

Defined benefit annual funding statement 2013



May 2013

The Pensions
Regulator

Introduction

1. This year's annual statement is relevant for trustees and employers of all defined benefit (DB) pension schemes but is primarily aimed at those who are undertaking valuations with effective dates in the period 22 September 2012 to 21 September 2013 (2013 valuations).
2. This statement builds upon some of our key messages in our **2012 Statement** and sets out our views on acceptable approaches to the valuation process in the current economic environment. We are also outlining our approach for how we will regulate schemes submitting their valuations.
3. In the 2013 Budget, the Government announced that they intend to legislate to give the regulator a new additional statutory objective. The announcement stated:

'Across the entire regulatory system, the Government is taking action to shift the balance of regulation in favour of private sector investment and growth. This is particularly important for the regulation of DB pensions as recent economic conditions have put companies sponsoring DB schemes under significant financial pressure. The Government will provide The Pensions Regulator with a new objective to support scheme funding arrangements that are compatible with sustainable growth for the sponsoring employer and fully consistent with the 2004 funding legislation. The precise wording of this new objective will be set out in legislation that the Department for Work and Pensions (DWP) will publish later in spring 2013.'

4. The precise wording of the new objective will not become clear until later in 2013 and is subject to parliamentary process. In the autumn of this year we will consult on revisions to our scheme funding **Code of practice** as well as on our approach to the regulation of DB schemes, which will be published as a regulatory strategy early in 2014. These will reflect the new objective and set out how we plan to take it into account in our regulatory approach.
5. Alongside this statement, we are publishing an analysis of the expected positions of DB pension schemes with 2013 valuations, highlighting the impact of the change in market conditions. The financial position of schemes and the ability of employers to afford deficit repair contributions will vary and trustees may need to make greater use of the flexibilities available than needed for their preceding valuations.



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Investment returns and setting discount rates

6. Legislation requires that the discount rates used in setting technical provisions must be chosen prudently, taking into account either:
 - the yield on assets held by the scheme to fund future benefits and the anticipated future investment returns and/or
 - the market redemption yields on government or high quality bonds.
7. Trustees can use the flexibility available in setting the discount rates for technical provisions and the investment return assumptions for recovery plans to adopt an approach that best suits the individual characteristics of their scheme and employer.
8. The assumptions made for the relative returns of different asset classes may rise or fall from preceding valuations reflecting changes in market conditions and the outlook for future returns. Trustees should ensure that they document their reasons for change and have due consideration to any increase in risk this might bring.
9. The recovery plan contributions will also be affected by the choice of investment return in the recovery plan. Whilst this assumption does not necessarily have to be the same as the technical provisions discount rate, it is important that it is consistent with the overall risk management of the scheme.



Trustees can use the flexibility available in setting the discount rates...The assumptions made for the relative returns of different asset classes may rise or fall from preceding valuations.

Setting appropriate contributions and recovery plans

10. Trustees can use the flexibilities available in recovery plans to ensure that they are appropriately tailored to the scheme and employer's circumstances. In setting contribution levels trustees should take into account what is reasonably affordable for the employer. This will be an employer-specific assessment and our analysis highlights that there is a wide variety in employers' circumstances.
11. As a starting point, trustees should consider whether the current level of contributions can be maintained. For some employers it may be reasonable to make increases, perhaps as a result of improvements in business performance, without damaging any future plans that grow the covenant to the scheme. Others may find that they are unable to do so.
12. Where there are significant affordability issues trustees may need to consider whether it is appropriate to agree lower contributions and this may also include a longer recovery plan. Trustees should ensure that they document the reasons for any change and indicate that they have had due consideration of the risks.
13. A strong and ongoing employer alongside an appropriate funding plan is the best support for a scheme. Where there is tension between the need for scheme contributions and for investment in the employer's business, it is important that the solution found neither damages the employer's covenant nor benefits other stakeholders at the expense of the scheme. If investment in the business is being prioritised at the expense of what otherwise would have been affordable contributions, it is important that it is being used to improve the employer's covenant. The treatment of the pension scheme should be compared to that of other stakeholders, taking account of their priority ranking, and continue to reflect the scheme's status as a creditor to the employer.



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Use of flexibilities and understanding of risk

14. Trustees should seek an open dialogue with the employer and agree how to use the flexibilities within the funding framework to most appropriately fit their individual circumstances. Trustees should understand the risks facing their scheme and seek to ensure that appropriate plans for mitigation are in place. An important consideration will be the size of the scheme's liabilities, deficit and exposure to risks relative to the size and riskiness of the employer's current and expected future operations.
15. We are encouraging trustees to take an integrated approach to addressing covenant, investment, and funding risks and to be in a position to evidence how this has been done. This evidence need not be an undue burden or additional exercise but could be part of the development of good governance by demonstrating a sound risk management approach for the scheme. Advice should be sought where it is needed, including where appropriate, an assessment of the strength of the employer covenant.
16. This will enable trustees to incorporate the ability of employers to support the scheme in their overall risk management approach and allow for an appropriate level of risk to be taken that is neither overly prudent nor overly optimistic.
17. For example, a scheme's investment strategy should be compatible with the employer's ability to address investment underperformance. Integrating these elements of covenant and investment risk could be done by combining analysis of the chance and impact of investment losses with a plan of how the support from the employer could mitigate such losses if they occur, for instance through the use of a contingent asset. Integrated risk management is an area that we aim to discuss in more detail in our consultation later in the year.



Allow for an appropriate level of risk to be taken that is neither overly prudent nor overly optimistic.

What you can expect from us

18. We have previously communicated that FRS17 (or IAS19) is unlikely to be a good indicator of prudence and that our regulatory approach does not hinge on a 10 year trigger. We are therefore moving away from setting triggers focused on individual items such as technical provisions and continue to evolve our suite of risk indicators as part of our filter mechanism. These include:
- whether recovery plan contributions and the amount of investment risk appropriately reflects the relative strength of the employer and also the affordability of contributions
 - any specific issues and concerns relating to deterioration in sponsor covenant strength or possible avoidance
 - the shape of recovery plans including initial low levels of contributions
 - the investment performance assumed over the life of the recovery plan and
 - any significant issues that we had with previous valuation submissions.
19. We have indicated that trustees should adopt an integrated approach to risk management and our risk indicators are being designed to reflect this approach. We use these to focus our intervention on schemes that we believe pose the greatest risks and where we may have the greatest impact. As part of this we will be improving our approach to how we engage with schemes. This will include looking to address risks thematically, focusing our interventions on schemes where we are most likely to take action and streamlining our communication process to trustees. Where we do engage with schemes, a key area of focus will be the link between the strength of the covenant, the scheme's investment strategy, and the prudence in the discount rates compared to expected investment returns.
20. Our autumn consultation will include our regulatory approach and how we assess risk. We will be seeking stakeholders' feedback to ensure our approach is appropriate whilst remaining flexible enough to adapt to changes to individual scheme's and employer's circumstances as well as to market conditions.



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Appendix: Proactive engagement

1. Last year we engaged proactively with a small number of large schemes undergoing valuations between 22 September 2011 and 21 September 2012 (2012 valuations). These schemes account for almost half of the 2012 valuation portfolio by value.
2. Most of these schemes already have complex and tailored funding arrangements. While their experiences do not necessarily reflect the position of smaller schemes, this engagement allowed us to better understand a wide range of scheme circumstances. This included discussing how some schemes are incorporating our messages into their funding plans, obtaining additional insight into the issues faced by these schemes and assessing the scheme-level impact of market conditions.
3. Whilst care should be taken in drawing conclusions from such a small number of valuations for large schemes, many of which are still work-in-progress, we have seen evidence of the following:
 - Whilst a number of schemes faced challenging conditions, many of the employers were able to broadly maintain or increase their existing contributions with little or no change to recovery plans, as our modelling suggested
 - Schemes developing their approach to risk management and long term objectives rather than a focus on adjustments to contributions or recovery plan length
 - Significant lump sum contributions for tax or accounting reasons
 - Contingent asset strategies to mitigate the risk that market conditions do not improve in the medium term
 - A polarisation between schemes which either introduced significant hedging in 2011 or already had this in place, and those which did not.
4. We are grateful to the schemes which participated as we found this engagement to be invaluable. We intend to run a similar process again this year for some schemes undertaking their 2013 valuations. This will help us to refine the thinking behind the proposals which will be the subject of our consultation in the autumn.



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