



## THE PCS ALERT The latest in DB Pensions

### IS THE PENSIONS REGULATOR DRIVING YOU TO INSOLVENCY?

*Dear Sid*

Times are extremely hard for companies and their pension schemes. The UK economy is in the midst of a very painful recession and pension scheme deficits are at record levels. Against this backdrop, the Pensions Regulator in a number of recent statements is taking a tougher and tougher line with trustees on pension scheme funding. Many companies are worried that this will drive them into insolvency.

If directors do not take action to control the fear trustees have of the Regulator, then there is a material risk that many more companies will be driven to insolvency by their pension scheme. Every time the Regulator speaks about scheme funding, he suggests that trustees should be more prudent. Trustees, fearing intervention by the Regulator, take these comments as requirements and seek increased cash payments from the sponsoring company.

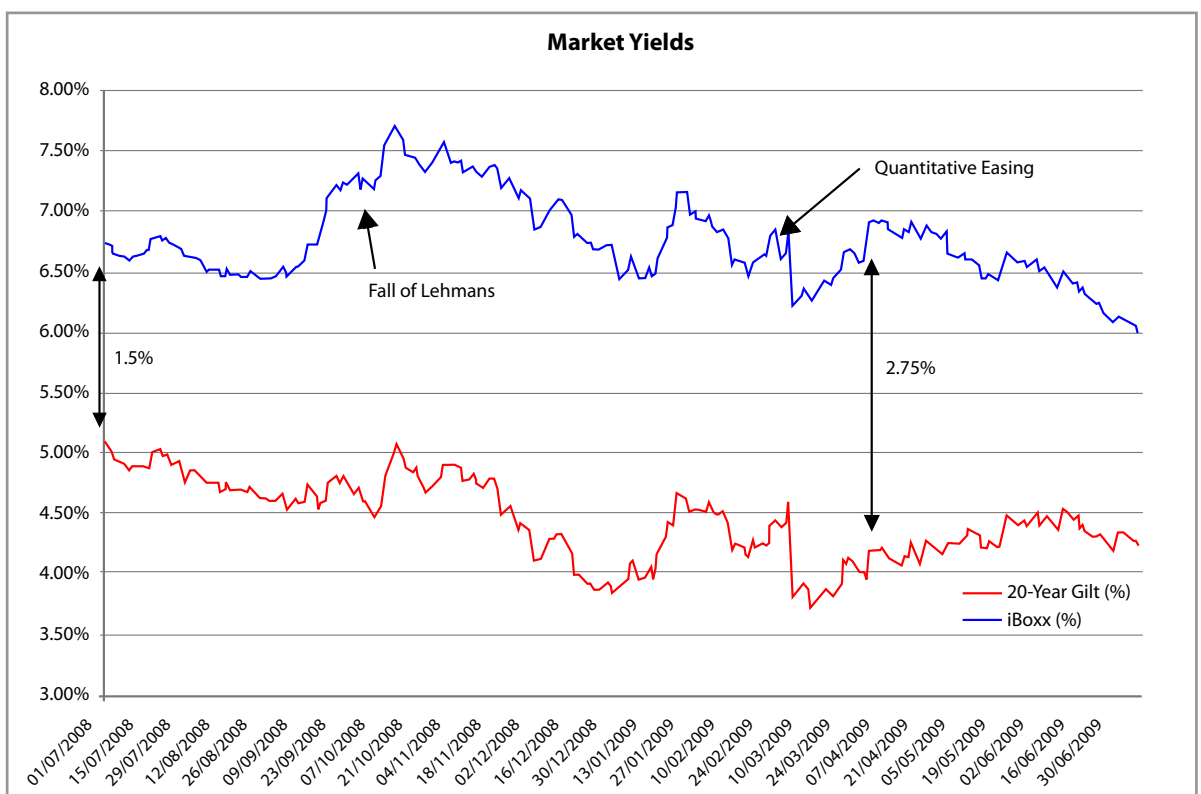
In the current economic climate directors are taking hard decisions to ensure the continued survival of their company, but this can all be wiped out by a demand for more cash from trustees.

Many companies are too frightened to seek help from the trustees with short term cash flow issues, fearful that this will be a signal to the trustees and Regulator of a weakening covenant, which leads to an increase in pension scheme liabilities and a demand for more cash from the trustees. Yes, illogical but that's what the Regulator seems to want.

Whilst the Regulator has said "the current regulatory framework and approach to scheme funding is sufficiently flexible to cope with these conditions....Where employers are cash constrained, trustees should look for the widest range of flexibility in recovery plans", in practice this does not seem to be the case. We are working with a number of companies who have reached agreement with the trustees on the valuation, only to be told by the Regulator to redo the valuation on a more prudent basis.

Only two years ago, the Regulator said funding on a corporate bond basis (in line with the liabilities on a company's balance sheet) was appropriate. Now it is unacceptable! In his review of scheme funding, published in December 2008, the Regulator showed there was a move amongst schemes to use a bond basis for discounting liabilities. This had already led to significant increases in the level of cash companies were contributing to their pension scheme. But the Regulator was not happy with this and wanted more cash. He went on to say that a bond-based funding strategy was unlikely to be prudent now, due to the widening gap between yields on bonds and yields on gilts.

Companies should be wary of giving in to the Trustees demands prompted by the Regulator even if you have the immediate cash. Achieving a 100% funding level on an unnecessarily prudent basis could result in stranded surplus having to be spent to improve benefits beyond what was originally promised and even at a time in the future when a business may be struggling.



A scheme funded on a bond basis will not have seen much change in its liabilities over the last 9 months, but a scheme using a gilt basis will have seen its liabilities increase by almost 20%, an increase that has to be funded by cash from the company. More alarmingly, if a scheme was funded on a bond basis and has its valuation in 2009, a move to a gilt basis could add over 50% to the value of the liabilities. These increases are on top of increased deficits through current low equity values and ever-increasing life expectancy. Our latest analysis of FTSE100 Pension Schemes showed a total deficit of £90 billion calculated on the normal IAS19 accounting basis. If this total deficit were to be calculated on a gilt basis it would increase to over £200 billion. To repay this extra deficit over 10 years would require a massive increase in deficit contributions from the current level of £5 billion per annum to about £20 billion per annum.

Companies simply cannot afford such increases, even in non-recessionary times, let alone in the current climate. It used to be the case that pension schemes were funded on a simple approach that saw companies pay more in the good times as a buffer to cope with the bad times. No longer, it seems - now companies have to pay even more in the bad times.

In our view, knee jerk reactions are not necessary. We are in turbulent financial markets and we question whether it is appropriate to make long term funding decisions based on current financial conditions. Indeed, to borrow a much-loved phrase from the Regulator, we question whether it is "prudent" in the current gloom of a recession to put such additional burdens on companies.

The Government's Quantitative Easing programme has not helped matters. This programme of buying gilts and corporate bonds has simply driven down yields and increased pension liabilities. Following the initial purchase of gilts, the 20 year gilt yield dropped 40 basis points, increasing pension liabilities by 10%.

Directors need to be proactive in advance of the next funding valuation and open up discussions early with trustees to explain why a move to a more prudent funding basis is not appropriate. Indeed, the cost of buying a pension (as determined by annuity rates) has fallen over the last 2 years, so why does the Regulator want schemes to assume the cost has increased? The general view was that funding was moving in the right direction and a bond basis for liabilities has the appropriate degree of prudence so why change now?

#### **What if the cash requirements are too high?**

A company can only afford a limited amount of its budget to be directed towards the pension scheme. There are other calls on the budget, many that are essential to the continued operation of the business.

If the trustee requirements are too steep then one solution is to cease providing final salary pensions for all employees and replace the DB pension scheme with a much simpler and more predictable DC Scheme. Companies have held off from taking this "last resort" option, but in the face of the current economic climate and an ever vocal Pensions Regulator many are making the changes now.

#### **In conclusion**

Company directors need to take a proactive and decisive stand on pension scheme funding. We are in uncharted financial waters and now is not the time to be making long-term financial decisions that could destroy all the hard work companies have done to ensure their survival.

PCS has already helped a number of companies justify sensible funding strategies to both the trustees and the Pensions Regulator. This is achieved through a carefully prepared justification for a funding strategy, and recovery plan that can meet the requirements of the trustees but within the financial constraints of what the business can afford.

Yours sincerely,



Rob Dales



For more information on how we might help, please contact Rob Dales on 0113 203 5883 or Charles Cowling on 0161 242 5388. Alternatively email us at [solutions@pensionstrategies.co.uk](mailto:solutions@pensionstrategies.co.uk) or visit our website at [www.pensionstrategies.co.uk](http://www.pensionstrategies.co.uk) to register your interest.

*Whilst all reasonable care has been taken in the preparation of this publication no liability is accepted under any circumstances by Jardine Lloyd Thompson for any loss or damage occurring as a result of reliance on any statement, opinion, or any error or omission contained herein. Any statement or opinion unless otherwise stated should not be construed as independent research and reflects our understanding of current or proposed legislation and regulation, which may change without notice. The content of this document should not be regarded as specific advice in relation to the matters addressed.*

Pension Capital Strategies Ltd. Authorised and regulated by the Financial Services Authority.  
A member of the Jardine Lloyd Thompson Group. Registered Office: 6 Crutched Friars, London EC3N 2PH.  
Registered in England No 5651461. VAT No. 244 2321 96.