Summary of the key messages from the 2018 annual funding statement

April 2018

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Agenda

- Purpose of the annual funding statement
- Three important messages:
  - Affordability and managing deficits
  - Fair treatment
  - Risk management and contingency plans
- Other key messages

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Purpose of the annual funding statement

- The annual funding statement highlights some of the key issues we have identified facing schemes with valuations from September 2017 to September 2018. (Tranche 13 schemes or T13 schemes)
- Our analysis of T13 schemes suggests a marginally better funding level compared to three years ago. However, schemes will have been affected differently by market conditions and our analysis has identified groups of schemes which have been impacted in particular ways (see next slide).
- The continuing uncertainty over future economic conditions and the persistent low interest rate environment highlight the importance of effective risk management.
- Trustees and employers should use this statement to identify good practice approaches for their scheme type and take appropriate action.

Affordability and managing deficits

Trustees should take appropriate action depending upon the group they fall into as outlined in the table below.

Employer characteristics	Scheme characteristics	What we expect of trustees
Strong or tending to strong employers	• Scheme's funding position is on track to meet long term funding objective • Technical provisions are not weak • Recovery plans are not unduly long	• Consider strengthening technical provisions, increasing contributions or reducing recovery plan lengths • Where dividends/other forms of covenant leakage are disproportionate to DRCs, we expect a short recovery plan
Strong or tending to strong employers	• Combination of weak technical provisions and/or long recovery plans	• Strengthen technical provisions, increase DRCs and reduce recovery plan lengths • Consider strengthening short term security though other means such as contingent assets and guarantees
Weaker employer with limited affordability	• Scheme funding on track to meet long term target, technical provisions are not weak and contributions are reducing deficits at a slower but affordable pace	• Prioritise scheme liabilities over shareholder returns • Retain cash within the company to fund sustainable growth and address pensions deficit • Monitor sponsor covenant risk and limit member risk by securing proportionate reward for scheme from employer growth and/or maximising other forms of available support

Affordability and managing deficits continued

Trustees should take appropriate action depending upon the group they fall into as outlined in the table below.

Scheme employer type	Scheme characteristics	We expect trustees
Weaker employer with limited affordability	• Combination of weak technical provisions and/or long recovery plans	• Prioritise scheme liabilities over shareholder returns • Maximise support for scheme by assessing (a) affordability and determining what cash, contingent assets and formal group support are available and (b) what plans and strategies put forward by the employer will sufficiently strengthen future covenant • Seek opportunities to reduce risk in order to protect employer and members
Weak employer, unable or unlikely to provide adequate support	• Stressed schemes with limited or no ability to use flexibilities in the funding regime	• Seek best possible funding outcomes for members in the circumstances • Be prepared to show evidence of appropriate measures taken

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Fair treatment

- We are concerned about the growing disparity between dividend growth and stable deficit reduction payments
- Recent corporate failures highlight the risk of long recovery plans while payments to shareholders are excessive relative to DRCs
- Pensions are deferred pay and pension deficits are corporate liabilities which need to be repaid
- We expect trustees to negotiate robustly with the employer to secure a fair deal for the pension scheme
- A strong covenant in itself is not a sufficient reason to accept a recovery plan with lower contributions than would otherwise be considered reasonable
- Where dividends are disproportionate relative to DRCs, we would consider affordability not to be an issue
- Trustees should be alert to other forms of covenant leakage when considering affordability and whether the scheme is being treated fairly

Risk management and contingency plans

- Trustees need to monitor risks and take action when required, irrespective of the scheme’s funding position.
- Scheme size should not be a barrier to undertaking necessary work to understand the scale and nature of the risks.
- Trustees should prioritise risks and advisors have access to numerous tools to quantify this risk. Our quick guide to IRM is designed to help trustees with this.
- Effective risk management requires documented and workable contingency plans. Where possible, legally enforceable contingency plans represent the best protection for schemes.
- Where it is not possible, the trustees should at least agree the actions that would be taken if risks arose.
- If trustees are not satisfied that they could rely on a contingency plan which is not legally enforceable, they should consider a different overall strategy which leaves the scheme less exposed.

Other key messages

- Discount rates
- Transfer activity
- Scheme maturity
- Brexit uncertainty
- Knowledge and understanding
- Late valuations
- Proactive approach to scheme engagement to include smaller schemes
- Our risk assessment and case interventions

Discount rates

- Consider whether market conditions affect the longer term view of expected risk and returns, the choice of investment strategy and therefore the discount rates being used.
- Document the rationale for the chosen discount rate even if the method is not set to change.

Transfer activity

- Trustees considering whether to allow for transfer values in their valuation assumptions should consider their scheme's experience and likely future trends. If by making an allowance it reduces technical provisions, monitor experience and put contingency plan in place to make good any funding strains.
- Trustees should monitor transfer activity closely and take advice on liquidity management, consider the impact on investment strategy and suitability of their transfer value basis.
- Trustees should consider whether to reduce transfer values where there is underfunding. Smaller schemes should be alert to members with a large proportion of the liabilities where their transfer value can have a significant impact on funding.
- If trustees have concerns over the level of transfer value activity or the quality of the advice being given they should contact us or the FCA.

Scheme maturity

- We expect advisers to alert trustees to the risks to funding and investment from increasing scheme maturity.
- Trustees should understand the risks where a scheme is underfunded, volatility in the scheme assets and where the scheme is maturing rapidly. It is also worth understanding how an increase in transfer value activity can accelerate the scheme maturity.

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Brexit uncertainty

- Whilst there remains uncertainty about how Brexit may affect schemes and sponsors, we expect open and collaborative discussions between trustees and sponsors to understand the potential impact for the scheme and the sponsor.
- Where it is considered reasonable for sponsors to hold back cash by extending recovery plans because of uncertainty due to Brexit, trustees should ensure that shareholders share the burden proportionately and trustees seek forms of other security.

Knowledge and understanding

- Where trustees perceive a lack of skills or conflicts, we expect them to seek appropriate advice.
- Trustees are entitled to expect their advisers to find proportionate and cost efficient ways of delivering advice and help.
- If advice is not clear, then trustees should challenge their advisers to deliver this in a way that allows trustees to understand the issues.

Late valuations

- We have discretion to impose a penalty where trustees fail to agree valuation within the applicable timescale.
- Trustees should take all reasonable steps to finalise the valuation.
- Where there is a genuine reason why the valuation cannot be finalised, we may choose not to impose a penalty.
- Trustees should not agree an inappropriate valuation merely because the deadline is imminent or has been missed.

Proactive approach for smaller schemes

- Extending our proactive approach to scheme engagement to include smaller schemes.
- We have approached a number of schemes and explained how we rate their covenant and set out the issues we want the trustees to address before their valuation is finalised.
- We have asked that when trustees submit their valuation they explain how they have addresses the issues we raised.

Our risk assessment and case interventions

- TPR is now clearer about what we expect, quicker to act and tougher on those who fail to act in the interests of members.
- We can intervene if a scheme is not being treated fairly using a selection of interventions from our regulatory toolkit, depending on the risk posed by the scheme.
- We judge the suitability of a scheme's technical provisions and recovery plan by quantifying the overall risks in the funding and investment strategies and the manner in which trustees are seeking to manage them.
- We can use our powers to direct how a scheme's technical provisions should be calculated and how (including over what period) its deficit should be funded (our powers under section 231 of the Pensions Act 2004).
- The approaches we use can vary from one-to-one supervision through to use of an improvement notice or a full anti-avoidance investigation.
- We have several investigations under way, all of which could lead to us exercising the power to help us achieve our objectives for a scheme.

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