Hewitt

SPOTLIGHT

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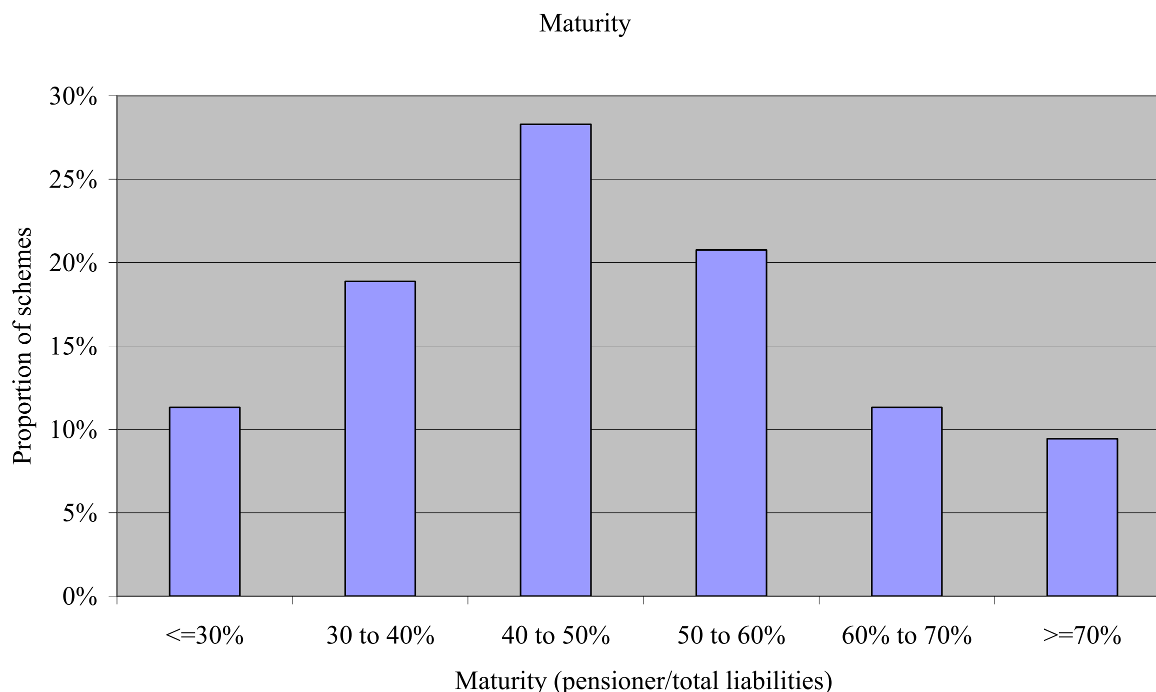
Issue 64: Survey of £1bn+ schemes shows impact of funding requirements

Hewitt advises over 50 clients that have pension fund assets greater than £1bn. Our recent survey considered a wide range of aspects of these "mega schemes" and here we look at what we found.

About these funds
By their very nature you may expect funds this big to have pensioners as a large proportion of their liabilities (i.e. to be mature). The average maturity is 50% but this hides a range from 5% to 85%.



A third of these funds are still open to new entrants - one reason might be that the new entrants do not pose much additional risk in return for retaining the goodwill of interested stakeholders. In other cases, companies may retain traditional objectives and the view that defined benefit provision is best.

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Funding for the benefits, and managing funding risk
The Pensions Regulator appears to have been successful in raising the funding target for these schemes. Most are now aiming for somewhere around 100% of PPF or FRS17 funding (with some aiming well above), although a significant minority are still aiming below. Most are using “Medium Cohort” mortality assumptions and only a very few are aiming for a deficit repair period in excess of 10 years.

The Pensions Regulator has set a quasi-target in the form of its funding triggers and most of these schemes are aiming to avoid its attention. They are herding around “Medium Cohort” as their definition of mortality, perhaps because it appears ‘safe’ when many others are also using this. However, we believe that valuations being started this year are likely to have even stronger mortality assumptions than those recently completed and trustees need to keep up-to-date on developments on mortality between valuations. Spotlight Issue 66, due out in September, will be covering this topic.

A significant minority of schemes surveyed are either:

a) Having legitimate regard to scheme specific factors and setting technical provisions or recovery plan lengths that are likely to trigger the Regulator’s further attention (e.g. if the employer is financially strong, the trustees may agree to set technical provisions at a lower level than the Regulator’s trigger point)

b) Allowing for higher expected equity returns in their recovery plan than in their technical provisions.

If a scheme is likely to trigger further investigation from the Pensions Regulator, then the trustees need to ensure that the process they followed will stand up to scrutiny as they are likely to be asked to justify their approach, e.g. how did the trustees assess the employer covenant?

If higher equity returns are allowed for in the Recovery Plan the company contributions required will be lower. This increases the chances that the company will find they have a new deficit to deal with at the next valuation. We advise trustees that they should consider what happens if markets do not perform and trustees sometimes then ask for guarantees from the company that it will increase contributions to compensate or provide other security.

The survey shows that big pension schemes are looking beyond conventional cash contributions in order to manage overall funding risk. 40% of schemes surveyed already have some form of contingent asset in place - providing additional security to the scheme should the employer fail. This is a high proportion, given that they were hardly used before the scheme-specific funding requirements were introduced. Another 20% of schemes indicated that they are actively considering putting such a structure in place.

Among those surveyed, the most frequently used approach is a Parent Company Guarantee, which can allow the trustees to ignore the complexity of the corporate structure and focus on the ultimate owning company. It is not surprising that the parent company guarantee is the most popular contingent asset solution as it does not directly cost money or tie up assets. For schemes of this size it is worth the expense of managing these complex contingent asset solutions, but until the costs fall they may not become widespread among smaller funds.

There will be more information on the survey in the next issue of Spotlight. Please note we are not releasing the full results of this survey for reasons of client confidentiality, but if you are interested in a specific area and what it might mean for your scheme please contact your usual Hewitt consultant or Lynda Whitney (e-mail lynda.whitney@hewitt.com or phone +44 (0) 1372 733617)

If you would like to receive these bulletins by e-mail please email spotlight.enquiries@hewitt.com.

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