Scheme Specific Funding

What is happening in practice – preliminary findings

September 2006

The results of the first round of actuarial valuations under the new funding regime are currently under discussion between companies and trustees. This is a critical time – the outcome of the first 'scheme specific valuation' will set the scene for company contributions in the future. Our survey into the preliminary results provides unique insights into the early trends.

Background

With effect from September 2005, valuations must be carried out under the new funding regime. This regime is generally expected to strengthen the financial security of members' benefits, ie improve the funding position and require greater contributions and/or security from companies.

There are greater obligations on trustees and companies during the course of a valuation; in particular, they will typically need to agree the contributions – in most cases, this represents a significant step-change in the balance of powers. The Regulator has made clear that he expects trustees to act independently and to adopt a scheme-specific basis, which takes into account the strength of the company covenant.

The valuation outcomes will be assessed by the Regulator, using a series of "trigger points" which primarily look at the relative level of the scheme's funding target (the present value of pension promises made) and the length of the recovery period (the period over which any deficit is corrected).

The key findings

Our findings, based on preliminary results for 42 valuations, show that:

- Around half of all schemes are considering funding targets below the Regulator's 'trigger points' (see below). In general, this is by making allowance for some element of equity outperformance in setting the funding target.
- The use of different discount rates for pre and post retirement is becoming increasingly common, with just over half of schemes considering this approach. Typically the pre-retirement rate will be higher reflecting some equity investment with the post retirement rate being mainly derived from bond yields.

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- Most schemes that have little or no allowance for equity outperformance in the discount rate are considering allowing for this in the recovery period.
- Mortality assumptions are being strengthened, with almost two thirds of schemes making allowance for future improvements in longevity as 'encouraged' by the Regulator, although the level and way schemes are making this allowance varies from scheme to scheme.
- Few schemes intend to use a recovery period longer than 10 years (one of the Regulator's trigger points). Indeed, the use of periods of five years or less is under active consideration in a number of cases.

What are the implications?

Although the Regulator published its twin trigger points for funding targets (IAS19 and Pension Protection Fund liabilities) in May this year, our survey suggests they are not necessarily becoming the standards adopted for valuation purposes. This finding is reassuring as it provides evidence that trustees and companies are properly considering scheme-specific factors, rather than being driven by external measures. The Regulator has clearly stated that this is the approach it would encourage.

However, recovery periods appear to be shorter than had previously been common-place. Undoubtedly this has been influenced by the Regulator's trigger point of 10 years.

Our early experience is that around half of schemes may have funding targets below the Regulator's trigger point. The Regulator has informally suggested that as many as two-thirds of schemes might be expected to fail the initial triggers. In such cases, our early experience is that the Regulator will examine the rationale in the context of the scheme and the sponsor and, providing this is well supported, it will not intervene.

Where schemes are considering a funding target based on an IAS19 type discount rate (i.e. AA corporate bond yields), there is evidence of more complex approaches being adopted in how this relates to contribution requirements over time.

The first valuation under this new regime will be a significant event for most companies. The Regulator has stated that any weakening of the prudence at future valuations will need to be justified and therefore this first valuation will set the framework for the funding of the scheme for years to come.

Further information

We will continue to monitor the first sets of valuations – it is likely that the preliminary findings above will develop over the coming weeks and months. We will be happy to discuss with you our findings in more detail.

If you would like to find out more about these preliminary results, please contact your Watson Wyatt consultant or call Andrew Reid on 020 7222 8033 or Steven Dicker on 0161 839 1600.