Annual funding statement analysis

An overview of funding outcomes for schemes with effective valuation dates in the period between 22 September 2012 and 21 September 2013 **(Tranche 8)**

May 2015

The Pensions Regulator

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Introduction

We published our second annual funding statement in April 2013[1]. It was aimed at trustees and employers of defined benefit (DB) pension schemes undertaking their scheme valuations with effective dates in the period 22 September 2012 to 21 September 2013 (Tranche 8 schemes).

The statement set out our views on acceptable approaches to the valuation process in the context of the prevailing economic environment at the time of publication.

Alongside the statement we also published an evidence and analysis document[2] containing information on the approach that informed our 2013 statement. Our modelling, as set out in the analysis document, suggested that the funding regime was sufficiently flexible to enable schemes and employers to manage their deficits while acknowledging some may need to make greater use of the flexibilities available than in previous valuations. The statement also stressed the importance of trustees understanding the risks facing their scheme and seeking to ensure that appropriate plans for mitigation are in place.

The following analysis is intended to provide further information and transparency on the funding outcomes from Tranche 8 valuations and some insight into scheme behaviours. In particular it shows how schemes have managed increased deficits using provisions in the funding regime, notably with regards to discount rate outperformance, recovery plan (RP) length and increases in deficit repair contributions (DRCs).

Official statistics on Tranche 8 valuations and RPs can be found in our 2015 scheme funding statistics publication[3].

1
www.tpr.gov.uk/
funding2013

2
www.tpr.gov.uk/
analysis2013

3
www.tpr.gov.uk/
funding2015

Overview

- We received 1,893 valuations with a Tranche 8 effective date by the end of January 2015.
- 1,743 (92%) of Tranche 8 schemes had also conducted valuations in Tranche 5.
- 1,254 (72%) of these schemes face an increased deficit on a broadly consistent 'reference basis[4]'.
- The 2013 statement's key messages focused on how Tranche 8 schemes could use the available flexibilities to manage increased deficits.
- The analysis in this document focuses primarily on the 1,254 schemes with increased reference deficits – 'the analysis population' – and includes schemes with sufficient data to allow meaningful analyses of changes in certain key variables and assumptions.
- This analysis population represents 72% of all Tranche 8 valuations received up to 31 January 2015. The number of schemes may vary slightly by analysis.

4
Liabilities are estimated using the Bank of England 20 year nominal spot rate plus an excess return of 0.5%. This allows liabilities to be compared on a consistent basis across schemes.

Key findings

Broad outcomes and affordability

The majority of schemes facing an increased reference deficit (the analysis population) extended their Tranche 5 RP end dates. The median extension to end dates is approximately three years (Figures 11, 12A and 12B). Of the same population, more than half of schemes increased DRCs in nominal terms (Table 2).

Over half of employers who were profitable at both valuations reported some increase in profit before tax (PBT) (Figure 10A).

In respect of changes in DRCs[5], the middle 50% of weak[6] employers exhibit a wider range and a greater median increase compared to strong employers. This is likely to be due in part to generally improved affordability in 2012 relative to 2009 for weak employers, although the range of relative changes in affordability for the middle 50% of weak employers sits below that of strong employers (Figures 9 and 10C).

Funding positions

The outcomes noted above reflect a general worsening in funding positions. Around a third of schemes in the analysis population face increased deficits (calculated on a reference basis) of up to 60% (Figure 1).

The average[7] increase in both technical provisions (TPs) and assets between Tranches 5 and 8 is 29% while the average increase in reference liabilities is 32%[8].

Assumptions

For the majority of schemes in the analysis population the discount rate outperformance[9] over the 20 year spot rate is greater in Tranche 8 compared to Tranche 5 whilst holdings in return-seeking assets are generally reduced. In absolute terms however, a greater holding of return-seeking assets is generally associated with higher outperformance (Figures 2 and 5).

Stronger covenants are also generally associated with higher outperformance although a less defined relationship exists between employer covenant and the scheme's allocation to return-seeking assets (Figures 4A and 4B).

For just over half of schemes with a valuation in both Tranches 5 and 8, the increase in outperformance is greater than 0.25% (Figure 2).

5
DRCs in this analysis are calculated as the average of the first four years of the RP.

6
Assessed in Tranche 8 and defined as: covenant group 1(strong), 2 (tending to strong), 3 (tending to weak), 4 (weak). See 'Notes on data and methodology'.

7
Averages are unweighted.

8
Scheme funding statistics 2015 at **www.tpr.gov.uk/funding2015**

9
The spread of the nominal discount rate over 20 year nominal government spot rate. The nominal discount rate is also referred to as the single effective discount rate (SEDR), a single equivalent rate estimated from investment return assumptions reported by schemes. The methodology underlying the calculation of the SEDR can be found in the Scheme funding statistics publication (link in footnote 8).

Schemes grouped by change in discount rate outperformance only

Schemes with the same or reduced outperformance relative to the previous valuation generally have a smaller relative change in reference deficit, but a greater relative change in technical provisions deficit compared to the other two groups (Figures 6 and 7).

Schemes which increased outperformance by up to 0.25% exhibited generally similar changes in both reference and technical provisions deficit (Figures 6 and 7).

Schemes with greater than a 0.25% increase in outperformance generally have greater relative changes in reference deficit but smaller relative changes in technical provisions deficit, compared to the other two groups (Figures 6 and 7).

Schemes grouped by the relative change in DRCs only

For the sub-population where employers were profitable in both tranches, schemes that increased DRCs by more than 25% generally have employers who reported a greater relative increase in profit before tax (PBT) compared to those groups comprising schemes with up to a 25% increase in DRCs (Figure 10B).

Schemes grouped by both change in outperformance and relative change in DRCs

There are limited discernible differences in the changes to both RP end dates and employer affordability across schemes grouped by the combination of changes to both discount rate outperformance and DRCs, the highlighted flexibilities in the 2013 statement. This may reflect that factors influencing changes in DRCs and changes in outperformance are not necessarily the same nor move in parallel (Figures 12B and 13B).

Summary

Overall, schemes with greater increases in outperformance (as a group) generally faced greater increases in deficits (measured on a reference basis). Across all schemes, higher outperformance is generally associated with a greater allocation to return-seeking asset classes and stronger covenants.

Schemes with greater changes in employer profitability and weak employers are associated with greater increases in DRCs (despite the latter having smaller increases in profitability overall). The analysis suggests that there are greater increases in DRCs among schemes whose employers had greater increases in profitability irrespective of the comparative level of assessed covenant support.

The analysis suggests, as is expected of a scheme-specific regime, that in order to manage larger deficits, schemes adjusted their funding strategies in different ways according to their circumstances and those of the employer.

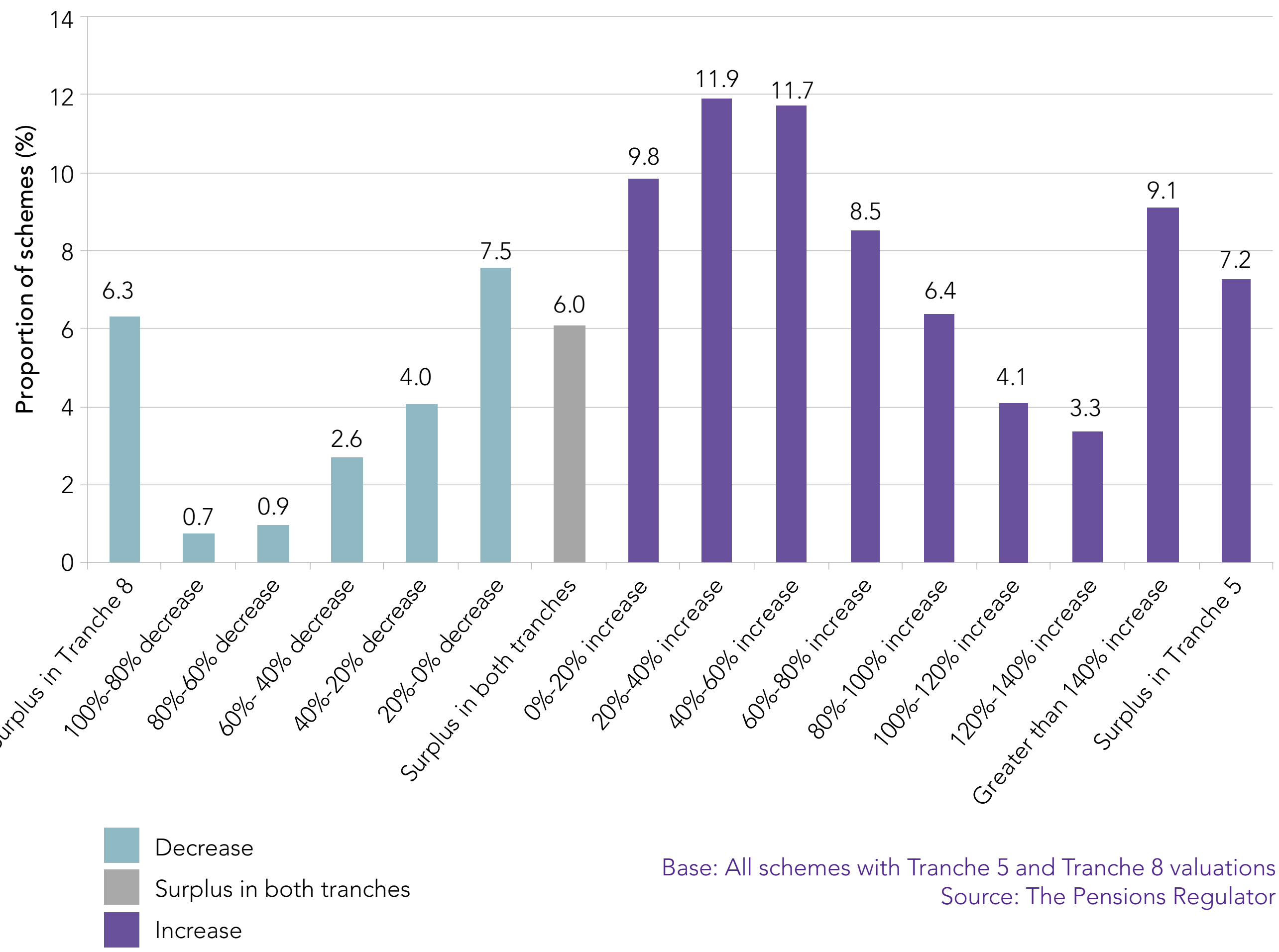
The DB funding regime is sufficiently flexible to enable trustees and employers to agree appropriate funding solutions. Trustees should ensure that in using these flexibilities, risks to members remain actively managed.

Analysis

Increased deficits

Figure 1 illustrates the distribution of changes in reference deficits faced by Tranche 8 schemes that also submitted Tranche 5 valuations.

Figure 1: Distribution of percentage change in deficit calculated on a reference basis



Base: All schemes with Tranche 5 and Tranche 8 valuations
Source: The Pensions Regulator

- 22% of schemes with valuations in both Tranche 5 and Tranche 8 have seen a reduction in their deficit calculated on a reference basis.
- 22% of schemes submitting a valuation in both Tranche 5 and Tranche 8 have seen an increase in their deficit calculated on a reference basis of up to 40%.
- 16% of schemes face an increase in deficit of over 100%.
- Just over 7% of schemes have moved out of a surplus position in Tranche 5 to a deficit position in Tranche 8, while over 6% have experienced the reverse.

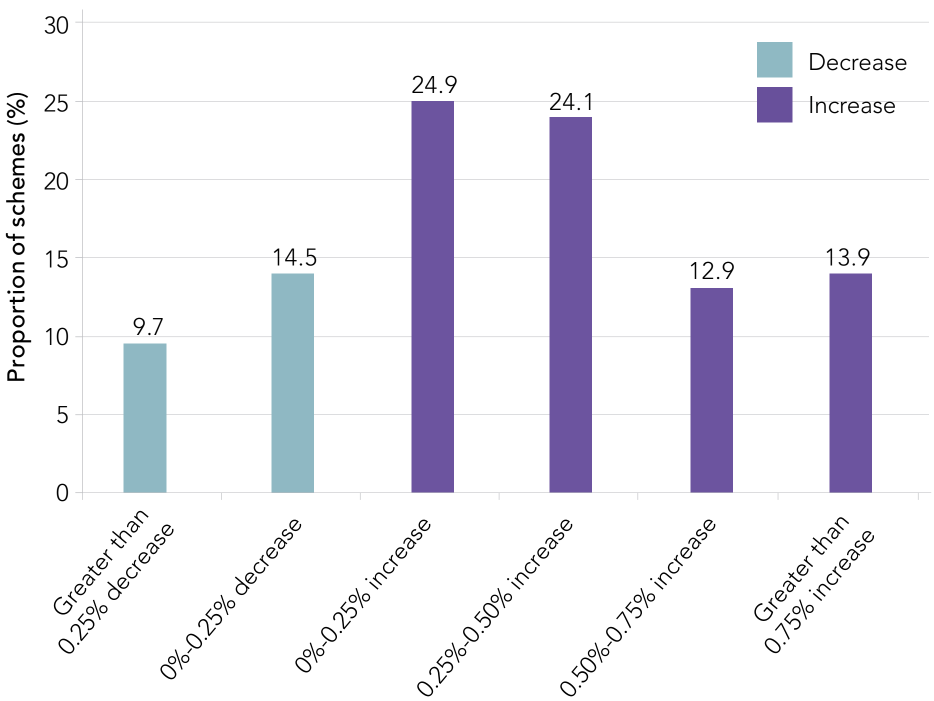
Managing increased deficits: discount rate outperformance

The analysis supporting the 2013 statement highlighted some of the flexibilities available to schemes to manage their funding strategy in a way that is tailored to their individual circumstances.

In particular the analysis illustrated how many extra years of contributions would meet the estimated increase in deficit from Tranche 5 to Tranche 8 with an increase in discount rate of 0.25%.

Figure 2 shows how nominal discount rate outperformance changed between Tranche 5 and Tranche 8 valuations for schemes conducting a valuation in both tranches.

Figure 2: Distribution of percentage change in discount rate outperformance



Base: All schemes with Tranche 5 and Tranche 8 valuations
Sources: The Pensions Regulator, Thomson Reuters, Bank of England

Compared to Tranche 5 the median outperformance over the 20 year nominal spot rate is 0.24% higher for Tranche 8. The median outperformance of the real discount rate over the 20 year real government spot rate is 1.05% for Tranche 8, compared to 0.81% for Tranche 5[10].

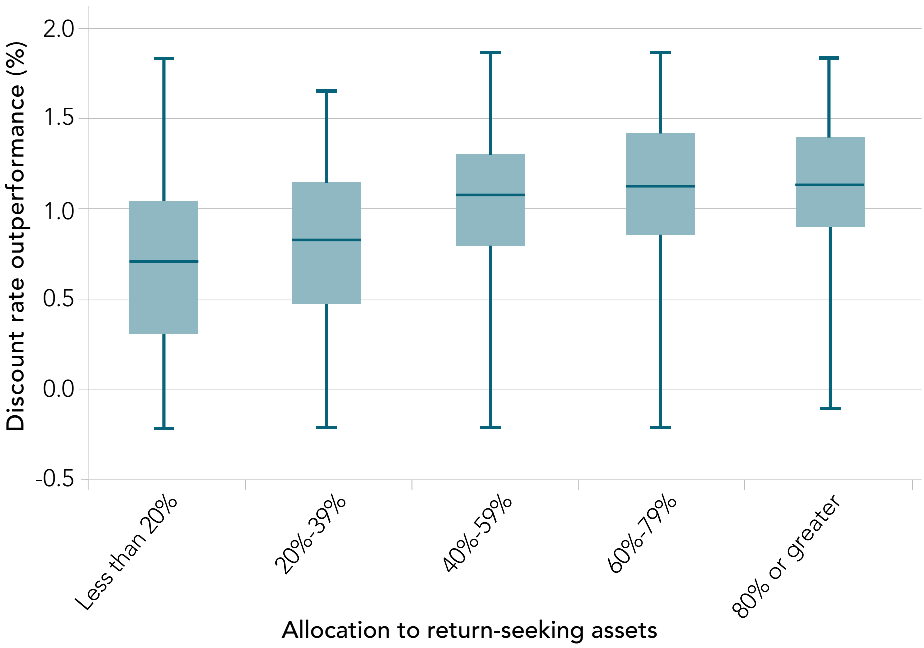
Among schemes conducting a valuation in both tranches, nearly a quarter either maintained the same outperformance in the discount rate or reduced it. A further quarter increased it by up to 0.25%.

10 Scheme funding statistics 2015 at **www.tpr.gov.uk/funding2015**

Two important considerations in setting the outperformance of the discount rate are investment risk (approximated here by a scheme's allocation to return-seeking assets[11]) and the strength of employer covenant underwriting that risk.

Figure 3 shows the relationship between discount rate outperformance and allocation to return-seeking assets, while Figure 4 shows the relationship between outperformance in the discount rate and covenant strength.

Figure 3: Distribution of discount rate outperformance by allocation to return-seeking assets group



Base: All Tranche 8 valuations received up to 31 January 2015
Sources: The Pensions Regulator, Thomson Reuters, Bank of England

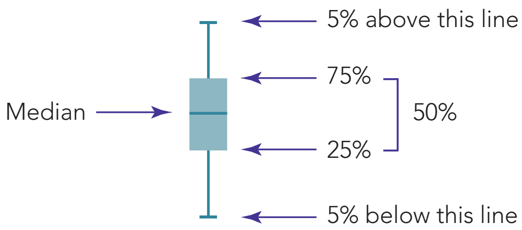


Figure 3 shows that across all Tranche 8 schemes, a higher proportion of return-seeking assets is generally associated with a higher level of discount rate outperformance.

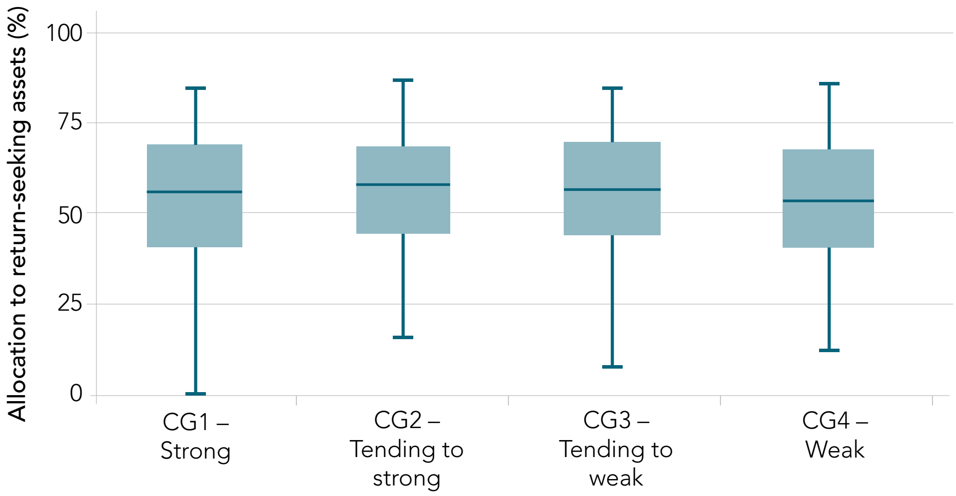
continued...

11
'Return-seeking assets' here includes equities, property, commodities, hedge funds, 50% of corporate bonds, and assets held in the 'other' category. In the absence of credit ratings, this assumes that 50% of corporate bonds held rank below investment grade.

The median discount rate outperformance for Tranche 8 schemes with a return-seeking asset allocation of less than 20% is 0.71%, with 50% of values falling between 0.31% and 1.05%. For schemes with greater than 80% of total assets held in return-seeking asset classes the median outperformance in the discount rate is 1.14%, with 50% of values falling between 0.90% and 1.41%.

There is a wide range of assumptions in discount rate outperformance among schemes with a similar allocation to return-seeking assets.

Figure 4A: Distribution of allocation to return-seeking assets by Tranche 8 covenant group

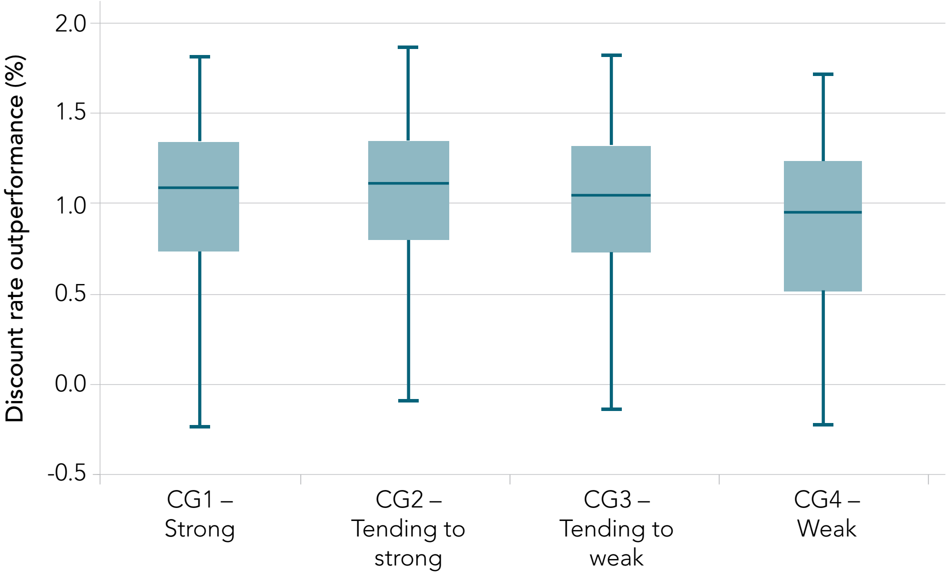


Base: All Tranche 8 valuations received up to 31 January 2015
Source: The Pensions Regulator

Figure 4A shows a less well defined association between allocation to return-seeking assets and covenant strength.

The median allocation to return-seeking assets for Tranche 8 schemes with an employer covenant assessed by the regulator as being strong is 56%, with 50% of such values falling between 40% and 68%; while for those with an employer covenant assessed as being weak the median allocation to return-seeking assets is 53%, with 50% of values falling between 40% and 67%.

Figure 4B: Distribution of nominal discount rate outperformance by Tranche 8 covenant group

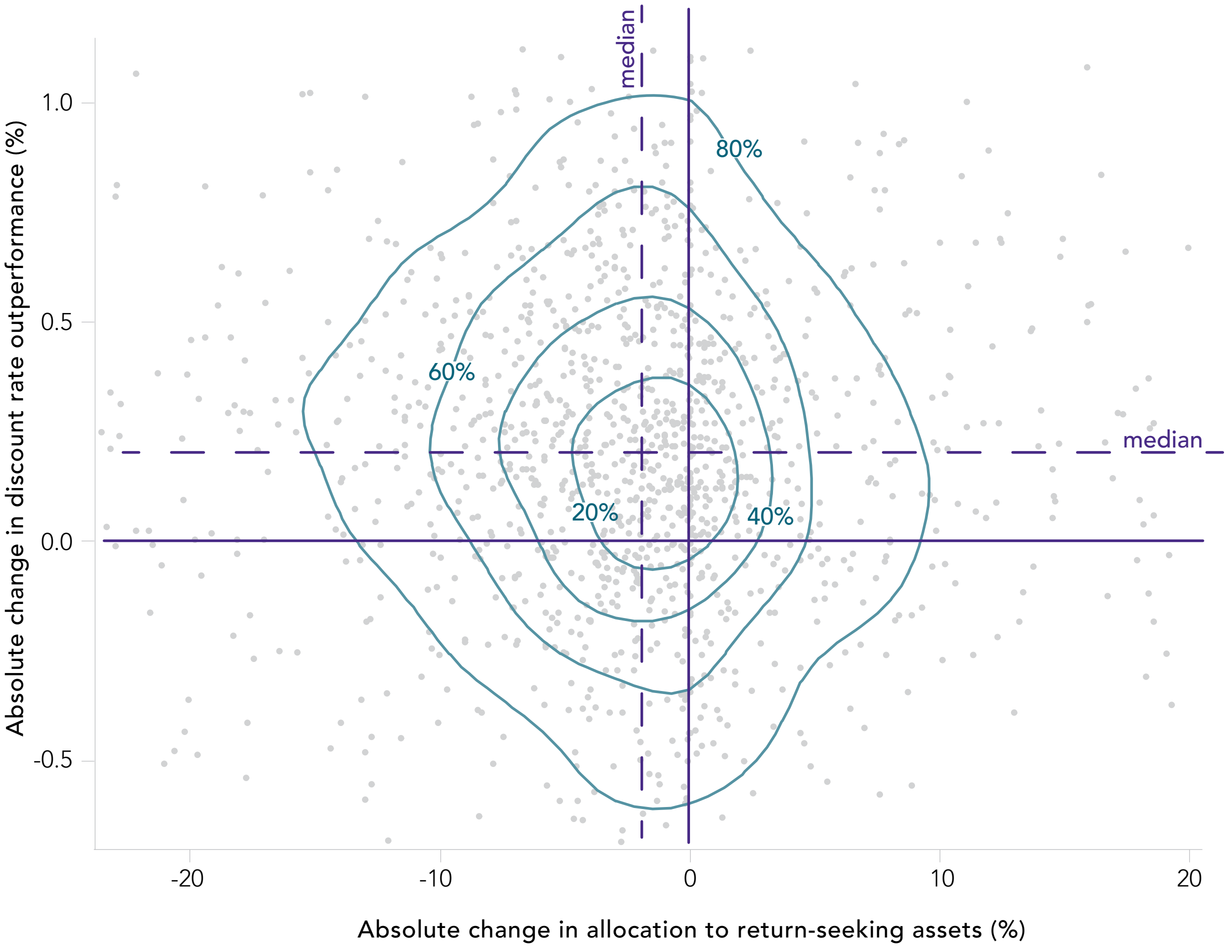


Base: All Tranche 8 valuations received up to 31 January 2015
Sources: The Pensions Regulator, Thomson Reuters, Bank of England

Figure 4B shows a shows a weak but slightly better defined association between assumptions about discount rate outperformance and covenant strength.

The median discount rate outperformance for Tranche 8 schemes with an employer covenant assessed by the regulator as being strong is 1.09%, with 50% of such values falling between 0.75% and 1.37%; while for those with an employer covenant assessed as being weak the median outperformance is 0.95%, with 50% of values falling between 0.52% and 1.25%.

Figure 5: Distribution of change in discount rate outperformance by change in allocation to return-seeking assets



Base: All schemes with Tranche 5 and Tranche 8 valuations
Sources: The Pensions Regulator, Thomson Reuters, Bank of England

Figure 5 shows how changes in return-seeking asset allocation relate to the changes in discount rate outperformance for schemes conducting valuations in both tranches.

- 20% of schemes are contained within each ring while the dotted vertical and horizontal lines indicate where median values lie for each axis respectively.
- At the median there has been a small decrease in allocation to return-seeking assets (-2%) compared to an increase in the discount rate outperformance (0.20%).
- The area of the innermost ring is bounded at about -5% and 2% approximately in terms of absolute change in return-seeking assets, and at about -0.07% and 0.37% in terms of absolute change in discount rate outperformance.
- The majority of the innermost ring (20% of schemes) lies in the upper left quadrant of the chart. This suggests that the majority of these schemes reduced their allocation to return-seeking assets while increasing their discount rate outperformance.
- A similar pattern is observed across the other four segments (rings) shown.

For any particular level of change in return-seeking asset allocation, there is a wide distribution of change in discount rate outperformance. This suggests that although outperformance in the discount rate varies by return-seeking assets held, changes to the outperformance assumption are not very sensitive to changes to return-seeking allocation, and/or that there may be other significant factors influencing these assumptions.

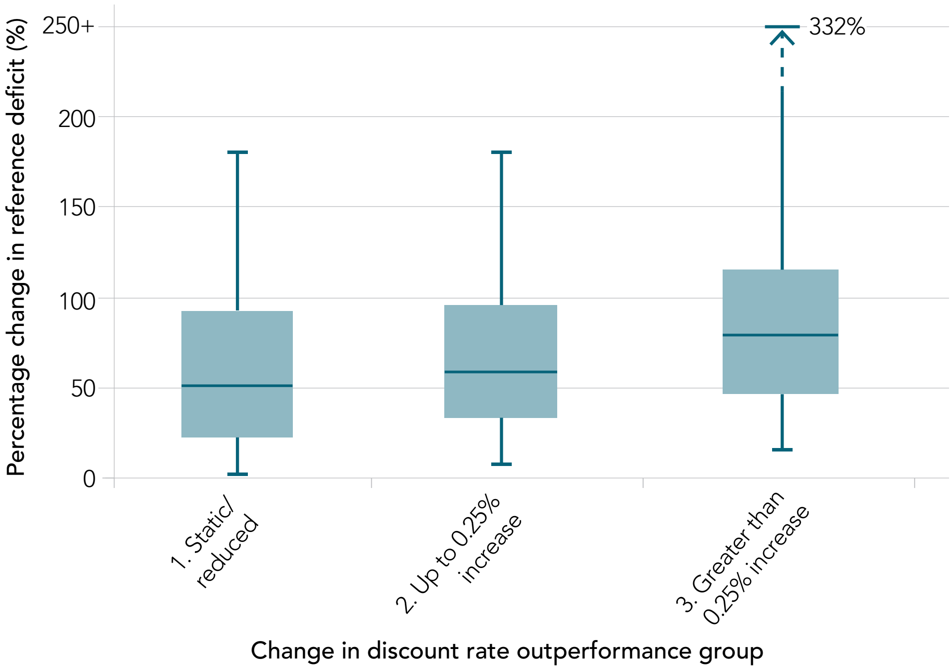
To facilitate further analysis, schemes are grouped according to how discount rate outperformance has changed from Tranche 5 to Tranche 8 for those facing an increased reference deficit. This is shown in Table 1.

Table 1: Analysis population categorised by extent of change in discount rate outperformance

Group	Change in discount rate outperformance	Proportion of analysis population
1	Static/reduced discount rate outperformance over 20 year nominal spot rate	24%
2	Up to 0.25% increase in discount rate out-performance over 20 year nominal spot rate	25%
3	Greater than 0.25% increase in discount rate outperformance over 20 year nominal spot rate	51%

Figures 6 and 7 compare the change in deficit (on a reference basis and on a technical provisions (TP) basis) for each group in Table 1.

Figure 6: Distribution of percentage change in reference deficit by change in discount rate outperformance group

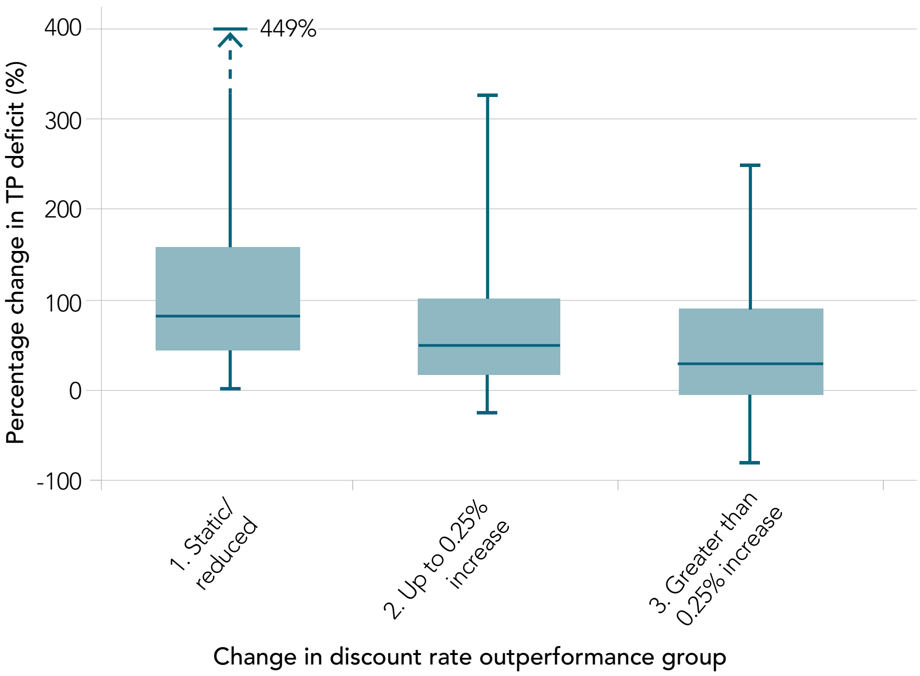


Base: Analysis population
Sources: The Pensions Regulator, Thomson Reuters, Bank of England

Figure 6 shows how reference deficits have changed for each discount rate outperformance change group.

A greater increase in deficit on a reference basis is generally associated with a greater increase in discount rate outperformance. For Group 1, deficits increased at the median by 50% (with 50% of values falling between 23% and 91%) compared to a median increase of 83% in Group 3 (with 50% of values falling between 47% and 117%).

Figure 7: Distribution of percentage change in TP deficit by change percentage in discount rate outperformance



Base: Analysis population
Sources: The Pensions Regulator, Thomson Reuters, Bank of England

1,185 schemes in the analysis population face increased deficits on a TP basis compared to 1,254 on a reference basis.

Figure 7 shows that generally the greater the increase in discount rate outperformance, the smaller the increase in TP deficit. For Group 1, deficits increased at the median by 92% (with 50% of values falling between 43% and 160%) compared to an increase of 26% at the median for Group 3 (with 50% of values falling between -4% and 94%).

However, there is a wide distribution in percentage changes in TP deficits even within groups of schemes with similar changes in assumed discount rate outperformance.

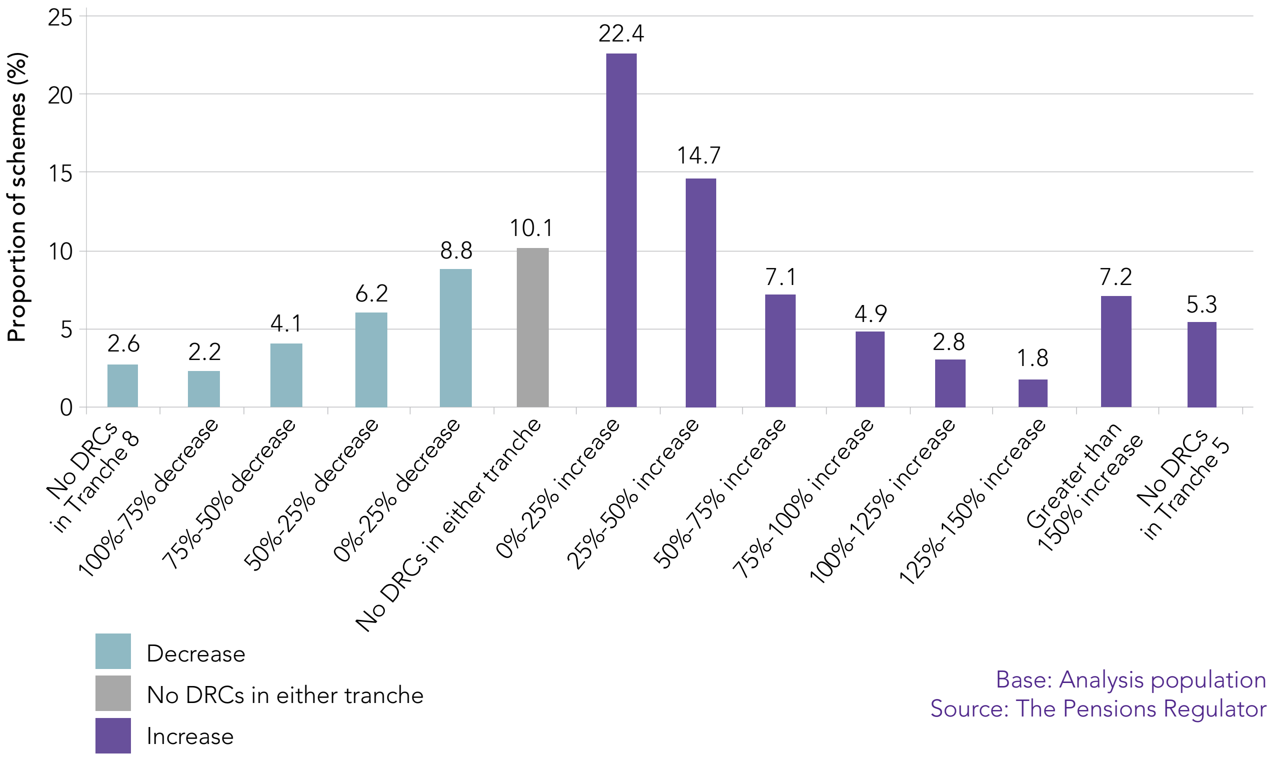
Managing increased deficits: DRCs

DRCs and the length of the RP are other key aspects of a trustee's approach to managing increased deficits. RPs can be tailored to scheme and employer circumstances.

The analysis supporting the 2013 annual funding statement modelled the impact on RP length of an increase in DRCs of 25% coupled with an increase in the discount rate of 0.25%.

Figure 8 shows the distribution of changes to average annual DRCs (based on nominal values) for the analysis population.

Figure 8: Percentage change in nominal DRCs



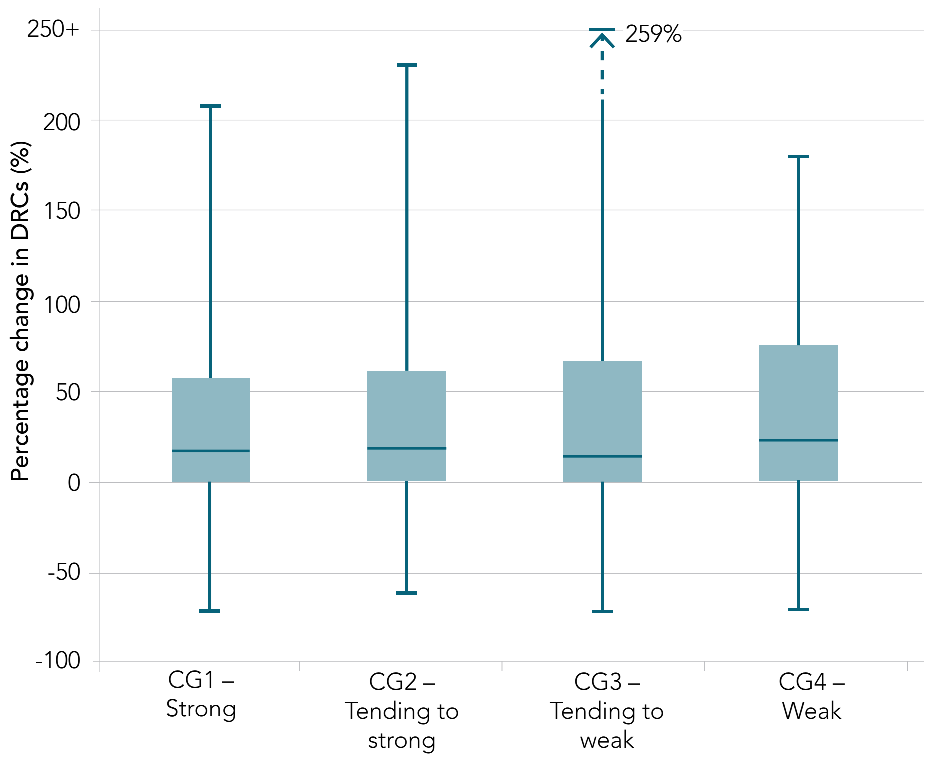
Base: Analysis population
Source: The Pensions Regulator

34% of schemes maintained or reduced DRCs, 22% of schemes increased their DRCs by up to 25%, and 44% of schemes increased DRCs by more than 25%.

The employer covenant, including affordability (approximated in this analysis by the employer's PBT), is an important consideration in agreeing an appropriate level of DRCs.

Figure 9 shows the relationship between the change in nominal DRCs, and the strength of the employer covenant (approximated here by covenant groups 1-4).

Figure 9: Distribution of percentage change in DRCs by Tranche 8 covenant group



Base: Analysis population
Source: The Pensions Regulator

Figure 9 shows that, on average, schemes in the analysis population increased nominal DRCs by a broadly similar amount irrespective of the assessed strength of their employer covenant.

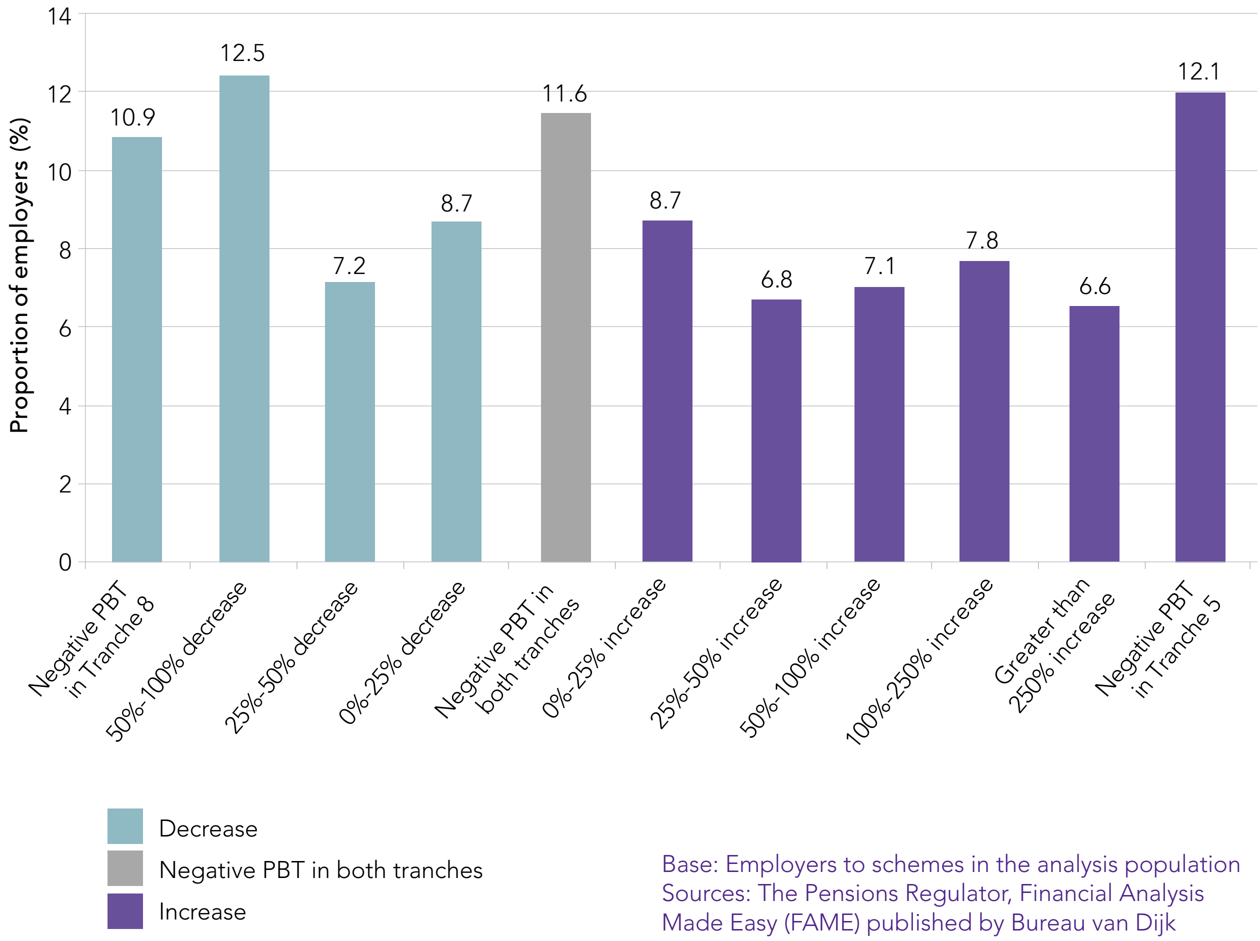
For schemes assessed as having a strong employer covenant, DRCs increased at the median by 18% (with 50% of schemes in this group having increases of between 0% and 58%) compared to an increase at the median of 23% amongst schemes assessed as having a weak covenant (with 50% of schemes in this group having increased DRCs between 0% and 73%).

To facilitate further analysis, schemes are grouped into three categories which relate to the extent of the changes they have made to nominal DRCs.

Table 2: Analysis population categorised by extent of change in nominal DRCs

Group	Change in DRCs	Proportion of analysis population
1	Static/reduced nominal annual average DRCs	34%
2	Up to 25% increase in nominal annual average DRCs	22%
3	Greater than 25% increase in nominal annual average DRCs	44%

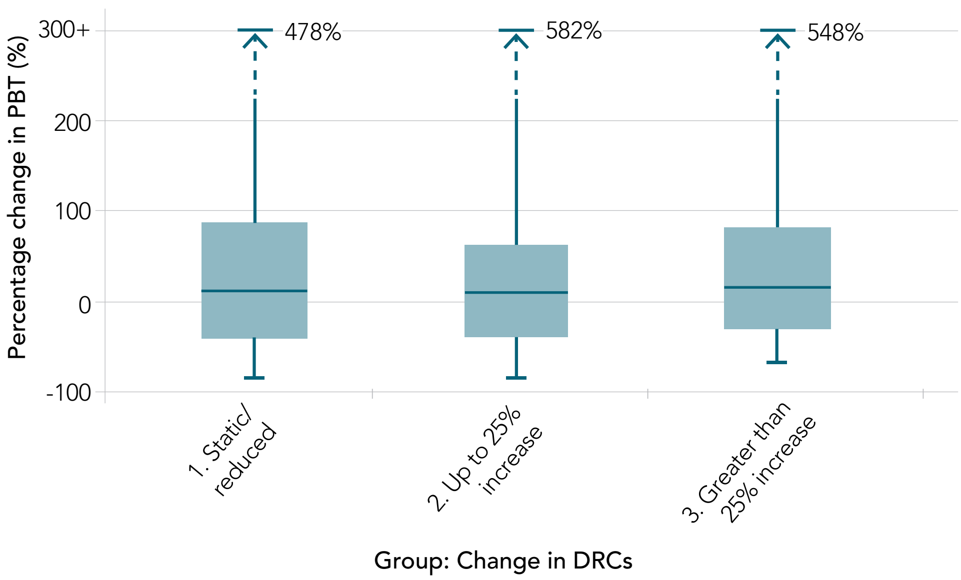
Figure 10A: Distribution of percentage change in employers' PBT



Base: Employers to schemes in the analysis population
Sources: The Pensions Regulator, Financial Analysis Made Easy (FAME) published by Bureau van Dijk

The distribution of relative change in employers' PBT for the analysis population is shown in Figure 10A. There are a significant number of employers who were loss-making in one or both tranches, although similar proportions went from a profitable to loss making position and vice versa. They have been excluded from the boxplots in Figures 10B and 10C to aid interpretation and visualisation.

Figure 10B: Distribution of percentage change in employers' PBT by change in DRCs group



Base: Employers for schemes in the analysis population reporting profits for both Tranche 5 and 8 periods.
Sources: The Pensions Regulator, FAME published by Bureau van Dijk

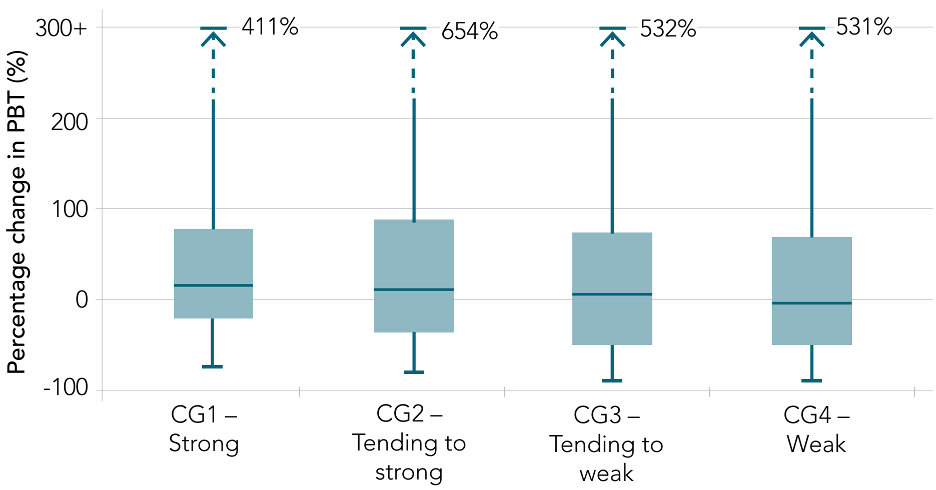
This chart shows that in general, in respect of relative changes in PBT, the experience of employers in the analysis population is broadly similar across the groups defined in Table 2.

For schemes that maintained or reduced nominal DRCs, employers' PBT increased by 10% at the median (with 50% of employers in this group having a relative change in PBT of between -40%[12] and 86%). This is compared to an increase of 14% at the median among schemes which had increased nominal DRCs by more than 25% (with 50% of employers in this group having a relative change in PBT of between -32%[13] and 83%).

12
That is to say that PBT in Tranche 8 (2012) was 40% less than that in Tranche 5 (2009), ie it had reduced by two fifths.

13
That is to say that PBT in Tranche 8 (2012) was 32% less than that in Tranche 5 (2009), ie it reduced by approximately one third.

Figure 10C: Distribution of percentage change in employers' PBT by Tranche 8 covenant group



Base: Employers for schemes in the analysis population reporting profits for both Tranche 5 and 8 periods.
Sources: The Pensions Regulator, FAME published by Bureau van Dijk

This chart shows that in general the experience of employers in the analysis population with respect to changes in PBT is broadly similar across covenant groups, although in general the proportion of PBT growth can be seen to reduce with declining covenant strength.

For schemes assessed as having a strong employer covenant, employers' PBT increased by 16% at the median (with 50% of employers in this group having a relative change in PBT of between -19%[14] and 78%). This is compared to a decrease of -5% at the median amongst schemes assessed as having a weak covenant (with 50% of employers in this group having a relative change in PBT of between -51%[15] and 69%).

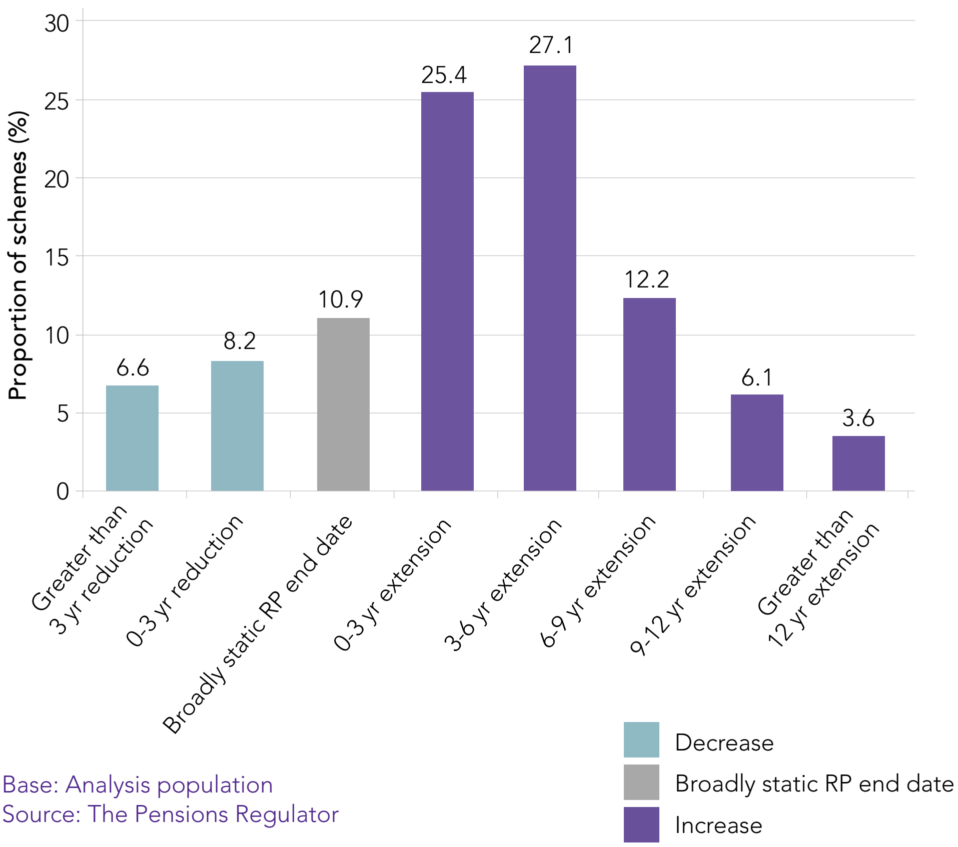
14
That is to say that PBT in Tranche 8 (2012) was 19% less than that in Tranche 5 (2009), ie it had declined by approximately one fifth.

15
That is to say that PBT in Tranche 8 (2012) was 51% less than that in Tranche 5 (2009), ie it had broadly halved.

Analysis of RP outcomes

Figure 11 shows the distribution of changes to RP end dates for the analysis population.

Figure 11: Distribution of changes to RP end dates



Base: Analysis population
Source: The Pensions Regulator

- The median increase in RP end date is just over three years in the analysis population.
- Around 15% of schemes have brought forward their RP end date.
- 11% have maintained their RP end date (+/- 1 month relative to the end date under the Tranche 5 RP).
- 25% of schemes have extended their RP end date by up to and including three years.
- Just under one half of schemes extended their RP by more than three years; with 10% of schemes extending plans by more than nine years.

Table 3 groups schemes into four categories based on differing combinations of their use of the key flexibilities highlighted in the 2013 statement: discount rate outperformance and increases to nominal DRCs, according to those groups previously defined in Tables 1 and 2.

Table 3: Analysis population categorised by extent of use of two highlighted flexibilities

		Discount rate outperformance change group			
		1. Static/reduced SEDR spread over 20 yr nominal spot rate	2. Up to 0.25% increase SEDR spread over 20 yr nominal spot rate	3. Greater than 0.25% increase SEDR spread over 20 yr nominal spot rate	Total
DRCs change group	1. Static/reduced nominal annual average DRCs	7%	7%	20%	34%
	2. Up to 25% increase in nominal annual average DRCs	5%	6%	11%	22%
	3. Greater than 25% increase in nominal annual average DRCs	12%	11%	20%	44%
	Total	24%	25%	51%	100%

Key to grouping:

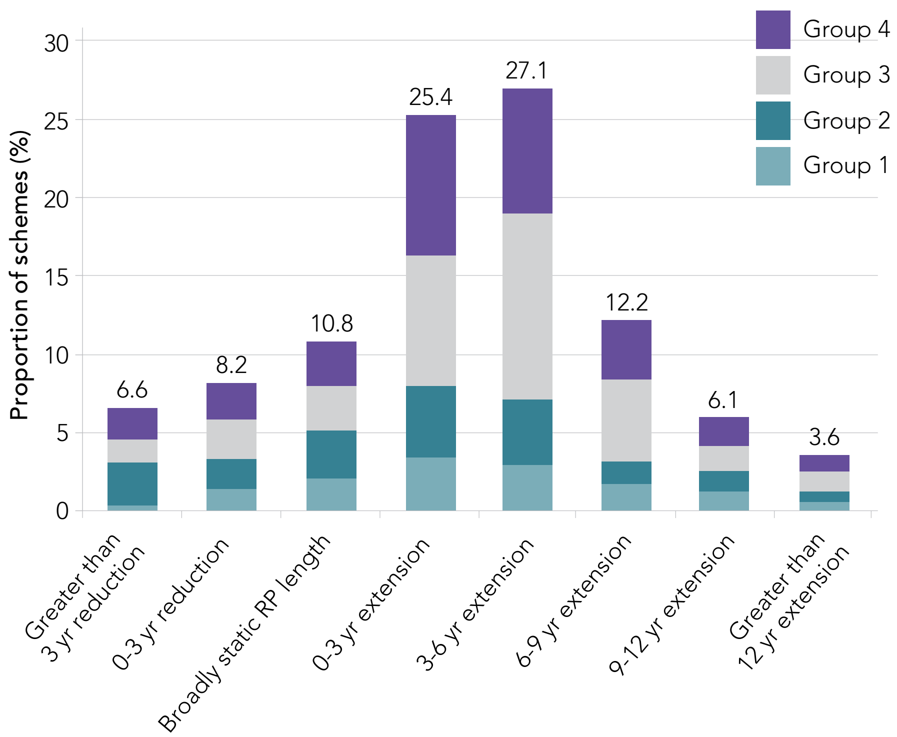
	1	1	2	
	3	3	4	
	3	3	4	

Table 3 shows that schemes managed their increased deficits in different ways depending on their specific circumstances (which could include for example: the extent to which deficits increased, the structure of the existing RP, the level of nominal DRCs already being paid, employer affordability and sustainable growth plans).

- Group 1 comprises 14% of the analysis population. They increased discount rate outperformance by up to 0.25% whilst maintaining or reducing nominal DRCs.
- Group 2 comprises 20% of the analysis population. They increased discount rate outperformance by greater than 0.25% whilst maintaining or reducing nominal DRCs.
- Group 3 comprises 34% of the analysis population. They increased discount rate outperformance by up to 0.25% whilst also increasing nominal DRCs.
- Group 4 comprises 31% of the analysis population. They increased discount rate outperformance by greater than 0.25% whilst also increasing nominal DRCs.

Figure 12A and Table 4 illustrate the concentration of changes to RP end dates for the analysis groups (defined in Table 3) at different ranges. Figure 12B illustrates the distribution of changes to RP end dates by the groups.

Figure 12A: Distribution of changes to RP end dates at different ranges

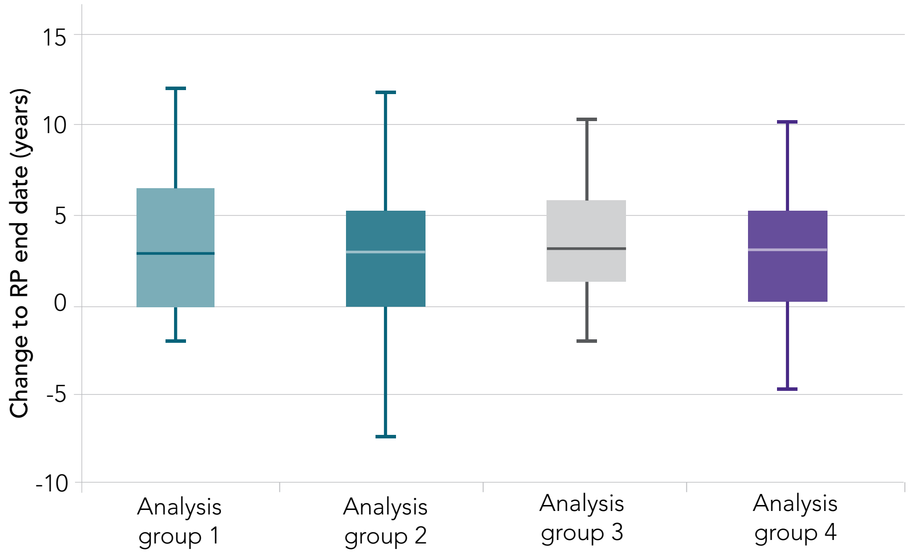


Base: Analysis population
Source: The Pensions Regulator

Table 4: Distribution of changes to RP end date by analysis group

Proportion of respective group (%)	Greater than 3 yr reduction	0-3yr reduction	Broadly static RP length	0-3yr extension	3-6yr extension	6-9yr extension	9-12yr extension	Greater than 12 yr extension
1: Static/reduced DRCs and up to 0.25% increase in outperformance	2.9%	10.3%	14.8%	24.6%	21.1%	12.5%	9.2%	4.6%
2: Static/reduced DRCs and greater than 0.25% increase in outperformance	13.5%	9.5%	15.9%	23.1%	21.1%	7.2%	6.4%	3.2%
3: Increased DRCs and up to 0.25% increase in outperformance	4.1%	7.3%	7.9%	23.8%	33.8%	15.0%	4.5%	3.6%
4: Increased DRCs and greater than 0.25% increase in outperformance	6.7%	7.5%	9.0%	28.9%	26.1%	12.2%	6.2%	3.4%

Figure 12B: Distribution of changes to RP end date by analysis group



- Analysis group 1: Static/reduced DRCs and up to 0.25% increase in outperformance
- Analysis group 2: Static/reduced DRCs and greater than 0.25% increase in outperformance
- Analysis group 3: Increase in DRCs and up to 0.25% increase in outperformance
- Analysis group 4: Increase in DRCs and greater than 0.25% increase in outperformance

Base: Analysis population
Source: The Pensions Regulator

These charts show that the distribution of changes to RP end date is broad for the analysis groups defined in Table 3.

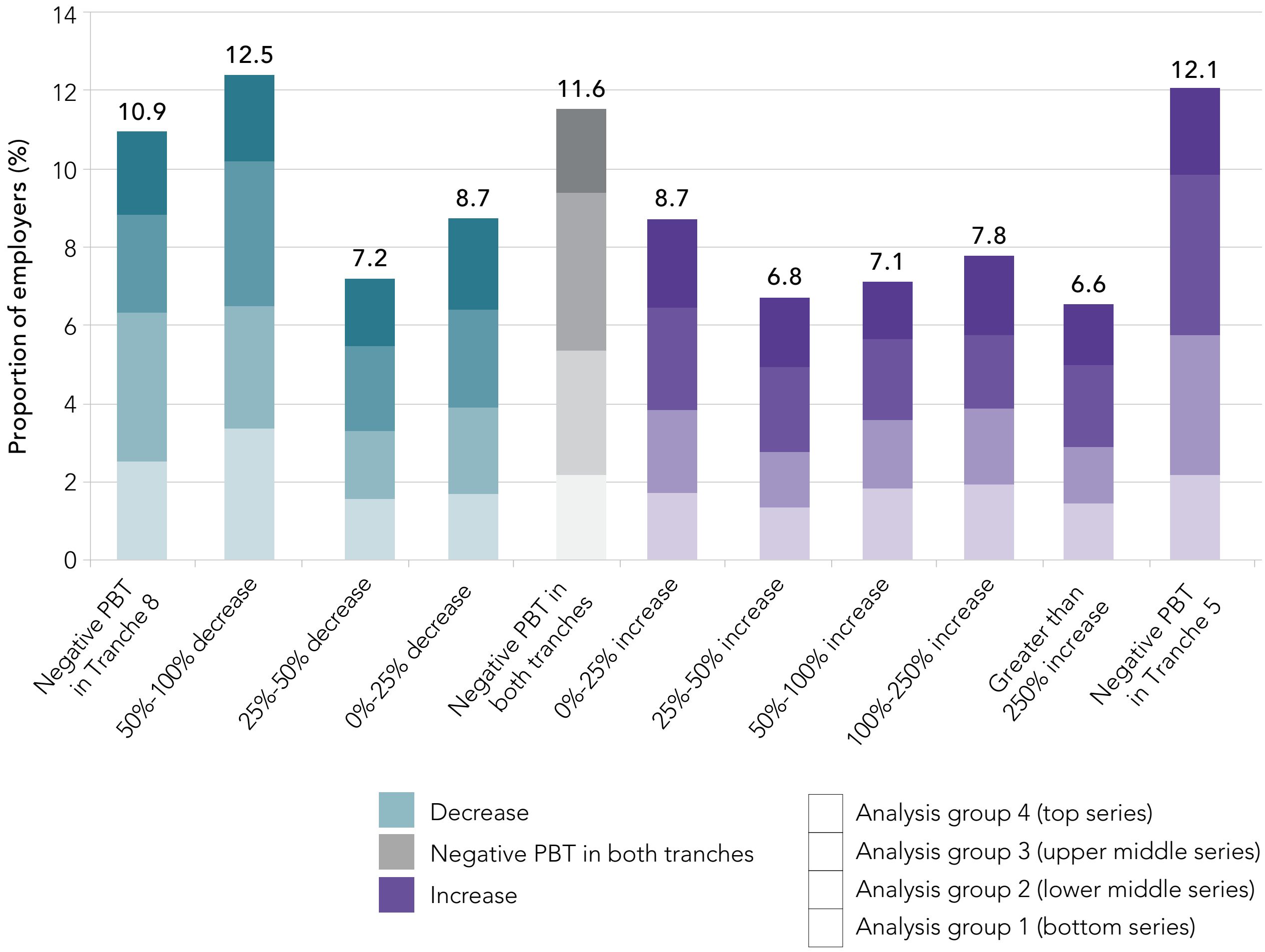
For Group 1 (comprising 14% of the analysis population who increased discount rate outperformance by up to 0.25% whilst maintaining or reducing nominal DRCs), RPs were extended by 2.9 years at the median (with 50% of schemes in this group extending their RP by between 0.0 and 6.4 years).

This can be compared to Group 4 (comprising 31% of the analysis population, who increased discount rate outperformance by greater than 0.25% whilst also increasing nominal DRCs), for whom RPs were extended by 3.0 years at the median. 50% of schemes in this group extended their RP by between 0.3 and 5.3 years.

Analysis of changes in affordability

Figure 13A and Table 5 illustrate the concentration of the change in employers' PBT for the analysis groups at different ranges. Figure 13B illustrates the distribution of changes in employers' PBT by the analysis groups.

Figure 13A: Distribution of changes in employers' PBT at different ranges



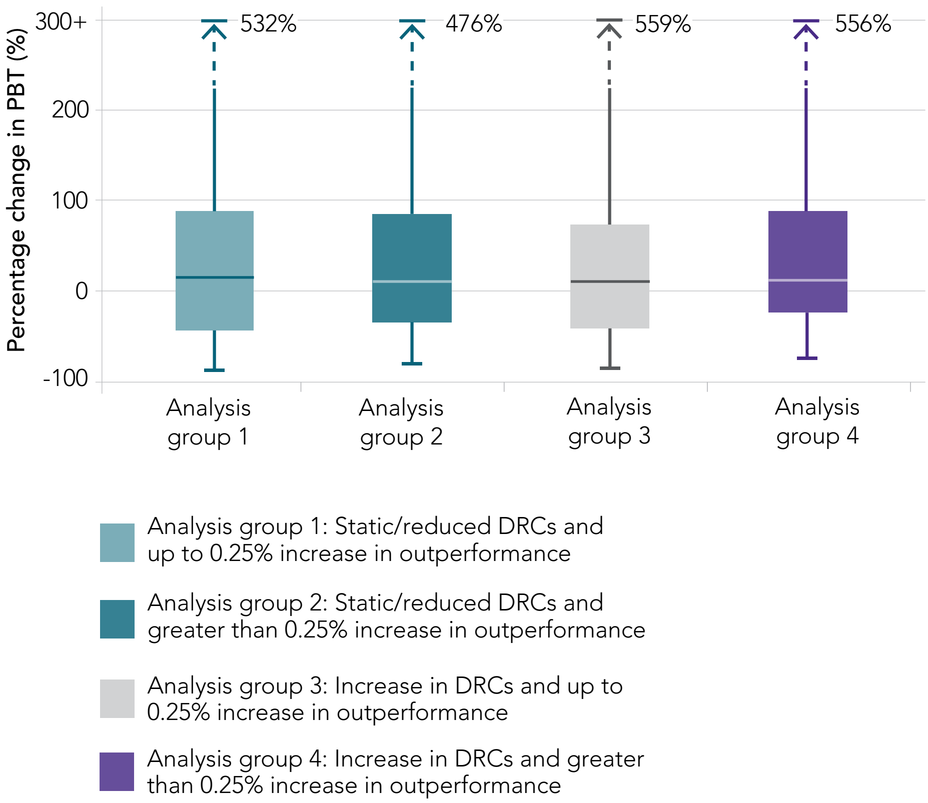
Base: Employers for schemes in the analysis population
Sources: The Pensions Regulator, FAME published by Bureau van Dijk

There are a significant number of employers who were loss-making in one or both tranches, though similar proportions went from a profitable to loss making position and vice versa. They are excluded from Figure 13B to aid interpretation and visualisation.

Table 5: Distribution of changes in employers' PBT by analysis group

Proportion of respective group (%)	Negative PBT in Tranche 8	50%-100% decrease	25%-50% decrease	0%-25% decrease	Negative PBT in both tranches	0%-25% increase	25%-50% increase	50%-100% increase	100%-250% increase	Greater than 250% increase	Negative PBT in Tranche 5
1: Static/reduced DRCs and up to 0.25% increase in outperformance	11.3%	15.7%	7.1%	7.9%	10.0%	7.9%	6.3%	8.4%	8.9%	6.6%	10.0%
2: Static/reduced DRCs and greater than 0.25% increase in outperformance	14.7%	11.5%	6.6%	8.3%	12.1%	8.1%	5.5%	6.6%	7.4%	5.7%	13.4%
3: Increased DRCs and up to 0.25% increase in outperformance	8.3%	12.8%	7.3%	8.3%	13.5%	8.8%	7.1%	7.0%	6.2%	7.0%	13.9%
4: Increased DRCs and greater than 0.25% increase in outperformance	9.8%	10.0%	8.0%	10.8%	9.8%	10.3%	8.2%	6.7%	9.3%	7.2%	10.0%

Figure 13B: Percentage change in employers' PBT by analysis group



Base: Employers for schemes in the analysis population reporting profits for both Tranche 5 and 8 periods.
Sources: The Pensions Regulator, FAME published by Bureau van Dijk

Figure 13B shows that the experience of employers in the analysis population with respect to relative changes in PBT is broadly similar across analysis groups.

For analysis group 1 (comprising 14% of the analysis population, who increased discount rate outperformance by up to 0.25% whilst maintaining or reducing nominal DRCs), employers' PBT increased by 14.6% at the median. 50% of employers in this group had a relative change in PBT of between -46%[16] and 88%.

This can be compared to an increase of 11.8% at the median for analysis group 4 for example (comprising 31% of the analysis population, who increased SEDR outperformance by greater than 0.25% whilst also increasing nominal DRCs). 50% of employers in this group had a relative change in PBT between -26%[17] and 86%.

16
That is to say that PBT in Tranche 8 (2012) was 46% less than that in Tranche 5 (2009), ie it had almost halved.

17
That is to say that PBT in Tranche 8 (2012) was 26% less than that in Tranche 5 (2009), ie it reduced by approximately one quarter.

Notes on data and methodology

Methodology

Average annual DRCs are calculated as the average of DRCs over the first four years of the RP.

Liabilities are calculated on a broadly consistent 'reference' basis to facilitate comparison, using the Bank of England 20 year nominal gilts plus an excess return of 0.5%.

Covenant groups (1-4) are assigned at the point of initial RP reviews to facilitate prioritisation. These grades may vary to the view taken during case level intervention, where a wider range of information is taken into account. They are defined as: covenant group 1 – strong; 2 – tending to strong; 3 – tending to weak; 4 – weak. Covenant assessments are not usually undertaken for surplus schemes. In this analysis all covenant groups were assigned in respect of the Tranche 8 valuation.

Return-seeking assets in this report include equities, property, commodities, hedge funds, 50% of corporate bonds, and assets held in the 'other' category. In the absence of credit ratings, this report assumes that 50% of corporate bonds held rank below investment grade.

Extreme or negative values have either been excluded or visualisations capped at an upper bound to aid interpretation where appropriate.

Employer data

We rely solely on the information supplied to us via scheme returns to identify our employer population, which may not be the most up to date or contain the level of detail that would be available to covenant advisors when advising their clients. This inevitably leads to many more simplifications and approximations in the methods we use to estimate aggregate and individual covenant support.

Much of the data underlying the analyses rely on an evaluation of the ownership of participating employers by other group entities. Ownership is defined as where a company is the UK-domiciled domestic ultimate owner (DUO) of a participating employer, with a minimum controlling stake or interest of 50.01% in that employer. In some cases we do not have sufficient data to identify the DUO of a subject company (participating employer).

We have used the latest published corporate financial data available from our sources as at 1 April 2015 in respect of statutory employers to which more than one DB membership is directly attributable. We have used 2009 financial year end data as relevant to the Tranche 5 valuation, and 2012 for the Tranche 8. For some employers (and therefore some schemes) the required data was not available – mainly SMEs, public/third sector or overseas companies – and therefore the analyses may not be representative of these schemes and/or sectors.

In order to estimate the available covenant support we have made certain assumptions and simplifications, the principal ones (though not an exhaustive list) are:

- where an employer participates in more than one scheme and/or a scheme is sponsored by more than one employer, we have made assumptions about the division and aggregation of an employer's financial support among the pension schemes in which it participates, based on the relative size of each scheme's deficit, and the number of members in each scheme attributable to each employer
- where corporate financial information for statutory employers was not available individually, where appropriate we have used consolidated accounts for the relevant group, thus potentially overstating the covenant support available
- where corporate financial information was not available for all statutory employers to a scheme, we have used information aggregated over only those employers for whom the relevant data was available, thus potentially understating the covenant support available

Any of these assumptions, made to overcome data limitations, may be a significant source of error at the individual scheme/employer level.

Moreover, accounting-based metrics may be poor indicators of formally assessed covenant strength and accordingly this analysis should not be seen as a substitute for bespoke assessments.

Glossary

Deficit repair contributions (DRCs)	These are contributions made by employers to the scheme in order to address any asset to TPs deficit, in line with the Schedule of Contributions and the RP. Throughout this analysis we have used DRCs in the context of the value the scheme receives without making any allowance for any tax benefit the sponsoring employer may receive. All DRCs values in this analysis are an annual average of the first four years of the RP.
Profit before tax (PBT)	Profit before tax is a profitability measure after deduction of all operating expenses, interest on debt and depreciation but before the deduction of corporate tax. We have used PBT as a reasonable indicator of cash generation after debt service and maintenance capital expenditure (capex). We make no adjustments to remove the impact of any pension items already included in the reported figure.
Recovery plan (RP)	Under Part 3 of the Pensions Act 2004, where there is a funding shortfall at the effective date of the actuarial valuation, the trustees must prepare a plan to achieve full funding in relation to the TPs. The plan to address this shortfall is known as an RP.
RP length	The RP length is the time that it is assumed it will take for a scheme to eliminate any shortfall at the effective date of the actuarial valuation, so that by the end of the RP it will be fully funded in relation to the TPs.
Single effective discount rate (SEDR)	Two approaches are used by pension schemes in respect of the discount rate assumption: a single investment return approach (single rates approach) and a different investment returns approach (different rates approach). The SEDR is a single composite rate made up of constituents of the different rates approach, allowing approximately for the maturity of schemes. In this analysis, the terms 'discount rate' and 'SEDR' are synonymous.

Technical provisions (TPs)

The funding measure used for the purposes of Part 3 valuations (see above). The TPs are a calculation undertaken by the actuary of the assets needed at any particular time to make provision for benefits already considered accrued under the scheme using assumptions prudently chosen by the trustees – in other words, what is required for the scheme to meet the statutory funding objective. These include pensions in payment (including those payable to survivors of former members) and benefits accrued by other members and beneficiaries, which will become payable in the future.

Tranches

Tranches are the set of schemes that are required to carry out a scheme-specific funding valuation within a particular time period. Schemes whose valuation dates fell from 22 September 2005 to 21 September 2006 (both dates inclusive) were in Tranche 1, from 22 September 2006 to 21 September 2007 were Tranche 2 (both dates inclusive) etc. Because scheme-specific funding valuations are generally required every three years, schemes whose valuations are in Tranche 1 will also be likely to carry out valuations in Tranches 4, 7 and 10.

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Annual funding statement
Tranche 8

The Pensions Regulator