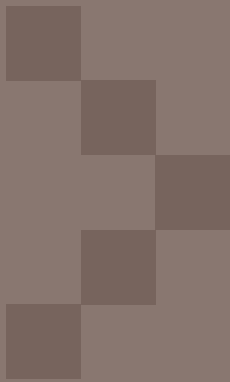


The funding cycle – the four key stages

Scheme Funding

October 2011



The Scheme Funding Cycle

We often talk of the scheme funding triangle with funding, investment and covenant at each apex. But it is equally pertinent to speak of the process as the scheme funding cycle.

A DB scheme must meet the requirement to have sufficient assets to cover the scheme's liabilities on an ongoing basis. The cycle for ensuring this happens falls into four key stages. We have used these four stages as the focus for this paper analysing the legal position. We have also used some case studies from the firm's experience to highlight certain practical issues.

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Abbreviations

Code: TPR's Code of Practice "Funding Defined Benefits"

DB: defined benefit

DC: defined contribution

PA04: Pensions Act 2004

PPF: Pension Protection Fund

SFP: Statement of Funding Principles

SIP: Statement of Investment Principles

TKU: Trustee Knowledge and Understanding

TPR: The Pensions Regulator

A Scheme Funding Action Plan

This sample action plan sets out in more detail each of the first three stages of the scheme funding cycle. As trustees must complete the funding process within 15 months of the effective date of the actuarial valuation, they will need to monitor progress against an action plan. This plan assumes that the valuation and accounts have the same effective date of 31 March 2011.

January 2011	Preliminary discussions regarding valuation process, including confirmation of action plan and strategic objectives and bases
March 2011	Trustee meeting including: <ul style="list-style-type: none"> • trustee training on the valuation process • identifying conflicts • audit of statutory employers • scoping employer covenant review
31 March 2011	Effective date of valuation and scheme accounts
May 2011	Employer covenant review to be completed
June 2011	Scheme accounts to be available in draft
June 2011	Trustees meeting to consider: <ul style="list-style-type: none"> • draft assumptions • preliminary valuation results • scheme accounts • employer covenant review
July 2011	Membership data to be confirmed
September 2011	Company to be presented with draft assumptions
September 2011	Trustee meeting to discuss: <ul style="list-style-type: none"> • report on preliminary valuation results • report on discussions with company on draft assumptions • report on employer covenant • statement of funding principles
October 2011	Final scheme accounts
December 2011	Trustee meeting: <ul style="list-style-type: none"> • finalise assumptions • discuss schedule of contributions and recovery plan • consider statement of funding principles
January 2012	Draft recovery plan and schedule of contributions presented to the company
February 2012	Further discussions with company regarding schedule of contributions and recovery plan
March 2011	Trustee meeting: <ul style="list-style-type: none"> • finalise all documents • all documents to receive sign off by trustees
May 2011	Send all documents to TPR: <ul style="list-style-type: none"> • deadline is 30 June 2012 • action plan builds in contingency for delays
June 2012	Submit section 179 valuation



Stage 1: Groundwork

The preparation stage is crucial. Trustees must be ready to take the decisions they need to in stage 2. This will require, among other things, a focus on scheme governance and an employer covenant review.

In our action plan, the preparation stage may typically take 6 months, some of which may be completed before the effective date of the valuation.

Governance

The mesh of disciplines, that come under the banner of scheme governance – such as conflicts, TKU, risk management – have a key role to play in getting ready for scheme funding discussions.

How to manage conflicts

Management of conflicts is crucial to transparent decision-making. The position of the sponsoring employer's finance director (FD) as a trustee can be thrown into sharp relief under the spotlight of scheme funding discussions. The FD's key role in determining corporate strategy, including the financing of the pension scheme, may lead to the impossible situation of a finance director effectively negotiating with himself.

There are ways of managing scheme conflicts, for instance, by delegating discussion of funding to a smaller sub-committee of the trustees. But perhaps the trickiest issue to overcome is that a trustee is required to make available to the trustee board any relevant information they hold, in whatever capacity. The FD in particular will have access to confidential price sensitive information which he may not wish to, nor be able to, disclose.

And it is not just the trustees; advisers may be under scrutiny too. Most professions have strict guidelines which can help trustees manage conflicts. For instance, the Actuarial Profession is currently consulting on revisions to its guidance which includes a helpful guide for trustees on conflicts which may arise for scheme actuaries.

Trustee Knowledge and Understanding

Trustees must have the right mix of skills and experience. They should consider having a refresher course on the scheme funding process shortly before the valuation date to ensure they are properly equipped to make decisions. Bespoke training which focuses on the scheme rules is often more effective than generic training.

➤ Case Study:

How Sackers can help meet governance targets

The Maybourne Hotels Group Pension Scheme provides benefits for employees who work at top London hotels – Claridge’s, the Connaught and the Berkeley.

Over the last few years, a great deal of corporate activity has impacted on the Scheme.

These changes generated a significant amount of work for the Trustees and the secretary to the Trustees. This has continued in more recent times as employer’s loans have come within the control of the Irish National Asset Management Agency, and investors have sold their stakes in the group. Each corporate event has had repercussions for the Trustees, who have needed to keep up with rapidly changing circumstances.

Through all of these changes and challenges, in addition to providing legal advice, we have bolstered the scheme’s resource to provide the Trustees and the secretary to the Trustees with support that includes:

- help with planning meetings and agendas;
- drafting minutes of meetings;
- assisting with management of projects driven by corporate activity;
- strategic input – for example, advising on tactics and preparing for negotiations with the employer.

For further details of these types of services, please contact
Sackers Support Services:
E: enquiries@sackerssupport.com
T: 020 7615 9510



Trustees should also know when to ask for extra help with governance. Keeping on top of correct process such as the action plan for scheme funding can take time and resources. ”

The employers

As scheme sponsor, the employer underwrites the risks to which the scheme is exposed, including underfunding, longevity, investment and inflation. “Employer covenant” is shorthand for this legally required support. This, in turn, affects the level of technical provisions (actuarial assumptions) and investments that are appropriate for the scheme, as well as any recovery plan.

Identifying your statutory employer

The question of who is a statutory employer is a technical, legal question based on legislation. A principal or participating employer is not necessarily a statutory employer, unless it meets the legislative test.¹

This issue has recently come to prominence because of TPR’s July 2011 Statement: Identifying your Statutory Employer. From November 2011 a statutory employer will have to be identified on the Scheme Return. As a result, many schemes are currently undergoing an audit to establish their statutory employers.

Employer covenant

Trustees need to assess and keep under review the employer covenant of all the scheme’s statutory employers. TPR has defined covenant as “the employer’s legal obligation and its ability to fund the scheme.”²

There is no express legal obligation on trustees to get expert covenant advice. TPR recognises the trustees may well have the necessary skill set and the appropriate relationship with the employer to get access to and assess information themselves. But an independent view can often add a new perspective. When spending scheme funds to pay for covenant advice, trustees should take a proportionate approach in the context of the scheme’s exposure to risk and volatility.

There is plenty of choice, with a well developed market of covenant advisers. We can help trustees run a robust selection process and map out the type of review to be undertaken. In our experience, the careful scoping of a covenant review is the key to unlocking the scheme specific answers trustees need.

¹ An “employer” is defined as “the employer of persons in the description or category of employment to which the scheme in question relates”

² TPR’s Statement on monitoring employer support published in November 2010

Establishing Negotiating Positions

As well as doing due diligence on the employers, it is essential to establish the relative negotiating positions of the parties. Knowing the answer to these key questions can set the tone for all the funding discussions.

Who sets the contribution rate?

The basic position is that the trustees and employer have to agree the contribution rate. But in order to preserve the pre-PA04 balance of powers under scheme rules where either the trustees or the actuary set the contribution rate, the legislation provides for a number of exceptions to this general rule.

Setting contributions: Legislation or Scheme Rules?

Only the scheme's statutory employers are responsible under legislation for meeting the funding obligations (and paying any employer debts which arise). However, there may be other employers who have obligations under the scheme rules.

In addition, the long-standing question over the interaction of the legislative provisions and a scheme's own funding rules received some resolution last year in the *Pilots Case*³. Sackers acted for one of the employers participating in the Pilots National Pension Fund, a UK industry-wide pension scheme for marine pilots which is approximately £300m in deficit. The trustee asked the High Court for guidance on a number of issues.

Confirming his own 2007 judgment in *British Vita*,⁴ Warren J concluded that it was open to trustees to set a contribution rate higher than that required by the statutory funding regime under the scheme rules.



Trustees may have to get agreement from the employers on key scheme funding decisions.”

³ *Pilots National Pension Scheme v Taylor* (2010)

⁴ *British Vita Unlimited v (1) British Vita Pension Fund Trustees Limited (2) British Vita SE & D Pension Fund Trustees Limited*



Stage 2: Key Decisions

The key decisions in the scheme funding process are on the method and assumptions which form the bedrock of the schedule of contributions and recovery plan. This is likely to be the longest stage on the action plan, probably taking 9-10 months, with scheme funding discussions the focus of 2-3 trustee meetings in that period.

Method and Assumptions

It is the trustees' responsibility to choose which funding method and assumptions are to be adopted for the calculation of the scheme's technical provisions within the legislative parameters. The trustees must take advice from the scheme actuary, reach agreement with the employer, and ensure that the method and assumptions (taken as a whole package) are prudent.

Prudence is deliberately not defined in the legislation and there is very little guidance on what would be considered prudent by TPR in either the Code or related guidance. Prudence therefore needs to be decided on a scheme by scheme basis.

Method

The Code requires that trustees must "choose an accrued benefits funding method for calculating the scheme's technical provisions". Trustees must take advice from their actuary on the differences between the available methods in relation to their scheme.

The Code lists a number of factors which should be covered by that advice and discussed with the employer,⁵ including the relationship between the technical provisions required under a particular funding method and the future contributions (if any) needed to support them, taking into account expected future pay increases for active members.

Assumptions

The assumptions are estimates made for the purpose of calculating benefits. Assumptions include:

- return on investments (including an allowance for equity out-performance of bonds)
- the inflation rate
- life expectancy; and
- decisions within the employer's control, such as salary increases and availability of discretionary benefits.

The trustees decide which assumptions should be adopted for the calculation of the scheme's technical provisions. To do so, trustees should take advice from the scheme actuary and reach agreement with the employer. In an ongoing scheme this does not mean that the trustees should be aiming for a buy-out level of funding or that all risk needs to be eliminated. The Code indicates that trustees "should choose individual assumptions with a level of prudence consistent with the overall confidence they want to have that the resulting technical provisions will prove adequate to pay benefits as they fall due..."⁶

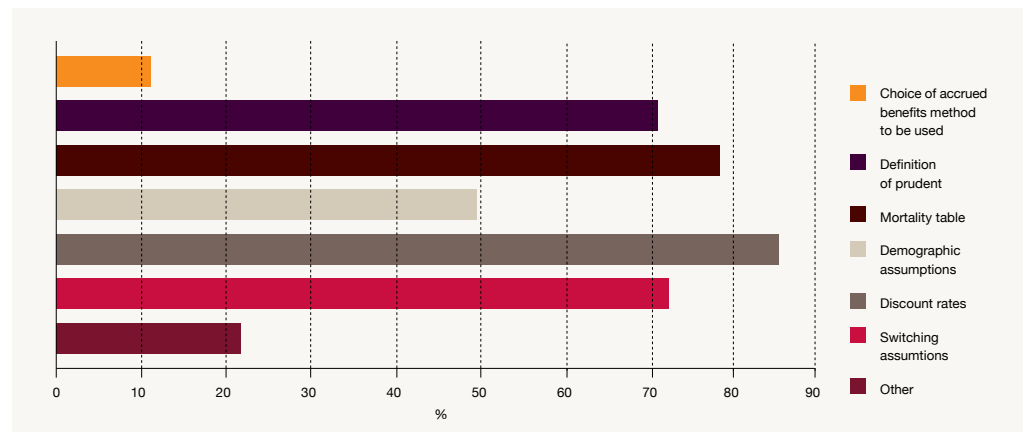
⁵ Paragraph 75

⁶ Paragraph 84

But trustees will need to provide for a reasonable reserve against “adverse deviation” from expectations. The million dollar question is just what should the reserve be? This will impact directly on the level of future contributions required.

As the chart below illustrates, Sackers’ experience has been that discussions on scheme funding raise a wide range of issues. Discussions on discount rates lead the pack but with a survey of our lawyers revealing that more than 70% have had discussions on the definition of prudent, mortality tables and switching assumptions, it demonstrates these are also significant issues. Only the choice of the method to be used appears to be little debated.

What have been the key components of discussions on setting assumptions?



Discount Rate

The discount rate is a method of calculating the present value of a sum due at a later date. The assumed investment return is used to discount that sum due to its current value.

Our experience over the last few years has been that the discount rate has been the greatest source of contention between trustees and employers – with a staggering 85% our lawyers suggesting this had been an issue in funding discussions. Not a surprise when TPR’s December 2010 Report: “Recovery plans – Assumptions and triggers” acknowledged it as the “most significant determinant of a scheme’s technical provisions”.

Lord Hutton also highlighted the importance of this issue by shining a spotlight on the discount rates used by public sector pension schemes in his Independent Public Service Pensions Commission report published in October 2010. Lord Hutton criticised the discount rates used in the public sector as too high (meaning the contributions were artificially low).

Changes to the Method or Assumptions

Trustees may choose a different method or assumptions to those previously adopted for the scheme but only where justified by “a change of legal, demographic or economic circumstances”.⁷ The Code requires trustees to keep a record of the reasons for making any such changes.⁸

As many schemes have now completed their second valuations under the new scheme funding provisions, our experience is that this issue has produced many of the recent debates relating to assumptions. Employers, in particular, have felt that this provision has provided little flexibility to make changes.

Contribution Schedule

The schedule of contributions sets out the rates of contributions payable and the dates by when the contributions should be paid. This can include contributions for both active members and deficit repair contributions. Trustees need to monitor payment against the schedule and report any contribution failure to TPR.

Statement of Funding Principles

The aim of the SFP is to provide a written statement of the trustees' or managers' policy for ensuring that the scheme's statutory funding objective is met. It is also a record of the decisions taken by the trustees regarding the valuation methods and assumptions to be used in calculating the scheme's technical provisions.

TPR's view is that "in order to comply with the spirit of the legislation and best practice", the statement should include an explanation of the trustees' reasoning behind the assumptions chosen.

Recovery Plans

In addition to setting the method and assumptions, trustees must agree a recovery plan with the employer. This will set out the contributions required to repair any deficit in the scheme. TPR's December 2010 Report notes that TPR has found that the average length of a recovery plan in the latest batch of valuations analysed is 9.4 years, just under the 10 year trigger threshold. For more about the triggers used by TPR, please see the next section.

⁷ Regulation 5 of the Scheme Funding Regulations

⁸ Paragraph 94



Stage 3: Liaison with TPR

Once they have agreed the valuation and recovery plan with the employer trustees must submit all of the relevant documents to TPR. This stage is right at the end of the 15 month deadline but trustees must leave time to liaise properly with TPR. TPR are not themselves bound by time limits on confirming they are happy with the technical provisions or recovery plan and can re-open the issues several months after documentation is submitted.

What happens if the trustees and employer can't agree?

If the trustees are unable to reach agreement with the employer, they must report this failure to TPR. The Code says that “the reasonable period for reporting a failure to agree is ten working days from the relevant deadline.⁹ In practice, our experience is that TPR are prepared to be reasonable and extend the deadline provided trustees and employers have a plan and structure in which to reach agreement. This may be an extension to the action plan for the whole process. As far as we are aware, no failure to agree has got further than the EMI funding dispute, highlighted below.

➤ Case Study:

The EMI Funding Deal

In October 2010, EMI finally agreed a funding deal with the EMI trustees worth nearly £200 million after a four year battle. The EMI deal with the trustees amounted to worth of contributions to the scheme between October 2010 and April 2016, with an immediate payment of £16 million. Peter Murphy, a partner at Sackers who acted for the trustees, said: “It is good news for everyone associated with the EMI Group Pension Fund that agreement has been reached in relation to future funding.”

The deficit in the pension scheme remained unresolved since 2007, despite being referred to TPR in the same year. Commenting on the deal, June Mulroy of TPR was quite clear that TPR can provide the leverage required for the parties to reach a deal, saying: “as is often the case, our ability to impose a solution provides an incentive for the parties to agree, even if at the last moment. We are determined that scheme funding targets are set with appropriate levels of prudence, and will not hesitate to invoke our powers where necessary”.

As advisers to the trustees, Sackers was preparing for a Determinations Panel hearing when the deal was reached.

Triggers

In addition to schemes which come to their attention as a result of a failure to agree, TPR has also developed “triggers” to help it to identify those whose funding plans may be based on imprudent or inappropriate assumptions. This is part of its risk-based approach to monitoring

There are four triggers. The first applies if TPR considers the method and assumptions are imprudent and three are related to the recovery plan – TPR will investigate further if the recovery plan is over 10 years, back-end loaded or the investment return assumptions underlying the recovery plan appear inappropriate.

An astonishing 81% of all schemes triggered further investigation in the latest tranche of schemes to be analysed by TPR¹⁰. Investment return assumptions triggered the most investigations at 60% of all recovery plans being investigated, with technical provisions at 39%, plan lengths at 27% and 14% on back-end loading. With this level of schemes triggering further investigation resourcing is likely to be an issue at TPR.

Regulator’s Powers

In the event that the trustees have not complied with any of the scheme funding requirements, or have been unable to reach agreement with the employer, TPR has a number of powers under the scheme funding legislation.¹¹ Although we understand TPR has not yet used any of these powers, it can:

- modify the scheme as regards future accrual of benefits;
- give directions as to the manner in which the scheme’s technical provisions are to be calculated (including the method and assumptions) and the recovery period;
- impose a schedule of contributions specifying the rates payable and the dates on which contributions are to be paid.

In addition, TPR has a number of other powers which it can use including removing and appointing trustees. In 2007, TPR acted swiftly and decisively on behalf of the trustee of the telent (formerly Marconi) pension scheme. Sackers acted for the trustee to obtain the appointment of independent trustees following a bid for telent by Pension Corporation.



TPR expects the trustees and employers to agree without it becoming involved. It views its role as a “referee not a player”.

¹⁰ TPR – Recovery Plans: assumptions and triggers, December 2010

¹¹ See section 231



Stage 4: Preparation for next time

Setting the investment strategy

For DB schemes, it is the trustees who must decide the investment strategy that the scheme should adopt, taking into account both the funding and covenant of the employers.

The trustees must consider a number of factors which fall into three broad groups: trustee duties, statutory provisions and the restrictions in the trust deed and rules (if any). Only those investments which meet all the relevant criteria will be suitable for the scheme.

Statement of Investment Principles

The SIP must set out the basis on which the trustees plan to invest the scheme assets. The scheme's sponsoring employer has a right to be consulted on the contents of the SIP, and any revisions the trustees periodically make, but may not dictate the scheme's investment policy. (It may be combined with the SFP.)

The SIP should include policy on:

- choosing investments;
- the kinds of investments to be held, and the balance between different kinds of investment;
- risk, including how risk is to be measured and managed, and the expected return on investments;
- realising investments;
- the extent, if any, social, environmental or ethical considerations are taken into account; and
- the use of any rights (including voting rights) attached to investments.

De-risking

Examples of de-risking strategies used by clients include buy-ins or buy-outs, asset-backed contributions (ABCs) and longevity hedging.

Buy-ins/Buy-outs

A buy-out is the bulk purchase of annuities in respect of some or all of the members of a pension scheme. The difference between a buy-out and a buy-in is that, in the former, the annuities are purchased in the names of the scheme members and the liabilities involved are removed from the scheme entirely. As an annuity held in the trustees' name, the "buy-in" is simply another scheme investment.

Sackers has been involved a number of buy-in and buy-out arrangements in the past year, including GlaxoSmithKline's purchase of £900 million of insurance contracts with Prudential for two of its DB schemes. These contracts cover changes in interest rates, inflation and longevity expectations for about 15% of GSK's UK DB pensioner liabilities.

Asset-Backed Contributions

ABC arrangements allow an employer to use non-cash assets, such as real estate or even intellectual property, to underpin regular cash contributions or income streams to its pension scheme.

But the way in which they are structured is under scrutiny. Recognising the flexibility ABCs provide for employers and pension schemes, the Government does not intend to inhibit their use. However, it is concerned that some asset-backed funding arrangements may give rise to tax relief that is greater than the fair value of the assets received by the scheme.



Pressing economic conditions have forced employers to seek increasingly creative solutions to funding their DB scheme deficits. ”



Case Study:

ITV Longevity Swap

Sackers acted on behalf of the Trustee of the ITV Pension Scheme on its longevity swap contract with Credit Suisse.

The longevity swap protects the ITV Pension Scheme against the risk of covered members living longer than expected. The sensitivity of the technical provisions to changes in mortality is such that an additional year of life adds about 3% to a scheme's liabilities.

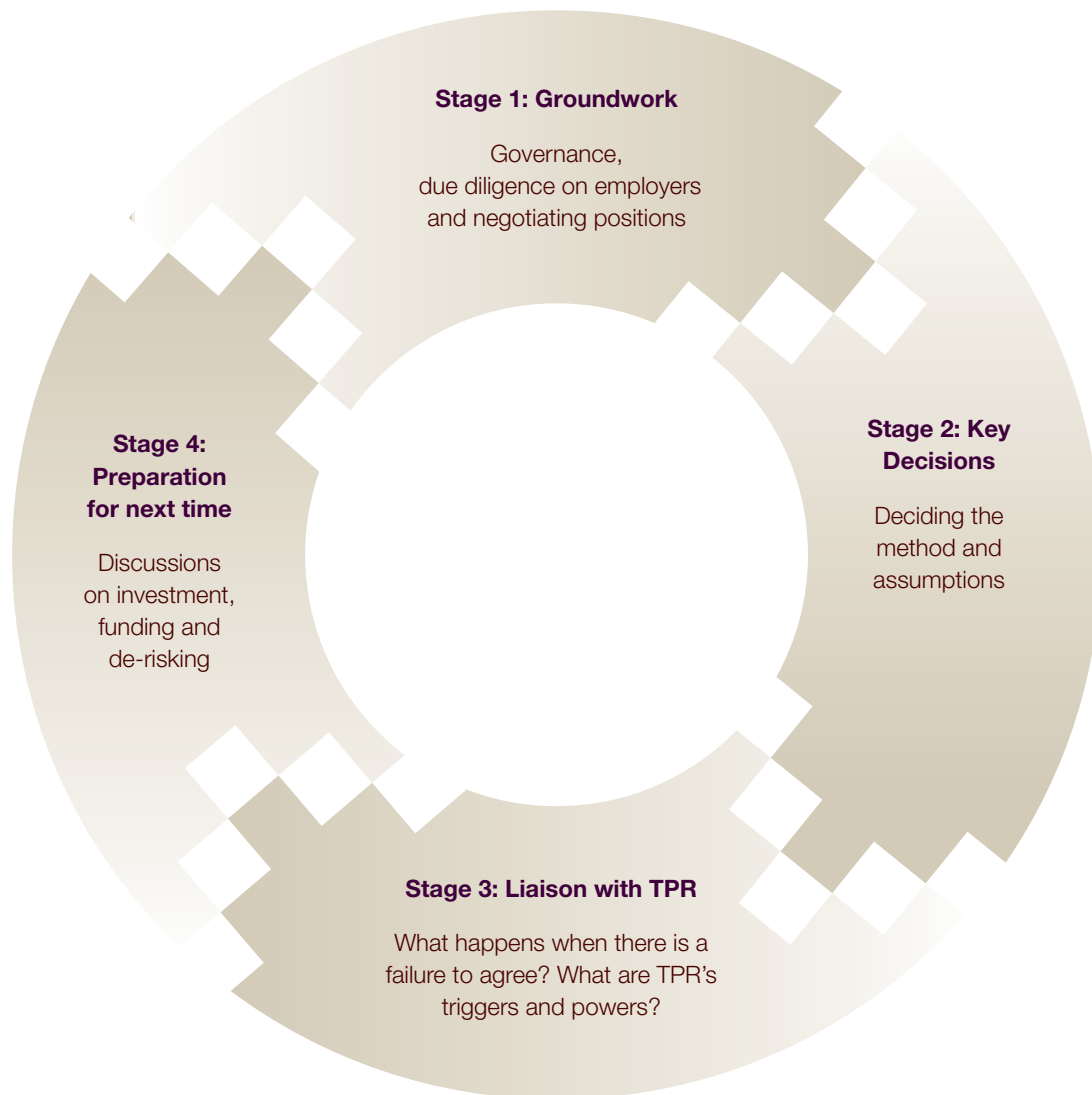
The swap covers benefits due to almost 12,000 retired members and dependants and is one of the largest risk transfer exercises to have been undertaken by a UK pension scheme. It is worth up to £1.7bn over 70 years.

Graham Parrott, Chairman of the ITV Pension Scheme Trustee, said "This longevity swap removes a significant risk from the Scheme and meets a key trustee goal of enhancing the security of members' benefits. Sackers provided specialist legal advice to the Trustee as our team of advisers worked together to negotiate a contract which meets our objectives."



Longevity swaps continue to appeal to both sponsoring employers and trustees as a way of mitigating risk. The ITV Pension Scheme Trustee has taken a concrete step towards enhancing the security of members' benefits. ”

The Scheme Funding Cycle



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