

Scheme funding and the employer covenant

*Prudence, affordability, applying
flexibility through the economic cycle*

A statement by the Pensions Regulator

In October 2008 and February 2009, the Pensions Regulator ('the regulator') set out general positions to employers and trustees of defined benefit (DB) pension schemes facing depleted asset values and increased deficits in deteriorating economic conditions.

This month, through a series of national workshops, we have provided further explanation of our scheme-specific and flexible approach to funding valuations. Our goal has been to ensure trustees and advisers continue to focus on proper consideration of the employer covenant in setting prudent funding targets and appropriate recovery plans.

For those trustees, employers and advisers unable to attend the workshops, this statement provides a consolidated summary of this approach (as articulated in our code and guidance on scheme funding). The key points are:

- * Economic and financial conditions have resulted in cash constraints for many employers in the short term, and for some, greater uncertainty about longer term prospects;
- * The current regulatory framework and approach to scheme funding is sufficiently flexible to cope with these conditions;
- * Technical provisions are the scheme-specific funding standard which pension schemes must target and our requirement is that they are set prudently; however there is flexibility in setting a recovery plan to repair a deficit to meet the funding objective;
- * At the current time, FRS17 is unlikely to represent an adequate level of prudence without further adjustment;
- * Any risk margin in the assumptions for setting technical provisions must take account of the extent to which the employer covenant can support them;

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- * Technical provisions should not be compromised to make a recovery plan appear affordable; the size of the deficit does not necessarily dictate annual deficit repair contributions to the pension scheme, these must be determined with reference to what is reasonably affordable for the employer;
- * Assessing the employer covenant is complex and requires openness and cooperation between trustees and their sponsoring employers. Trustees should be clear about the questions they need to have answered by sponsoring employers and advisers and should address any conflicts of interest and issues of confidentiality; and
- * Where employers are cash constrained, trustees should look at the widest range of flexibility in recovery plans, mindful of their duties to secure member benefits; these can include lengthening recovery plans, step-up payments, back-end loading of recovery plans, and further security through the use of contingent assets and the distribution of profits fairly between creditors and equity providers.

Setting technical provisions

The scheme funding requirements of the Pensions Act 2004 focus on the value to be placed on a scheme's accrued liabilities, known as 'technical provisions'. We issued *Code of practice no. 3: Funding defined benefits* which provides practical guidelines and sets out expected standards of conduct and practice for those who must meet the legislative requirements.

As with any actuarial calculation, the estimate of technical provisions requires assumptions to be made about the future, and these assumptions must be chosen prudently. Trustees must obtain actuarial advice before choosing assumptions and, subject to certain exceptions governed by the scheme rules, they must obtain the agreement of the employer. The main assumptions should include the assumed investment return and other economic assumptions as well as future longevity.

Trustees need to decide on the level of technical provisions, based on prudent assumptions, in relation to their assessment of the employer covenant (a section on calculating the covenant follows).

Where the employer covenant is so weak as to be negligible, the assumptions should be chosen so that the scheme is self-sufficient. This means that technical provisions should be set at the level at which they can be expected to meet the full accrued liabilities and expenses in future, on the basis that the scheme had been closed and all risks minimised. In particular, there is unlikely to be scope for assuming any risk premium in the discount rate as it is improbable that the employer can meet any additional cost if returns are not achieved as expected. The technical provisions will also have to include any allowance for future expenses over that which it is expected the employer will meet.

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Setting technical provisions *continued*

If the employer covenant is considered to be strong relative to the scheme, the technical provisions could be set using assumptions which reflect the strong ability of the employer to underwrite any risks that the actual experience in future might vary from the assumptions made. Therefore a discount rate can take credit in advance for some prudent level of investment out-performance over and above a risk-free rate of return. However, even in circumstances of a strong employer covenant, the assumptions made will still have to be prudent in the context of the scheme.

Generally, trustees will have to take into account the risks inherent in the investment strategy of the scheme, the probability of a poorer than assumed investment return and the financial impact of such an outcome. In setting the discount rate, the trustees together with any advisers will have to examine how the employer could realistically be expected to support any higher level of contribution requirement if the achieved investment return is lower than the discount rate assumed and the circumstances in which that might occur.

In addition to technical provisions, which we consider the most appropriate standard to protect member benefits and the Pension Protection Fund (PPF) for the long-term, other standards have been created which have some relevance:

- * Section 179 is the valuation of PPF compensation benefits under section 179 of the Pensions Act 2004; any deficit on this basis will have an effect on the scheme's PPF levy;
- * FRS17/IAS19 prescribes the accounting and disclosure framework of employee benefits including pensions for companies. Depending on the spread between gilts and AA corporate bonds, the assumptions may be similar to those used for technical provisions, but this is not currently so and parties should be wary of referencing this in scheme funding discussions;
- * Buy-out level is an estimate of the cost of securing scheme benefits (for example buying-out with an insurer). In some circumstances these assumptions may be consistent with, or more prudent than self-sufficiency, in other cases they will be weaker.

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The employer covenant

The aim of assessing the employer covenant is to examine the support the employer can provide for the scheme in the long-term. Trustees will be seeking answers to questions including:

- * What are the employer's legal obligations to fund the scheme?
- * What is the effect of the employer's corporate group structure?
- * What is the employer's ability to meet ongoing demands as they fall due?
- * What is the employer's ability to stand behind any adverse experience in an ongoing situation, including the investment risk taken by the scheme?
- * What would be the scheme's position on insolvency of the sponsor?
- * Are there options to obtain security for the scheme?

In approaching the covenant assessment trustees will need to decide on the level of detail they need, or areas of the assessment they need to concentrate on, to have sufficient understanding of the employer covenant in order to set technical provisions. In some circumstances, the trustees may consider that they have sufficient information on the employer, as well as sufficient knowledge and experience amongst the trustees, to answer these questions and arrive at what they see to be an objective assessment of the ability of the employer to support the scheme.

However in many circumstances the trustees are likely to consider they either do not have the detailed knowledge, experience, or independence needed to make an objective assessment. The issues to be addressed in arriving at an assessment of the financial prospects for many employers and the implications for the pension scheme will be complex and uncertain. Legal advice may be needed to understand corporate structure, legal obligations and the position of the scheme if the employer were to become insolvent. Professional advisers experienced in making credit and financial assessments in relation to the strength of the employer covenant may need to consider a wide range of information including:

- * The position of the employer, including its financial strength, intra-group relationships and policies, management record and future plans;
- * The nature of the industry sector in which the employer operates and the employer's position within the industry; and
- * The position of the economy as a whole.

As well as estimating what value might flow to the scheme on insolvency of the employer, the assessment should examine the likely future performance of the employer (which may be based on past and current information and trends).

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The employer covenant *continued*

It is important to recognise that the strength of the employer covenant can change rapidly and therefore trustees will want to ensure they have mechanisms for regular monitoring and review. It may be necessary for trustees and sponsoring employers to draw up suitable confidentiality agreements to enable the necessary flow of information to assess and monitor covenant issues.

Appendix A of our clearance guidance provides more detail on assessing the employer covenant.

The recovery plan

Any funding shortfall must be met in the manner which is set out in the statement of funding principles. Our guidance is clear that the trustees should aim for any shortfall to be eliminated as quickly as the employer can reasonably afford. What is possible and reasonably affordable will be informed by the trustees' assessment of the employer's covenant.

In February this year, we issued a statement to employers sponsoring defined benefit pension schemes which set out our position on recovery plans. That statement referred to our position on agreeing recovery plans in general as well as instances where there might be a perceived need to renegotiate an already agreed plan.

We expect trustees to take a realistic approach to setting and agreeing recovery plans, which should take into account the ability of the employer to meet the agreed cash payments to the scheme. It remains vitally important that the pension scheme and the members of the scheme should not be disadvantaged by the terms of the recovery plan.

We explained in our statement of February 2009 that although having a recovery plan of over 10 years is a trigger for us to look more closely at the arrangements, in practice we have considered recovery plans ranging in length from 1 year to over 20 years to be appropriate given the circumstances of the specific schemes involved.

However there are many more approaches to recovery plans other than simply extending the duration that may be appropriate in the current economic circumstances. Whatever structure or duration of recovery plan is considered the trustees must ensure that their pension scheme is treated fairly in relation to other creditors and equity providers and not disadvantaged.

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The recovery plan *continued*

Where employers are short-term cash constrained, one approach which is reasonable would be to reflect that situation in the early years of a recovery plan, and then increase payments in line with the business plans, in effect back-end loading the recovery plan. The plan could also include provision for contributions to accelerate further if the financial position of the employer improves.

There are also a variety of contingent assets that could be secured, including guarantees from related companies or third parties, security over assets and assets in escrow accounts. Contingent assets need to be approached with care and specialist advice may be needed by trustees and employers. In particular the company will want to ensure that terms do not hamper their ability to do business in future and trustees will want to ensure that terms enable them to crystallise the contingent asset should they have need, in relation to specific events such as levels of scheme funding, investment return or insolvency of a sponsoring employer.

The regulator will continue to work openly with all of our regulated community to deepen understanding of our scheme-specific approach to both secure member benefits for the long-term and to protect the Pension Protection Fund. We encourage trustees and employers to work positively and openly towards this end and those with concerns should contact the regulator for further support.

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