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Briefing note

Valuation services

This note sets out some of the key issues for consideration by employers as part of a formal valuation process. Around one-third of pension schemes should have a formal actuarial valuation due in 2015, and many of these will have an effective date of 31 December, 31 March or early April.

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The key talking point for 2015 valuations will be government bond yields, on which the calculation of the liabilities is usually based, which reached historic lows in January 2015. Generally speaking, this will lead to higher liabilities than at the previous valuation as inflation expectations have remained broadly unchanged from three years ago.

On the other hand, both growth and protection assets should have performed quite well over the past three years, with UK equities returning around 35% over the three-year period and overseas equities substantially more, which could limit the impact of falling yields to some extent.

New scheme funding code of practice

In the Pensions Bill 2013, The Pensions Regulator (TPR) was given a new statutory objective to 'minimise any adverse impact on the sustainable growth of an employer'. In recognition of this objective, TPR has published its proposed changes to the code of practice on defined benefit (DB) scheme funding, effective for valuations completed from July 2014.

The new code focuses on an 'integrated risk' approach to funding, as well as striking a balance between the needs of the scheme and reasonable affordability for the employer. The integrated risk approach addresses covenant, investment and funding risks. It also recognises that a scheme's most valuable asset is a healthy sponsoring employer. The revised approach may help employers to negotiate lower deficit contributions if it can be demonstrated that investing the funds elsewhere in the business will lead to a stronger covenant longer-term.

Caution must be taken, however, in relation to claims made about planned investments towards sustainable growth. TPR has directed trustees to seek access to funds allocated for investment in employer growth (and used to negotiate down scheme contributions) but not subsequently spent in that way.

Start early

Even when the valuation date is several months away there is plenty that can be done in preparation so that employers and trustees are aware of the likely issues in advance and can avoid delays or surprises. For example, funding estimates can be available before the valuation date so that the employer has up to date information for budgeting purposes.

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Identify your objectives

For most schemes, the process of setting the valuation assumptions and contributions requires the agreement of the trustees and the employer. Before entering into discussions with the trustees the employer should understand what it is trying to achieve. For example, would it be better to keep short-term contribution commitments low but with an increase in a few years? Is stability and certainty key to meeting other business objectives? Might a strategy agreed now to solve a short-term problem reduce flexibility in future? The trustees will focus on what the employer can reasonably afford to pay and this needs to be thought through and presented carefully.

Engage with the trustees

The valuation process is ‘owned’ and driven by the trustees. However, the employer has a key role to play and its interests are likely to be best served by developing a constructive relationship with the trustees. In many cases trustees are sympathetic to the employer’s circumstances but need the employer to present a clear view on the issues.

The employer is likely to benefit from getting involved in the valuation process at an early stage. Having an opportunity to comment before the trustees have made major decisions is better than being asked to agree after decisions have already been made.

Where there has been clear communication between the trustees and the employer and there is a good working relationship, trustees may be more accepting of the employer’s proposals.

Prepare for employer covenant assessment

Trustees are required to consider the ‘employer covenant’ as part of the valuation process. This is often defined as the employer’s ability and willingness to support the scheme but TPR is increasingly focussed on the legal obligation of an employer to fund the scheme and tangible support rather than a perceived ‘willingness’. Employers have a legal duty to provide information to the trustees for this purpose. They should recognise the trustees’ obligations and understand how the information provided will be used.

TPR states that a full employer covenant assessment should be undertaken and it is increasingly common for trustees to consider commissioning an independent review of the employer’s covenant. The cost of such a review is ultimately borne by the employer and the trustees may consider an independent review unnecessary if the employer provides a good flow of information. For example, a presentation to trustees could be made early in the process on the current state of the business, including forecasts, etc.

However, many trustees consider independent reviews important and find them useful. If a review is carried out, it is likely to put the employer in the best light if the employer fully engages with the reviewers.

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Having a strong covenant, or being able to demonstrate an improved covenant since the previous valuation will allow the trustees to be more flexible in the assumptions they determine for the valuation. This may result in a lower deficit, allowing the existing recovery plan to continue.

The information provided must be consistent with the objectives. For example, if the information shows a strong financial position, the trustees are unlikely to be persuaded that deficit reducing contributions are unaffordable unless the employer can demonstrate a pressing need for cashflow to be used elsewhere in the business.

Assumptions and recovery plan

For the majority of schemes the assumptions underlying the technical provisions and recovery plan need to be agreed with the employer. There is a wide range of assumptions that can be used and these can produce very different contribution requirements.

In April 2013 TPR began publishing an annual funding statement aimed at providing guidance for trustees and employers who are in the valuation process. The first two of these in 2013 and 2014 focussed on the flexibility surrounding the choice of the investment return and discount rate assumptions. This includes the ability for trustees to vary relative asset return assumptions from the previous valuation where market conditions or views have changed and the use of different investment return assumptions for the purpose of the recovery plan. TPR stresses, however, that these assumptions need to be considered within an overall risk context.

For schemes in deficit, there is also a variety of options for clearing the deficit through the recovery plan. TPR has stated that, in some cases, it may be appropriate to adopt longer recovery periods, ‘back-end loaded’ contribution rates, and/or less prudent assumptions. These can all help reduce employers’ short-term cashflow commitments.

Given the new code of practice and the continued fall in government bond yields, we are expecting the 2015 statement to reinforce these comments.

Investment strategy

A scheme’s investment strategy is one of the key drivers of the ultimate cost of the scheme to its employer. It is the trustees who have the responsibility for setting the strategy but the employer should recognise that it has an important role to play and should maintain an active interest.

In some cases, the employer may have different objectives from the trustees when considering investment strategy. For example, the employer may be concerned about volatility on its balance sheet, or the profit and loss charge, whereas the trustees may be concerned about security of benefits. By engaging with the trustees an employer can influence the trustees’ choice of investments and align the scheme’s strategy with its own objectives.

Given recent experience, both trustees and employers may be looking to better match the assets to the liabilities of the scheme by, for example, entering into ‘swaps’ which provide protection against movements in interest rates and/or inflation expectations. This can lead to greater stability in the scheme’s funding level and reduce the chance of shocks at future valuations.

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> Most schemes will currently be in the process of determining how they may be affected by the expected increase in demand for transfer values.

Contingent assets

One of the bargaining tools potentially available to employers in funding negotiations is the provision of a contingent asset (for example a group/parent company guarantee or a charge over a property owned by the employer). This is an asset that is available to the trustees in certain circumstances – such as employer insolvency.

The trustees may be willing to accept additional investment risk, weaker assumptions and/or longer recovery periods (all of which can result in lower contributions) if they know that they will have recourse to extra funding if things go wrong. In addition, a contingent asset can serve to reduce the levy payable to the Pension Protection Fund.

A key theme within TPR's latest statement this year is the consideration of the underlying risk and taking an integrated approach towards risk management. It therefore remains important to analyse and be able to provide evidence of the employer's ability to underwrite risks associated with the scheme's funding/investment strategy, including the use of any contingent support.

Recognise the Regulator

TPR will review the funding plans of schemes when they are submitted. In our experience, the majority of schemes will receive some comment or suggested changes to their funding plans. In some cases TPR will enter into detailed correspondence with the trustees and employer which can be costly and time consuming.

Our experience of TPR's procedures and likely feedback can enable our clients to reduce the amount of work involved in dealing with TPR. Recognising TPR's requirements early in the valuation process can prove cost effective and enable a swift conclusion to the valuation process.

Benefit changes

Most employers are reviewing, or have recently reviewed, the benefits provided by their schemes. The end of contracting out from April 2016 is another driver for change and employers will need to take action to avoid an increase in costs. The expected cost of different benefit options can easily be determined as part of a funding valuation and this is the ideal time to consider any savings that can be made from future service benefits. The introduction of auto-enrolment legislation requiring employers to provide pensions for all employees will also be a key consideration for all employers, whether they provide DB or defined contribution DCarrangements.

The DC flexibilities that came into force on 6 April 2015 may also be a factor. Most schemes will currently be in the process of determining how they may be affected by the expected increase in demand for transfer values. Employers should consider setting a 'settlement strategy' that drives funding and investment strategies alongside covenant considerations, i.e. extending TPR's 'triangle'.

> Illuminate allows the employer and trustees to change assumptions and immediately see the effect that these changes will have on the liabilities and potential recovery plan contributions.

Investment

- security for benefit payments
- future asset returns
- capital and income volatility appropriate to covenant funding and benefit settlement strategy
- liquidity considerations
- shortened durations

Funding

- technical provisions appropriate to covenant, investment and benefit settlement strategy
- future recovery plan balanced with sponsor's spending for sustainable growth
- cash cost of settling benefits
- return on expenditure v's 'day job IRR'

Covenant

- future reliance on sponsor
- capacity to absorb adverse movements
- bedrock of TPR funding regime
- member view of early settlement?

Benefit settlement

- transfer options
- exchange options
- lump sum options
- insured solutions
- bulk exercises and structural options
- bedrock of integrated strategy

For example, employers offering a transfer at retirement option should consider incorporating an allowance for this in the valuation assumptions. The liquidity requirements of such an option would also have an impact on the scheme's investment strategy.

Illuminate

Valuation negotiations can sometimes be a laborious process, with proposals and counter proposals taking time to calculate and assess. We have developed an online tool, Illuminate, to help avoid these delays.

Illuminate allows the employer and trustees to change assumptions and immediately see the effect that these changes will have on the liabilities and potential recovery plan contributions. The tool can also look at different types of recovery plan and will show the reliance that the chosen funding strategy is placing on the employer. This can allow the employer and the trustees to reach agreement on the valuation more quickly, whilst also considering the impact of the investment strategy and the employer covenant on the results.

Illuminate also incorporates a funding tracker which monitors changes in the assets and estimated liabilities of the scheme over time. The tracker updates on a daily basis and will be based on the valuation results (potentially the provisional results if using Illuminate for the first time).

This will allow the employer and the trustees to understand any significant changes that may have occurred since the valuation date and, in the longer term, will allow the employer to monitor the funding level compared to the expected position.

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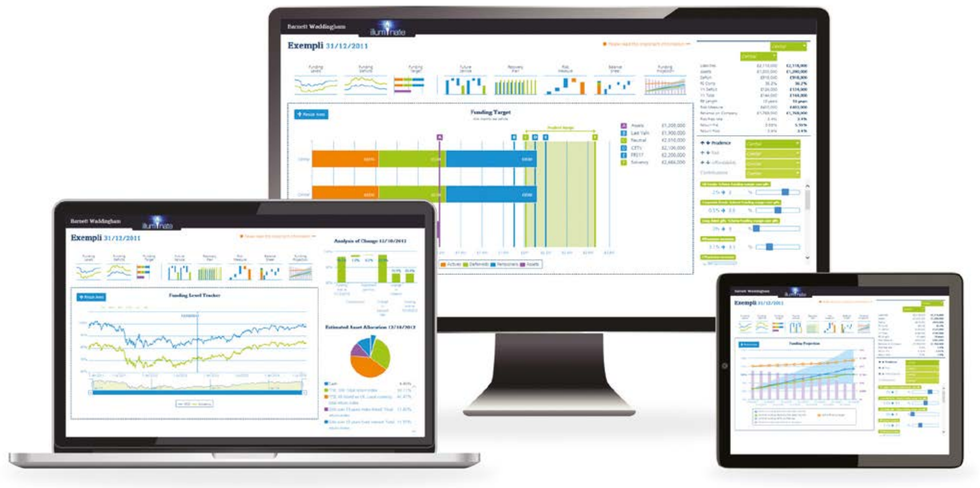
Barnett Waddingham has considerable experience in assisting employers throughout the actuarial valuation process and we would be happy to discuss solutions that would be appropriate to your circumstances.

An example Illuminate system (pictured below) is available on our website – please contact us for the login details if you would like to take a closer look.



Conclusion

As the uncertain recovery continues, employers may be continuing to experience difficult trading conditions and additional demands on cashflow from pension schemes are unlikely to be welcome. However, as mentioned above, there are many ways in which employers can take the initiative and help manage their exposure to pension liabilities.

Barnett Waddingham has considerable experience in assisting employers throughout the actuarial valuation process and we would be happy to discuss solutions that would be appropriate to your circumstances.

Post-valuation exercises

Some exercises are best undertaken immediately after completing a formal valuation (or even before completion, given that the data and calculations will usually be finalised well before the valuation and recovery plan are formally agreed and signed off). This is because membership movements and changes in market conditions will render the results of calculations undertaken as at the valuation date – and therefore the decisions made based on those results - less reliable as time progresses.

Liability management feasibility studies

Consideration of any liability management exercise will usually involve a feasibility study to analyse the potential benefits of the exercise as well as the expected costs. There is no better time to perform a feasibility study than straight after a formal valuation – when the membership data is fairly recent, any data issues have been identified and hopefully addressed, and assessments of the employer covenant (whether formal or informal) are up to date.

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Factor reviews

Actuarial factors are used to implement member benefit options. The key factors are those applying at the point of retirement, namely:

- early and late retirement adjustments
- commutation (exchanging some pension for a cash lump sum)
- pension increase exchange (if this option is available at retirement)
- dependant's pension exchange (again, if this option is available at retirement)

These factors are typically fixed from one review to the next, rather than varying with market conditions. It is therefore important to review the factors at a reasonable frequency and this is commonly undertaken following each formal valuation.

Factors are typically set by the trustees, but the employer can yield influence if they initiate a review, or at least engage with the trustees early in their factor review process.

The transfer value basis (used to calculate the amount that will be paid to extinguish a member's benefits if they choose to transfer out of the scheme) is typically updated for market conditions either monthly or on a case by case basis, but the derivation of financial assumptions and the demographic assumptions are set at the review date.

The assumptions are commonly based on the funding valuation assumptions, but adjusted to represent a best estimate (rather than a prudent estimate) allowing for possible selection against the scheme and margins to protect against adverse market changes between factor updates. If transfers out of the scheme are reasonably common, or if a liability management exercise is under consideration, then the transfer value basis should be reviewed as soon as possible following the formal valuation so that an 'insufficiency report' can be prepared to enable transfer values to be appropriately reduced. This is particularly important in light of the expected increase in transfer activity as a result of the new DC flexibilities.

The negotiations were challenging as our analysis provided good evidence for the company to pay reduced contributions.

CASE STUDY 1

Our work involved providing support to a multinational company which acquired a UK operation with a large (> £3 billion) DB scheme several years ago through a historic transaction. We provided support to the company in its negotiations with the trustees during the triennial valuation process.

This involved keeping the management team, based in Europe, up to date with developments in UK pensions, analysing and challenging assumptions and figures prepared by the scheme actuary, exploring alternative scenarios with the company and preparing a counter-proposal and support during meetings with a trustee sub-committee.

As part of the analysis we were able to demonstrate that, under the trustees' proposed funding plan, the scheme could potentially be fully funded on a buy-out basis ahead of the end of the proposed recovery period. As part of the counter-proposal to the trustees we helped develop a framework which could be used to manage the funding level of the scheme towards a buy-out position over a longer time horizon. One of the conclusions reached was that it would be more efficient to target a buy-out once the majority of deferred members had retired, to avoid having to purchase deferred annuities which tend to be much more expensive compared to immediate annuities.

We also worked closely with our investment team, who are advising the company, in developing the counter-proposal. They used cashflows provided by the scheme actuary to prepare an analysis of the progression of the funding level over time which the company was able to use as part of the counter-proposal. The investment team also carried out an analysis for the company to give them a better understanding of the interest rate, inflation and credit risks inherent in the trustees' investment strategy which highlighted potential areas where further de-risking could be considered.

The negotiations were challenging as our analysis provided good evidence for the company to pay reduced contributions. The strategy adopted by the scheme had served it well over the three years to the valuation date and the position had improved. The trustees were reluctant to accept a reduction to the current level of contributions and the matter was further complicated because the scheme actuary has a role in setting the contribution rate.

The end result was that although the company was unable to secure an extension to the recovery period, it was able to negotiate down the deficit and secure a significant reduction in total contributions. The company was also able to secure a cap on future contribution requirements should the deficit increase at the next valuation (which is effectively an undertaking to extend the recovery period in the event of adverse experience).

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CASE STUDY 2

Our work involved providing support to a UK subsidiary of a European multinational on its £300 million DB scheme. The scheme is relatively immature and is open to accrual. We provided an analysis of the proposals made by the trustees on assumptions for the valuation and the recovery plan and illustrated potential alternatives showing the impact on the funding level and contributions.

This analysis was used to prepare a response to the trustees with a counter proposal. At the same time as the valuation negotiations, the company was also looking at putting into place an asset backed funding solution to address the deficit – our analysis indicated that the company could achieve the level of contributions it wanted through other means. The use of the asset backed funding solution carried other benefits for the company so we helped them understand at a high level how the structure of payments under such an arrangement would vary if the trustee could be moved on its proposed assumptions.

The company ultimately decided to put in place the asset-backed funding vehicle. The value of this arrangement was more than enough to cover the deficit. This was done to effectively pre-fund part of the cost of the future accrual of benefits, allowing the company's cash contributions to remain unchanged when otherwise there would have been a significant increase.

CASE STUDY 3

Our work involved providing support to a major UK regulated financial services company with a very large (>£8 billion) pension scheme. We helped the company in its negotiations with the trustees during the triennial valuation process.

We were appointed after the valuation process had begun and the trustees' initial estimate of the deficit was around £2 billion.

We were tasked by the company to help it negotiate with the trustees to reduce the headline deficit figure (which was a key determinant of the regulatory capital it had to hold). Our approach was to work with the trustee and scheme actuary in a collaborative but robust way. In doing this:

- we made sure that the trustee understood the company's commercial and regulatory constraints
- we presented counter-proposals that were fully evidenced and justified (bearing in mind that small changes in assumptions can have big effects on the deficit)
- our strategy centred around removing 'hidden prudence':
  - > best estimates (based on experience and future business plans) were proposed for all of the actuarial assumptions except for the discount rates and mortality assumptions where prudence was conceded
  - > the company proposed that discretions would no longer be pre-funded but will be funded on a pay-as-you-go basis for future cases
- we were also able to agree an adjustment to the assumptions that reflected that market yields were at historic lows and had improved since the valuation date

The outcome was an agreed revised deficit of around £1.1 billion which gave the company an acceptable recovery plan and regulatory capital impact.

This briefing note is for information only and should not be construed as advice.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

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