2016 Funding valuations

Chinu Patel
The Pensions Regulator

ACA Sessional Meeting, Leeds

Tuesday 3 May 2016

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Preview of 2016 Annual Funding Statement

1. Share some of the analysis which has informed this year's statement
2. Key messages for trustees carrying out Tranche 11 valuations (Sept 2015 – Sept 2016)
3. What you can expect from us by way of engagement with schemes, and other things we are working on
4. Questions and discussion

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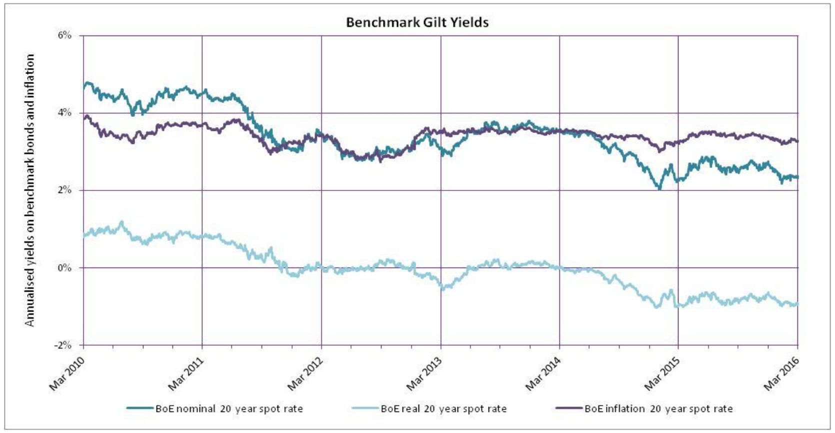
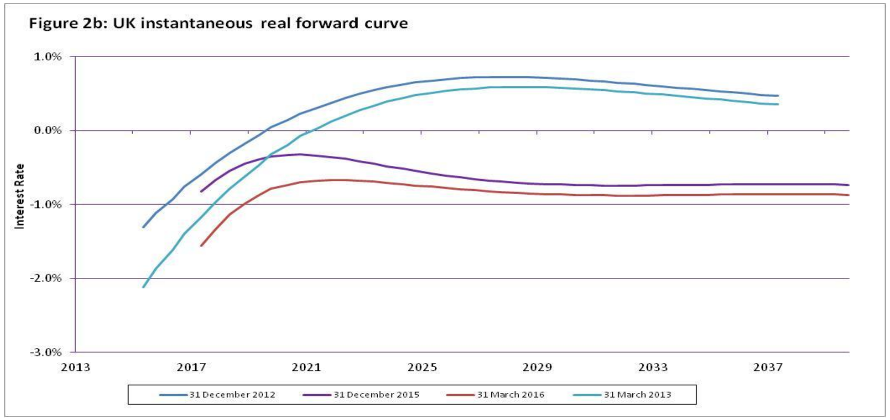
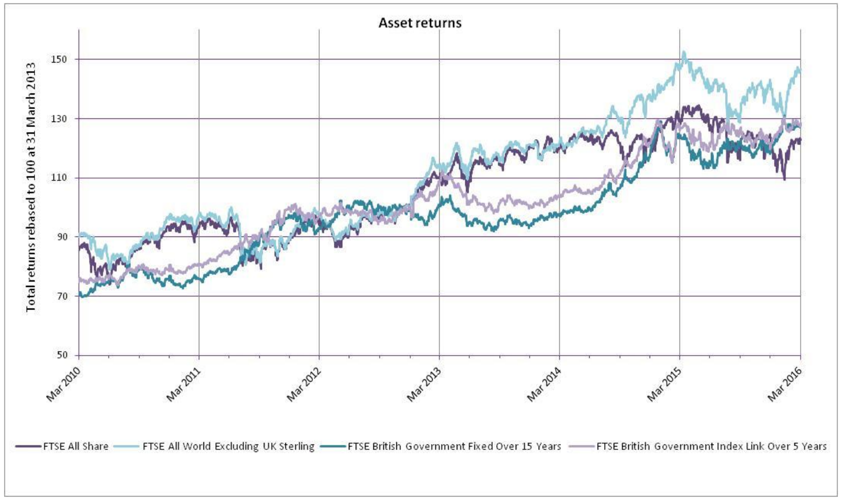
Financial conditions: past three years







- Reduced nominal and real yields
- Good investment returns

.... but not enough for most schemes

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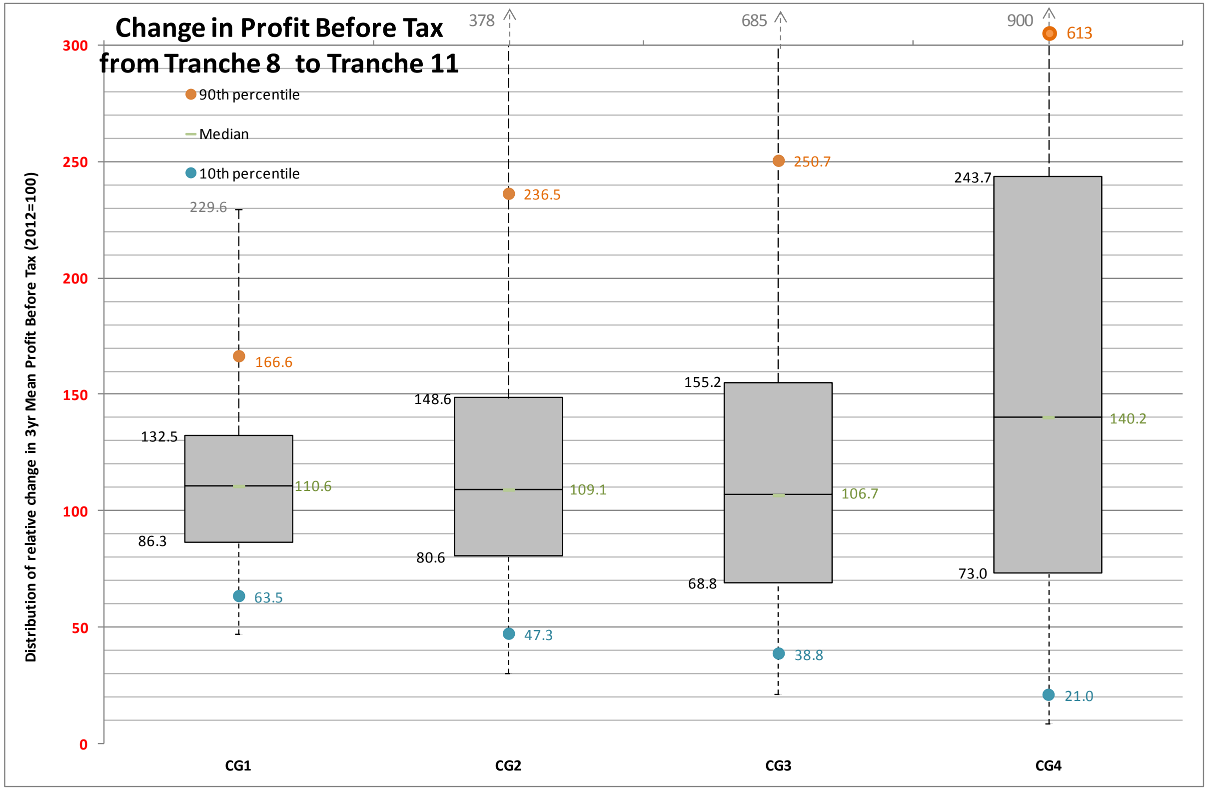
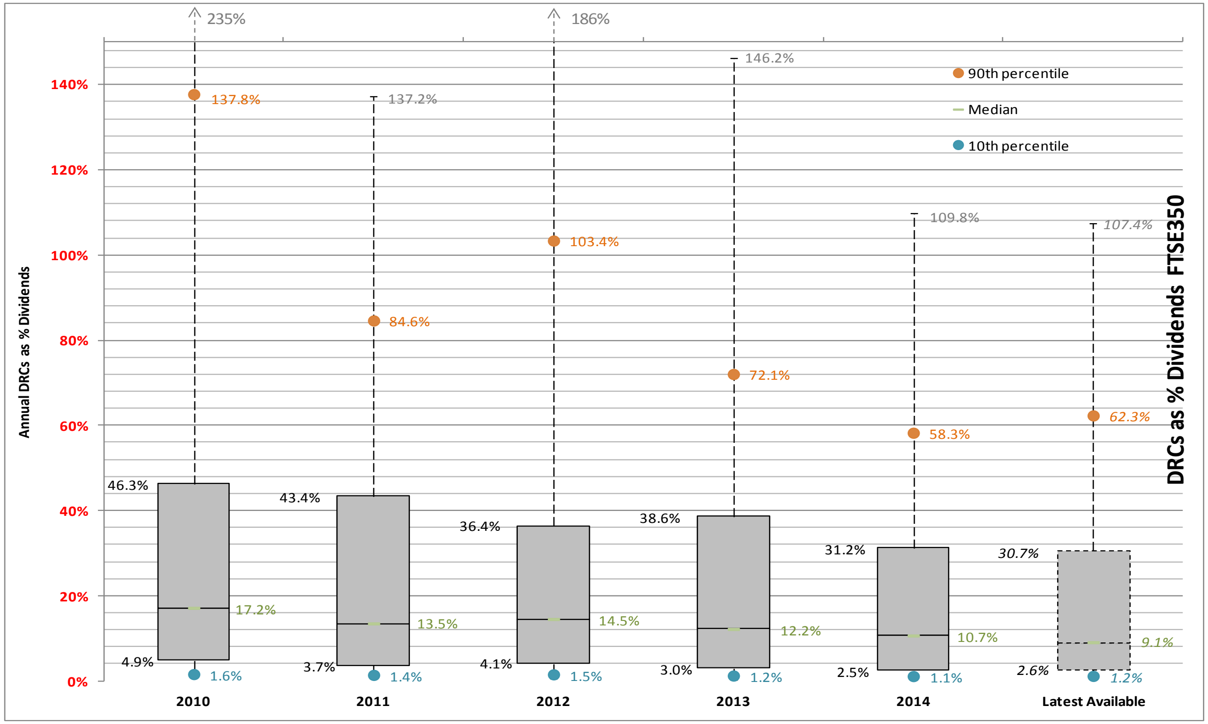
Affordability (1): General trends in PBT



- Improved trends, but wide variation
- PBT not the only measure

Affordability (2): DRCs vs dividends



- Dividend pay-outs appear to have 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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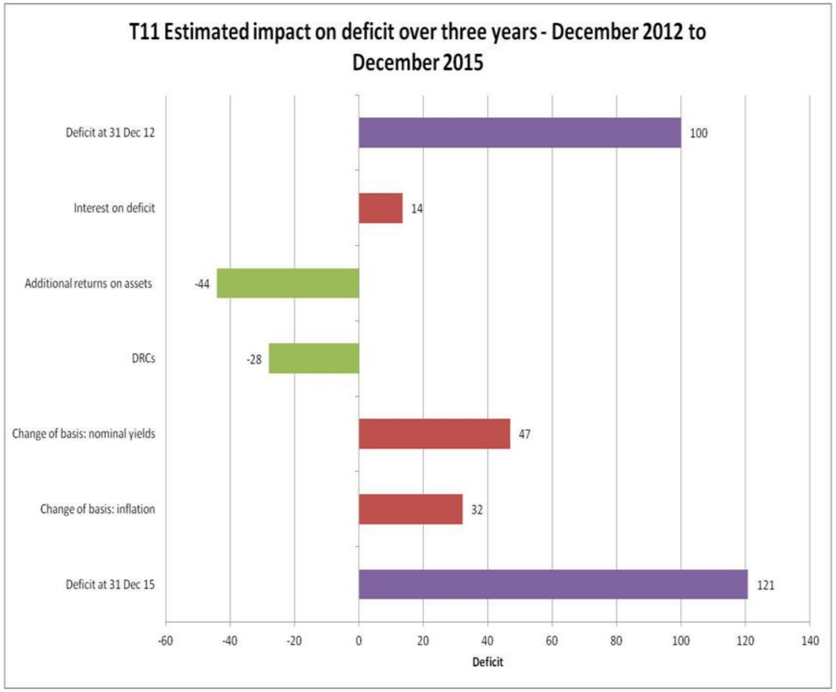
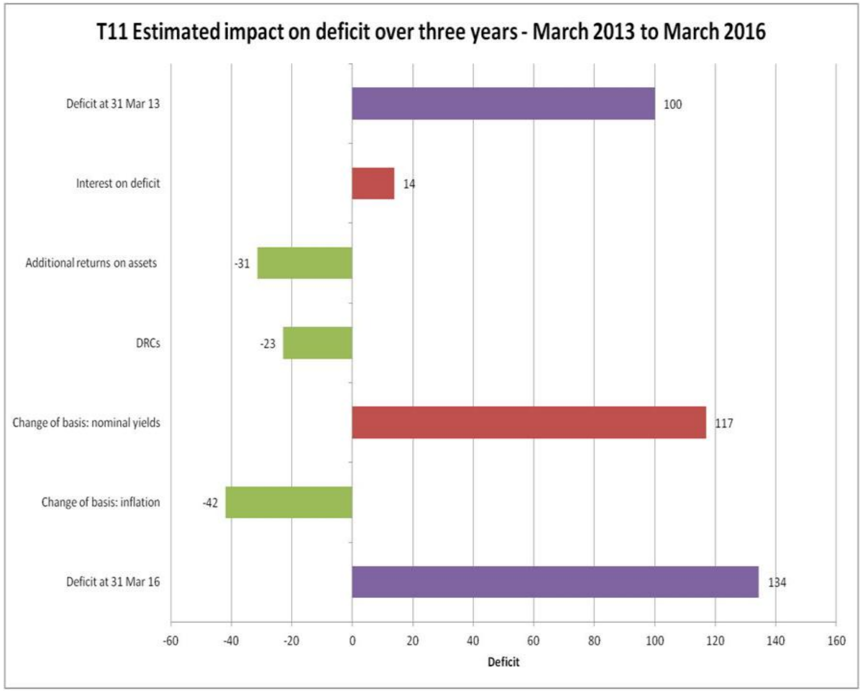
Estimated T11 deficits: key movements

Dec valuations



About 25% of schemes

Mar valuations



About 50% of schemes

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

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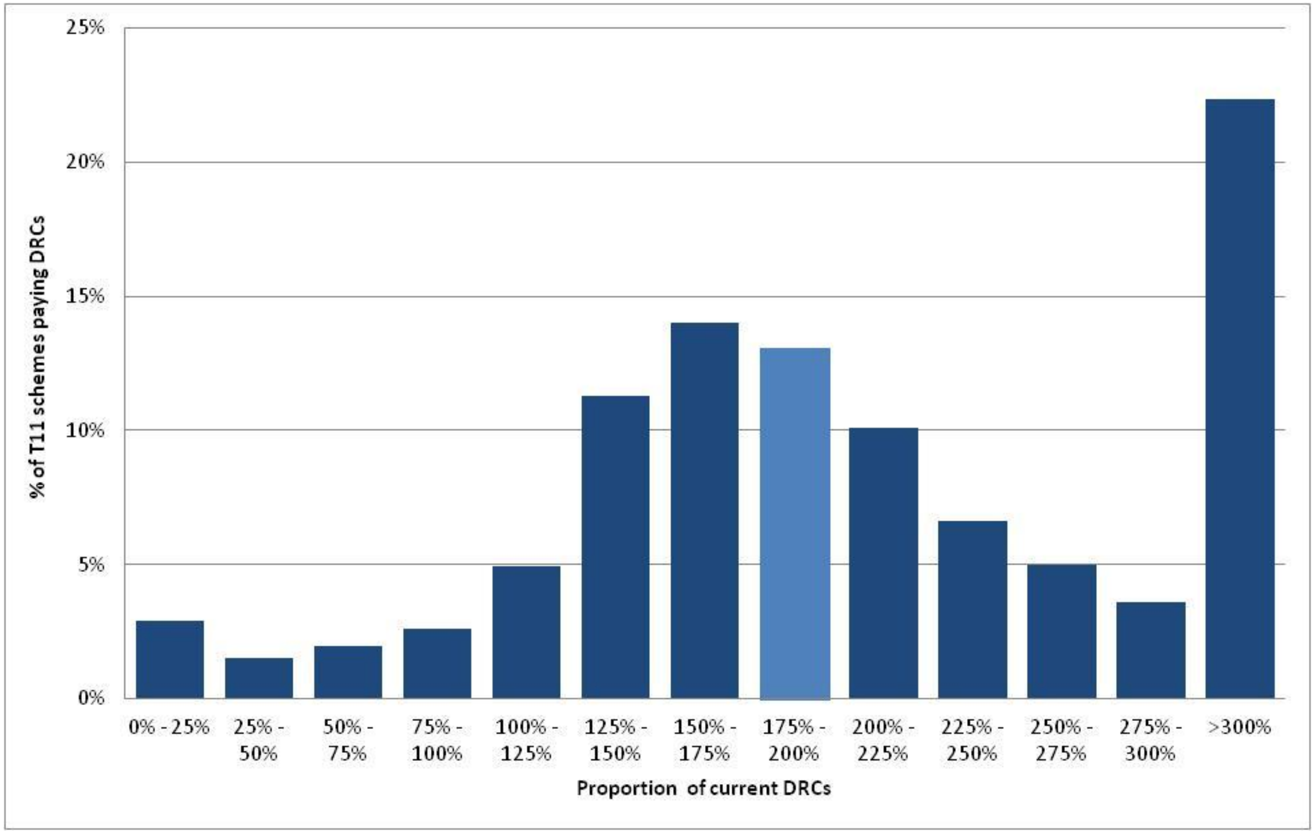
Impact on contributions
(if recovery plan end dates maintained)



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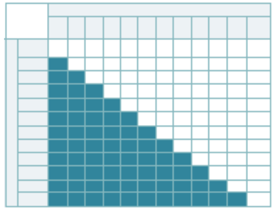
Impact on contributions

(relative to sponsor’s profit)

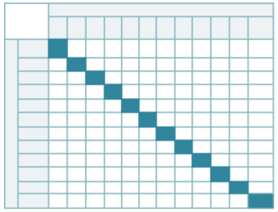
Current DRCs as % of 2012 PBT	Modelled T11 DRCs as % of latest PBT											
	Zero	0% - 10%	10% - 20%	20% - 30%	30% - 40%	40% - 50%	50% - 60%	60% - 70%	70% - 80%	80% - 90%	90% - 100%	> 100%
Zero	82	69	11	9	5	0	2	2	1	0	0	5
0% - 10%	13	177	65	20	13	11	2	1	0	3	0	13
10% - 20%	2	14	40	30	23	7	11	6	10	2	4	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

Group A



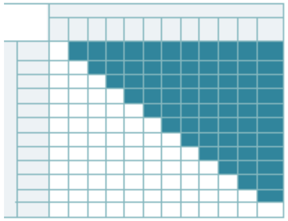
A –T11 DRCs/PBT < T8

Group B



B –T11 DRCs/PBT = T8

Group C



C –T11 DRCs/PBT > T8

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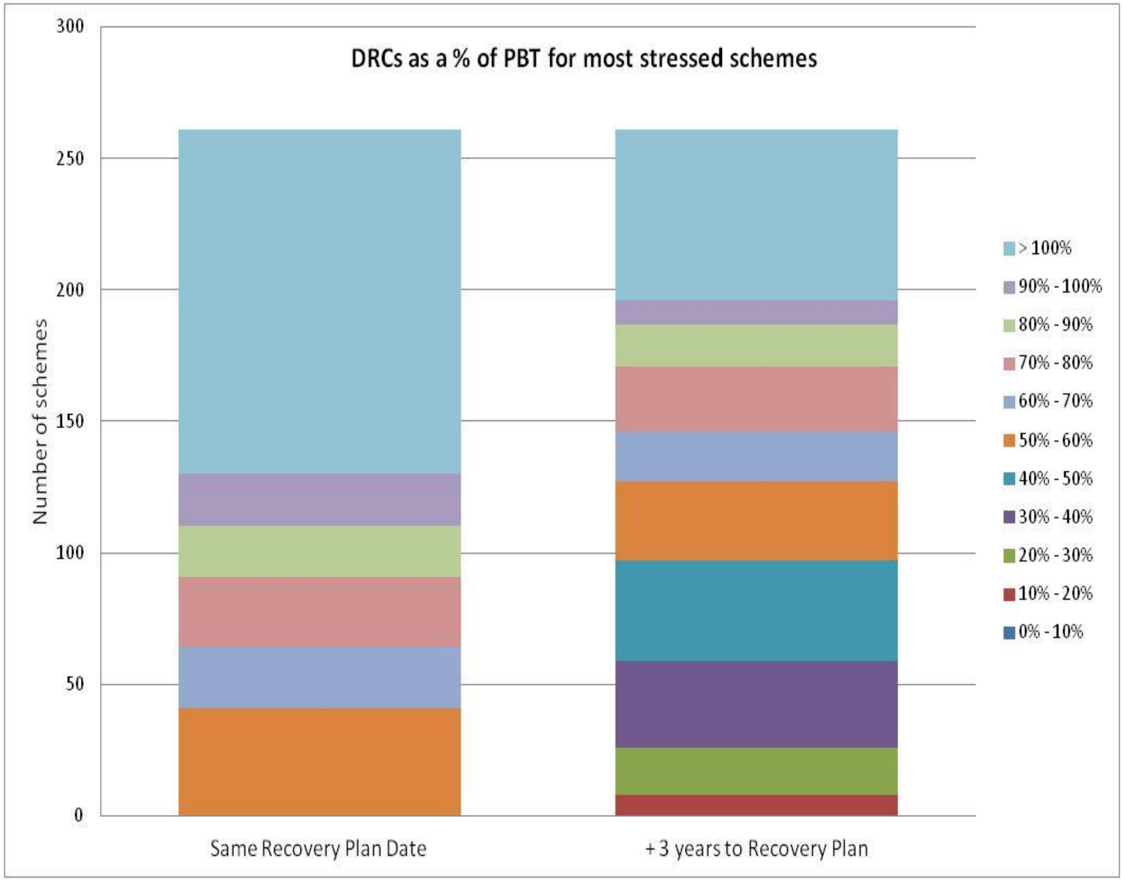
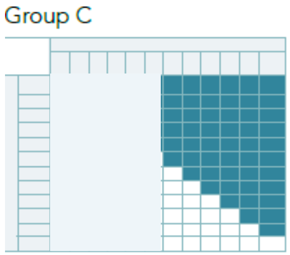
Impact on contributions

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



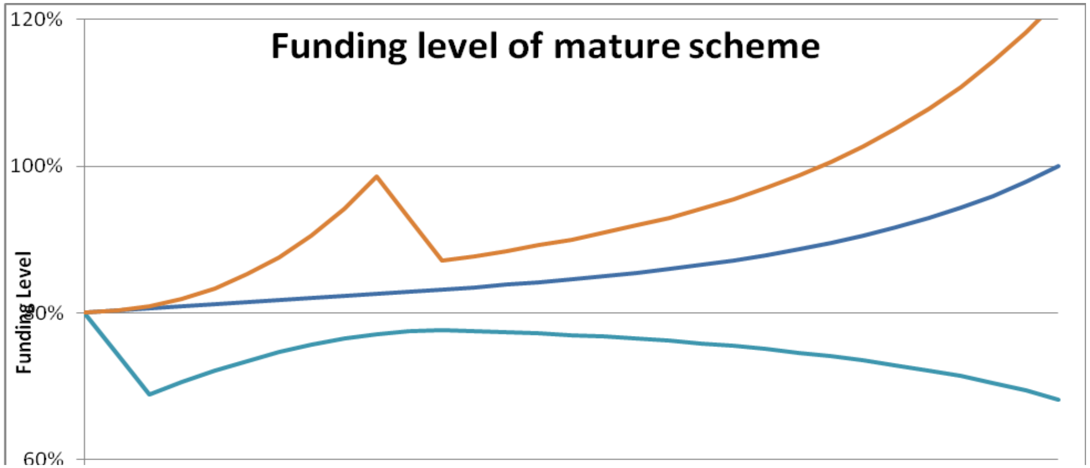
For the sub-set of Group C for whom the modelled DRCs would increase to over 50% of PBT if recovery plan end date maintained



Summary of analysis

- Assets have done well but liabilities have grown faster and so we expect higher deficits, more for March 2016 than Dec 2015 valuations.
- Sponsor affordability generally appears to have improved, but there is a wide distribution
- Our modelling shows that:
  - 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 to make it affordable
  - And there will be a pocket of around 10% requiring more complex solutions.

The challenge of scheme maturity



- Relatively mature scheme
- Same (best estimate type) return over the period, but achieved in 3 different ways

- Funding dynamics are different during pay-out phase.
- Differing impacts for different schemes but they 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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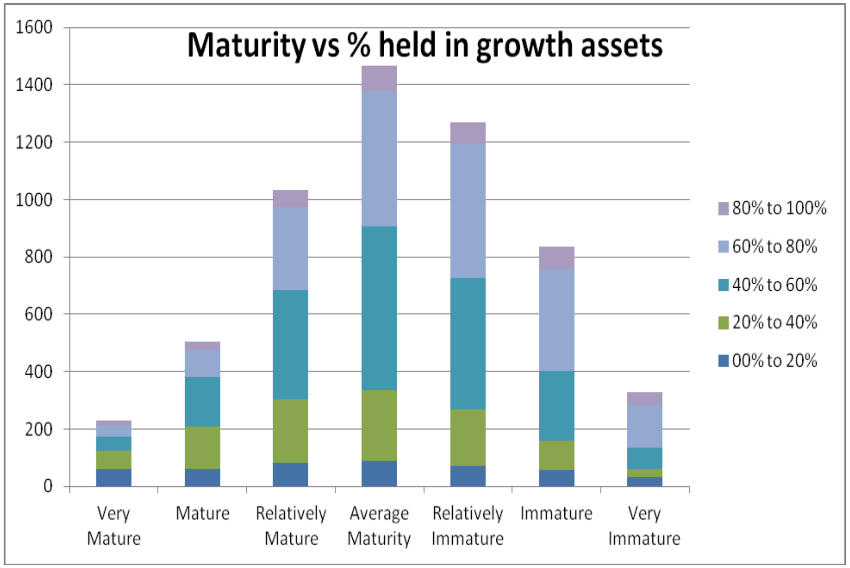
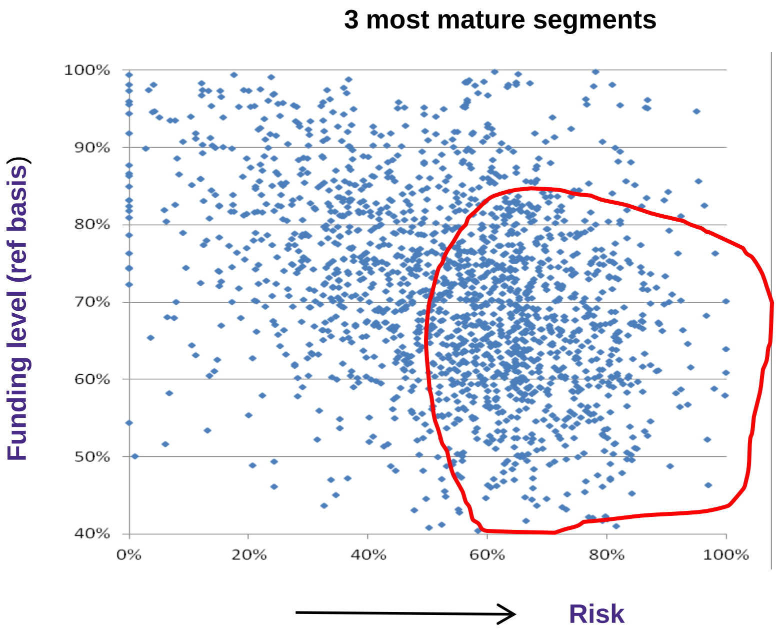
Scheme maturity: a distant problem?





- Not uncommon even for most mature schemes to take 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

2016 Valuations: General messages

- Collaborative working between trustees, sponsor and advisors to understand risks in the funding strategy and potential actions under different scenarios. Document decisions, reasons and supporting analysis
- Understand the employer covenant, with a focus on sponsor's ability to provide financial support as needed, both now and in future
- Understand the impact of future economic scenarios on the scheme and sponsor. Measure the sensitivity, its impact on scheme funding, the potential calls on the sponsor and their ability to provide support in those scenarios.
- Use IRM principles to put in place a funding and risk management strategy which is integrated across the three areas of funding, investment and employer covenant.
- Not necessary to eliminate all risk, but use IRM to ensure risk taken is properly understood, well monitored and appropriate to the scheme and sponsor.
- Be aware of impending scheme maturity issues which could put pressure on scheme's funding and investment strategies and/or the sponsor's business. Understand when liquidity could become an issue and plan for it.

2016 Valuations: Tranche specific messages (1)

Measurement of deficits

- We expect that most schemes will set funding strategies based on lower expected investment returns from most asset classes than at their last valuation.
- We would consider it reasonable for trustees to update base mortality to CMI2015 if they consider it appropriate after taking advice on the impact of a reversal in the coming years. But we consider it unlikely at this stage for the long-term improvement assumption to be reduced until it is clearer that recent experience is 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)

Paying for deficits

- Trustees who at their last valuation took account of yield reversion, should now consider implementing the contingency plan the contingency plan they should have put in place to address any significant adverse impacts.
- We expect trustees to 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, it is important for trustees and employers to discuss openly why current levels of contributions cannot be increased.
- Where the recovery plan is changed to incorporate more risk the trustees and employer should consider the potential impact of these additional risks, and the options available to provide security against them.
- If investment in the sponsor’s business is being prioritised consider whether the scheme is being 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.
- Contribution rates should recognise the increased cost of future accrual and not compromise the scheme’s risk management and funding plan.
- Understand impact of post-valuation experience and whether to allow in recovery plan

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
- 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.
- If continuing to use assumptions about quicker and/or higher yield reversion than implied by the markets then reconsider the implications of it not happening, and have in place a plan for the potential mitigating actions.

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

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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Any questions?

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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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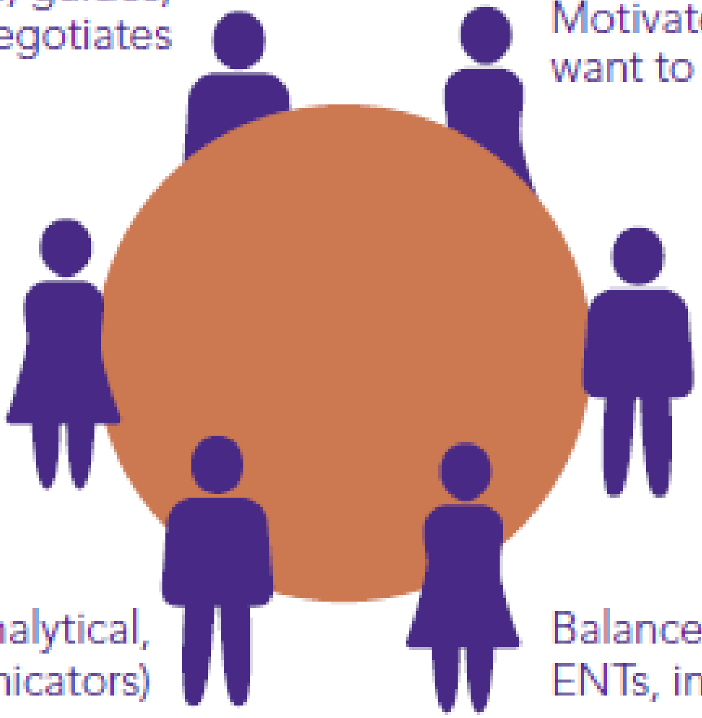
The makeup of an effective trustee board



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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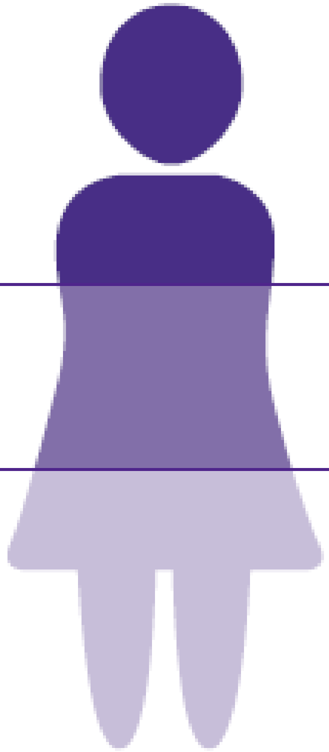
Essential qualities for an effective trustee



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

Any questions?

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