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# Pension Scheme Valuations Challenges and Opportunities in 2015

# Preparing for a scheme funding valuation

**The issue**

Many companies with UK Defined Benefit pension scheme valuations in 2015 (and probably 2016) will find there are significant deficits in their schemes which will need to be funded.

It is the pension scheme trustees' (the "Trustees") responsibility, with the assistance of their Scheme Actuary and other advisors, to assess the value of their scheme's liabilities and compare these to the scheme assets to determine the funding level. As a result, many companies can be reactive to the valuation process.

Preparing for the valuation, proactively engaging with the Trustees and having a holistic valuation strategy, can help smooth the valuation process. This can reduce the risk of the Trustees or Scheme Actuary proposing overly prudent assumptions and, as a result, requesting excessive deficit reduction contributions from the company. So, how can companies best prepare for a valuation?

## Introduction

In our paper "Pension Scheme Valuations – Challenges and Opportunities in 2015" we highlighted the impact of falling long term Gilts yields on pension scheme valuations and 5 actions for companies to consider for their defined benefit pension schemes. In this paper we consider the second possible action: preparing for a scheme funding valuation.

## Background

In the normal course of events, the Trustees of a UK Defined Benefit pension scheme will instruct the Scheme Actuary to conduct a full scheme funding actuarial valuation once every 3 years.

A key factor that drives the assessed value of the scheme's liabilities (the "Technical Provisions") is the set of actuarial assumptions proposed by the Scheme Actuary. These assumptions are, in turn, largely driven by:

- financial conditions at the valuation date;
- the scheme's Investment Strategy;
- the sponsoring employer's strength (the "Employer Covenant");
- population demographics; and
- scheme experience.

The Trustees are largely dependent on their Scheme Actuary and other advisors to assess the Employer Covenant, set the key assumptions (based on the Employer Covenant and Investment Strategy), conduct the actuarial valuation to assess the net funding position and then to recommend a recovery plan that the Trustees will then need to negotiate with the sponsoring employer.

**Investment Strategy**

A scheme's investment strategy is the set of principles that guides how the assets are invested. In particular, it will specify the asset allocation across the major asset classes (e.g. equities, bonds, property etc.)

**Employer Covenant**

The Pensions Regulator defines the Employer Covenant as the sponsoring employer's "legal obligation and financial ability to support their defined benefit scheme now and in the future".

## The Pensions Regulator and its Annual Funding Statement 2015

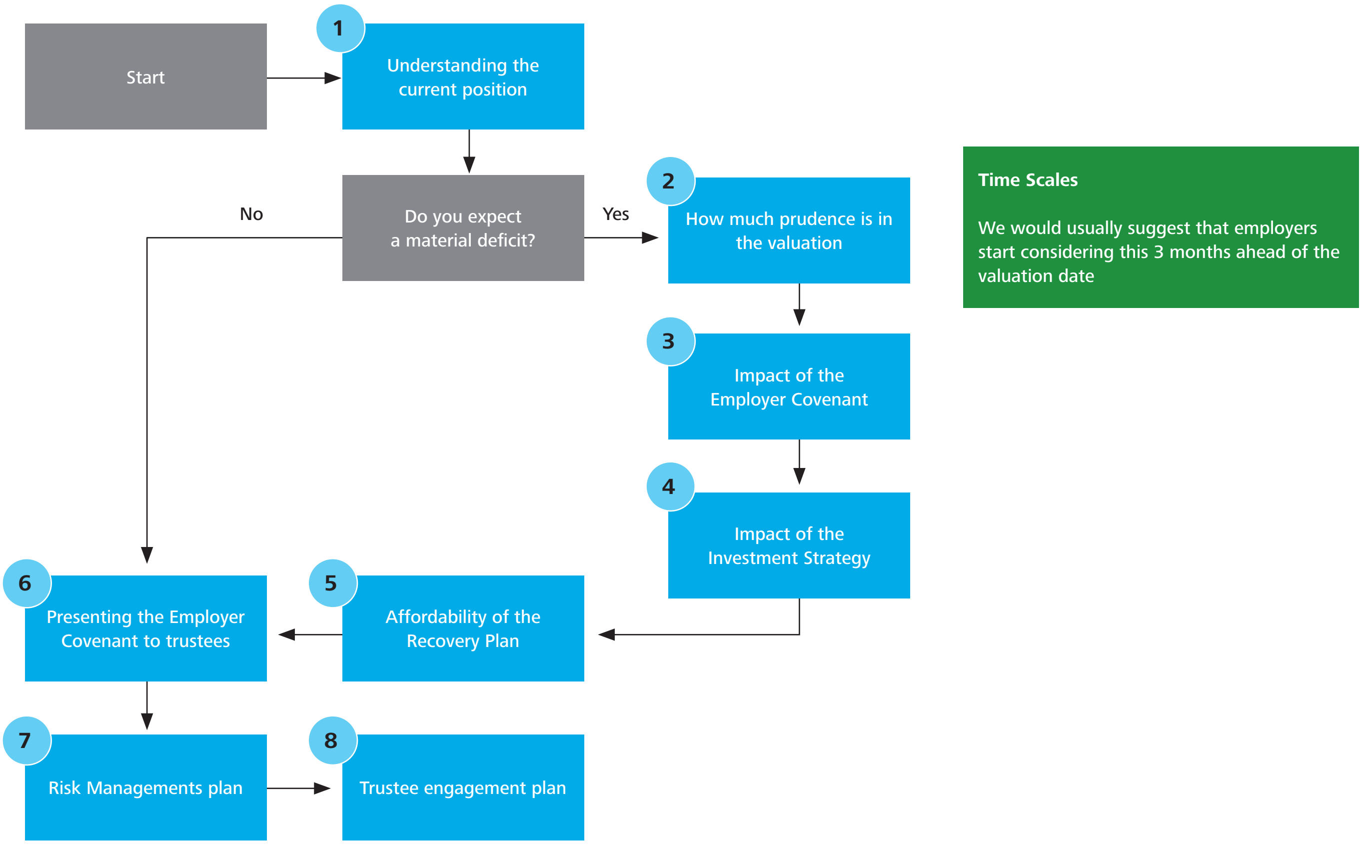
In its 2015 Annual Funding Statement the Pensions Regulator has again highlighted the need for Trustees to take an integrated approach to managing pension scheme funding and the risk involved. The integrated approach requires a considered approach to combining actuarial, investment and covenant advice into a single coherent and integrated funding strategy. This is good advice for the Trustees and it follows that the corporate should also be considering the upcoming funding valuation with all these key aspect in mind in order to be able to engage meaningfully with the Trustees, assist the Trustees and guide the outcome to one that meets the combined objective of the corporate, the Trustees and is in line with the Pensions Regulator's guidance.

Helpfully for the corporate the Pensions Regulator's statement also draws attention to the need for trustees to very much consider contribution demands in the light of employer affordability and the employer's sustainable growth plans. It also highlights solutions such as a modest increase in contributions alongside modest extension of recovery periods to meet higher deficits, as well as reconsidering allowance for investment returns.

## Preparing for a funding valuation

The exact funding valuation preparation approach will depend on each sponsoring employer, its wider group, trustee relations, scheme specific factors and of course timescales. However, in our view, an employer preparing for a funding valuation should consider the following 8 key considerations.

**Figure 1. Corporate funding valuation preparation approach**




In our view, following such an approach tailored to your specific circumstances can often result in a more efficient valuation process, reduced management time and ultimately a contribution profile that fits with your company's business plans. We now consider each of these key considerations in turn.

## 1. Understanding the current position

The starting point for the Trustees and Scheme Actuary will usually be to assess the liabilities (i.e. Technical Provisions) on a basis consistent with that used at the last valuation, but updated for current financial conditions.

The sponsoring employer's corporate pension advisors can broadly estimate the likely outcome of the valuation on such a basis, which enables the corporate to understand the movement in the deficit.

If there has been no change to the Investment Strategy and Employer Covenant, the Trustees may adopt a consistent set of assumptions to the previous valuation. Understanding the broad magnitude of the deficit (or surplus) on a consistent set of assumptions allows companies to decide on how much preparation is required and then to have a productive initial dialogue with the Trustees.

## 2. How much prudence is in the valuation

The Trustees are required to set their assumptions based on the Employer Covenant, Investment Strategy and Market Conditions at the valuation date.

The Trustees will usually seek a formal "covenant review" conducted by specialist advisors. These advisors typically rate the sponsoring employer(s) and any other group entity providing support to the scheme on a scale from strong to weak, with various options in between. The Scheme Actuary will then recommend a prudent assumption for the investment return/discount rate based on the Investment Strategy and Employer Covenant.

To illustrate the potential impact of the Employer Covenant assessment and Investment Strategy on the funding position, we can consider an example scheme with £85m of assets and liabilities of £100m when valued on a basis consistent with a "Tending to Strong" Employer Covenant and "Medium Risk" Investment Strategy. If, all else being equal, the Trustees set a discount rate assumption consistent with Figure 2 below, this may result in the potential funding positions set out in Figure 3 below.

**Figure 2. Impact of Employer Covenant and Investment Strategy on discount rate**

| | | Employer covenant | | | |
|---|---|---|---|---|---|
| | | Strong | Tending to strong | Tending to weak | Weak |
| Investment Strategy | Higher Risk | Gilts + 3.0% p.a. | Gilts + 2.0% p.a. | Gilts + 1.25% p.a. | Gilts + 0.75% p.a. |
| | Medium Risk | Gilts + 1.5% p.a. | Gilts + 1.0% p.a. | Gilts + 0.75% p.a. | Gilts + 0.5% p.a. |
| | Lower Risk | Gilts +0.5% p.a. | Gilts + 0.3% p.a. | Gilts + 0.1% p.a. | Gilts + 0.0% p.a. |

**Figure 3. Impact of Employer Covenant and Investment Strategy on deficit**

| Surplus/(Deficit) | | Employer covenant | | | |
|---|---|---|---|---|---|
| | | Strong | Tending to strong | Tending to weak | Weak |
| Investment Strategy | Higher Risk | £17m | (£2m) | (£10m) | (£20m) |
| | Medium Risk | (£6m) | (£15m) | (£20m) | (£25m) |
| | Lower Risk | (£25m) | (£30m) | (£34m) | (£36m) |

In practice a variety of approaches are possible and different Scheme Actuaries and Trustees will have different views on appropriate margins.

This analysis can be conducted by your corporate pensions advisors. It allows companies to understand how much time to spend preparing for a valuation and where to focus their attention. We recommend the company considers the impact of the Employer Covenant and Investment Strategy, if they are material to the valuation and sponsor.

## 3. Impact of the Employer Covenant

As a recovery plan will need to be put in place to remove any deficit (which will typically involve the sponsoring employer(s) paying cash contributions over a 5 to 10 year time frame, but could be longer), it is possible to put a value on the impact of changes in the sponsoring employer(s) covenant.

Your corporate pensions advisors working in conjunction with Employer Covenant Specialists are able to advise the current impact of the sponsoring employer(s) covenant and sensitivity of the funding deficit to the covenant rating.

**Figure 4. Example: Employer Covenant Impact**

**If the Employer Covenant is rated as "Tending to Strong" rather than "Strong" then the discount rate assumption may be 0.5% p.a. too prudent**

**On a typical scheme with £100m of Technical Provisions and assets of £85m, this is responsible for c. £9m of the £15m deficit**

**If this is to be paid off over a 10 year period this could reduce the annual cash contributions by c. £1.2m.**

It is then possible to consider a series of actions that could improve your Employer Covenant and assess if the net impact will be positive or negative to the group's overall financial position.

As an example, if the sponsoring employer to this scheme grants the Trustees an unsecured Parent Guarantee for the full buy-out deficit (c. £70m), we can consider the impact on the key stakeholders:

**Figure 5. Net impact of improving Employer Covenant via an unsecured Parent Guarantee**

**Pension Scheme**
The Trustees see an improvement in Employer Covenant and as a result they may increase the Employer Covenant rating to "Strong"

This results in a reduction in annual cash contributions by c. £1.2m

**Secured Debt**
As the Parent Guarantee ranks below the Secured Debt, there is no change to the cost of Secured Debt

**Unsecured Debt/Creditors**
In the event of a default unsecured creditors will receive a lower recovery as the pension scheme now ranks alongside them.

This may increase costs for the company for Unsecured Debt etc.

Providing a parent guarantee or alternative securities, for example, to the scheme could strengthen the Employer Covenant, but it could also impact the recovery for debt holders in the event of insolvency. This may increase the cost of debt, however, if this is less than the price of prudence, there may be a net overall cashflow benefit to the sponsor.

This kind of analysis allows companies to negotiate from a position of knowledge with the Trustees on enhancing the Employer Covenant, in exchange for a reduction in deficit and consequently cash contributions.

## 4. Impact of the Investment Strategy

The investment strategy of the pension scheme is clearly crucial in assessing the likely level of future investment return for the scheme, and the risks to achieving that return. Using this information from the investment consultant, the Scheme Actuary will select a prudent return rate on the investments in order to set the discount rate. The level of complexity in this mapping can vary hugely from a single discount rate to a dual discount rate to a full discount rate curve. The level of scrutiny of the Investment Strategy, its dynamism and how well it is mirrored in the actuarial assumptions will also vary.

**Figure 6. Considerations for allowing for the Investment Strategy in a funding valuation**

Could we quantify how much risk there is in the Investment Strategy?

Could we set a prudent investment return assumption so that we are X% confident the Investment Strategy will out perform the assumed return?

We set the X% confidence level based on the assessment of the Employer Covenant?

How would this compare to the Scheme Actuary's view?

For the corporate, it is important to analyse this area to ensure the assumptions setting is going to provide a fair reflection of the expected Investment Strategy and importantly, how that will change over time. In many situations actuarial methodology and assumptions can assume that effectively all pensioners are to be backed by gilt or corporate bond investment. This may not be the case and lead to inappropriate prudence in the valuation and higher contribution requirements than otherwise needed.

In addition, the Trustees might be considering implementing changes to the Investment Strategy. It is important the company can feed its views into this process as early as possible, to ensure any strategy changes do not adversely affect the level and timing of cash contributions the company could be expected to pay.

The company with its advisors can undergo a high level Investment Strategy review, independently of the Trustees, to gain a firm understanding of the types of strategies and changes that better suits their business cash flow objectives.

## 5. Affordability of the Recovery Plan

Ultimately, if there is a deficit in the scheme on a fair assessment of the Employer Covenant and Investment Strategy, this will need to be funded by the sponsoring employer(s). In our next paper in this series we will investigate the options for dealing with a deficit and how companies can explore alternative funding options in further detail. However, in advance of the valuation it is useful for the company to consider its options for dealing with a deficit.

This will usually include an assessment of what is affordable for the sponsoring employers to pay into the scheme and how this integrates into the corporate's business plans. Having this prepared in advance will aid recovery plan negotiations later in the process and, if presented at the same time as the Employer Covenant, it will give the Trustees a realistic expectation as to what they can negotiate, and "anchor" the corporate's position.

In July 2014 the Pensions Regulator's new objective "to minimise any adverse impact on the sustainable growth of an employer" came into force. The Pensions Regulator's guidance[1] states "Trustees should recognise that employers often need to invest in their businesses to enable them to grow and/or fulfil their obligations which should, in turn, help the trustees to achieve their key funding objective" and "where an employer proposes to prioritise the investment it wishes to make in its business over making funding available to the scheme the trustees should understand how this impacts on the employer covenant."

**Anchoring**
"Anchoring" occurs when an individual overly relies on a specific piece of information to govern their thought process.

Once the anchor is set, there is a bias towards adjusting or interpreting the "anchored" information.

This can effect future decision making and information analysis

As such internal investment and other Employer Covenant enhancing actions could now be considered by the Trustees as potentially reasonable uses of the sponsoring employers resources, the Trustees may consider this in their assessment of cash affordability.

### 6. Presenting the Employer Covenant to trustees

Often, the sponsor can take a proactive approach to presenting the covenant to the Trustees (and to their Employer Covenant advisors) that will help them "put their best foot forward".

Sponsors can work with corporate pensions and covenant advisors to understand how the covenant will be assessed and how best to achieve a fair result for the sponsor. Some of the key questions to consider are:

- What questions/information will the Trustees or their advisors ask for?
- Which entities in the group are obliged to fund the deficit?
- Could the buy-out debt be recovered in the event of insolvency?
- Are one-off costs obscuring more favourable underlying performance?
- How is it best to present and share this with the Trustees?
- Should confidential business plans be shared?
- Who should present to the Trustees?
- How should any conflicts of interest be managed?

**Deloitte Observation**
In practice we have found that simple things like having senior staff explain their vision for the business in person can be extremely powerful in helping the trustees see the strength of the Employer Covenant.

### 7. Risk Management Plans

Trustees are now required by the regulator to develop "Risk Management Plans". It is early days and we have yet to see a clear market practice develop.

The Pensions Regulator states that "in simple form, it can involve the identification of triggers for provision of information and review and discussion by both trustees and employer of how matters might be addressed" but also that "where trustees agree with the employer to accept more risk than can be supported by the available employer covenant, contingency plans will need to be more definitive as they can provide additional support for the scheme."

The Pensions Regulator's guidance[1] includes an number of potential options that can be used to support more risk than can be supported by the available Employer Covenant alone. These include:

- provision of contingent assets;
- contingent cash funding;
- negative pledges;
- improving the insolvency priority of the scheme;
- parent and third party guarantees; and
- use of escrow accounts.

**Risk Management Plans**
The Pensions Regulator states that "Trustee risk management plans should identify the potential steps they may take to preserve an appropriately balanced funding strategy and when to take those steps."

1 The Pension Regulator: Code of Practice no. 3: Funding Defined Benefits

By using these and similar options, it may be possible for companies and trustees to agree to accept more risk or an alternative Investment Strategy and therefore have a lower deficit and lower deficit reduction contributions. The company should therefore consider in advance of the Trustees initial valuation results and as part of the funding valuation preparation what (if anything) it might be willing to offer the trustees.

## 8. Trustee engagement plan

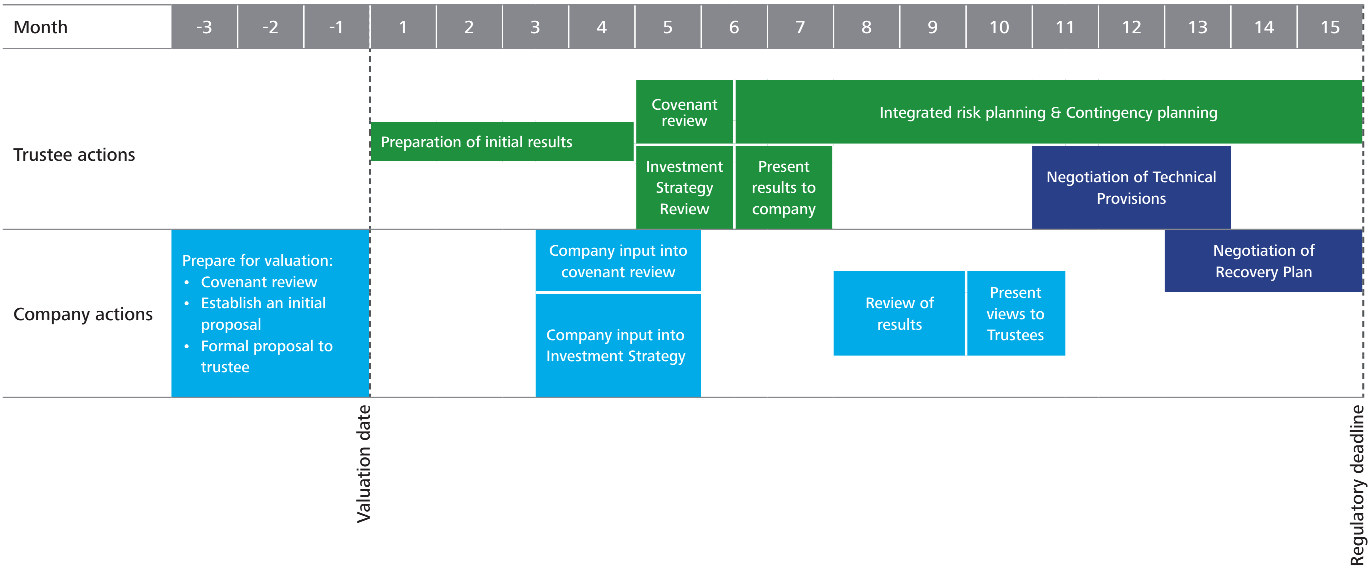
In our view it is often crucial to a corporate valuation strategy to get the company's proposals set out early in the process. Initiating dialogue with the trustees early not only shows a willingness to address the funding position, but will ensure that negotiations set off from a realistic starting point.

If the Scheme Actuary prepares initial valuation results on a basis which is overly prudent and discusses these with the trustees, prior to receiving company input, the trustees may find it hard psychologically to move away from those – the initial results become the anchor point for the trustees' expectations. Similarly, once the trustees make a formal proposal to the company, there is likely to be a natural reluctance to accept material changes to those proposals.

In most cases, we also advise employers to initiate a dialogue with the trustees ahead of the valuation date and share the company's views of the Employer Covenant and Investment Strategy to anchor the position. This would include the company's view of the Employer Covenant, the level of risks adopted within the Investment Strategy, what is affordable for the sponsoring employers and what the deficit might look like.

When the Trustees still propose a set of assumptions, corresponding funding level and recovery plan, that are unacceptable to the Company, then the Company will be well positioned through its earlier analysis to negotiate with the Trustees on the assumptions. The company could potentially offer an enhanced Risk Management Plan or take other actions to improve the Employer Covenant and therefore reduce the Trustees cash demands.

**Figure 7. Funding valuation timeline**



## Contact us

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 in this series of papers or in preparing for a valuation please feel free to make contact with us using the details below or directly through your usual Deloitte contact.

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