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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 pension schemes with valuation dates between 22 September 2017 and 21 September 2018 (Tranche 13 schemes).

The Regulator believes that overall, schemes undertaking valuations at 31 March 2018 will have marginally improved funding levels, and deficits, from those reported three years ago. However, the deficits have not improved to the extent that would have been expected over the inter-valuation period, and so it is likely that current recovery plans will not be on track to remove the deficit revealed at the previous valuation. The Regulator states that if trustees want to retain the same end date to their current recovery plan, deficit reduction contributions (DRCs) will need to be increased.

This FYI summarises some of the key points to come out of this latest analysis.

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Market Indicators

The Regulator notes the significant fall in gilt yields over the past six years, while inflation expectations have remained broadly unchanged.

As has been the case for a couple of years, this is likely to have a significant impact on expected returns across various asset classes. All else being equal, the Regulator would again expect that most Tranche 13 schemes will set funding strategies based on lower expected investment returns from most asset classes than at their last valuation. As a result, most schemes are expected to have a larger reported value on their liabilities at their valuation date than would have been forecast three years ago.

Over the last three years, returns have been significantly positive for most asset classes. This is mainly due to strong asset returns in 2016 (with many asset classes' returns being relatively flat or negative during 2015 and 2017). Most asset classes returned significantly more over the period December 2014 to December 2017 than March 2015 to March 2018. This is primarily due to the positive returns on these asset classes over the period

December 2014 to March 2015, coupled with relatively low or negative returns over the period December 2017 to March 2018.

Aggregate Funding of Defined Benefit Schemes

In the three years to 31 December 2017, deficit contributions, coupled with better than expected asset returns and lower than expected rates of deferred revaluation and pension increases, have more than offset the increase in liabilities, due to the change in market conditions (assuming that the mortality base table assumptions used by the scheme actuary at the last valuation remain unchanged, but that future improvements are updated to use the latest Continuous Mortality Investigation projections with no change to long-term rates of improvement).

The Regulator estimates that the aggregate deficit of Tranche 13 schemes as at 31 March 2018 could have reduced slightly from three years ago, although this estimated reduction is not as significant as from December 2014 to December 2017. Most asset classes returned significantly better returns between December 2014 and December 2017, than between March 2015 and March 2018.

The analysis shows that overall funding levels and deficits are likely to have improved over this period. However, this is based on aggregated scheme data, and in practice individual schemes may experience higher or lower levels of impact over the three years.

Employer Profitability, Balance Sheets, and Dividend Payments

A key consideration for trustees and employers when setting their scheme funding plans is the strength of the employer covenant. The Regulator’s analysis suggests that the majority of employers have seen an increase in the nominal value of their profits and balance sheets over the last three years. It should be noted, however that there is a wide distribution of how profits have changed across, and between, individual employers, and there remains a considerable proportion of pension schemes where the sponsors have experienced a decline in profits over the period in question.

For the group of FTSE350 companies that paid both DRCs and dividends in each of the previous six years, the Regulator has seen, at the median level, the ratio of dividends to DRCs increase from 10.2:1 to 14.8:1. This is mainly driven by the significant increase in dividends over the period, without a similar increase in contributions.

For non-FTSE350 public companies that paid DRCs and at least one dividend during the past decade, the ratio of dividends to DRCs has increased from 3.1:1 to 4.8:1.

Implications for Scheme Funding

Many schemes are likely to have a lower deficit than revealed at their previous valuation date.

However, with deficits unlikely to have reduced as much as forecast since the last valuation, it is therefore likely that trustees will need to amend their recovery plans as current plans will not be on track to remove deficits.

The Regulator’s analysis highlights that affordability may have increased for a number of employers, which means that they may also have a greater number of deficit management strategies available to them than before. Furthermore the increase in dividends suggests an increase in affordability which could be used to shorten recovery plans instead.

Potential impact on DRCs

The Regulator suggests that about 35% of schemes would be able to retain their DRCs at the same level or less, either because of an improvement in their funding position or, for those schemes nearing the end of their recovery plan, the possibility of a moderate increase in the recovery plan length.

Around 45% of schemes would need an increase of between 0 and 100%, and the remainder would need to increase DRCs by more than 100% (including approximately 7% that would need to increase their DRCs to more than three times their current levels).

However, the Regulator's further examination of the schemes in this last category showed that the majority of them are supported by strong employers who will have greater ability to increase contributions.

Employer affordability

A key factor for trustees and employers when agreeing an appropriate recovery plan is the affordability position of the employer, recognising that what is affordable may be affected by the employer's plans for sustainable growth.

The Regulator's annual funding statement segments defined benefit pension schemes into five broad categories depending on the employer and funding characteristics. The analysis below sets out the percentage of Tranche 13 schemes that fall into each category, along with a reminder of the key risks and the Regulator's expectations of trustees.

	Characteristics	Percentage of schemes	Key risks to manage	The Regulator's expectations of trustees
A	Strong/tending to strong employers with neither weak technical provisions nor unduly long recovery plans	51%	• Sudden downturn in business • Future weakening of covenant / investment underperformance • Lack of long-term covenant visibility	• Consider strengthening technical provisions, increasing contributions or reducing recovery plan lengths • Short recovery plans where dividends and other forms of covenant leakage are disproportionate to DRCs
B	Strong/tending to strong employers with weak technical provisions and/or long recovery plans	6%	As (A) above but greater imperative to improve funding / reduce member risk	• Strengthen technical provisions, increase DRCs and reduce recovery plan lengths • Consider strengthening short term security via contingents assets / guarantees
C	Weaker employer with limited affordability and technical provisions that are not weak and deficits being reduced at a slower but affordable pace	22%	• As (A) above but with weaker covenant less able to withstand much downside risk • Pressure to employ limited affordability to grow company	• Prioritise scheme liabilities over shareholder returns • Retain cash within the company to fund sustainable growth and address pension deficit • Monitor covenant risk and limit member risk by securing proportionate reward for scheme from employer growth and/or maximising other forms of support , including contingent assets and formal group support

	Characteristics	Percentage of schemes	Key risks to manage	The Regulator's expectations of trustees
D	Weaker employer with limited affordability and a combination of weak technical provisions and/or long recovery plans	18%	As (C) above but greater need to improve funding / reduce member risk	• Prioritise scheme liabilities over shareholder returns • Maximise scheme support be assessing: o affordability and availability of cash, contingent assets and formal group support o employer's plans and strategies for sufficiently strengthening future covenant • Seek risk reducing opportunities to protect employer/members
E	Weak employers that are unable/unlikely to provide adequate support with limited/no ability to use the flexibilities in the funding regime	3%	Crystallisation of unsupported investment risk and/or employer affordability weakening further	• Seek best possible funding outcome for members • Be prepared to evidence appropriate measures, such as cessation of future accrual, awareness of future risks and ability to manage them, avoidance of covenant weakening, maximising non-cash support, and consideration of winding up of scheme

Comment

The Regulator highlights the increased affordability many sponsors may have with regard to their defined benefit pension schemes, in light of increased dividend payments over recent years.

Sponsors should be mindful of what the Regulator has to say about this, in light of recent high profile scheme failures, and the Regulator's call for greater powers to target employers deemed to not be sufficiently meeting their pension obligations.

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