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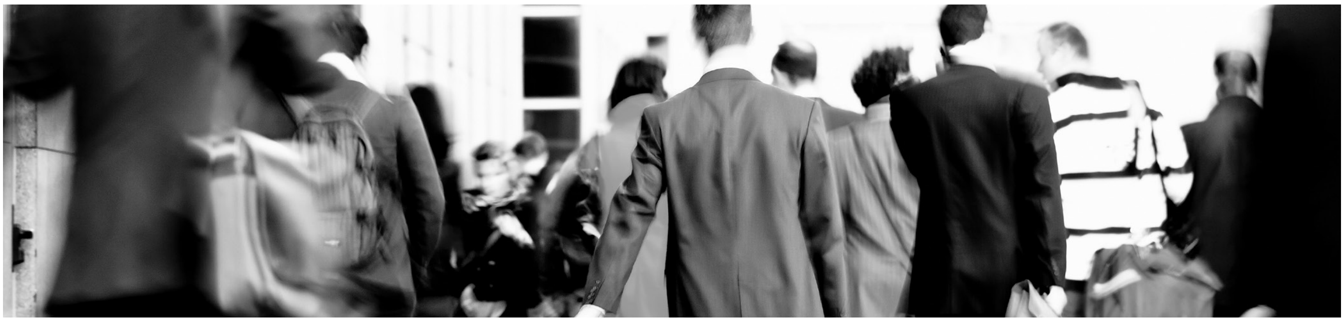

Pensions briefing

The Regulator's 2016 DB Funding Statement – greater employer contributions expected where there is "sufficient affordability"

Briefing

May 2016

The Regulator's fifth annual funding statement confirms that most schemes with valuation dates between September 22, 2015 and September 21, 2016 will see a greater than expected increase in their funding deficits. While investment performance has been good over the past three years, gilt yields are down and interest rates remain low. Despite this, the Regulator expects trustees to seek higher employer contributions where there is evidence of "sufficient affordability".

Introduction

The Pensions Regulator (TPR) has published its fifth annual DB funding statement (8 pages) which, it says, should be read in conjunction with the DB Code of Practice, which TPR expects trustees to take into account in their valuations. It is aimed principally at those schemes undertaking valuations with effective dates between September 22, 2015 and September, 21 2016 (Tranche 11) but is also of interest to other schemes.

The funding statement is accompanied by a 38-page statistical analysis document.

Key points in the funding statement

The statement confirms that, in TPR's view, most Tranche 11 schemes will see a greater than expected increase in their funding deficits. Despite this, TPR expects trustees to seek higher employer contributions where there is evidence of "sufficient affordability".

On the investment front, TPR notes that while overall investment performance in the last three years has been good, yields on long-dated gilts have fallen and market expectations are for interest rates to remain lower for longer and to revert to lower long-term levels. TPR recognises there has been significant recent market volatility for a variety of reasons, including the forthcoming EU referendum, and notes that a further statement may be considered following the referendum result.

Tranche 11 schemes currently undertaking the valuation process would last have done so in 2013, before the concept of integrated risk management (IRM) applied. IRM is now a central feature of the revised DB Code and TPR expects trustees to take a proportionate approach to understanding the scheme's exposure to risk across the employer covenant, investment and funding. While it is not necessary to eliminate all risk, the funding and risk management strategy should be integrated across these three areas. As usual, TPR highlights that a clear understanding of the employer covenant, a framework for integrated risk management and the trustees, advisers and employers working collaboratively in an open and transparent manner remain fundamental to the funding process.

TPR highlights that trustees should document their decisions, and the reasons behind them, citing any supporting analysis.

In respect of the assumptions used, TPR notes that the 2015 version of the Continuous Mortality Investigation (CMI2015) model produces life expectancies lower than the 2014 version. Trustees who use CMI data may reasonably be expected to update for CMI2015, but should be wary of assuming that decreased life expectancy is to be a long-term trend. Similarly, caution should be exercised in adjusting assumptions for transfer take-up under the new flexibilities, as TPR notes it is still early days for the new pension freedoms.

TPR emphasises that trustees of Tranche 11 schemes must ensure that they finalise the valuation itself, statement of funding principles, recovery plan and schedule of contributions within 15 months after the effective date of the valuation. TPR expects schemes to comply with this statutory deadline, and where there may be difficulty meeting it, trustees are urged to contact TPR at an early stage. There is a greater likelihood of enforcement action being taken trustees where they have not forewarned TPR that they may miss their deadline.

Key points in TPR's analysis

The main points set out in TPR's accompanying analysis paper (39 pages) are summarised below:

Global growth impact on scheme returns

Although most major asset classes have performed well since the last valuation date, there are wider concerns for global growth, and reductions in nominal and real yields are likely to have a significant impact on schemes' expected returns over the medium- and longer-term. Trustees who made allowances at the last valuation for gilt yields to revert to higher levels may need to take action to manage the impact on funding if these assumptions are not borne out.

A decline in the ratio of deficit repair contributions to dividends

Although employers' profits have generally improved since their last scheme valuation, TPR is concerned that for those FTSE 350 companies which paid both deficit repair contributions (DRCs) and dividends over the last six years, the median ratio of DRCs to dividends has dropped by about seven per cent. This has been driven by a significant increase in dividends over the period without, TPR says, a similar increase in contributions. This implies to TPR that an increase in DRCs for many employers may be affordable without materially affecting their plans for sustainable growth. Indeed, TPR states that increases in DRCs of "75 per cent to 100 per cent ... may be affordable".

A study of the ratio of DRCs to employers' profit before tax

The analysis paper dedicates several pages to an illustration of the significance of employers' modelled DRCs at Tranche 11 compared to profit before tax (PBT) at the schemes' last valuation. Where modelled Tranche 11 contributions are less than 30 per cent of PBT, TPR's view seems to be that these may be as affordable for the sponsor as its DRCs agreed in Tranche 8, which were then a lower percentage of profit.

Recovery plan length

Where schemes have a larger than expected deficit at their valuation date, changes will be needed to the recovery plan. Trustees should consider the long term view with their advisers and also whether to take post-valuation experience into account when considering the length of the recovery plan. For schemes to maintain the existing recovery plans, they may need to increase their DRCs, which TPR considers will be affordable in many cases, given the increase in dividends compared to DRCs.

Risks for maturing schemes

In the case of underfunded mature schemes, the analysis highlights that cash flow needs can have a significant impact on the trajectory of scheme funding in circumstances where there are volatile market movements over the valuation cycle. Assets should be managed in a way which minimises the risk of forced sales in depressed markets, in order to meet cash flow demands without negatively affecting the scheme’s funding plan.

Comment

The funding statement is likely to be greeted with some concern by employers, as TPR’s expectation of increased contributions being widely affordable could be very adverse for them. Although TPR recognises that there is a wide range of performance across different industries, with many employers finding higher contributions an impossibility in the current climate of a potential Brexit and economic uncertainty, TPR does take the view that there has been a general improvement in profitability in scheme sponsors in recent years. TPR expects there to be an open discussion on contribution levels, and if a longer recovery plan is put in place, trustees should consider seeking additional security for the scheme.

Where employers have paid increased dividends to shareholders since their last valuation and their DRC/dividend ratio has dropped, TPR is particularly likely to consider that they could now afford to increase scheme contributions to keep their recovery plans on track. There is still a statutory objective for TPR to minimise any adverse impact on the sustainable growth of an employer in the exercise of its scheme funding functions but its concern is that schemes should not be making recovery periods longer simply because of the low yield environment. This is a change in emphasis from previous years. TPR expects trustees to seek higher DRCs where there is “sufficient affordability” and where such contributions would not have a material impact on sponsors’ sustainable growth plans.

Scheme funding is currently particularly high-profile, with the recent press headlines involving household corporate names. The potential impact on the Pension Protection Fund of the BHS and the British Steel pension schemes, and the scrutiny of TPR’s role relating to the BHS scheme, will inevitably mean that TPR is extra-vigilant over the next tranche of valuations and related recovery plans, and it will be keen to be seen to be monitoring members’ interests closely. Its statement that a level of increase in DRCs “in the region of 75 per cent to 100 per cent ... may be affordable” is alarming. Similarly, TPR’s analysis of the relationship between an employer’s PBT and its DRCs leads it to conclude that members’ benefits are likely to be less secure unless contributions are increased, and that such an increase may be affordable for a significant number of employers.

TPR’s statement and accompanying analysis give a useful steer for trustees of schemes undergoing their valuation in Tranche 11. The information will also be useful for schemes with valuations at a later date, as this is the first scheme funding statement after the publication of the IRM guidance in December 2015.

The overarching theme of the statement is the impact of lower than expected returns, and a likely increase in contributions for employers. However, TPR's analysis is very broad, and it obviously ignores scheme specific issues such as hedging arrangements, additional contributions and levels of pension increases.

Given that trustees have been forewarned that TPR is likely to take a dim view of valuations submitted past their 15-month deadline, the process should be started in good time, so that covenant, investment and funding risks can be managed transparently under the IRM regime.

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