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The Pensions Regulator's latest expectations on scheme funding

The Pensions Regulator has somewhat later than originally intended published this year's 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 2020 (Tranche 15), 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. Unsurprisingly, this is dominated by the impact of COVID-19 on financial markets and sponsoring employers. It means the Regulator has given greater attention this year to the employer covenant principle of the integrated risk management framework.

Background

At the beginning of March, the Regulator launched the first stage of a major consultation on its revised code of practice for DB funding. The COVID-19 crisis has led it to extend the deadline for this consultation to 2 September, and the second consultation on the draft code itself, is not now expected until sometime in 2021. The Regulator is also expecting to be given new powers in relation to scheme funding as a result of the Pension Schemes Bill, currently before Parliament. However, whilst the Regulator is no doubt influenced by this, it stresses that all valuations covered by this statement will be regulated according to the requirements of the existing legislation and guidance.

Market conditions

At the end of December 2019, the Regulator notes a general improvement in funding levels, compared with the previous three years reflecting better than expected investment performance. Schemes that had hedged interest rate and inflation risks appeared to be above target while others were marginally below. However, the situation now will be very different for many schemes due to the COVID-19 crisis. Moreover, the full impact the crisis will have on the pension landscape is, as yet, unknown. Accordingly, as the duration and impact of the current economic uncertainty evolves, the Regulator has promised to consider issuing further guidance in the autumn.

During the first quarter of this year, UK equities fell sharply, mainly due to the initial impact of COVID-19. Global equites fell to a lesser extent. The yield on gilts also dropped, as did the inflation expectations of investors in the gilts market.

Despite the unusually depressed market conditions at 31 March 2020, the funding positions of all schemes is not anticipated to have deteriorated to the same extent as the recent market reductions. This is because in recent years, pension schemes in general have de-risked considerably as they have become better funded and more mature.

Schemes with low exposure to equity markets and good levels of hedging remain above target or are marginally below, despite the market conditions. These are likely to be schemes that have managed their risks well, with sufficient resilience to withstand the current market conditions and the governance to react quickly.

At the other end, a smaller proportion of schemes who were heavily exposed to equities and were not sufficiently hedged against interest rate risk have experienced a sharp fall in funding levels.

Scheme-specific considerations

Post-valuation experience

Schemes with valuation dates in late December 2019 or earlier are not required to change their valuation assumptions. However, trustees are expected to consider post-valuation experience in setting recovery plans, with a focus on employer affordability. Post-valuation experience must be applied consistently with both positive and negative experience being considered.

Changing the valuation date

Trustees of schemes with valuation dates around 31 March 2020 who may be considering bringing forward the effective date of their valuation to a date considered more normal, e.g. December 2019, are asked to consider very carefully whether this is in the best interest of scheme members. Such a change would require the trustees to obtain and act on actuarial and legal advice and trustees can expect to have to justify this change to the Regulator.

Calculating technical provisions

The Regulator accepts calculating March and April 2020 valuations will be challenging. Trustees may not have sufficient information to form a reliable view on, long term future returns from investments or, employer covenant and affordability. They may therefore decide to delay making decisions until the position becomes clearer.

When considering their technical provision assumptions, trustees should consider a range of possible future outcomes. To help understand the key underlying economic variables trustees should discuss with their advisers the key assumptions in the models used by the Scheme Actuary and if they have or will change in the current environment. These discussions will form the basis of trustees' decisions around discount rates and other assumptions. In doing this, trustees should not be overly influenced by short-term fluctuations.

During any period of delay due to COVID-19, schemes should proceed with as much of the preliminary valuation work as possible on preparing and validating data, programming and the background analysis on the date.

Recovery plans and affordability

Trustees are asked to work collaboratively with sponsoring employers whilst carrying out the necessary due diligence to assess employer covenant. Work must be carried out in accordance with the Regulator's COVID-19 guidance and deal with any changes of pension deficits alongside an assessment of the employer's financial position. They should plan to recover deficits with a focus on affordability and the sustainable growth of the employer.

In addition to deficit repair contributions (DRCs), where possible, trustees should incorporate appropriate incremental increases in contributions, which track corporate health recovery, especially when the scheme has taken on additional funding risk while supporting the employer's recovery. Additional contributions should be based on appropriate triggers such as free cash flow and payments to other creditors.

Additional contributions could also be linked to investment performance. Where the investment return assumed in the recovery plan is more optimistic than the prudent view taken in the technical provisions, trustees should be mindful of the consequences for member security of this optimism not being borne out. They should therefore keep the matter under review and, if appropriate, consider underpinning the additional risk with contingent security or link additional DRCs to triggers based on investment performance.

Shareholder distributions

Employers are warned that dividends and other covenant leakage should cease or be significantly reduced whilst balance sheets are rebuilt and recovery takes place. Where employers recommence shareholder distributions, the Regulator will assume liquidity and affordability to have been largely restored, and will expect DRCs to reflect this. Where significant reductions in DRCs have been agreed to support the employer, particularly in response to COVID-19, trustees and employers are expected to ensure schemes are treated fairly as recovery takes place.

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 employers 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 employers. For example, 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. In the current climate schemes with such long-term plans already in place should be able to continue to focus on those plans with suitable short-term modifications.

The Pension Schemes Bill is to introduce a legal requirement for schemes to have a specific long-term strategy. Trustees of schemes without such a strategy are encouraged to take steps to put one in place and agree it with the employer in readiness for this change in law.

Covenant assessment

The Regulator emphasises the uncertainty over employer covenant which has been brought about by COVID-19 and Brexit. It highlights the importance of obtaining independent specialist advice to support covenant assessment. This is even more important where the covenant is complex, deteriorating or where a scheme has a high degree of reliance on it. Trustees are warned against undertaking their own covenant assessment where they have insufficient expertise in this area. Trustees doing so should fully document their reasons for not taking professional advice as well as their own assessment and conclusions. The Regulator in such circumstances may well ask to see the appropriate paper trail.

Covenant monitoring and contingency plans

Trustees are expected to increase the frequency and intensity of covenant monitoring in the current environment, and have employer-agreed contingency plans in place, to deal with adverse changes and allow trustees to react to such changes. Ideally such plans would have trigger points in place which result in specific actions being taken. Again, the Regulator may ask to see relevant documentation.

Covenant leakage

The Regulator is concerned about covenant leakage and expects trustees to be vigilant in this regard. Whilst dividends are the most obvious leakage, the Regulator also asks trustees to look out for:

- cash pooling and intercompany lending arrangements;
- group trading arrangements;
- management fees, royalties, and similar charges;
- transfers of business or assets at undervalue; and
- excessive executive remuneration.

Where trustees consider covenant leakage is not justified, they are expected to seek suitable protections to compensate their scheme for the resulting deterioration in covenant, particularly where there are weaker covenants and longer recovery plans. This includes, for example, security over employer assets, or 'upside sharing mechanisms' so that, in the event of employer performance improving in future, the scheme can receive increased contributions.

Managing risks

The Regulator continue to expect trustees to focus on the integrated management of three broad areas of risk: the ability of the employer to support the scheme, the investment risks, and the scheme's funding plans. They should work with their advisers in all these areas to develop and maintain an integrated risk management framework and associated governance which focuses on providing trustees with pragmatic and useful information for their decision-making.

In last year's annual funding statement, the Regulator introduced tables to set out its expectations, recognising that some broad segmentation according to the key drivers – funding strength, covenant and scheme maturity – would better enable trustees to match individual scheme circumstances with its guidance. Each table identified the key risks that the Regulator expected trustees to focus on, and the plans it expected them to develop, depending on their scheme and employer characteristics. These tables are reproduced in this year's statement and are identical to those in the 2019 statement. Whilst the tables have not changed, the trustees are asked to consider whether their sponsoring employer's covenant has changed as a result of COVID-19 and Brexit, and how good their funding position is relative to their long-term funding target, given the period over which they are aiming to achieve it.

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. But it is also trying to be pragmatic in the light of the current COVID-19 crisis, and to a lesser extent, Brexit.

Some themes do reappear every year, and in particular, the Regulator's focus on integrated risk management is a regular feature of the annual funding statement. This year is no different, and at a time when employer covenants are likely to be under significant pressure, this is understandable. Trustees should keep their integrated risk management policy under close review.

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 is being introduced by the government in any event.

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