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The Pensions Regulator's 2017 Annual Funding Statement

The Pensions Regulator has published this year's annual funding statement, giving its views on the current scheme funding environment for defined benefit pension schemes.

Although the statement is relevant to trustees and employers of all defined benefit pension schemes, it is mainly aimed at those undertaking valuations with effective dates in the 12 months to 21 September 2017.

The mathematical analysis that usually accompanies the statement will not be issued until after the General Election.

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Background

At about this time each year the Pensions Regulator issues its annual funding statement setting out its views on the issues facing trustees of defined benefit (DB) pension schemes currently undertaking valuations. Schemes will have been affected differently by market conditions and the Regulator's analysis identifies groups of schemes which have been impacted in particular ways.

Trustees are expected to read the statement alongside the Regulator's code of practice on scheme funding and to fully incorporate the principles in the DB code into their valuations.

Market Conditions

The Regulator notes that bond market yields have remained low over a relatively long period and uncertainty remains about when and if gilt yields will revert to historically higher levels. While most asset classes have performed well in the last three years, the increase in value of scheme assets has not generally matched the increase in liability values. Many schemes will thus show larger funding deficits than was projected at the last valuation.

The Regulator stresses the importance of its integrated risk management guidance and notes the need for trustees to put contingency plans into action to recover scheme funding positions and to mitigate against further downside events.

Affordability and Managing Deficits

In line with the DWP's analysis provided in the DWP's recent Green Paper, the Regulator believes 85% to 90% of DB schemes will have sponsoring employers who can manage their pension scheme deficits without any long term sustainability issues. It has however segregated schemes based on their risk profile and told trustees to take appropriate action depending upon the group they fall into as outlined in the following table.

Scheme Employer Type	Scheme characteristics	Action for Trustees
Strong/Tending to strong employers	Funding position is on track to meet their funding objectives, 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.
	A combination of weak technical provisions and long recovery plans.	Seek higher contributions now to mitigate against the risk of the employer covenant weakening and other scheme risks materialising in the future.
Weaker employers	An assumption of a strong covenant because the employer is part of a stronger and larger group of companies but has no formal support in place.	Seek legally enforceable support. The Regulator will not take into account the wider group covenant in its risk assessment where the scheme cannot rely upon it. 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. Regulator 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.

Stressed Schemes

The Regulator believes approximately 5% of schemes in the valuation cycle have a sponsoring employer whose covenant is weak or tending to weak 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 these sponsoring employers will not inevitably be insolvent in the next 12 months, which means applying to sever the scheme from the sponsoring employer via a regulated apportionment agreement is not appropriate.

In such circumstances the least detrimental impact for members' benefits may be for the scheme to continue, even if that represents a potential cost to the employer and risk to the Pension Protection Fund. Trustees are expected to seek to the best possible funding outcome for their individual scheme's circumstances. This may include ceasing future accrual (where a scheme remains open), watching for any dividend payments, obtaining additional security where they can, controlling risks and considering winding up the scheme if their rules allow.

Late Valuations

In 2016, approximately 10% of DB schemes completed their valuation later than the statutory deadline. The Regulator warns that this year it will be taking a tougher stance on schemes that submit valuations late.

Where schemes are having difficulties meeting the deadline, they need to engage with the Regulator as early as possible, and provide a clear timetable for completing the valuation which is agreed by all parties.

Trustees are warned that where delays could have been predicted, or where they do not engage with the Regulator, then further action is likely.

A Gentle Reminder

Trustees are reminded:

- Of their duty to notify the Regulator about certain circumstances or decisions which affect the long term security of the scheme, (notifiable events).
- To consider how current economic conditions might impact on longer term views of risk and return, and how this feeds into valuation assumptions, given the scheme's funding plans and risk appetite.
- To obtain robust advice from their Scheme Actuary on valuation assumptions, and in particular, on the discount rate.
- To monitor risks and take action when required irrespective of the scheme's funding position. Where funding has worsened they need to implement their contingency plans, which may include increasing contributions, re-assessing their risk exposure, and employer's risk tolerance/ability to support downside events.

The Employer Covenant

Trustees are directed to focus on the sponsor's ability to contribute cash to the scheme and, where the employer covenant is strong now but less certain in the future, trustees should aim to reach a position where there is little ongoing reliance on the employer's support.

Where a sponsor could increase contributions, the Regulator expects an appropriate balance to be struck between funding the pension scheme and payment of dividends. Schemes are expected to have shorter recovery plans where sponsors are paying more in dividends than deficit recovery contributions to the scheme.

Comment

In line with other communications coming from the Regulator at the moment, the annual funding statement suggests that 2017 will see the Regulator taking a much tougher approach to governance. Current actuarial valuations are going to be examined far more critically than in previous years and this is not the year to submit your valuation late!

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