2016 Funding valuations

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The Pensions Regulator

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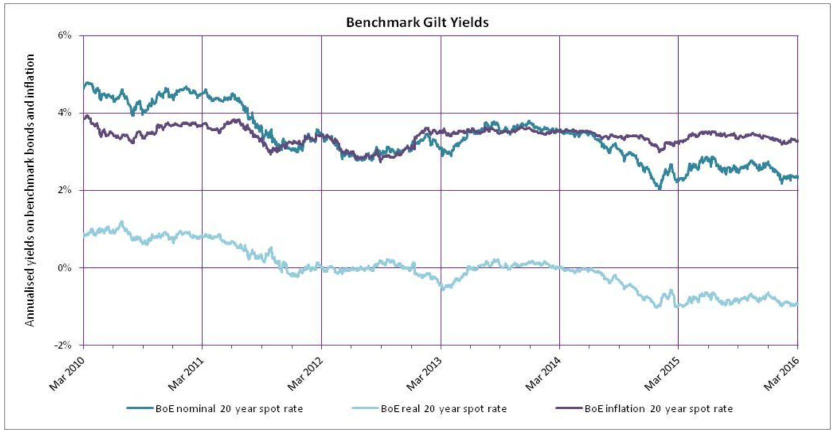
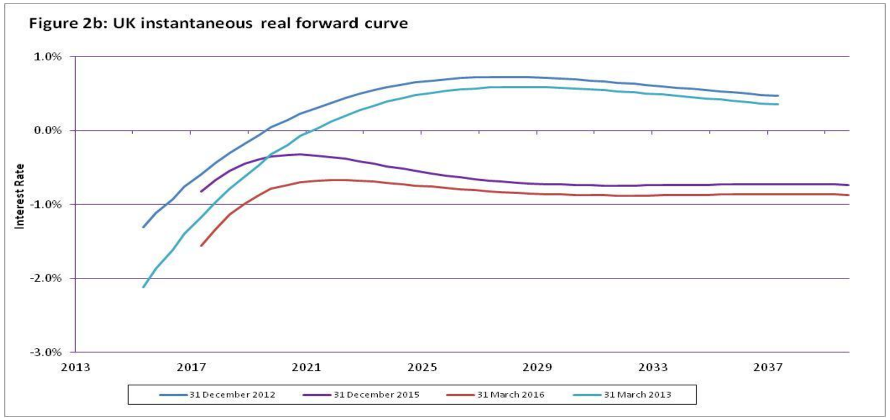
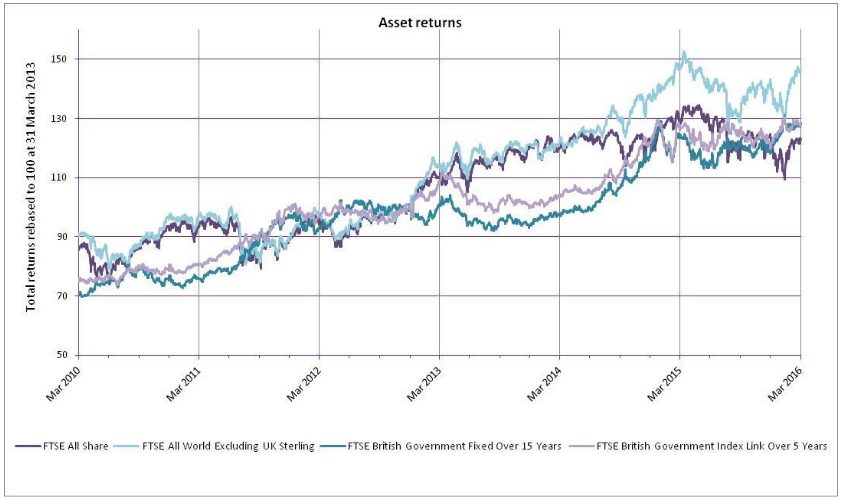
2016 Funding Valuations

1. Analysis which has informed AFS16
2. Key messages for trustees carrying out T11 valuations (Sept 2015 – Sept 2016)
3. TPR's engagement with schemes, and other things we are working on
4. 21st Century Trusteeship
5. Questions and discussion

Financial conditions: past three years







- Reduced nominal and real yields
- Good investment returns

.... but not enough for most schemes

Sources: BOE, Thomson Reuters, FTSE Group and TPR

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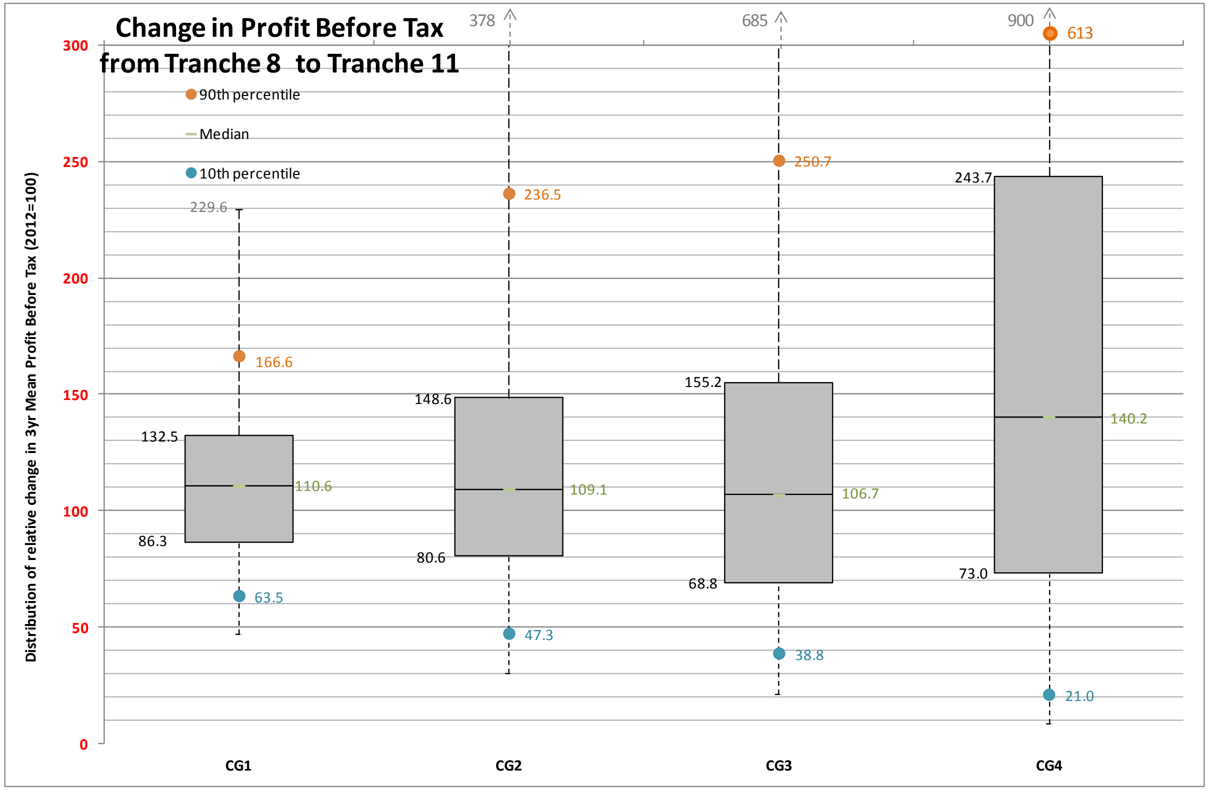
Affordability (1): General trends in PBT



Sources: FAME by Bureau van Dijk and TPR

- Improved trends, more significant increase for weaker companies, but wide variation
- PBT not the only measure

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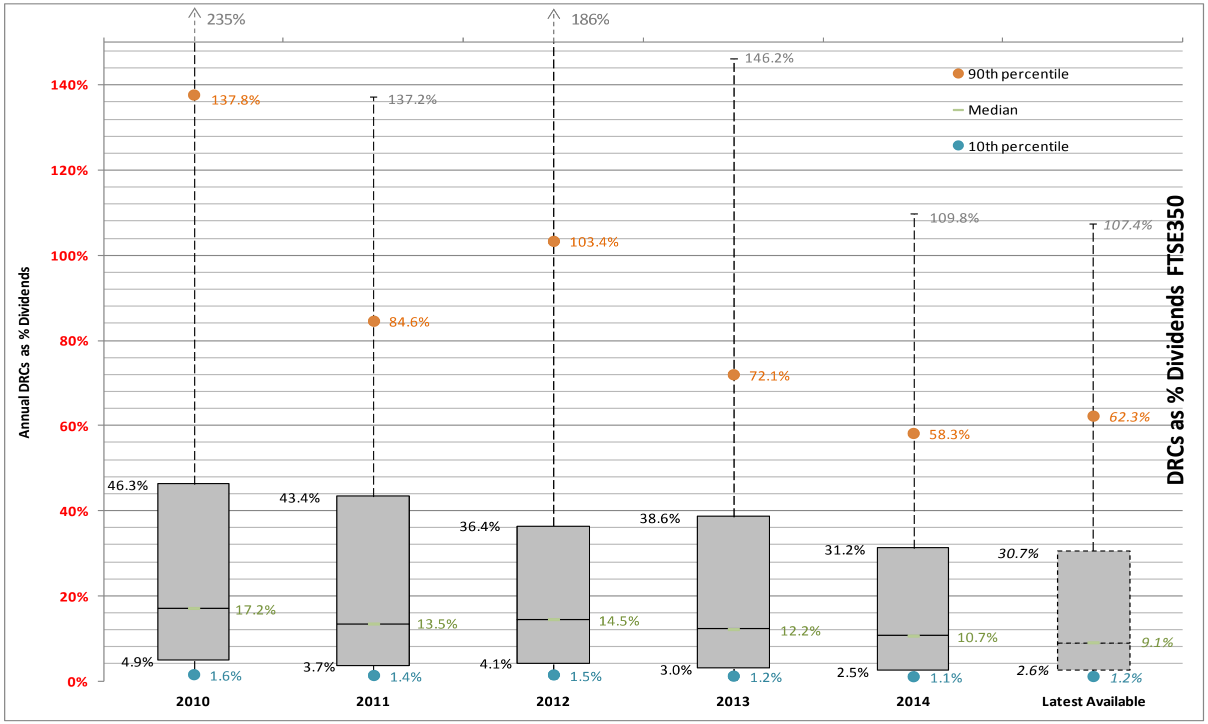
Affordability (2): DRCs vs dividends



Sources: FAME by Bureau van Dijk and TPR

- Dividend pay-outs increased relative to DRCs, but wide variation
- And sample may not be representative of all T11 schemes

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Financial conditions: future outlook

- Outlook for future investment returns
  - Continuing uncertainty about future economic and financial conditions
  - Market expectations: interest rates to remain lower for longer, and to revert to lower long-term levels.

- Most funding strategies likely to be based on lower expected investment returns.

- But a scheme specific assessment

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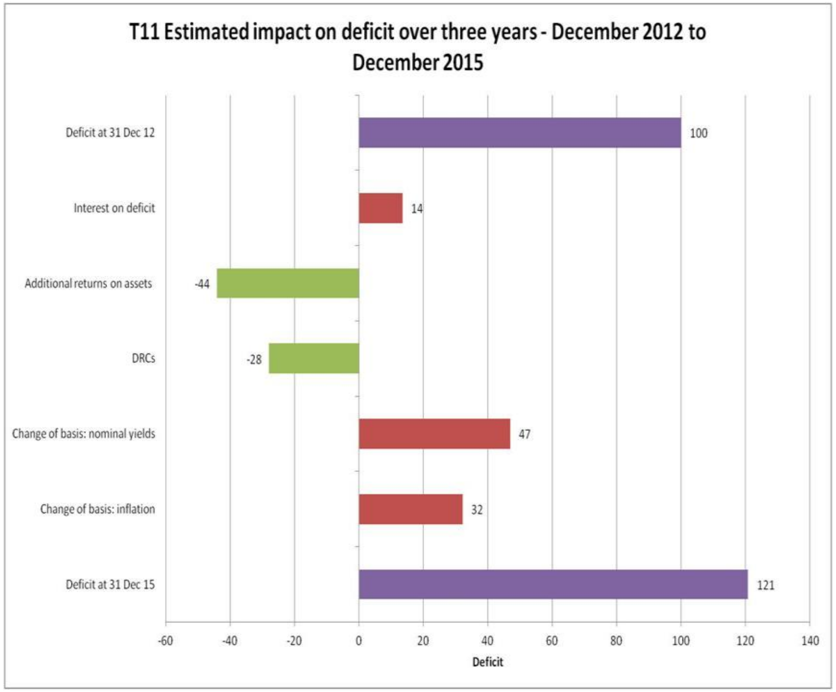
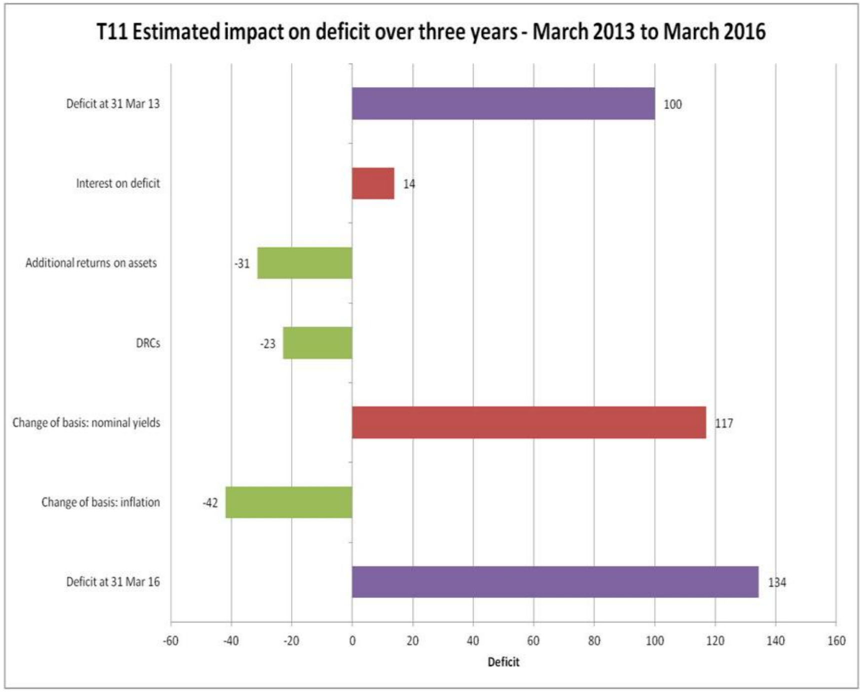
Estimated T11 deficits: key movements

December valuations

March valuations





About 25% of schemes

Source: TPR

About 50% of schemes

- Good asset performance + planned flow of contributions swamped by reduction in real yields
- Valuation dates matter
- And other scheme specific drivers as well.

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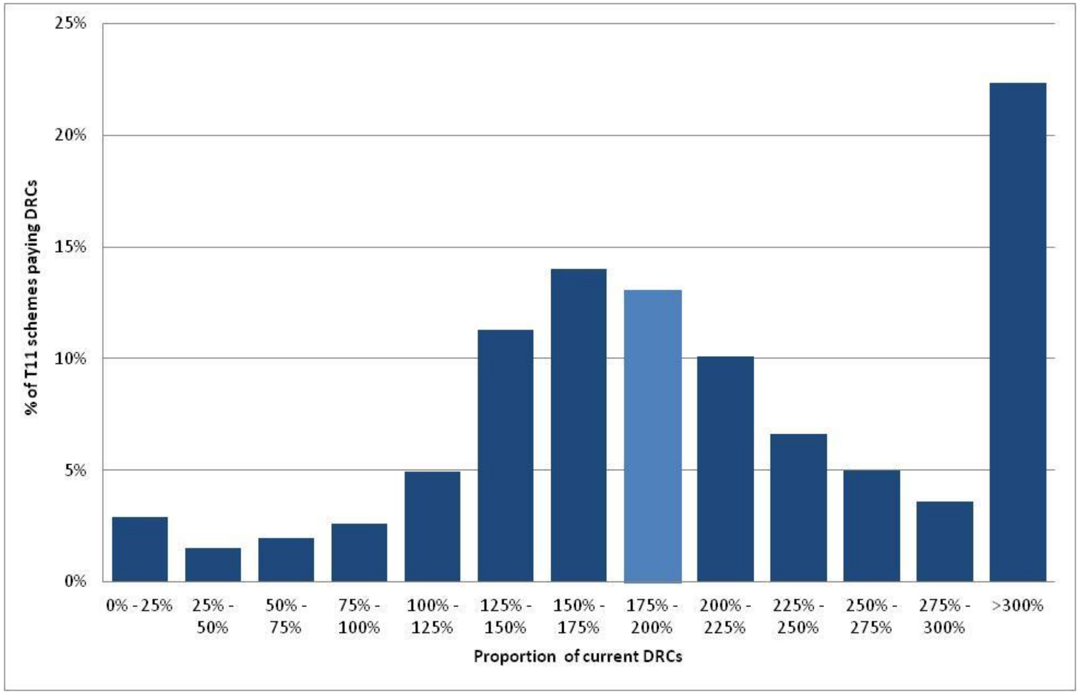
Impact on contributions

(if recovery plan end dates maintained)



Source: TPR

- Some TPR assumptions
- Data limitations – no hedging
- Distortions from small DRCs and RP lengths

- But increase for most and quite severe for some

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Impact on contributions

(relative to sponsor’s profit) RP end dates maintained

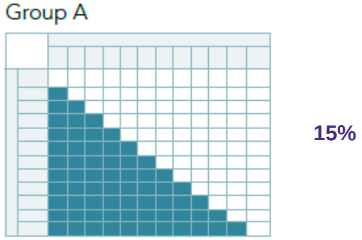
Modelled T11 DRCs as % of latest PBT

Current DRCs as % of 2012 PBT

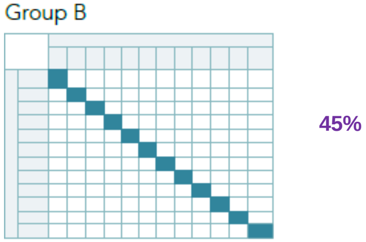
	Zero	0% - 10%	10% - 20%	20% - 30%	30% - 40%	40% - 50%	50% - 60%	60% - 70%	70% - 80%	80% - 90%	90% - 100%	> 100%
Zero	82	69	11	9	5	0	2	2	1	0	0	5
0% - 10%	13	177	65	20	13	11	2	1	0	3	0	13
10% - 20%	2	14	40	30	23	7	11	6	10	2	4	15
20% - 30%	1	4	7	13	14	10	13	8	4	3	4	21
30% - 40%	1	5	7	4	9	11	7	5	6	2	3	20
40% - 50%	1	2	1	3	3	2	8	1	2	4	2	12
50% - 60%	1	0	1	2	3	1	1	2	3	4	3	8
60% - 70%	1	1	1	0	1	0	0	3	2	0	0	15
70% - 80%	1	0	2	1	0	0	1	1	2	1	4	11
80% - 90%	1	1	1	0	1	0	0	0	0	2	0	6
90% - 100%	0	0	0	1	0	0	0	0	0	1	0	10
> 100%	2	3	1	5	4	4	8	1	5	5	5	117

61% of T11 schemes

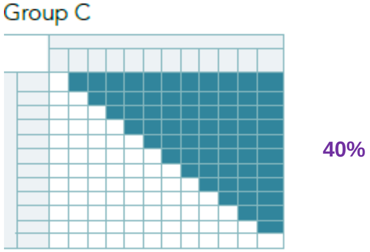
Sources: FAME by Bureau van Dijk and TPR



A –T11 DRCs/PBT < T8



B –T11 DRCs/PBT = T8



C –T11 DRCs/PBT > T8

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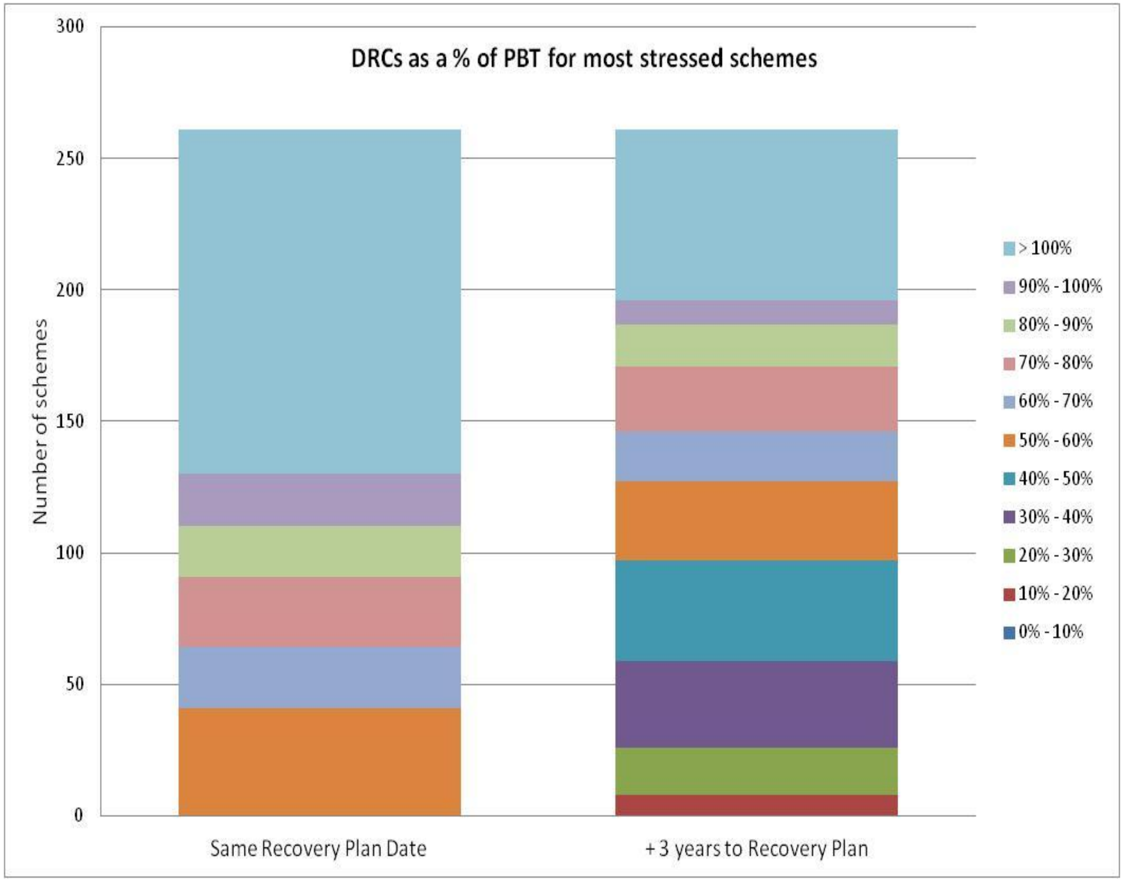
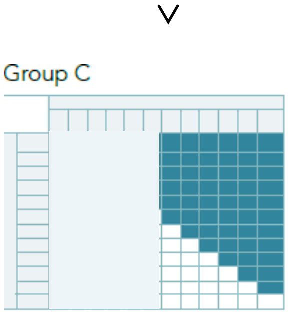
Impact on contributions

(with a 3 yr extension to RP length for the most stressed schemes)



Sources: FAME by Bureau van Dijk and TPR

For the sub-set of Group C for whom the modelled DRCs would increase to over 50% of PBT if recovery plan end date maintained



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Impact on contributions

(relative to sponsor's profit) RP end dates maintained

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Sources: FAME by Bureau van Dijk and TPR

10% of schemes
Are market conditions really the problem?

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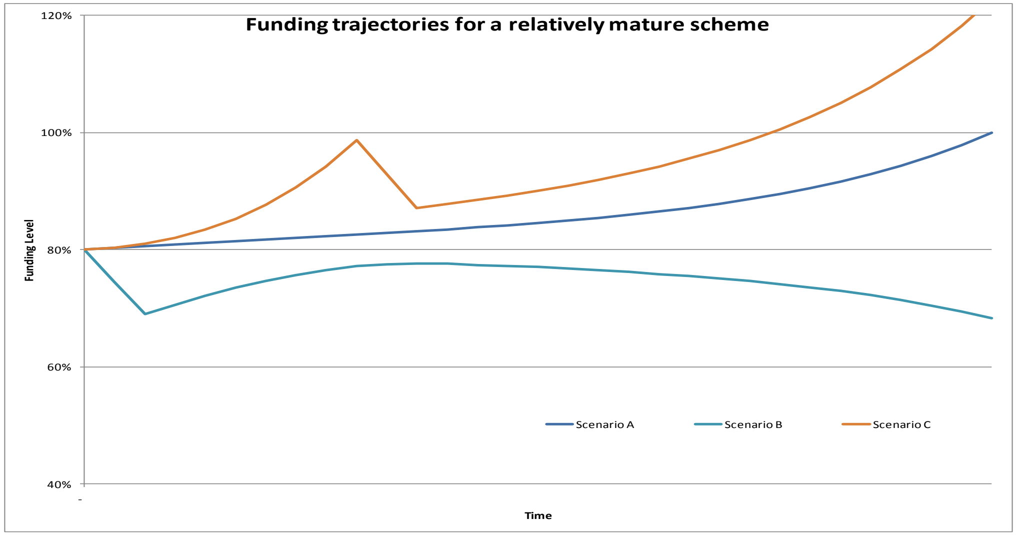
Summary of analysis

- Expect higher deficits, more for March 2016 than December 2015 valuations.
- Sponsor affordability generally improved, but a wide distribution
- Our modelling shows:
  - Around 60% of schemes may be able to afford DRC increases to retain RP end dates, without materially affecting business investment.
  - Another 20% could increase DRCs, but less affordable.
  - A further 10-20% may need to increase recovery plan length, if appropriate, to make it affordable
  - And a pocket of around 10% requiring more complex solutions.

The challenge of scheme maturity



Source: TPR

- Relatively mature scheme
- Same return over the period, but achieved in 3 different ways

- Funding dynamics are different during pay-out phase.
- Differing impacts for different schemes but trustees need to understand and plan for them.
- *Beware mature schemes in deficit waiting to be bailed out by good investment returns – we certainly have many of these in the landscape as the next chart shows*

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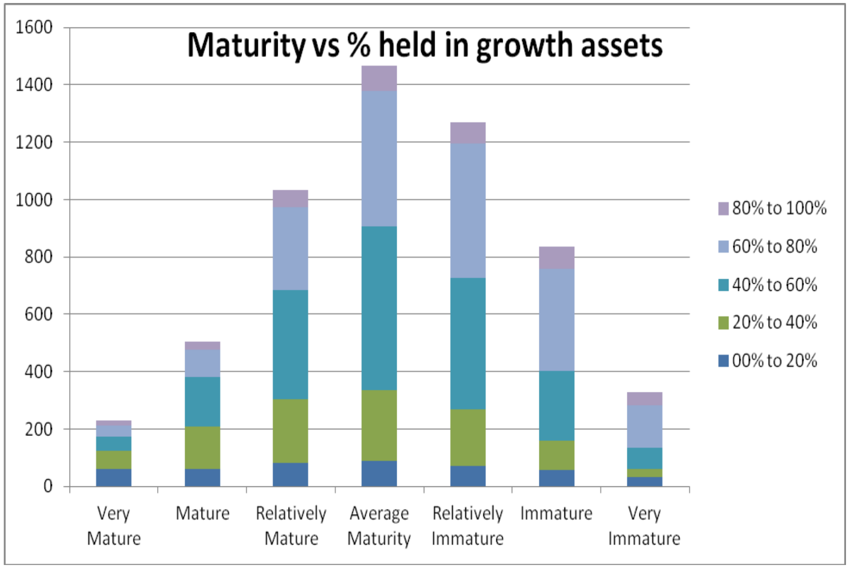
Scheme maturity: a distant problem?



Source: TPR

- Not uncommon even for most mature schemes to be significantly underfunded and taking high levels of investment risk
- Various reasons, among them
    A. Underfunded with little covenant: Need to take risk
    B. Underfunded but have strong covenant : Can support risk
    C. Underfunded but maturity not an immediate issue: Have the time

TPR advice: Think again in context of maturity issues

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2016 Funding Valuations

- General messages
- Tranche specific messages
  - Measurement of deficits
  - Paying for deficits
  - Managing risks
- What you can expect from us

Approaching scheme valuations

- Collaborative working
- Understand the employer covenant; focus on ability to provide support as needed, now and in future
- Understand impact of future economic scenarios on the scheme and sponsor.
- Use IRM principles to put in place appropriate funding and risk management strategies.
- Not necessary to eliminate all risk – but should be appropriate, affordable and monitored.
- Be aware of impending scheme maturity issues and plan for them

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2016 Valuations: Tranche specific messages (1)

Measurement of deficits

- Expect most schemes to set funding strategies based on lower expected investment returns from most asset classes than at previous valuation.
- Reasonable for trustees to update base mortality to CMI2015 if appropriate and with advice on impact of a reversal.
- But recent experience not yet indicative of a change in the long term trend .
- When setting assumptions, be aware of lack of evidence around take up of transfers from DB schemes as a result of ‘pensions freedoms’.

2016 Valuations: Tranche specific messages (2)

Managing deficits

- If you relied on yield reversion at last valuation, consider implementing the contingency plan that was put in place to address any significant adverse impacts.
- Seek higher contributions where there is sufficient affordability for the sponsor, without a material impact on its sustainable growth plans.
- Where this is not the case, trustees and employers should discuss openly the reasons, and the other options.
- If RP is changed to incorporate more risk, consider its potential impact and options to provide security.
- If investment in the sponsor’s business is being prioritised consider whether the scheme is being treated fairly.
- Recognise the increased cost of future accrual in contribution rates to avoid compromising scheme’s risk management and funding plan.
- Understand impact of post-valuation experience and whether to allow in recovery plan

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2016 Valuations: Tranche specific messages (3)

Managing risks

- Do not be overly focussed on short term market movements, instead consider with your advisors the impact on longer-term view of expected risk and returns and how this interacts with your funding plans and risk appetite
- Use your IRM framework to decide how much and when to hedge against risks. Be aware of the implications of un-hedged risk, including tail risks.
- If current conditions have made your risk exposures inappropriate, reconsider the risk/rewards of your current strategy against alternative approaches and put in place mechanisms to identify opportunities to adjust the strategy in a timely manner, as appropriate.
- If continuing to rely on quicker and/or higher yield reversion than implied by the markets then reconsider the implications of it not happening, and have in place a contingency plan.

What you can expect from us

- Proactive engagement continues
- Engagement with schemes - focus on trustees' quality of decision making and contingency planning
- Risk indicators reviewed annually to reflect economic and market conditions
- Further guidance to support the Code
- Analysis of first set of valuations post new Code
- Late valuations – we will take swift enforcement action

Any questions?

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Key points 2016

- Encouraging an understanding of the medium-longer term view given short term volatility in markets;
- Highlighting expectations for investment returns will be lower, including revisiting assumptions on ‘yield reversion’;
- Expecting trustees to seek higher DRCs where there is affordability, but recognise this may not be appropriate for all and risks to changes in recovery plans need to be assessed and managed;
- Encouraging a review of scheme risk management and hedging position in light of market conditions;
- Acknowledging recent decrease in mortality expectations but warn against changes to long term assumptions;
- Being aware of lack of evidence around take up of transfers from DB schemes as a result of pension freedom in setting assumptions;
- Noting that the Cost of future accrual is likely to have increased but should not compromise schemes’ recovery plans.

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21st century trusteeship

May 2016

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21st century trusteeship

Progress to date

- Quantitative research published October 2015
- Further qualitative research on board dynamics and trustee training
- Stakeholder workshops in December and January
- Observations of trustee board meetings from November to January

Next steps

Discussion paper considering how government, regulatory bodies and the pensions industry can raise standards of trustee competence and effectiveness, increasing the likelihood that members’ retirement savings are in good quality, well-governed schemes.

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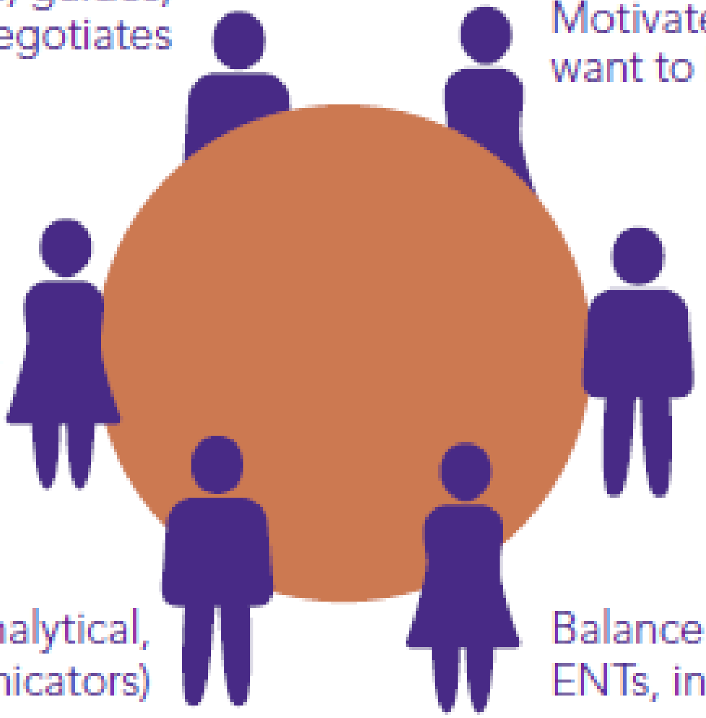
The makeup of an effective trustee board



Chair who leads, guides, challenges and negotiates

Motivated individuals who want to be trustees

Balance of personalities to work well together

Balance of skills and experience

Personal attributes (analytical, challenging, good communicators)

Balance of interests (MNTs, ENTs, independents)

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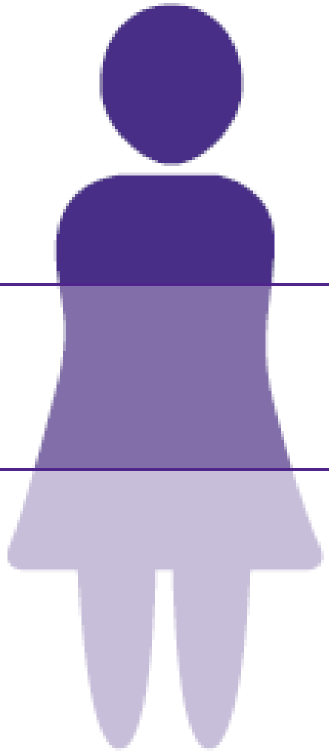
Essential qualities for an effective trustee



Governance skills and personal qualities	'Soft skills' and effective communication, such as: inquisitiveness, analytical skills, ability to challenge and scrutinise, being quick to understand, absorb and apply knowledge and information
Technical knowledge	Technical knowledge of pensions and an understanding of the trustee role
Motivation to undertake the role	Without an interest, other qualities are almost useless

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Observing effective boards

- Seeking examples of **good practice**; focusing on key **behaviours** and **practices** of **effective trustees**

- Gaining deeper insight into the **issues** and **challenges**

Key themes of effective governance:

Roles and responsibilities

Structure and composition

Purpose and strategy

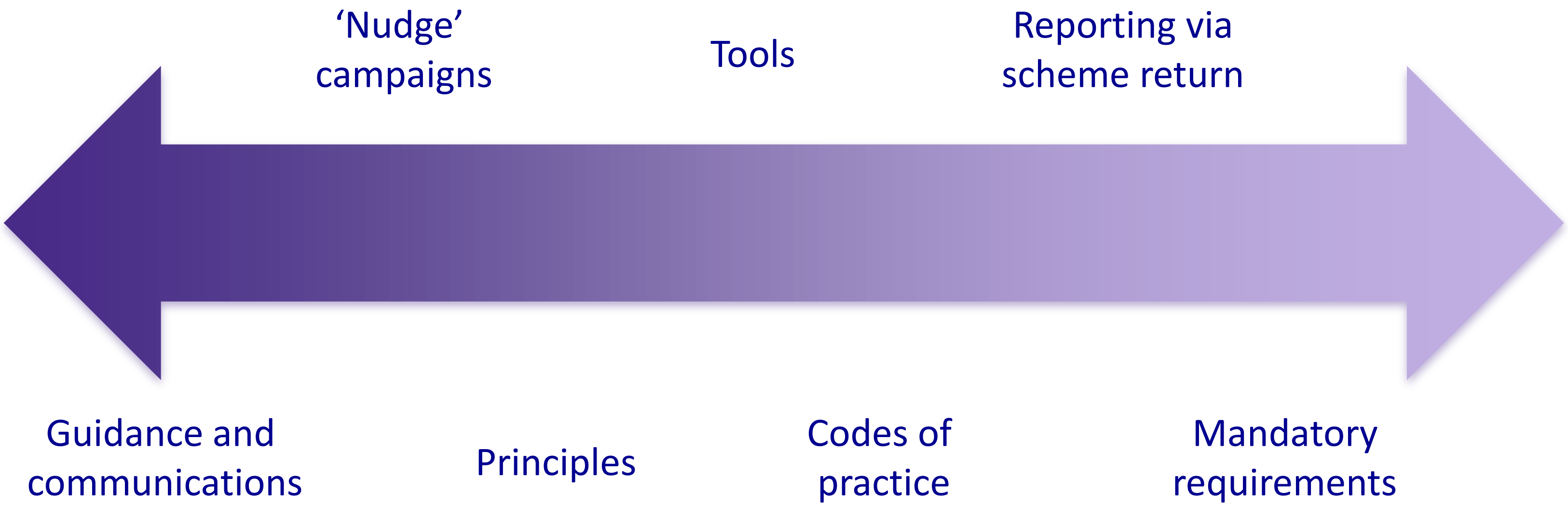
Effectiveness and evaluation

Accountability and integrity

Engaging and reporting

Observing effective boards

- What should a 21st Century trustee look like?
- And what should be our regulatory approach?
- Range of options from light-touch to more burdensome



'Nudge' campaigns

Tools

Reporting via scheme return

Guidance and communications

Principles

Codes of practice

Mandatory requirements

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Any questions?

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