



Independent Trustees



Briefing note – April 2012

Overview

- The Pensions Regulator (tPR) has published its first annual statement on scheme funding; providing comment on how it expects trustees and employers to approach funding valuations in the current economic environment.
- tPR recognises that recent economic conditions have placed pressure on pension scheme funding, and this statement applies to valuations carried out over the twelve month period to September 2012.

tPR continues to believe that:

- the scheme funding framework is flexible enough to cope with conditions across the economic cycle
- primacy should be given to the technical provisions
- most importantly, there is room for flexibility in the recovery plan.

Pension scheme funding in the current environment

Background

Current market conditions are certainly challenging for the funding of pension schemes. Since September 2011 both real and nominal gilt yields have fallen to historical lows due to the high demand for gilts from both quantitative easing (QE) and flight to quality to the perceived safe haven of UK gilts in light of the Eurozone troubles. Low gilt yields have driven up liabilities and, for the majority of schemes, this has not been matched by an increase in asset values; resulting in large deficits.

Despite this, tPR expects that the majority of schemes carrying out valuations in the period covered by the statement are likely to either have funding deficits at similar levels to those identified three years ago or be broadly on track with previously agreed plans. This will be true for some, mainly due to the fact that their previous valuation was carried out in the wake of the Lehman Brothers' collapse which led to huge drops in most schemes' asset values and, therefore, large funding deficits. However, many, particularly those with little or no hedging, will be looking at bigger deficits and will have been hoping for some help from tPR's statement.

Technical provisions

tPR reiterates its view that **technical provisions need to be set prudently, taking into account the covenant of the employer**. It has provided some clarification on questions that were being asked about how current conditions may affect calculations and what allowances could be made.

Allowing for market reversion – stakeholders had questioned tPR about whether schemes could incorporate an allowance for an improvement in economic circumstances, in particular gilt yields reverting to more 'normal' levels. Some, especially those with unhedged investment strategies, would argue this is justified due to gilt yields being artificially low from the effects of quantitative easing and increased demand for 'safe haven' UK gilts. tPR's view is that such **allowances should not be made in the assessment of technical provisions as it would not be prudent to second-guess the market**. Any strongly held views about future market conditions should be accommodated in the recovery plan.

Increasing the assumed level of outperformance in the discount rate

– typically, liabilities are valued using a discount rate that is based on a risk-free rate plus a prudent allowance for additional expected returns, for example, equities may have a future return assumption of gilts plus 2% per annum. With gilt yields falling to record lows, there was a question over whether a greater assumed return above the gilt yield could be justified, e.g. if trustees view equities as having relatively higher expected returns following the market changes, they may conclude gilts plus 2.5% per annum is an appropriate assumption.

However, in its statement, **tPR says it will view any such increase in the discount rate as an increase in the reliance on the employer's covenant**. This appears to restrict the freedom for trustees to justify such a change by reference to their interpretation of economic conditions. Further, if they do increase the outperformance allowance, they will be expected to examine additional risk implications and be convinced that the employer could realistically support any higher level of contributions required if the actual investment return falls short of what is required. Trustees may therefore need to increase the levels of analysis they carry out.

Smoothing of discount rates – tPR also views smoothing as inappropriate as this would not be consistent with the legislative requirement to value assets on a mark-to-market basis.

tPR therefore makes clear that in the context of technical provisions there should be no manipulating of assumptions to make allowance for the perceived extreme market conditions. It does, however, leave the door open for some allowance to be made in the recovery plan.

Recovery plan

Again, tPR reiterates that **there is flexibility when setting the recovery plan** and this should be **based on what is affordable** without compromising the employer's long-term ability to support the scheme.

In line with existing guidance, it highlights that, as a starting point, the current level of deficit repair contributions are maintained in real terms and, where deficit contributions are reduced, trustees should document their justification.

tPR covers the new concept of where schemes choose to rely on anticipated changes to the current circumstances, e.g. by assuming some form of gilt yield reversion in the recovery plan assumptions. This is an interesting concept given previous allowances, e.g. allowing for subsequent asset recoveries in 2009, allowed for actual rather than anticipated changes.

It should be noted, however, that it uses the phrase 'by exception' when referring to making such an allowance so tPR is not anticipating this approach being the norm. It says that schemes using such an approach should have viable contingency plans to address the situation where such assumptions are not borne out and such plans should be suitably documented.

In line with guidance given in 2009, tPR also highlights that **allowing for post valuation experience is acceptable**. It remains to be seen how market conditions will evolve before these valuations are completed but this may prove to be a useful avenue for schemes that had an effective date at the height of the poor conditions, e.g. at 31 December 2011.

tPR also makes the point that, where schemes are close to their funding targets and there is a possibility that changes in market conditions may lead to surplus funding, they may wish to consider other mechanisms such as escrow accounts.

Follow up

tPR will be seeking to identify schemes where approaches are not in line with its statement and where its intervention may have the greatest impact. It will also consider whether any individual feedback given in relation to prior valuations has been taken into account.

tPR is anticipating that this statement will reduce the need for regulatory involvement as trustees and employers will have a greater understanding of what tPR finds acceptable.

tPR plans to issue a statement each year helping trustees to understand its expectations and acceptable approaches to the scheme funding process within the prevailing economic conditions. **tPR's full document can be found at <http://thepensionsregulator.gov.uk/press/pn12-12>**

This briefing note is provided for general information only and should not be relied upon as advice on your specific circumstances.

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Find out more

If you have any questions about the Pension Regulator's statement on scheme funding in the current environment, please contact Mark Homer.



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