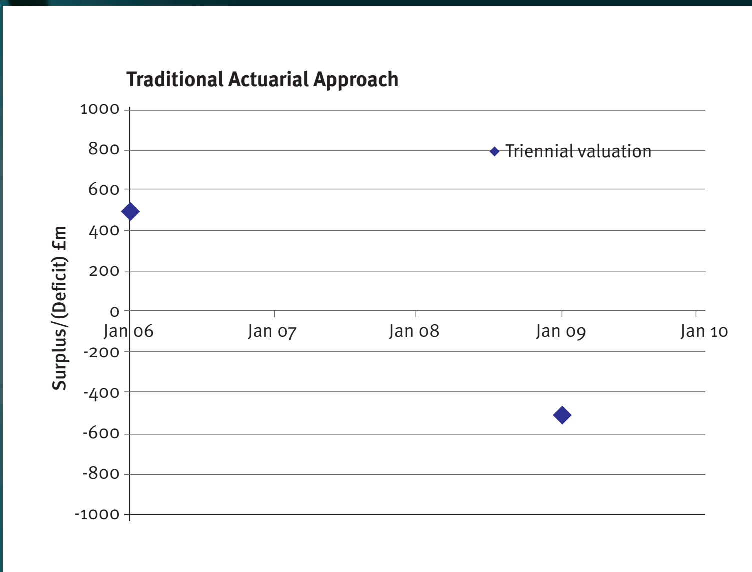
A major variable that such calculations will fail to capture on a daily basis is membership data, for example, "so you don't know what is happening," Cooper says. "You can do a routine calculation in 24 hours, but it doesn't actually add a huge amount of value to anything. The bits that add value are the bits that take the time and they can't be done in 24 hours."

But according to Pensions First, the consultants have got it all wrong. When the firm claims it can provide monthly actuarial valuations within 24 hours, it is not talking about updating calculations or roll-forwards. It is referring to formal actuarial valuations that are as accurate as a pension scheme's mandatory triennial valuation.

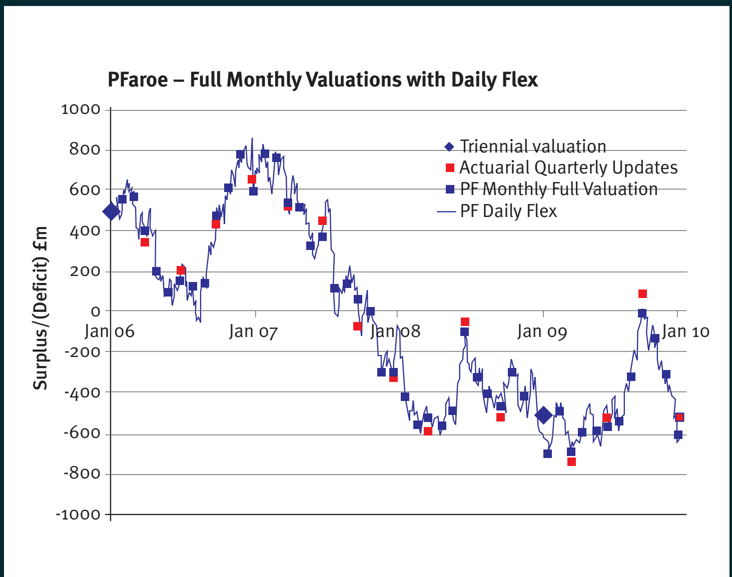
Timothy Lyons, partner at Pensions First is quite specific: PFaroe can provide a full valuation, not a simple update calculation. It is therefore very different from what consultants typically offer, he says.

"The updated valuations that a scheme will receive from its consultant will be a roll-forward from the last formal valuation. And a roll-forward is far from an accurate analysis of the scheme," Lyons says.

The further in time these roll-forwards move from the formal valuation date, the more key parameters, such as interest rates and inflation, change during the period, and so the



The graph shows the results of two triennial valuations of a hypothetical pension scheme.



Pensions First says clients can alter assumptions and run what-if scenarios on a daily basis. The hypothetical graph here shows the potential fluctuation between valuations.

less accurate they become. Lyons says this eventually develops to a point where such updates become "useless as a risk management measure".

But surely if it can take weeks – or months – to produce a traditional full actuarial valuation of a pension scheme, it must be impossible to deliver what Lyons is describing within 24 hours?

It is possible, Lyons says, because of the technology that Pensions First has developed. The company was initially founded in 2007 to manage pension fund assets and to develop investment products that hedge a scheme's exposures to markets, scheme-specific longevity and inflation risks. It failed to win any business, but in the meantime developed the PFaroe system as a means of managing the defined benefit risk it would be taking on. It became clear that the system was something that could be marketed to pension funds directly.

End-users of the service will be required to go through an 'onboarding' process, whereby all the scheme rules, member data and investment information is uploaded onto the PFaroe system. Each pension scheme will have its own bespoke template based on individual scheme rules, and once 'onboarded' the system can be updated regularly. Cashflows can be produced at an individual scheme member level and for each scheme asset, allowing users to conduct various alternative scenario analyses by changing different assumptions.

Importantly, the theory has been put into practice through what Pensions First describe as a rigorous beta-testing programme involving a number of UK companies, including Aga (which has a large pension scheme relative to the capitalisation of the company), Alliance Boots, JPMorgan Cazenove and DMGT Pensions.

PensionsFirst provide a number of anonymous quotes from these beta-testers: "In a few years' time we will ask ourselves how we ever managed without a tool like this"; "It borders on the brilliant!"

These should be taken with a pinch of salt, obviously. But speaking to Geoffrey Staines, pensions director at DMGT Pensions, the comments certainly sound credible. "This is in my view industry-changing software," he says emphatically.

Staines explains that DMGT Pensions, which manages the final salary schemes of the Daily Mail General Trust, has been looking for a system that can help manage risk. The arrival onto the scene of PFaroe was uncannily fortuitous, he says, given that it was "pretty much identical to our specification".

He explains: "To us it's risk management software and it allows us to optimise the decision-making on transferring the risk away from our balance sheet to the market. It allows us to ask what-if questions and to really integrate some very deep information into the risk strategy – the kind of information we don't usually have on the table to make these decisions."

Despite the 24-hour tag attracting most of the headlines, Pensions First stresses that PFaroe is primarily a risk management tool and is not there as

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a substitute for the mandatory triennial valuation. The Pensions Regulator says it is aware of the product and "will be looking at it", but – as is usual – stated it does not endorse any products.

Early indications – such as the glowing reviews emanating from DMGT Pensions – are that PFaroe might well serve as a significant wake-up call for the sleepy defined benefit valuations space. Pensions First forecast "a rapid adoption of the product" from more than 20 pension schemes before the end of 2010. But the question still remains: are most pension schemes asking for monthly valuations?

Mercer's Cooper emphasises that there is little point in producing regular valuations if the information is not be being used. "It is just work for the sake of it", with no value added, she says. Quarterly updates can be helpful for some of the larger pension schemes, but the long-term investment horizon of most institutions means there is rarely a need to value on a monthly basis.

Lyons of Pensions First says there is a long-established and widespread notion that there is no need to attempt to manage long-term liabilities with shorter-term accuracy. But this is a misconception, he believes. Not managing liabilities and investments with "granular attention" leads to "the extraordinary volatility that many pension schemes have suffered in the last couple of years," he says.

What is clear is that managers, sponsors and trustees of pension schemes should be asking themselves whether they would benefit from a service like PFaroe. If the answer is yes, another question would be: why is no one else doing it? That is probably one for the consultants to answer. ■