I offer pension scheme, asset management and corporate clients services in the following areas:

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The Pensions Regulator - Annual Funding Statement

11th May 2012

Given current market conditions - in particular gilt yields - the Pensions Regulator was widely reported as preparing guidance for trustees of defined benefit schemes, in particular those moving through the actuarial valuation process at the current time.

The Regulator has now published the annual funding statement (web-link below), which addresses this question.

Some schemes will have significant bond or real yield sensitive investment portfolios - either directly or via a liability hedging program - and these will have served to partly cushion the blow that 2011 markets dealt when compared to unhedged schemes with predominantly equity or growth-oriented assets. However, bond-only or completely hedged schemes are a rarity, so the Regulator's paper is of broad interest and rewards careful reading.

The Regulator has considered the options available to schemes and issued clear and, in our opinion, extremely helpful advice. In particular, many of the mitigants that had been proposed - for example in press or professional comments - to cope with current conditions are addressed:

- The Regulator re-iterates that the calculation of technical provisions is based on prudent assumptions in relation to the assessment of employer covenant, irrespective of the deficit revealed;

- Investment performance should be measured relative to the near-risk free returns that would be assumed given a substantially hedged position. {Schemes should therefore employ something along the lines of a gilts+x% methodology - and be ready to justify the size of the x% in the light of the employer covenant - rather than making blunter absolute return assumptions: e.g. UK equities y% per year returns};

- Schemes should not time effective valuation dates to capture more favourable circumstances in order to reduce deficits. However markets do move and if these move significantly away from effective date levels, the use of post valuation experience may be acceptable. {Our understanding of this is that if the scheme effective date hits a particularly low / expensive real yield which subsequently improves during the technical provision calculation period, then some allowance for that recovery could be sought};

- There is no certainty as to when gilt yields will return to more normal levels, or what those levels will be. Consequently, schemes should generally not build in assumptions as to the evolution of gilt yields beyond those implied by the market - where these are forced by exception, contingency plans should be put in place to address the situation where this reversion does not occur. {As an aside, we would suggest that there is little evidence that the forward markets in gilts or other financial instruments form good predictors of future evolution of prices - we believe that gilt yields one year on are likely to be well away from current forward market predictions and this volatility is one of the key problems we face};

- The Regulator would expect, as a starting point, that current Recovery Plan levels would be maintained in real terms. Where the employer covenant is weakened so existing commitments or increased payments in respect of a larger deficit cannot be supported, then trustees may need to consider and be prepared to justify a longer Recovery Plan. The Regulator therefore does show understanding of the circumstances of the schemes with most distressed sponsors;

- The Regulator does expect that schemes with comparatively stronger covenants should ensure that they are dealt equitably with by the employer in assessing the competing stakeholder demands and deployment of corporate resources - in particular, where cash is being used in the business at the expense of pension contributions. Dividend payments are given special attention in the paper.

Pensions Regulator press release

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