Annual funding statement

May 2016

The Pensions Regulator

Introduction

This statement is relevant to trustees and employers of all defined benefit (DB) pension schemes but is primarily aimed at those undertaking valuations with effective dates in the period 22 September 2015 to 21 September 2016 (2016 valuations).

The statement should be read in conjunction with our code of practice on scheme funding (found at **www.tpr.gov.uk/code3**) and supporting guidance. We expect schemes with 2016 valuations to fully incorporate the principles contained in the DB code into their valuations.

In this statement we are highlighting some of the key principles from the code we expect trustees to take into account in their valuations and providing guidance on areas that are likely to be of most concern for trustees and employers carrying out 2016 valuations, given current market conditions.

Most major asset classes have performed well over the last three years. However, yields on long-dated gilts have fallen and market expectations are for interest rates to remain lower for longer and to revert to lower long-term levels. This, along with wider concerns for global growth, is likely to have a negative impact on the expected returns across various asset classes over the medium and longer term. Our analysis suggests that as a result, many schemes will have larger funding deficits than previously predicted.

Alongside this statement we are also publishing a quantitative analysis of schemes with 2016 valuations. This gives greater detail on our estimated impacts of market conditions on schemes and trends in sponsors' affordability, as well as illustrating the impact on schemes' recovery plans, and can be found at **www.tpr.gov.uk/review2016**.

We are also publishing a summary of the main messages from this statement in a PowerPoint presentation, which advisers can use in their discussions with trustees and employers – see **www.tpr.gov.uk/slides2016.**

We are highlighting some of the key principles from the code and providing guidance.

Approach to scheme valuations

Integrated risk management (IRM) is a central feature of the DB code and was discussed in our funding statement in 2013, which most schemes with 2016 valuations should have taken into account in their last valuations. Trustees should take a proportionate approach to understanding the scheme's exposure to risk across employer covenant, investment and funding, and put in place a funding and risk management strategy that is integrated across these three areas. Our IRM guidance can be found at **www.tpr.gov.uk/irm**.

Having a clear understanding of the covenant to the scheme is a vital part of the IRM process. The covenant assessment should focus on the ability of the sponsor to provide financial support to the scheme, both now and in the future. Our guidance can be found at **www.tpr.gov.uk/covenant-guidance**.

It is important for trustees to measure the sensitivity of the scheme's assets and liabilities to different future economic scenarios and the impact this would have on the scheme's funding position. Trustees should consider with their sponsors what action the scheme might take in these scenarios, including an assessment of what the potential calls on the sponsor for additional financial support might be. This assessment can then be joined up with the trustees' view of the sponsor's ability to provide the required support in these scenarios and the impact this would have on their plans for sustainable growth.

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It is not necessary to eliminate all risk through this process. However, IRM will help trustees ensure that the level of risk being taken is properly understood, well monitored and appropriate to the circumstances of the scheme and employer.

As schemes mature, liquidity planning is becoming an important consideration, especially where the cash flow requirements represent a significant proportion of the scheme assets. Market developments may mean that schemes are forced to sell assets at lower than expected prices in order to meet cash flow demands. This could put increased pressure on the scheme's funding plans and on the sponsor for higher contributions over a shorter period than anticipated, affecting their plans for sustainable growth. It is important that trustees understand when liquidity could become an issue and have appropriate cash flow management plans in place.

This overall assessment should be performed with the trustees, advisers and employers working collaboratively in an open and transparent manner. Trustees and their sponsors should fully understand and be comfortable with the inherent risks to the scheme's approach to funding and the possible actions the scheme can take under different future scenarios.

Trustees should appropriately document their decisions and the reasons behind those decisions, referencing any key supporting analysis.

Trustees should consider the longer term view of expected risk and returns.

Key issues for schemes carrying out 2016 valuations

Volatility and valuation dates

There has been significant financial market volatility recently, especially at the start of 2016, and for a variety of reasons, including the upcoming EU referendum. This volatility can have a material impact on a scheme's reported funding position. Trustees should not be overly focused on short term market movements but consider with their advisers the extent to which volatility and changing market conditions affect their longer term view of expected risk and returns and how this interacts with their funding plans and risk appetite.

Trustees of all schemes should understand the impact on their assets and liabilities of worsening or improving market conditions since the valuation date. Trustees should consider whether to take this post-valuation date experience into account when setting an appropriate recovery plan.

Investment returns

Given the current market conditions and expectations for the medium to longer term, all else being equal, we would expect that most schemes will set funding strategies based on lower expected investment returns from most asset classes than at their last valuation.

Trustees who continue to assume that gilt yields would revert to a higher level and/or sooner than implied by the markets ('yield reversion') should reconsider their assumptions in light of market developments. This should include whether it would be more appropriate to assume reversion over a longer time period and to lower levels than before.

It is important that trustees understand the implications of yield reversion not occurring in practice and have in place a plan for the potential mitigating actions available to address this.

Trustees who at their last valuation took account of yield reversion, should now consider implementing the contingency plan that was put in place to manage the impacts of these assumptions not being borne out and take appropriate action to address any significant adverse impacts.

Affordability and managing deficits

We expect that most schemes will have a larger than expected deficit at their valuation date and will need to make changes to their existing recovery plan. Trustees and employers should assess the level of risk associated with any changes to the recovery plan and ensure it is consistent with their risk tolerance and overall funding and risk management plan. Schemes that took a more prudent approach at their last valuation are likely to have more capacity for accepting additional risk, if necessary.

Our analysis indicates that for the majority of schemes there may be sufficient affordability for the sponsor to increase contributions so that their existing recovery plan end date can be maintained. We expect trustees to seek higher contributions where there is sufficient affordability for the sponsor, without a material impact on its sustainable growth plans.

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For others, an increase in contributions may not be affordable, or affordability may have decreased and current levels of contributions may not be able to be maintained, meaning the scheme will need to make other adjustments in order to put in place an appropriate recovery plan. Where this is the case, it is important for trustees and employers to discuss openly why current levels of contributions cannot be increased.

Where changes to the recovery plan mean that the scheme is running a higher level of risk – for example through extending the recovery plan length – it is important that the trustees and employer consider the potential impact of these additional risks and what options are available to provide security against them as appropriate.

If investment in an employer's business is being prioritised, constraining the level of contributions to the scheme, it is important that the scheme is treated fairly. Our code and covenant guidance set out some of the key questions and actions trustees should consider with their employer in these circumstances. See paragraphs 76-82 at **www.tpr.gov.uk/code3**, and the section on assessing sustainable growth plans and Examples 14 and 15 at **www.tpr.gov.uk/covenant-guidance** for more information.

Managing risks

As part of their IRM approach, trustees should decide how much and when to hedge against risks. Trustees should be aware of the degree of risk which remains un-hedged, including any tail risks.

Where current conditions mean that the scheme is exposed to an inappropriate level of risk, trustees should reconsider their diversification and hedging strategy in that context. This can include considering the risk/rewards of their current strategy against alternative approaches and being in a position to identify opportunities to adjust the strategy in a timely manner, as appropriate.

Valuation assumptions – recent developments

The 2015 version of the Continuous Mortality Investigation model (CMI2015) produces life expectancies that are lower than the 2014 version. We would consider it reasonable for trustees who use data from the CMI, to update to CMI2015 if they wish. However they should consider with their advisers what the effects would be if this reduction is reversed in the coming years. The CMI model is driven by assumptions, one of which is the single long-term improvement rate, and we would consider it unlikely to be appropriate to make any changes to this assumption until it is clearer that recent experience is indicative of being a trend over the longer term.

Trustees may be considering adjusting their assumptions regarding the take up of transfers from their scheme in light of 'pensions freedoms'. Assumptions should be evidence-based and, as it is still early days under the new freedoms, there is likely to be very little evidence at this time to support adjustments. It is important that trustees choose assumptions consistent with the overall level of prudence required for the scheme and their funding and risk management strategy. Our guidance can be found at **www.tpr.gov.uk/db-dc**.

Reduced expectations for future returns also mean an increase in the cost of funding future accrual. It is important that contribution rates for future accrual are set at a level that appropriately reflects the cost and does not compromise the scheme's risk management and funding plan.

Trustees should decide how much and when to hedge against risks as part of their IRM approach.

What you can expect from us

We continue our approach of educating, enabling and enforcing. Our regulatory approach is set out in our DB funding regulatory and enforcement policy at www.tpr.gov.uk/db-policy.

As in previous years, we have selected a number of schemes for proactive engagement ahead of their valuations being submitted. We have already contacted all the schemes carrying out 2016 valuations selected for proactive engagement.

In 2015, a number of DB schemes submitted their scheme valuation later than the statutory deadlines. We expect schemes to fulfil their requirements in this respect. Where schemes are having difficulties meeting the deadlines, they should engage with us in relation to the factors causing the delay and provide a clear timetable for completing the valuation, agreed by all parties. Trustees should plan to avoid unnecessary delays. We are more likely to take enforcement action in relation to the breach of law in this area, when delays could have been predicted, or where trustees do not engage with us regarding the breach.

As part of our educational activities to enhance understanding of the new DB funding code, we are planning to publish a review of the first tranche of schemes to carry out a valuation following our revised code of practice on scheme funding and additional practical guidance on setting an investment strategy. We will also consider whether a further statement from us is necessary following the results of the EU referendum.

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Free online learning for those running public service schemes

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