

Issues for pension scheme trustees during current market turmoil

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Barnett Waddingham

Background

Since the start of September, the crisis in the world's financial system has been developing rapidly. Beginning with the bankruptcy of the US investment bank Lehman Brothers, the crisis has widened to bring many global financial institutions to the brink of collapse. In an attempt to restore stability, governments and central banks have been forced to inject vast sums of capital into the system, effectively resulting in the nationalisation of some of the largest and best known companies in the financial sector.

Against this background, global equity markets have fallen by around 30% since the end of August, on top of the falls already seen during 2008. As a consequence, pension schemes with significant amounts invested in equity markets will have seen sharp falls in their funding level. The real economy is also faltering – the outlook for economic growth is gloomy with the possibility of a recession looming. Reports of falling house prices continue and the latest figures show that unemployment is at its highest level for many years.

Although employers and trustees of occupational pension schemes can take some comfort from the fact that pension schemes are long-term investors, this briefing note covers some of the issues trustees might want to consider in light of the current turmoil.

Employer covenant

Trustees are expected to monitor the strength of the employer covenant – the ability and willingness of the employer to support the pension scheme – on an ongoing basis. Trustees should ask employers to confirm the impact that recent events have had on their business, its financial position and its prospects. If the trustees feel that there has been a significant decrease in the strength of the employer

covenant, then there may be a need to review funding and investment strategy in light of this.

Trustees may wish to remind employers of the list of Notifiable Events that need to be reported to the Pensions Regulator, as these may be more likely to occur in the current climate (for example a decrease in credit rating).

Funding

The Statement of Funding Principles ("SoFP") sets out the responsibilities of the various parties with regard to the funding of a pension scheme. This includes the frequency with which the trustees will obtain valuations and the circumstances in which the trustees would consider reviewing a schedule of contributions or obtaining an out-of-cycle valuation. This may include specific trigger points related to changes in market indices or asset values. The trustees should review the requirements of their SoFP, and in particular whether any trigger points for reviewing funding plans have been met.

In deciding whether any agreed funding plan remains appropriate, the trustees should also consider any change in the strength of the employer covenant.

Trustees in the middle of a valuation process need to consider whether the funding position at the valuation date is appropriate for determining contribution requirements, as the funding position may have deteriorated significantly given recent events.

Investment

Trustees may wish to ask their investment manager certain questions regarding their risks and exposures in light of recent volatility in investment markets and the specific problems faced by some institutions. Trustees may also

want to reconsider their investment strategy in light of recent events.

Further commentary on the investment issues relating to the current turmoil is set out in a separate briefing note on our website at <http://www.barnett-waddingham.co.uk/articles/index.aspx?did=685>.

Transfer value reductions

Trustees are permitted to reduce transfer values where the assets of a pension scheme are insufficient to pay full transfer values for all members. This avoids a reduction in the security of non-transferring members' benefits.

Recent falls in investment markets are likely to have substantially reduced pension schemes' ability to pay full transfer values. Trustees may wish to review the ability of the scheme to pay full transfers or the level of any existing reduction.

Again, the extent to which it might be appropriate to reduce transfer values depends on the trustees' views of the employer covenant. In extreme cases, where recent events have given rise to serious concerns over the strength of the employer, trustees may wish to hold off issuing transfer values whilst a review of the ability of the scheme to pay full transfer values is carried out.

Contingent assets

In the current climate, contingent assets such as bank guarantees may be difficult to obtain on favourable terms.

Trustees, in conjunction with the employer, should review any contingent assets they have in place. In particular, any contingent assets which require renewal each year (e.g. bank guarantees for the purposes of reducing the Pension Protection Fund levy) should be reviewed for actions necessary in advance of the renewal date.

Communications with members

Members of pension schemes may be worried about the security of their pension benefits. Trustees should consider issuing an announcement to members or preparing responses to likely questions ready for dealing with member enquiries.

Members receive updates on the funding of a pension scheme each year in the form of a Summary Funding Statement ("SFS"). Trustees should take care sending a SFS based on out of date funding information, and may wish to include comments on the likely impact of recent events on funding.

Internal controls and risk register

Trustees should review their internal controls and risk register to ensure they adequately cover the scenarios presented by the recent crisis.

Please contact your Barnett Waddingham consultant if you would like to discuss any topics in more detail. Alternatively, visit our website at www.barnett-waddingham.co.uk.



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