Case examples

May 2012

Scenarios for scheme funding plans in the current economic conditions

The Pensions Regulator

Introduction

We have developed three scheme scenarios to illustrate how we see the approaches that we outline in our **'Pension scheme funding in the current environment'** statement working in practice.

They are simplified examples, which illustrate three very different situations where schemes may need to make changes to the plans agreed at their last valuation. We believe that many schemes will be able to identify with some aspects of these scenarios. It is worth noting that there will always be scheme-specific differences. Trustees' and employers' approaches to their own schemes should always be based on their scheme's circumstances and the regulator's consideration will be informed by these circumstances. Therefore, these scenarios should not be taken as an indication of the regulator's stance or views with regard to any particular scheme.

It is useful to read all of the scenarios to reflect on the different approaches which are relevant in different scenarios.

Scenario 1 is a scheme which only has a slight increase in deficit at their March 2012 valuation date.

We believe that these types of schemes will only need minor changes to their funding strategy from the last valuation.

Scenario 2 is a scheme that has had a much greater increase in deficit due to a combination of factors.

Schemes in this position face greater challenges to agree a reasonable recovery plan. It is likely they will require an increase in contributions, or additional security, to be provided.

We believe that some schemes like the scheme in scenario 2 will be able to meet these challenges through increased employer support.

Scenario 3 also concerns a scheme with a large deficit, but with an employer so affected by the recession they will not find it easy to increase contributions or security.

The employer needs as much flexibility as possible to agree an acceptable recovery plan.

We believe that these types of schemes are likely to be able to meet their challenges through increasing the risk in the scheme in the short term. They can do this by extending recovery plans, or factoring into their plans assumptions about increases in the 'return relative to gilts'.

'These are simplified examples, which illustrate three very different situations where schemes may need to make changes to the plans agreed at their last valuation.'

Low security schemes

The scheme in scenario 3 is struggling significantly. However, the trustees are of the view that conditions will improve for the scheme and its employer. In this case, the trustees can be sufficiently confident that the scheme members will eventually be paid the benefits they have been promised.

This is in contrast to schemes where the trustees' view is different, ie where it is unlikely that the scheme will be able to pay the benefits promised without taking risks that the employer cannot underwrite (and this is not likely to improve in the future). We have published Section 89 (s89) reports for Polestar and Uniq which were real schemes in this situation and these show our thinking about how such situations should be approached.

'We believe that many schemes will be able to identify with some aspects of these scenarios.'

<table>
<tr><th colspan="2">Scenario 1 is a scheme which only has a slightly increased deficit at their March 2012 valuation date.</th></tr>
<tr><td colspan="2">The regulator says: ‘Schemes faced with these circumstances will only need minor changes to their funding strategy from the last valuation.’</td></tr>
<tr><td>Employer:</td><td>The employer provides a strong covenant to the scheme. It has been consistently profitable for a number of years and the trustees’ assessment is that it will maintain and build on this profitability. Dividends have been steadily increasing above the rate of inflation.</td></tr>
<tr><td>Valuation:</td><td>It is unlikely that the prudence of the assumptions will need to be changed from the 2009 valuation if the assessment of covenant is largely unchanged.

In 2009 the trustees and employer agreed a recovery plan of eight years. If the contributions and assumptions from the 2009 valuation are used for the deficit under the 2012 valuation then the recovery plan would be for nine years (an increase of four years in the end date).</td></tr>
<tr><td>Options that the trustees and employer are likely to consider appropriate for dealing with the small increase in deficit include

NB: options are not mutually exclusive and may have to be used in combination.</td><td>• Contribution increases to maintain end date of previously agreed recovery plan.
• Contribution increases in line with the increase in dividends since the last valuation.
• Drawing up an escrow for payments targeted at the newly revealed deficit.
• Short recovery plan extension underwritten by contingent assets in the event of employer insolvency.
• Additional action, such as contribution increase if the employer covenant weakens, for example measured by credit rating falls.</td></tr>
<tr><td colspan="2">The regulator says: ‘As the scheme in this scenario has many appropriate options for dealing with the increase in deficit, it would not be appropriate to increase the risk by factoring into the recovery plan an assumption of an equity risk premium above that justified on a long term basis.’</td></tr>
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Scenario 2 is a scheme which has had a big increase in its deficit due to a combination of factors:

- **a December 2011 valuation date**
- **significant impact of the fall in interest rates on liabilities and little improvement in asset position, and**
- **low contributions based on a low funding target.**

The regulator says: 'Schemes in this position will require employer support (in the form of increased contributions or security) to be made tangible, in order to agree a reasonable recovery plan.'

Employer:	The employer provides a strong covenant to the scheme. It has been consistently profitable since the scheme's previous valuation. It has good future prospects but its business sector is very competitive and attractive to new entrants. Continued cash generation has resulted in recent increases in dividends to shareholders and the dividend level is several times that of the deficit contributions. In addition, it holds some unencumbered property assets.
Valuation:	In the 2008 valuation, a relatively low contribution level was agreed because the trustees and employers thought it was in all interests to strengthen the covenant by paying down debt and investing in the business. This resulted in a 10 year recovery plan. The trustees and employer agreed significant reliance on investment outperformance based on the employer's ability to underwrite losses. If current contributions and assumptions are maintained, the recovery plan will be 30 years long. Updating the valuation to the position in March 2012 and introducing future index-linking of contributions would enable the deficit to be recovered in 15 years.
Options that the trustees and employer are likely to consider appropriate for dealing with the increase in deficit include NB: options are not mutually exclusive and may have to be used in combination.	• Contribution increases maintaining the existing recovery plan length to reflect good cash generation and equitable treatment of the scheme, now other cash demands have been met, or • An extension to the recovery plan underwritten by the property assets, as contingency in the event of employer insolvency. In addition, consideration of options to mitigate the downside risks of weak investment performance or weakening covenant is given to: • Planned contribution increases triggered by investment underperformance. • Contingent assets passing to the scheme if the employer covenant weakens, for example measured by credit rating falls.

The regulator says: 'Although the employer has to contribute materially more to reduce the deficit in this scenario, the fact that dividends have significantly increased and are well in excess of deficit contributions indicates that it would be reasonably affordable to do so. A viable recovery plan of reasonable length can be agreed. Therefore, it would not be appropriate to increase the risk in the funding plan by factoring in an assumption to the technical provisions of an increase in gilt yields, or to assume an equity risk premium above the long term rate in the recovery plan.'

Scenario 3 is a scheme with a straightforward investment strategy with no hedging. Its valuation as at April 2012 has been hit by the drop in gilt yields and its asset portfolio has not increased as much as industry benchmarks. The deficit has increased. The employer itself has been hit by the recession and can offer little in way of increased contributions or security for the scheme.	
The regulator says: 'We believe that these types of schemes may have to consider increased risk in the scheme in the short term by factoring into their recovery plan assumptions about increases in the 'return relative to gilts' (or by lengthening the recovery plan). We expect trustees to monitor their ongoing risks closely, and here in particular, the experience of these assumptions.'	
Employer:	The employer has significant secured debt which is due to be refinanced. If the scheme was to wind up now, the employer would become insolvent, and there would be insufficient funds for the lenders to recover their debt. The employer's business performance has dropped significantly in recent years. It has partly recovered, but not to pre-recession levels, and prospects are mixed.
Valuation:	Assumptions for the 2009 valuation were set strongly relative to gilts, based on the view that the employer covenant was weak. Consequently the trustees are unlikely to need to review their assumptions. Contributions at the last valuation were limited by affordability and a 12 year recovery plan was agreed. Preliminary results show that if the assumptions are maintained at their current levels, the recovery plan needed is 18 years. This represents a substantial risk given the employer's weakness. The trustees recognise that the next few years will be key in determining whether they will be able to meet the promises made to members. If the business does not recover and/or market conditions for the scheme remain unchanged it is extremely likely that they will become insolvent and the scheme will be wound up. However, having taken advice and considered the employer's business plans, they believe there is a reasonable likelihood that the business will revive and prosper. They are also confident that that the funding position of the scheme will improve in future based on their current investment portfolio.

Scenario 3 continued...	
Options that the trustees and employer are likely to consider appropriate in this scenario centre around ensuring that everything that can be done is being done; that value is not leaving the business at the expense of the scheme; and the scheme's position is not being subordinated NB: options are not mutually exclusive and may have to be used in combination.	• Equitable treatment of interest payments and deficit repair contributions. • Interest on debt and pension scheme contributions reduced proportionately for a period to fund investment in the business. • Dividends not to be taken unless the next valuation shows an improved position. • Extension of the recovery plan. • Taking some account of gilt yield reversion, that is not matched in a fall in equity markets, in the recovery plan assumptions.

The regulator says: 'This may be the kind of exceptional case for which trustees either need to consider that the recovery plan will be very long or agree to factor in an early return to higher gilt yields without a corresponding equity market fall. Where there is reliance on favourable conditions emerging that proves not to be realised over the next few years, the scheme's position may in future become irrecoverable, and be considered as a low security situation.'

How to contact us

Napier House
Trafalgar Place
Brighton
BN1 4DW

T 0845 600 0707
F 0870 241 1144
E customersupport@tpr.gov.uk

www.thepensionsregulator.gov.uk
www.trusteetoolkit.com

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