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The Pensions Regulator's latest expectations on scheme funding

Volume 2019

Issue 07

8 March 2019

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The Pensions Regulator has published its latest annual funding statement for trustees and sponsors of defined benefit 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 2019 (Tranche 14), 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.

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Background

The Regulator is currently working on a revised code of practice for defined benefit pension scheme funding. As such, there is perhaps not as much in the latest statement as in past years. This new code will be clearer on approaches to funding, with particular priority given to the prudence of technical provisions and the appropriateness of funding plans.

The Regulator will be consulting over the summer on various options for a revised funding framework and consultation on the revised code of practice will then follow. Trustees and sponsors are reminded that until the revised code of practice comes into force (which is unlikely to be before next year) the current code and associated guidance remain relevant for current valuations.

Key points for trustees

1. **Establish a long-term funding target**
2. **Ensure the scheme is treated equitably by the sponsor**
3. **Consider the scheme's integrated risk management framework in light of the statement**

Market conditions

The Regulator's preliminary assessment of the total funding position for schemes in Tranche 14 suggests the individual schemes could either be marginally better, or worse, compared with the previous valuation, depending on the exact date of the valuation and other scheme-specific circumstances. Schemes with low hedging levels are expected to have fared less favourably.

Any current mention of market conditions cannot omit reference to Brexit, and trustees and sponsors are reminded of the Regulator's statement published in January 2019 on the UK's exit from the European Union, which outlined the Brexit-related steps to consider. The Regulator will continue to monitor the situation and has pledged to issue further guidance if necessary.

The Regulator's expectations

Long-term funding targets

Defined benefit pension schemes need to have clear plans to meet the objective of paying members their promised benefits, and the Regulator recognises that this is made easier for schemes where trustees and sponsors agree a clear strategy to achieve this, focusing on the principles of integrated risk management – the relationship between risks associated with funding, investment, and the employer covenant.

This often leads to a long-term funding target being agreed between trustees and sponsors. This target would, for instance, be for the amount of assets the scheme would need by the time it has reached a level of maturity at which it would be prudent to reduce the scheme's dependence on the employer, in order to allow it to be managed thereafter with a high degree of resilience to investment risks.

The Regulator expects all schemes to follow similar practice and set a long-term funding target consistent with how the trustees and sponsors expect to deliver the scheme's ultimate objective, and then be prepared to evidence that their shorter-term investment and funding strategies are aligned with it. (This is consistent with the proposal in the government's White Paper last year to introduce a requirement for defined benefit schemes to have a specific long-term destination.)

Balancing risks

Trustees are expected to focus on their scheme's integrated risk management framework, and also take into account risks arising from scheme maturity, with a greater proportion of pensioners in a scheme's membership meaning that there are different risk management considerations, particularly regarding investment volatility.

When reviewing funding plans, the Regulator balances its statutory objectives to protect members and the Pension Protection Fund, with the needs of employers to invest in their business. It does not assess the appropriateness of schemes' technical provisions or discount rates based on predetermined relationships to gilt yields or other indices. Instead, their suitability is judged on the risks in trustees' funding and investment strategies, and how trustees appear to manage them.

The Regulator applies an integrated approach to assessing each scheme's overall risk profile, using a number of factors. A large part of the Regulator's statement is comprised of tables that set out the key risks that trustees and sponsors should focus on and the actions to take, depending upon the general characteristics of a scheme. (These are only broad guides however, and individual scheme circumstances may mean that alternative action is appropriate.)

With most schemes now closed to new members, scheme maturity issues are expected to assume greater significance for setting funding and investment strategies going forward. In the statement's tables, scheme maturity is referred to in relative terms, but scheme actuaries are expected to advise trustees on the broad current position of their scheme, and how it may change in the future. In the context of scheme funding, the interaction between (a) the level of assets, the degree of underfunding and the amount of benefits paid out, and (b) the scheme's ability to close the funding gap from investments and new contributions in a reasonable timeframe, is pivotal.

For schemes with high levels of transfer activity, advisers are expected to alert trustees to the funding and investment risks arising from increasing scheme maturity. As schemes approach high levels of maturity, trustees should ensure the sponsor is funding their scheme to a level where these risks are being appropriately managed.

Equitable treatment

As highlighted previously, the Regulator expects sponsors to treat defined benefit pension schemes fairly, and not give undue priority to other "financial stakeholders". It remains concerned about the disparity between dividend growth, and the stable payment of deficit reduction contributions that was first mentioned in last year's statement. This year, concern is also expressed about other forms of what the Regulator calls "covenant leakage", which may be given priority over higher deficit reduction contributions and shorter recovery plans.

A number of schemes have been, and continue to be, contacted by the Regulator ahead of their valuation, where it has concerns about inequitable treatment, enquiring about previous and current funding approaches, and negotiations. The Regulator is intending to continue with these interventions (regardless of a scheme's covenant position).

The Regulator expectations in this area can be summarised as follows:

- Strong funding targets and relatively short recovery plans for schemes where dividends and other distributions to shareholders exceed deficit repair contributions.
- Larger deficit repair contributions than shareholder distributions where the employer covenant is weak/tending to weak (unless there is a short recovery plan and strong funding target).
- Cessation of shareholder distributions – where the employer covenant is weak and the scheme cannot be supported.

Recovery plans

Trustees are likely to be hearing from the Regulator where it considers the current recovery plan is too long. (The Regulator's data indicates the median recovery plan length to be seven years.) The Regulator will outline its concerns, asking relevant questions and setting out its expectations for the upcoming valuation. (Schemes selected for this engagement will cover the whole spectrum of employer covenant strengths.)

While some trustees may not consider their current recovery plan to be long, the Regulator will be looking at both the maturity of the pension scheme and the employer covenant in deciding what an acceptable recovery plan length is. As an example, if a relatively mature scheme with a strong employer has a current recovery plan in excess of the average length for the universe of schemes, that would be considered to be too long.

Other interventions

The Regulator will continue to risk assess all valuation submissions it receives. These assessments look at the overall risk profile of a scheme relative to the ability of the sponsor to support it. Trustees and sponsors should be fully prepared to justify their approach with evidence of robust negotiations having taken place.

Late valuations

Trustees are once again reminded that the valuation process should not be left until the last minute. A project plan should be used to ensure there is sufficient time to allow for advice to be taken and considered, and for negotiations with the sponsor. Trustees should not agree an inappropriate valuation and funding plan simply because the deadline is approaching, and they should approach the Regulator if they are pressured into doing so by the employer or a third party.

While breaches of the 15-month deadline must be reported to the Regulator, it does not automatically follow that the trustees will be penalised. Where trustees have acted responsibly and taken all reasonable steps to finalise their valuation, but there remains a genuine reason why it cannot be finalised, the Regulator may choose not to apply a penalty. It would prefer to ensure that the best outcome is reached for the pension scheme, rather than one agreed under pressure simply to meet the deadline. Trustees will be supported if they cannot agree a valuation for valid reasons.

The Regulator's powers

The Regulator reminds trustees and sponsors of the range of interventions it has at its disposal (which it is becoming increasingly comfortable in using) where agreement cannot be reached over a scheme's valuation. This includes enforcing a funding solution: a situation all trustees and sponsors should want to avoid.

Comment

The fact that the Regulator's tone in these statements has changed over the years should not surprise anybody. The Regulator is increasingly willing to use its powers (and be seen to do so) and intervene in valuations where it feels it should.

If they have not already done so, trustees and sponsors should pay particular attention to the requirement to set a long-term funding target, as this looks set to be introduced by the government in any event.

The Regulator acknowledges that it is being far more explicit in what it expects schemes to consider on funding, investment, and employer covenant, to help trustees consider the risks to their scheme, acceptable levels of risk, and any appropriate mitigation. Individual scheme circumstances may mean the trustees seek a different path, but they would need to be able to justify their actions to the Regulator.

The annual funding statement is a key communication from the Regulator, and is as pertinent to pension schemes currently undertaking a valuation as in any other year. However, later in 2019, the Regulator will be consulting on its new code of practice for defined benefit funding, and this is likely to give us a far greater insight into the Regulator's expectations more generally going forward.

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