



Information
for journalists

A quick guide to...

scheme specific funding, valuation and recovery plans

The Pensions
Regulator

Key points

- The amount of money (or assets) a scheme will need to pay members' accrued benefits will depend on many factors, including a member's life expectancy and investment returns.
- Defined benefit (DB) schemes with assets worth less than their accrued liabilities must submit a recovery plan to The Pensions Regulator ('the regulator').
- A recovery plan sets out how and over what period the employer plans to fill the funding gap.
- The regulator has no pre-conceived target in terms of recovery plan length (eg 10 years) and structure. A recovery plan has many moving parts and there may be scope for flexibility.
- The appropriate length and structure of a recovery plan is determined by the strength of the employer covenant.

Scheme specific funding

The scheme specific funding (SSF) regime requires the majority of DB schemes to complete an actuarial valuation at least every 3 years. Annual update reports are carried out in the intervening years.

The actuarial valuation establishes how much the scheme's assets are worth and how much the scheme needs in order to pay pensions as they fall due (the 'technical provisions' or 'funding target'). The valuation reflects a particular point in time and assumes that the scheme will continue in the future.

The SSF regime requires a scheme to be funded (have assets) to at least cover its technical provisions. If the trustees find the scheme to be in deficit, they must draw up a plan to address that funding gap. This is a recovery plan.

For most schemes, trustees must reach an agreement with the employer on the assumptions and method used to calculate the scheme's technical provisions, as well as the terms of the recovery plan.

Once agreed, the recovery plan can stay in place until the next valuation. However, if there are any significant changes to the situation of the employer during that time, the trustees may consider bringing forward the valuation and making changes to the recovery plan.

The trustees of a scheme have 15 months from the valuation date to complete a statement of funding principles, a schedule of contributions and, if there is a deficit, they must submit this recovery plan to us and a summary of the valuation.

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The valuation process

To calculate the scheme's technical provisions, and when deciding how to eliminate deficit, trustees need to make assumptions about a number of factors. These include mortality rates, future investment returns, and the rate of inflation.

Trustees also need to make an assessment of the employer's ability to meet its legal obligations to the scheme now and in the future. This is known as the 'employer covenant'.

Legislation states that trustees must be 'prudent' when choosing the assumptions on which to base the valuation. Assumptions and investment decisions must be prudent in light of the strength of the employer covenant. Decisions on assumptions will also have been informed by a scheme's investment strategy and the trustee's investment risk appetite, and developed in light of an assessment of the strength of the employer.

A strong employer covenant means that the trustees can rely on the employer to provide support for the scheme in the event of, for example, poor investment performance, increasing life expectancy or rising inflation. In this situation, trustees are able to use more optimistic assumptions.

Conversely, where the covenant is weak, assumptions would need to be more cautious.

An example of an employer with a strong covenant would be a company in a strong financial position with viable long-term prospects. In contrast, an employer with a weak covenant would be a company that is struggling financially and has few assets to support its obligations to the scheme.

Trustees also need to make an assessment of the employer's ability to meet its legal obligations to the scheme now and in the future.

Key factors in the valuation

Longevity (mortality)

An increase in life expectancy will increase the amount of money that the scheme needs to pay the promised pensions in the long term.

Investment return

Pension payments will in part be met by a return on the scheme's investments. Funds can be affected by stock market volatility so assumptions about future investment return (known as the 'discount rate') must be set prudently.

Salary increases

Payments from a DB scheme are often linked to the members' final salary. Salary increases will therefore increase the amount of money the scheme requires to meet retirement benefits.

Inflation

There will be revaluation of the benefits of members who have left the scheme but have not retired (deferred members) and increase pensions in payment every year. These commitments are usually linked to inflation.

Employer covenant

The SSF regime requires trustees to assess the employer's ability to meet its legal obligations to the scheme now and in the future. The assumptions used in preparing the valuation must be chosen in light of the strength of the employer covenant.

Recovery plans

Once the trustees and the sponsoring employer have agreed the technical provisions, and if the scheme is found to be in deficit, the shape and duration of the recovery plan will be discussed.

Recovery plans must be submitted to us along with a summary of the valuation. This means that there is no ideal length or shape for a recovery plan. What is appropriate in each case depends on the individual circumstances of the pension scheme and sponsoring employer. This will be strongly influenced by the employer covenant.

We expect any shortfall to be eliminated as quickly as the employer can reasonably afford. However, the SSF regime allows for flexibility in the way a recovery plan is structured.

We consider every recovery plan submitted to us, and, in scrutinising recovery plans, we take into account a range of factors. These include the length of the plan, the contribution schedule including any 'back-end loading' (a promise of higher contributions in the future), and the treatment of shareholders and other creditors. We also consider the use of any non-cash support or 'contingent assets', such as guarantees or the pledging of other assets like property, for example. Where the plan and valuation seem reasonable, we will communicate with the trustees to let them know we will be taking no further action.

Whilst we regard cash contributions as the best support for a pension scheme, in cash-constrained situations it may be appropriate for trustees to consider accepting non-cash support or 'contingent assets' as a means of support for the scheme. Trustees need to ensure that any agreement relating to contingent assets is legally enforceable and allows them to realise the value of the asset, should the contingent event – such as an insolvency – occur.

To help identify plans that may pose particular risk to members' benefits, there are a series of 'triggers'. Plans which trigger may be scrutinised more closely, for example where the length of the recovery period exceeds 10 years or we consider the assumptions that have been made about the return on investment are imprudent.

A valuation and recovery plan submitted outside the prescribed 15-month period will also result in us approaching the trustees to ask further questions.

Reaching agreement

Where agreement between the employer and the trustees is not forthcoming, we encourage both parties to explore all possible solutions. This could involve the use of non-cash support. However, it should never mean artificially adjusting the funding target to suit what the employer can afford. If the 15-month period expires and the parties are still unable to reach an agreement, the trustees should report this to the regulator.

At this point, we will look at the reasons for the difficulties on both sides and, if appropriate, will step in to help facilitate discussions between the parties to help them reach an agreement.

If discussions between the trustees and employer about the valuation and/or recovery plan end in stalemate, or are unnecessarily protracted, we may be required to use our powers to set the funding target or recovery plan. These powers would be exercised through the Determinations Panel (DP).

We neither 'approve' or 'clear' recovery plans. We expect the scheme and employer to agree a prudent valuation and appropriate recovery plan. Where we have no issues with the agreed plans, and based on the information available, we notify the scheme that we do not intend to take further action.

In cash-constrained situations, it may be appropriate for trustees to consider accepting non-cash support.

Appendix A: Different ways of valuing the scheme

The SSF regime is geared towards the specific circumstances of each scheme. Other methods use common assumptions. We would place the greatest weight on the SSF valuation. However, we would take into account the following points as part of our scrutiny of scheme valuations.

Best estimate

A valuation conducted on a 'best estimate' basis assumes that the investment assumptions that have been made will be borne out precisely, as predicted. This is an approach which does not build in much, if any, margin to mitigate for adverse circumstances, that the scheme may face over the lifetime of the fund.

Buy-out/s75

The buy-out valuation tells trustees how much money they would need to 'buy-out' the scheme with an insurance company. Buy-out is where an insurer takes responsibility for paying out the promised benefits to members until the last member dies.

The buy-out deficit is also sometimes referred to as the s.75 debt. Section 75 of the Pensions Act 1995 requires employers to pay the cost of buying out the scheme, less the scheme assets, upon insolvency, employment cessation (for multi-employer schemes) or scheme wind up from the scheme. An insurer would then take on the risk that members live longer than expected.

For this reason, buying out a DB scheme is an expensive process. Few schemes are funded on a buy-out basis.

FRS17

Financial Reporting Standard 17, or FRS17, is the method by which companies calculate their pension liabilities for the purposes of reporting in their annual report and accounts. This produces a figure that the company states as its overall liability to any and all DB schemes that it sponsors.

This is usually a relatively optimistic way of valuing the liabilities, in part because some of the assumptions (eg longevity) can be set by the employer.

PPF/s179

This is the valuation method used to calculate the deficit as recorded in the PPF7800 index.

Valuation under s179 of the Pensions Act 2004 relates to the compensation offered by the Pension Protection Fund (PPF).

The PPF was set up in 2005 to pay compensation to members of DB schemes whose employer has become insolvent and left the pension scheme with insufficient funds to meet the promises that have been made.

Broadly speaking, members who have already reached retirement age will receive 100% of what they expected. Members who have yet to retire will receive 90% of their promised pension, up to a limit of £29,897.42 (as at April 2011). The limit is adjusted according to the age at which compensation comes into payment. The figure of £29,897.42 applies after the 90% has been applied. There are also restrictions on annual pension increases.

A s179 valuation applies the PPF restrictions to the valuation and will show whether the scheme would need to call on the PPF, if the employer was to enter into insolvency.

Self sufficiency

A self-sufficient basis considers that the scheme will never again have the support of an employer and will have no way of generating income, other than by investing its own funds.

The assumptions that are used for this valuation are not prescribed and are for the trustees to decide. They should be cautious about the assumptions they employ.

This guide complements our existing regulatory guidance and should not be considered as a statement of the law.

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