Grant Thornton Pensions Advisory podcasts

1. Key issues for pension schemes: transcript

Welcome to this series of Pensions Podcasts from Grant Thornton.

In this the first edition, we are going to look at some of the key issues and challenges facing pension scheme trustees, their employers and other stakeholders at the moment.

To make sense of those challenges and issues, I'm joined by my colleagues from the Pensions Advisory team, Phil Green and Jamie MacKenzie, both of whom are very experienced pensions professionals, who've worked over many years on employer covenant and scheme funding projects.

Russell My first question then Jamie is a simple one. What are the kind of issues we're seeing at the moment that trustees specifically should be aware of, from the point of view that it might affect the health of a pension scheme?

Jamie One of the major things we are seeing that trustees should be aware of is a lot of guidance coming out of the regulator. They are trying to be a lot more proactive in getting things out, so there is an annual statement every year, but two significant documents have come out recently - the code of practice, which came into force in July 2014. This really talked about how the regulator would like to see an integrated approach to risk management, so taking into account the employer covenant and investment risk funding risk, and linking at them all together to assess the risk management of a scheme going forward.

This code of practice was also a chance to refresh on the previous code and bring it into more current real world situation where the economy has moved on. I don't think they were expecting a credit crisis in between, so this guidance takes that into account from that perspective.

The other document that has come in recently, as of August 2015, is a new document on assessing and monitoring the employer covenant. This again emphasised the need for a holistic approach in dealing with the scheme, so covenant, investment and funding risks, but it also talked about being clear on which employers were legally obliged to be supporting the scheme and a consideration of affordability around that.

Russell I think we've seen some changes at the Pensions Regulator this year, Phil. Is it going to have any impact that we know of?

Phil Well the changes in the regulator's key position is that there is a new CEO down there. It's not quite clear yet whether that's going change fundamentally the approach the regulator takes, but I think it is certainly going to start to feed through in the wording and the focus, which is put into the guidance and the practice notes that come out.

Where that may take us I don't know, but generally we are seeing more focus on the more difficult schemes, the ones with the greater levels of deficits, and the ones which are expected to be in trouble for a longer period of time. I think that focus will continue.

Jamie Yes the regulator acts on a proportionate level, so it'll be interesting to see where that goes, because for a long time there was an Interim CEO, so it will be interesting to see where Lesley Titcomb takes the regulator.

Russell What about the PPF Levy? Huge changes there this year as well.

Jamie Yes, recently there have been some significant changes to the way the PPF Levy is calculated and the methodology behind it. The most notable change is the insolvency score metric. The PPF have moved from using Dun & Bradstreet to using a new PPF-specific insolvency score model they developed with Experian.

We have seen a lot of employers move levy bands as a result of this, so the amount schemes and employers can be paying can significantly vary. These changes came into account in October 2014, but it will come more sharply into focus as the invoices for the 2015-16 levy year are submitted.

Russell OK, that's trustees. Phil, what about any issues employers need to be aware of?

Phil Well, affordability still seems to be key for employers. Last year, the Pensions Regulator provided a new statutory objective, which said the trustees had to take into account sustainable growth for the employers going forward. That is going to be used by the employers as a rationale for providing more internal investment from their free cash flows and pushing out recovery plan payments and length of deficit repair plans.

It's not necessarily a bad thing, but trustees have to be very wary of the position where, when the companies have money, they use it to selfinvest as opposed to funding the pension scheme deficit. In that case, the pension schemes don't get what they should rightfully get out of the free cash.

The alternative to that though is, when they can't afford to pay and they struggle or companies begin to become loss-making or go into some form of recovery scenario, then they can't pay significant sums of money into the pension scheme, so both ends of that particular spectrum, the schemes are very badly funded. This is something then trustees need to keep an eye on, not just what the business is doing at the moment and therefore allowing reinvestment for sustainable growth, but in the longer term as well to make sure they keep up with their investment profiles.

Russell What about investment issues like gilts? Jamie?

Jamie Gilt yields have been long expected to improve going forward, but this really hasn't come to fruition so far, but as and when it does come, I think schemes and employers need to be aware of the idea of trapped surpluses and taking that into account as a future issue.

Phil Trapped surpluses at the moment are a relatively key issue, from the point of view if trustees have a clause that says that if there is a surplus that can be returned to the employers, a resolution needs to be passed by the end of March next year, 2016, which will allow that to still continue to happen. But there is a 3 month notice period for that resolution before it can actually be passed, which really means it's something the trustees and the employers are considering now, towards the end of 2015, so they have a couple of months left to do that in so it's a key issue for them at the moment.

Russell Nothing affects a pension scheme like a transaction involving its employer so one assumes that levels of transactions have been relatively depressed for the last few years? What's the story out there, Jamie?

Jamie Currently we as a firm have been seeing a lot more activity and a lot more transactions coming through, just as the UK and global economy has improved over that period.

We're starting to see a lot of that coming through, so it's something for trustees and employers to be aware of actually, from the perspective of you'd normally think of an acquisition as covenant-enhancing, but it needs to be considered as to how it's been financed, so whether debt has been put on the group and you need to think of the impact of the pension scheme

What we would normally do is look at it pre- and post-transaction, look at the transaction in isolation and look at the level of detriment that it causes and if there is significant detriment we would be advising the trustees to seek mitigation.

Russell Phil, I assume the regulator have some thoughts on this?

Phil Well then regulator's view is very much that if there is a detrimental impact upon the scheme, the trustees should be seeking mitigation, either in cash terms or through some additional security to be provided or something of that nature.

As Jamie said, it's not just acquisitions and disposals which could impact upon a covenant, so if you remove half of the employer's trade because it's been sold on, that's obviously got a fairly clear potential detriment.

Acquisitions though can also have a problem, because even although you would expect the employers to be buying a profitable business, if to buy that business they are loading a lot of debt onto the balance sheet, that could impact where it sits on the priority of creditors. Then once again that could have a potential impact on the covenant, so both acquisitions and disposals need to be considered by the trustees and they do need, as Jamie was saying earlier, look at the pre and post position to get a view as to whether there is detriment.

Russell One of the biggest pensions stories of 2015 was the introduction of the new pensions freedoms. What impacts have we seen on DB schemes, Phil?

Phil Well, you wouldn't immediately that pensions freedoms would have any impact on DB schemes, because the purpose of pensions freedoms is that anyone over the age of 55 can now get their hands on their defined contribution pot, if they have one.

However, you can transfer out of a DB scheme into a Defined Contribution scheme and therefore there is an impact with people moving out of DB schemes, so they can get their hands on this money. I think the Association of British Insurers came out recently and said they think in the first six months since the pensions freedoms came in, about £5 billion has been moved out of pension schemes.

Now this could have a significant impact upon on the funding position of defined benefit pension schemes. It's not expected that that level of funding in six months is going to carry on going forward, it's expected that there will be a settling of this position, but even so in the long term there could be some significant changes in the funding profiles of DB pension schemes, which will have to be addressed by both trustees and employers

Russell But Jamie that presumably means it's incumbent on the trustee to monitor their covenant all the time, not only at Triennial Valuation time?

Jamie Exactly, yes. Covenants can change quickly, trustees need to monitor the covenant between valuations, and think about developing contingency plans about how to deal with things.

And key points for trustees to consider are things that could have an impact – it varies from employer to employer – but things like material changes in the affordability, changes in the group structure, maybe any plans to refinance, so raising external refinancing or dividend payments and one other thing trustees may not think about, actual changes in the employers industry so if there was a merger between two competitors, how might that impact? So if the trustees can look to set certain triggers, they would be able to deal with them.

Gentlemen, thank you . And thank you for taking the time to watch today. As usual you can find all the information you will need on this complex subject, including a transcript of this podcast, on our web pages at **http://www.grantthornton.co.uk/pensionsadvisory**

Grant Thornton
An instinct for growth™