Deloitte.

Faculty of Actuaries Students' Society.

Current Topics 2008. Pensions.

The Year in Pensions

March 2008

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1. Accounting

Market movements

The graph below shows the movement of the yield available on the AA-rated 15+year corporate bond index, the Bank of England measure of market-implied inflation over 20 years and the FTSE All-Share Index over 2007.

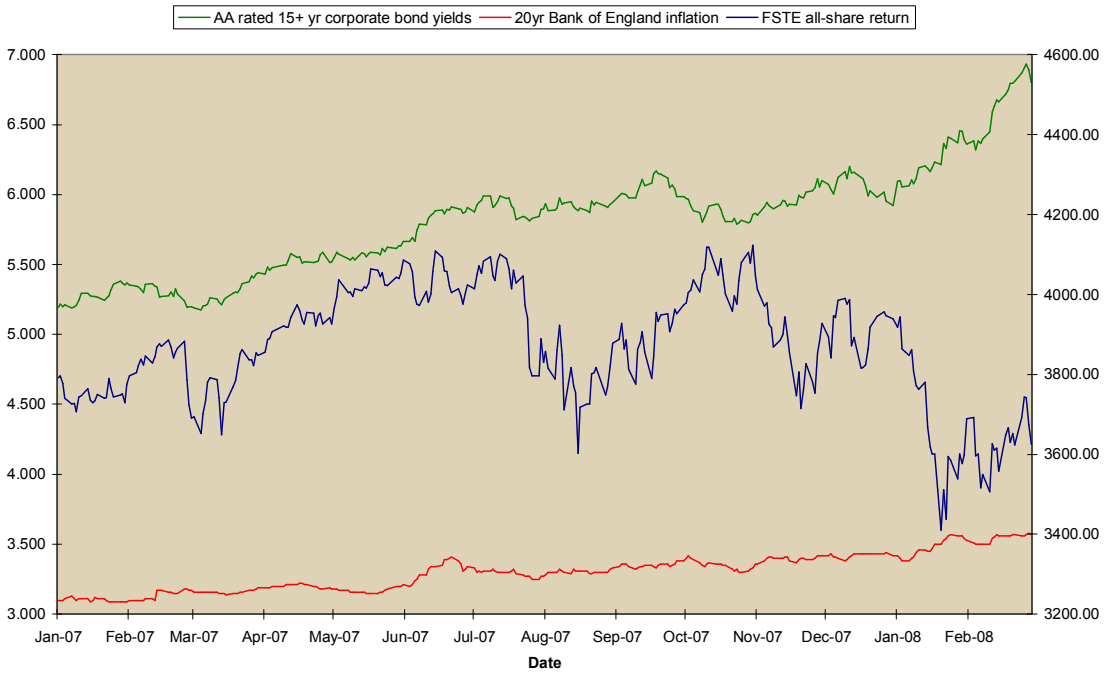

Figure 1: The yield on the 15+ year AA-rated corporate bond index; the 20-year Bank of England Inflation Measure; and the FTSE All-Share index

Under the accounting standards FRS17 and IAS19, currently in force for all UK companies with defined benefit pension schemes, liabilities are measured using a market value approach. Future cash flows are projected using, as appropriate, market-implied inflation, expected salary increases etc to project increases in benefits, and discounted at a rate determined by the yield available on high quality corporate bonds. Both of these measures should be calculated from bonds with durations similar to that of the pension liabilities.

Corporate bond yields have increased at all durations (in absolute terms and also relative to gilts) over 2007 due to increased pessimism in the markets over the state of the UK economy - a sentiment not discouraged by the “credit crunch” in the second half of the year. Market-implied inflation measures have also increased, reflecting fears of future inflation, but increases in inflation have not kept pace with increases in corporate bond yields. This has led to a general decrease in the accounting value of pension liabilities in the UK.

Pension scheme asset levels have increased over the year with equity returns of around 3.5% over the year[1]. Due to high volatility in equity returns (as shown in the graph above), many pension schemes have reduced their exposure to equities and moved to other reduce investment risks. These schemes were still able to experience high relative returns in 2007.

An increase in asset levels also occurred as a result of many schemes receiving a higher level of employer contributions than in previous years. According to the Pensions Trend Survey

[1] Based on movements of the FTSE All-Share Index

Report…2 2007 34% of employers have made fixed monthly or annual additional contributions to their scheme and another 31% have paid significant lump sums to reduce their scheme deficits. The survey also notes that increased employer contributions have been put in place in 65% of schemes in order to meet future service benefits[2].

These market movements have led to significant improvements in funding levels on an accounting basis, with many pension schemes in surplus on an accounting basis at the end of 2007 for the first time. This can be seen on the graph below which shows the movement of aggregate FTSE 100 surplus over 2007, as estimated by Deloitte.

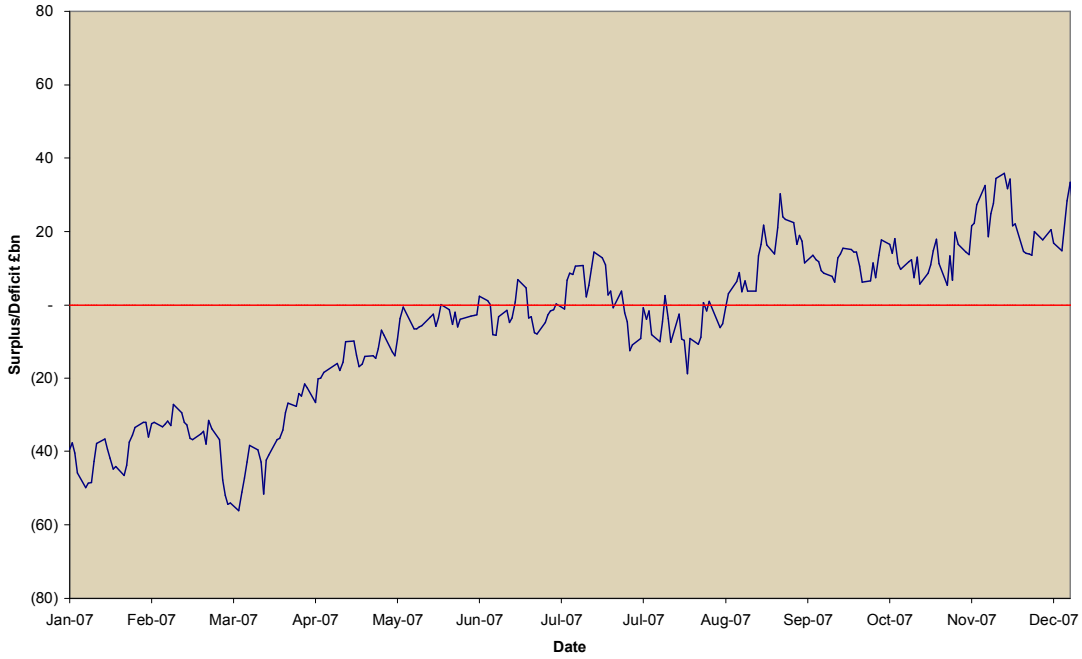

Figure 2: Deloitte estimate of aggregate FTSE100 pension funding under FRS17.

1.2 Disclosure of surplus

The accounting interpretation IFRIC 14, which was finalised on 5 July 2007, acts to provide a clearer interpretation of the availability, or economic benefit for an employer, of a surplus measured on an accounting basis. It is effective for all accounting periods beginning on or after 1 January 2008 although early adoption is allowed. The aim of IFRIC 14 is to ensure that entities recognise an asset in relation to a surplus on a consistent basis.

Many employers have a liability to pay future contributions into a scheme in respect of past service (i.e. to repair the deficit) – they must now consider whether these contributions give rise to an "irrecoverable surplus". This is a surplus from which no economic value is available to the employer either by way of a refund of the surplus or a reduction in future contributions (IAS19 Paragraph 58).

If so, the contribution commitment must be recognised as a liability. This may increase the deficit reported on balance sheet (or even lead to a deficit where the actuary has calculated a surplus). Therefore it is extremely important that companies and auditors think about any funding commitments.

[2] UK 2007 ACA Pension Trends Survey Report…2

Actuarial technical support is vital to establish if a pension scheme surplus is really an asset, and if additional liabilities exist due to funding agreements[3].

1.3 Proposed move to risk free rates for corporate accounting.

The Accounting Standards Board has issued proposals to change the discount rate used for calculating scheme liabilities – a move that could increase FTSE 100 scheme liabilities by £90bn. The UK accounting body said its discussion paper – The Financial reporting of Pensions, issued in conjunction with European standard setters – proposes to replace the AA corporate bond discount rate currently used for calculating scheme liabilities with a risk-free rate of return, such as government gilts or a swap rate. This will have the effect of bringing scheme liabilities more into line with that of discontinuance/buyout valuations.

The proposals also include modifications to the way returns on assets are accounted for and reduces the account taken in the liability assumptions for future increases in salary.

Commenting on the proposals, ASB chairman Ian Mackintosh said: “The current generation of pension accounting standards have served the financial community well but, with the benefit of our experience of applying these standards, the time is right for a fundamental review by the International Accounting Standards Board and the Financial Accounting Standards Board. This paper presents a coherent set of proposals, which sets out the agenda for such a review. We look forward to a wide response so that all views on these important issues can be considered.”

Comments on the discussion paper are requested by July 14. After consideration of the responses to the proposals, a report setting out final recommendations will be issued for consideration by the IASB and FASB.

If these proposals are implemented, companies will be required to recognise a pension liability on their balance sheets closer to a buy-out valuation. This may increase the level of buy-out activity as the additional margin required, relative to the accounting liability to affect a buy-out, will be reduced.

[3] IASPlus

2 M&A Activity

It has been an interesting year in corporate transactions with the first half of the year buoyant and seeing a number of large scale transactions and, following the credit crunch, the second half of the year seeing a lower level of activity although still with a number of mid-sized transactions going through.

When corporate transactions occur and there are defined benefit pension liabilities on the target companies balance sheet, the assessment of the amount of debt recognised in pricing the deal and the contributions required by the trustees of any pension schemes after the deal can be critical.

The Pensions Regulator has wide-ranging powers to intervene in transactions which may threaten the security of the pension scheme. He may impose contribution notices or financial support directions requiring either extra cash or security to be given to the scheme altering the profitability of the deal. Participants in a deal may seek comfort from the Regulator that a proposed transaction will not trigger these powers and 'clearance' is more likely to be obtained if it is sought with the agreement of the trustees. When deals are made with trustees in a transaction, they may consist of a mixture of upfront funding paid into the scheme, increased contributions or charges over the sponsor's assets in default.

The Alliance Boots transaction was completed in April 2007 and was the first private equity purchase of a FTSE100 company with a final purchase price £11.1bn. The debt raised for this transaction carried a 'covenant-lite' arrangement which waters down the financial restrictions usually placed on private equity funds in highly-geared transactions. As a result of the transaction, KKR were forced to give the pension scheme trustee a £1 billion package to cover the company's pension schemes, comprising a security package worth £600m and increased contributions amounting to £418m spread over ten years.

Following the credit crunch there were sharp increases in the cost of borrowing and reductions in the amounts of money that banks were willing to lend. As servicing debt requires liquidity and as market liquidity has dried-up and credit spreads have widened, highly-geared private equity transactions and entities such as hedge funds and investment banks have been hit particularly hard. As many pension schemes are now investing in private equity and hedge funds, the credit crunch may hit pension scheme assets directly if a number of these entities become insolvent or cannot do deals.

Sovereign wealth funds, owned by overseas governments, are not exposed to the same sources of liquidity as private equity funds and so have been able to carry out some transactions. Between July and November 2007, Quatari-backed Delta Two made an approach to purchase Sainsbury's in a £10.6bn bid. In early 2006, Sainsbury's had paid £350 million into its £580 million pension deficit after raising £2 billion securitising some of its properties. Discussions with its pension scheme trustees began in September 2007 and it was estimated that still a package of as much as £2bn might be required. Delta Two decided not to proceed with an offer in November.

If liquidity remains a problem in the markets then the amount of distressed debt is likely to increase. As asset values remain volatile and have been falling, a number of companies may become vulnerable to takeover approaches and a level of M&A activity is likely to continue.

3 Trends in Provisions

3.1 Continued movement towards DC provision

According the Pensions Regulator's statistics, almost 2,000 defined benefit schemes closed between 1995 and 2005. This trend peaked in 2002 following dramatic falls in equity markets and pension scheme assets. The shift from defined benefit pension arrangements to defined contribution arrangements is continuing; albeit at a slower rate than before, with several high-profile scheme closures in the last year. Examples include Unilever, who closed their final salary scheme to new members and replaced it with a hybrid scheme and Michelin, who closed their scheme to future accrual.

The 2007 ACA Pension Trends survey found that 81% of defined benefit schemes run by respondents are closed to new entrants, up from 68% two years ago. The number of such schemes closed to future accrual of pension has increased to 14% of schemes.

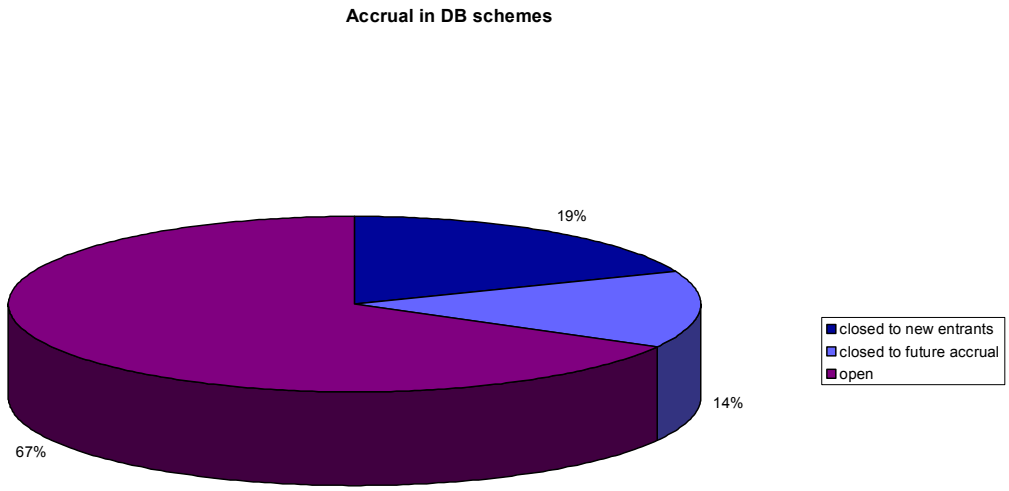

Figure 3: Current status of UK DB schemes[4]

[4] UK 2007 ACA Trends Survey Report…2

The survey also found an increase in the closures of occupational defined contribution schemes, where trust based arrangements are being displaced by contract-based plans, notably Group Personal Pensions.

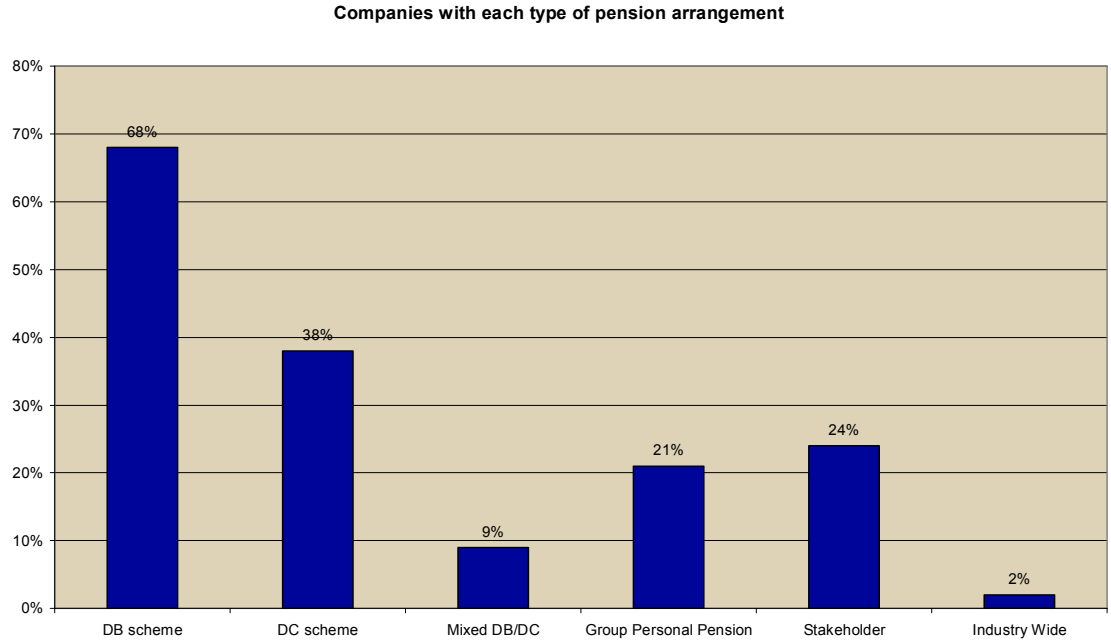

Figure 4: Types of UK pension schemes in which benefits are accruing[5]

3.2 Rising employer defined contributions

One of the concerns about the move to defined contribution schemes is that, as well as transferring the investment and longevity risks to individuals, it has also been linked to a reduction in contribution levels by employers. However, the ACA Pension Trends surveys show that average employers' contributions to their defined contribution schemes have increased over the last five years. This trend may alternatively reflect more large employers offering defined contribution schemes at greater contribution rates.

The table below reveals a trend of increasing average employer contributions (as a percentage of total earnings), without as significant an increase in employee contributions.

		2002	2003	2004	2005	2006	2007	Long-term expected
Defined Contribution	**Employer**	5.1%	5.2%	5.8%	5.9%	6.0%	6.2%	7.4%
	Employee	3.4%	3.5%	4.0%	4.1%	4.1%	4.1%	5.0%
Group Personal Pension	**Employer**	5.6%	5.6%	5.8%	6.1%	5.8%	6.0%	7.2%
	Employee	3.6%	3.8%	3.6%	3.8%	4.0%	3.9%	4.3%
Stakeholder	**Employer**	5.0%	5.2%	4.3%	4.5%	4.0%	4.1%	6.0%
	Employee	3.3%	3.5%	3.7%	3.8%	4.1%	4.1%	5.3%

Figure 5: Trends in contributions to defined contribution arrangements[6]

[5] UK 2007 ACA Trends Survey Report…2
[6] UK 2007 ACA Trends Survey Report…2

3.3 De-Risking of DB Pensions

In recent years companies have become increasingly concerned with the investment and mortality risks associated with their defined benefit pension schemes. Many companies are now making the move of 'de-risking' their schemes. De-risking strategies range from changes in the benefits provided, to the implementation of Liability Driven Investment (LDI), to partial or even full buy-out of the pension scheme liabilities.

3.3.1 Buy-Out Strategies

In the last few years, the buy-out market has seen a significant influx of new participants including Paternoster, PIC, Lucida, Goldman Sachs (Rothesay Life) and Synesis Life. The new entrants have transformed the dynamics of the industry: there has been a reduction in buy-out costs due to increased competition; and there has been a dramatic improvement in service standards and reduction in the time required to execute buy-out periods.

However buy-out can still remain a relatively expensive option for most companies, relative to their accounting provisions or technical provisions:

- Buy-out companies discount cashflows using swap yields or other proxies for risk-free interest rates allowing them to reduce their exposure to investment risks. As risk-free rates are significantly lower than the discount rates used in funding valuations or for accounting this will tend to increase estimates of the liabilities.
- Buy-out providers incorporate a degree of prudence in their mortality assumptions to reduce their exposure to the longevity risks of the scheme. Often buy-out mortality assumptions will be more prudent than those used for funding valuations or for accounting and this will tend to increase estimates of the liabilities.
- Insurance companies will expect buy-outs to generate profit. This is explicitly allowed for in an additional margin for profit which is not required in funding or accounting valuations.

Buy-out tends to be most attractive for companies with relatively mature pension schemes and few active members. In these circumstances the cost of buy-out is likely to be less than for the average scheme and the balance between the reduced risks and costs likely to be more favourable. These schemes may also make a long-term saving per-member fees paid to advisors and administrators.

Although highly dependent on the membership profile of the scheme, recent estimates of liabilities on a buy-out basis show that buy-out costs between 20% and 40% more than the ongoing liabilities calculated on an accounting basis.

The main types of risk-transfer to insurers typically considered are:

- Full buy-out: all obligations to administer and pay benefits are transferred to the insurer. This leaves the company with no further pension liability or risk.
- Partial risk transfer: the liabilities of members with the lowest increase in cost to buy-out may be secured for annuity contracts either within the scheme or by transferring the liabilities themselves. Although this option may reduce the liabilities, it may increase the risks left behind in the scheme as the members with the lowest cost to buy-out are likely to represent the lowest risk. This has been common in the past where schemes purchase annuities when members' benefits are put into payment.
- Progressive risk transfer: a programme of successive partial transfers of liabilities are made.
- Reinsurance: another option for risk-transfer is by reinsurance of the funding position in the scheme. Under this arrangement the reinsurer insures the variation between the expected and actual deficit at a specified point in the future for a given portfolio of liabilities and investment strategy. Types of cover for the variation may vary as with other reinsurance arrangements.

As with all transfers of risk, the greater the certainty offered to the pension scheme, the greater the cost in obtaining the transfer. Recent transactions in the buy-out market include:

- £800m transfer of shipping company P&O's pensioners to Paternoster in December 2007; and
- £700m buy-out of gaming company, Rank's entire pension scheme by Goldman Sachs in February 2008.

Other arrangements may reduce pension scheme risks such as futures or swaps to eliminate investment and inflation risks. Although a clear intention of many market participants, the longevity derivative market is still very much in its early stages.

3.3.2 Deferred Liability Management (DLM)

Despite the falling costs, the option of fully removing all the pension risks through buy-out still remains an unviable option for many companies and pension schemes.

Instead, there has been an increasing tendency for companies to take action to reduce their liabilities due to deferred members, through deferred liabilities exercises such as:

- enhancing the normal transfer amount for deferred members;
- paying a cash sum directly to them in order to encourage them to transfer out of the scheme; or
- encouraging members to take advantage of the trivial commutation rules.

These exercises reduce the overall liabilities and the administration expenses incurred in valuing and paying small individual benefits. The actual reduction of deferred liabilities, and hence savings, depends on several factors, including the budget available for cash incentive payments and the take-up rate by the members.

Deferred liability exercises are usually led and implemented by the sponsoring company with the knowledge and support of the pension scheme trustees.

4 Mortality

Increasing longevity, particularly among people born between the wars, has received a high degree of media coverage and produced a significant strain on pension schemes over the past 20 years. As mortality assumptions have been strengthened to reflect these improvements, they have been responsible for increasing liabilities and contribution rates. Uncertainty over future rates of improvements in mortality has prompted greater scrutiny by the Regulator of the assumptions used by pension schemes and greater research by the actuarial profession into predictive models of future improvements.

A technical explanation of terms: a 'base' table is a table giving a single assumption of mortality for each year of life and in a single calendar year. It should be a graduated set of results from a mortality experience survey. A base table may be projected into the future to produce a 2-dimensial table of assumptions giving the mortality of each year of life in each calendar year covered by the projection. The method for estimating annuities may then be based on either following the mortality for each age group in a single calendar year (calendar year method); or by following the path of someone born in a particular across the projection (birth year method).

4.1 CMI SAPS survey – new graduations released

The Continuous Mortality Investigation (CMI) is responsible for providing standardised tables for use by the UK actuarial profession. Historically the CMI has used life-office experience data to produce annuitant tables owing to the quality and availability of life-office data. The most up-to-date base tables for life-office annuitants released by the CMI are the '00' series released in 2006[7].

As pension scheme data has become more computerised and improved in quality, the CMI launched the Self-Administered Pension Schemes (SAPS) survey and carry out analysis on pension scheme data collected in actuarial valuations between 2000 and 2006. The greater number of annuitants within pension schemes has given the CMI SAPS survey a much larger volume of data than the life-office survey with exposed to risk of c.£48bn pa available for the amounts analysis. Graduations of the CMI SAPS results should be more consistent with pension scheme mortality experience.

Following consultations with the actuarial profession during 2007, the CMI SAPS survey released its first graduations in January 2008[8]. The graduations are split to give normal retirement pensioners, ill-health retirement pensioners and dependents base tables. It was found that pension amount provided a significant factor affecting mortality and the tables for male pensioners are split into 'heavy' and 'light' mortality groups with the 'heavy' mortality group receiving less than £8,500pa. Both female pensioners and dependants tables are split into 'heavy' and 'light' mortality with 'heavy' mortality applying below £3,000pa. Due to the volume of data available for male dependants no split is available for these members.

[7] CMI Working papers 21 and 22
[8] CMI Working papers 31 and 32

The following figure shows the mortality assumptions of:

- PMA92 (Pensioner Male Amounts from the '92 series') projected to calendar year 2000 with the medium cohort projection;
- PNMA00 (Normal as opposed to Early retirements) unprojected;
- SNMA03 (SAPS Normal as opposed to Ill-health retirements) light unprojected; and
- SNMA03 heavy unprojected

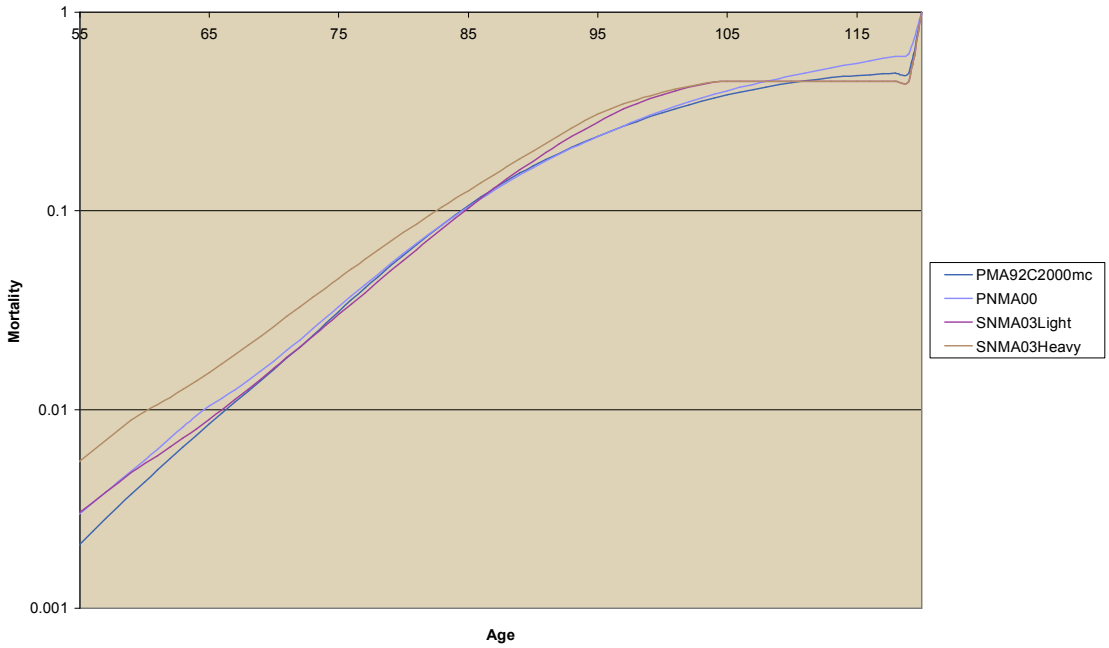

Figure 6: PMA92C2000mc, PMNA00, SNMA03 light and SNMA03 heavy

These tables are base tables with the exception of PMAc2000mc which has been projected using the medium cohort projection released by the CMI in 2002. In all of these assumptions, the mortality at age 120 is assumed to be 1 (a certainty of death).

The heavy mortality group in the SAPS survey has experienced heavier mortality than the groups underlying the Life-Office assumptions and this may suggest that pension schemes have over-estimated liabilities using Life-Office tables. However, as pension scheme liabilities have long durations, liability estimates rely heavily on the method of projecting mortality into the future and may be more sensitive to this assumption. No analysis of trends in mortality experience from the SAPS survey has been released as yet.

4.2 Research into improvements

Research into recent rates of mortality improvements and into the models to project these rates into the future is a major area of actuarial discussion. There are a number of methods available and used by pensions actuaries to build margins for future improvements into mortality assumptions. Little consensus has emerged as to the most appropriate methods to use in the future although the cohort improvement factors are still the most commonly used at present.

The 92 series were issued with in-built assumptions of future mortality, projected using a formula. When subsequent mortality experience showed that the formula had understated mortality improvements, a 'quick-fix' set of interim projections were released by the CMI in 2002 to model the mortality improvements of the cohort of male lives that had improved the most rapidly, the cohort projections. These came in three types: the short, medium and long cohorts with increasing allowances for time of improvements applying.

The CMI decided not release a set of mortality projections to be used with the '00' series tables In 2006. The emphasis of CMI research has shifted into providing actuaries with the tools necessary to project mortality improvements for themselves from either standard datasets, such as ONS data, or from the mortality experience data collected by individual actuaries.

A number of projection tools have been presented in working papers issued by the CMI including the P-spline and Lee-Carter models. These models need a number of assumptions to be determined by the user, can be highly sensitive to the most recent data in the dataset and only limited consensus has been formed as to their suitability. In particular there is an increasing recognition that mortality improvements should not be assumed to tail off to zero or even increase mortality in the future. Under certain sets of assumptions both models can produce these outcomes.

Although it is important to be consistent with the datasets underlying the base and mortality projection assumptions, the quantity of data required and the number of years needed for credible results to be obtained mean in practice that standard tables and projections are the most common approaches. Pensions actuaries have not generally adopted these tools to project future mortality improvements and are taking simpler approaches instead. Although not theoretically justified, a common approach is to use the cohort projections, designed initially to modify the male '92' series amounts table (PMA92), to project both male and female base tables from the '00' series. As the cohort projections tend to a zero in the long term, these may also be modified to include a floor in improvements, commonly between 0.75% and 1.5%.

A simpler approach still would be to use a flat rate to model improvements, possibly limited to certain age groups. The base tables or projected assumptions could be further modified by using an age rating (i.e. applying the mortality of a different age); by reducing the discount rate used to value the liabilities; or by applying a global multiplication factor over the mortality assumption (a K-factor). Reductions to the discount rates used to value liabilities is a proxy for a flat rate approach although are a less sensitive tool.

The major causes of improvements in mortality over the last one hundred years have been due the reduction in death due to infectious diseases and due to respiratory diseases. Possible future reductions may occur due to reduced rates of smoking in the population or the discovery of a cure for cancer. With increased levels of data recorded at death, there has been some work to analyse trends in causes of death caused and it is hoped that by building models of these improvements, more accurate projections of future mortality may be obtained. The work in this area is at a very preliminary stage, although it may form the basis of future models.

4.3 Funding and accounting assumptions

With funding valuations required by law to be carried out on pension schemes at least every three years, many schemes are encountering the scheme specific funding objectives (SFO), introduced in 2006, for first time. Under SFO the assumptions used in the valuation should be specific to the circumstances of the pension scheme. Mortality assumptions should therefore receive increased focus in determining whether they may be considered appropriate and this may lead to a general trend of increasing strength in mortality assumptions.

This trend has been seen in the increasing strength in the mortality assumptions used for funding and accounting valuations. Our preliminary analysis of accounting assumptions used as at 31 December 2007 show that:

- The most common assumption used in accounting is still PMA92 projected using the medium cohort and using a year of birth approach.
- An increasing number of pension schemes have adopted the '00' series base tables and are projecting them using the cohort projections. These schemes are also most likely to be modifying the cohort assumptions to introduce a floor into mortality improvements.
- A significant number of schemes are still using older assumptions such as PMA92 with the original 92 series projections applied.

- A range of schemes are using reductions in discount rate, age ratings or K-factors to model improvement.

The variety of mortality assumptions used in practice shows the difficulties in comparing pension scheme liabilities and the variety of possible mortality experience in the underlying schemes. Whilst the general trend has been to increase liabilities, this has happened at different rates for different pension schemes. Whether this reflects an accurate assessment of differing future mortality improvements remains to be seen and the support of actuarial advice is vital for companies and trustees to be able to understand which assumption is the most appropriate given their particular circumstances.

5. Regulator News

5.1 Overview on the purpose of the Regulator and its powers

The Pensions Regulator (the "Regulator") replaced the Occupational Pensions Regulatory Authority from 6 April 2005.

The Regulator's statutory objectives are to:

- protect the benefits of members of work-based pension schemes;
- promote good administration of work-based pension schemes; and
- reduce the risk of situations arising that may lead to claims for compensation from the Pension Protection Fund (PPF).

The Regulator has powers to act where they believe that an employer is deliberately attempting to avoid their pension obligations, leaving the PPF to pay their pension liabilities. These powers are known as the moral hazard powers of the Regulator.

The Regulator has a number of powers:

- Contribution Notices: These notices allow the Regulator to direct that, where there is a deliberate attempt to avoid a statutory debt, those involved must pay an amount up to the full statutory debt either to the scheme or to the PPF.
- Financial Support Direction (FSD): These require financial support to be put in place for an underfunded scheme where the Regulator concludes that the sponsoring employer is either a service company or is insufficiently resourced.
- The Regulator may also appoint independent trustees to pension schemes it feels do not have sufficient expertise available to them.

The Regulator also operates a clearance procedure, available for anyone who wishes to confirm that they will not be subject to either a contribution notice or a financial support direction following a proposed transaction, payment of extraordinary dividends, change in financing or control of a sponsoring employer.

5.2 Regulator issues FSDs to Sea Containers Ltd

In June 2007, the Pensions Regulator's published Determination Notices indicating the intention to issue its first FSDs to Sea Containers Limited.

The Pensions Regulator confirmed on 6 February 2008 that on 31 January, Sea Containers withdrew its appeal to the Pensions Regulator Tribunal against the decision to issue the Financial Support Directions on the company.

Sea Containers Limited will now be compelled to provide a form of financial support which is satisfactory to the Regulator to the two schemes within 30 days of the FSD being issued.

From the Regulator issuing a Warning Notice to Sea Containers in October 2006, it has taken approximately 16 months to reach this position, reinforcing the uphill battle it faces in exercising its moral hazard powers. This is the first time that the Regulator has issued FSDs and used its anti-avoidance powers against a company that is avoiding its pension obligations[9][10].

[9] The Regulator Press Release – 6 February 2008, 18 June 2007
[10] Sea Containers Ltd Press Releases – 6 February 2008, 24 July 2007, 18 June 2007,

5.3 Regulator appoints three independent trustees to Telent pension scheme

When most of the former Marconi business was sold to the Ericsson Group in 2006, it left the remainder of the company, renamed as Telent, with control of the pension scheme. As part of the clearance application to the Regulator at the time, Telent set aside a sum for the protection of pension benefits under the company's pension scheme. Part of this sum was set aside in an escrow account.

Following a bid for Telent made by the Pension Corporation LLC in September 2007, the Trustee Board of the Telent Scheme voiced their concerns to the Regulator about the potential implications for the security of the members' benefits. In October 2007, the Pensions Regulator confirmed that it has successfully applied to use its powers to appoint three independent trustees with immediate effect. This was the first time the Regulator had applied its power to appoint independent trustees without issuing a Warning Notice[11][12].

In a press statement released on 19 October 2007, Jonathan Seres of Sackers, lawyers to the Telent trustees, said: "The appointment of independent trustees by the Pension Regulator to protect the pension scheme of Telent is a timely and decisive move. It shows that the Regulator will not simply watch from the wings when there is concern that a pension scheme may be at risk."

5.4 Importance of a strong employer covenant and Scheme Specific Funding

The Pensions Regulator describes the employer covenant as "the employer's financial position and prospects, as well as its willingness to continue to fund the scheme's benefits".

Before 30 December 2005, scrutiny of the funding position of defined benefit schemes was based on the minimum funding requirement (MFR). This valuation basis valued accrued rights on leaving service and took no account of the cost of future service. This was a very weak basis and being fully funded on this basis offered little security to members.

The Pensions Act 2004 introduced the statutory funding objective (SFO) to encourage pension schemes to increase funding levels. The SFO requires defined benefit schemes to hold sufficient and appropriate assets to cover its 'technical provisions' - the amount required to provide for its liabilities.

This new scheme-specific funding basis is generally much higher than the MFR, and gives trustees the power to set funding targets according to the circumstances of the scheme and the strength of the employer. In the past, many companies had control of, or at least a veto over, the contribution rate. The new regime requires trustees and sponsors to agree the basis used for funding valuations and the contributions required to meet any deficit identified. This has added to pressure on companies to increase pension scheme funding levels.

The Regulator has made it clear that it is essential for trustees to make an objective assessment of the employer's covenant in order to make decisions on both the technical provisions and any Recovery Plan needed.

Where the scheme is found to be insufficiently funded to meet its technical liabilities, a Recovery Plan must be submitted to the Regulator, setting out the steps to be taken to meet the SFO and the period within which that is to be achieved.

The Recovery Plan will then be scrutinised by the Regulator against 'trigger points' in order to decide what, if any, further action needs to be taken to meet the Regulators objectives.

[11] Telent Pensions Update newsletter February 2008
[12] The Regulator Press Release – 9 November 2007, 19 October 2007

The trigger points that Recovery Plans are measured against are:

- a recovery plan longer than 10 years;
- a contribution schedule that assumes contributions will increase significantly - 'back-end loading'; and
- inappropriate long-term return on assets assumption[13].

The extent to which trustees and sponsors have embraced the new funding regime was revealed in an analysis of the recovery plan data by the Regulator in September 2007.

- No further action was required for around 1/3 of recovery plans submitted;
- Of the schemes that hit trigger points, a large proportion needed only minimal action, such as a request for further information or the need for clarification of points of detail with trustees.
- Intervention in Recovery Plans has only been required in c.10% of scheme valuations[14].

5.5 Consultation on trigger of long cohort projection

In February 2008, the Pensions Regulator published a consultation document setting out a new approach to scrutinising the mortality assumptions being used for scheme funding valuations and recovery plans. Closer examination will be applied to any scheme which assumes rates of mortality improvement which:

- appear to be weaker than the "long cohort" projections; and
- assume that the rate of improvement tend to zero in future, that is, do not include a "floor" or underpin to the rates of improvement.

This change in policy will be applied retrospectively to all scheme valuations with an effective date later than 31 March 2007 and so may affect schemes whose valuation is already in progress as well as those going forwards.

The proposal represents a wider and long term trend towards recognising the rapid improvements in mortality which have been observed in recent years and the likelihood that they will continue for the foreseeable future. Although the Regulator's remit only extends to funding valuations, it is likely that, if adopted, this guidance will also influence the choice of assumptions used for pensions disclosures in company accounts.

In practise this will probably affect the majority of schemes currently submitting funding valuations and recovery plans. The Regulator's own research indicated that 99% of schemes which submitted valuations before September 2007 would have triggered further scrutiny if these proposals had been implemented.

For a scheme currently using the medium cohort projections, moving to the tables indicated by the Regulator could add up to 10% onto the present value of the scheme's liabilities. Consequently, this will increase the funding required by scheme sponsors.

The proposal is still at the consultation stage. If adopted, it could significantly increase the burden of funding pensions place on companies and may push some to reconsider the relative merits of running defined benefit pension schemes[15].

[13] www.thepensionsregulator.gov.uk
[14] Recovery Plans – an initial analysis (September 2007)
[15] Pensions Regulator press release – "Regulator sets out intentions on longevity" – 18 February 2008

In a press release on 18 February 2008, the Regulator's Chief executive, Tony Hobman, said: "Over the past couple of years there have been significant developments in our knowledge of trends in mortality. It is the regulator's view that some projections that have been in common use can no longer be considered reasonable assumptions. We wish to bring these developments to the attention of trustees and outline how they should go about deciding on funding assumptions for defined benefit schemes. Scheme members living longer adds to the cost of pensions and it is right that schemes recognise this in their funding."

5.6 Consultation on defined contribution schemes

On 13 November 2006 the Regulator issued a consultation document on "How the Pensions Regulator will regulate defined contribution ("DC") schemes in relation to risks to our members". In this the Regulator proposed a 3-pronged approach:

- Education and Guidance on the standards which the Regulator expects in relation to a well dun DC scheme;
- Working in partnership with the industry, the FSA and the government to develop good practice guidance and identify future initiatives; and
- Intervention when risks in DC are identified

Following the consultation period the Regulator concluded that the comments provided did not merit any fundamental changes to the approach proposed. In particular the Regulator stressed that the approach is not intended to increase the burden of those running DC schemes but rather to provide guidance and information and to encourage common standards. The Regulator also made clear that any intervention will only be considered as a last resort and that in such a case appropriate and proportionate powers would be used.

Good practice guidance will now be developed taking into account the consultation responses received and using examples set by already well-run schemes within the industry[16].

The consultation closes on 12 May 2008.

5.7 Regulator consultation on conflicts of interest

The Pensions Regulator has published a consultation document on guidance relating to conflicts of interest.

The draft guidance is designed to help trustees of occupational pension schemes assess the adequacy of governance arrangements they put in place to manage conflicts of interest which may arise when a personal interest or duty to another party conflicts with their fiduciary duty to the scheme. Such conflicts could inhibit open discussions or result in decisions, actions or inactions that are not in the best interests of the beneficiaries. The guidance also covers conflicts of interest affecting professional advisers and pensions managers involved in running the scheme.

TPR chief executive Tony Hobman said: "Robust processes to identify, monitor and manage conflicts are integral to a well governed scheme. Effective governance of conflict of interest by trustees is critical to helping us achieve our objectives of protecting members' benefits and promoting good scheme administration.

[16] Consultation Report – How the Pensions Regulator will regulate defined contribution schemes in relation to members (April 2007)

The key principles covered in the guidance are:

- Understanding the importance of conflicts of interest;
- Conflicts of interest policy;
- Identifying conflicts of interest;
- Evaluation, management or avoidance of conflicts; and
- Managing adviser conflicts

The consultation closes on 30 May 2008.

6 The Pension Protection Fund

The Pension Protection Fund (PPF) is a public corporation, established under the Pensions Act 2004, whose function is to provide compensation to members of eligible DB pension schemes,

- when the sponsoring employer suffers a qualifying insolvency event; and
- there are estimated to be insufficient assets in the pension scheme to cover the benefits protected by the PPF (PPF liabilities).

As at March 2007, there were 179 DB schemes in the PPF's assessment period (which is triggered by a qualifying insolvency event of an employer of an eligible scheme), with a total membership of 115,000. Around 51% of the schemes in assessment came from the manufacturing industry, whilst 16% came from services. The majority of schemes in assessment were medium sized in terms of membership, with 94 schemes having between 100 and 1,000 members. There were only 4 schemes with more than 3,000 members.[17]

At March 2007, 9 schemes had completed the assessment period and entered the PPF, which was paying 1,457 pensioners compensation at a rate of £6.6m pa. A further 7 schemes were transferred into the PPF in the period to the end of January 2008[18].

One of the PPF's main sources of funding is through an annual levy paid by eligible defined benefit schemes:

- 20% of the levy is calculated under a "scheme-based" formula
- the remaining 80% is calculated using a "risk-based" formula.

Scheme-Based Levy

This is calculated as a fixed proportion of the funding a scheme would need in order to pay out the benefits protected by the PPF. All eligible defined benefit schemes must pay the scheme based element of the pension protection levy.

Risk Based Levy

The risk based element of the levy is based on an analysis of:

- the difference between the value of the scheme's assets and its PPF liabilities; and
- the likelihood of an insolvency event in relation to the sponsoring employers measured through the Dun&Bradstreet failure score.

Recognition is also given in the calculation to any contingent assets the scheme may call upon should the financial position of its sponsor deteriorate. Examples include parent company or bank guarantees, charges over sponsor's assets or other security put in place by the scheme.

On 29 November 2007, the PPF published its proposals of how the levy will be calculated in the scheme year 2008/09. Although the total levy which the PPF aims to collect for 2008/09 remains constant at the 2007/08 amount of £675m, this does not mean "no change" for schemes:

- the funding threshold over which schemes pay a reduced risk-based levy has moved from 104% to 120%, and schemes need to be over 140% funded to pay no risk-based levy.
- the per-scheme cap on the risk-based element of the levy will be reduced from 1.25% to 1% of PPF liabilities. The aim of this is to protest the weakest schemes from disproportionately high levy bills.

The PPF takes the view that long-term fairness supports these proposals, which are designed to result in a higher proportion of the levy being collected from larger, well-funded schemes[19].

[17] The Purple Book 2007
[18] PPF List of Transferred Schemes – January 2008

[19] www.pensionprotectionfund.org.uk