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Pension Scheme Valuations
Challenges and opportunities in 2015

The issue
In mid-December long term gilts yields hit their lowest point in five years and continued falling to new lows throughout January. As a result of these dramatic falls companies and trustees with late 2014 and early 2015 pension scheme valuations could be in for a very nasty surprise when they open their initial valuation results.

Background

During 2014 and the early part of 2015, pension deficits have been on the rise for most defined benefit pension schemes. The value of pension liabilities is driven by long term UK government gilt yields. Those gilt yields have dropped from 3.6% p.a. at the start of 2014 to 2.4% p.a. at the start of 2015 and, whilst inflation expectations have damped somewhat to offset the drop in gilt yields, the overall impact has been to increase pension liabilities.

On the asset side, returns on return seeking assets (e.g. equities) have been generally disappointing and falling far short of covering the increases in liabilities.

We have seen a divergence of the impact on pension schemes split broadly into 2 camps.

First, those schemes where a significant proportion of the assets are return seeking have been hit hard by the change in the gilt yields with gaping deficits opening up.

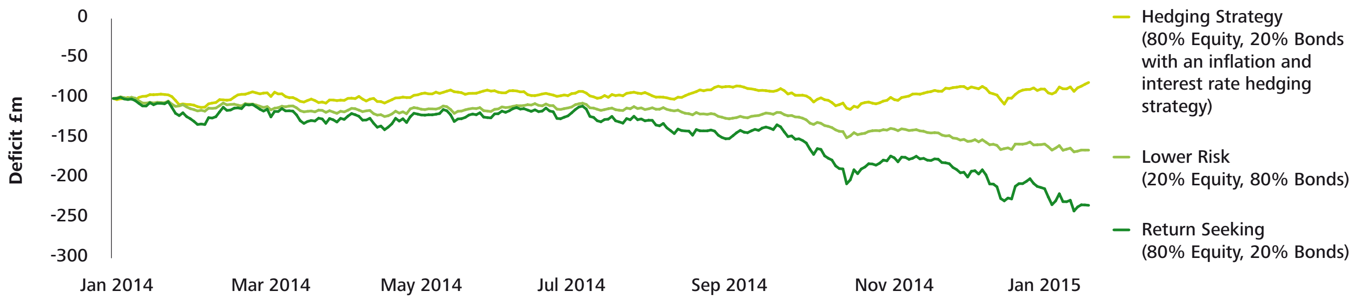
Second are the schemes where either the assets are predominantly invested in matching asset classes such as gilts, corporate bonds and index-linked gilts or the inflation and interest rate risks are effectively hedged through a swap portfolio.

For these schemes the impact has been much less and the protection offered from the matching assets or hedging has proved valuable during this period.

How have funding levels moved for these pension schemes?

We illustrate this below by following the funding levels over 2014 and early 2015 of three example schemes with Return Seeking, Lower Risk and Hedging investment strategies. The difference in fortunes is stark:

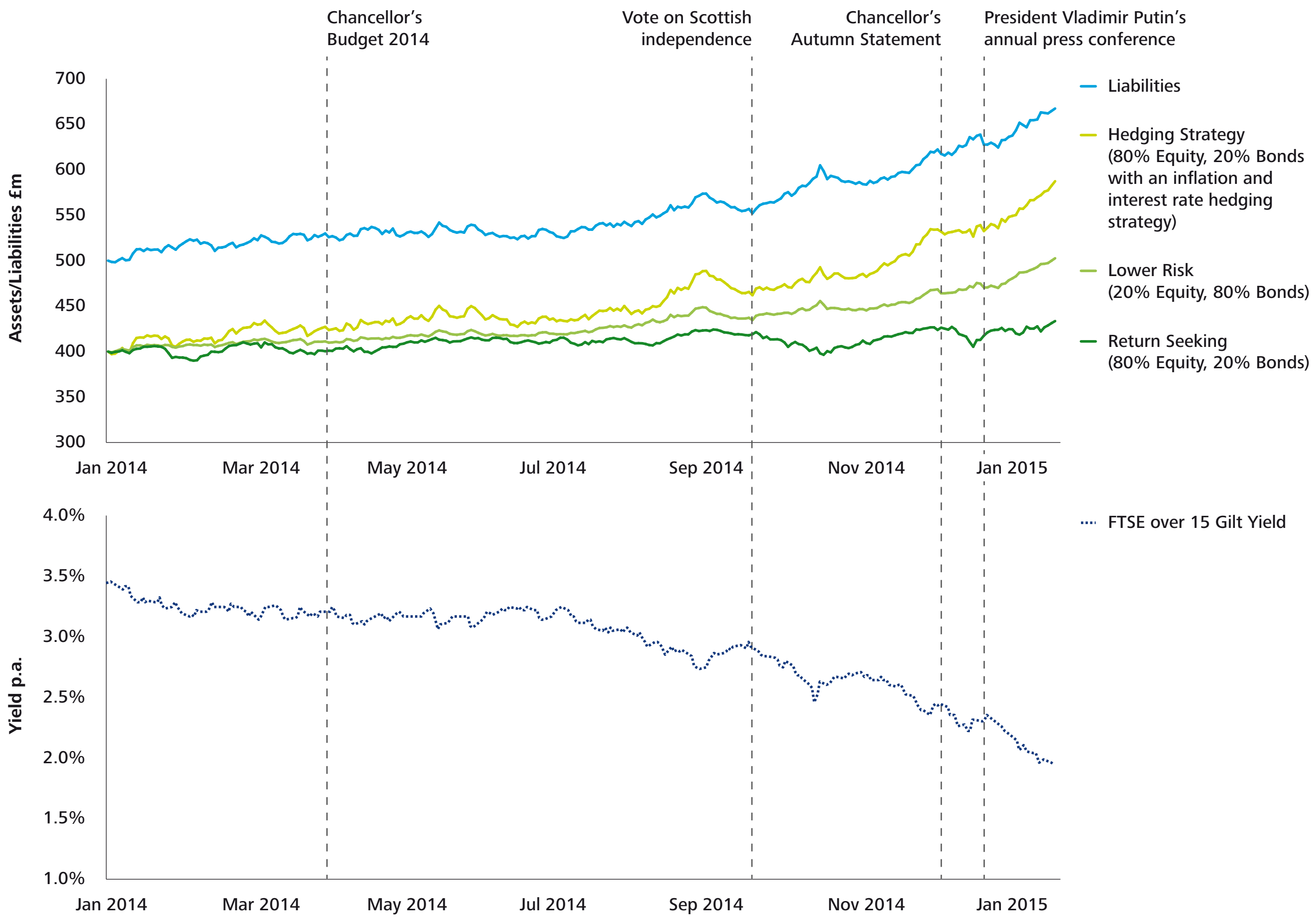
Figure 1. Impact of investment strategy on deficit over 2014 and early 2015



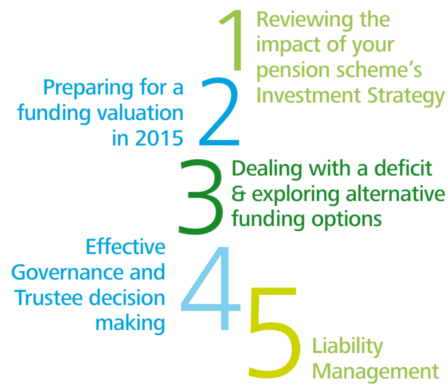
At the start of 2014 each scheme started with liabilities of £500m and assets of £400m. Over 2014 and early 2015 the Hedging Strategy paid off and kept the deficit relatively stable around £100m. The Lower Risk strategy resulted in a c. £75m deterioration as the assets and liabilities were not fully matched. The Return Seeking strategy performed worse and resulted in a deterioration from a deficit of £100m to c. £250m.

Overleaf we show the separate movement of assets and liabilities under these strategies.

Figure 2. Movements in assets and liabilities over 2014 and early 2015



Over the period liabilities have increased as a result of the falling gilt yields. This has been slightly offset by the falling expectation of future inflation. The Return Seeking asset values have remained relatively flat over the period and even the Lower Risk investment strategy failed to fully keep up as the liability values have increased. Only the Hedging Strategy kept up with liability values, albeit not closing the deficit significantly either.



What actions can companies consider in 2015 for their defined benefit pension schemes?

Many companies will have seen their pension schemes funding levels and accounting positions deteriorate significantly over 2014. There are a number of actions companies could consider to proactively manage their pension schemes' volatility, funding levels and the cash contribution demands from their schemes trustees.

However, while companies underwriting pension schemes have a keen interest in these issues, it is ultimately the pension scheme trustees that make key investment and funding decisions. A further challenge for 2015 is to ensure that pension scheme governance is robust and that trustee boards have the requisite skills and knowledge to navigate through an increasingly complex landscape.

Overleaf we set out some of the key actions companies could consider in 2015.

1. Reviewing the impact of your pension scheme's Investment Strategy

The investment strategy set by the pension scheme trustees is paramount in determining the volatility of the pension scheme funding level and in particular, its vulnerability to short term changes in gilt yields. Every company should refocus on the investment strategy being pursued by the trustees and ask some questions:

1. Does the strategy meet corporate objectives?
2. Is the company actively involving itself in the setting and monitoring of the investment strategy? Whilst the investment strategy is the responsibility of the trustees they will usually welcome company involvement in setting the investment strategy.
3. For some companies a long term strategy of pursuing higher expected returns through equities may make sense but the short term consequences need to be thought through.
4. Equally, the merits of a move to hedge out interest rate risk now should be considered carefully, doing so will remove any upside potential associated with a rebound in gilt yields and effectively lock in the recent deficits that have emerged.

2. Preparing for a funding valuation in 2015

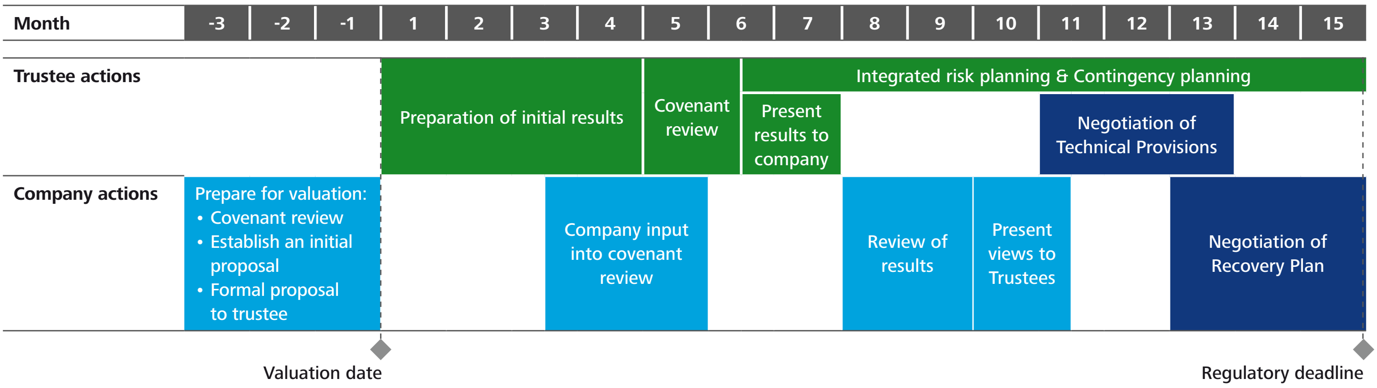
For companies with a funding valuation due during 2015, early preparation on the company side will usually be an investment of time well made.

Companies should plan out the valuation timescale and plan their input into the process. We believe it is important for companies to engage with the trustees early in the process and to put their views on the key assumptions and likely outcomes to the pension scheme trustees in advance of the trustees preparing their initial results. This can help anchor the discussion around outcomes that are acceptable to the company and address head-on any areas of undue prudence that were built into the last valuation approach and outcome.

Companies should be aware of the Pensions Regulator's guidance on funding valuations and changing market practice. The concept of integrated risk management: bringing together investment, employer covenant and actuarial considerations to manage risk holistically, has become important and should be factored into pre valuation preparations.

In addition, the Pensions Regulator now expects trustees to develop and maintain risk management plans that include contingency plans to support schemes if faced with deteriorating funding conditions. Companies need to consider what they are prepared to agree to in advance to deal with contingency situations and how will it approach that discussion with the trustees.

Figure 3. Funding valuation timeline



3. Dealing with a deficit & exploring alternative funding options

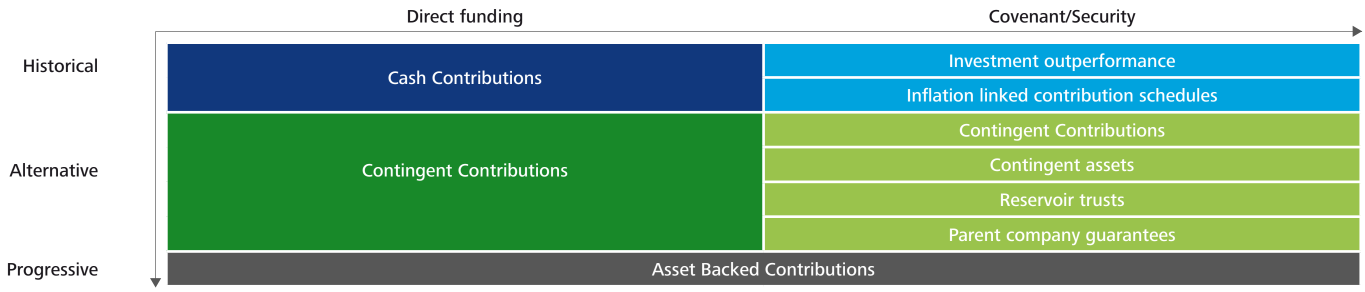
In many cases, an increased deficit will be an unavoidable outcome for a funding valuation during 2015. The next question for the company is then how to deal with an increased deficit in an efficient and effective way?

Key objectives might be to reduce the short term impact on company cash flow as well as some opportunity to manage the "regret risk" of potentially overfunding a scheme where market conditions might act to remove the deficit in coming years.

Options to be explored include:

- Asset Backed Contributions to deal with a portion of the deficit. These can be tax efficient, offer effective cash flow management and managing the regret risk of overfunding for the company.
- Inflation linked contribution schedules. The impact of inflation linking combined with perhaps a few years longer schedule can harness the power of compound interest and help keep short term contributions unchanged even in the face of an increased deficit.
- Parent company guarantees or security over assets can help improve the covenant ranking and reduce the headline deficit but, in addition, give trustees greater confidence in agreeing a longer repair period allowing cash flow to be focussed back into building your business.
- Reservoir trusts can also be used to give trustees confidence in the availability of backing funds whilst managing the regret risk of overfunding for the company.
- Contingent contributions linked to profitability or free cash flow can help by providing contributions to the scheme based on actual affordability and so prevent the Company overcommitting in the short term.

Figure 4. Alternative Funding Options



4. Effective Governance and Trustee decision making

When was the last time your company undertook a review of the governance arrangements of the defined benefit pension scheme? All too often, pension scheme trustee boards are left to run themselves with little oversight or review from the company. In the end, it is the company that picks up the cheque to cover deficits and expenses that arise from poor decision making, ineffective structures and slow implementation. In many cases companies can appoint or remove trustees and determine the overall governance and operational make up of the trustee board. In any event trustee boards/trustees will usually be willing to work with the company to identify issues and areas where change is needed.

Companies should look to review how effective their trustee board is and, in particular, how investment decisions are made, how discretions are exercised and whether the trustees have the necessary skills and focus to undertake their duties effectively. As trustees often rely heavily on external professional advice, reviewing their advisers' performance regularly will help ensure that the trustees get better quality and cost effective advice. Often the same standards of regular review and procurement that apply day to day in your business are missing in the pension scheme resulting in additional cost through poor and slow decision making.

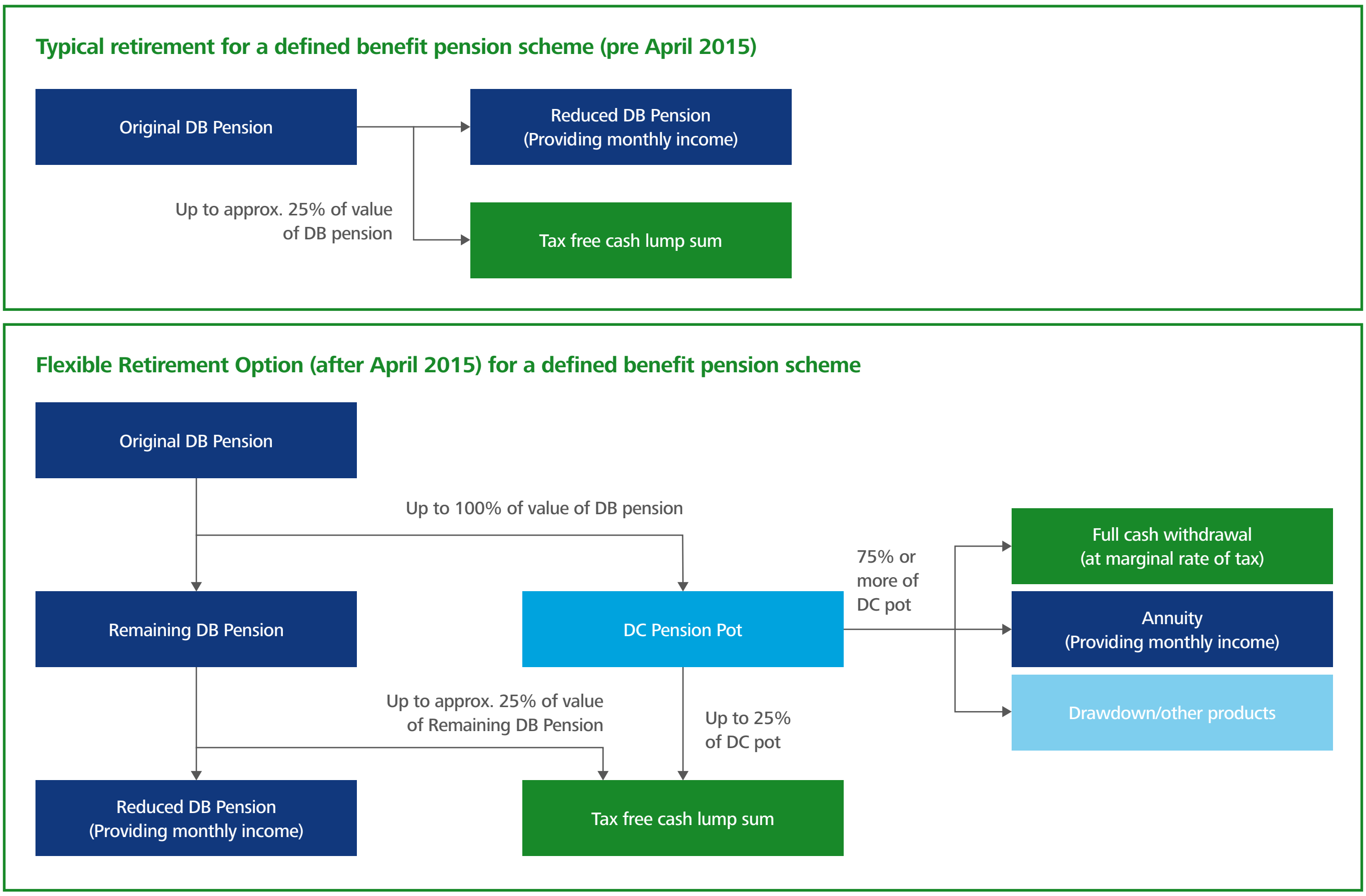
For larger schemes, it is often worth reviewing the overall governance structure to ensure that trustee meetings focus sufficient time and effort on key decisions and do not get bogged down with procedure. Governance structures that make appropriate use of sub-committees with clearly defined terms of reference tend to be more nimble and effective. This allows trustees to concentrate on meeting their defined strategic objectives without becoming overwhelmed with compliance issues.

Overall, companies should look to take action collaboratively with their pension scheme trustees to ensure funding deficits and additional costs are not arising simply through poor governance.

5. Liability Management

All Companies should take the opportunity to review the potential to undertake liability management exercises on their pension schemes. This can range from scheme mergers to release operational savings, Pension Increase Exchanges and Flexible Retirement Options to allow retiring Defined Benefit (DB) members to take advantage of the new flexibility in Defined Contribution (DC) pensions. These actions can help to manage down liabilities, settle them more quickly and reduce volatility.

Figure 5. Example Flexible Retirement Options



Members of most schemes currently have the right to transfer their DB pension into a DC pension before retirement, but few members choose to take this option. Offering members Flexible Retirement Options builds on this right, but through a supported and managed process that helps members make better decisions and not necessarily opt for the default DB pension in retirement. Where members choose a Flexible Retirement Option and transfer their DB pension into a DC pension, benefits are immediately settled reducing the size and volatility of the defined benefit pension scheme.

Setting and implementing a pensions strategy

The first stage to determining or updating your pensions strategy is usually to determine the current scale and magnitude of the deficit/surplus in your scheme and then to quantify the various risks posed by any mismatch between the schemes assets and liabilities.

We would then recommend working with your advisors to ensure the risk profile of your scheme is within your acceptable range and, where there is a material deficit, you look at both the range of liability management options that could be used to reduce the deficit and the funding options available in advance of your schemes next full funding valuation.

Deloitte has an extensive network of professionals working in an integrated way to bring cutting edge pensions advice and solutions to our clients. If you would like to speak to us about any of the opportunities raised above or setting and implementing a pension strategy please feel free to make contact with us using the details below or directly through your usual Deloitte contact.

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