Statement from The Pensions Regulator

April 2012

Pension scheme funding in the current environment

Introduction

This statement is aimed at trustees and employers of defined benefit (DB) pension schemes who are undertaking their scheme valuations with effective dates in the period September 2011 to September 2012. It will also be relevant to all trustees and employers with a DB pension scheme. To date, nearly all schemes should have undertaken at least 2 valuations under the legislative funding framework, so a high assumed level of understanding of the framework and a high standard of proficiency in its application are implied in this statement.

It sets out The Pensions Regulator's (the regulator's) views on acceptable approaches to the valuation process in the current economic environment in order to protect members' benefits, without undermining the viability of employers, whose support is vital to pension schemes. This statement builds upon the regulator's published views of how to operate the funding framework.

Under the funding framework, a DB pension scheme's funding strategy must be tailored to its own specific circumstances. DB pension schemes encompass a wide variety of scheme design, maturity, investment holdings, funding level and employer support. Therefore, not all of the statements in this document will apply equally to all schemes. However, it is our view that these statements are consistent with the universally applicable principles which underlie the funding framework.

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The Pensions Regulator

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Economic circumstances

1. The regulator recognises that the current economic conditions will put pressure on pension scheme funding.

2. Whilst many schemes undertaking their valuations from September 2011 will be faced with challenges, there is sufficient flexibility within the funding framework to address these, and achieve an appropriate and balanced outcome.

3. We recognise the volatility in deficits shown at different effective dates. Schemes with effective dates in December 2011 may appear less well funded than those with effective dates in March 2012 because of the general improvement in conditions during the first quarter of 2012. However the flexibilities mean that the outcome should not necessarily be more burdensome for those employers. Economic conditions for the remainder of the year are of course unknown.

4. Long dated index-linked gilt yields are at an all time low due to a combination of economic factors driving down their yields. These include supply and demand issues and the perception of UK bonds as a safe haven, as well as the Bank of England's quantitative easing (QE) programme.

5. The possibility of further rounds of QE has not been ruled out. However the Bank of England has also stated its intention to reverse the QE programme at some stage in future. It is unclear when, and to what extent, this single factor will lead to changes to relevant yields, particularly in the face of other drivers, and the corresponding impact on other asset classes.

6. Low gilt yields have the effect of driving up current measures of pension scheme liabilities and as a result will typically worsen scheme funding levels. Therefore, funding deficits may remain at the levels identified three years ago, or even higher for some schemes, despite significant deficit repair contributions over the last three years.

7. However, the impact across schemes will vary. We believe that a substantial proportion of schemes will find that their particular risk management, asset allocation and contribution strategies, together in some cases with prudent allowance for liability reductions as a result of the Consumer Price Index (CPI) change, leave them broadly on track to achieve previously agreed plans.

8. The ability of employers to afford deficit repair contributions will also vary widely. Amongst other factors, re-financing will provide opportunities to lower corporate financing costs for some, but there will also be significant challenges for others.

'We recognise that the current economic conditions will put pressure on pension scheme funding.'

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9. Planning for an uncertain future is a key part of pension scheme management and current market conditions serve to emphasise that. Although some commentators believe gilt yields will return to more 'normal' levels, there is no certainty that this will be the case, or what 'normal' might be.

10. It is the regulator's view that the majority of schemes and employers will be able to manage their deficits within current plans or, if appropriate, by modest contribution increases and/or modest extensions to recovery plans. Therefore, for these schemes the question of needing to rely on increases to gilt yields beyond those implied by the market does not arise.

Risk management

11. We expect trustees to adopt an integrated approach to scheme funding and to complete valuations on time. As part of their due diligence, trustees should be bringing together information and advice on the investment, covenant and actuarial strands to inform a complete financial management plan.

12. We expect trustees to document their considerations and be in a position to be able to explain the decisions based on the interplay of the different information and advice strands.

13. Trustees should undertake contingency planning. Future positions may not reflect the assumptions made and, therefore, trustees need to have viable alternative options if assumptions are not borne out. The level of detail in plans should be proportionate to the risk being taken.

14. Trustees should not utilise an earlier effective date reflecting more favourable circumstances in order to reduce deficit repair contributions. However economic conditions will continue to develop whilst trustees are going through the valuation process. Where appropriate the use of actual post valuation experience is acceptable.

15. Where schemes are at, or close to, their funding targets and the trustees and employer consider that market changes and contributions may lead to surplus funding, they may wish to consider mechanisms such as an escrow agreement.

'Planning for an uncertain future is a key part of pension scheme management.'

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Technical provisions

16. It is a requirement for trustees to calculate technical provisions based on prudent assumptions in relation to their assessment of the employer covenant. This duty applies irrespective of the deficit it may reveal.

17. In the regulator's view, investment outperformance should be measured relative to the kind of near-risk free return that would be assumed were the scheme to adopt a substantially hedged investment strategy.

18. We do not consider smoothing of the discount rate to be consistent with the legislative requirement to value assets on a mark-to-market basis. We consider asset and liability measures should be consistent.

19. The regulator views any increase in the asset outperformance assumed in the discount rate to reflect perceived market conditions as an increase in the reliance on the employer's covenant. Therefore, we will expect trustees to have examined the additional risk implications for members and be convinced that the employer could realistically support any higher level of contributions required if the actual investment return falls short of that assumed.

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20. Our meetings with stakeholders have indicated a desire from some schemes to incorporate an allowance for an anticipated improvement in economic circumstances – in particular increased discount rates in their valuations, based on gilt yields reverting to 'normal' levels. However, it is the regulator's view that it would not be prudent to try to second guess market movements by assuming that gilt yields will inevitably improve in the near-term. Such assessments may turn out to be inaccurate and conceal important risks to the scheme's ability to meet its liabilities. Any strongly held views about future financial market conditions should therefore be accommodated in the recovery plan (rather than the technical provisions) where they are more clearly identified and mitigated should the assumption turn out to be false.

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Recovery plans and employer's ability to pay

21. Irrespective of the current economic climate, recovery plans should usually be based on what is reasonably affordable without compromising the employer's long term ability to support the scheme. In the vast majority of situations, a strong and ongoing sponsoring employer is the best support for a scheme.

22. As a starting point, we expect the current level of deficit repair contributions to be maintained in real terms, unless there is a demonstrable change in the employer's ability to meet them. This of course assumes that the current contributions were properly set.

23. There should be documented justification where deficit contributions are reduced. Conversely, it may be appropriate to increase contributions at this point, in line with business performance.

24. Where deficits have increased, some employers will be in a position to accommodate deficit repair contribution increases in their business plans. Others will have significant competing demands making cash contribution increases difficult. Servicing of other debts and facilitation of appropriate capital expenditure are necessary features of successful businesses as part of ensuring ongoing employer support.

25. The pension scheme should, however, be equitably treated among the competing demands on an employer (eg to balance the business dynamics for capital investment and dividends payments with obligations to service debt). Where cash is being used within the business at the expense of what otherwise would have been affordable pension contributions, it is important that it is being used to improve the employer's covenant – rather than benefits accruing disproportionately to other stakeholders.

26. Most employers can afford appropriate dividend payments without prejudice to the funding of the pension scheme. However, if there is substantial risk to the likelihood of the pension scheme delivering the benefit entitlements promised within it, then dividend payments need to be re-assessed in light of the obligations to the pension scheme, and other creditors.

27. Where the employer's covenant has weakened and it cannot afford to continue contributions at previously agreed levels, or is unable to pay more in respect of a larger deficit, trustees may need to agree to a longer recovery plan. A material extension to the recovery plan end date will require sound justification.

28. Where, by exception, schemes choose to rely on anticipated changes to the current circumstances (eg by assuming some form of gilt yield reversion in the recovery plan assumptions), they should have viable contingency plans to address the situation where this is not borne out and such plans should be suitably documented.

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What you can expect from us

29. We are providing this statement to enable trustees and employers to reach funding agreements that the regulator finds acceptable. This should avoid the need for regulatory involvement in the majority of pension schemes.

30. We will seek to identify schemes where approaches are not in line with this statement and where our intervention may have the greatest impact. We will consider these schemes in more depth. For a very small minority of schemes, we may engage with them before conclusion of the valuation process.

31. As outlined in this statement, where outcomes have weakened or are insufficiently robust, we will expect justification that this is necessary to protect members' interests. As all parties should be familiar with the scheme funding process, we do not expect late valuations or issues with governance. Where these issues arise, we will use our powers as necessary.

32. We will consider whether the flexibility in the funding framework has been used appropriately and/or whether the feedback we have given in relation to prior valuations has been taken into account. Where there is an issue with the appropriateness of the outcome we will seek further clarification.

33. Where we look in depth, we will consider the extent to which trustees have brought the funding, investment and covenant strands together to produce a complete financial management plan, which includes contingency mechanisms to address risk where appropriate.

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