

## YET MORE ISSUES FOR FINAL SALARY SCHEMES

### Introduction

Hardly a day goes by without some issue relating to final salary schemes being reported in the newspapers, either in the financial pages or, increasingly, in the main press. Companies continue to close their final salary schemes. We were not taken seriously last year when we predicted that private sector final salary schemes will be virtually extinct within 5 years. More people are agreeing with us daily!

And to add grist to the mill, recently new issues have cropped up with will simply accelerate the decline of these schemes.

### The Pensions Regulator and how they view funding

The Pensions Regulator (TPR) is now admitting that they made an error in that, when they issued their draft Code of Practice on Scheme Specific Funding, they said that there would be various "trigger" points, and if a trigger was hit, they would consider investigating. The "trigger" points were advised by them as being:

- a) funding on something weaker than the FRS 17 basis and
- b) a recovery period for elimination of the shortfall of more than 10 years.

As one might expect, these "trigger" points have rapidly been treated by the industry and more widely as the new "norm", which is NOT what TPR intended - but they recognise that it is probably too late to backtrack!

Further, TPR has looked into FRS 17 bases and found that typically they are equivalent to between 70% and 80% of the discontinuance basis. So even if schemes fund on the preferred TPR basis, schemes will only be between 70% and 80% funded in 10 years time - and Finance

Directors and Boards currently (understandably) think that if they follow the TPR's proposed funding basis, their scheme will be 100% funded in 10 years time: WRONG!!!

Couple this with the fact that all final salary schemes will have to issue their first Annual Funding Statement (AFS) to all members by 21st September and that AFS will have to include an estimate of the discontinuance funding position. Just imagine what the reaction will be from members when they see that, should their scheme be discontinued, their benefits are only say 40% or 50% funded. Will they be certain that their employer has sufficient assets to bring them up to 100%? Ask BA employees!

But it gets worse... Let us introduce you to our friend "Prudence"

### Funding and Prudence

It is the responsibility of the Trustees now to set the funding basis i.e. the actuarial assumptions. This is on longer the domain of the employer.

Trustees are **required by law** to set actuarial funding assumptions that are **prudent**. Prudence is though not defined! But it goes further. The law requires that the investment assumption is prudent **and** the mortality assumption must also be prudent. In other words, trustees are required by law to set actuarial funding assumptions that are doubly prudent. This is bound to mean that the results of the ongoing actuarial valuation will, from the Employer's viewpoint, be "worse". Imagine the discussions/conflicts between trustees and managing/finance directors? How can any officer of a company be a trustee given this obvious conflict of interest?

It gets better! Let us introduce Prudence's "friend", "Appropriate".

## **Funding of shortfalls**

If there is a shortfall (which of course applies to just about every scheme), the funding of the shortfall is based on "appropriate" actuarial assumptions. TPR interprets "appropriate" as "best estimate" i.e. realistic. Hence "appropriate" will be less conservative than "realistic".

So we will have situations where the Scheme Specific Funding valuation discloses a deficit, but no additional contributions will be required to fund the deficit, as on "appropriate" funding assumptions, there is no deficit!

The world has gone mad! How can anyone expect scheme members to take this seriously? TPR really has to have a major rethink about this.

Bear in mind too, that TPR is in reality only concerned about member's benefits up to those that are provided by the PPF i.e. for active members; a maximum of 90% of their accrued pension, subject to an overall maximum of £25,000, and most likely there will be reduced cost of living increases. So even if TPR is happy, as the scheme is sufficiently well funded that it would have no claim on the PPF in the event of its demise, members' benefits would not be fully secured.

## **The PPF levy – another cost for final salary schemes**

The levy to the Pension Protection Fund (PPF) run by The Pensions Regulator (TPR) will be partially "risk" based. The way it works is that the levy will be calculated in two parts:

1. A scheme-based component of 0.014% of the liabilities protected by the PPF - so every £1M of PPF protected benefits generates a levy of £140
2. A risk-based part found by using the following formula:  
 $80\% \times \text{asset shortfall} \times \text{probability of employer insolvency} \times 0.53$

The "asset shortfall" is "105% of the value of the protected benefits" less "the scheme assets"

The probability of insolvency is found by applying a Dun & Bradstreet failure score to a table produced by TPR. The Dun & Bradstreet failure score can be obtained from Dun & Bradstreet, for a cost of c£25. It would be prudent and sensible for the Trustees to obtain this, so that the failure score can be obtained and the likely levy estimated.

The risk-based element of the levy has a maximum of 0.5% of the protected liabilities.

The levy invoices will be sent out by TPR in the summer of 2006. The levy will be billed to the trustees but of course the employer must ultimately meet the cost and therefore the levy should be added to the employer contributions.

## **How to reduce the levy**

Although it is probably too late to take action to reduce the 2006 levy, there are ways that future levies can be reduced.

The company could pay additional contributions or perhaps accelerate the payment of planned contributions. Indeed, if extra contributions have been paid to help fund a deficit since the last MFR valuation reported in the Regulator's return, action can be taken to have these recognised in the levy calculation. The Scheme Actuary will need to effect and submit an Actuarial Certificate of Deficit Reduction Contributions.

TPR has introduced a new concept of "contingent funding", which takes trustees into whole new areas of corporate finance.

## **Contingent funding**

There is the option for contingent funding to be put in place that would help reduce future levies. There are 3 options:

- i) If the company is part of a Group, the trustees could enter into a formal agreement with the parent company so that another company within the Group will pay off the deficit in full should the Principal Employer become insolvent.
- ii) The trustees could obtain a priority charge over an asset such as cash or property or securities so that this would become a scheme asset in the event of insolvency
- iii) The trustees could obtain a letter of credit from a third party or a bank guarantee.

### **Implications for trustees**

This is taking trustees into the field of becoming shadow finance committees, financiers and bankers. They will inevitably become embroiled in the overall corporate financing of the business.

Is this really sensible? Is it really what the legislators wanted? Is it really what TPR wants? Does it help the members

Most importantly, which lay trustees have these skills? It would frighten the living daylight out of many "director" trustees, let alone Member Nominated Trustees!

### **Investing assets of final salary schemes**

Let's turn to another delicate issue. Final salary schemes have traditionally invested substantially in equities. There has been a move towards more investment in fixed interest, for 2 main reasons:

- a) as schemes have matured, they have more pensioners and deferred members, for whom fixed interest investments are more appropriate.
- b) there has been a debate within the actuarial with some actuaries arguing that fixed interest is a more suitable match, in any event, for active members as well as pensioners and deferreds. Not all actuaries agree with that!

One leading actuarial firm, who advise many of the UK's largest pension funds, are now arguing that they should invest heavily in alternative assets such as hedge funds, commodities, private equity, junk bonds and infrastructure bonds. The actuaries argue that by investing in this way funds can expect an annual return of 8.4% with dramatically reduced volatility. The probability of a negative return is seemingly 20%, compared with 27% for a conventional fund. Returns would be within plus or minus 9.7% in 2 out of every 3 years, compared with a range of plus or minus 13.2% with conventional funds – or so claim the actuaries.

The actuaries do admit that their recommendation is "a bit visionary"! Enough said – we don't think many schemes will follow such an approach. Imagine the macro-economic implications on stock markets if such significant sales of equities took place.

But what it does do is highlight yet again areas that trustees will need to consider in the future. Is there really a role for the "amateur" trustee within pension funds?

### **Then there is the transfer value problem**

Actuaries have also been debating transfer value bases. These are ultimately set by the trustees of course. Actuaries have traditionally used an actuarial basis that takes some account of anticipated equity yields, when setting transfer value bases. But in line with the above, there has been actuarial argument for using gilt yields rather than equity yields, which would have the effect of increasing transfer values. This is unpopular with employers! The actuarial profession has agreed that it cannot agree and so has asked the Government to step in and set the actuarial basis for the calculation of transfer value bases. The Government has said it will! Yet another area where actuaries will just become "policemen" in the future, rather than advisors. (Oh dear, will the death of final salary schemes mean the death of the pensions actuary?)

## **And let's not forget the British Airways factor**

British Airways' main pension scheme has liabilities of £12bn and, on the FRS 17 basis, a £2bn deficit. Put this in the context that BA has a market capitalization of just £4bn!

BA has proposed a "solution" which is quite complex, but in essence is:

1. BA will put in £500m as a special contribution, this being on top of its normal annual contribution of £120m.
2. most staff will have their normal pension age (NPA) raised from 60 to 65
3. pilots will have their NPA raised from 55 to 60, but it may rise to 65 later
4. cabin crew will have their NPA increased from 55 to 60 for the next 5 years and in 5 years' time it will increase to 65
5. pension accrual for those whose NPA is currently 5 will reduce from n/52<sup>nd</sup> to n/56<sup>th</sup>
6. no change in employee contribution rate of 5.25%

BA are advised by their actuaries that these changes to the scheme will cut £450m from the FRS 17 deficit.

But remember what we said before about what TPR had found – typically the FRS 17 funding basis is only equivalent to 70% to 80% funding on discontinuance. So if BA's FRS 17 liabilities are £14bn, it suggests that their discontinuance liabilities are perhaps £17.5bn to £20bn. Hence the discontinuance shortfall is perhaps £8bn. Is this financially soluble?

## **Help is available!**

The need is for pension schemes (which, remember, are **big** money) to be looked after professionally, with at least one professional independent trustee on the trustee body.

We provide that service through Moores Williams Trustees Limited. We understand the corporate issues and are practical and pragmatic in working with employers and other trustees in "managing" the problem towards the final solution.

It is important that schemes also receive practical and pragmatic advice in the key areas of legal and actuarial advice. For that reason, we have teamed up with Harper Macleod to provide specialist pension legal advice and Scottish Widows to provide pragmatic actuarial advice. Scottish Widows also provide a high quality and efficient administration service.

All these services – trusteeship, actuarial advice, legal advice and administration are provided on a fully transparent fee basis, with fixed fees wherever possible.

We call it the Professional Pensions Alliance – professionals working together for the benefit of the client.

Please contact us and ask for more details for your clients.

What is there to lose?

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**MW Pensions Ltd, Oaklands Park, Hooton Road, Hooton**

**South Wirral CH66 7NZ**

**Tel: 0151 328 1777 Fax: 0151 328 0707**

**Website: [www.mwpensions.co.uk](http://www.mwpensions.co.uk)**

**Email: [admin@mwpensions.co.uk](mailto:admin@mwpensions.co.uk)**