The Trustee toolkit downloadable

DB recovery plans, contributions and funding principles

Tutorial three: Recovery plans

By the end of this tutorial you will better understand:

- what a recovery plan is
- the different actions trustees can take in the recovery plan to make up a scheme deficit
- the importance of regularly reviewing the recovery plan and amending it when the position of the scheme changes

This tutorial is part of **Scenario two**.

Glossary

A detailed glossary of technical terms can be downloaded from the Resources tab when you log in at **www.trusteetoolkit.com**

The Pensions Regulator

The Night Watch scheme

The trustees of the Night Watch pension scheme are talking at a board meeting. The Night Watch scheme is completing its latest triennial valuation. The trustees have been through the process of agreeing the assumptions and the method for calculating the technical provisions and the calculations have been made. The calculations show that the scheme's ongoing funding deficit has increased and the trustees now have to review their existing recovery plan.

Recovery plans: The basics

The trustees are discussing what that entails for the benefit of the new trustees on the board.

What are recovery plans?

When there is a funding deficit on the technical provisions (or scheme funding/ongoing) basis trustees are required to prepare (or review and if necessary revise) a recovery plan, which addresses how and by when that deficit will be made good and full funding will be achieved.

Trustees will also need to prepare or review a schedule of contributions which sets out regular contributions for future service (where the scheme has active members) and also the amount of any extra contributions required to eliminate the scheme funding deficit in respect of past service (deficit repair contributions).

The 'Funding defined benefits' code of practice issued by TPR states that a recovery plan should be appropriate. What is possible and reasonable depends on the trustee's assessment of the employer's covenant.

What should trustees consider?

There are various factors which trustees will need to consider when producing or reviewing their recovery plan which will determine the length and structure of the plan. The trustees need to consider:

- the strength of the employer covenant and the extent to which they can rely on employer support over the long term
- how much the employer can reasonably afford to pay, in the light of any business plans and commitments it may have including any plans for sustainable growth

Back-end loading

If the employer has significant short-term commitments, eg a loan is due for repayment, the trustees could consider whether back-end loading the schedule of contributions is appropriate. This means that the employer pays smaller contributions for an initial period, and then larger contributions for the rest of the recovery period.

However, the trustees should be careful to distinguish between mandatory and optional loan repayments so as to ensure that the employer is not opting to pay off other creditors whilst postponing payments to the scheme.

The trustees also need to consider whether delaying the payments needed to fund the scheme is a risk that they can reasonably take. They need to bear in mind the strength of the employer covenant, in particular, the degree of risk of the employer going into insolvency before those payments are received.

TPR is of the view that trustees should only consider back-end loading if the employer's financial situation can genuinely be expected to improve, eg if the employer is scheduled to pay off a loan within a few years or if the employer is investing in its business over the shorter term in order to grow and strengthen its longer term covenant to the scheme.

Investment return

The investment return assumption used for the recovery plan can be different to the discount rate used for the technical provisions, but this must be made clear in the plan and obvious to TPR.What's more, if trustees use a higher allowance for investment returns than that in the technical provisions discount rate there will be a higher risk that the statutory funding objective is not met by the end of the period covered by the recovery plan.

The Pensions Regulator's (TPR) statement: 2013

In May 2013 TPR published a statement stressing its view that there is sufficient flexibility within the funding framework (eg through the length of structure of the recovery plan) to address challenges and achieve an appropriate and balanced outcome. The statement also comments that a strong and ongoing employer alongside an appropriate funding plan is the best support for a scheme. It is therefore important that the funding plan proposed neither damages the employer's covenant nor benefits other stakeholders at the expense of the scheme.

Code of practice

TPR's 'Funding defined benefits' code of practice re-iterates this need for a balanced approach and supports the setting of a recovery plan that is appropriate to current and expected circumstances rather than those which have existed in the past.

It explains, for example, that if deficit repair contributions have been set at a low level for affordability reasons trustees should consider whether those reasons persist or whether changed circumstances mean that an increased level is appropriate.

Useful links
Read the 'Funding defined benefits' code of practice at www.tpr.gov.uk/code3.

Reviewing recovery plans

The trustees continue discussing the recovery plan.

The deficit has increased

In the case of the Night Watch scheme, the deficit has increased compared to that revealed at the previous valuation. The Pensions Regulator recognises that schemes may need to extend their recovery plans appropriately if affordability has not improved, and if the trustees are satisfied that this reflects a reasonable balance between:

- prudently recognising the need to pay promised benefits, whilst
- minimising any adverse impact on the employer's sustainable growth and therefore, its long term ability to support the scheme

Alternatively the contributions could be increased if the employer can afford to do so.

What if the deficit has reduced?

If the deficit had been reduced at this valuation the trustees and the employer would have had various options available to them including:

- to continue with their current planned payment rate
- to increase the contributions but reduce the recovery period
- to keep the recovery period the same but reduce the level of contributions over that time if, for example, the employer is facing new affordability constraints

What if the technical provisions deficit has been made good in its entirety?

If the Night Watch scheme no longer had a deficit at this valuation on a suitably prudent basis and the trustees have high confidence in the employer's covenant, the employer might be able to:

- cease making deficit-recovery contributions
- make some contributions to an escrow account instead of the scheme to avoid the risk of a 'trapped surplus'

However, if the covenant has deteriorated, a schedule of contributions based on more demanding technical provisions might be appropriate.

Next steps

The trustees of the Night Watch scheme have sought advice from Ben, their scheme actuary, regarding the recovery plan. So what's the next step?

The trustees

Because of how the scheme rules are drafted, the trustees need to obtain the agreement of the employer to the recovery plan. Once the employer has reviewed and agreed to it, the recovery plan needs to be signed by all parties and submitted to TPR together with a schedule of contributions. The recovery plan should be clear about the assumptions used to eliminate the shortfall.

The Pensions Regulator (TPR)

TPR will review the recovery plan in light of the scheme's circumstances. It will consider a broad range of risk indicators to allow for a rounded view of scheme characteristics before reaching any judgement on the overall risk a scheme presents and whether to engage further.

Risk indicators include (but are not limited to):

- inappropriate back-end loading
- reduction in contributions relative to any existing recovery plan
- reliance on investment outperformance in the recovery plan
- actions taken to weaken the employer covenant