

Annual funding statement analysis

A look forward to schemes with valuation dates between
September 2014 and September 2015 (Tranche 10)

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Introduction

In order to provide further context to our **2015 annual funding statement**: www.tpr.gov.uk/statement2015 we are publishing our analysis of the expected positions as at March 2015 of defined benefit (DB) pension schemes with valuation dates between 22 September 2014 and 21 September 2015 (Tranche 10). This analysis highlights the estimated impact of the changes in market conditions since the date of these schemes' previous valuations.

This analysis has been used to inform our approach and commentary on market conditions in our statement and our key messages to trustees and employers. However, our observations are of a generic nature having regard to market trends and their likely implications for scheme valuations. Individual schemes may, of course, have significantly different experiences and challenges.

Summary

Our modelling suggests that, for many schemes, liabilities have grown faster than assets since their Tranche 7 valuation, resulting in increased deficits. However, each scheme's funding position will be highly dependent on its individual circumstances and scheme-specific factors.

Our modelling shows that schemes with different valuation dates and/or different investment strategies will see different movements in their funding positions. Setting an appropriate investment strategy, with an associated level of investment risk, depends on the covenant supporting a scheme and maturity of the scheme's liabilities.

Similarly, our high level analysis of the sponsoring employers' profitability and balance sheet positions suggests a marked variation between individual companies. This emphasises the importance of trustees making scheme and employer-specific assessments of covenant strength and affordability in order to agree appropriate recovery plans.

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Summary continued...

We have modelled the impact of these potentially higher deficits on scheme deficit repair contributions (DRCs) and recovery plan (RP) lengths based on our estimates of their Tranche 10 valuations. This modelling shows that:

- ▶ if the end date of the current RP was maintained, the modelled DRCs that schemes would need to pay would be lower than their current DRCs for about 15% of schemes because of deficits reducing, and a further 24% of schemes would see an increase of up to 50%. The remaining schemes would see a bigger increase.
- ▶ if, alternatively, the current levels of DRCs were maintained, about 15% of schemes could reduce their RP length because of deficits reducing, and a further 30% could contain the increase to less than three years. The remaining schemes would have to increase the RP length by a longer period.

However, our modelling involves a number of approximations and does not take account of some scheme-specific characteristics. The position of individual schemes will depend on numerous factors including: the performance of their investment strategy, the DRCs paid during the inter-valuation period, the impact of any interest rate and hedging strategies and trustees' views on future investment returns reflected both in the discount rate and the asset return assumption in the recovery plan.

In practice, many schemes may choose to manage increased deficits through a combination of affordable increases in DRCs and modest extensions in RP lengths.

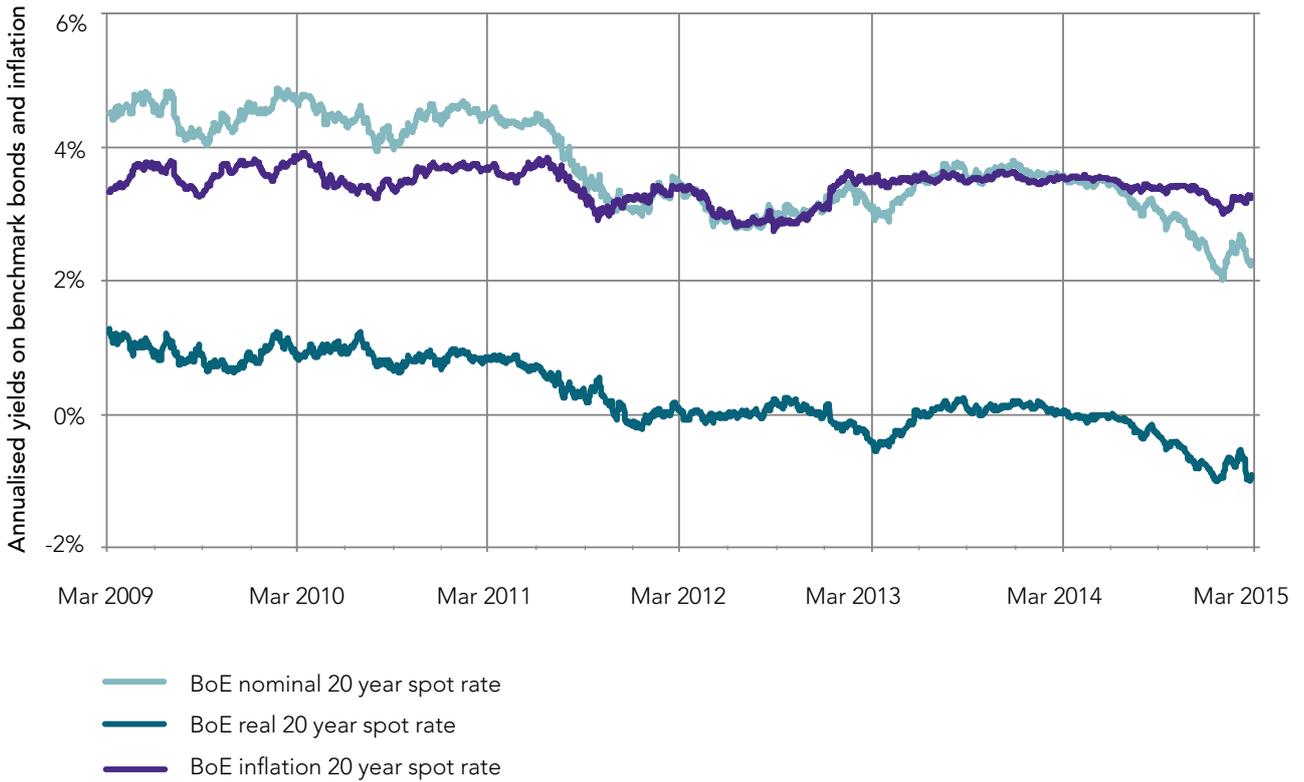
The ability of the employer to pay contributions now and in the future is employer-specific. Many employers appear to be able to afford higher DRCs without undue impact on employers' profits, balance sheet positions or dividends. Whilst for other employers, affordability will be more constrained and trustees and employers will have to work hard to agree an appropriate solution.

Market indicators

Scheme funding is sensitive to the impact of the changes in market conditions on both schemes' assets and the valuation of their liabilities. The changes in bond yields, expectations for interest rates and inflation, and the returns on various asset classes are key aspects to this.

Figure 1 shows the Bank of England estimates of nominal and real gilt yields and implied inflation (as measured by the Retail Prices Index or RPI) over a 20-year period at each date from 31 March 2009.

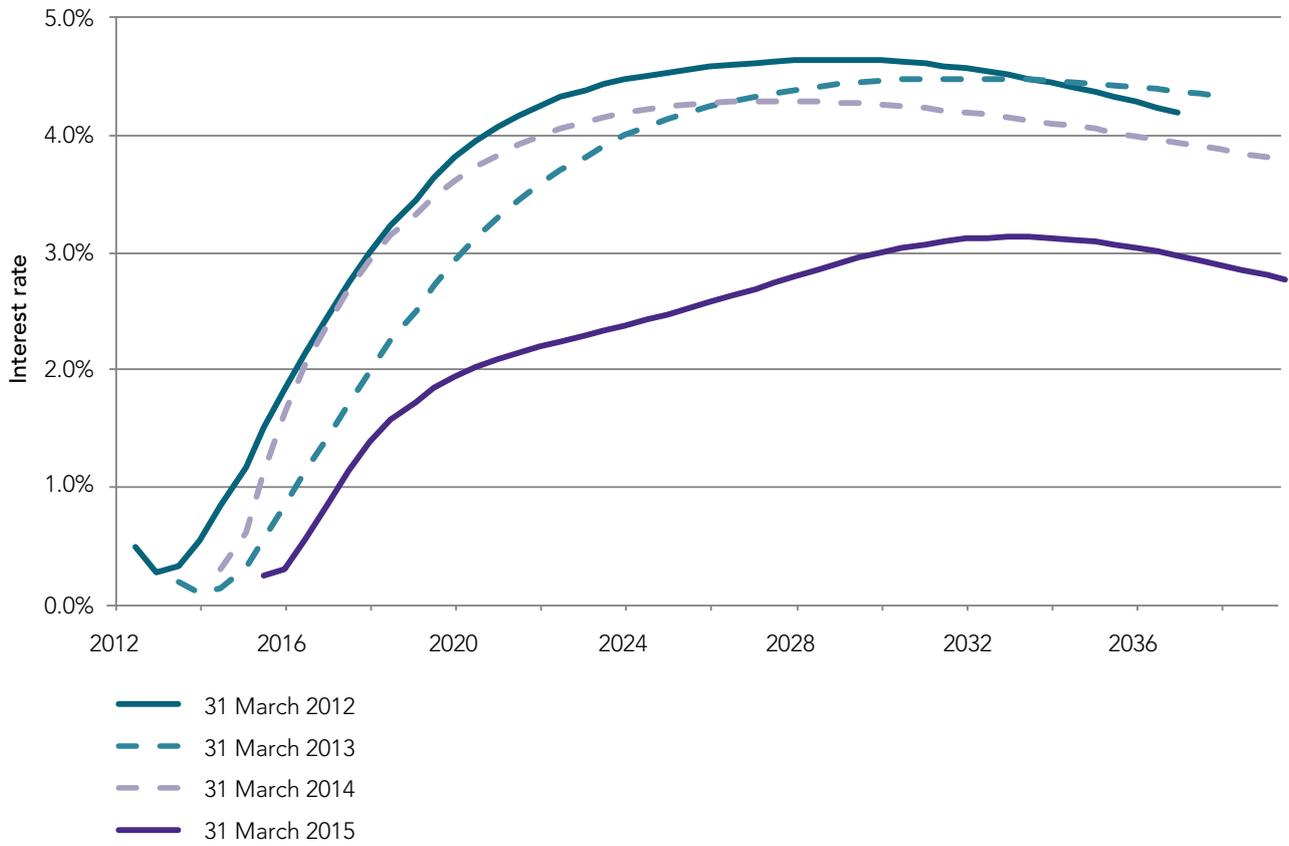
Figure 1: Benchmark gilt yields



Source(s): Bank of England (BoE), Thomson Reuters

Figure 2a shows the nominal forward interest rates as estimated by the Bank of England as at 31 March 2012, 2013, 2014 and 2015.

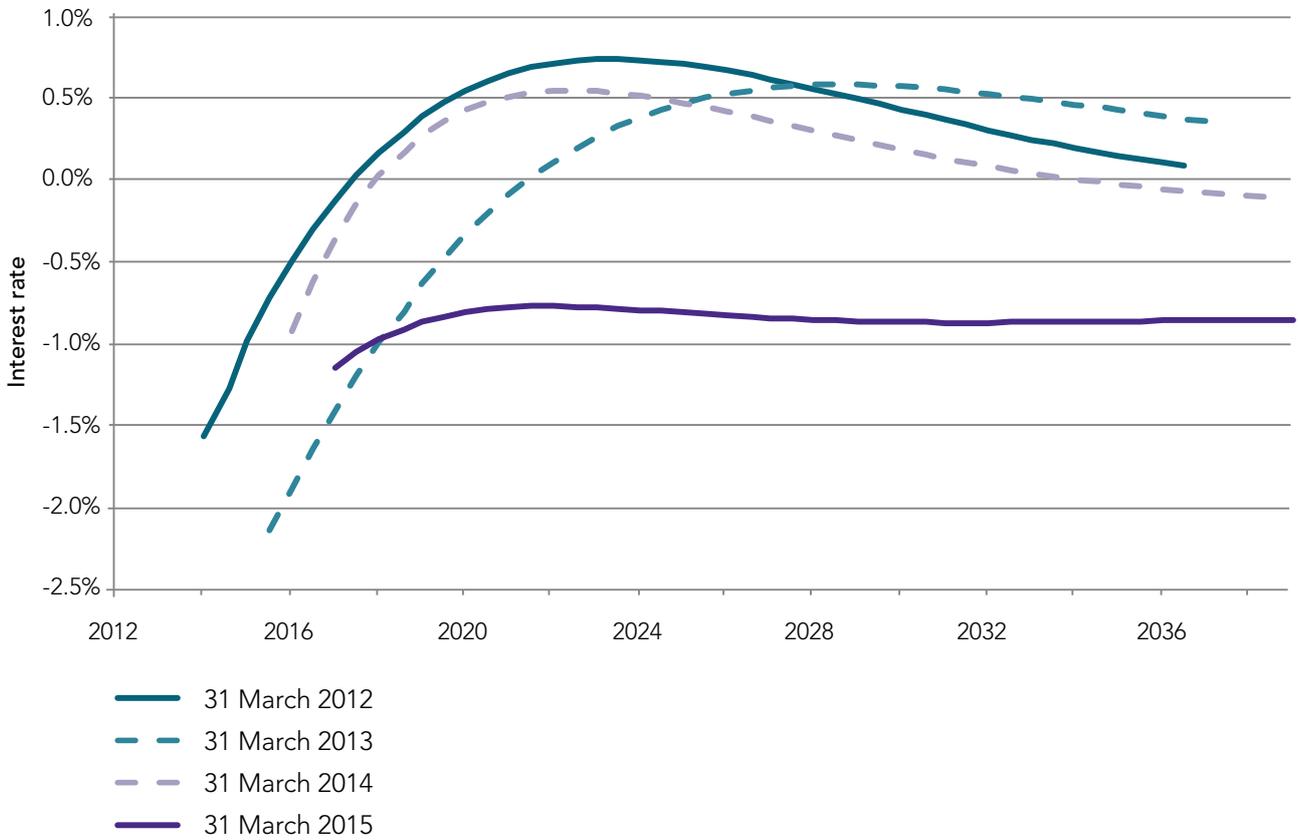
Figure 2a: UK instantaneous nominal forward gilt curves



Source(s): Bank of England (BoE)

Figure 2b shows the real forward interest rates as estimated by the Bank of England as at 31 March 2012, 2013, 2014 and 2015.

Figure 2b: UK instantaneous real forward gilt curves

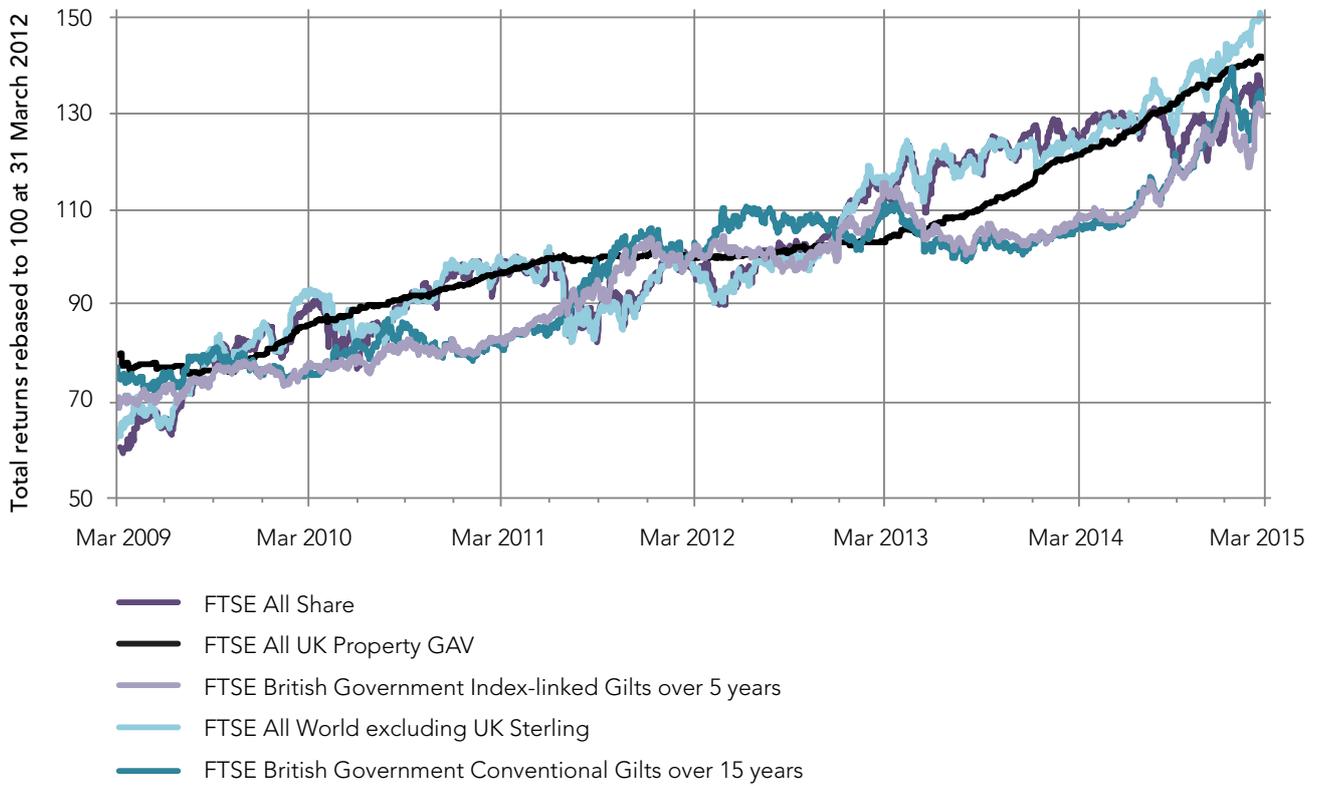


Source(s): Bank of England (BoE)

Taken together, these three charts show that long-dated gilt yields have fallen significantly in the twelve months to 31 March 2015 without a corresponding decrease in expectations for (RPI) inflation and implied nominal and real interest rates are now lower in both the short and long term than previously.

Figure 3 shows total returns (ie increases in value with income re-invested) for a range of asset class indices since 2009. The returns have been re-based to 100 at 31 March 2012 (the central Tranche 7 valuation date) so that if equal amounts had been invested in each asset class index at that date, the chart shows the relative change from that point.

Figure 3: Asset returns



Source(s): Thomson Reuters, FTSE group

Table 1 shows the total returns for the asset class indices over the periods from 31 March 2012 to 31 March 2015 and 31 December 2011 to 31 December 2014, these dates representing the two key inter-valuation periods for Tranche 10 schemes.

Table 1: Total returns for various asset indices

Index name (Asset class)	Total returns over the period 31 March 2012 to 31 March 2015	Total returns over the period 31 December 2011 to 31 December 2014
FTSE All Share (UK equities)	33.2%	37.3%
FTSE All World excluding UK Sterling (Overseas equities)	49.6%	52.1%
FTSE All UK Property GAV	41.7%	36.5%
FTSE British Government Conventional Gilts over 15 years	33.4%	22.1%
FTSE British Government Index-linked Gilts over 5 years	29.6%	22.7%

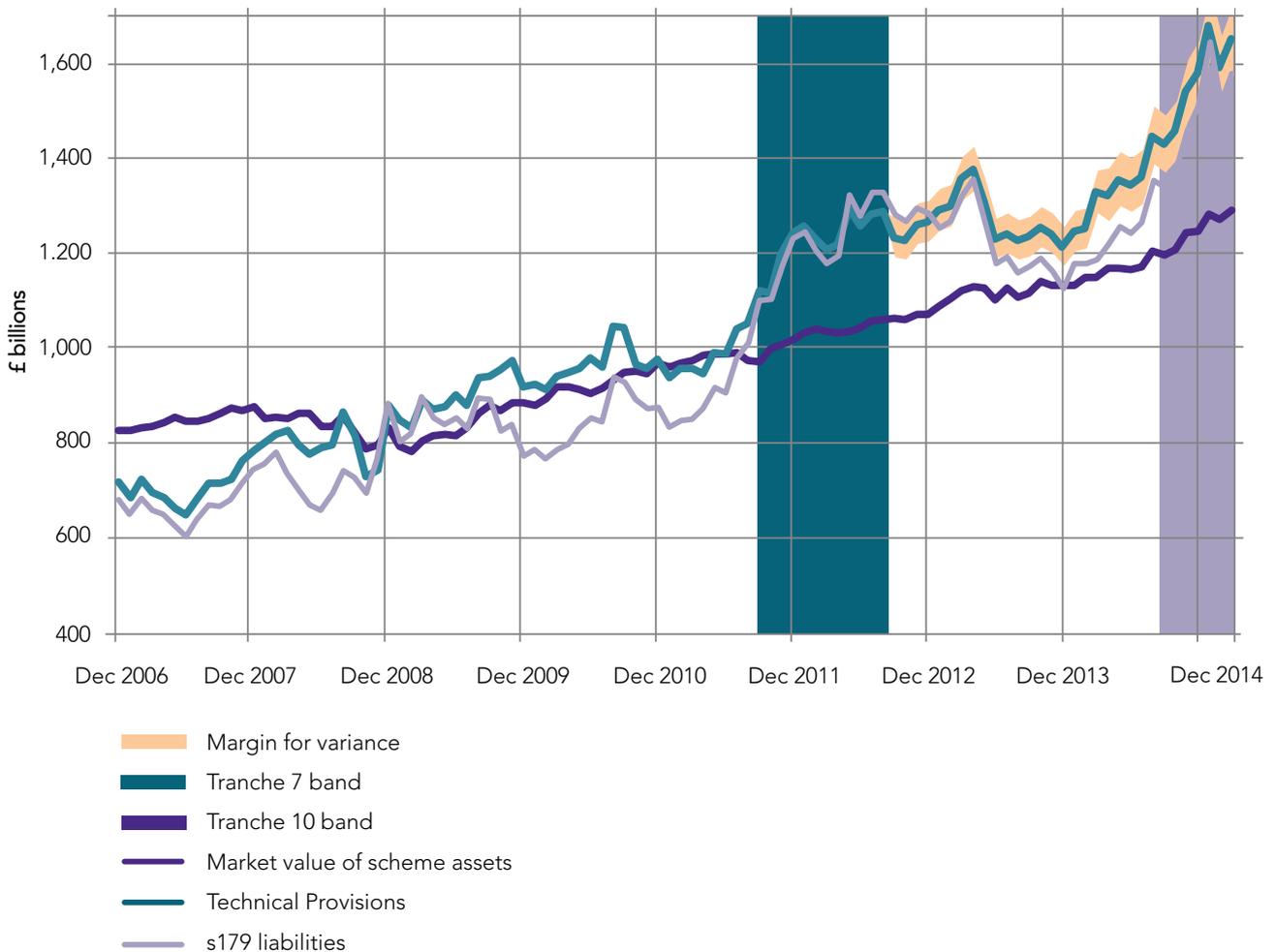
Source(s): Thomson Reuters, FTSE group

Defined benefit (DB) schemes

Funding position of DB schemes in aggregate

Figure 4 shows estimates of assets, section 179 liabilities and technical provisions derived from the movement in the PPF 7800 index for all schemes in that index. This is an aggregate analysis based on highly summarised data and shows an illustrative range for the value of technical provisions. It may not be representative of individual schemes whose assets and liabilities will depend on many scheme-specific factors.

Figure 4: Estimated assets and liability positions of DB pension schemes



Source(s): The Pension Protection Fund (PPF), The Pensions Regulator

The changes in market conditions since their last valuation mean that deficits on a technical provisions basis are likely to have increased for many schemes in Tranche 10, although some schemes with risk management strategies such as derivative-based interest rate hedging should have fared better and schemes with different valuation dates will see different relative movements in their funding positions.

Potential impact on scheme deficits

The impact of market conditions on deficits will vary depending on schemes' specific circumstances including the exact timing of valuations, asset allocation and interest rate and inflation hedging strategies. In practice, changes in a scheme's funding position will also depend on other scheme specific factors such as the level of deficit contributions paid into the scheme, the starting funding position, the scheme's demographic experience and the approach taken to setting discount rates at the Tranche 7 and Tranche 10 valuations.

In Figures 5a to 5d we look at the following example schemes performing a valuation as at 31 March 2015:

Example scheme	Investment strategy	Discount rate
Scheme A	45% in gilts and bonds, 35% in equities, 5% in cash and 15% in other return-seeking asset classes	BoE 20 year nominal spot rate + 1.0% a year ¹
Scheme B	15% in gilts and bonds, 55% in equities, 5% in cash and 25% in other return-seeking asset classes	BoE 20 year nominal spot rate + 1.5% a year
Scheme C	75% in gilts and bonds, 15% in equities, 5% in cash and 5% in other return-seeking assets	BoE 20 year nominal spot rate + 0.5% a year
Scheme D	As per Scheme A with 25% of interest rates and inflation risk hedged through derivatives	BoE 20 year nominal spot rate + 1.0% a year

We have assumed that:

- ▶ All schemes had the same starting assets, liabilities and deficits as at 31 March 2012 and a starting funding level in line with the average of all Tranche 7 schemes taken in aggregate. The starting deficit for all schemes has been notionally set at 100.
- ▶ The same annual rate of deficit repair contributions (DRCs) has been paid into each scheme (at around 12% of the starting deficit). This is broadly consistent with the rate of DRCs paid by all Tranche 7 schemes taken in aggregate.

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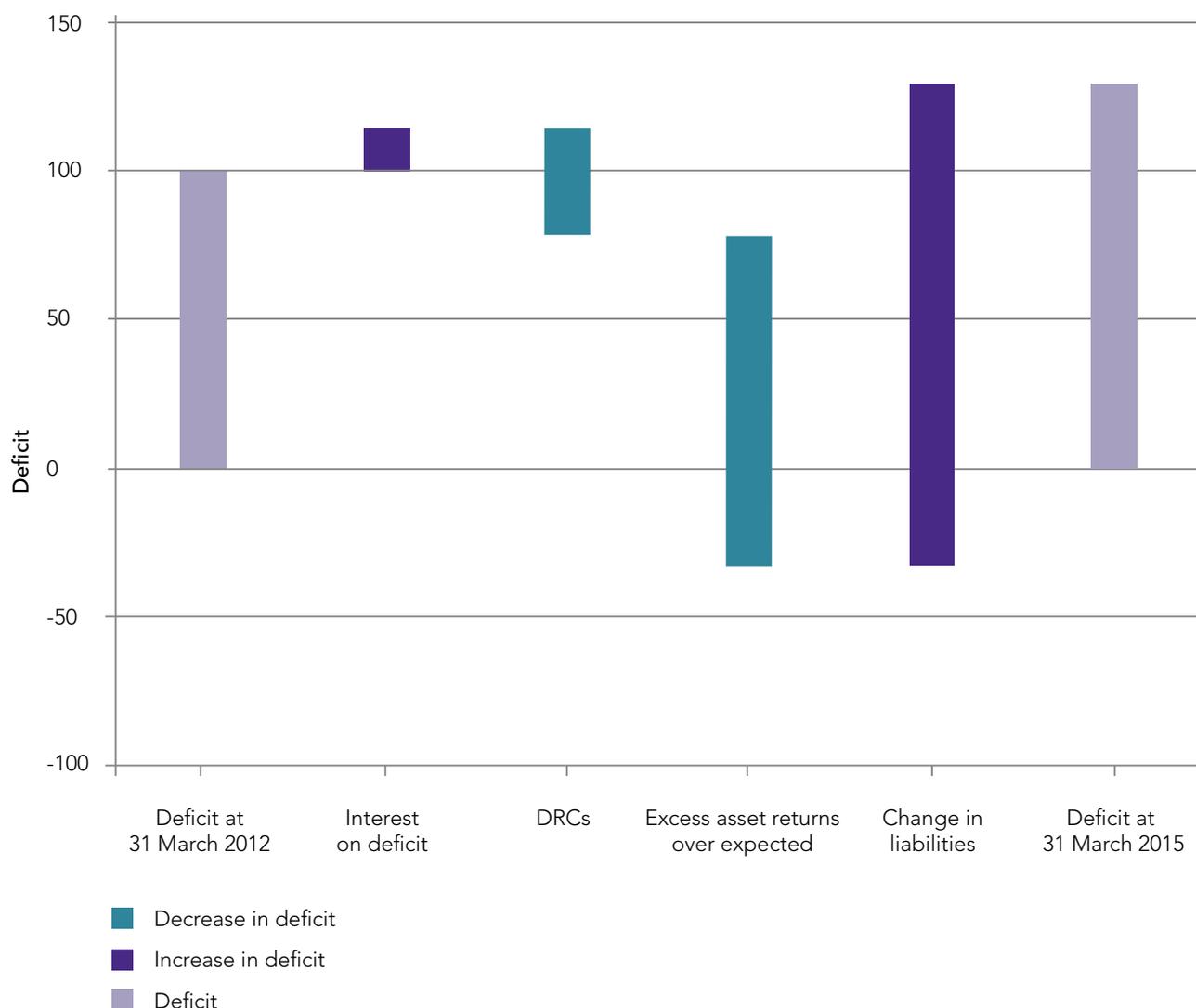
The BoE 20 year nominal spot rate was 3.43% at 31 March 2012 and 2.29% at 31 March 2015. An allowance for 1.0% a year outperformance over gilts is consistent with the average outperformance assumption used by Tranche 7 schemes, see [Scheme funding statistics – Valuations and recovery plans of UK defined benefit and hybrid pension schemes \(May 2015\): www.tpr.gov.uk/funding2015](#)

Potential impact on scheme deficits continued...

The asset allocation for Scheme A is broadly in line with the average asset allocation of all Tranche 7 schemes taken in aggregate. The asset allocations for the other schemes are to show the effect of variations from this typical strategy, with Scheme B having 30% less in gilts and bonds and more return-seeking assets, Scheme C having 30% more in gilts and bonds and fewer return-seeking assets and Scheme D having the same physical asset allocation as Scheme A but with a derivative strategy in place to hedge 25% of the movement in the liabilities resulting from changes in interest rates and future expectations of inflation.

We have also assumed the same spread of discount rates relative to gilts is used in the calculation of technical provisions at the Tranche 10 valuation date as the previous valuation. This applies for all of the subsequent analysis in this document and is for illustrative purposes only.

In practice, schemes can choose to adjust their discount rates to reflect their views of changes in the market conditions, changes in their investment strategy and/or other changes in circumstances such as in the covenant supporting the scheme, in line with their integrated approach to managing risk.

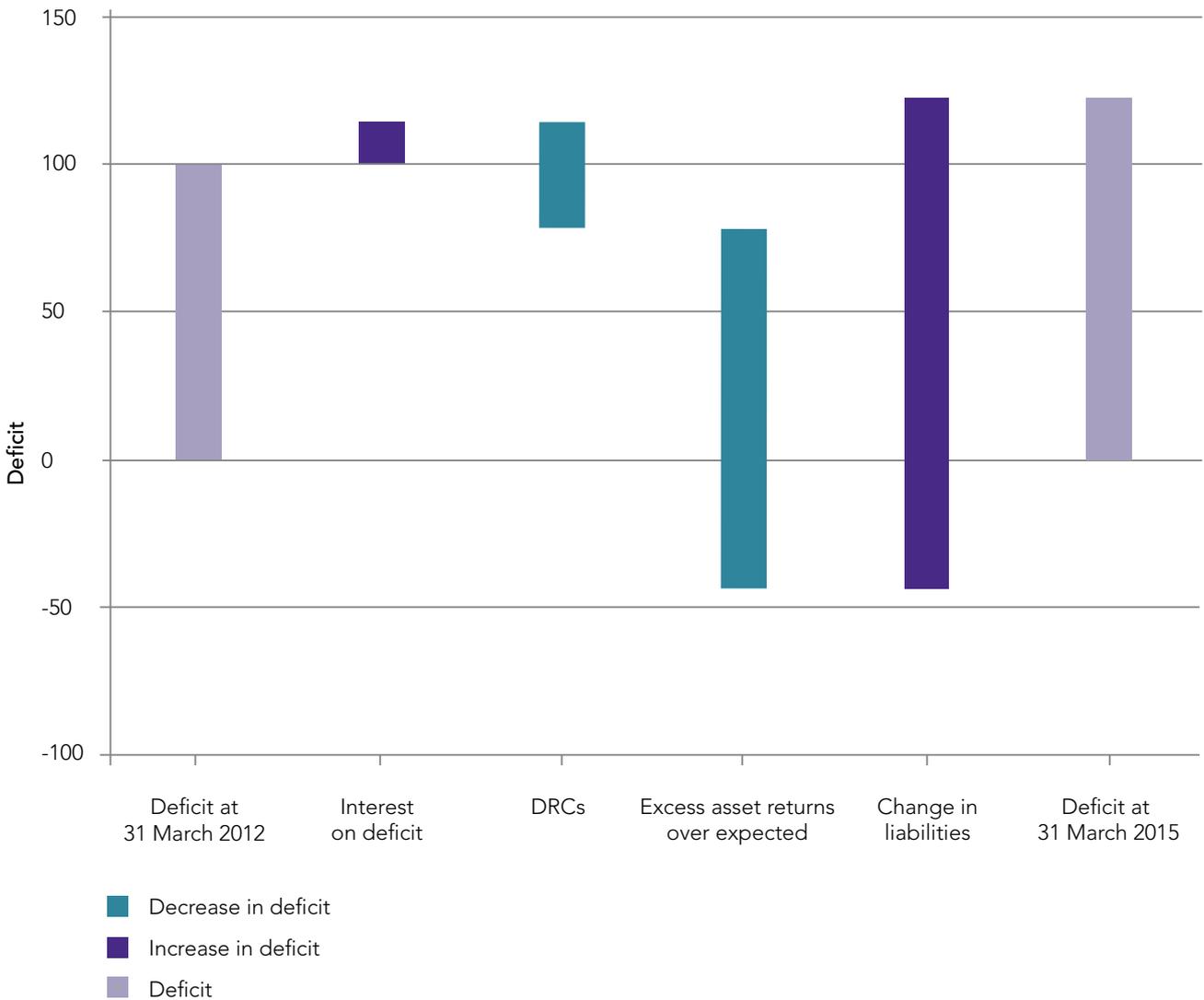
Figure 5a: Estimated impact of market conditions on Scheme A

Source(s): The Pensions Regulator, Thomson Reuters, FTSE group, Markit iBoxx

The DRCs paid into Scheme A over the period are greater than the interest on the starting deficit and hence the deficit was expected to reduce over the period if the assumptions used at the last valuation had been borne out. Furthermore, the actual returns on Scheme A's assets have been significantly above those expected. However, changes in financial conditions, specifically the significant fall in gilt yields, have resulted in a change in liabilities which more than outweighs this better than expected asset performance. As a result Scheme A has a significantly bigger estimated deficit as at 31 March 2015 than three years earlier.

The deficits of schemes with different valuation dates will have moved differently. For example, if a scheme with the same characteristics as Scheme A had performed a valuation at 31 December 2011, we estimate that this scheme's deficit would have reduced over the three-year period to 31 December 2014, albeit the starting deficit would have been higher at 31 December 2011 than for Scheme A at 31 March 2012 due to the different market conditions at those two dates.

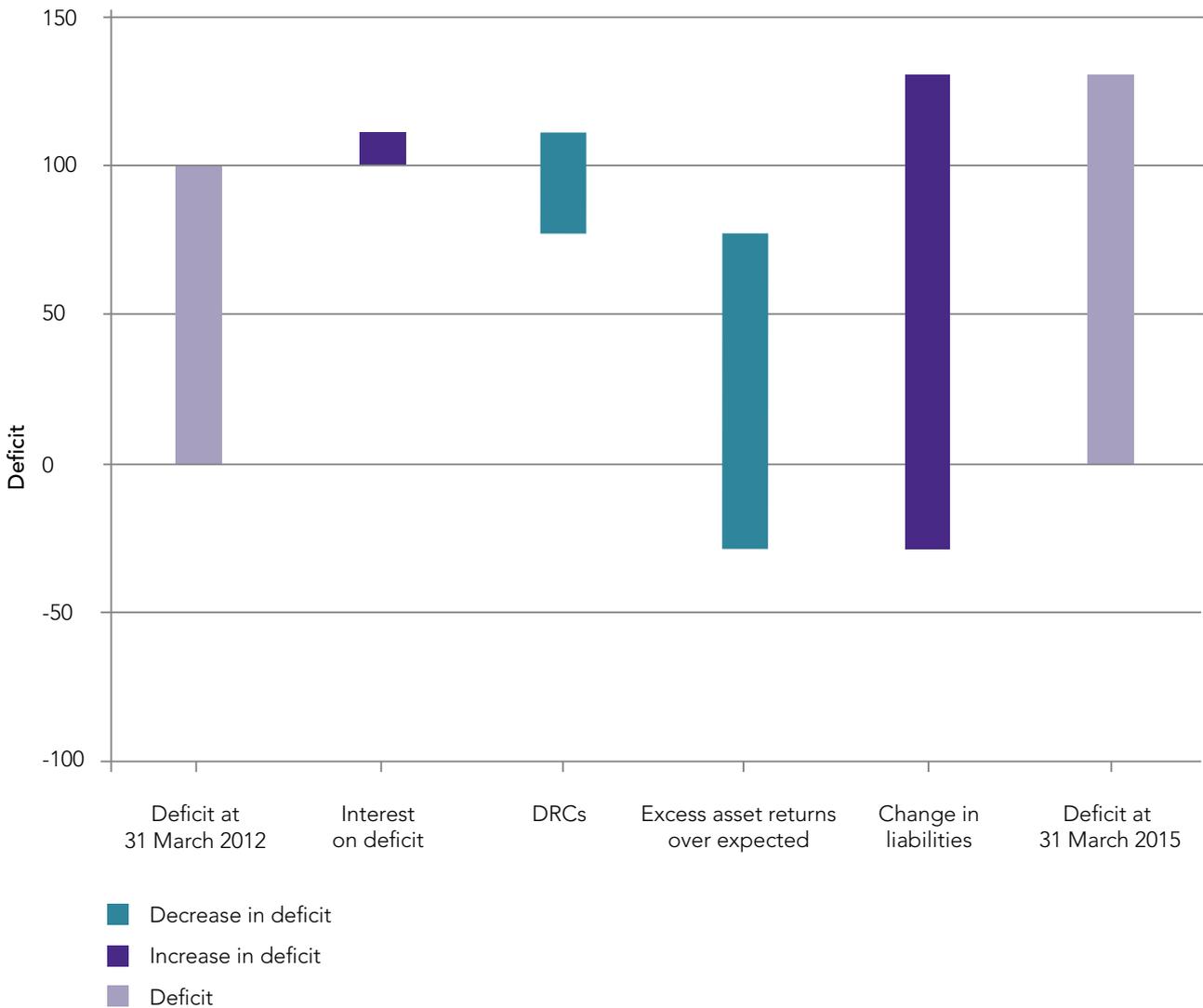
Figure 5b: Estimated impact of market conditions on Scheme B



Source(s): The Pensions Regulator, Thomson Reuters, FTSE group, Markit iBoxx

In comparison to Scheme A, Scheme B’s deficit has grown by slightly less over the three-year period. This reflects the fact that the actual returns on return-seeking assets (such as equities) held by Scheme B were slightly higher than the returns on gilts and bonds over the period. As a result the excess asset returns over those expected is slightly higher for Scheme B since it holds more return-seeking assets and fewer gilts and bonds than Scheme A.

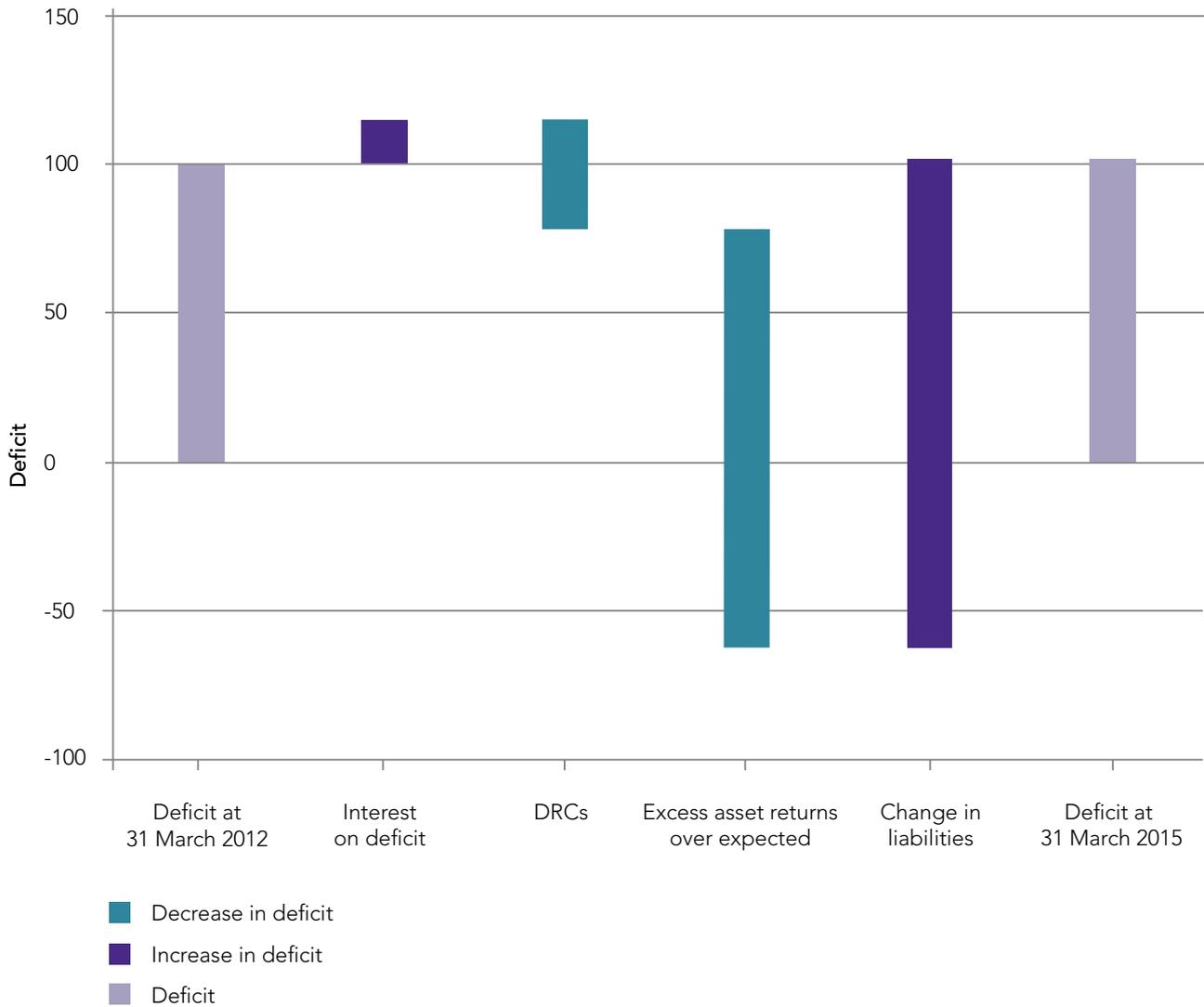
Figure 5c: Estimated impact of market conditions on Scheme C



Source(s): The Pensions Regulator, Thomson Reuters, FTSE group, Markit iBoxx

In comparison to Scheme A, Scheme C’s deficit has grown by slightly more over the three-year period. This reflects the fact that the actual returns on return-seeking assets (such as equities) held by Scheme C were slightly higher than the returns on gilts and bonds over the period. As a result the excess asset returns over those expected is slightly lower for Scheme C since it holds more gilts and bonds and fewer return-seeking assets than Scheme A.

Figure 5d: Estimated impact of market conditions on Scheme D



Source(s): The Pensions Regulator, Thomson Reuters, FTSE group, Markit iBoxx

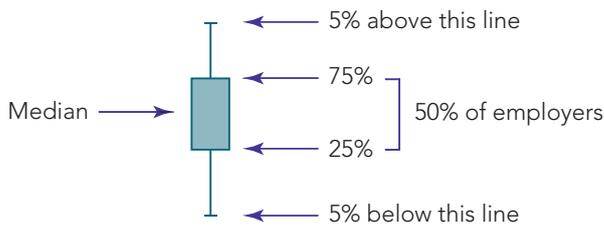
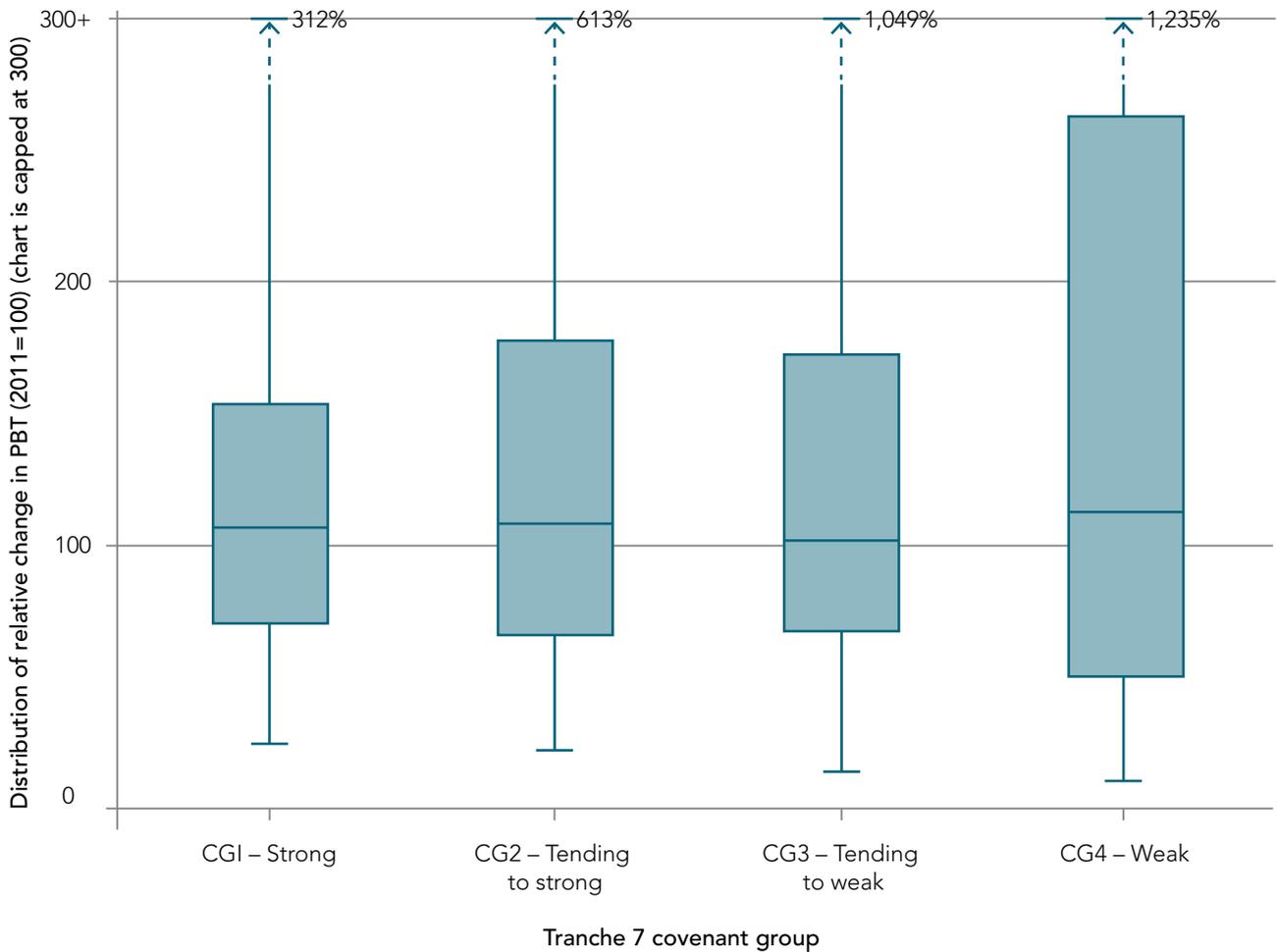
In comparison to Scheme A, Scheme D’s deficit has grown by significantly less over the three-year period. This reflects the fact that, by hedging more of the interest rate and inflation risk, the value of its assets have increased by more as interest rates have fallen. At the same time, Scheme D has continued to benefit from the high returns on the return-seeking assets (such as equities) that it holds. As a result the relative gap between the excess asset returns over those expected and the change in liabilities is significantly lower for Scheme D than Scheme A.

Scheme D’s investment strategy performed better than Scheme A’s strategy over the three-year period to 31 March 2015. Scheme B’s strategy performed slightly better and Scheme C’s strategy slightly worse than Scheme A over the same period. However, this does not provide a guide for how the strategies of the four schemes might perform in the future. Furthermore, if we did a comparison of the four schemes over a different period, for example 31 March 2014 to the 31 March 2015, the relative changes in their funding positions would be different.

Employer trends

In Figure 6 below we have considered employers who sponsor Tranche 10 schemes, and who reported a profit in 2011 and in the most recently published accounts.

Figure 6: Profit before tax by covenant group² (Tranche 10 employers)



Source(s): The Pensions Regulator, Financial Analysis Made Easy published by Bureau van Dijk

2

Covenant groups (CG) 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 in-surplus schemes.

Figure 6 continued...

Of those employers where we have sufficient data on profit before tax (PBT)³, 61% are included in the analysis for Figure 6. We look at how the level of profitability of the group of employers included in Figure 6 has changed since 2011, segmented by strength of covenant assessed in Tranche 7. For each employer, PBT from the most recently published accounts is compared to PBT in 2011 which has been re-based to 100.

Within the 39% of employers excluded from Figure 6 (due to having less meaningful measures given they were loss-making in one or both tranches), similar proportions went from being profitable to loss-making and vice versa:

- ▶ Around one-third reported a **loss** in 2011 and a **profit** in the most recently published accounts.
- ▶ Around one-third reported a **profit** in 2011 and a **loss** in the most recently published accounts.
- ▶ Around one-third reported a **loss** in both 2011 and in the most recently published accounts.

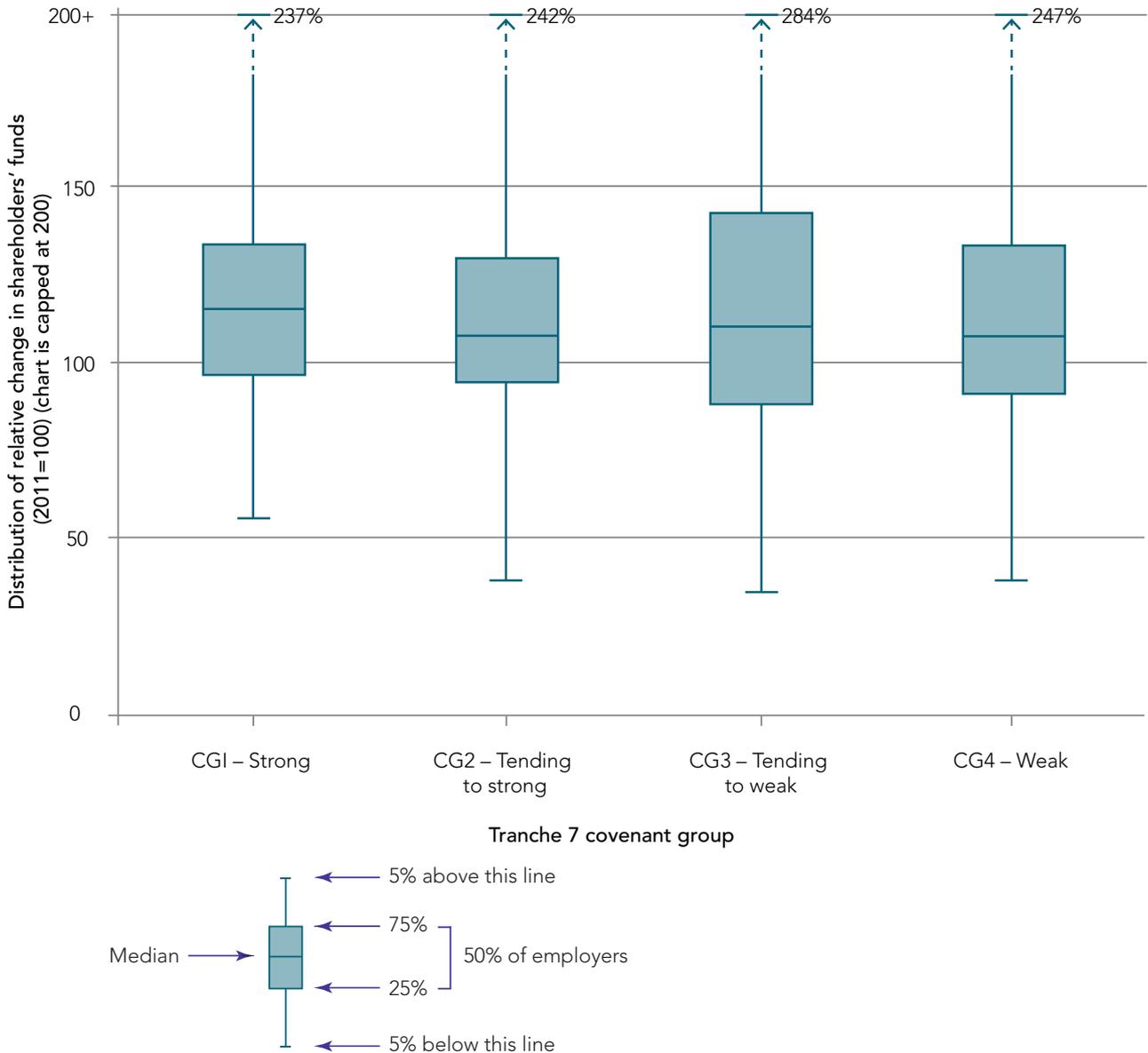
From Figure 6, we can see that within the included group of employers, there has been a modest improvement in the median level of PBT (0-15%) but with considerable variation at an individual employer level. Those employers with weak covenants (CG4) have seen the greatest variation in PBT since 2011.

3

In total we have adequate PBT data (for both 2011 and a more recent, latest available financial year end) for approximately 70% of employers sponsoring Tranche 10 schemes. Also see Methods, principal assumptions and limitations on page 32.

Figure 7 shows similar information as Figure 6 for shareholders' funds. For this analysis, we have included those Tranche 10 employers who reported a positive figure for shareholders' funds in 2011 and also in the most recently published accounts.

Figure 7: Shareholders' funds by covenant group (Tranche 10 employers)



Source(s): The Pensions Regulator, Financial Analysis Made Easy published by Bureau van Dijk

Of those employers where we have sufficient shareholders' funds data⁴, 87% are included in the analysis for Figure 7. For each employer, shareholders' funds from the most recently published accounts was compared to shareholders' funds in 2011 which has been re-based to 100, segmented by strength of covenant assessed in Tranche 7.

Within the 13% of employers excluded from Figure 7 (due to exhibiting less meaningful trend ratios/measures given they reported a negative shareholders' funds position in one or both tranches), similar proportions went from a negative position in 2011 to a positive position in the most recently published accounts and vice versa, and a significant majority reported a negative position in both tranches:

- ▶ Around one-sixth reported a **negative** value for shareholder funds in 2011 and a **positive** value in the most recently published accounts.
- ▶ Around one-sixth reported a **positive** value for shareholder funds in 2011 and a **negative** value in the most recently published accounts.
- ▶ Around two-thirds reported a **negative** value for shareholder funds in both 2011 and the most recently published accounts.

From Figure 7 we can see that, within the included group of employers, there has been modest improvement in the position of company balance sheets at the median (8-16%), but with considerable variation at an individual employer level. Those employers with tending to weak covenants (CG3) have seen the greatest variation although the difference between the employers of different strength of covenant is not great.

4

In total we have adequate shareholders' funds data (for both 2011 and a more recent, latest available financial year end) for approximately 83% of employers participating in schemes with an anticipated Tranche 10 valuation date. Also see Methods, principal assumptions and limitations on page 32.

Figure 8 shows gross dividends paid by the FTSE 350 from 2007 to 2014 split by those employers who sponsor DB schemes and those who do not⁵.

Figure 8: Gross dividends paid by FTSE 350 companies



Source(s): The Pensions Regulator, Capita Registrars and Financial Analysis Made Easy published by Bureau van Dijk

FTSE 350 aggregate dividends dropped in 2009 and 2010 but returned to higher levels in 2012, with a record headline figure of £97.4bn in 2014 (up 21% year-on-year), although underlying dividends (excluding special dividends of £18.3bn) grew by just 1.4% year-on-year over the same period, to £79.1bn⁶.

Capita Registrars' current forecast for 2015 is for aggregate headline dividends to hit £86.5bn, with underlying dividends projected to reach £84.1bn, up 6.4% year-on-year, the fastest rate of growth since 2012⁷.

5 Includes 202 FTSE 350 companies who are estimated to have DB pension obligations (either directly or via ownership of participating employers) as at 28 April 2015 – please see Methods, principal assumptions and limitations on page 32.

6 www.capitaassetservices.com/sites/default/files/SS14420_Dividend_Monitor_Q1_2015-r3.PP_.pdf
7 www.capitaassetservices.com/sites/default/files/Dividend_Monitor_July.pdf

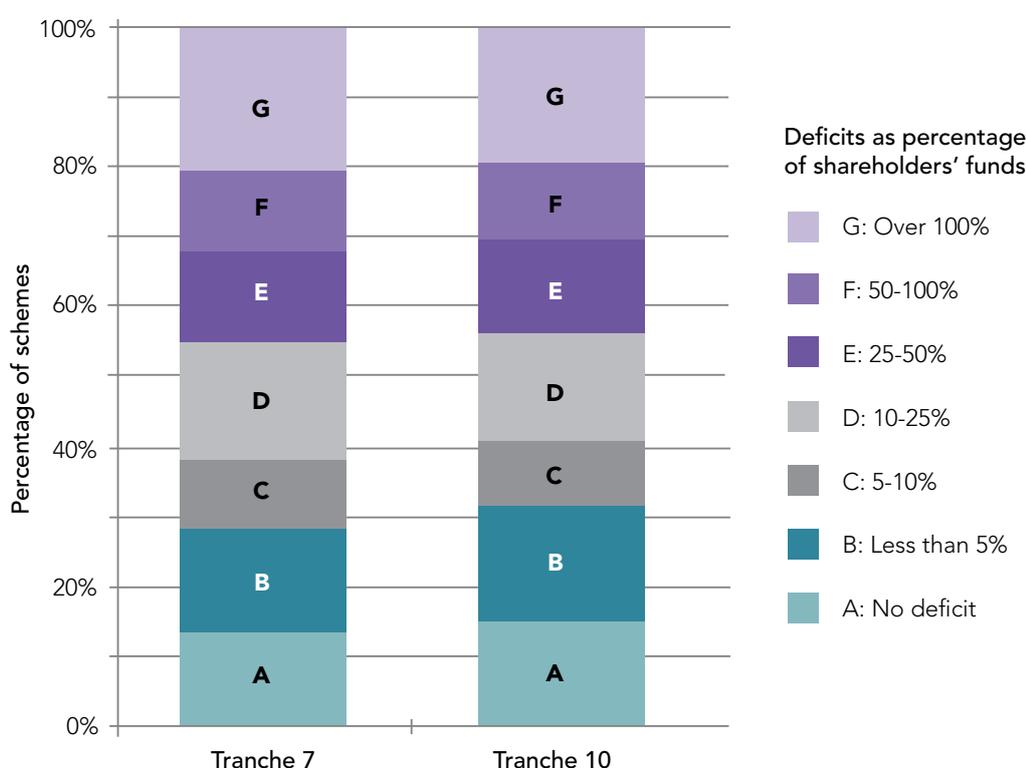
Implications for scheme funding

Potential impact of deficits on employers' balance sheets

The significance of schemes and their deficits to their employers varies. For some schemes, deficits are easily manageable given the strength of the employer relative to the requirements of the pension scheme. However, for others, the level of potential employer support and the extent to which it would be available when needed by the pension scheme can be a material consideration for both the scheme and the employer.

Figure 9 shows the relationship between company balance sheets and the pension scheme deficits they support.

Figure 9: Scheme deficits as a proportion of shareholders' funds



Source(s): The Pensions Regulator, *Financial Analysis Made Easy* published by Bureau van Dijk

The bar on the left shows the deficit on the technical provisions basis for each scheme as a proportion of the employer's shareholders' funds relevant at their Tranche 7 valuation date. The bar on the right shows the same metric based on our estimate of the new deficit as at 31 March 2015 and the most recent employers' shareholders' funds⁸ data available. For example, the right hand bar above shows that deficits at Tranche 10 are less than 10% of shareholders' funds (Groups A, B and C) for just over 40% of schemes in this analysis, a marginally larger proportion than in Tranche 7.

8

Covers approximately 80% of Tranche 10 schemes, excluding those where shareholders' fund data was negative or not available. Also see Methods, principal assumptions and limitations on page 32.

This analysis suggests that for many schemes the ratio of a scheme's deficit relative to the employer's shareholders' funds is likely to have stayed broadly the same over the last three years (in spite of higher estimated deficits for most schemes) and that the new market conditions are not imposing any additional significant strain across the system.

Potential impact on deficit repair contributions (DRCs)

Our revised DB funding code emphasises the need to adopt an integrated approach which strikes an appropriate balance between contributions paid into the scheme, the investment risk borne by the scheme, the employer's affordability and appetite for supporting the investment risk and the risk to members from recovery plans. Recovery plans can be tailored to the circumstances of the scheme and employer but it is important that deficits are recovered over an appropriate period.

While the aggregate impact of decisions agreed individually between trustees and employers is impossible to model in advance, we examine below a number of 'what if' scenarios to illustrate some of the ways schemes faced with increased deficits arising from prevailing market conditions may be able to manage these in the context of their specific circumstances, including employer affordability. This analysis has informed the guidance we provide in the 2015 annual funding statement.

A. Keeping the same recovery plan end date

In this scenario we examine the impact on deficit repair contributions (DRCs) if each Tranche 10 scheme aims to recover its new deficit over the remaining duration of its current recovery plan⁹.

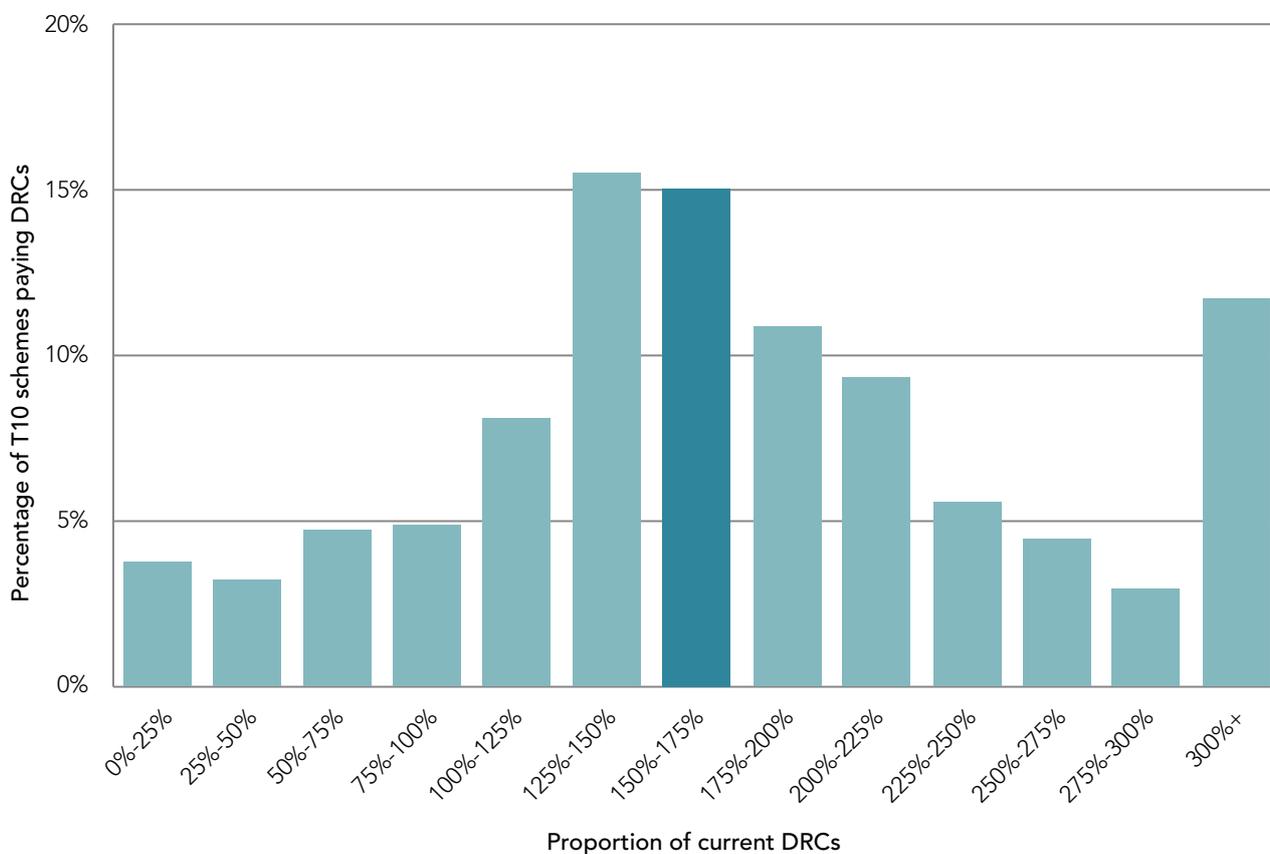
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With the exception of schemes with less than three years of the current recovery plan remaining, where we have modelled the new recovery plan over three years.

The impact of this is illustrated in Figure 10 which compares for each scheme the resulting DRCs (modelled DRCs)¹⁰ with what they are currently paying.

Figure 10: Modelled Tranche 10 DRCs as a proportion of current DRCs – based on same RP end date as last valuation¹¹



Source: The Pensions Regulator

Figure 10 shows that:

- ▶ Around 15% of schemes would see a reduction in modelled DRCs (meaning a ratio of DRCs of less than 100%) because of an improvement in the funding position compared to the previous valuation date.
- ▶ A further 24% would see modelled DRCs increasing by 50% or less (meaning a ratio of DRCs of between 100% and 150%).
- ▶ The median increase in modelled DRCs is 66% (as indicated by the dark bar above).

¹⁰ Our analysis makes no allowance for other changes to the funding strategy such as an increase to the discount rate outperformance.

¹¹ Figure 10 and Table 2 exclude schemes which reported a surplus, or zero DRCs, at their Tranche 7 valuation and/or have an estimated surplus at 31 March 2015.

We also examine in greater detail the group of 181 schemes whose modelled DRCs are three times (300%+) or more of their current DRCs. For these schemes we analyse the distribution of the modelled DRCs against both the latest available PBT of the employer and the remaining length of their current recovery plan. The results are summarised in Table 2.

Table 2: Schemes for which modelled Tranche 10 DRCs are at least three times (300%+) the current DRCs

	Remaining length of current recovery plan					Total
	3 years or less	3–6 years	6–9 years	9–12 years	More than 12 years	
Modelled Tranche 10 DRCs as percentage of latest PBT						
0–25% PBT	15	22	17	4	1	59
25–50% PBT	4	14	2	0	1	21
50–75% PBT	2	5	3	1	0	11
75–100% PBT	2	4	4	0	0	10
>100% PBT	11	7	9	3	1	31
Negative PBT	5	12	5	3	1	26
No PBT data	9	7	3	1	3	23
Total	48	71	43	12	7	181

Source(s): The Pensions Regulator, Financial Analysis Made Easy published by Bureau van Dijk

More than half of schemes in this segment have remaining recovery plan lengths of three years or less and/or have modelled DRCs which are less than 50% of their employer’s PBT (represented by the purple shaded area). The ratio of DRCs to PBT may not always reflect a sponsoring employer’s affordability. For example, DRCs may be funded by other companies within the employer’s group. However, there are some schemes where finding recovery plans with affordable DRCs payable over an appropriate period is likely to prove challenging, and trustees and employers will need to work together in order to agree appropriate recovery plans.

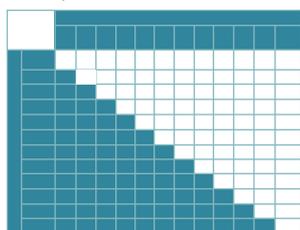
In the context of a balanced solution, trustees need to take other factors into account. A key consideration is the affordability of the employer and the impact the contributions may have on its plans for sustainable growth. Therefore we also compare, in Table 3, the modelled DRCs to the employer’s profitability for all Tranche 10 schemes.

Table 3: DRCs compared to employer’s PBT in Tranches 7 and 10

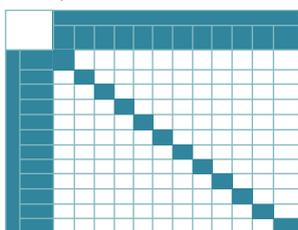
Modelled Tranche 10 DRCs as a percentage of latest available PBT												
	0	0–10%	10–20%	20–30%	30–40%	40–50%	50–60%	60–70%	70–80%	80–90%	90–100%	100%+
0	11	27	2	2	0	1	1	0	0	0	2	4
0–10%	24	163	54	21	11	4	3	4	2	1	0	4
10–20%	12	22	32	24	23	10	7	1	2	1	0	10
20–30%	5	7	13	20	12	11	7	8	4	2	2	8
30–40%	3	5	7	9	8	7	10	1	4	1	4	11
40–50%	3	3	1	2	3	3	1	5	4	2	2	18
50–60%	0	2	2	2	3	2	2	6	3	3	5	10
60–70%	2	1	1	1	0	0	3	5	2	3	0	9
70–80%	3	1	2	3	2	2	2	4	3	2	1	11
80–90%	0	0	2	0	0	1	1	2	1	2	0	13
90–100%	0	1	0	1	0	2	0	1	0	0	1	11
100%+	10	2	2	3	5	7	5	7	5	3	4	81

Source(s): The Pensions Regulator, Financial Analysis Made Easy published by Bureau van Dijk

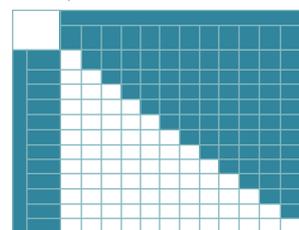
Group A



Group B



Group C



In Table 3¹²:

- ▶ the left hand column shows the DRCs agreed in Tranche 7 as a proportion of the three-year average PBT of the employer up to 2011 (the information that would have been relevant at Tranche 7 valuation dates).
- ▶ the row at the top shows the modelled DRCs for Tranche 10 as a proportion of the three-year average PBT of the employer up to the latest available date.

For example, our modelling estimates that 24 schemes agreed DRCs in Tranche 7 that were in the band 10-20% of the employer's PBT and, under the modelled scenario for Tranche 10, the new DRCs for these schemes are estimated to be between 20-30% of the employer's PBT. Those schemes included in the zero column are those which we estimate to be in surplus and so require zero modelled DRCs. The schemes in Table 3 can be split into three groups:

- ▶ Schemes in Group A are those where the modelled Tranche 10 DRCs as a proportion of the employer's PBT are estimated to be less than those agreed in Tranche 7. This represents 23% of schemes shown in the table.
- ▶ Schemes in Group B are those where the modelled Tranche 10 DRCs as a proportion of the employer's PBT are estimated to be in the same range as that agreed in Tranche 7. This represents 34% of schemes shown in the table.
- ▶ Schemes in Group C are those where the modelled Tranche 10 DRCs as a proportion of the employer's PBT are estimated to be greater than those agreed in Tranche 7. This represents 43% of schemes shown in the table.

This table also shows that for most schemes the modelled DRCs for Tranche 10 are likely to be affordable without impacting adversely on the employer's plans for sustainable growth because the ratio of modelled DRCs to PBT appears to be relatively low for the majority of schemes.

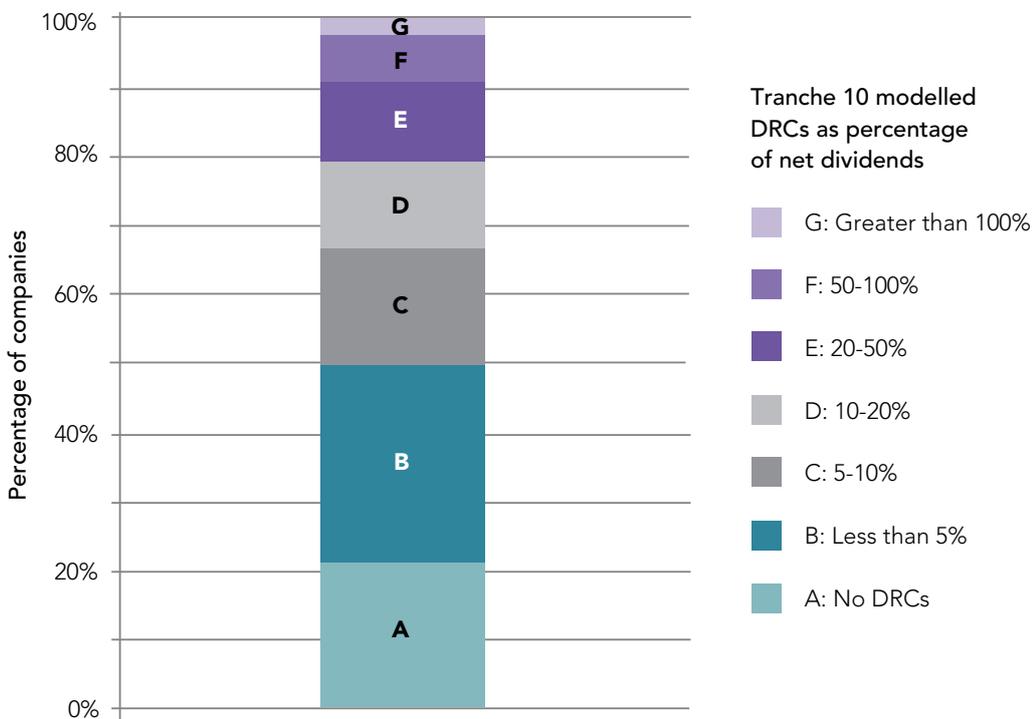
However, this analysis also highlights a group of schemes for whom the change in the modelled DRCs appears to be significant and on top of what might already have been large contributions relative to profits. In some cases this may simply be a consequence of inaccurate, misleading or absent data resulting from a complex group structure within which one or more employer(s) sits. In other cases, trustees and employers in this situation may need to consider other options to contain contribution increases within affordability levels.

12

Covers approximately 52% of Tranche 10 schemes, excluding 89 schemes whose sponsoring employers collectively had negative PBT at the latest available date but who were paying DRCs following the Tranche 7 valuation and 482 schemes where there is insufficient PBT data for the sponsoring employers up to 2011 and/or up to the latest available date.

We also compare, in Figure 11, the modelled DRCs¹³ under this scenario against another measure of corporate health – dividend payouts by employers supporting DB pension schemes in 2004.

Figure 11: Modelled DRCs as a percentage of dividends for FTSE 350 companies



Source(s): The Pensions Regulator, Capita Registrars and Financial Analysis Made Easy published by Bureau van Dijk

This analysis shows that, among the companies that paid dividends¹⁴, approximately 67% have modelled DRCs which are less than 10% of the value of net dividends paid to shareholders in 2014, and for a further 12% of companies this ratio is less than 20%.

Approximately 3% are estimated to be presently paying DRCs which are more than 100% of the value of net dividends paid to shareholders in 2014, with a further 7% paying DRCs between 50% and 100%.

Whilst this analysis is confined to a select group of FTSE 350 employers it does nevertheless show that the majority of these employers appear to have more than sufficient free cash to pay both DRCs to their pension schemes and dividends to shareholders.

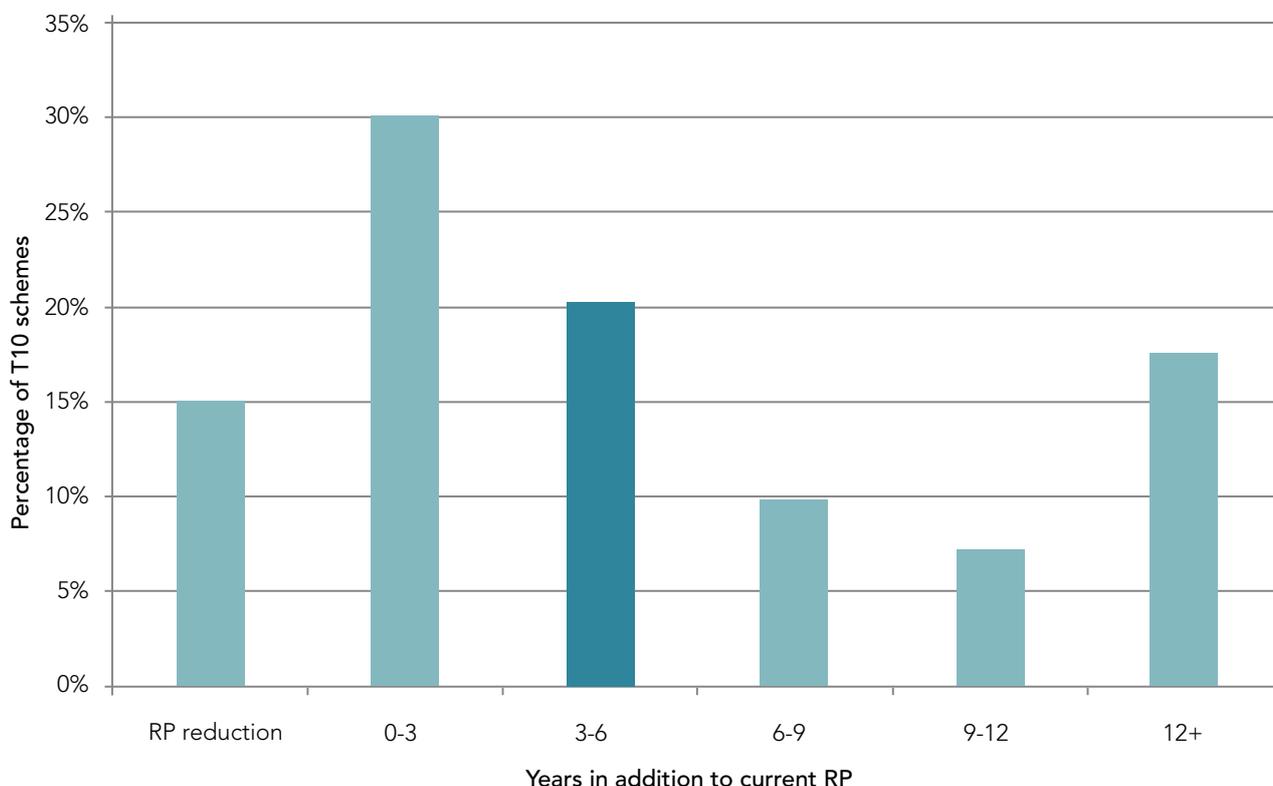
13
DRCs are the amounts the scheme would receive, without adjusting for any tax benefit the employer may receive. For each company, the aggregate DRCs for all supported DB schemes' are included – for the Tranche 10 schemes these are our modelled DRCs and for others the DRCs are an average of the first four years of the most recent recovery plan.

14
8% of FTSE 350 companies who sponsor DB pension schemes paid no dividends at all.

B. Extending recovery plan lengths

In this scenario we examine the impact on recovery plan lengths if each Tranche 10 scheme maintains DRCs at current levels and extends the recovery plan length for as long as necessary to pay off the new modelled deficit. This is illustrated in Figure 12 which shows the number of years by which the current recovery plan would need to be extended.

Figure 12: Additional years of currently planned DRCs required to meet the estimated deficit¹⁵



Source: The Pensions Regulator

The chart shows that:

- ▶ Around 15% of schemes could reduce the length of their recovery plan as the modelled deficit is lower than expected.
- ▶ A further 30% of schemes could make good their modelled deficit by extending their recovery plan length by three years or less.
- ▶ Around 17% of schemes would require an RP extension of twelve years or more.

The calculated median extension to recovery plan lengths based on the new modelled deficits is around 3.5 years (as indicated by the dark bar above).

¹⁵

Figure 12 and Table 4 exclude schemes which reported a surplus, or zero DRCs, at their T7 valuation and/or have an estimated surplus at 31 March 2015.

In Table 4, we also examine in greater detail the group of 271 schemes in Figure 12 whose modelled Tranche 10 RP lengths are estimated to increase by more than twelve years. For these schemes we analyse the distribution of their DRCs relative to the latest available profit of the employer(s).

Table 4: DRCs as percentage of PBT where Tranche 7 recovery plans are extended by 12 years or more

DRCs as a percentage of the latest PBT	Number of schemes
0-25% PBT	121
25-50% PBT	14
50-75% PBT	13
75-100% PBT	10
>100% PBT	22
Negative PBT	46
No PBT data	45
Total	271

Source(s): The Pensions Regulator, Financial Analysis Made Easy published by Bureau van Dijk

Of those schemes where we have sufficient PBT data, nearly half are currently paying DRCs which are less than 50% of PBT. However, there are some schemes where finding recovery plans over an appropriate period with an affordable level of DRCs is likely to prove challenging, and trustees and employers will need to work together in order to agree appropriate recovery plans.

Methods, principal assumptions and limitations

Scheme data

We rely solely on the information supplied to us via scheme returns, which may not be the most up to date or contain the level of detail that would be available to scheme actuaries when advising their clients. This inevitably leads to many more simplifications and approximations in the methods we use to estimate aggregate and individual funding positions compared with the more robust calculations carried out for formal valuation and recovery plan reporting by scheme trustees.

Many of these assumptions or simplifications have been driven by data limitations. For example, we have used index-tracking of major asset classes, made no allowance for hedging instruments to mitigate interest rate or inflation risk or for changes in asset strategy since the previous valuation, and have made assumptions about scheme liabilities in aggregate that may not accurately reflect the underlying liabilities of individual schemes.

The baseline for estimating the current deficit of each scheme is based on the results reported to us following its last valuation, adjusted approximately for contributions paid and movements in assets and liabilities in line with appropriate indices. Our analysis relies upon point-in-time valuations of schemes' assets and liabilities. We have used the simplifying assumption that all Tranche 10 schemes have their next actuarial valuation as at 31 March 2015. Further, we have assumed that the discount rate used to measure the liabilities of each scheme will have changed exactly in line with the movement in gilt yields between these two dates. If, collectively trustees choose to use discount rates which are lower than we have assumed, then both the estimated liabilities and deficits are likely to be higher than those modelled in this analysis and vice versa.

This is not an exhaustive list of actuarial assumptions. The assumptions we have made may be a significant source of difference when compared with formal valuation results at the individual scheme level. In particular, for individual schemes, the results will be highly dependent on the exact date of valuation, the scheme's asset strategy including any changes made during the intervaluation period, any changes to its mortality and longevity assumptions to reflect new information and emerging experience and the scheme's assessment of the appropriate discount rate to measure its liabilities.

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 – the most recent data primarily relating to accounting years ending in 2013 or 2014.

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, and
- ▶ 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.

Throughout this analysis we have used certain accounting-based metrics (see the Glossary on pages 34 and 35) as indicators of covenant support to compare with actuarially assessed liabilities, deficits or contributions. In practice other measures may provide more appropriate indicators of formally assessed covenant strength and these may vary, among other things, by type of employer. Accordingly this analysis, or the metrics, should not be seen as a substitute for such bespoke assessments.

Glossary

Deficit repair contributions (DRCs)

These are contributions made by employers to the scheme in order to address any deficit in the value of the assets compared to the TPs, in line with the Schedule of Contributions and the RP. For the purpose of this analysis, we have assumed current contributions to be those in year 4 of the RP agreed at the Tranche 7 valuation, except for RPs which were shorter than four years where we have assumed that the contributions paid in the last full year of the plan have continued. 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.

Dividends

Dividends shown are total dividends paid in each respective year, including any special dividends but excluding share buy-backs. In Figure 8 these are shown 'gross' ie including a notional 10% tax credit but in Figure 11 they have been shown 'net' ie excluding this notional tax credit. We have not made any adjustments for any bias due to large payouts from a small number of companies.

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. Except for Figure 6 (which shows trends in profitability since 2011), we use the average of the last available three years' profits for all of our analysis 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 a recovery plan.

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.

[continued over...](#)

Section 179 liabilities (s179)

This refers to a valuation of PPF compensation benefits under section 179 of the Pensions Act 2004, for PPF levy purposes. This measure is designed to be a close approximation to the liability measure that would be used to decide whether the PPF would need to take on the scheme were the employer to become insolvent. In contrast to TPs, the assumptions to be used in an s179 valuation are prescribed by the PPF and are standard across all schemes. They are designed such that s179 is close to the cost of securing the value of PPF compensation level of benefits with an insurance company at the valuation date.

Shareholders' funds

Shareholders' funds are an estimate of a firm's total assets minus its total liabilities. We use the reported shareholders' funds for either 2011 or the latest date possible as an indicator of the sponsoring employer's net worth (no adjustment is made to remove the impact of any pension accounting items already included in the reported figure).

Technical provisions (TPs)

The funding measure used for the purposes of Part 3 valuations. 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

'Tranche' refers to the set of schemes which are required to carry out a scheme-specific funding valuation within a particular time period. Schemes whose valuation dates fall between 22 September 2014 and 21 September 2015 (both dates inclusive) are in Tranche 10. Because scheme-specific funding valuations are generally required every three years, these schemes (with a few exceptions) had their last formal valuation in Tranche 7 (valuation dates between 22 September 2011 and 21 September 2012).

How to contact us

Napier House
Trafalgar Place
Brighton
BN1 4DW

0845 600 0707
customersupport@tpr.gov.uk
www.tpr.gov.uk

www.trusteetoolkit.com
Free online learning for trustees

www.pensionseducationportal.com
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Annual funding statement analysis

A look forward to schemes with valuation dates between September 2014 and September 2015 (**Tranche 10**)

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