Exploring Group
Pensions

Issue 7

By Mattioli Woods

Exploring Group Pensions is designed and written for those who have an active role in the administration, management and auditing of group pension arrangements

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Issue 7 introduces guest writers – Philip Allsop and Howard Ringrose of Barber Harrison & Platt and David Pettitt of Cartwright Consulting Limited.

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Mattioli Woods
Pension Consultants

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barber harrison & platt
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Grasp the Nettle – Investment Turmoil

We all have every right to be angry. We have been led to believe that our banking system in the UK was the 'envy of the world', sophisticated and stable. We were told Britain had never enjoyed such sustainable economic growth, and that the level of deregulation in the City was a positive.

Whilst the above affects almost everyone in the UK, the impact on defined benefit schemes is likely to be right up there in contributing maximum misery.

Whilst it might be stating the obvious, there are quite a large number of factors emanating from the credit crunch which will worsen the plight of defined benefit schemes, and threaten members' pensions. First and foremost is the almost inevitable long-term consequence on long-dated gilt yields. It is almost certain that interest rates will continue to decline in an attempt to restore equilibrium and growth to the economy, and we think that this may be the start of a new 'step-down' in interest rates over the long-term – much the same as was seen in the 90s.

Since almost all investment returns are closely interrelated, particularly so with the yield on long-dated gilts, it is going to be harder for trustees to find investment returns that match actuaries' recent assumptions. A fall of say 2% in long-term gilt yields would, in very approximate terms, increase liabilities for a typical scheme by around 40%.

Against a backdrop of possibly enduring economic weakness, prospective price-earnings ratios of the major stock market indices are likely to fall compared with those of a few years ago. This would imply that it may take many years for stock markets to fully recover their historic highs,

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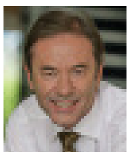


further exacerbating widening deficits. This will give trustees some very difficult decisions over if and when equity exposure should be reduced: consider the following possible scenarios.

Scenario 1

The recession only lasts a year or so, and we emerge with reasonably good growth and maintain our position on the world's stage. Clearly, in this scenario, it would probably be right to maintain existing equity allocations.

Scenario 2

The recession lasts several years, and followed by enduring economic weakness the UK slides down the international economic league tables, with Sterling accompanying the slide. Much like Japan for the last 20 years, stock market levels never really recover. Under these circumstances, an early switch out of equities into high-grade fixed-interest could well be the only successful strategy to recover some or all of the lost ground and strengthen the schemes.

Whilst all of this is going on, trustees also have to contend with continuing legislation which tends to strengthen actuarial requirements, thus inexorably adding to stress levels (both financial/actuarial and emotional!).

Whilst the Pensions Regulator, after consultation has confirmed that scheme longevity assumptions will now not be viewed as a trigger point, we believe this may be reviewed again and think it more likely than not that this will not be the last change in this direction.

For the vast majority of companies, defined benefit schemes no longer have a material part to play in the future of the business and, worse still, may well be one of the most significant factors in holding it back. There are a number of techniques by which the problem can be minimised, but we fear these will become evermore expensive.

PENSIONS CREDIT CRUNCH

Cartwright Consulting Ltd is a medium-sized actuarial consultancy which works together with Mattioli Woods on a number of joint clients. We take a look at some comments on the impact the recent credit crunch will have on defined benefit schemes.

All institutions, both financial and non-financial, are facing difficult times in the current 'credit crunch' and most, if not all, will be reviewing operational procedures to ensure these are robust in what are extremely turbulent times. Pension schemes are not immune to the 'credit crunch' and both trustees and sponsoring employers should be acting now to identify risks and implement any appropriate response.

Stock market volatility

Since the beginning of the year the FTSE 100 has fallen by approximately 30% (to the start of December 2008). Similar falls have occurred on all the major exchanges around the world. Most pension schemes still invest a significant portion of their assets in equities and as a result funding levels will have dropped, deficits will have increased.

For a pension scheme that was 80% funded on an ongoing basis at the start of the year, and assuming an equity asset allocation of 70%, the current funding level is likely to have dropped to 65%. In monetary terms this would have turned a £1million deficit into a £1.7million deficit – an increase of 70%. Mattioli Woods has also asked us to consider what would happen if the situation got even worse – for example, if long-term gilt yields were to fall from their current level of around 4.5% p.a. to around 3% p.a.. In such a scenario the liabilities on an ongoing basis would increase substantially and the deficit in the above example would increase further to around £3.2million. Hopefully this is not likely but it does illustrate how bad things could get.

Key issues

Trustees and employers should consider the following:

- Scheme funding may have deteriorated so much that the current funding plan is wholly inappropriate and an out-of-cycle valuation should be carried out and additional contributions requested; indeed the Statement of Funding Principles may make this a requirement.

- Transfer values may present an opportunity for deferred members to 'cash out' at a level that cannot be supported by the current funding level – this is likely to be further exacerbated if the trustees strengthened the transfer value basis in light of the new transfer value regulations.

- The impact of the pension scheme on the employer's year-end balance sheet and next year's P&L could be significantly worse than last year – expectations of shareholders, banks, etc should start to be managed.

- The effect of the 'credit crunch' on the employer's covenant should be considered by the trustees in terms of the impact on the security of members' benefits – if the trustees have powers to take action (for example requesting additional contributions) they should at the very least consider using such powers.

Comment

We are not advocating pressing the panic button. Actions which exacerbate any problems experienced by the employer are not necessarily in the spirit of the Pensions Regulator's mantra that a healthy employer is the best backing for a company pension scheme. However, the trustees' duty to monitor the funding level must be taken seriously and importantly must be seen to be taken seriously. Trustees need to talk to the employer and demonstrate to others (members, the TPR...) that issues generated by changing conditions are being considered. Waiting for a meeting next year or a valuation in two years' time, for example, is unlikely to show the required level of diligence.

Article by David Pettitt
Cartwright Consulting Ltd

Mattioli Woods is one of the UK's leading and fastest growing consultancies in its area of expertise, the provision of pension and wealth management services for controlling directors, professional persons, owner-managed businesses and small to medium-sized PLCs. In particular, the practice has specialised in the application and provision of small self-administered pension schemes (SSAS) and self-invested personal pensions (SIPP), and Group Schemes.

In October last year the Pensions Regulator confirmed it would be forwarding statements to trustees of all work-based pension schemes setting out its general position in relation to current market conditions.

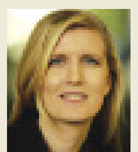
The statement highlights that:

- Recent developments in the financial markets will be of great concern to pension scheme trustees, sponsoring employers and scheme members;
- Trustees need to remain vigilant and to keep the position of their schemes under review;
- The regulator's current codes and guidance cover the relevant issues and allow sufficient flexibility for trustees;
- Trustees should continue to focus on making sound decisions in the long-term interests of scheme members.

David Norgrove, chairman of the Pensions Regulator is quoted as saying "The main issues faced by pension schemes in the current economic climate seem likely to be the more general fall in asset values and emerging pressures on employer covenants....trustees should continue to focus on making sound decisions in the long-term interests of scheme members."

David Norgrove also comments that pension schemes are long-term undertakings. We would echo his comments, and would add that apathy is a trustee's and employer's enemy. In these times it is important that we pull on all resources available and work with the appropriate professionals to obtain as much guidance and assistance as needed.

Hence for this edition we have called upon our professional contacts to give us their views, which we hope you will find to be interesting reading.



Article by
Karena
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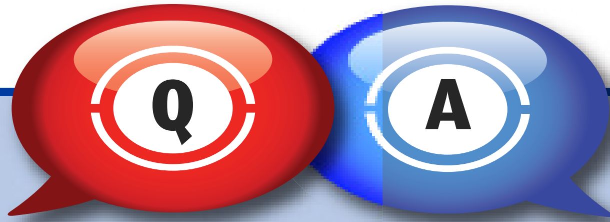

Pension Covenant Reviews – A tool for Pension Trustees in the current economic downturn

The current global financial crisis is a particularly challenging time for trustees of defined benefit pension schemes. The economic downturn is putting significant pressure on employer companies and supporting their pension scheme is only one of the competing priorities for the directors. It is important therefore that the scheme trustees take strong independent steps to protect the interests of the scheme members as far as possible. An ongoing dialogue with the directors is clearly essential, but the trustees also need to perform regular reviews of the financial strength of the sponsoring employer to ensure that it can meet its obligations to the scheme. These are referred to as 'Employer Covenant Reviews' and they have been required for the last few years under the Pensions Act 2004.

Why are covenant reviews being encouraged so much?

The short answer is because The Pensions Regulator is keen to steer schemes away from potential financial difficulties and future reliance on the Pension Protection Fund. Principal employers are generally long-standing companies that have been very profitable in the past, but this may no longer be the case. Even if the company is still profitable, a change in ownership may have given it heavy financial commitments, e.g. borrowings to finance a management buyout or guarantees to support group borrowings. Many schemes are now closed to future membership and sometimes even to future accrual. Hence they are increasingly becoming a legacy issue for companies and as such, have to compete with many other financial priorities. Covenant reviews give the trustees an understanding of the financial position of the employer so that they are aware of any current problems and can risk assess any future problem areas. This understanding is also essential if they are to be in a position to negotiate properly with the employer about scheme funding.

What should trustees look for when carrying out a review?

Essentially the trustees are seeking to assess the employer's ability to fund the scheme on an ongoing basis along with the surrounding risks. The latest full financial statements of the employer company are the starting point, supplemented by information on current financial performance and also future financial projections. High levels of debt will increase the risk of the covenant and so details of the banking arrangements could be important. An understanding of the strategic direction of the business and plans for expansion or disposals should be obtained through discussion with the company directors. If the employer is part of a group, a clear understanding of the group structure and strategy is very important. The financial strength of the group as a whole could be relevant, although the position could be complicated if it includes overseas companies.

When should a covenant review be undertaken?

As mentioned above, trustees are required to perform regular reviews, but certain situations will make them a particular priority. The first is where the scheme has a funding deficit.

In these increasingly common circumstances, the schedule of contributions will need to include a recovery plan, negotiated between the trustees and the employer to bring the scheme up to its target funding level. An independent covenant review will assist the trustees in their negotiations with the employer by providing guidance on what the employer can afford to pay and over what timescale. Another option to protect the scheme may be the utilisation of contingent assets that would be triggered in the event of employer insolvency.

A review is also necessary when the employer is proposing to enter into a corporate transaction which may impact on the quality of the scheme covenant. The trustees need to be consulted and they have the right to refer to The Pensions Regulator if they are concerned by the proposal and suitable clearance has not been sought.

There has been a lot of debate about whether trustees can carry out a review on their own or whether they should pay for a third party to carry it out. Is help necessary?

Trustee bodies may include individuals considered to have sufficient financial experience to complete such a review but they may not be sufficiently independent of the employer. For example, the finance director may have a conflict of interest when advising fellow trustees on the company's finances. If none of the independent trustees have suitable financial experience, it is important they seek assistance from independent specialists. Their experience of similar situations will enable them to seek relevant information, interpret it in the context of the scheme's funding position and advise the trustees impartially on the key concerns arising from their review.

The current financial crisis – A Perfect Storm?

The current financial crisis will almost inevitably increase the risk of all schemes. The employer's profitability is likely to be falling, whilst the scheme deficit will be inflated by both falling asset values and increasing liabilities driven by reducing discount rates. This triple whammy is potentially a 'perfect storm' for defined benefit schemes and so all trustees are recommended to review their scheme urgently.

Article by Philip Allsop and Howard Ringrose – Barber Harrison & Platt