SCHEME SPECIFIC FUNDING, VALUATIONS AND RECOVERY PLANS

Members of the IFB met with The Pensions Regulator in November to discuss issues around the funding of defined benefit (DB) occupational pension schemes. In this article The Pensions Regulator sets out an overview of the scheme specific funding requirements, and the processes scheme trustees need to go through when valuing the scheme, putting in place a recovery plan, and reaching agreement with the sponsoring employer.

An overview of the Scheme Specific Funding regime

- The Scheme Specific Funding (SSF) regime requires the majority of DB schemes to complete an actuarial valuation at least every three years. Annual update reports are carried out in the intervening years.
- The actuarial valuation establishes how much the scheme's assets are worth and how much the scheme needs in order to pay pensions as they fall due (known as the 'technical provisions' or 'funding target'). The valuation reflects a particular point in time and assumes that the scheme will continue in the future.
- For most schemes, trustees must reach agreement with the employer on the assumptions and method used to calculate the scheme's technical provisions.
- The SSF regime requires a scheme to be funded to at least the level of its technical provisions. If the trustees find the scheme to be in deficit, they must draw up a plan to address that funding gap – known as a recovery plan.
- The trustees have 15 months from the valuation date to submit a statement of funding principles, a schedule of contributions and a recovery plan (if appropriate) to the regulator.
- Once agreed, the recovery plan can stay in place until the next valuation. However if there are any significant changes to the situation of the employer during that time, then the trustees may consider bringing forward the valuation and making changes to the recovery plan.

The valuation process

The valuation process determines the assets required to meet the pensions promises made to all members over the long-term. To calculate the technical provisions, trustees need to make assumptions about a number of factors, including mortality rates, future investment returns, salary increases, and the rate of inflation. Legislation states that trustees must be 'prudent' when choosing the assumptions on which to base the valuation.

The employer covenant

As part of the valuation process, trustees also need to make an assessment of the employer's ability to meet its legal obligations to the scheme now and in the future. This is known by The Pensions Regulator as the 'employer covenant'. Assumptions must be prudent in light of the strength of the employer covenant, as the sponsoring employer effectively underwrites the full liabilities of its DB scheme. A strong, resilient employer will be better able to underwrite risks such as poor investment performance, increasing life expectancy and rising inflation and therefore have a strong covenant. This means that trustees are able to use more optimistic assumptions. Conversely, where the covenant is weak, assumptions would need to be more cautious.

The Pensions Regulator published guidance for trustees at the end of last year on how they should assess the strength of the employer covenant – this should take into account both the employer's legal obligations to the scheme, and its financial position. In assessing the financial strength of the employer, the trustees should consider

- the position of the employer, including its financial strength, intra-group relationships and policies, management records and future plans;
- the scale of the obligations to the pension scheme relative to the size of the employer's operating cash-flow;

- the nature of the industry sector in which the employer operates and the employer's position within the industry;
- the position of the economy as a whole;
- the relative priority placed on the pension scheme compared to competing calls on corporate finances, such as dividend payments, capital expenditure and bonus payments; and
- an estimate of the value that might flow to the scheme on insolvency of the employer as well as the likelihood of that eventuality (the assessment being based on past and current information and trends).

(http://www.thepensionsregulator.gov.uk/docs/employer-support-DB-statement-june-2010.pdf)

An example of an employer with a strong covenant would be a company in a strong financial position, with viable long-term prospects. In contrast, an employer with a weak covenant would be a company which is struggling financially, has few assets to support its obligations to the scheme, or is reluctant to fund the scheme adequately.

The regulator has also published a short guide for employers – 'the employer covenant at a glance' – which explains how trustees and employers can work together to increase the strength of employer covenant to enable more flexibility in the length and shape of recovery plans where cash is constrained. (http://www.thepensionsregulator.gov.uk/docs/employer-covenant-at-a-glance.pdf)

Recovery plans

Only once the trustees and the sponsoring employer have agreed the technical provisions, and if the scheme is found to be in deficit, will discussions begin about the shape and duration of the recovery plan. The funding target should never be adjusted to suit what the employer can afford.

Recovery plans are submitted to The Pensions Regulator along with a summary of the valuation. It is important to remember that there is no standard length or shape for a recovery plan - what is appropriate in each case depends upon the individual circumstances of the pension scheme and sponsoring employer. We expect any shortfall to be filled as quickly as the employer can reasonably afford. The SSF regime allows for flexibility in the way a recovery plan is structured, and what is reasonable and appropriate will depend on the trustees' assessment of the employer's covenant.

In scrutinising recovery plans, The Pensions Regulator takes into account a range of factors including

- the length of the plan;
- the contribution schedule - including any 'back-end loading' or promise of higher contributions in the future;
- the treatment of shareholders and other creditors; and
- the use of 'contingent assets' such as guarantees or the pledging of other assets such as property, made as part of the funding strategy.

In general The Pensions Regulator regards cash contributions as the best support for a pension scheme. However, in cash-constrained situations it may be appropriate for trustees to consider accepting contingent assets as a means of support to the scheme. Trustees need to ensure that any agreement relating to contingent assets is legally enforceable and allows them to realise the value of the asset should the contingent event – such as an insolvency – occur.

The Pensions Regulator looks at all submitted recovery plans. We use a series of 'triggers' to help us identify those plans that may pose particular risk to members' benefits, and plans which trigger may be scrutinised more closely. However, triggering does not necessarily mean that the plan is inappropriate to the circumstances of the scheme and the sponsoring employer. It is not uncommon for us to accept recovery plans in excess of 10 years, or to look more closely at plans with very short recovery periods – it all depends on the circumstances of the case.

Reaching agreement

If the scheme trustees and sponsoring employer are finding it difficult to reach an agreement on the valuation and/or recovery plan within the 15 month period, we encourage them to come to The Pensions Regulator as early as possible, and if appropriate we will step in to help facilitate discussions between the parties to help them reach an agreement.

The regulator does not ‘approve’ or ‘clear’ recovery plans. However, if the plan does not raise any material concerns then the scheme will be notified that, based on the information provided, the regulator does not intend to take any action.

Further guidance

Further guidance is available for trustees, employers and their advisers at the Pensions Regulator’s website at www.thepensionsregulator.gov.uk. Or if you want to speak to someone about the circumstances of your scheme you can call us on 0870 6063636. The regulator’s free e-learning programme for trustees has been developed to help them understand all aspects of their role, including guidance on working with professional advisers. The toolkit can be accessed at www.trusteetoolkit.com.