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The Pensions Regulator's Latest Analysis of Pension Schemes Currently Undertaking Valuations

In order to provide further context to its latest annual funding statement, the Regulator has published its analysis of the expected positions of defined benefit (DB) pension schemes with valuation dates between 22 September 2016 and 21 September 2017 (Tranche 12 schemes). This would normally be issued at the same time as the annual funding statement, but has been delayed this year, due to the snap General Election.

The data suggests the majority of DB schemes are supported by employers that can manage deficits, but also highlights the impact of current conditions on the ability of sponsors to maintain and increase deficit repair contributions.

It also shows that the ratio of deficit repair contributions to dividend payments by sponsoring employers has declined.

Key Messages

Key points of the Tranche 12 analysis include:

- Many Tranche 12 schemes experienced relatively favourable market conditions when conducting their last valuations (Tranche 9 in 2014) and as such will have been more significantly impacted by the current market conditions than schemes in earlier tranches.
- Although asset returns have been better than expected, this has not generally been sufficient to offset the increase in liabilities due to the change in market conditions, so overall deficits have increased and funding levels have fallen.
- Around half of Tranche 12 schemes are resilient enough to maintain the same pace of funding and many will be able to increase their contributions if the scheme's circumstances require it.
- A further 37% of schemes have an employer covenant which the Regulator considers adequate to support the scheme.
- For the group of FTSE350 companies who paid both deficit repair contributions and dividends in each of the previous six years, the ratio of deficit repair contributions to dividends declined from around 10% to around 7%. This is mainly driven by the significant increase in dividends over the period, without a similar increase in contributions.

Market Conditions and Impacts on Scheme Funding

In terms of valuations being carried out this year, most major asset classes have performed well since their last valuation date. However, wider concerns for global growth and reductions in yields are likely to significantly impact the expected returns across various asset classes over the medium and longer term.

Overall, the Regulator expects that for most schemes, the value of liabilities is likely to have outgrown assets since the last valuation. The level of increase in deficits could vary greatly between schemes compared with the Regulator's aggregate estimates depending on their valuation dates, their funding and investment strategies and especially the extent to which interest rate risks have been hedged.

Sponsor Considerations

The strength of the employer covenant is a key consideration for trustees and sponsors when setting their funding plans. The Regulator's analysis suggests that the majority of sponsors have seen an increase in the nominal value of their profits and balance sheets over the last three years. This should suggest an increase in the general strength of employer covenants. However, a wide distribution of how profits have changed across and between individual companies is also noted, and there is still a considerable proportion of schemes whose employers have experienced a decline in profits over the period.

Impact on Recovery Plans and Affordability

The Regulator's modelling highlights that if Tranche 12 schemes were to retain their recovery plan end dates (or make a modest increase in the length for those schemes nearing the end of their current plan) the median increase in deficit repair contributions would be in the region of 75%-100%. About 20% of schemes would be able to retain their deficit repair contributions at the same level or less, and a similar number would need to increase the contributions to more than three times their current levels. This latter group has a high proportion of schemes which are large compared to the size of the employer.

The Regulator’s Assessment of Affordability for Tranche 12 Schemes

- 50% have the resilience to continue to maintain the same pace of funding and many will be able to increase their contributions if need be.
- 37% have an employer covenant the Regulator deems adequate to support the scheme. Current contributions and/or risk strategies pose unnecessary longer term risks which may be mitigated by an increased pace of funding combined, for some schemes, with a reduction in the level of risk.
- 8% have the potential to benefit from wider group support either from a UK or a global entity. It may be the case that this wider group has no legal obligation to support the scheme.
- 5% have no certain, or minimal, prospect of additional support. For these schemes the least detrimental impact for members’ benefits may be for the scheme to continue to take a reasonable level of unsupported risk.

Implications for Scheme Funding

Most schemes are likely to have a larger than expected deficit at their valuation date and will have to make changes to their recovery plan. However, affordability may have increased for a number of employers, which may increase the options in terms of deficit management strategies.

Potential Impact on Deficit Repair Contributions

The analysis considers the potential impact on deficit repair contributions for Tranche 12 valuations, expressed as a percentage of the level of current deficit repair contributions (i.e. what was agreed in Tranche 9 valuations). This assumes, for the purpose of illustration and to remove the distorting impact of short remaining periods, that each scheme aims to eliminate the deficit over the higher of five years and the remaining term of the recovery plan agreed at the last valuation.

On these assumptions:

- About 20% of schemes would be able to retain their deficit repair contributions at the same level or less.
- Around 35% of schemes would see an increase of between 0-100%
- The remainder would need to increase deficit repair contributions by more than 100%, including a significant minority (over 20%) that would need an increase of more than three times the current levels.

Comparing these Impacts to the Employer's Affordability

This is a key factor for both trustees and employers when agreeing an appropriate recovery plan, including whether the proposed contributions may have an unreasonable impact on their plans for sustainable growth. The Regulator's analysis suggests that the percentage of Tranche 12 schemes that have the potential to be facing significant affordability issues is relatively small.

Comment

The Regulator's analysis seems to be broadly in line with the picture of DB funding painted by the DWP in the Green Paper on security and sustainability earlier this year. Most schemes are not deemed to be unaffordable and sponsors should be able to meet their scheme funding obligations.

The Regulator has noted that some employers are putting shareholders ahead of their funding duties. Since it adopted a statutory objective of minimising any adverse impact on the sustainable growth of an employer in respect of DB scheme funding, it has run the risk of employers being minded to focus more on shareholders' interests over contributions to the pension scheme.

It will be interesting to see how the Regulator acts in this respect going forward. At a time when the BHS affair is still fresh in the memory, it would not be a surprise to see the Regulator intervening more where sponsors are not deemed to be giving sufficient priority to their pension schemes.

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