PSIT Independent Trustees

Briefing note – June 2012

In April, the Pensions Regulator (tPR) issued a statement about pension scheme funding in the current environment (see our briefing note for full details), providing comment on how it expects trustees and employers to approach funding valuations carried out over the twelve month period to September 2012.

The Pensions Regulator's statement on scheme funding – what has really changed?

In the statement tPR made it very clear that no allowance for current market conditions should be made in the technical provisions. However, it did suggest that flexibility exists, where the circumstances of the sponsor permit it, to take into account an allowance for the unwinding of any distorting effects on current yields within the funding and recovery plans (in other words, when gilt and bond yields return to a more 'normal' level).

This may provide trustees with limited scope to agree some relief for the sponsor and offers them the ability take a more integrated approach.

However, **the strength of the employer covenant will be a key factor** and, if the additional flexibility in the recovery plan is to be used, trustees must:

- be able to **identify and manage the additional risk introduced** and be confident that the sponsor is able to underwrite this;
- **clearly document their rationale** to justify the additional risk; and
- **prepare contingency plans** in case the expected unwinding of gilt yields does not materialise and a step up in funding is required.

The message is that **trustees will need to have a clear audit trail of their thought process and be able to demonstrate that they are able to manage the additional risk.**

tPR's example scenarios

At first sight, the apparent prospect for some breathing space in the recovery plan where conditions justify it will be welcome to employers. However, since releasing the statement, tPR have published three example scenarios to illustrate their requirements. These focus on a limited range of circumstances, but provide a slightly different slant on how the statement could be interpreted.

In particular, one example suggests that it would only be appropriate to allow for a reversion to more 'normal' gilt yields within the recovery plan in cases where:

- the outlook for the business is mixed;
- affordability is currently limited;
- no security to the scheme can be provided; and yet
- there remains a reasonable likelihood of recovery.

The other examples cover employers with relatively stronger covenants and the ability to increase or maintain contributions by allocating less to dividends and/or investment in the business. In some circumstances, these employers might offer some form of security in return for an extension in the recovery plan.

There are other scenarios that are not covered by the examples where we feel some specific guidance would have been valuable. For example, a small-medium sized scheme with an unhedged investment strategy where the sponsoring employer is not paying dividends, has limited means of pledging security and is concentrating on restoring balance sheet strength or other business related priorities.

Trustees need to tread very carefully when considering a proposal to extend the recovery plan or make an allowance for a return to 'normal' gilt yields. Although tPR's statement seems to permit some flexibility, it appears from its limited examples that this option will be considered less than satisfactory where a sponsor can either maintain or increase existing contribution levels or offer some other form of security.

As usual, **trustees will face a delicate balancing act** between keeping all stakeholders happy and being able to justify the approach they decide to take. In these situations, **having someone who can lead the process is important.** The reasons for this are well rehearsed – managing any conflicts arising in the funding discussions, finding a practical result that is satisfactory to all parties etc.

So what has changed?

You could argue, nothing really.

What appears to be important now is the ability to formulate a combined funding and investment plan and demonstrate the agreed approach can be justified.

In reality, every scheme is different and it is clear that the spread of potential outcomes is much wider than just the three scenarios given in tPR's examples. Our experience of helping clients formulate a combined investment and funding strategy has shown this on its own can be complex in practice. Add in the need to be able to demonstrate the justification of your decision and ensure an appropriate audit trail is in place and it is clear trustees may benefit from taking specialist advice.

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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