

# Actuarial Valuations – Issues for Employers

Employers sponsoring a defined benefit pension scheme that is carrying out its triennial valuation this year are likely to see upward pressure on the contributions being requested by the trustees. It is essential that employers take the initiative and get involved in the valuation process at an early stage.

## Introduction

With many stock markets trading at lower levels than three years ago, schemes invested in equities will have seen their funding position deteriorate as the previous valuations would have typically assumed a positive 3 year investment return of around 15 to 20%. In addition, concern over future inflation is likely to put upward pressure on scheme liabilities. This could lead to increased contribution requirements at a time when economic conditions are putting pressure on corporate cashflow. The Pensions Regulator has issued statements to both employers and trustees that give some relief to struggling sponsors but it is still clear that it expects funding the pension scheme to be a primary consideration.

This note sets out some of the key issues employers should consider.

## Start early

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

## Identify your objectives

For most schemes, the process of setting the valuation assumptions and the timing and magnitude of deficit reduction contributions requires the agreement of the trustees and employer.

Before entering into discussions with the trustees the employer must 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 key determinant of the employer's strategy is what it can reasonably afford to pay and this needs to be thought through 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 trustees. In many cases trustees are sympathetic to their 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. The valuation process will run more smoothly if the employer has the opportunity to feed into the process before the trustees have made any major decisions.

## Prepare for employer covenant assessment

The trustees are required to consider the “employer covenant” as part of the valuation process and employers should understand these obligations.

The employer’s covenant has often been defined as the employer’s “willingness and ability” to support the scheme although recent statements from the Pensions Regulator place greater emphasis on the trustees understanding the employer’s “legal obligation” to fund the scheme.

Employers should understand how the information they provide to the trustees will be used and ensure it provides a message that is consistent with the employer’s objectives. For example, if the information shows the employer to be in a strong position the trustees are unlikely to be persuaded that deficit reducing contributions are unaffordable unless information on other proposed uses for these assets are provided.

It is increasingly common for trustees to consider commissioning an independent review of their employer’s covenant. The cost of such a review is ultimately borne by the employer but 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.

## Assumptions and Recovery Plans

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.

For schemes in deficit, there are a variety of options when structuring a Recovery Plan to clear the deficit. The Regulator has stated that, in some cases, it may be appropriate for longer recovery periods, “back-end loaded” contribution rates, and/or less prudent assumptions. These can all help reduce employers’ short-term cashflow commitments.

## 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. Trustees are required to consult with employers over changes to the investment strategy but the employer’s explicit agreement is not needed.

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 at least get these alternative objectives recognised. Often trustees will be willing to invest in a particular way as a condition of receiving additional or accelerated funding or some other form of enhanced security.

## Contingent assets

One of the bargaining tools potentially available to employers in funding negotiations is the provision of a contingent asset. 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 (for example a group/parent company guarantee) might serve to reduce the levy payable to the Pension Protection Fund.



## Recognise the Regulator

The Scheme Funding process is in theory one for agreement between the employer and trustees with the Regulator only being involved in disputes or exceptional cases. However, trustees will nonetheless be conscious of the potential for regulatory involvement and this can often influence their approach. It is also the case that the Regulator has powers to get involved even where the employer and the trustees have reached agreement.

More recently the Regulator has issued statements aimed at both trustees and employers recognising the difficulties that may be faced in trying to reach agreement on pension scheme funding when employers themselves may be facing problems. Whilst these statements appear to give trustees and employers greater flexibility, employers will be wary of the restrictions placed on them.

## Securing liabilities with an insurance company

An increasing number of employers are opting to reduce risk in their schemes by securing some (or even all) of the liabilities with insurance companies. The valuation year is ideal for looking into the options available as the scheme data should be readily available at the valuation date; therefore obtaining quotes from insurers should be easier than in non-valuation years.

As well as being able to compare the difference between the costs of insuring benefits to the amount trustees are asking employers to reserve for, considering these options in a valuation year enables the employer to be able to ask trustees to agree to any plans as part of the valuation process.

## Benefit changes

Most employers are reviewing, or have recently reviewed, the benefits provided by their schemes. 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.

## Conclusion

Employers are likely to be experiencing difficult trading conditions due to the continuing unstable economic conditions and therefore 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.

## Further information

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

Alternatively, please email:  
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