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The Pensions Regulator's (unhelpful) statement on Scheme Funding

The Pensions Regulator (tPR) has issued a statement aimed at schemes with a valuation date falling between September 2011 and September 2012. The Regulator has recognised that gilt yields are at an all-time low, due in large part to "Quantitative Easing", and that because of this the value placed on scheme liabilities, and hence scheme deficits, is likely to have increased for many schemes. The statement sets out the Regulator's expectations for scheme funding plans during such difficult times.

However, in our view, the Regulator's statement is not helpful at all. Although the Regulator acknowledges that many believe that current gilt yields are artificially low due to QE, and that the Bank of England has stated its intention to reverse its program of QE, the Regulator specifically states that they do not want schemes to allow for expectations of gilt yields reverting to more normal, higher levels in their funding plans.

Instead, the Regulator expects schemes' valuations to reflect the falls in gilt yields – regardless of how the scheme is actually invested – despite the pressure this is likely to put on scheme funding.

The key points from the Regulator's statement are:

1. The degree of risk in the assumptions for future investment performance (as reflected in the discount rate) should be measured relative to a risk-free hedged position – which in turn should reflect the yield on gilts / swaps.

2. tPR does not believe smoothing of discount rates is appropriate – schemes should not assume gilt yields will increase from their current historic low levels - and any increase in the margin in the discount rate relative to gilt yields implies increased reliance on the sponsor.

3. tPR expects the current level of deficit repair contributions to be maintained in real terms, unless an employer can demonstrably show it can no longer afford them. Any decision to reduce contributions and / or lengthen the recovery plan must be justified and documented

4. The Regulator expects trustees to ensure the scheme is treated equitably among the competing demands on the employer (e.g. for investment and debt servicing). Subsequent case studies issued by the Regulator show how they focus particularly on the level of dividends being paid by an employer

5. Schemes should not choose an out-of-cycle valuation date just to pick a more favourable effective date of the calculation.

6. If the employer is concerned that if and when gilt yields revert to normal there is the danger of having surplus trapped in the scheme they could consider paying contributions into escrow rather than directly into the scheme.

7. Trustees should consider using contingent assets where possible, or perhaps having a trigger mechanism to prompt additional contributions to the scheme if investment outperformance does not materialise, in order to increase security.

8. In exceptional circumstances, allowance for gilt yield reversion could feature as one part of a recovery plan (although not in the calculation of the Technical Provisions). The case studies show that the kind of exceptional case the Regulator is thinking of here is where the employer is weak and there is a significant scheme deficit.

Comment

It is disappointing, although not surprising, that the Regulator continues to adopt a short-term view and will not accept sensible adjustments to scheme funding plans to allow for gilt yields returning to more normal levels.

Interestingly, the Regulator's view is not an inevitable consequence of the Legislation. The Regulator essentially demands that discount rates must be set relative to gilt yields, regardless of the assets actually held by the scheme. In contrast, the Legislation states that discount rates can reflect ***either*** of:

- The yield on assets held by the Scheme and the anticipated future investment returns *(the trustees are required to take advice on what these might be – but note the Regulator is not able to give this advice!), or*

- The yields on gilts or other high-quality bonds

So as well as the question of whether gilt yields will revert to "normal" there is the more fundamental question of why we need to place such emphasis on gilt yields in the first place. If a scheme has no intention / need to buy annuities or to invest in gilts, then what does the current gilt yield have to do with anything anyway? tPR wishes future rates of return on the various asset classes to be market related **and** referenced to the gilt yield at the valuation date. However the relationship between the gilt yield and the yield on other assets is not necessarily stable and in our view short term distortions should not be forced to automatically drive long term assumptions.

The Regulator acknowledges in its statement the volatility in funding level that results from this type of rigid approach but fails to acknowledge that this kind of short term volatility is not necessarily appropriate in the context of a pension scheme which is long term in nature.

In our view, the Regulator's short-termism, with a focus on current gilt yields, stems from an underlying conflict of interest – its prime duty is to protect the Pension Protection Fund, and as the PPF chooses to measure its liabilities relative to gilt yields, and as if there were an immediate insolvency of the scheme sponsor, the Regulator seems to believe it is appropriate for on-going schemes to do the same.

Our belief is that it would be far better, and in line with the Legislation, if trustees were allowed to set discount rates taking a long-term prudent view of the anticipated returns on the assets held by their scheme as indicated by their advisers and investment managers. For many schemes this would render the current gilt yield as largely irrelevant and prevent the knee-jerk reactions that result from short-termism.

What can schemes do to relieve the cash burden on employers?

Few trustees will be willing to fight the Regulator over whether its stance has become over-prudent. The Regulator has the power to remove trustees and / or impose a schedule of contributions if it is unhappy with the actions being taken by any particular scheme. So what practical steps can be taken within the existing framework to relieve the burden on employers? A few options are:

- Although the effective date of the valuation must determine the formal Technical Provisions it is permissible for the contribution requirements to take into account changes in market conditions since the valuation date – so consider actuarial advice on how the recovery plan could be structured if based on updated calculations.

- To consider index-linked, or back-end loaded, recovery plans – increasing contributions in later years implies some relief on short-term cash demands.

- To consider profit-related recovery plans.

- Making use of contingent assets where possible to justify longer recovery plans and / or reduced cash payments to the scheme.

- For schemes that are close to being fully funded and are worried about creating a trapped surplus consider the use of escrow accounts.

- To pay even closer attention to the employer's covenant, to see what, if any, change to the assumptions being used in the valuation can be justified by a change in the employer covenant. The analysis should also focus on the question of what is reasonably affordable and whether an extended recovery plan is justifiable.

- Trustees should ensure they have sound advice and documented reasons to justify what has been done, especially if the plan departs from the Regulator's ideals.

The Regulator's statement, and the associated case studies, can be found here:

http://www.thepensionsregulator.gov.uk/docs/pension-scheme-funding-in-the-current-environment-statement-april-2012.pdf

http://www.thepensionsregulator.gov.uk/docs/scheme-funding-scenarios-current-conditions.pdf

For further information or assistance please contact Andrew Allsopp FIA on 01527 598688.