Annual defined benefit funding statement

June 2014

The Pensions Regulator

Introduction

1. This statement is relevant to trustees and employers of all defined benefit (DB) pension schemes but is primarily aimed at those who are undertaking valuations with effective dates in the period 22 September 2013 to 21 September 2014 (2014 valuations).

2. In this statement, we are setting out our key messages for schemes undertaking 2014 valuations in light of current market conditions. Our observations are of a general nature, having regard to market trends and their likely implications for scheme valuations. Individual schemes may, of course, have significantly different experiences.

3. We are also setting out how we will be approaching the review of valuations and recovery plans submitted in the coming year.

4. Our revised **Code of practice no. 3 – Funding defined benefits**[1] is expected to come into force in the coming months, subject to the parliamentary process[2]. Trustees and employers should take into account the new code as far as it is reasonable for them to do so, given where they are in their valuation cycle. We expect schemes that have not already carried out a substantial amount of work when the code comes into force to be incorporating the messages contained in our new code into their valuation.

5. In order to provide further context, we are publishing alongside this statement:

   - **Scheme funding analysis: A review of valuation and recovery plans for scheme valuations with effective dates in the period September 2011 to September 2012 (Tranche 7)** – analysis[3] of the funding plans of schemes for which we provided guidance in our first annual funding statement in 2012 and who have since submitted their valuations to the regulator, and

   - **Scheme funding analysis: A look forward to schemes with valuation dates between September 2013 and September 2014 (Tranche 9)** – analysis of the expected positions of DB pension schemes undertaking 2014 valuations, highlighting the impact of the changes in market conditions since the date of their previous valuations[4].

We are setting out our key messages for schemes undertaking valuations.

1
www.tpr.gov.uk/db-pensions

2
The code will come into force in Northern Ireland once it has passed through the Northern Irish Assembly.

3
www.tpr.gov.uk/review2014

4
www.tpr.gov.uk/forward2014

Our view of market conditions for schemes carrying out 2014 valuations

6. The Office of Budget Responsibility[4] has recently highlighted that UK economic growth in 2013 has been faster than previously thought. Expectations for 2014 and 2015 have been revised upwards accordingly. Business investment is recovering and inflation is expected to remain close to set targets. There remain concerns over productivity and wage growth, and the extent to which they underpin income growth and the sustainability of the recovery.

7. Real yields on long-dated index-linked gilts are still close to zero, having been negative a year ago. As a result, many schemes may have lower real discount rates relative to retail price index (RPI) than three years ago.

8. Compared to 2011, market expectations are for future interest rates to be lower for longer and with lower yields in the long term. There is potential for yields to remain low for an extended period. The risk that this occurs and the implication this has for future returns on other asset classes, are significant issues for scheme funding.

9. There remains a live debate as to the impact of quantitative easing (QE) on these yields, and many market commentators consider that other asset classes have also been supported by the QE process. There is continued uncertainty around the long-term effects of this and how any unwinding of QE may affect both the position of scheme funding and sponsoring employers.

10. The extent of the impact of market conditions will depend on schemes' specific circumstances. Schemes who adopted risk management strategies, such as hedging, are likely to have fared better, while others may face more challenging conditions.

11. Despite positive asset returns over the period since the previous valuation, and many employers paying deficit repair contributions, our analysis shows that many schemes carrying out 2014 valuations are likely to have a larger funding deficit. However, more recent improvements in the market mean that the position is likely to be markedly better than that shown by funding updates in 2013.

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4 http://cdn.budgetresponsibility.org.uk/98261-Mar14_EFO_PN.pdf

12. For many employers, improved economic conditions are likely to mean they are in a stronger position to support their scheme in the future. Employers' affordability is likely to also be increasing and may be affected by borrowing costs remaining low and credit and equity access easing, representing an opportunity for employers to increase investment in the sustainable growth of their business.

13. Affordability is, however, an employer-specific assessment. Our analysis highlights that whilst many sponsors may be able to afford increases in contributions whilst minimising any adverse impact on their ability to invest in sustainable growth, others may be facing challenging financial conditions.

Our key messages

14. Trustees can use the flexibilities available in the funding regime to set funding strategies that are appropriately tailored to the scheme's and employer's circumstances and which represent a balanced outcome. Our analysis highlights that most schemes with a 2014 valuation showing an increase in deficit should be able to manage the impact of this through an appropriate use of the flexibilities available.

15. However, we recognise that many schemes and employers may find themselves in more challenging positions. These schemes may need to make greater use of flexibilities in order to agree appropriate funding plans.

16. An open dialogue and collaborative working between trustees and employers are essential steps in ensuring that the valuation process runs as smoothly as possible and schemes reach appropriate funding outcomes.

17. The continuing low interest rate environment means that schemes may need to plan for a longer period of low yields than previously expected. As market conditions are uncertain, we expect schemes to keep their risk levels and funding strategies under review and ensure that their approach is prudent given their specific circumstances.

18. Trustees should seek to manage the risks to their scheme through a proportionate application of an integrated approach to risk management. Trustees should take into account their views on market conditions and the outlook for future asset returns and the associated uncertainty of those returns and what this means for their scheme and employer(s). We expect trustees to be in a position to evidence how they have approached this for their 2014 valuations.

Trustees should manage risks through a proportionate application of an integrated approach.

19. We also expect trustees to be in a position to evidence how they have taken a proportionate approach to assessing the employer covenant, including their analysis of the employer's affordability and plans for sustainable growth, given the economic conditions for their employer. This should be set in the context of the trustees' approach to risk management and the impact of potential upside and downside scenarios.

20. Trustees should assess the ability of the employer to address a range of likely adverse outcomes over an appropriate period. This should include how they are able to underwrite investment risk, and what impact redressing likely adverse outcomes would have on the covenant to the scheme and on the ability of the employer to invest for sustainable growth.

We will be applying our regulatory approach consistently with our policy.

What you can expect from us

21. Our revised funding policy[5] sets out in detail how we look at risk, segment the landscape by covenant strength, assess schemes' valuations and prioritise schemes for further engagement. We also explain what schemes can expect from us during this process and how we aim to be outcome-focused, targeted, proactive, transparent and consistent in our approach. We will be applying our regulatory approach consistently with our funding policy.

22. For the vast majority of schemes we will continue to review valuations and recovery plans as they are submitted. We will evolve our suite of risk indicators and our approach to engaging with schemes to help ensure that our regulatory focus is targeted and consistent. Our risk indicators focus on the key areas of covenant, funding and investment and also on scheme governance.

23. We will take a pragmatic approach to the level at which we expect schemes to have taken into account our new code of practice given where they were in their valuation cycle at the point of the code coming into force.

24. We will also be continuing with our approach to selecting a number of schemes for proactive engagement. We will have contacted these schemes by the end of June 2014.

5 www.tpr.gov.uk/db-policy

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