Annual defined benefit funding statement 2015

May 2015

The Pensions Regulator

Introduction

1. This statement is relevant to trustees and employers of all defined benefit (DB) pension schemes but is primarily aimed at those undertaking valuations with effective dates in the period 22 September 2014 to 21 September 2015 (2015 valuations).

2. In this statement, we are setting out our key messages for these schemes. In particular we provide our views on current market conditions and how trustees and employers can agree appropriate funding plans which protect members' benefits without undermining the sustainable growth of the employer. Our observations are of a general nature, having regard to market trends and their likely implications for 2015 valuations. Individual schemes may, of course, have significantly different experiences.

We are setting out our key messages for schemes undertaking 2015 valuations.

3. This statement reinforces the key principles outlined in our revised **code of practice on funding defined benefits** (the DB code: **www.tpr.gov.uk/code3**) and explains how these can be applied in current market conditions. We expect trustees and employers with 2015 valuations to incorporate fully the messages contained in the DB code.

4. We also explain how we will be approaching our review of the valuations and recovery plans submitted to us in the coming year and comment on recent developments in relation to post valuation experience and DB to DC transfers.

5. In order to provide further context, we are publishing alongside this statement:

    - **Annual funding statement analysis: A look forward to schemes with valuation dates between September 2014 and September 2015 (Tranche 10): www.tpr.gov.uk/forward2015.** This analysis of the impact of the changes in market conditions and the expected position of DB schemes undertaking 2015 valuations provides the evidence base which underpins the messages in this statement.

    - **Annual funding statement analysis: A review of valuations and recovery plans for schemes with valuation effective dates in the period September 2012 to September 2013 (Tranche 8): www.tpr.gov.uk/review2015.** This analysis covers the schemes for which we provided guidance in our 2013 annual funding statement.

An integrated approach to managing risks

6. Paying the promised benefits as they fall due is the key objective for scheme trustees. The DB code recognises that, in doing so, it is not necessary to eliminate or manage all risk but the level of risk taken must be appropriate to the circumstances of each scheme and employer, in particular the ability of the employer to support the scheme when needed. We expect trustees to understand the scheme's sensitivity to different risks, form a view on the likelihood and impact of a range of scenarios and then set investment and funding strategies that carry an appropriate level of risk, which is then clearly managed. It is also important that trustees document their decisions and the reasons behind those decisions, referencing any key supporting analysis.

7. We encourage trustees, in discussion with employers, to undertake contingency planning to enable prompt action, where necessary, to ensure risk levels remain appropriate. Contingency planning and monitoring are not only useful tools to manage downside risks. They can also help trustees and employers identify when a scheme's funding position is improving and take action, for instance to change the investment strategy or to reduce employer contributions.

8. A sound understanding of scheme risks and a strategy to address these risks are particularly important for mature schemes. These schemes are more susceptible to a deteriorating funding position if their investments do not perform as well as expected and they have less time to redress deficits should downside risks crystallise.

The level of risk taken must be appropriate to the circumstances of each scheme and employer.

Market conditions and impact on scheme funding

9. In 2014, the UK economy grew at its fastest rate since 2006. Despite sustained economic growth and a tightening labour market, consumer price inflation has fallen to a record low. Economic growth forecasts for 2015 and 2016 have been revised upward and the Consumer Prices Index (CPI) is expected to remain low in the near term before returning to the two per cent Bank of England target within two years[1].

10. Yields on long-dated gilts have fallen significantly in the last 12 months[2]. Long-term real gilt yields are now significantly negative and considerably lower than they were three years ago. Low interest rates can have the effect of driving up current measures of pension scheme liabilities but also the value of gilts and other assets.

11. There is continued uncertainty about future economic and financial conditions and the outlook for gilt yields in the short, medium and long term. Compared to previous years, market expectations are for interest rates to remain lower for longer and to revert to lower long-term levels than previously thought[3], which has significant implications for scheme funding strategies.

12. Despite all major asset classes having performed well[4] and schemes having paid £44bn in deficit repair contributions over the last three years[5], our analysis suggests that many schemes with 2015 valuations will have larger funding deficits[6] due to the impact of falling interest rates and schemes not being fully hedged against this risk.

13. The extent of the impact of market conditions will depend on a scheme's specific circumstances such as the exact dates of valuations, asset allocations and interest rate and inflation-hedging strategies[7].

14. Those schemes which are relatively unhedged against interest rates and inflation should be aware of the degree of risk exposure that remains unhedged. Decisions regarding a scheme's level of hedging should be informed, among other factors, by the trustees' consideration of the potential impact of future changes in interest rates and inflation, either up or down, on the scheme in the context of the employer's risk tolerance and its ability to support downside events.

1
http://www.ons.gov.uk/ons/dcp171766_401022.pdf

http://cdn.budgetresponsibility.independent.gov.uk/March2015EFO_18-03-webv1.pdf

http://www.bankofengland.co.uk/publications/Pages/inflationreport/infrep.aspx

2
Figure 1, Tranche 10 analysis.

3
Figures 2a and 2b, Tranche 10 analysis.

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Figure 3, Tranche 10 analysis.

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The Pensions Regulator's data and analysis.

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Figure 4, Tranche 10 analysis.

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Figures 5a-5d, Tranche 10 analysis.

Investment returns

15. For most schemes, expected investment returns are a key determinant of the overall level of prudence in the scheme's funding strategy, as the discount rates used to calculate technical provisions and/or the assumption for asset returns over any recovery period are set with reference to the expected investment return.

16. Given the uncertainty about future market conditions, it is important that trustees carefully consider the potential impact on their scheme of different scenarios for investment returns, including those where returns are higher or lower than expected. They should be comfortable with the level of risk associated with the expected investment return not being borne out and understand what action, if any, could be taken should this risk materialise. We anticipate that most schemes will set funding strategies based on lower expected investment returns than at their last valuation.

17. Trustees who, at their last valuation, allowed for gilt yields reverting to a higher level and/or sooner than implied by the markets ("gilt reversion") should consider the effect that their assumptions not being borne out has had on the scheme's funding. They should implement contingency planning and take appropriate action to address any significant adverse impacts. This may, for instance, mean seeking additional deficit repair contributions (DRCs) or new contingent security.

18. Trustees who wish to allow for gilt reversion in their 2015 valuation should consider their assumption in light of current expectations for interest rates[8], understand the implications for their schemes if gilt reversion does not occur as assumed and consider the potential actions that could be taken. In particular, trustees who have previously assumed gilt reversion should consider whether it would be more appropriate to assume reversion over a longer time period and to lower levels than before.

We anticipate that most schemes will set funding strategies based on lower expected investment returns than at their last valuation.

8 Figure 2a and 2b, Tranche 10 analysis.

Setting appropriate recovery plans

19. The DB funding regime is designed to be sufficiently flexible to enable trustees and employers to agree funding strategies which meet the scheme's funding requirements without compromising the ability of the employer to invest in their business and support the scheme in the long term.

20. Where the scheme is in deficit, it is important that the recovery period is appropriate and that trustees are comfortable with the overall level of risk within the recovery plan. In agreeing a recovery plan, trustees should consider key factors such as the scheme's liability profile and duration, the extent to which the covenant can support downside scenarios, additional security from any contingent assets, and the employer's affordability, including its sustainable growth plans.

21. In particular, when considering an appropriate recovery plan period, trustees should be mindful that longer plans can result in an increase in scheme risks as the certainty with which the employer's covenant and expected investment returns can be relied upon reduces over time.

Managing deficits in the current market conditions

22. Funding strategies should be scheme-specific, reflecting the scheme's and employer's circumstances, including their approach to risk-taking[9].

23. Some schemes will still have capacity to take additional risk, for example because they have previously chosen to take a more prudent approach or the employer covenant has improved. These schemes are likely to be in a better position to manage the risks flowing from a larger than expected deficit at the 2015 valuation. They should be able to address their deficit without taking excessive risk through appropriate changes to their funding strategy, such as a modest extension to their recovery plans, a modest increase in DRCs and/or changing their assumptions relating to investment returns. The balance between these elements will depend on how much the deficit has increased, the strength of, and changes in, the employer covenant and its affordability.

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Schemes with additional capacity to take risk should be able to address their deficit through a modest extension to their recovery plans, a modest increase in DRCs and/or changing their assumptions relating to investment returns.

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Figures 10-12 and Tables 1-4,Tranche 10 analysis.

24. Other schemes have more limited capacity to take additional risk, for example because they have previously chosen to take a less prudent approach or their employer covenant has worsened. For these schemes, the range of options available to manage the risks flowing from larger than expected deficits at the 2015 valuation will be more limited. Where there is affordability and the employer of these schemes can accommodate more contributions without adversely affecting its sustainable growth plans, we expect trustees to seek higher DRCs with a view to maintaining the same recovery plan end date.

Affordability and sustainable growth

25. The ability of the employer to pay contributions now and in the future is employer-specific. Our analysis highlights that whereas many sponsors may be able to afford the required increases in contributions whilst minimising any adverse impact on their sustainable growth, others may be facing challenging financial conditions[10].

26. Where the employer's affordability is constrained (for example because of reduced profitability or plans to service debt, step up necessary capital expenditure or support growth), trustees may be faced with a lower level of DRCs than they think the scheme needs. In such cases, trustees should undertake a higher level of due diligence on the employer's affordability (including any sustainable growth plans) and, in particular, understand why previous levels of contributions cannot be maintained if the deficit has increased. They should understand the greater risk a lower level of DRCs may bring to the scheme.

27. Trustees should seek to manage this risk, for example by obtaining additional security for the scheme, securing contributions from alternative sources or structuring the recovery plan differently. Where trustees have to accept a greater level of risk, it underscores the need for them to have a robust monitoring framework in place to identify any further increase in the scheme's risk profile.

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Whereas many sponsors may be able to afford increases in contributions whilst minimising any adverse impact on their sustainable growth, others may be facing challenging financial conditions.

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Figures 6, 7, 8 and 9, Tranche 10 analysis.

28. Employers need to be able to invest in the sustainable growth of their business. In most cases employers are able to do so and afford the contributions required to appropriately fund the scheme. If investment in an employer's business is being prioritised at the expense of such contributions, it is important that this investment is being used to improve the employer's covenant. Trustees should seek to understand what the employer is looking to achieve, how these plans will benefit the covenant and how and when growth will fund increased contributions to the scheme where necessary. The scheme should be treated fairly and the other stakeholders of the employer should likewise adequately support its growth plans, eg through dividend blocks or restrictions.

Recent developments

Post valuation experience

29. Trustees should understand the impact of worsening or improving market conditions on the scheme's position, the likelihood of these market conditions persisting in the longer term and whether valuation date assumptions are still appropriate. They should actively monitor the impact of market conditions on their scheme risks, consider the ways in which this could be managed and take action where necessary.

30. The funding positions of many schemes with 2014 valuations are likely to have worsened significantly compared to what they were at the valuation date. When finalising these valuations, trustees should consider carefully the factors set out in the above paragraph.

Trustees should understand the impact of worsening or improving market conditions on the scheme's position.

DB to DC transfer values

31. From 6 April 2015, members of defined contribution (DC) schemes have greater flexibility to access their pension savings. The new flexibilities have the potential to increase the attractiveness of DB to DC transfers. A significant number of member transfers to DC arrangements may materially affect the funding level of a DB scheme and the timing of the scheme's cash flows and therefore its investment and funding strategies. The trustees of DB schemes should seek appropriate advice on the implications of changes to the incidence of members taking transfers on their funding assumptions and their scheme's long-term membership trends. We recently published our **regulatory guidance on DB to DC transfers and conversions: www.tpr.gov.uk/db-dc**

What you can expect from us

32. Our regulatory approach is set out in our **defined benefit funding regulatory and enforcement policy** (DB funding policy: **www.tpr.gov.uk/db-policy**) published last year. In particular it outlines how we assess risk and select schemes for further engagement and what schemes can expect from us during that process.

33. We continue to use a broad range of risk indicators (detailed in Appendix C of the DB funding policy) to identify those schemes with which we wish to engage further. In assessing funding plans we primarily focus on the overall outcome and whether there is an appropriate balance between reliance on investment returns and contributions in light of the employer covenant.

34. Our risk indicators are reviewed annually to reflect economic and market conditions, including expectations for future interest rates and investment returns. At the dates of 2014 valuations, market conditions, in particular real gilt yields, and schemes' funding levels were relatively better than for the previous tranche of valuations. As a result, we allowed for lower future investment returns over gilts in our risk indicators for 2014 valuations.

35. When we decide to engage with a scheme, we seek to understand the trustees' decisions in relation to specific risks and the quality of their decision-making process. For instance we look to understand whether they have assessed the employer covenant (including affordability and, where relevant, sustainable growth plans), undertaken due diligence with respect to understanding the implications of their funding strategies, especially in light of the uncertain future market conditions, and considered what appropriate action they might take if downside risks crystallise.

When we decide to engage with a scheme, we seek to understand the trustees' decisions in relation to specific risks and the quality of their decision-making process.

36. We continue with our approach of selecting a number of schemes for proactive engagement ahead of their valuations being submitted. We have already contacted all the Tranche 10 schemes selected for proactive engagement.

37. As part of our educational activities to enhance understanding of the new DB funding code we are planning to publish, in the coming months, additional practical guidance on an integrated approach to managing risk, covenant assessment and setting an investment strategy to complement the code.

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