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The Pensions Regulator's latest scheme funding analysis

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 in the 12 months to 21 September 2020 (Tranche 15 schemes).

Overall, the Regulator believes that trustees undertaking valuations at 31 March 2020 will find their funding levels and deficits have worsened in comparison with those reported three years ago, due to the COVID-19 crisis. Thus, it is likely that recovery plans will not be on track to remove the deficit revealed at the previous valuation.

Tranche 15 schemes with 31 March 2020 valuation dates that retain their recovery plan end dates will see a median increase in required deficit reduction contributions (DRCs) of 50% to 75%. Thus, the Regulator recognises that DRCs in such cases may be limited, especially in the short term, by employer affordability.

The position is less bleak for schemes with 31 December 2019 valuations which are likely to show improved funding levels and deficits from those reported three years previously and whose recovery plans should be on track.

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

Employer covenant and affordability

While the strength of the employer covenant is a key consideration for trustees and employers when setting funding strategies, the Regulator has this year excluded trends in employer affordability and segmentation of Tranche 15 schemes based on covenant strength from its analysis. This is because such data is historic and takes no account of the COVID-19 crisis and its uneven impact on employer covenant.

Market indicators

The Regulator notes the significant fall in gilt yields since March 2014 while inflation expectations have remained broadly unchanged, falling slightly below 3% during March 2020.

Over the three-year periods to December 2019 and March 2020 the implied real forward interest rate curve has changed shape with a significant fall in real interest rates in the short and medium term (up to 2036) balanced by increased rates in the long term (this is perhaps driven by falling inflation expectations at longer terms as a result of the Governments consultation on possible reform to RPI inflation).

Where discount rates are set with the same margin above gilt yields as at the previous valuation, the net effect of the changes to the real yield curve will be to increase the value of liabilities.

Asset returns were strong over the three years to December 2019, but with significantly worse returns over the period to 31 March 2020 primarily driven by the market impact of COVID-19.

Index name (Asset class)	Total three year returns to 31 December 2019	Total three year returns to 31 March 2020
FTSE All Share (UK equities)	22%	-12.2%
FTSE All World Excluding UK Sterling (Overseas equities)	35.4%	8%
Iboxx UK Sterling Corporate Bond All Maturities (Corporate Bonds)	14%	5.6%
FTSE British Government Fixed Over 15 years (Fixed interest gilts)	16.1%	25.8%
FTSE British Government Index Link Over 5 years (Index link gilts)	9.1%	9%
Composite DGF Index*	25.4%	8.1%
FTSE Global Real Estate (Property)	28%	-8.7%

*(based on 60% FTSE all World, 20% Iboxx UK, and 20% FTSE British Government Fixed)

Aggregate funding of defined benefit schemes

The analysis highlights how the positions of Tranche 15 schemes will differ significantly depending on their valuation date. The two most popular valuation dates are 31 December 2019 and 31 March 2020.

In the three years to 31 December 2019, funding levels will have improved for typical schemes. DRCs combined with better than expected asset returns and updated assumptions for future mortality improvements, will have offset the increase in liabilities driven by falling real yields and the reduction in relative expected outperformance. However, it is expected that deficits will have increased since 31 December 2019 and this post-valuation experience can be reflected in schemes' funding plans.

In the three years to 31 March 2020 deficits will have increased significantly mainly due to financial market movements over the three months to 31 March 2020 – with most asset classes falling significantly in value and real interest rates falling across much of the yield curve.

The Regulator notes this is a simplistic approach and different schemes will have different experiences depending on their individual investment strategies and funding plans. The most significant factors in driving this variation in experiences are the extent to which schemes hedged interest rates and invested in growth assets (equities and property). Interest rate hedging had a positive impact for all Tranche 15 schemes; whereas investment in equities and property was positive for those with 31 December 2019 valuation dates, but negative for 31 March 2020 valuations.

Implications for scheme funding

Many schemes are likely to have deficits larger than those revealed at their previous valuation, particularly if they have valuation dates in March and April 2020. While those schemes with earlier valuation dates will likely report reduced deficits, they will have suffered from poor post-valuation experience. It is therefore likely that trustees will need to amend their recovery plans as current plans will no longer be on track to remove deficits.

Potential impact on DRCs

The Regulator suggests that fewer than 15% of schemes would be able to retain their DRCs at the same level or less. 40% of schemes will need to increase their DRCs by up to 100%. Around 20% of schemes will need an increased in DRCs to more than three times their current level.

Employer affordability

A key factor for trustees and sponsors when agreeing an appropriate recovery plan is the affordability position of the employer, recognising that what is affordable may have been impacted by the COVID-19 crisis – potentially meaning that some trustees may need to extend the length of their current recovery plans.

Comment

This has been a period where funding levels may have broadly held up for well hedged schemes with low-risk investment portfolios. However, funding levels will have deteriorated for schemes with low hedge ratios and a significant level of investment risks – with a major deterioration in funding seen over February and March 2020 and little recovery since.

We expect that schemes with strong employer covenants are likely to come under increasing pressure to pay off deficits quickly. This is clearly a focus of the Regulator, in light of recent high-profile scheme failures – especially where large dividends are paid or there are other forms of covenant leakage – and the Regulator's call for greater powers to target employers deemed to not be sufficiently meeting their pension obligations.

The Regulator highlights the decreased affordability for many sponsors caused by the COVID-19 crisis and accepts that despite the increase in deficits many DRCs and recovery plans will be dictated by employer affordability.

The ongoing consultation on the future funding regime has been postponed for long enough to not impact many schemes in Tranche 15. However, the Regulator's analysis and statement of current expectations is very clear and could result in some difficult discussions between trustees and sponsors.

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