

BBS briefing note

The Regulator's Analysis of Scheme Funding Returns

The Pensions Regulator has this month published its report "*Scheme funding : An analysis of recovery plans*". The report analyses Recovery Plans submitted to the Regulator by 31 July 2009, covering the first three years of the new Statutory Funding Objective (SFO) funding regime, i.e. valuations with effective dates between 22 September 2005 and 21 September 2008. This *BBS briefing note* summarises the findings.

BACKGROUND

The new SFO funding regime applies to all actuarial valuations with an effective date on or after 22 September 2005 and requires that a Recovery Plan must be put in place and submitted to the Regulator where a scheme's assets are less than the Technical Provisions.

By 31 July 2009, the Regulator had received 4,931 Recovery Plans out of an eligible universe of around 7,400 schemes. A further 600 Recovery Plans are expected to be received after the 31 July 2009 cut off. The balance of around 1,900 schemes are expected to have shown a surplus at their valuation date.

The data is divided into three tranches based on the effective dates of the valuation:

- Tranche 1 (T1) – 22 September 2005 to 21 September 2006;
- Tranche 2 (T2) – 22 September 2006 to 21 September 2007; and
- Tranche 3 (T3) – 22 September 2007 to 21 September 2008.

The Regulator acknowledges that the data submitted and the trends disclosed will have been influenced by scheme-specific issues and, in particular, changing market conditions.

SCHEME FUNDING

The average ratio of assets to Technical Provisions, i.e. the funding level (for schemes which have a funding level less than 100%), has remained relatively stable over the period.

	T1	T2	T3
Funding level	79.8%	82.2%	82.0%

The Regulator notes that the increase in funding levels between tranche 1 and tranche 2 was largely due to improving asset values, although this had been partially offset by more prudent assumptions adopted for assessing the Technical Provisions.

A further analysis of the funding levels established that:

- Larger schemes (by membership or Technical Provisions) have a higher funding level than smaller schemes;
- More mature schemes (by proportion of pensioners) have a higher funding level than immature schemes; and
- Schemes with a higher Dun&Bradstreet rating (as used for assessing PPF levies) have a higher funding level than those with a lower rating.

ASSUMPTIONS FOR TECHNICAL PROVISIONS – DISCOUNT RATE

Discount rates are used to calculate the present value of future cash flows and hence establish the Technical Provisions.



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There are two common approaches taken in practice:

- A dual-discount rate approach where a different discount rate is adopted for the pre-retirement and post-retirement periods; and
- A single discount rate adopted for both periods.

Where different discount rates have been adopted, the Regulator has calculated an *effective single rate*. The average nominal rates adopted are as follows:

Discount Rate	T1	T2	T3
Pre-retirement	6.2%	6.4%	6.5%
Post-retirement	4.6%	4.9%	5.0%
Effective single	5.4%	5.6%	5.8%
Single	5.0%	5.3%	5.7%

The trend indicates increasing discount rates, both in nominal terms and relative to gilt yields, and hence lower Technical Provisions. The Regulator suggests that the increase is due to the increase in the corporate bond spread over gilt yields and an adoption of increased allowances for future equity returns as equity markets are believed to be low.

The Regulator is concerned that Technical Provisions will be understated if schemes adopt too high a discount rate. Tranche 4 may better determine the extent of the trend as it will cover the period when markets fell dramatically.

ASSUMPTIONS FOR TECHNICAL PROVISIONS – LONGEVITY

Longevity assumptions include a view on the current rate of mortality together with an

allowance for future improvements to this rate. The current rate of mortality has in 99% of cases been based upon a standard table with an increasing percentage of schemes adopting the “00” series. The S1 series relates to the experience under large self-administered pension schemes (SAPS) and were first published in 2008.

Mortality table	T1	T2	T3
92 series	97%	73%	41%
00 series	2%	26%	53%
S1 series	0%	0%	5%
Other	1%	1%	1%

50% of schemes in tranche 3 have applied an adjustment to the base table, with a roughly even distribution between the application of an age rating and an adjustment to the underlying mortality rates.

The most common approach for allowing for future improvements is to allow for a Medium Cohort adjustment (63% of schemes in tranche 3) although a Long Cohort adjustment (32% of schemes in tranche 3, up from 13% in tranche 2) is gaining in popularity. In tranche 3, 62% of schemes also applied a minimum underpin to the rate of improvement (up from 23% in tranche 2).

The result of the trend in longevity assumptions has been an increase in the assumed average life expectancy of between one and two years. Each additional year of life expectancy is estimated to increase liabilities by about 3%.

Current age	Life Expectancy		
	T1	T2	T3
45	86.6	87.7	88.3
65	85.3	86.1	86.4

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THE REGULATOR'S TRIGGERS AND RECOVERY PLANS

The Regulator employs triggers to determine whether Technical Provisions or Recovery Plans will give rise to further investigation. The Regulator will also carry out further investigations on schemes that do not trigger where it is felt to be appropriate.

The Regulator emphasises that the triggers are not targets, that Technical Provisions should be robust, and that there exists flexibility on Recovery Plans where needed. The primary triggers are as follows:

- Technical Provisions – the trigger is set at a point between the value of the FRS17 liabilities and the s179 liabilities (dependent on scheme maturity and employer covenant); and
- Recovery Plans will trigger if:
 - The Plan is longer than 10 years;
 - The Plan appears to be excessively back-end loaded; and
 - The investment return assumption appears inappropriate.

The percentage of schemes triggering, broken down by trigger breached, was as follows:

Tranche	Technical Provisions		Recovery Plan	
	only	only	Both	Neither
T1	26%	19%	25%	30%
T2	22%	17%	13%	48%
T3	18%	24%	18%	40%

The percentage of schemes which triggered reduced from tranche 1 (70%) to tranche 2 (52%) reflecting an increased understanding of the funding regime and more favourable economic conditions. As economic conditions

deteriorated into tranche 3 the number of schemes triggering increased (60%).

Those schemes which triggered the Recovery Plan trigger have been further analysed (with each trigger breach recorded separately):

Tranche	Plan Length	Back-end Loaded	Investment Return
T1	19%	14%	20%
T2	13%	9%	12%
T3	18%	12%	25%

The average length of Recovery Plan has been between 7 and 8 years over the three years, with 50% of Plans being between 5 and 10 years and 95% of Plans less than 15 years.

An analysis of the Technical Provisions trigger indicates that:

- The tendency to trigger on Technical Provisions reduces as the size of the scheme increases;
- The tendency to trigger on Technical Provisions reduces as the maturity of the scheme increases; and
- Schemes with a higher Dun&Bradstreet rating (as used for assessing PPF levies) trigger less on Technical Provisions than those with a lower rating.

BBS VIEW

This and previous reports provide valuable information on scheme funding to Trustees, employers and actuaries. The sensitivity to economic conditions is notable in the results and the next tranche of valuations will further test the flexibility in the system.

