

Recovery plans:

an initial analysis

Recovery plans: an initial analysis

Background

The new funding regime for defined benefit pension schemes, under Part 3 of the Pensions Act 2004, came into force on 30 December 2005. This regime replaced, and was a radical departure from, the highly prescriptive Minimum Funding Requirement (MFR) of the previous Pensions Act 1995. It is designed to be phased in over a period of about three years to synchronise with when an MFR valuation would otherwise have been due.

All pension schemes with a deficit are required to submit a recovery plan to the regulator setting out how the deficit is going to be eliminated. Schemes set out how quickly the deficit will be paid off (known as the recovery plan length) and, in an accompanying valuation summary, state the assumptions on which they have calculated the value placed on their liabilities (their technical provisions).

What has been published?

This analysis is based on a dataset of 1,292 recovery plans submitted to us until the end of July 2007 based on valuations with effective dates during the last quarter of 2005 and the first quarter of 2006.

Why has it been published?

The analysis is being published in response to requests from the pensions industry and in order to maintain transparency over what we have seen from the recovery plans submitted to us. We anticipate that this analysis will be updated in future.

About the data

This analysis is based on data taken from recovery plans (and valuation summaries) as they were received by the regulator and does not necessarily represent how the data would look after recovery plans passed through our trigger process (see below) and we had engaged with schemes.

The data should not be interpreted in any way as indicating what the regulator views as 'acceptable'. All recovery plans should be set on a scheme specific basis and are considered by us on that basis.

Assumptions underpinning the recovery plans included in this analysis will reflect the economic situation and business climate at the time that the scheme valuations took place (ie Q4 2005 and Q1 2006).

Our 'triggers'

In line with our risk-based approach all recovery plans submitted to us are passed through a number of triggers that help us to focus our resources on those plans most likely to require further consideration.

These triggers are as follows:

* **Technical provisions**

There is one trigger set at a point between the value of liabilities in accordance with the employer's accounting standard (either FRS17 or IAS19) and the value placed on the Pension Protection Fund (PPF) level of compensation benefits for levy purposes (s179). The precise point in the range will vary between schemes depending on the maturity of the scheme and the strength of the employer covenant; and/or

* **Recovery plans**

There are three triggers that will filter a plan for further review:

- period of the plan is longer than 10 years and/or
- the plan is excessively back-end loaded and/or
- the investment return assumption over the life of the plan appears to be inappropriate

Our published guidance makes clear that these triggers are not targets. We expect trustees to give primacy to technical provisions (ie we expect schemes to agree prudent technical provisions even if that leads to a long recovery plan).

Key findings

The key findings from our analysis are as follows:

- * As might be expected, there is a great deal of diversity across schemes reflecting the scheme specific nature of the funding regime
- * The majority of trustees and employers appear to have embraced the scheme specific nature of the regime positively, and submitted recovery plans recognising the need to make prudent assumptions for the calculation of their technical provisions - with average technical provisions coming out close to the FRS17 accounting standard and above s179
- * Around a third of plans did not trigger on any basis and have required no action by the regulator. Of the 70% of recovery plans that did trigger, a large proportion needed only minimal action on our part (such as requesting further information or seeking a clarification from trustees).
- * In only a small percentage of cases (10%) has action been escalated to a point where regulatory intervention may be required, reflecting the degree of concern about the plan submitted to us. We would expect many of these to be resolved by agreement.
- * Schemes appear to have given due attention to our code of practice on the funding of defined benefits and are, in general, acknowledging the principle of reasonable affordability in eliminating the disclosed deficit.
- * Over 80% of schemes are producing plans no longer than 10 years in length, with an average plan length of 7.5 years
- * The post-retirement mortality assumptions we have observed are predominantly based around the medium cohort adjustments to the '92' series Continuous Mortality Investigation (CMI) pensioner tables.

Our observations

It is still early days in terms of the scheme funding regime. Many of the recovery plans received by us and included in the dataset for this analysis are still being looked at. This analysis should, therefore, be seen as a snapshot of a dynamic and still unfolding situation rather than as providing a basis for any definitive conclusions on the overall impact on scheme funding.

That being said, there are a number of observations that we would make based on our experience to date:

- * **Triggers**

These have had to be set relatively widely in order to reflect the very diverse nature of schemes and employers. It is important to stress that these triggers are not targets

- * **Longevity assumptions**

Those we have seen have been predominantly based on the medium cohort adjustments to the '92' series CMI pensioner tables. This may reflect the fact that these plans were developed prior to recent debate on what might be considered prudent. We would expect future recovery plans to take into account more recent arguments for strengthening assumptions to reflect the latest data suggesting that mortality is continuing to decline at historically high rates

- * **Failures to agree**

We have begun to see some failures to agree. We take this issue very seriously. Our powers in this regard are set out below and we will use them where appropriate

- * **Late returns/requests for extension**

We are concerned about a trend for some schemes (especially those who were due to submit plans in July 2007) to notify us at the last moment that they would be late in submitting their plans.

Handling plans that trigger

Whilst many of the recovery plans submitted have triggered this should not be seen as a cause for concern. Our triggers are intended to filter in any plans that may warrant further enquiry and given the wide diversity of schemes and employers covered by the scheme funding regime it is not surprising that many plans are caught by one or more of our triggers.

We deploy our resources in a risk-based manner. A large proportion of the plans that trigger require only minimal scrutiny on our part. The number of plans requiring more than a brief review to assess the extent of the overall risk is small in comparison to the overall number of plans submitted.

It has been notable that in a number of cases where we have made further enquiries into how the length of a recovery plan has been determined, and without further prompting, substantial additional employer contributions have been forthcoming and the length of the plan reduced.

Using a sample of 766 recovery plans taken from our dataset of 1,292, we were able to track how plans progress through our triggers to possible regulatory intervention.

- * We started with a sample of 766 plans received before July 2007
- * Of these, 30% did not trigger on any basis
- * By the end of July 2007, we had written to 465 schemes indicating that we did not intend to exercise our powers in relation to their recovery plans and another 67 schemes were in the process of being sent letters
- * Of the remaining plans which were still going through our processes only 75 had been escalated for possible regulatory intervention

As we have frequently emphasised we seek to achieve positive outcomes without recourse to the use of our powers. Based on what we have seen so far in terms of the recovery plans submitted to us we believe that this approach has been largely effective - subject to the observations above.

Our powers

We have a range of powers which may be exercised, if there has been non-compliance with Part 3 of the Pensions Act 2004:

- * to modify the future accrual of benefits;
- * to direct how technical provisions are to be calculated;
- * to direct how any funding shortfall is to be remedied; and/or
- * to impose a schedule of contributions, detailing active member and employer contributions.

The above powers are in addition to our other existing powers, which include the power to:

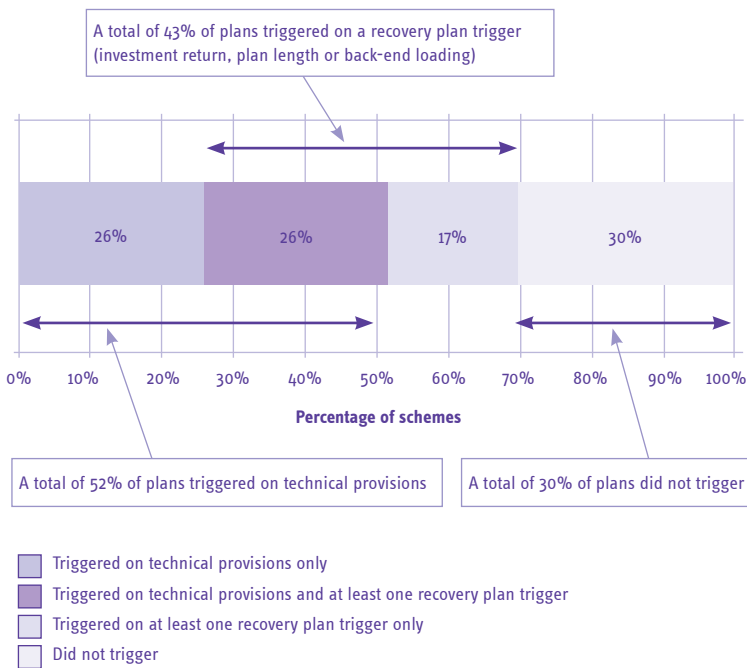
- * appoint a trustee;
- * prohibit a trustee;
- * issue an improvement or third party notice;
- * issue a freezing order; or
- * wind up a scheme.

Detailed findings

Of all 1,292 recovery plans received to 30 July 2007, 30% of funding plans did not trigger. Some 26% of funding plans triggered on technical provisions alone, a further 26% on technical provisions and at least one recovery plan trigger (investment return, plan length or back-end loading), and 17% on just the recovery plan. These are mutually exclusive categories.

Percentage of recovery plans triggering

30% of plans did not trigger



Bars may not sum to 100% due to rounding.

Base: 1,292 schemes at 30 July 2007

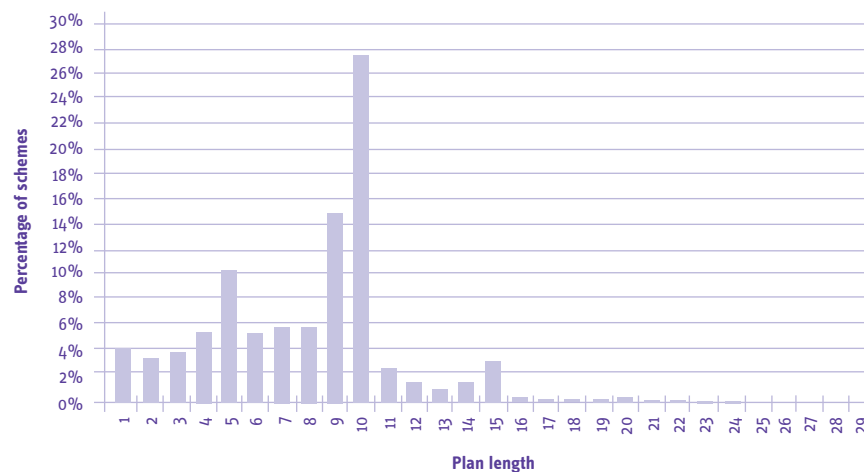
It should be noted that the triggering statistics presented here are representative of recovery plans as initially submitted to the regulator. For example, a scheme may trigger on the level of its technical provisions when first submitted, but after engagement with the regulator, may adopt higher technical provisions which would not have triggered.

Recovery plan length

Whilst over 80% of schemes have set recovery plans at no longer than 10 years there is a noticeable spike at the 10 year mark (the point at which our publicly disclosed plan length trigger point has been set). This suggests the 10 year trigger is influencing trustees in a general, rather than scheme specific, way.

We believe that typical recovery periods before the new scheme funding regime were around 15 years, and are encouraged by this apparent change in behaviour to reduce recovery periods under the new scheme funding regime. Furthermore, while the 80% of schemes in our dataset which have submitted plans of no longer than 10 years is less than the 94% of schemes behaving similarly in the Mercer Human Resources survey on scheme funding¹ published earlier this year, it is still more than the 38% of schemes that Mercer quoted as planning to pay down funding deficits in less than 10 years in 2004 when the MFR was in force.

Distribution of recovery plan lengths



Base: 1,236 schemes as at 30 July 2007

It is important to note the recovery plan length graphs presented here are based on plan length data as initially submitted to the regulator. Where longer plan lengths have triggered, and in our view there is scope to reduce them, we have engaged with some schemes to action this. However, in other situations, after engagement, we may conclude that longer recovery plans are acceptable.

¹ Mercer Human Resource Consulting, April 2007: 'SFO Valuations - The first year's crop - Highlights'

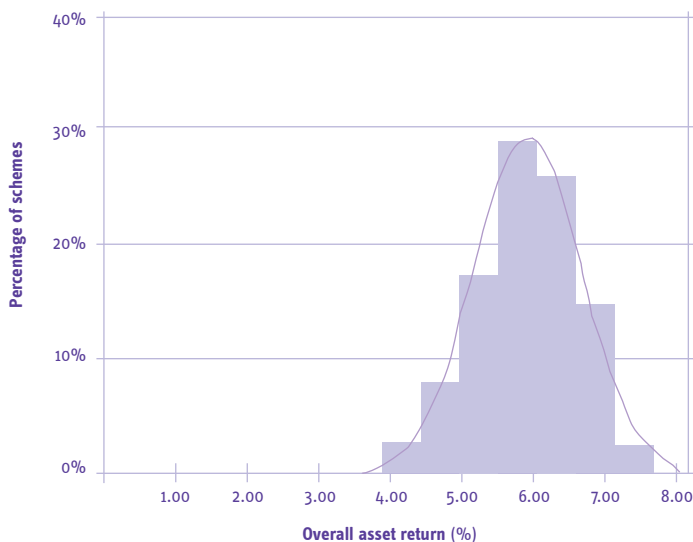
Recovery plan length *continued*

The average recovery plan length for the 1,236 schemes for which we held cleaned data was 7.5 years, with the weighted average (by technical provisions) the same. For the largest 100 schemes with the highest technical provisions, the average plan length was 7.4 years and the weighted average (by technical provisions) a little longer at 7.6 years. Finally, for the worst funded 100 schemes by funding on a technical provisions basis (assets as a percentage of technical provisions), the average plan length was 8.6 years, and weighted average a little shorter at 8.2 years.

Investment return

Our trigger process filters out schemes from further investigation if the investment return assumption over the period of the recovery plan (the overall asset return) appears appropriate. The range of return assumptions shown in the chart below is, as expected, wide. This may be explained by schemes' different investment strategies and the ability to assume realistic returns over the recovery plan period.

Distribution of overall asset return

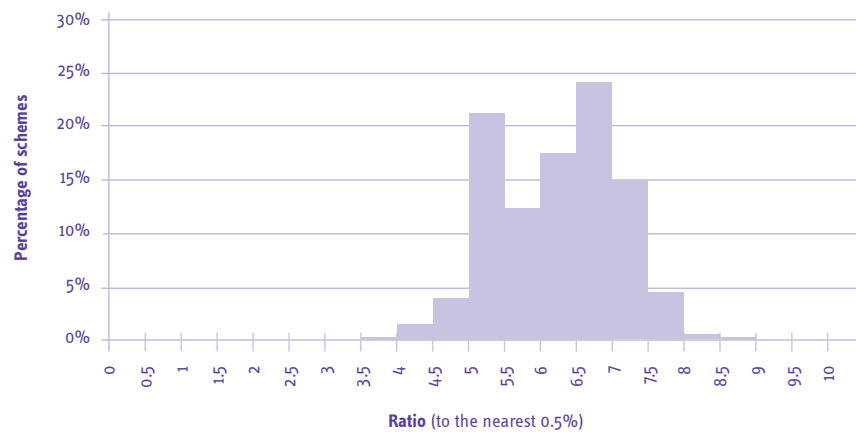


Base: 1,182 schemes at 30 July 2007

Discount rates

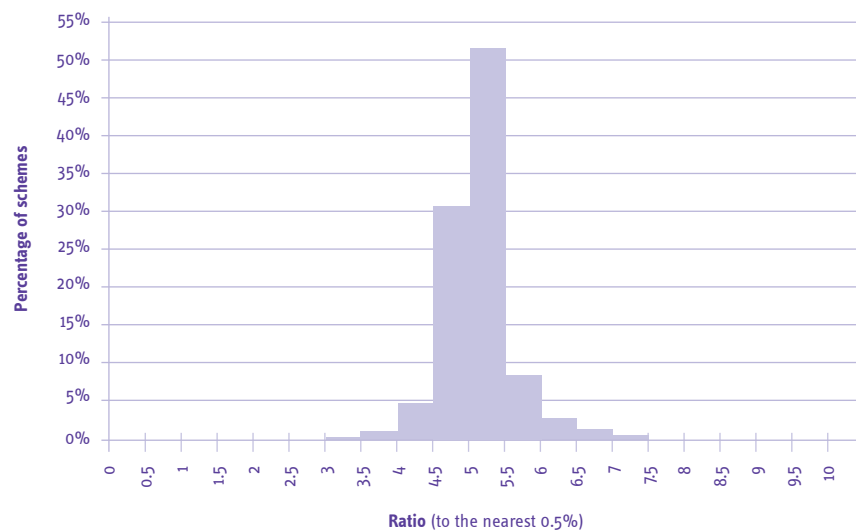
What we have observed is that, as expected, pre-retirement discount rates were more variable than pensioner rates. This is not surprising as most trustees match pensioner liabilities by bonds but may take into account the employer covenant, where strong enough, for pre-retirement rates. The discount rates in either case are broadly speaking within the ranges we expected to see. Average discount rates (weighted by technical provisions) based on the total of 1,167 schemes for which we had cleaned data were 5.6% per annum for the pre-retirement period and 4.9% per annum for the pensioner (post-retirement) period. However, not all schemes differentiated between the two periods and quoted a composite rate pre- and post-retirement.

Percentage distribution of pre-retirement discount rates



Base: 1,167 schemes at 30 July 2007

Percentage distribution of pensioner discount rates



Base: 1,167 schemes at 30 July 2007

The statistics presented above should not be interpreted as meaning that calculating technical provisions using discount rates near to our weighted averages of around 6% pre-retirement and 5% post-retirement will not lead to any regulatory action.

Mortality assumptions

The appropriate allowance for future mortality improvements has been a subject of much debate over the last year. To put this into context, a one year increase in the life expectancy of 65-year olds can increase scheme liabilities by around 3%. There are two aspects to the decision:

- * the current rates of mortality appropriate for the scheme’s membership; and
- * the reductions in those rates anticipated in the future.

Most recent debate has centred on the latter, much of it around three adjustments to the CMI ‘92’ series pensioner tables known as the short, medium and long cohort projections. All are attempts to allow for the so-called ‘cohort effect’ observed in UK population and insurance company data showing that generations born between about 1910 and 1942 have enjoyed a positive step change in their mortality compared to previous generations. Subsequent generations, whilst still showing improvements, have not improved at such high rates.

The three cohort adjustments were designed to be applied in conjunction with the ‘92’ series CMI pensioner tables which already incorporated an allowance for future reductions in mortality rates (though assumed to tail off to zero). The adjustments all incorporated observed improvements up to 1999 and projected these higher improvement rates to merge with the ‘92’ projection rates in 2010, 2020 and 2040.

The strength of mortality assumptions adopted when setting technical provisions varied significantly in our dataset of schemes. This was to be expected given trustees are required to consider the profile of their particular scheme’s membership when setting this assumption. It is also in line with the findings of other surveys.

Percentage distribution of base table used *(with or without adjustment)*

Base table used <i>(with or without adjustment)</i>	% of schemes
PXA92	97%
PXA00	2%
PA90	1%
PXA80	1%
PXL92	<0.5%
a55	<0.5%
Scheme experience	<0.5%
Population tables	<0.5%
	100%

Column may not sum to 100% due to rounding

Base: 1,138 schemes as at 30 July 2007

Percentage distribution of method for allowing for future improvements

Method of allowing for future improvements	% of schemes
Year of birth	61%
Calendar year	36%
Not specified	3%

Column may not sum to 100% due to rounding
 Base: 1,138 schemes as at 30 July 2007

Percentage distribution of allowance for the cohort effect

Allowance for cohort effect	% of schemes
No cohort	33%
Short cohort	11%
Medium cohort	55%
Long cohort	<0.5%
Not specified	<0.5%
	100%

Column may not sum to 100% due to rounding
 Base: 1,138 schemes as at 30 July 2007

It should be noted that the data processed and analysed for this document relates to valuations carried out with effective dates between 30 September 2005 and 6 April 2006, when there was no clear consensus around which of the cohort projections was the most appropriate. Very few schemes in our dataset allowed for improvements in excess of those predicted by the medium cohort projections and around 33% made no explicit allowance for the cohort effect.

In fact, recent research produced by the CMI indicates that the rate of mortality improvement is not slowing down as would be expected under either the short or medium cohort projections. Paragraph 80 of our code of practice on the funding of defined benefit pension schemes requires trustees to consider with their actuary the latest available data when deciding what allowance to make for future improvements in mortality. Although considerable uncertainty remains around the rate of future mortality improvements, we expect trustees and their advisors will consider this latest research when setting the assumptions to be used for future valuations.

Liability measures and funding levels

We do not present figures adding up the combined totals for our liability measures or for funding deficits. We do not intend this analysis to make inferences about the aggregate deficit for all defined benefit schemes. Aggregate s179 figures are published in the monthly PPF7800 Index².

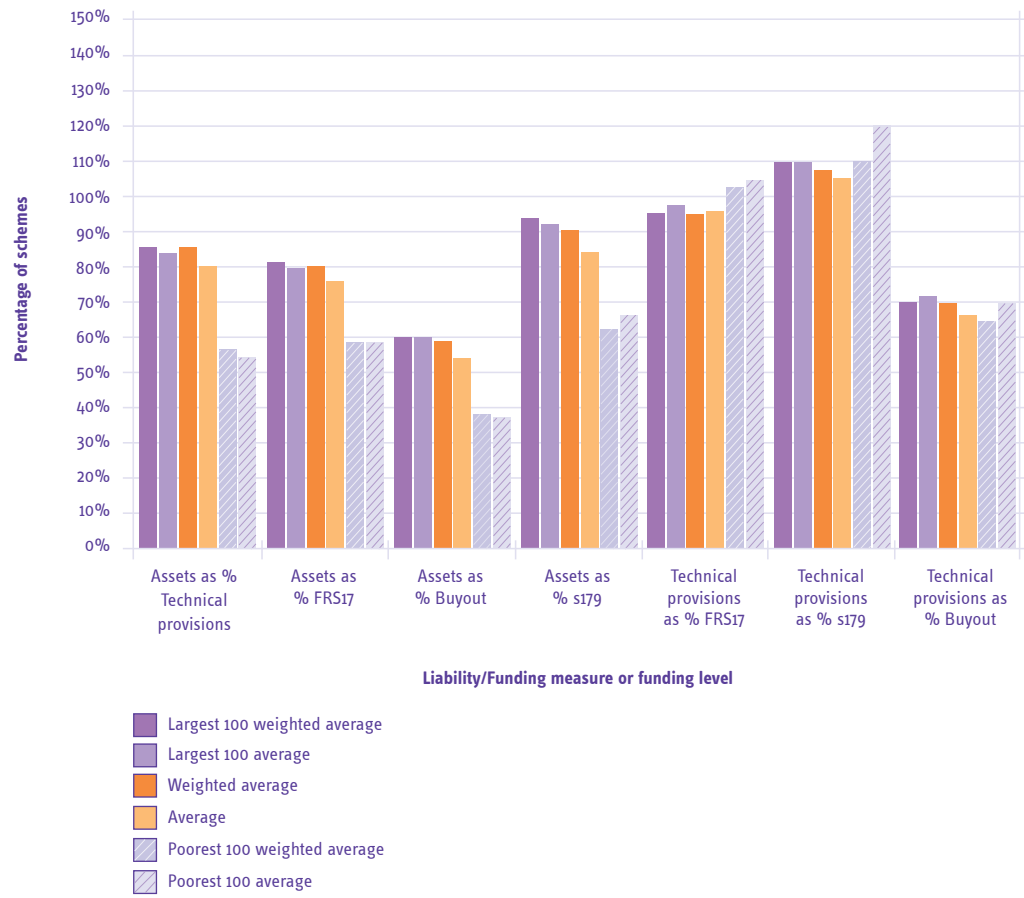
The following chart compares liability measures and funding levels on the various bases. It removes outliers where liability or funding ratios were over 200% (there may be good scheme specific reasons for such high ratios and we cover these in our full analysis on our website). Furthermore, it compares the average and weighted averages for the whole dataset, the largest 100 (by technical provisions) and the worst funded 100 (by assets as a percentage of technical provisions).

Different legislative or auditing requirements where scheme benefits are matched by insurance policies held in the name of the trustees mean that it is not possible to compare liabilities on different valuation bases in an entirely consistent way. In particular, technical provisions are permitted to exclude matching insurance policies whereas s179 and FRS17 will normally include them³. Also, the assets taken into account for comparison with technical provisions may not be appropriate to calculating funding levels on a different valuation basis. Internal sense checking and advice suggests the impact is small. To the extent that there is any bias, it will tend to make the s179 and FRS17 values look slightly higher relative to technical provisions than is the case.

² The Pension Protection Fund, 2007: www.pensionprotectionfund.org.uk/index/ppf_7800_index.htm

³ One exception to this rule is set out in the PPF's S179 valuations guidance (paragraph 5.5), where s179 valuations do not have to include insured benefits for which contracts of insurance were taken out prior to 6 April 1997 and where relevant information regarding these contracts cannot be reasonably found.

Average and weighted average liability comparisons and funding levels



Base: maximum of 1,286 schemes at 30 July 2007 (1,292 schemes less some outliers that are currently being investigated by the regulator)

Liability measures and funding levels *continued*

Weighted average liability measures and funding levels for the whole dataset were as follows:

- * Buyout places the highest value on liabilities, and, as expected, it is significantly higher than technical provisions. The weighted average technical provisions as a percentage of buyout is 69%.
- * Technical provisions are roughly equal to FRS17. The weighted average here is 96%, though there is considerable spread in the tails either side.
- * Technical provisions are a little higher than s179 liabilities. Weighted average technical provisions as a percentage of s179 is 108%. This means that if the deficits are closed on a technical provisions basis, on average, there would be a surplus on a s179 basis. However, there is again considerable dispersion.
- * Finally, with regards to funding levels, the weighted average funding level on a technical provisions basis is 85%, just slightly lower than on a s179 basis (92%). The weighted average funding level on an FRS17 basis is 82% but, as expected, funding on a buyout basis was lowest (59%).

Although the full dataset and the largest 100 schemes have similar average and weighted average liability measure ratios and funding levels, the worst 100 funded schemes do seem to be setting the highest technical provisions relative to FRS17 and s179. The exception is the comparison with buyout, where the ratio is similar to that for the whole dataset. This suggests that the buyout measures in respect of the 100 worst funded schemes are relatively high. This is likely to be explained by the fact that this group of schemes are distinctly less mature than the dataset as a whole (because the buyout measure compared to FRS17 is usually relatively higher in respect of non-pensioners than it is in respect of pensioners). The relatively high technical provisions for this group is likely to be explained by their poorer than average employer covenants.

**A full analysis, which looks at a wider range of factors, can be found on our website at:
<http://www.thepensionsregulator.gov.uk/pdf/recoveryPlansSept2007longVersion.pdf>**

