The Trustee toolkit downloadable

How a DB scheme works

Tutorial two: Managing the liabilities

By the end of this tutorial you will better understand:

- the issues trustees should consider in managing a scheme deficit

This tutorial is part of Scenario one.

Glossary

A detailed glossary of technical terms can be downloaded from the Resources tab when you log in at www.trusteetoolkit.com

The Pensions Regulator

Handling a deficit

A group of trustees are discussing their schemes, all are in deficit (on an ongoing funding basis).

Theo

The latest valuation of Theo's scheme revealed a fairly large deficit whereas at previous valuation dates, the scheme had been in surplus. The company he works for is a well established quoted company that has just announced record annual profits. Theo is concerned that his employer is being rather miserly and could be doing a lot more to reduce the deficit over a shorter timeframe.

The employer here is certainly able to support the scheme, but it does not seem very willing to pay off the deficit over a relatively short period. The trustees are considering their options for agreeing funding with the employer to eliminate the deficit over an appropriate timescale.

Donald

Donald's scheme is also in deficit, but the position of his scheme is different to Theo's because the employer is on the brink of insolvency.

After the last triennial valuation the employer was unable to make the extra contributions which were required to clear the ongoing funding deficit within a reasonable timeframe. Since then the financial position of the company has deteriorated further.

Therese

Therese is in a challenging position. Her scheme has seen its deficit increase since the last valuation. The employer is a manufacturing business which is profitable but in a competitive sector, and its revenue has been in gradual decline since the last valuation.

Based on recent profits and previous willingness of the employer to pay contributions to the scheme, the employer initially seems to provide a good covenant to the scheme, but the company wants to reduce funding for the next three years from that agreed in the current recovery plan to allow for investment in new machinery.

The employer wants to continue paying dividends to its parent company overseas. The company also wants the trustees to agree to increase the equity risk premium allowance (ie the return it is assumed the scheme's investments will make) in the recovery plan to help offset the lower cash contributions the employer wants to make.

The employer says this is key to ensure it remains healthy over the long term. The trustees are being pushed by the employer to agree but know they need to decide what action would be in the best interests of members.

Plugging the deficit for Theo's scheme

Theo's employer is financially stable but seems reluctant to address the scheme's liabilities. Donald and Therese have some suggestions.

What does Donald suggest?

Donald suggests that Theo should push the employer to pay off the deficit. He thinks that as the employer could afford to plug the deficit quickly, Theo should seek money while it is available.

What does Therese suggest?

On the other hand, Therese points out that because the company is financially stable, Theo could feel relatively secure that the deficit will be paid, even if the payment was being made over a longer period.

What does Theo think?

Theo sees merit in both Donald and Therese's ideas. However he understands that The Pensions Regulator (TPR) recognises that a strong, ongoing employer alongside an appropriate funding plan provides the best scheme support. He thinks a recovery plan that reflects the employer's current strong position, but does not constrain its business plans (including those for sustainable growth) would be a good outcome for all.

He knows the trustees will continue to monitor the employer covenant alongside the scheme's investment performance and its funding level to make sure they know whether the overall balance of risk is worsening and whether they need to take action.

Some options for Donald's scheme

In Donald's case, the sponsoring employer is in a precarious financial situation. So plugging the deficit for this scheme is not straightforward.

What is Theo's advice?

Theo says that Donald could demand that the deficit is repaid immediately, but this could force the employer into insolvency. Donald thinks that this might not be in the best interests of the members of his scheme. Active members could be made redundant and members could see their pension benefits reduced if the return to the scheme from the insolvency was not sufficient to ensure that the members receive their full pensions.

Insolvency, by definition, involves a company having insufficient assets to meet its liabilities. In these circumstances, if the company is liquidated, creditors whose debts are not secured by assets will only receive a portion of the sums owed. For example, if a company has £1,000 worth of assets and creditors are owed £10,000 in total, each equal ranking creditor will receive only 10% of the sums owed to them.

A pension scheme is a creditor (and usually an unsecured creditor) of the employer. By contrast, a bank which has provided the company with a mortgage has security for that loan in the form of the property secured against the mortgage debt. In the event of the company's insolvency, the bank is entitled to the proceeds of the property and is not required to share those with other creditors.

Donald needs to understand his options and protect the interests of members. It's a very tricky position, and Theo suggests he might need to obtain outside advice from a covenant expert.

What is Therese's advice?

Therese suggests that the employer and trustees could agree to reduce future benefits, after consulting the members of course. Although this would help to reduce the costs to some extent, it wouldn't directly help with the deficit on pension promises already earned.

Alternatively, Therese suggests that the trustees could help the employer by agreeing to reduce employer contributions and invest heavily in equities in the hope that the return on those assets will be high enough to make up the deficit.

What does Donald think?

Donald thinks that Theo is right. The trustees need covenant advice in order to understand the implications of an insolvency of the employer for the scheme and to help them assess their options. He thinks that the trustees need to be aware of just how bad the employer's financial position really is and take a realistic view on its prospects.

Donald thinks that taking additional investment risk is the wrong approach as the employer probably won't be able to provide additional cash if the investments underperform. However he thinks the reducing future benefits idea should be seriously considered as the trustees need to focus on being able to meet the liabilities that have already been earned.

Therese's conundrum

Therese is a trustee of a DB scheme with an employer which has a strong covenant but which says it has short term affordability constraints as it needs to invest funds back into its business.

Theo's view

Theo says TPR's view is that the best support for a scheme is a strong ongoing employer and that trustees can recognise competing demands for the employer's cash where these will improve the employer's covenant. So it may be reasonable for the trustees to agree to a recovery plan that sets deficit repair contributions at a level that accommodate some investment by the employer in new machinery.

Theo also thinks that amending the scheme's investment strategy to allow an increase in the investment return assumption would be reasonable if the employer covenant is strong enough to address a range of likely adverse outcomes over an appropriate period. However, he wonders whether this is the case, given the employer's business has been in gradual decline, and thinks it is important to understand the employer's future strategy and prospects.

Donald's view

Donald questions whether the employer should continue paying dividends to shareholders in preference to the scheme deficit repair contributions, and wonders why dividends would be paid given the employer needs to invest funds back into the business. He wonders whether there is pressure on the employer to pay dividends because the wider group is short of cash.

Donald thinks the trustees could agree lower pension contributions, a higher risk investment strategy and higher investment return assumptions if they are comfortable that the long term covenant is strong. However, he thinks the trustees should seek:

- a guarantee for the deficit from a stronger company in the group
- security over assets of value in return for accepting lower contributions initially, and/or
- use other mechanisms such as profit share to increase cash funding to the scheme in the future if the business becomes more profitable as a result of the investment in the machinery

He believes that it may be appropriate to limit dividends being paid out of the group as part of any agreement reached with the employer to reduce deficit repair contributions in the short term.

Therese's views

Therese appreciates these views. The trustees want to support the employer, but are uncomfortable with the continued dividends and uncertain about the future prospects for the employer.

Therese thinks the trustees need to take covenant advice and challenge the employer's proposals thoroughly before they can agree to anything. If they then can't reach agreement they might end up missing the deadline for submission of the valuation to TPR. They would need to report the failure to agree to TPR.

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