Cash availability in the downturn – what trustees need to consider (Part 2)

Executive summary

- It should be possible to agree sensible funding arrangements that meet a scheme's particular circumstances in the light of the current economic environment, but continuing dialogue is essential
- Trustees need to keep their eye on the long-term, as well as the short-term, situation; they don't need to act exactly like bankers
- DC trustees need to review fund ranges, retirement processes and member communications

Ian Wright

Many trustees are between a rock and a hard place at the moment.

For defined benefit (DB) schemes, the (still fairly new) statutory funding regime changed the balance of powers between trustees and employers and generally resulted in increased deficits. Trustees were still feeling their way in this new regime when the current recession broke. They now also have to contend with ballooning deficits, challenging investment conditions and concerns about employer viability. Trustees and members are keen to see the deficit plugged. Yet lack of available credit means that many employers are equally keen to keep cash in the business and out of the pension scheme for now. Employers may want, or even need, to reduce their pension contributions even though the deficit is bigger than ever.

For defined contribution (DC) schemes, in many cases members are seeing the value of their pension accounts significantly eroded. This can lead to member complaints and member disengagement.

Funding DB schemes – the legal framework

The legislation imposes a statutory funding objective that a scheme must have "sufficient and appropriate assets to cover its technical provisions". So, the starting point is an assumption that a scheme should be fully funded. Where the statutory funding objective isn't met, a recovery plan has to be put in place to deliver full funding.

To achieve this, trustees of DB schemes have to ensure a valuation occurs at least every three years, but they can require one more frequently if they want. The valuation assumptions (which determine the technical provisions, i.e. the value placed on scheme liabilities), and any recovery plan, normally have to be agreed with the employer. If the Pensions Regulator is not happy with the level of prudence in the assumptions used or the recovery plan, it can intervene.

The regulator's views

The regulator has produced a Code of Practice and various guidance notes on what it expects of trustees and employers. While not strictly legally binding, in practice trustees will want to ensure that they have taken account of its views or have good scheme-specific reasons why not.

The regulator sees the trustees' view of the 'employer covenant' as a key part of choosing the right assumptions. Where trustees have more reason to doubt the ability and willingness of the employer to support the scheme, the assumptions should be more prudent, reflecting the fact that the scheme may have more need than some to be self-sufficient.

The regulator has also said that trustees should aim for any shortfall to be eliminated as quickly as the employer can reasonably afford. This is consistent with the underlying intention that schemes should be fully funded on their own scheme-specific basis. But it has raised questions about what 'reasonably affordable' means, particularly in the current climate.

The recent statement from the regulator (June 2009) has helped clarify what flexibility there is. It confirmed that valuation assumptions should be set in the light of the strength or weakness of the employer covenant. However, it accepts that the resulting recovery plan is allowed to reflect the current economic situation. This might include a longer recovery period, or back-end loading, to reflect the employer's business plans.

In effect, this means that the assumptions should be set having regard to the trustees' view of the employer's ability to support the scheme over the long term, but that the recovery plan can properly have regard to more short-term cash flow pressures on employers.

Trustees as bankers

The regulator has famously said that trustees should learn to act more like bankers.

This makes sense in many ways – trustees may end up being the employer's biggest creditor and members' benefits may depend on its creditworthiness – but there are also important differences. You know how much you owe the bank, and banks don't have to lend money to you if they don't want to. Once your loan is repaid, the bank has no further interest in your continued success. The amount an employer 'owes' the trustees fluctuates wildly due to external factors and could in the end evaporate altogether. Equally, the fact that an employer has paid off its deficit one day does not mean that the trustees or

members have no interest in its continued success: the next valuation could show another deficit and mean they need more employer support after all. Pensions is a very long term business and the certainties change from one decade to another.

Paying off a deficit 'in full' in the short term may seem to be the ideal as far as trustees and members are concerned but it isn't for the employer. And the regulator agrees that the best guarantee that members' benefits will be paid is a strong employer standing behind the scheme over the long term. While legislation requires scheme to target full funding over an agreed period, trustees need to keep aware of the longer term as well. Trustees need to maintain a good ongoing relationship with the employer over the lifetime of the scheme. Acting too much like bankers may ultimately be counter-productive.

Putting it into practice

As Alan Higham explained last month, trustees need an accurate assessment of both the long-term covenant and also how much cash is available to the employer in question. They need to understand what else the employer wants to use any available cash for and what other assets the business has. A temporary reduction in cash contributions may be the best result to ensure a strong supportive employer in the longer term provided that there is a clear understanding of when more cash will be available. A package that delivers full funding over a reasonable period backed by some additional long term commitment from the company (by way of some contingent asset) may ultimately be better for everyone than an immediate cash payment to remove the current deficit which leaves the employer weaker in ten years time.

Trustees should consider seeking specialist advice on these issues to ensure that they achieve, and can show their members that they have achieved, the right result. There is no off-the-peg solution – the essence of the new funding regime is that the right answer will be specific to the scheme and employer in question.

The employer has a key role here. Clear business plans and projections shared with the trustees will make it easier to for trustees and employers to reach a common view as to what is reasonably affordable, and to justify that view to the regulator if the need arises. Continued and regular dialogue between trustees and the employer:

- helps the trustee understand how the business is faring and whether business plans and projections are being achieved
- provides a framework to agree how to protect the scheme in the light of proposed acquisitions, dividends or changes in the employer's borrowing position or business
- enables trustees to keep the employer up-to-date on the changing funding position of the scheme, smoothing valuation-related discussions and allowing both parties to agree how to respond without the need for an out-of-cycle valuation

It shouldn't be a triennial discussion!

Don't forget about DC

DB members may well be concerned about a deficit, but they may rest easier if a sensible package to support the scheme can be agreed and communicated to members. For DC members the current situation is more worrying, as they see the value of their pension savings declining and no-one with any duty to repair the position. With current proposals to make annuities even more secure and costly, those a few years further from retirement may have even more to fear. For those DC members approaching retirement, this is a particularly serious problem. Prompted by the effects of the downturn on DC members, the regulator recently issued a statement (July 2009) encouraging trustees to review their DC retirement processes.

Trustees of DC arrangements, including money purchase Additional Voluntary Contribution arrangements under DB schemes, can't wave a magic wand and change the current investment situation or the level of annuity rates available. But there are some things they can do.

Review the fund range offered to members

DC trustees should regularly review the managers and the range of funds offered to members to ensure that they remain appropriate and that the charges reflect value for money. A review at this time may be sensible, and a follow-up communication to members should give members some comfort that the trustees are doing their best to look after them.

Retirement processes

Review the retirement processes and the literature made available to members approaching retirement. Ensure that members are aware of their options well in advance of reaching retirement. This should include a reminder about the open market option and any option to defer retirement under the scheme. The regulator produced a useful generic member leaflet in July 2006 on retirement choices, see www.thepensionsregulator.gov.uk/pdf/retirementChoices2006.pdf, which could be provided to members if trustees do not wish to provide a scheme specific version covering other options (such as unsecured pensions) which may not be offered under the scheme but a member could access by transferring out.

Member communications

Even where DC members have access to regular information about their pension savings, the 2009 annual benefit statement may come as a shock. DC trustees should consider whether supplemental communications about economic conditions and the range of funds available would be helpful.

Key message

In these challenging times, clear communication is more essential than ever. Trustees and employers need to be open with each other in funding discussions and beyond and ensure members are kept informed to manage expectations.

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