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Regulator publishes its annual funding statement 2020

At a glance

An important statement on DB funding has been issued by the Pensions Regulator

Somewhat later than intended, due to the Covid-19 outbreak and the accompanying dramatic changes in financial markets, the Pensions Regulator has issued this year's DB funding statement. As in previous years it sets out the Regulator's key messages for trustees and sponsors who are undertaking valuations at the current time. It is consistent with previous statements, but with a greater focus on the covenant aspect of integrated risk management.

The Regulator also wants trustees and employers to work together to manage the immediate effects of Covid-19 with a focus on long-term planning and risk management to protect savers. It also says that it is *"here to support and provide guidance to businesses and trustees"* and to ensure savers are protected.

Key Actions

Trustees and sponsors, especially those currently carrying out or approaching a valuation

- Read the statement, establish which type your scheme most closely resembles and assess whether the statement affects the current approach being taken in relation to covenant, investment and funding issues.
- If not already done so, draw up a long-term goal for paying the promised benefits, set a consistent long-term funding target (LTFT) in relation to this goal, and establish a journey plan for progressing to the LTFT, ensuring that investment and funding strategies in the interim period are also aligned.
- Check whether the scheme is being treated fairly compared to other stakeholders.

The Detail

It applies to valuations being carried out at the current time – as well as certain other schemes

On 30 April 2020 the Pensions Regulator issued its annual funding statement, aimed at trustees and sponsors of DB schemes. The statement is focussed on valuations with effective dates between 22 September 2019 and 21 September 2020 as well as schemes undergoing significant changes that require a review of their funding and risk strategies.

The statement comes, once more, ahead of the new powers that the Regulator should be getting in the scheme funding arena and the new Code of Practice on funding defined benefits, as a result of the Pension Schemes Bill currently before Parliament and the Regulator's funding consultation document issued in March. Although it is inevitably very much influenced by how the new funding regime is intended to operate, the Regulator confirms that all valuations subject to this statement *"will be regulated according to the requirements of the existing legislation and guidance"*.

It is clearly influenced by the shape of the new DB funding regime before Parliament and under consultation

The statement remains as lengthy as last year's, and this time round is divided into three parts. Once more, the bulk of the document comprises tables setting out a segmentation of DB schemes containing the key risks that trustees and employers should focus on and actions they should take depending on the characteristics of the scheme and sponsor. The tables are word for word identical to those in last year's statement. However, what may differ is the category in which trustees place their schemes and so the actions they should now be taking.

And is in three parts

The Regulator promises to publish the analysis supporting this statement, which may not follow the same format or have the same content as in previous years, in the summer. It is also possible that the Regulator will issue further guidance in the autumn. Separately, its second consultation on the new funding regime will now not take place until 2021.

1. Scheme specific considerations

After saying a few words about Covid-19 and how funding positions are likely to have developed, the statement turns to five "scheme-specific considerations" as follows:

First, a checklist of funding points particularly relevant at the current time

- **Post valuation experience** – schemes with valuation dates around 31 December 2019 or earlier are asked to consider taking into account post valuation experience when preparing their recovery plans.
- **Changing the valuation date** – schemes with valuation dates on or around 31 March 2020 that may be considering whether to bring forward the valuation date to when conditions were considered to be more normal, such as December 2019, are asked to consider very carefully, having taken legal and actuarial advice, whether this is in the best interests of scheme members. Trustees who decide to proceed can expect the Regulator to question their reasons for change.
- **Calculating technical provisions** – March and April 2020 valuation dates *"will be challenging"*, with many trustees not having sufficient information to form a reliable view of future investment returns and the employer covenant and affordability. Trustees should consider exploring a range of possible scenarios when setting assumptions, whilst preliminary valuation work (such as data preparation and validation) is undertaken.
- **Recovery plans and affordability** – trustees are asked to work collaboratively with the employer to carry out additional due diligence on the employer's financial position, in accordance with the Regulator's Covid-19 guidance, obtain specialist

advice as appropriate, and form their own assessment of the employer covenant strength. They should then deal with any changes in pension deficits in this light and seek to recover deficits "*with a focus on the affordability of the employer*" (while maintaining fair treatment and balancing of the sustainable growth of the employer).

The Pensions Regulator provides examples of different contingent contribution arrangements to be explored by trustees to protect the scheme.

- **Shareholder distributions** – many distributions will have ceased or have been significantly reduced. When they recommence, the Regulator expects liquidity and affordability to have been largely restored and recovery plans to reflect that position. So where significant reductions in DRCs are agreed to support the employer, the Regulator spells out three clear expectations of trustees – around contingent contributions and/or dividend blocks, restrictions on the use of this additional liquidity and the repayment of deferred contributions – whose purpose is to ensure that the scheme is treated fairly as the company recovers.

Our viewpoint

This list is a mixture of hints, warnings, practical suggestions and demands, with the Regulator clearly concerned that trustees may take their eye off the ball when it comes to employer covenant, corporate recovery and the scheme obtaining a fair share of available cash.

2. What the Pensions Regulator expects of trustees

Once more the Pensions Regulator stresses that paying the promised benefits is the key objective for all schemes and that it is important for trustees to look ahead, set clear plans for how this objective will be delivered and then manage its delivery within an integrated risk framework.

Then two specific areas before the tables come into view

Long-term funding targets

Consistent with last year's message and the direction of travel of the Pension Schemes Bill and funding consultation, the Regulator encourages all DB schemes to set a long-term funding target (LTFT) consistent with how the trustees and employers expect to deliver the scheme's benefits.

(1) Trustees are encouraged to set long-term funding targets in addition to technical provisions

The Regulator also encourages investment and funding strategies in the interim being aligned to the LTFT via journey plans which look beyond becoming fully funded on a technical provisions basis, to becoming fully funded up to the LTFT.

Our viewpoint

Schemes will need to do this from their first valuation after the Pension Schemes Bill provisions are commenced. Although this may be some time yet, the Regulator's view is clear in the meantime and so schemes that have yet to embrace LTFTs and journey plans should consider this as part of their current valuations.

Covenant matters

The Regulator has more to say at this point in respect of the employer covenant which it arranges under three sections

(2) Trustees are also expected to sharpen their focus on certain covenant issues

- **Covenant assessment** – the importance of this is emphasised again, particularly in the Covid-19 context. The Regulator gives perhaps its strongest steer yet for trustees to obtain independent specialist advice in these uncertain times, stressing that trustees should only undertake their own covenant assessment where they have sufficient expertise and that objectivity is also important. Where trustees themselves complete the assessment the Regulator wants a full audit trail of their considerations and decisions to be set down – and may ask to see the detailed documentation.

- **Covenant monitoring and contingency plans** – given current circumstances the Regulator wants the frequency and intensity of covenant monitoring to be significantly increased until covenant visibility and strength is restored. Key aspects of the covenant need to be identified and tracked, with accompanying triggers or thresholds for action laid down. The Regulator also wants to see contingency plans in place, ideally drawn up with the employer, so it is clear what happens should a threshold be reached.

- **Covenant leakage** – whilst trustees should be supportive of employers under pressure as ongoing employer support is vital, the Regulator is concerned about the many forms in which covenant can be diluted, pointing out five specific forms of leakage in addition to dividend payments. Where trustees consider that covenant leakage is not justified they are asked to obtain suitable protections to compensate their scheme for the resultant deterioration in covenant.

Our viewpoint

All this is perfectly understandable in the current context but will be a clear step up in practice and considerations for a number of schemes.

Managing risks

The Regulator continues to expect trustees to focus on the integrated management of three broad areas of risk – covenant, investment, and funding – and to take into account specific risks that arise from scheme maturity. Once more it provides a comprehensive set of tables in which it sets out its expectations across covenant, investment and funding, which differ according to the characteristics of the scheme.

Integrated risk management remains key – covenant, investment and funding

There are five scheme types as follows:

	Covenant	Funding
A	Strong or tending to strong	Funding position considered to be strong, technical provisions are strong and recovery plan is shorter than average (less than 7 years)
B	Strong or tending to strong	Technical provisions are weak and/or recovery plans are long (more than 7 years)
C	Weaker employer with limited affordability	Scheme funding on track to meet long-term funding objective, technical provisions are strong and contributions are reducing deficits at a slower but affordable pace
D	Weaker employer with limited affordability	Technical provisions are weak and/or recovery plans are long (more than 7 years)
E	Weak employer unable to provide support	Stressed scheme with limited or no ability to use flexibilities in the funding regime

each of which are further sub-divided according to whether the scheme is relatively immature or relatively mature.

The tables themselves are word for word identical to those in last year's statement. What could well differ is which table trustees think best represents their scheme now. The Regulator specifically asks trustees to decide whether the sponsor's covenant has changed as a result of Covid-19 and how good their funding position is, following the market turmoil, relative to their long-term objective.

The tables are identical to those last year, but where a scheme sits could well differ given recent events

Having done this, trustees are asked to prepare their recovery plan to balance visible affordability with contributions linked to well defined triggers, contingency plans and other protections for member security, as suggested earlier in the statement.

Our viewpoint

In some ways it is pleasing that during this time of market instability and an uncertain business outlook, the Regulator has held steady when it comes to describing the different scheme types and its expectations for each. However, some sponsors may be concerned that the expectations are unchanged in these current challenging times. What will be interesting is to see how trustees place their schemes in these tables.

3. What to expect from the Pensions Regulator

In the last part of the statement the Regulator reminds everyone that the regulatory initiatives detailed in last year's funding statement have been suspended due to the health emergency but will be restarted at some point.

The Regulator concludes with a few remarks

The Regulator concludes by reminding trustees that each valuation submission it receives is risk-assessed in a proportionate way and that *"Trustees and employers should be fully prepared to justify and explain their approach with supporting evidence"*. It then goes on to remind everyone of the Regulator's current suite of powers in the DB funding space.

In conclusion

This latest funding statement from the Regulator is essential reading for trustees, employers and their advisers ahead of undertaking valuations, and where schemes have funding challenges – with updated messages on what it will take to stay the right side of the Regulator. However, we note that much of the teeth will remain missing until the Regulator gets its new powers through the Pension Schemes Bill.

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