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The Pensions Regulator's latest annual funding statement

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 2022 (Tranche 17), 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 general risk management practices, regulatory developments and current issues facing schemes, which are expected to have a bearing on pension scheme management.

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Background

The Regulator acknowledges the challenging conditions faced by many sponsors and trustees in advance of Tranche 17 valuations. Economic growth is slowing, against a backdrop of higher inflation, interest rates and energy prices – all of which may impact on scheme funding and the employer covenant. Other current uncertainties include how the conflict in Ukraine will evolve and lingering impacts of COVID-19 and Brexit.

These risks highlight the importance of trustees ensuring a robust risk management strategy is in place across all areas of a scheme's assets, liabilities and covenant. Trustees should be using the actuarial valuation to reconsider if their funding plans are appropriate and whether they have effective monitoring mechanisms in place. Future protections such as contingency plans and dividend-sharing mechanisms should also be considered.

Favourable investment conditions over the last three years may mean that, for many schemes, their funding levels are ahead of plan, but not for all. The Regulator expects the impact of hedging to have benefitted schemes, depending on the level of inflation hedging and inflation linkage in benefits.

Trustee actions

The Regulator is not breaking any new ground in this year's statement. Trustees should:

- Consider their long-term funding target (LTFT) and their journey towards it. (Although the LTFT has not yet been introduced in law, it will soon be brought into effect, and trustees need to be prepared.) Where schemes are in deficit against their technical provisions, trustees should focus on recovering the deficit and managing their risks.
- Consider how their liquidity needs will change in the absence of future contributions from the employer, where schemes have recently achieved full funding on a technical provisions basis, or are expected to do so soon.
- Ensure that their journey plans remain appropriate and focus on managing other risks through contingent funding plans linked to suitable triggers. If trustees are concerned about longer-term covenant risks, they should consider alternative funding and investment strategies.
- Remain alert to their scheme's funding position and covenant changing very quickly - especially in the current environment.
- Understand the key risks to their scheme and the effectiveness of their strategies to manage them. These risks are often connected by the same underlying factors, so trustees should consider their impact on the scheme and the employer's covenant in an integrated way. Scenario planning is a useful way of considering this, to provide insights to the key aspects of funding strategies like de-risking, journey planning and contingency planning.

Each scheme should consider its position depending on its own circumstances.

Key risks and the Regulator's expectations

As in recent years, the Regulator has set out its expectations in tables for the key risks trustees and employers should focus on, and actions to take, depending on their specific characteristics. Some broad segmentation according to the key drivers – funding strength, covenant and scheme maturity – should assist trustees in developing funding strategies within an integrated risk management framework.

This year's tables are unchanged from those accompanying the 2021 statement, except that the reference to the length of the recovery plan has been updated from seven years to six, in recognition of how recovery plan lengths have generally decreased over recent years.

These tables are not intended to be exhaustive for each category and the recommendations in the tables are thematic and should not be considered in isolation. The Regulator continues to emphasise the importance of integrated monitoring, and for trustees to be alert to shareholder distributions and other value leakage to ensure fair treatment for their scheme, as well as being alert to any corporate activity. Trustees should seek mitigation where appropriate.

Forthcoming Regulator materials

For trustees and sponsors awaiting an update on the Regulator's new DB funding code of practice, the statement merely reiterates that the second consultation on the draft code is expected to be launched later this year.

All Tranche 17 valuations will be subject to existing legislation and guidance currently in force, with the current funding regime, code of practice and guidance applying until it is replaced (from a date still to be confirmed, although it seems unlikely to be before mid-2023).

As part of the second consultation on the new draft code, the Regulator plans to set out its proposals to change its guidance on assessing and monitoring the employer covenant which dates back nearly seven years.

The Regulator also intends to provide more detail on how to treat guarantees for scheme funding purposes and more information regarding ESG and how this can be factored into the employer covenant, along with various examples to support trustees in understanding how to apply any updated guidance.

Buck comment

Given the current economic challenges facing sponsors and trustees, along with a war in Eastern Europe, and with the full implications of the pandemic and Brexit still to be understood, it was hoped that that Regulator would have more to say this year. Unfortunately, but understandably, the Regulator is largely delivering the same messages as in recent annual funding statements.

This is due to the delays in implementing the new funding code and the associated legislation in the Pension Schemes Act 2021, leaving trustees and sponsors of DB schemes with Tranche 17 valuations still subject to the existing scheme funding framework.

The Regulator will, no doubt, be hoping to provide a more enlightened update in 2023.