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The Pensions Regulator's latest expectations on scheme funding

The Pensions Regulator has 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 2021 (Tranche 16), 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 a challenging year dominated by COVID-19 and Brexit has had on financial markets and sponsoring employers' covenants.

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Background

Although the Pension Schemes Act 2021 is now in force, many of the regulations which will give effect to it are still to be finalised. This includes regulations providing for trustees to prepare and maintain a long-term funding strategy. The Regulator makes it clear that the current regime in force before the Act applies to all Tranche 16 valuations.

Market conditions

At the end of December 2020, the Regulator notes funding levels were broadly unchanged, compared with the previous three years. Schemes that had hedged interest rate and inflation risks appeared to be above target, while others were marginally below.

During the first quarter of this year, equities rose both in the UK and globally, whilst the prices of bonds and gilts fell. Consequently, the yield on gilts has risen, and to a lesser extent so have the inflation

expectations of investors in the gilts market. Accordingly, aggregate funding positions of schemes as at 31 March 2021 should be favourable compared to December 2020.

Despite COVID-19, over the three-year period to March 2021, the aggregate funding levels of Tranche 16 schemes on a technical provisions' basis should have generally improved. However, the position of individual schemes may vary greatly depending on scheme-specific inter-valuation experience, valuation dates, funding assumptions and investment strategies.

Schemes ahead of their recovery plan target are encouraged to focus on longer-term targets and their journey towards it. Those behind target will need to consider how best to get back on track.

Current valuations

Recent events have highlighted the importance of trustees' understanding key assumptions in any modelling undertaken. They need to consider a range of potential outcomes when considering the prudent technical provisions basis to adopt. The Regulator encourages scenario planning as part of a scheme's integrated risk management framework. Trustees should be aware that future economic circumstances can impact not just investment returns, but also employer covenant and potentially mortality.

Inflation

With the Retail Prices Index being aligned with the Consumer Prices Index including owner-occupied housing costs (CPIH) from 2030, trustees need to have this in mind when choosing assumptions.

Mortality

The Regulator acknowledges there are different views on the impact of the COVID-19 pandemic. However, for most schemes the impact is seen as low, although it will depend on the member demographics of each scheme.

While recognising these divergent views, and that the true position will not be known for some years, the Regulator thinks it reasonable to retain similar mortality assumptions to those used in previous valuations. If different assumptions emerge over time any savings can be recognised at future valuations.

Alternatively, another reasonable approach would be to use the latest base mortality tables and projections, suitably updated for any scheme experience. Caution is urged on how much weight should be placed on recent events in any such models.

Whatever assumptions are chosen, trustees should ensure that they are balanced, evidence based, and derived using sound methodology.

Scheme-specific considerations

Post-valuation experience

Trustees are expected to consider whether to take into account post-valuation experience in setting recovery plans, with a focus on employer affordability. This must be applied consistently with both positive and negative experience being considered. It should not be an opportunity for trustees and employers to simply pick the most favourable date when agreeing the recovery plan.

Taking employer affordability into account, any changes arising from factoring in favourable post-valuation events should result in reduced recovery plan periods, rather than a reduction in the level of annual payments.

Investment considerations

As most schemes are closed to new members and maturing, trustees need to actively monitor and mitigate their liquidity risks alongside other risks such as diversification.

Covenant assessment

The Regulator emphasises the continued uncertainty over employer covenant which has been brought about by COVID-19 and Brexit, and that its impact has varied on different schemes. Although it does say short-term covenant visibility has improved over the last 12 months, the importance of obtaining independent specialist advice to support covenant assessment is also highlighted. 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. The Regulator divides sponsoring employers of schemes into broadly three categories:

- COVID 19 has had a limited impact on the business.
- COVID-19 had an impact, but the employer is recovering strongly.
- COVID-19 continues to have a material impact.

Trustees' views on covenant and their approach to their valuation will vary depending on which category their sponsoring employer falls into. Stress testing or scenario planning is recommended, especially for those cases which fall into the third category.

Finally, deficit recovery should focus on affordability, whilst maintaining fair treatment and balancing the sustainable growth of the employer. Where the employer is in a state of stress, covenant leakage e.g. dividends, should be minimised.

Brexit

Where Brexit provides additional uncertainty, as regards employer covenant, trustees need to understand whether the impact is likely to be short or long term.

Recovery plans and affordability

Where COVID-19 and Brexit have had a limited impact on the employer's business, trustees are expected to take a "business as usual" approach to setting recovery plans. As such, deficit recovery contributions are not expected to be reduced, or recovery plan lengths increased.

Where the impacts were material, but trading is recovering, short-term affordability constraints may result in a temporary reduction in contributions, provided dividends are not paid. Trustees should also seek to obtain suitable mitigations, such as appropriate incremental increases, as the financial position of the employer recovers. It should be ensured that a scheme is treated fairly in comparison with other creditors.

Covenant monitoring and contingency plans

The Regulator notes an employer's covenant strength can change materially over a short period of time, as highlighted by recent events. The Regulator welcomes the more frequent covenant monitoring that it has been seeing and warns about trustees reducing this until covenant visibility and strength are

restored to more stable levels. Contingency plans should be drawn up by trustees and employers with agreed trigger points that will result in specific actions taking place.

Even if a lack of legally binding support means that trustees do not rely on the wider group in their covenant assessment, they should include key financial metrics of that wider group in their covenant monitoring, as financial risk or corporate activity at group level can impact direct employer support. The Regulator stresses the importance of laying a proper paper trail on covenant monitoring and warns that it may ask to see relevant documents.

Corporate transactions

The Regulator is expecting to see corporate activity increase as the UK recovers from the COVID-19 pandemic. Trustees should be alert to this and be able to identify detrimental events that affect an employer's ability to meet their obligations to the pension scheme, either on an ongoing basis, or on insolvency.

Trustees must be rigorous in their approach to assessing the impact of corporate transactions and to ensure fair treatment with other creditors. Mitigation should be negotiated where relevant. Again, an appropriate paper trail is important. Trustees must be given the same information as other stakeholders and be part of any negotiations.

Where a valuation happens at the same time as a corporate event, this can give trustees additional leverage in negotiations with an employer. However, in such scenarios, trustees are expected to obtain mitigation for any detriment caused by the corporate event, independently of the valuation. They should then make appropriate changes to funding elements of the scheme's valuation, taking account of the changes in covenant and mitigation received.

The Regulator notes the Corporate Insolvency and Governance Act came into force on 26 June 2020. Trustees should be aware of the new procedures introduced for distressed companies and seek specialist advice in any cases affected by the Act.

Managing risks

The Regulator continues 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 (IRM) framework and associated governance which focuses on providing trustees with pragmatic and useful information for their decision-making.

In 2019'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.

Climate change

Trustees should consider the impact of climate change on its IRM framework. This may impact on the assumptions used in actuarial valuations, the investment strategy and the sponsor covenant. The

Regulator expects trustees to take a proactive approach to climate change and has highlighted its recent climate change strategy.

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 IRM.

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.

All schemes are expected to set a long-term funding target focusing on how the trustees and sponsor 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.

In view of the forthcoming legal requirement for schemes to have a specific long-term strategy, trustees are encouraged to take steps to put one in place (if they haven't already done so) and agree it with the employer in readiness for this change in the law.

Scheme maturity

With most schemes now closed to new members, scheme maturity issues are expected to assume greater significance for setting funding and investment strategies as time goes on. Trustees need to be alert to the risks to funding and investment from increased scheme maturity.

IRM and governance

The Regulator takes a look into the future, and its expectation that all schemes with 100 or more members will be asked to carry out and document their Own Risk Assessment (ORA) at some stage during the next inter-valuation period. It therefore recommends documenting key risks at the current valuation and how they are being managed within an IRM framework to make their first ORA a simpler task.

Comment

There is nothing particularly new in this year's annual funding statement and most of it will therefore be very familiar to trustees.

Some themes do reappear every year, and in particular, the Regulator's focus on employer covenants is understandable given current events. Trustees should keep their IRM policy under close review.

If they have not already done so, trustees and sponsors should ensure they set and maintain a long-term funding target for their schemes, as this will soon be a legal requirement.

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