



# Pensions – opportunities at the actuarial valuation

By James Saunders

DEFINED BENEFIT PENSIONS HAVE BEEN AN INCREASING problem for finance directors for the past decade, and the pain does not seem to be easing. Pension schemes can be resource-hungry, taking up management time, swallowing cash and then returning for a further helping every few years as scheme members live longer and investments underperform.

Continuing legislative and economic changes bring new challenges, but also opportunities to manage the pension position more effectively, often to the mutual benefit of the members and the sponsoring company.

Each scheme must carry out an actuarial valuation every three years (as a minimum) to assess the cash funding requirements. In most cases, agreement is required between the trustees and the sponsor on both the way the deficit is calculated and the recovery plan for achieving full funding. It is important to realise there is an element of negotiation possible rather than simply following a prescribed set of rules. The process of the triennial valuation can extend over many months but can also be a key opportunity for the sponsor to influence the future direction of the scheme.

So, what can the finance director do to optimise the company's position at valuation time?

## Preparation

First and foremost, prepare for the forthcoming negotiation. Expectations upon the trustees are set by the scheme's documentation and, importantly, the Pensions Regulator's Code of Practice on Scheme Funding. Trustees are expected to act independently from the sponsor and negotiate the best deal they can in terms of recovering the deficit.

So, before the valuation process even begins, the company should seek independent advice and take the time to understand the scheme, the regulatory framework and its responsibilities. It should consider its own preferences (e.g. what cash it can afford to contribute and when) and constraints (e.g. banking covenants). From these deliberations it can derive some high level objectives to underpin the valuation process.

## Employer Covenant

Of key importance is the strength of the "employer's covenant" to the scheme. Which companies in the Group stand behind the pension promises? What is their financial strength? What does the future hold? How have these things changed since the previous valuation? And how

willing is the sponsor to inject funds when needed?

Trustees are expected to understand these matters and may commission an independent report. But the finance director can lead the covenant debate and help the trustees by first setting out the company's views and providing the evidence to back them up.

When determining the assumptions to use in a valuation, the trustees' view on the strength of the covenant provided to the Scheme by the Company is extremely important. The weaker the trustees perceive the employer's covenant to be, the more prudent their assumptions should be, and hence the higher the value placed on the pension liabilities. The Pensions Regulator has recently issued new guidance about the importance of understanding the employer covenant, so you can expect this to be a key theme in future valuations.

### Assumptions

The valuation itself is a snapshot of the funding position of the scheme. In order to do calculate this, the Scheme Actuary must project the future cash flows of the scheme, and discount them back to the valuation date to obtain a present value of the liabilities. This requires a large number of assumptions, which usually come from the previous valuation as a starting point and are updated based on evidence from the financial markets, mortality studies and other sources. Some of these are easier to challenge than others, and some will be significant in impact while others are relatively trivial. It is important to focus on the low-hanging fruits, both in terms of easy pickings and the value yielded to the company.

The one thing that is certain is that any number produced from this process is wrong. The valuation is a budgeting exercise, to determine an appropriate pace of funding for the next few years. Marginal differences in the measured deficit will make little difference to the contributions in the short term, but may result in higher contributions in the medium to long term. Don't forget that this time's agreement is also the starting point for the next valuation. If you allow excessive prudence to creep into the assumptions then you could also be conceding ground for the next negotiation in three years' time.

### Anchoring – a pre-emptive strike on the valuation assumptions

Of course, the sponsor can just wait for the trustees to produce initial results and then challenge the outcome if it is not satisfactory. But it is often worth getting your view in first by making a proposal to the trustees on the assumptions to be used in the valuation, before the Scheme Actuary presents initial results on a prudent basis.

The psychology behind this is that the first number in the field of play tends to act as a base line. If the sponsor puts forward no view, it can prove difficult to move the trustees away from the initial figures which they had seen, on the Scheme Actuary's prudent basis, despite any strong arguments made by the sponsor. The first numbers seen by the trustees tend to have an "anchoring effect" so if the sponsor can get its view into the first round of results, this can positively influence how the negotiations develop.

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The assumptions you adopt for accounting disclosures can also be important here – if you follow the trustees' lead on non-prescribed assumptions such as mortality then that can be seen as tacit agreement with their prudent views.

Alongside your views on assumptions, you can also describe the strength of the employer covenant. Offer to present and explain that in detail to the trustees – you know the business best and you can guide them on key metrics and also any softer issues that a formal covenant review may not pick up on.

There is usually a time lag of several months between the effective date of the valuation and the initial results, during which the financial conditions are already known and the company can be preparing its case, reassuring the trustees and engaging proactively.

### Cash conservation

When you discuss the deficit recovery plan, the trustees will seek to secure the maximum contributions that are "reasonably affordable". Their views on this may not resonate with those of the company. If you need the cash for other purposes, you do not have to pay it in but the trustees will need to understand why. Some expenditure should be regarded as good expenditure by the trustees if it helps to improve and strengthen the business. Trustees can and do agree to back-end loaded or profit related recovery plan structures if they consider that this will enhance the covenant and ultimately improve the likely outcome for the members.

Non-cash alternatives or "contingent assets" such as security or guarantees may have a part to play, for instance in lengthening or re-shaping the recovery plan. And if you are paying in cash, don't forget to review the terms of the scheme's trust deed to ensure that if there is ever a surplus, the sponsor can get a refund.

If cash is a scarce resource then you can also work with the trustees over cost efficiency. What can the company do to influence and minimise the pension protection levy? Often there are measures that will improve the Dun & Bradstreet failure score which is a key cost driver here. Similarly, administration and advisory costs are significant and there may be simple and sensible measures that will improve value for money. Consider the scope of work as well as the hourly cost – not everything is compliance work and you should focus on adding value to the management of the scheme.

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### Risk management

Pension schemes are often cited as the single largest risk on the balance sheet of UK plc. The best outcome for the members is a strong employer backing the scheme, and risk management is important in preserving and enhancing the employer covenant.

The single most significant pension risk is investment strategy which is the preserve of the trustees under trust law. But trustees usually welcome proactive engagement by the sponsor. Investment strategy also affects the assumptions for funding purposes – less risk implies a lower discount rate and a larger deficit – so there is a balance to be struck. Hence, it is beneficial to develop a rounded company view on funding and investment matters and

use the triennial valuation process to put it in place.

There are also other measures that can be taken to reduce risk. The term “liability reduction” covers a range of measures where members can be asked to select options that reduce future pension exposure. Planning and communication for such exercises is crucial, to avoid the risk of members making the wrong choices and claiming compensation later on. But the results can be spectacular – ITV booked a gain of £38 million in 2009 as a result of its efforts in relation to pension increases.

### In summary – Act early and take advice

Proactive management offers the opportunity to achieve better control of cash and pension risks for the sponsor. The triennial actuarial valuation is a key event in the scheme calendar and is an opportunity for a finance director to positively influence the direction of travel. ■

The views expressed are solely those of the author and not of Punter Southall as a whole.



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