Annual funding statement

for defined benefit pension schemes

May 2017

The Pensions Regulator

Introduction

This statement is relevant to trustees and employers of all defined benefit (DB) pension schemes but is primarily aimed at those undertaking valuations with effective dates in the period 22 September 2016 to 21 September 2017 (2017 valuations).

It highlights some of the key issues we have identified facing schemes with 2017 valuations. Schemes will have been affected differently by market conditions and our analysis[1] has identified groups of schemes which have been impacted in particular ways. We have identified actions that trustees and employers falling into those groups should take in light of that impact. Trustees and employers should use this statement to identify whether their scheme falls into those groups and take appropriate action. This will form part of our assessment of 2017 valuation submissions for these schemes.

This statement highlights some of the key issues we have identified facing schemes with 2017 valuations.

You should read this statement alongside:

- Code of Practice no. 3: Funding defined benefits (the DB code) – www.tpr.gov.uk/code3
- supporting guidance on integrated risk management (IRM) – www.tpr.gov.uk/irm
- DB investment – www.tpr.gov.uk/investment-guidance
- 'Assessing and monitoring the employer covenant' – www.tpr.gov.uk/covenant-guidance

We expect schemes with 2017 valuations to fully incorporate the principles contained in our DB code into their valuations.

Market conditions and IRM

Bond market yields have remained low over a relatively long period in comparison to historical levels. Uncertainty remains around whether and when gilt yields will revert to higher levels. Low gilt yields and the general economic environment for returns from other asset classes have led to a debate on how to set valuation discount rates.

Scheme liability values have generally increased compared with three years ago when the majority of schemes with 2017 valuations would have been conducting their previous scheme funding valuations. Our analysis shows that most major asset classes have performed well, increasing scheme asset values but not to a level that may compensate fully for increased liabilities. Many schemes are therefore likely to show larger funding deficits than projected in their last valuation.

1
We intend to publish our analysis separately following the General Election.

The continuing uncertainty over future economic conditions and the persistent low interest rate environment highlights the importance of effective risk management, as set out in our IRM guidance and investment guidance.

All schemes need to put contingency plans in place in the event a downside risk materialises.[2] Schemes that hedged their interest rate risks will generally have fared better than those that did not over the last three years. Where schemes now find themselves in a worse funding position than anticipated, we expect them to implement their contingency plans, which should involve taking appropriate action to recover their funding position and to mitigate against any further downside events.[3]

Affordability and managing deficits

Our analysis indicates that a majority (85-90%) of schemes undertaking 2017 valuations have employers with the ability to manage their deficits and currently have no long term sustainability issues.

Based on our approach to DB scheme risk assessment,[4] we have segmented schemes based on their risk profile. This includes a combination of:

- the level of underfunding in the scheme taking into account the strength of the employer covenant and scheme maturity compared to the current cash contributions being paid
- the additional deficit that could arise from the investment strategy in the future, which may not be supportable by the covenant

2
See IRM guidance.

3
See Code of Practice no. 3, paragraphs 52-56.

4
DB funding policy, paragraphs 24-35 at www.tpr.gov.uk/db-policy and Corporate Plan 2017-2020, page 20, at www.tpr.gov.uk/plan.

Trustees should take appropriate action depending upon the group they fall into, as outlined in the table below.

Scheme employer type	Scheme characteristics	What we expect of trustees
a. With strong or tending to strong employers[5]	Where the scheme's funding position is on track to meet their funding objectives and where technical provisions are not weak and recovery plans are not unduly long.	As a minimum to continue with their current pace of funding by not extending their recovery plan end dates unless there is good reason to do so.
b. With strong or tending to strong employers[5]	With a combination of weak technical provisions and long recovery plans.	To seek higher contributions now to mitigate against the risk of the employer covenant weakening and other scheme risks materializing in the future.
c. With weaker employers	Who assume they have a strong covenant because they are part of a stronger and larger group of companies but have no formal support in place.	To seek legally enforceable support. We will not take into account the wider group covenant in our risk assessment where the scheme cannot rely upon it.[6] Where there is no legally enforceable support, trustees should not rely upon the covenant of the wider group to justify agreeing to higher levels of risk in their valuation. They should seek every opportunity to reduce risk to an appropriate level, or secure additional funding or legally enforceable support for the scheme. Our analysis indicates that 8% of schemes undertaking 2017 valuations are taking too much risk, which does not appear to be supported by the strength of the statutory employer.

5
DB funding policy, page 22, at www.tpr.gov.uk/db-policy.

6
See Code of Practice no. 3, paragraphs 54-56. See also 'Assessing and monitoring the employer covenant' guidance.

Stressed schemes

Our analysis indicates that there are approximately 5% of schemes in this valuation cycle where the employer is tending to weak, or weak[7] and where it appears they are at risk of becoming unable to, or are already unlikely to be able to adequately support the scheme.

Most of the employers of these schemes will not be inevitably insolvent in the next 12 months, which means that applying to us to sever the scheme from the employer via a regulated apportionment arrangement (RAA) would not be appropriate.[8] We recognise that the least detrimental impact for members' benefits in these circumstances may be for the scheme to continue, even if doing so represents a potential cost to employers and the Pension Protection Fund (because scheme liabilities may continue to increase).

We expect trustees of stressed schemes to reach the best possible funding outcome.

In these instances, we expect trustees of stressed schemes, who are facing a challenging valuation and have limited ability or no ability left to use the flexibilities in the funding regime, to reach the best possible funding outcome taking into account members' best interests and the scheme's specific circumstances.

Trustees of stressed schemes need to fully evidence to us that they have taken appropriate measures, including (this list is not exclusive or in priority order):

- that the employer has closed a stressed scheme to future accrual, where it has not already done so
- that they have tested the strength of the employer covenant to support scheme risks and considered whether any payments of dividends made or due to be made, limit the ability of the employer to support the scheme and invest in sustainable growth
- that they have sought to maximise non-cash support and security available to the scheme from the employer and, where there is one, the wider group
- that they have identified scheme risks and improved the scheme's ability to control these risks
- where scheme rules allow, that they have considered whether the scheme should be wound up

We will continue to support the Department for Work and Pensions in exploring options for stressed schemes as outlined in its current green paper on the security and sustainability of DB schemes.

7
See DB funding policy, page 22, at www.tpr.gov.uk/db-policy.

8
See RAA information at www.tpr.gov.uk/media-guides.

Notifiable events

Trustees and employers have a duty to notify us about certain circumstances or decisions which may affect the long term security of the scheme (these are known as notifiable events).[9] Employers must notify us as soon as reasonably practicable about employer-related events, for example a decision by an employer to cease business in the UK, or where a director becomes aware that the employer has no reasonable prospect of avoiding insolvency. Notifying us can give us the opportunity to assist or intervene. We also expect employers to communicate and provide early warning of employer-related events to the trustees of the scheme. Failure to report a notifiable event to us can lead to a civil penalty.

Valuation assumptions

When setting the valuation assumptions in the current economic environment, we expect trustees to consider with their advisers the extent to which changing market conditions affect the longer-term view of expected risk and returns, and how this interacts with the scheme's funding plans and risk appetite. Scenario planning and sensitivity analysis may help with this assessment, given the uncertainty of future economic developments.

Discount rate assumptions

At a time when there is industry debate on how to set valuation discount rates, we expect trustees to seek and duly consider robust advice from their scheme actuary on the valuation assumptions.

As set out in regulations,[10] trustees are responsible for determining which method and assumptions they use to calculate the scheme's technical provisions and must ensure that the assumptions used for the valuation are chosen prudently.[11]

The current debate on the approach to discount rates focuses on whether historical relationships between gilt yields and returns on other asset classes still hold true for the future. Proponents of a 'gilts plus' approach (typically meaning a fixed margin above gilts) argue that the historical relationship still holds and low gilt yields mean low returns on other asset classes. Opponents say that the gilt market is distorted and the historical relationship broken.

9
Section 69 of the Pensions Act 2004 and Code of Practice no. 2 at www.tpr.gov.uk/code2

10
Occupational Pension Schemes (Scheme Funding) Regulations 2005 section 5 (1).

11
Occupational Pension Schemes (Scheme Funding) Regulations 2005 section 5 (4) and Code of Practice no. 3, paragraph 129.

When reviewing the discount rate approach, trustees should consider its suitability taking into account their plan for achieving their long term objective and their current position relative to it. We are not prescriptive about the approach trustees should take when setting the valuation discount rate, provided that the outcome is consistent with the requirements of the legislation and the DB code.

Where trustees are looking to change the method used to set the discount rate following their review, we expect them to have a sound rationale behind the change and to document it clearly. This also applies where trustees continue to use the same method as before, documenting why the method remains prudent.

Risk management

Risk management is a dynamic process. Trustees need to monitor risks and take action when required, irrespective of the scheme's funding position.[12] Given the changes to market conditions over the inter-valuation period, schemes that effectively managed their risks, in particular interest rate risks, will have very likely fared better than those that did not.

For those schemes where the funding position is ahead of or in line with expectations, trustees should:

- check the scheme is on track to meet its long term funding objective and risk management plan
- monitor the scheme's position against any journey plan including reviewing the length of time to reach the scheme's long term target

For schemes that are in a worse funding position than expected, and are likely to only have managed a small proportion of liability risks, trustees should:

- check and, where necessary, implement the scheme's contingency plan and take action when agreeing the next recovery plan. This may include, for instance the scheme increasing contributions to recover its funding position.[13] We expect trustees to take decisive action where the scheme's funding position has been on a downward trajectory for more than one valuation or if they have faced any significant adverse impacts
- re-assess the scheme's exposure to risks and set an acceptable risk management plan which balances scheme risks along with the employer's risk tolerance and its ability to support downside events

Trustees should monitor the scheme's position against any journey plan including reviewing the length of time to reach the scheme's long term target.

12
See IRM guidance.

13
See Code of Practice no. 3, paragraphs 52-56.

Trustees need to have a contingency plan in place detailing actions they would need to take to correct the scheme's position in the event of a downside risk materialising. This is particularly important for trustees who decide to continue to run significant risk levels. This contingency plan needs to be agreed with the employer in advance and should be legally enforceable.

Small schemes

Trustees of small schemes should ensure they complete sufficient analysis to understand their risk exposure and take a balanced approach when considering the risks they run.

The pensions investment industry continues to develop and innovate. Industry opportunities for investment and risk management have continued to improve for smaller pension schemes. Where trustees have previously ruled out investment arrangements due to their scheme's size or governance arrangements, we encourage them to reassess the possibilities.

Trustees need to have a contingency plan in place in the event of a downside risk materialising.

Investment strategy

We recently published our DB investment guidance, which provides examples of approaches and factors we expect trustees to consider when setting their investment strategy and investing scheme assets. It can be found at www.tpr.gov.uk/investment-guidance.

When assessing valuation submissions, we measure the level of investment risk relative to the employer covenant and will intervene and engage with schemes where we believe that the scheme's investment strategy is inappropriate. We will do this where we believe a scheme is taking too much risk or where there is little or no diversification of a scheme's assets.

The employer covenant

While many of a scheme's liabilities are likely to be long term in nature, the strength of the employer covenant may change over time.

Trustees should focus on the ability of the employer to contribute cash to the scheme while there remains good visibility of covenant. Trustees should consider with their advisers the extent to which a lack of visibility of the covenant beyond the short to medium term presents additional risks to the scheme.

Trustees should also consider when their scheme is likely to be sufficiently well-funded, with a suitably low risk funding and investment strategy that places little ongoing reliance on the employer's covenant. Trustees should review and, where necessary, adapt their journey plan in light of these considerations.

Scheme maturity

When setting a cash flow management policy,[14] trustees need to take into account the liquidity characteristics of all the investments the scheme holds and how they might vary in different market environments. Trustees should have an action plan in place setting out how to deal with unexpected cash flow requirements.

While the vast majority of schemes have sufficient assets to meet short term cash flow requirements as they fall due, inadequately managing cash flow risks may have a significant bearing on a scheme's ability to meet its obligations to members retiring over the medium or long term.

Cash flow management is particularly important for mature schemes where worse than expected market conditions could have a severe impact on a scheme's future cash flow. In underfunded schemes the impact of scheme maturity may put additional strain on the investment strategy such that trustees may find it difficult to close the funding gap without additional demands on employer support. Trustees need to understand the risk and implications of this and plan for it in advance.

Irrespective of a scheme's level of maturity, trustees should:

- regularly monitor and assess the scheme's cash flow
- have an appropriate cash flow management policy in place
- monitor cash flow, focusing on the scheme's long term objective, not just the short term requirements

What you can expect from us

We are committed to doing all we can to ensure members of DB schemes receive the benefits they are entitled to at retirement. We will be placing more focus on proactive casework, and improving the way we identify cases that present the biggest risks to members, intervening early before recovery plans are submitted.

14 See the cash flow and liquidity risk sections of 'Investing to fund DB' in the investment guidance.

We intend to be clearer in our expectations of trustees and employers, and will quickly escalate our actions, using the full range of our powers as necessary to achieve the right outcome and doing all we can to ensure those we regulate are compliant with their duties. Looking at 2017 valuation submissions, in particular we will be focusing on fair treatment of schemes and late valuations.

We will also be developing our approach and interactions with smaller schemes, tailoring the way we work where necessary, so the protection of scheme members in this sector receives increased focus.

Fair treatment between schemes and shareholders

We are likely to intervene where we believe schemes are not being treated fairly, particularly in circumstances where:

- recovery plan end dates are being extended unnecessarily (for example where the recovery plan end date has been extended but there is sufficient affordability to increase contributions to the scheme)
- where the employer covenant is constrained and total payments to shareholders (including dividends and share buy backs) are being prioritised and therefore are restricting or reducing the level of contributions being paid to the scheme

One aspect we will consider is the impact of dividend payments on the employer covenant.

Trustees need to ensure that contributions to the scheme feature prominently in their employer's considerations and that its legal obligations to the scheme as a creditor are recognised ahead of shareholders with no legal entitlement to dividends, but who may exert pressure on the employer to obtain them.

We expect schemes where an employer's total distribution to shareholders is higher than deficit reduction contributions being paid to the pension scheme to have a relatively short recovery plan and that the recovery plan is underpinned by an appropriate investment strategy that does not rely excessively on investment outperformance.

Where this is not adhered to, we will consider opening an investigation to assess whether the levels of contributions being paid to the scheme are too low and whether the level of payments to shareholders suggests that the employer has greater affordability. Where we believe there is sufficient affordability to increase contributions to the scheme, we will take steps to ensure that an appropriate balance is struck between the interests of the scheme and shareholders by the employer.

We are likely to intervene where we believe that schemes are not being treated fairly.

Late valuations

In 2016, approximately 10% of DB schemes completed their scheme valuation later than the statutory deadline. As part of our drive to raise governance standards we are taking a tougher approach where schemes fail to submit their valuations on time.

Where schemes are having difficulties meeting the deadline, they should engage with us in relation to the factors causing the delay and provide a clear timetable for completing the valuation, agreed by all parties.[15]

Trustees should plan to avoid unnecessary delays. We are more likely to take enforcement action in relation to the breach of law in this area, when delays could have been predicted, or where trustees do not engage with us regarding the breach.

15
See DB funding policy, Appendix D, at www.tpr.gov.uk/db-policy.

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