HYMANS ROBERTSON

Sixty second summary

DB annual funding statement 2017

The Pensions Regulator has published its annual funding statement for the trustees and employers of defined benefit schemes, in particular those due to produce valuations with effective dates falling in the year to 21 September 2017.[1] The Regulator is notably clear about its yardsticks for this round of valuations, establishing a basis for action against those who do not meet its expectations.

Affordability & deficit management

The Regulator expresses different expectations depending on the attributes of the particular scheme and its sponsor(s). It reckons that around eighty-five to ninety per cent of the schemes with valuations due are currently sustainable, with sponsors that are capable of managing their deficits. Schemes with strong employers, that seem set to meet their funding objectives, have robust technical provisions, and recovery plans that are not protracted are expected to at least keep to their current pace of funding, and not extend their recovery plans without justification.

Schemes with strong employers but weaker technical provisions and extended recovery plans are expected to ask for higher contributions. Those with weaker employers are warned that they should only take risks based on the expectation of support from the wider corporate group if that backing is legally enforceable; the Regular thinks that around eight per cent of schemes in the target audience are taking risks disproportionate to the strength of statutory employer.

Trustees are told to consider whether an absence of clarity over the strength of the employer covenant over the longer term brings additional risks to their schemes.

Particular attention will be given to ensuring that schemes receive 'fair treatment' from their sponsors. Interventions are likely if recovery plans are extended unnecessarily, or shareholders are prioritized over scheme funding obligations. If distributions to shareholders (for example, dividends and share buy backs) exceed deficit recovery contributions, the Regulator will expect to see relatively brief recovery plans and investment strategies that do not assume high levels of outperformance.

Valuation methodology

The Regulator nods toward the current debate about valuation discount rates that has been prompted by the prolonged period of low gilt yields, but does not take a side. It says that many of the schemes in the target audience will have larger-than-anticipated deficits, with investments that have performed well, just not enough to outweigh the increase in their liabilities. Noting the opposing arguments, it says that it expects trustees to review their discount-rate approaches based on '*robust*' actuarial advice, in the context of their current circumstances and long-term funding plans, and to have a '*sound rationale*' for whatever decision they come to.

[1] <www.thepensionsregulator.gov.uk/docs/db-annual-funding-statement-2017.pdf>.

Risk management

The Regulator continues to encourage integrated risk-management approaches, with a particular emphasis on the need for all schemes to agree legally enforceable contingency plans with their scheme sponsors. Those that find themselves in a worse-than-anticipated position are now expected to put their plans into operation: the Regulator says that '*decisive action*' is required if successive valuations have shown that funding is on a downward trajectory, or schemes have experienced '*significant adverse impacts*'.

Stressed schemes

The Regulator estimates that five per cent of those with valuations due have employers that are unlikely capable of supporting the scheme. However, it says most of those sponsors are not imminently at risk of insolvency, so that '*regulated apportionment arrangements*' (a means of severing ties to the scheme) are not available. It expects the trustees to seek the best possible funding outcome in the circumstances, and to be able to show that, amongst other things, they have critically analysed the employer's justification for any dividend payments, maximized the availability of non-cash forms of support and, if they have the power, considered whether winding up would be in members' best interests.

Small schemes

The Regulator intends to increase its efforts in relation to smaller schemes, with an emphasis on member protection. It encourages the trustees of such schemes to reconsider their options for investment and risk management, noting that developments in the industry may have put previously unavailable arrangements within their reach.

Investment

The Regulator warns trustees to expect it to intervene if their investments are insufficiently diversified or they are otherwise taking too much risk.

Cash-flow management

The Regulator emphasizes need for schemes, especially the more mature ones, to anticipate and monitor their cash-flow needs and establish appropriate cash-flow management policies.

Intervention

The Regulator plans to identify the riskiest cases, and intervene *before* recovery plans are submitted. Recognizing that clarity is desirable, it warns trustees and employers to expect rapidly escalating intervention, involving its full range of powers, in the event of compliance breaches.

The Regulator will be stricter about failures to obtain valuations by the statutory deadline (fifteen months after the effective date). Enforcement is likely to be particularly rigorous if delays were predictable or if trustees are not open and cooperative about the breach.

This year's statement is notable as much for its tone as for its content. In response to the criticism that it has garnered for its involvement in the BHS affair, the Regulator seems determined to bare its teeth. And in the shadow of a DWP Green Paper that considered the need for changes to the legal framework, it appears intent upon applying the current legislation with a firmer hand so as to obviate the need for reform.