TPR's 2016 funding statement

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Introduction

TPR has published its annual funding statement for 2016. Although relevant to trustees and employers of all DB pension schemes, it is primarily aimed at those carrying out valuations with effective dates in the period from 22 September 2015 to 21 September 2016 (referred to as “Tranche 11”).

Key points

- TPR’s funding statement highlights key principles of the DB funding code and provides guidance as to how sponsoring employers and trustees of DB schemes can agree appropriate funding plans.
- Based on its accompanying analysis, TPR generally expects most schemes to have larger deficits this time around, but considers that the majority of employers should be in a position to increase contributions.
- Trustees need to consider the impact of a number of different risks which affect their scheme’s level of funding, including market volatility, investment returns and affordability.
- An integrated risk management approach is seen by TPR as key to understanding a scheme’s exposure to these different risks.
- TPR reminds trustees that their decisions should be documented, together with reasons for those decisions and references to key supporting analysis.

TPR’s analysis and impact for scheme funding plans

The statement is accompanied by TPR’s analysis of the expected funding positions of Tranche 11 schemes, based on data submitted by schemes in their annual returns.

TPR’s main findings since the last valuation date are that:

- schemes are likely to have seen most major asset classes performing well, but wider concerns for global growth and reductions in the nominal and real yields are likely to have a significant impact on expected

returns across various asset classes over the medium and longer term

- the majority of sponsoring employers have seen an increase in the nominal value of their profits and balance sheets over the last three years. That said, not all companies have seen such improvements and, for many others, there may have been a decline over the period
- the ratio of deficit repair contributions (DRCs) to dividends has declined over the last five years, to the extent that more than half of FTSE350 companies paid out ten times or more to shareholders than to their scheme.

As such, TPR's modelling suggests that for schemes to maintain their existing recovery plan end date, an increase in DRCs is likely to be needed. However, for the majority of sponsors, the revised DRCs compared to profits appear to TPR to be "relatively low and/or no higher than at their scheme's last valuation". TPR therefore believes that such an "increase may be affordable for the majority of sponsors without materially affecting their plans for sustainable growth".

Key issues to consider

For schemes working on valuations now, TPR explains that trustees will need to take account of various factors. These include:

Market volatility

The upcoming referendum on whether the UK should remain a member of the EU is one factor currently contributing to market volatility. However, whilst volatility can have a material impact on a scheme's reported funding position, trustees should 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, rather than concentrating on short-term market movements.

Trustees should also understand the impact of changes in market conditions since their valuation date and consider whether to take post-valuation date experience into account when setting an appropriate recovery plan.

Investment returns

TPR expects that, given current market conditions and expectations for the medium to longer term, most schemes will set funding strategies based on lower expected investment returns from most asset classes since their last valuation.

For trustees who continue to assume that gilt yields will revert to a higher level and/or sooner than implied by the markets (known as "yield reversion"), TPR recommends that they reconsider their assumptions in the light of market developments, including considering the implications of yield reversion not happening in practice. Likewise, those trustees who took account of yield reversion at the last valuation "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

As most schemes are likely to be facing larger deficits than anticipated at the last valuation, TPR recommends that trustees and employers 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.

TPR's analysis suggests that increasing contributions with a view to maintaining a recovery plan's end date should be affordable for many sponsoring employers. However, where affordability is an issue, other adjustments may be needed, such as extending the recovery plan's length. If changes to the recovery plan result in the scheme running a higher level of risk, TPR stresses the need for trustees and employers to consider the potential impact of such risks and the options available to provide security against them.

Integrated risk management

TPR reminds schemes that a proportionate approach to risk management is an important part of the valuation process and key to understanding a scheme's exposure to risk across employer covenant, investment and funding. TPR's IRM guidance explains how trustees can go about putting a strategy in place which is integrated across these three areas.

When approaching a valuation, there are a number of risks to take into account, including:

- **changes in the strength of the sponsor's covenant:** this should focus on the ability of the sponsor to provide financial support to the scheme, both now and in the future
- **the sensitivity of a scheme's assets and liabilities to different future economic scenarios:** trustees should consider with their sponsors what action might be taken in these scenarios and assess what the potential calls on the sponsor for additional financial support might be
- **liquidity planning and cash flow management:** as market developments can mean that schemes are forced to sell assets at lower than expected prices to meet cash flow demands, trustees need to understand when liquidity could become an issue and have appropriate cash flow management plans in place.

Whilst TPR recognises that not all risks can be eliminated, it reminds trustees that an IRM process will help them ensure that the level of risk being taken is properly understood, well monitored and appropriate to both the circumstances of the scheme and the sponsoring employer.

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