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UK

Volume 2018 | Issue 19 | 11 April 2018

The Balancing Act between Pension Scheme Funding and Rewarding Shareholders

The Pensions Regulator has published its latest annual funding statement for trustees and sponsors of defined benefit (DB) pension schemes.

While many of the messages contained in the statement are relevant to all defined benefit pension schemes, it is particularly aimed at those with valuation effective dates in the 12 months to 21 September 2018, as well as trustees and sponsors who are currently reviewing their risk and funding strategies.

As usual, the statement provides specific guidance on approaching a valuation, along with the Regulator's views on various topical issues, and perhaps most importantly what is expected of trustees and sponsors.

Background

At about this time each year the Pensions Regulator issues its annual funding statement setting out its views on the issues facing trustees of DB pension schemes currently undertaking valuations. Schemes will have been affected differently by market conditions and the Regulator's analysis identifies groups of schemes which have been impacted in particular ways.

Trustees are expected to read the statement alongside the Regulator's code of practice on funding defined benefits and to fully incorporate the principles in the DB code into their valuations. (The Regulator notes this year that following the recent DWP White Paper on protecting DB pension schemes there will be a new code of practice in the next couple of years, clarifying in particular the prudence of technical provisions and the appropriateness of recovery plans).

Market Conditions

The Regulator believes that those schemes with valuation effective dates between 22 September 2017 and 21 September 2018 (referred to as Tranche 13 schemes) will generally have marginally improved funding levels compared with three years ago. This will depend on a number of scheme-specific factors though, with those schemes that hedged their interest rate and inflation risks likely to have fared better.

Balancing Risks

The Regulator once again repeats its expectation of trustees to focus on integrated risk management, covering risks associated with the employer covenant, investment and scheme funding. Risks associated with scheme maturity (i.e. the increasing proportion of pensioners in relation to the total scheme membership) also need to be considered.

As in past years, the Regulator has published a table to summarise the key risks it broadly expects trustees to focus on and the actions to take, depending on the employer and funding characteristics.

Employer characteristics	Funding characteristics	Key risks to manage	The Regulator's expectations of trustees
Strong or tending to strong employers (Group A)	• On track to meet long term funding target • Technical provisions (TPs) not weak • Recovery plan not unduly long	• Sudden downturn in business • Future weakening of covenant, perhaps at same time as investment underperformance • Lack of long-term covenant visibility	• Consider strengthening of TPs/increasing contributions/reducing recovery plan length • Short recovery plan where dividends/other covenant leakage are disproportionate to deficit reduction contributions (DRCs)
Strong or tending to strong employers (Group B)	Combination of weak TPs and/or long recovery plans	As per above but with greater imperative to improve funding and reduce risk to members	• Strengthen TPs/increasing contributions/reducing recovery plan length • Consider strengthening short term security via contingent assets/guarantees etc
Weaker employers with limited affordability (Group C)	• On track to meet long term funding target • Technical provisions (TPs) not weak • Reducing deficits via contributions at a slower but affordable pace	• As per Group A but with weaker covenant which may be susceptible to downside risk • Pressure to employ limited affordability to grow sponsor	• Prioritise scheme liabilities over shareholder returns • Retain cash within sponsor to fund sustainable growth and address pension deficit • Monitor covenant risk & limit member risk by securing proportionate scheme reward from employer growth and/or maximising other forms of support
Weaker employers with limited affordability (Group D)	Combination of weak TPs and/or long recovery plans	As per Group C but more need to improve funding and reduce member risk	• Prioritise scheme liabilities over shareholder returns • Maximise scheme support by assessing affordability, what other support is available, and how the future covenant can be strengthened • Seek opportunities to reduce risk to protect sponsor and members
Weak employer unable/unlikely to provide adequate support (Group E)	Stressed schemes with limited/no abilities to use flexibilities in the funding regime	Crystallisation of unsupported investment risk and/or employer affordability reducing further	• Seek best possible funding outcome for members • Ability to evidence appropriate measures taken

Risk Management

Trustees must take a balanced approach to risk taking and risk management, and tailor this with the particular circumstances of their scheme. The Regulator highlights that scheme size should not be a barrier to taking action to manage risks, and when it engages with trustees it will not accept this as an excuse for poor risk management.

Trustees should work with their advisers to agree a practical approach to manage the key risks in a way that is proportionate and appropriate for their scheme. Risks should be prioritised on the extent they affect the scheme's long term funding target and the employer's capacity to support them.

Contingency planning

Analysis also needs to be taken in terms of contingency planning, to ensure the impact of key risks materialising is understood, and how the scheme's funding position could be remedied in the event of such risks occurring. This may require collaboration with the scheme sponsor to understand how any additional support could be provided. Contingency planning shouldn't just cover adverse events however. Trustees should recognise that opportunities may arise that put their scheme on a more solid footing and could help relieve the employer of future strain from the scheme.

Brexit

The Regulator recognises that trustees may have concerns about agreeing recovery plans with sponsors in light of uncertainty over Brexit. It expects trustees to have open and collaborative discussions with sponsors and consider how this uncertainty may affect the employer covenant. These discussions should cover their outlook for the whole economy, as well as the sponsor's particular sector, and employers should share their views on possible implications for their business, so that agreement can be reached on the risks to address.

The Regulator's Expectations of Trustees

When agreeing DRCs, the Regulator is very keen to see sponsors treating their pension scheme fairly. To agree a funding strategy with sponsors, trustees need an understanding of the employer's business plans. The Regulator stresses that a strong covenant is no reason in itself for trustees to accept a recovery plan with lower contributions than would otherwise be considered reasonable. DRCs should reflect the size of the scheme's deficit and the employer's cash flows.

A **reasonable contribution** should be judged on how quickly the employer's contributions are reducing the deficit and the trustees' view of the residual risk to members.

An **affordable contribution** for the employer should be measured against shareholder distributions and recent trends.

The main message to come from this year's statement is the Regulator's concern about growing disparity between shareholder dividends and stable DRCs. This comes in light of recent corporate failures which have highlighted the risk of implementing long recovery plans while dividend payments appear to take too great a priority over DRCs to the pension scheme.

Trustees are expected to assess the impact of dividends on the employer's covenant and whether the scheme is being treated fairly in light of what it needs to pay the promised benefits. To do this, trustees should analyse the relative amounts (of dividends and DRCs), and expect to receive sufficient access to the sponsor's budgets and cash flow forecasts to enable this.

Where dividend payments appear unreasonable relative to contributions, the Regulator expects trustees to negotiate robustly with the employer to secure a fair deal for the pension scheme. No specific ratio is set that the Regulator considers being “acceptable”, but where dividends are disproportionate to DRCs, it would consider affordability to not be an issue. In such circumstances, trustees are expected to prioritise the needs of the scheme and engage with their sponsor accordingly.

Sponsors with weaker covenants should give greater consideration to their scheme liabilities, and should normally retain cash to fund sustainable growth and their pension scheme, rather than focusing on shareholder dividends. That said, the Regulator does accept that situations may arise where trustees are comfortable limiting DRCs for specific periods to recognise the commitment of new funds by investors, including allowing reasonable returns to those investors for their new money without excessive risk for the scheme.

Where trustees are concerned that their scheme is disadvantaged, they should not agree to unreasonable valuations and notify the Regulator, if they cannot agree their valuation by their statutory deadline, to discuss their concerns.

What Trustees can expect from the Regulator

The Regulator is now clearer in terms of its expectations of trustees and, perhaps stung by the criticism it has attracted in light of recent corporate failures, it is quicker to act and tougher on those who fail to protect members’ interests.

Risk assessments by the Regulator

Risk assessments of schemes judge the suitability of a scheme’s TPs on the risks of the funding and investment strategies and how the trustees appear to be managing them. Where a scheme’s investment risk appears unsupportable by the covenant, or cash contributions seem to be disproportionately low relative to the scheme’s requirements, the Regulator will question the rationale behind the trustees’ chosen funding and investment strategies.

Small Schemes

The Regulator takes the opportunity to highlight its new proactive approach to scheme engagement of smaller schemes, and how it is currently contacting a sample of these schemes (thought to focus on schemes with assets under c£80 million) about the particular issues it is looking for trustees to address – such as covenant, funding and risk management – before their 2018 valuation is finalised.

Late valuations

Trustees should plan their valuation process, so as to ensure everything is agreed within the normal statutory 15-month deadlines.

Where these deadlines are not met, trustees and employers must make every effort to agree an appropriate valuation and recovery plan as soon as possible. The Regulator has the discretion to impose penalties, and enforcement proceedings have been brought against trustees who have not submitted their valuations on time.

Regulator’s powers

The Regulator has the power to direct how a scheme TPs should be calculated and the deficit should be funded (including the length of the recovery plan). This can occur where a valuation has not been agreed or where the valuation assumptions or recovery plans do not meet statutory requirements. It is currently investigating several schemes to determine whether to use this power.

It also has other powers at its disposal, ranging from one-to-one supervision to improvement notices and anti-avoidance investigations. What seems clear is that the Regulator has never been more ready to use its full range of powers, if it feels that trustees or sponsors are not meeting their statutory duties.

Actuarial Assumptions and Scheme Demographics

Discount rates

- Discount rates should be chosen using the trustees' integrated risk management principles.
- Trustees should discuss with their scheme actuary what the proposed discount rate assumes about future interest rates.

Mortality

- This should be appropriate to the scheme membership, taking account of socio-economic status and/or any health issues.
- Mortality assumptions should be evidence based and based upon a sound methodology.

Transfers

- If considering making an allowance in the valuation for increased transfer activity both the scheme's experience and likely trends should looked at before doing so.
- Where such an allowance is introduced and the TPs reduce, the Regulator expects the effect to be quantified in advance and subject to ongoing monitoring, with a contingency plan in place should the assumption not be borne out.
- Trustees should keep records of transfer activity, including details of the advisers and the receiving scheme.
- Transfer activity should be closely monitored and trustees should take advice on liquidity management, the impact on their investment strategy, and the suitability of their transfer value basis.

Scheme maturity

- The Regulator expects scheme advisers to alert trustees to the funding and investments risks arising from scheme maturity (particularly on schemes with high levels of transfer activity).
- For schemes approaching high levels of maturity, trustees should ensure the sponsor is funding the scheme at a sufficient level to actively manage these risks.

In Closing

The days of a passive Pensions Regulator are now gone. Stung by criticism of how it has handled recent corporate failures, the Regulator's get tough strategy, first unveiled in its latest business plan last year, means it is now serious about using its full range of powers, and as its response to last year's Green Paper demonstrated, wants the DWP to grant it greater ability to intervene where it feels sponsors are not dedicating enough resources to their pension scheme deficits.

This should be good news for trustees and sponsors, but there is still a lack of clarity. While the Regulator has signalled its intention to make sponsors prioritise DRCs instead of rewarding shareholders, it still has a statutory duty to ensure that employers balance the needs of their defined benefit pension scheme with growing their business. This is not an exact science.

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