Original Article

Scheme funding: Is it going to be easier second time around?

Received (in revised form): 1st May 2009

Keith Barton

is a consulting actuary with Hewitt Associates in the United Kingdom, where he specialises in advising trustees of pension schemes and sponsoring employers on funding and related matters such as scheme design, legislative requirements and risk management. He holds an MA in Mathematics from Oxford University and is a fellow of the Institute of Actuaries. He is currently Chairman of the UK-based Association of Consulting Actuaries.

ABSTRACT The UK funding regime for occupational defined benefit schemes was revised in 2005 and pension schemes are about to face their second triennial valuation under this regime. This paper examines the main economic and other changes that have taken place over this period, and their impact on funding valuations. It concludes that the present economic climate is likely to give rise to significant differences in viewpoints between employers and trustees as to appropriate funding assumptions for the calculation of liabilities and contribution levels, and highlights some of the likely outcomes.

Pensions (2009) 14, 164–171. doi:10.1057/pm.2009.18

Keywords: pension; funding; valuation; mortality; regulator; assumptions

INTRODUCTION

The funding regime for defined benefit occupational pension schemes in the United Kingdom, unlike in many other countries, has historically operated on a ‘light touch’ basis, with responsibility for setting funding assumptions vesting with the scheme sponsor, trustees and actuarial advisers without a statutory minimum funding test. This changed from April 1997, with the introduction of a ‘Minimum Funding Requirement’ (MFR) that prescribed assumptions for calculating liabilities, based on long-term expected returns on equity investments pre-retirement and gilt returns post-retirement. Schemes with insufficient assets to cover MFR liabilities were required to make good the deficit up to a 90 per cent funding level within 3 years and the full deficit within 5 years.

The MFR rapidly fell into disrepair, largely because its assumptions, being prescribed and based on long-term expected returns, did not react particularly well to the changing financial conditions. Crucially, although it was not a ‘solvency’ measure (that is, it was not designed to assess liabilities on an insurance annuity basis), it was widely misunderstood to be one. Thus, when several high-profile cases arose in which schemes that were fully funded under the MFR assumptions were wound up with members receiving significantly reduced benefits, something had to be done.

A package of measures, including the requirement for solvent employers to guarantee benefits on winding up and a ‘Pension Protection Fund’ to provide partial benefits when the employer became insolvent and therefore incapable of providing the guarantee, was introduced, alongside a new funding requirement to replace MFR.

Out went the ‘one-size-fits-all’ MFR test, and was replaced by a new regime that introduced *scheme-specific funding*.

Correspondence: Keith Barton
Retirement Practice, Hewitt, Prospect House,
Abbey View, St Albans AL1 2QU, UK

LEGISLATIVE FRAMEWORK

The legal requirements for scheme-specific funding are set out in the 2004 Pension Act and the Occupational Pension Schemes (Scheme Funding) Regulations 2005, which were in place and effective from 30 December 2005, although they applied to valuations with an effective date on or after 22 September 2005.

The Pensions Act also introduced the position of the Pensions Regulator to oversee UK Pension Schemes. The Regulator's statutory objectives are as follows:

- To protect the benefits of pension scheme members;
- To reduce the risk of calls on the Pension Protection Fund; and
- To promote the good administration of work-based pension schemes.

The legal documentation set out that the Pension Regulator was required to assist trustees and other parties running pension schemes, by issuing codes of practice. The Regulator's Code of Practice (CoP)¹ on Funding Defined Benefits came into force from February 2006, and therefore the legislative framework for the new regime of scheme-specific funding was in place and effective from early 2006.

NEW REGIME

The cornerstone of the new regime is the statement in the 2004 Pensions Act that 'every scheme is subject to a requirement (the *statutory funding objective*) that it must have sufficient and appropriate assets to cover its technical provisions'.

A scheme's *technical provisions* are defined as the amount required, on an actuarial calculation, to make provision for the scheme's liabilities. Where there is a shortfall of assets against the technical provisions a 'recovery plan' must be put in place to address this shortfall.

The various framework documents clarified the situation as follows:

'It is the trustee's responsibility to choose which assumptions are to be adopted for the calculation

of the scheme's technical provisions, although the trustee must take advice from the actuary and reach agreement with the company' (CoP para 76).

'The economic and actuarial assumptions must be chosen prudently, taking account, if applicable, of an appropriate margin for adverse deviation' (Reg 5.4).

The Regulator's CoP makes it clear that the employer's circumstances should be considered. It sets out that:

It is essential for the trustees to form an objective assessment of the employer's financial position and prospects as well as his willingness to continue to fund the scheme's benefits (*the employer covenant*). This will inform decisions on both the technical provisions and any recovery plan needed. (CoP para 57)

FIRST TIME AROUND

The main issues that trustees and employers grappled with in their first scheme-specific funding valuation were:

- agreeing on an appropriate level of 'prudence' for the assumptions,
- how to assess, and then take account of, the employer's covenant and
- how to factor in anticipated changes in assumptions (especially in mortality) for the future.

Employers also had to come to terms with the changed circumstances since previous valuations. In particular, for many schemes the new regime changed the balance of power from one in which the employer determined the assumptions underlying the valuation and the contributions to be paid to eliminate any deficit, to a position in which the trustees are much more in the driving seat.

Trustees had to contend with the uncertainty over what the Regulator might consider acceptable. They also had to consider paragraph 93 of the Regulator's CoP, which states:

At subsequent valuations, trustees may choose a different method or different assumptions to those previously adopted where justified by a change of legal, demographic or economic circumstances.

The first scheme-specific funding valuation for a set of trustees and the employer was, therefore, setting a strong precedent for the next (and future) valuations.

PRUDENCE AND ACCOUNTING

Historically, many trustees had set their funding assumptions at the same level as the company used to measure its pension cost accounting figures. Under the new regime, if this practice was to continue, trustees had to consider how to reconcile the explicit requirement for prudence, as set out in the legislative framework surrounding the scheme-specific funding regime, with the 'best estimate' requirements for company accounts.

In some cases, trustees and employers resolved this by noting that the discount rate to be applied in valuing the pension scheme liabilities under UK and international accounting standards was linked to a corporate bond yield, which, in general, could be considered prudent compared to the expected long-term return from the assets actually held by the pension scheme, which typically included a significant proportion of return-seeking assets such as equities and property.

It was, therefore, possible for the trustee and the employer to agree to use assumptions that were appropriate for both the company's pension cost accounting figures and the trustee's first scheme-specific funding valuation.

MORTALITY

The Regulator's CoP focused the trustee's attention on 'sensitive assumptions where even small deviations in the experience from the assumed values have a significant impact on the adequacy of the technical provisions'. It also went on to note:

Particular attention should be paid to assumptions about future mortality. Here the experience is of a sustained trend in one direction, that of longer life expectancy (ie, decreasing mortality rates). Trustees should consider with their actuary the latest available relevant data on likely future mortality rates.

(CoP para 80)

Discussions on the appropriate assumptions to use for mortality were often protracted for the first scheme-specific funding valuation, as trustees and employers considered the past experience that gave historic information specifically relating to their scheme, obtained generic information with regard to analysis of past trends for mortality in general and considered the consequences of adopting different rates of future improvements in longevity, in order to arrive at an appropriate scheme-specific assumption for both current mortality and any allowance for improvements in the future. Typically, rates of future improvement were set lower than recent experience had suggested, probably reflecting an unwillingness of employers to agree to funding future longevity improvements, which by their nature are highly subjective.

EMPLOYER COVENANT

In order to determine where to set the technical provisions and the length of the recovery plan for the first scheme-specific funding valuation, trustees needed to assess the employer's covenant.

Paragraphs 58 to 61 of the Regulator's CoP sets out the sort of information that trustees should consider in order to help them undertake the assessment. To avoid problems for trustees in obtaining the relevant information, the Regulations had clarified that there was an obligation on the employer to provide the trustees with the information that they reasonably require.

However, many trustee bodies still struggled with how to interpret the information that the company provided and the appropriate weight to place on the various factors. The Regulator noted that 'the trustees should also consider using commercially available services or other sources of information', and thus, as part of the first scheme-specific funding valuations, trustees often commissioned a covenant review from an external supplier.

However, trustee duties do not end once the valuation is completed. The Regulator's CoP sets out:

Trustees should consider reviewing and if necessary revising these funding documents where there is a significant improvement or decline in the employer's covenant.

(CoP para 138)

Trustees are, therefore, required to have an ongoing monitoring process in place for assessing whether there have been changes to their employer's covenant.

SUMMARY AND CONCLUSIONS OF FIRST SCHEME-SPECIFIC FUNDING VALUATIONS

In general, the first scheme-specific funding valuation took a considerable amount of time as the trustee and the employer resolved:

- what was an appropriate level of prudence,
- how to allow for future improvements in mortality and
- how to assess and monitor the employer's covenant.

In addition, as this valuation was being completed under a new regime, the trustees and employers were unsure as to what the Regulator might consider to be acceptable, and there was a significant educational process for both trustees and employers to get to grips with the new requirements.

WHAT IS ACCEPTABLE?

The Regulator's thinking on what is acceptable has developed over time, and various documents have been issued to help trustees and employers understand his position. In May 2006, the Regulator issued a statement setting out his general approach to scheme funding in which he set out particular triggers that he would use to identify the schemes he considered most at risk. The triggers relate to:

- the level of technical provisions relative to PPF liabilities and Company accounting liabilities;
- the length of recovery plan and whether it is back-end loaded or the assumptions underlying the plan appear inappropriate.

In December 2008 (following a similar document produced in 2007), the Regulator issued an analysis of over 3000 Recovery plans, which it had received.² Although this analysis is

helpful to trustees and employers, the Regulator noted that it was based on valuations with effective dates between September 2005 and September 2007, and that the figures reflect the benign economic circumstances at the time of the valuation.

Highlights of the analysis are as follows:

- There had been a general shift to more prudent assumptions over the period. Despite this, average funding level improved, reflecting the favourable economic conditions over this period.
- There had been a gradual shift to the use of higher longevity assumptions, with the more recent cases showing an average life expectancy for men currently aged 65 of 86 years, and 87.6 years for future pensioners currently aged 45 years.

The average 'recovery period' had shortened to 6 years – largely as a result of improving funding levels, meaning that employers could afford to pay off deficits more quickly.

On the face of it, the new regulatory regime had been a great success – funding had become more prudent, meaning that members would be more likely to receive their benefits in future, funding levels had risen in the benign economic conditions, and those schemes that were in deficit were dealing with the shortfall more quickly. But what about the future?

SECOND TIME AROUND

Given the time and effort spent on first scheme-specific funding valuations, the progress the Regulator has made in developing its own thinking on what is acceptable and conveying this to trustees and employers, and the very strong precedent set by the first valuation for future valuations as any change in method or assumptions has to be justified by a change in legal, demographic or economic circumstances, no doubt many employers and trustees hoped that it would be much easier and less time-consuming to agree on the funding assumptions and recovery plan for the 'second time around' valuation.

Unfortunately, this is not proving to be the case as there have been significant changes and developments that affect both pension schemes and employers.

Indeed, the regulator noted in December 2008 that the '(new) valuations are being conducted in a very different economic climate to (previous valuations)', and went on to set out its expectations that, briefly, were:

- 'Primacy' should be given to adequately strong technical provisions;
- There should be a continuing trend to stronger longevity assumptions;
- Greater focus on 'reasonable affordability' when setting contribution levels;
- The need for trustees to keep the employer covenant under review;
- There could be circumstances where previously agreed recovery plans could be revised if there might otherwise be 'serious risk of jeopardising the employer's future development or solvency'.

CREDIT CRUNCH

The world's economy has fallen into recession on the back of the banking crisis.

Confidence in companies has fallen, and this has been reflected in the additional yield investors are requiring from corporate bonds. Figure 1

shows the change in the yield gap between gilts and corporate bonds over the period from 31 March 2006.

In cases in which the Company's accounting basis was also used as the trustees' funding basis, there was usually a difference in the way these were described. The Company accounting basis used a corporate bond discount rate, whereas the trustees' funding basis would be described in terms of gilts plus a fixed margin.

The consequence of this is that there has been a divergence between a scheme funding basis and a company accounting basis over the period from 31 March 2006, which the graph in Figure 2 illustrates.

The significant difference in the two funding levels will lead the many trustees and the sponsoring

Figure 2: Divergence of scheme funding basis and company accounting basis (IAS 19).
Source: Hewitt Associates.

Figure 1: Credit crunch – Yield gap-yield on 'AA' rated corporate bonds in excess of yield on government bonds.
Source: Hewitt Associates.

employer to revisit their discussions over the appropriate allowance to make for prudence.

The credit crunch has also had a significant impact on the market capitalisation of companies, with a fall of 50 per cent or more since 2006 being not unusual.

The result is that companies' covenants are likely to be much weaker now than at the last valuation. In addition, the ability of companies to pay increased contributions is likely to have decreased.

The changed circumstances of employers at the second valuation could, therefore, lead to a wholesale review of all the decisions made, and the documentation prepared, for the previous valuation.

MORTALITY

The past 2 years have seen significant developments in investigating mortality.

A new set of mortality tables has recently been released based on self-administered pension schemes. Previously, the standard tables used for pension scheme valuations were based on insurance company data for assured lives, as this was the only large sample of data available.

As part of any new valuation, trustees will need to consider whether the analysis of their scheme's experience is more in line with the new tables or the old tables, and the advantages and disadvantages of making any change.

There have also been advances in the way mortality is being analysed. Recent developments

suggest that a person's postcode is a good proxy for many of the factors that affect life expectancy. Rather than just looking at age, sex and amounts of pension, adding in an individual's postcode will introduce other factors that can be used to build up a different perspective.

The results of postcode analysis can provide a 'scatter chart' that indicates the range within which it is expected that an individual's mortality might fall.

This leads to the approach where trustees could:

- Establish a base table for their scheme as a whole based on the experience of the scheme over the recent past; and
- Adjust the base table, on a member-by-member basis, to reflect postcode data that bring in the proxy for wealth and lifestyle.

In addition, as encouraged by the Pensions Regulator, there has been a much greater awareness in recent times of the trend for increasing longevity and the need to make adequate allowance in funding valuations.

There has been a long-established trend over the past 30 or so years of increasing longevity in the United Kingdom, as demonstrated in the attached chart in Figure 3.

The improvements have been put down to a variety of factors – improved health care and healthier lifestyles, together with higher pensioner incomes and standards of living – and the trend is expected to continue. The difficult issue is: at

Figure 3: Average improvements in mortality over 1 year periods.
Source: Hewitt Associates.

what rate? There are genuine differences of opinion as to what the appropriate level should be, and this leads to the potential for further disagreement between trustees seeking prudent funding of the scheme and the sponsoring employer wishing to minimise expenditure in difficult economic times.

DE-RISKING

Given the uncertainty and volatility in investment markets, many trustees and employers are looking to develop a long-term flight plan to de-risk their pension schemes.

Among the de-risking options that could be considered are:

- Moving to a liability-driven investment strategy – matching expected future cash flows with a mixture of bonds and gilts;
- Partial buy-out – buying annuities for pensions in payment;
- Buy-in – buying an insurance policy that will pay the scheme for the pensions in payment.

One question that trustees need to consider is whether the technical provisions and the level of prudence required in the valuation should change following any reduction in risk.

Lower risk probably means lower return, which may impact on the allowance for investment return that trustees are prepared to make in their valuation.

Conversely, a reduced level of risk may mean that the trustees are happy to accept a lower allowance for prudence, as adverse experience is less likely.

If a scheme has started the process of developing a flight plan for de-risking since the last valuation, trustees need to consider whether the technical provisions and recovery plan for any future valuations should be based on the ultimate de-risked position.

SUMMARY AND CONCLUSIONS FOR SECOND SCHEME-SPECIFIC FUNDING VALUATIONS

It appears that valuations second time around are going to prove just as much hard work and as

time-consuming for trustees and employers as were the first new regime valuations.

Current financial conditions and the consequential effect on employers, developments in mortality and ideas for de-risking pose new challenges, all of which will need to be considered and addressed as part of the second scheme-specific funding valuation.

Employers and trustees may well have different views on the likely impact of each of the above factors, and on how funding deficits should be made good. Employers are analysing carefully the assumptions used at the previous valuation, so that they can consider whether they remain 'appropriate', and, for example, to satisfy themselves that excessive margins have not been inadvertently included. The most significant assumption that affects the calculation of the technical provisions and resulting cash contributions is the discount rate, which is driven by the investment strategy adopted and the level of prudence. Accordingly, employer interest will tend to focus here, with employers perhaps arguing that after a period of poor financial returns the future is bound to be rosier and this should be reflected in assumed investment returns. Employers are also likely to take note of recent statements from the Pensions Regulator that longer 'recovery periods' (that is, the length of time expected to restore the scheme to a fully funded position) may be necessary in the current environment. Making allowance for higher investment returns over a longer recovery period can, in some cases, lead to a very low cash contribution requirement, as the impact of the assumed investment return over a longer period can be very significant.

Trustees, on the other hand, will be concerned about any attempt to weaken funding standards at an uncertain time. The failures of several highly regarded businesses in the United Kingdom, leaving behind underfunded schemes, have made trustees cautious and wishing to seek additional security or guarantees, as well as maximising cash contributions, while at the same time not wanting to damage the viability of the scheme sponsor.

Ultimately, where the employer and trustees are unable to agree on an appropriate level of

technical provisions and recovery plan, the Pensions Regulator may have to intervene and impose a solution, something that, for the understandable reason of not wishing to create a precedent, it may be reluctant to do. Any cases that are settled by the Regulator will be scrutinised intensely by both employers and trustees.

It remains an interesting and challenging time for all involved in employer-sponsored defined benefit pension schemes in the United Kingdom.

REFERENCES

- 1 See <http://www.thepensionsregulator.gov.uk/codesOfPractice/definedBenefit/index.aspx>.
- 2 See <http://www.thepensionsregulator.gov.uk/pdf/PurpleBook.pdf>.