

# **An overview of Tranche 9 Analysis**

DB schemes with valuations for the period  
22 September 2013 to 21 September 2014  
(‘Tranche 9’)

February 2017

**The Pensions  
Regulator**

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## Overview

This report examines how the first schemes undertaking valuations since the revised defined benefit (DB) code of practice and our new statutory objective came into force, have responded to our expectations.

We updated the DB code, 'funding defined benefits' and DB regulatory strategy in June 2014, to take into account our experience of regulating to date, and to reflect the new statutory objective to minimise adverse impact on the sustainable growth of an employer.

Our analysis focuses on schemes whose valuation dates fell between September 2013 and September 2014 (referred to as Tranche 9 or T9 schemes) and sets out our conclusions on how trustees and employers have behaved in light of the revised code and relevant Annual Funding Statement (AFS). This includes a subset of T9 schemes, focusing on those facing an increased deficit relative to their previous valuation, and the approaches they have taken to manage these increased deficits.

Overall, the analysis shows that schemes behaved consistently with our expectations both under the current regulatory regime and the supporting analysis that we produced in 2014. It also provides an insight into scheme behaviours in the context of affordability (whether DB scheme sponsors have the ability to pay additional contributions to the pension scheme to improve the scheme's funding position).

This overview should be read in conjunction with the Tranche 9 Analysis at [www.tpr.gov.uk/t9-analysis](http://www.tpr.gov.uk/t9-analysis).

## Summary of key findings

Deficits have increased for this subset of schemes, but sponsor affordability has also improved for around half of the schemes. This demonstrates that those employers with increased deficits but who also experienced an increase in affordability and did not increase their deficit recovery contributions (DRCs) had the ability to do so.

A majority of these schemes have made use of the flexibilities to manage the impact of their increased deficits to carry risk in the scheme and prioritise investing in the sustainable growth of the employer, rather than increasing DRCs.

A minority of schemes have not used or fully utilised the flexibilities highlighted in the 2014 AFS – ie they may have had the potential to take greater risk if they wished and were able to. The decision on whether or not to use flexibilities is a scheme specific decision and a variety of approaches are being adopted to suit the circumstances of different schemes and employers.

There has been an increase in the proportion of trustees and employers employing an integrated approach to risks.

## Market conditions and affordability

Between 2011 and 2014 interest rates remained low. The expectation is now that yields will continue to be lower for longer than originally anticipated. The implication of yields remaining low for an extended period creates issues for scheme funding. Our analysis shows that, despite positive asset returns since the previous valuation and many employers paying deficit contributions, over half of all schemes (around 60%) in this tranche have increased deficits as predicted in our T9 forward-look analysis.

Our analysis shows that, while many employers were able to afford increases in contributions (more than half of schemes increased DRCs in nominal terms), others faced challenging financial conditions. Under relatively stable economic conditions compared to previous years, about half of employers reported increased profits and improved balance sheets. The analysis shows that employers with higher covenant strength achieved a greater increase in affordability compared to those with lower covenant grading<sup>1</sup>. However, as might be expected, increases in profitability are generally not closely associated with an increase in DRCs<sup>2</sup>.

1  
Covenant group 1 employers' profit before tax increased by 23% at the median compared to an increase of 11% at the median for covenant group 4.

2  
Covenant group 1 increased DRCs at the median by 18% compared to an increase of 21% at the median for covenant group 4.

## Using flexibilities

Analysis of schemes with increased deficits shows that they used a wide range of flexibilities to manage their funding strategy in a way tailored to their individual circumstances. These include changes to recovery plan (RP) lengths, alternative forms of support (such as parent or group guarantees), and adjustments to discount rates used to calculate scheme Technical Provisions (TPs).

The analysis shows that schemes used the flexibilities moderately in their funding strategy decisions, and the most common adjustments used were changes to the recovery plan length and discount rates. Over two thirds of schemes with increased deficits extended their recovery plan length. We have observed that schemes that extended their RP did so by similar lengths (at the median by three years) in all four covenant groups (CG1-CG4).

A majority of these schemes have increased their discount rate outperformance relative to their Tranche 6 valuation. Partly due to adjustments to RPs and/or TPs, 40% of schemes did not increase DRCs. The remaining 60% have increased their DRCs regardless of the level of flexibilities they used.

Some schemes would have been able to use further flexibilities but chose not to. We have provided some examples of how individual schemes approached flexibilities in the case studies provided.

## Integrated risk management

Integrated risk management (IRM) is a central feature of the DB code, and in the 2014 AFS we stated that trustees should take an integrated approach to managing scheme funding risks. It is not possible to draw definitive conclusions on the extent to which schemes have adopted IRM using the valuation data we collect from schemes.

However, it is possible to examine the approaches that schemes have taken by looking at the findings from our AFS surveys carried out in 2014 and 2015. Since the new objective and code were introduced, the surveys show a significant increase in the proportion of responses from trustees and employers who followed an integrated approach to scheme funding risks compared with those undertaking valuations in the two previous tranches.

Integrated risk management continued...

In the 2014 and 2015 surveys, three out of five trustees stated that they manage all specified risk activities (Appendix 1, table 2 under section 'Integrated approach to risk'). In the survey carried out in early 2014, for schemes with 2011-2012 and 2012-2013 valuations, just over two in five gave similar responses.

The distribution of these results among differing sizes of schemes showed that larger schemes reported undertaking more risk activities than small ones. This suggests that larger schemes followed our messages/guidance more closely than smaller schemes. Although we understand that small schemes have limited resources, we still expect them to carry out IRM in a proportionate way and to support this we have since produced a quick guide to IRM aimed specifically at smaller schemes. See [www.tpr.gov.uk/pn16-54](http://www.tpr.gov.uk/pn16-54) for more.

The surveys also found that a majority of trustees and employers reported that scheme risks were integrated to some extent or fully, that there was an open and transparent relationship between trustees and employers, and that funding and investment strategies took account of the risk capacity and risk appetite of the sponsor employer.

## Sustainable growth

Our sustainable growth objective was introduced in the middle of this valuation period and informed the messages we gave to schemes. One of the key messages of the 2014 AFS was that trustees should take a proportionate approach to assessing the employer covenant, including their affordability and sustainable growth, given the economic conditions for their employer.

We have found that scheme behaviour in relation to sustainable growth (ie trustees taking the needs of the scheme and employer into account in a balanced way when making an assessment on funding), remained consistent across this tranche in comparison to their T6 valuation. This is in line with the assertion when the new objective came into force that trustees were already taking into consideration our approach to sustainable growth to ensure a better balanced funding position, but the new code makes it explicit that this needs to be the case across the DB landscape.

We have provided some case examples which exhibit how different schemes that we have been involved with have balanced the needs of the employer and the scheme.

## Case examples

The trends observed in the valuation analysis in appendix 1, are in aggregate and can mask a high degree of variability. The following case examples illustrate the wide range of circumstances and outcomes.

When we receive valuation data from schemes, we risk assess their investment, covenant and funding position in light of the market conditions and their previous funding record. Those that exceed our risk tolerance or do not pass our risk assessment are selected for proactive or reactive cases depending on where they are in the valuation cycle. All the cases below initially fell into this category.

### Case example 1

In this example the trustees and employer explored different flexibilities to reach an appropriate scheme funding plan as well as sustainable growth of the business in the long run. The example demonstrates that schemes may need to put support in place to ensure a newly acquired subsidiary can grow, and that unlocking growth can sometimes require making commitments to the scheme.

A sponsoring employer with a long term weak covenant (as a result of limited profitability and a very large and risky pension scheme) was approached by another business over a possible purchase.

The negotiations resulted in a combination of substantial conditional and unconditional guarantees from the purchasing company, which would provide additional covenant support to the scheme. An agreement was also reached to significantly increase the DRCs for the first two years of the recovery plan, giving the scheme increased funds in the short term, with lower contributions thereafter. Assurances were given that investment would be made into the scheme's employer group, giving support to the sustainable growth of the group.

When the deal was completed, the scheme had access to the parent company with significant assets (albeit capped by the guarantee at present), with a commitment to invest into the covenant.

## Case example 2

This case example illustrates how trustees balanced the needs of the scheme and that of the employer. It also shows how our sustainable growth objective balances against our other objectives. We understand that a strong and ongoing employer is vital to support the scheme in the long term and therefore take this into consideration when making our assessments and judgements as outlined in scheme funding code.

An employer needed to invest in its business in order to deliver a new product to market which was expected to improve the profitability of the business and, therefore, the covenant it offered to the scheme. The trustees were given independent advice that the project was likely to result in a significant increase in revenue and cash generation. They were also advised that not being able to make the investment in the business was likely to weaken the employer over the longer term, as their core market was evolving and the company needed to keep up with its competitors.

The trustees considered that, overall, the covenant would not be weakened by this investment and that mid-term growth and prospects offset the initial short-term uncertainty. We reviewed the rationale for this arrangement and supported the trustee's agreement to defer the payment of DRCs by two years. After this time, contributions would increase in order to reflect the anticipated improved profitability in the business in the future. An additional guarantee for a portion of the liabilities of the scheme was also provided by the wider employer group, which helped to mitigate any downside risk for the trustees.

## Case example 3

This example demonstrates the importance of trustees having enough information to make an informed decision on whether employer's plans are in the best interest of the scheme.

An employer undertook a debt refinancing initiative involving a large unsecured credit facility with a new one to be secured on property assets in favour of the lenders. The employer offered the trustees mitigation in the event of a risk materialising and impacting the scheme. However, the trustees were not in a position to form a view as to whether the mitigation being offered was sufficient.

We were concerned that the relationship between the employer and trustees was not transparent enough for the trustees to make an effective assessment. As a result of our direct communication with the employer and intention to investigate the case further, the trustees' covenant advisers were given sufficient information to fully analyse the project and conduct an up-to-date covenant assessment. They concluded that, although the project was materially detrimental, the large sum of cash that the scheme would receive was sufficient to mitigate the impact. Having discussed the reports in full with the trustees and their advisers, we had no reason to challenge the advice given to the trustees and we did not consider that our powers were applicable in this instance.



## Case example 4

This case example demonstrates that we expect employers to understand the appropriate amount of funding to manage risks in the scheme and that they treat their scheme's fairly alongside other business priorities.

We assessed a scheme with a long RP length, but whose sponsoring employer had a strong covenant and asset-backed contributions (ABC). The DRCs were particularly low for a scheme in this position, and the employer had been making dividend payments rather than using this cash flow to improve the scheme's funding position. Our key concern was the pace of funding for the scheme. The employer wasn't putting enough money into the scheme. Once ABCs are taken into account, DRC levels still need to be sufficient in relation to the affordability of the employer.

When we look at ABCs we do so in the round. When considering the valuation and the scheme's funding plans, we will look behind the net present value attributed to the ABC and consider the aggregate funding stream provided under any recovery plan and the ABC. If the payment period under the ABC is longer (or more back-end loaded) than an appropriate recovery plan then we will ask trustees to explain how they have concluded the value of and access to the underlying asset justifies the extended period for the scheme to become fully funded. We asked the employer to explore increasing contributions to fund the deficit and potentially reduce the RP length. Following our engagement, they agreed to increased contributions, better balancing the contribution levels against risk.

## Case example 5

This example shows how IRM works by helping trustees and employers focus on what's really important for their scheme and better assess, prioritise and manage their employer covenant, investment and funding risks.

The trustees and advisers of a large scheme initially considered that its employers were strong on the basis of its asset position rather than its affordability. Our primary concern was to see evidence that the employers were able to underpin the level of scheme's investment risk. The discussions we had with the trustees focused on the scheme and employer's risk capacity – which meant we covered employer affordability, the longer term evolution of the scheme and its risk profile. This focus on risk capacity highlighted to the employers a higher probability of future events requiring contribution increases. This was beyond the employers' risk appetite and posed too great a risk to their investment plans.

The trustee and employers took advantage of the flexibilities within the funding system to bring the scheme more in line with the employer and trustees' risk appetite through a combination of measures. As part of these discussions a risk monitoring framework was put in place to ensure that, in the future, risk was kept within agreed acceptable parameters. Our view was that this strikes the right balance of protecting the employer's investment and growth plan and achieving an RP with supportable risks over an appropriate period.

## How to contact us

Napier House  
Trafalgar Place  
Brighton  
BN1 4DW

[www.tpr.gov.uk](http://www.tpr.gov.uk)

[www.trusteetoolkit.com](http://www.trusteetoolkit.com)

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