

## Valuation services

In this note we address some of the main issues that employers should be considering as part of their formal valuation process in 2016.

Against a backdrop of economic uncertainty and volatile financial markets, employers should be forming a strategy for approaching their 2016 pension scheme valuation. With government bond yields remaining at historical lows, employers with valuation dates in 2016 are likely to see an increase in their liabilities compared to the previous valuation and, in many cases, an increase in deficit despite significant recovery plan contributions.

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### Start early

Even before the valuation date, 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 made available before the valuation date so that the employer has up-to-date information for budgeting purposes.



### Identify your objectives

The process of setting the valuation assumptions and contributions usually requires the agreement of the trustees and the employer. It is important that the employer is clear about what it is trying to achieve.

- Would it be better to keep short-term contribution commitments low but with an increase in later years?
- Is stability and certainty key to meeting other business objectives?
- How do the pension risks compare to the wider business risks?
- Is the pension strategy consistent with the employer's business strategy?

### Engage with the trustees

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 any 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.

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The integrated risk approach addresses employer covenant, funding and investment risks

## Funding defined benefits - Code of Practice



The Pensions Regulator's (TPR) new Code of Practice is applicable to all schemes with valuation dates in 2016. It 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 **employer covenant, funding** and **investment** 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 in the longer-term.

We believe that there is a fourth strand to the 'integrated risk' approach – how members take their benefits. We expect that there will be material numbers of members transferring out of defined benefit (DB) schemes to defined contribution (DC) schemes to take advantage of the recently introduced benefit flexibilities. Employers should therefore be devising their pension strategies assuming that not all of their DB members will require a pension for life. This can lead to opportunities for early settlement of liabilities with a resulting reduction in risk.



Our funding tool, **illuminate**, which is discussed in more detail below, can help employers explore the complex relationships between employer covenant, funding, investment and benefit settlement.

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A presentation to trustees could be made early in the process on the current state of the business, including forecasts

## Employer covenant - prepare for assessment



Employer covenant is defined by TPR as the extent of the employer's legal obligation and financial ability to support the scheme now and in the future. The assessment of employer covenant forms an important part of the trustees' valuation process.

It is increasingly common for trustees to commission an independent review of the employer's covenant, as many trustees consider these to be important and find them useful. It is therefore likely to put the employer in the best light if the employer fully engages with the reviewers.

As TPR does not require trustees to commission an independent review, and the cost of such a review is ultimately borne by the employer, engaging early with the trustees and providing a good flow of information may make an independent review unnecessary. For example, a presentation to trustees could be made early in the process on the current state of the business, including forecasts, etc. The information provided to the trustees should be consistent with the employer's objectives.

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.

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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.

## Funding - assumptions and recovery plan



For the majority of schemes, the assumptions underlying the scheme funding liabilities 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.

Once again, the employer should be proactive in engaging with the trustees as early on in the process as possible. This will give the employer a better opportunity to influence any decisions made in relation to the assumptions or funding method used.

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.

It may also be possible for the employer to agree with the trustees that some of the recovery plan payments can be used to fund benefit settlement exercises. This is a very efficient use of the employer's capital.

## Investment – setting the 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, particularly as the employer's objectives may differ from the trustees'. The employer may be concerned about balance sheet or the profit and loss volatility for example, 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.

## Illuminate

Our funding tool, Illuminate, can help trustees and employers explore the complex relationships between funding, investment, employer covenant and benefit settlement. Using Illuminate, our experts can easily demonstrate how the moving parts of a DB strategy fit together, enabling employers to make informed decisions and avoid the delays usually associated with valuation negotiations.



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. Our 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, while also considering the impact of the investment strategy and the employer covenant on the results.

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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

Illuminate also incorporates a funding tracker which monitors changes in the assets and estimated liabilities of the scheme over time, and updates on a daily basis. 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.



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

## Other considerations

### 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 (PPF).

Giving the trustees a contingent asset could also facilitate the early settlement of benefits for some members.

### 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 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.

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Employers offering a transfer option at retirement may want to consider allowing for an assumed take-up rate in the valuation assumptions

### Benefit changes

With DB schemes becoming increasingly expensive, and with the end of contracting-out from April 2016 resulting in further cost to employers, the funding valuation is the ideal time to consider any savings that can be made in relation to future service benefits.

Although the Budget changes that came into force on 6 April 2015 relate mostly to DC arrangements, these may provide some opportunities for employers looking to reduce the cost (and risk) of their DB scheme. For example, employers offering a transfer option at retirement may want to consider allowing for an assumed take-up rate in the valuation assumptions.

The main objective for employers is likely to be affordability, but any secondary longer-term objectives should be considered as part of the valuation process.



The employer's ultimate goal should be thought about in detail. For example, this may be ensuring that the scheme remains sustainable in the long-term so that it remains open to employees. More commonly these days, de-risking of the scheme and the path to settling liabilities within the employer's risk and cost constraints will be the main concerns.

### These objectives should be considered in negotiations with trustees.

- Will it be beneficial to pay in more contributions now, or carry out a liability management exercise, if this means that the timescales for buyout are brought forward?
- Is the investment strategy suitable in the context of the ultimate objective?

### 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.

### Benefit settlement feasibility studies

Consideration of any benefit settlement exercises will usually involve a feasibility study to verify that the expected benefits of the exercise will exceed the costs incurred. The feasibility study will also highlight the expected range of risk-adjusted returns that the exercise may give to the employer so that it can compare the exercise against its other capital projects and prioritise accordingly.

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The basis for calculating transfer values is particularly important at the moment, due to the increase in transfer activity resulting from the introduction of the new DC flexibilities.

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.

#### Factor reviews



Actuarial factors are used in calculating member benefit options, for example early retirement, cash commutation and transfers out.

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.

The basis for calculating transfer values is particularly important at the moment, due to the increase in transfer activity resulting from the introduction of the new DC flexibilities.

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. Consideration of the actuarial factors should take place alongside discussions on any benefit settlement exercises.

#### Conclusion

DB schemes continue to be a burden for many employers, but there are many ways in which employers can take the initiative and help manage their exposure to pension liabilities.

Barnett Waddingham has considerable experience of assisting employers throughout the actuarial valuation process and devising 'settlement paths'. We are happy to discuss solutions appropriate to your circumstances.

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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