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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 DB pension schemes.

While many of the messages contained in the statement are relevant to all DB schemes, it is particularly aimed at those with valuation effective dates in the 12 months to 21 September 2023 (Tranche 18), as well as trustees and sponsors who are currently reviewing their risk and funding strategies. It also applies to schemes that may be receiving requests for reduced contributions, amendments to contingent asset arrangements, and proposals for other uses of surplus.

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.

Background

There have been some momentous changes in the DB scheme environment over the past year, with the spike in nominal and index-linked gilt yields following the government's 'mini-Budget' last autumn, following a gradual rise throughout the earlier part of the year, taking many in the industry by surprise.

According to the Regulator:

- Employer covenants may appear proportionately stronger given reduced scheme sizes, but they may also have been impacted by high inflation, low economic growth, high energy costs and higher borrowing costs. Contingent assets such as guarantees, escrow accounts, and asset-backed funding arrangements expressed in nominal amounts may also now look more favourable.
- Funding positions of all but a minority of schemes should be ahead of plan and a significant number are expected to have exceeded buy-out funding levels.

Trustee actions

Trustees will need to consider if their long-term targets remain appropriate, whether buy-out is viable or whether to examine other end-game options.

Some schemes will also be facing calls from employers for reductions or suspensions to contributions, as well as from members for discretionary increases, given that pension increases may not have kept pace with inflation. When considering such pressures, trustees should be mindful of their overall position, the resilience of their investment strategy to future financial market movements and the level of covenant support.

Where funding levels will have fallen, including some schemes invested in pooled funds and others unable to meet the necessary liability-driven investments (LDI) collateral calls, trustees will need to reset their funding and investment strategies to reach their long-term targets and should review their operational governance processes to ensure future resilience, in line with the Regulator's recently published LDI guidance.

While most trustees should be approaching Tranche 18 valuations from a relatively healthy funding position, they should recognise the economic uncertainty that will continue to impact investments and employer covenant in different ways, including:

- further increases in interest rates, which could affect the scheme's assets and liabilities, as well as increasing borrowing costs for the employer, potentially making refinancing more difficult
- high rates of inflation and their knock-on effects on pension scheme liabilities and investment returns, as well as their effect on other employer costs, which they may not be able to pass onto customers
- volatile commodity and energy prices affecting profitability of employers and fuelling inflation in the wider economy
- the potential for ongoing or new geopolitical instability and/or conflict to affect supply and distribution chains or cost bases of employers

It should also be remembered that schemes should consider their specific position depending on their own circumstances but the Regulator has set out specific guidance depending on whether a scheme's funding level is:

- at or above buy-out;
- between technical provisions and buy-out; or
- below technical provisions.

Funding strategies

The Regulator's analysis shows that around a quarter of all DB schemes may now have sufficient assets to buy out their liabilities. They will need to consider whether to execute any previously agreed end-game plans or develop other options.

Many of the remaining schemes are estimated to have funding positions that are currently ahead of their funding plans, and in many cases ahead of their technical provisions. For them, this may be the trigger to review their pace of funding and level of risk-taking, or to re-consider their longer-term objectives and set new more ambitious targets.

As in recent years, the Regulator has set out its expectations 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.

Investment strategies

The key change in market conditions in 2022 was the rise in long-term global interest rates, which meant that bonds performed poorly compared to equities, specifically in the UK.

For many schemes, this will mean that current asset allocations may be materially different from where they were expected to be, and their investment strategy will need to be reviewed in light of current scheme funding. Trustees should consider the implications for their investment strategy, particularly the split between matching and growth assets.

Some schemes may have a greater proportion of scheme assets invested in illiquids than originally envisaged, especially where there was a material level of LDI or bonds in place. Therefore, trustees should speak with their advisers about managing illiquid assets given the significant change in market conditions.

Other considerations

Longevity

The COVID-19 pandemic has clouded the trends on mortality, but it appears that over the last 18 months mortality has begun to stabilise at a higher rate than immediately before the pandemic.

Going forward, the data may be more indicative of future mortality than previous years, and if so, this may suggest lower future life expectancies. However, this still needs to be interpreted with care and a degree of caution, but it will take time to see the new trends develop. Many trustees are expected to revise their mortality assumptions after taking advice from their scheme actuary (and should ensure the changes are appropriate and justifiable).

Inflation

The Regulator’s views on inflation are unchanged from last year, when it noted some of the challenges current high (and still high) inflation rates will have on the calculation of benefits and benefit increases built into valuation calculations, and in deriving assumptions such as salary increases.

Revising recovery plans and contingent assets

Where a scheme is ahead of plan and trustees are considering whether to reduce or stop deficit reduction contributions (DRCs) as part of an actuarial valuation, the Regulator expects trustees to firstly consider the following:

- Ensure that the level of prudence in the technical provisions remains appropriate and the level of investment risk is supported by the current assessment of the covenant (if the covenant has weakened, or was already weak).
- Consider reducing the remaining length of the recovery plan before reducing the level of DRCs (where a technical provisions deficit exists). This is particularly important if the recovery plan remains longer than six years, or the scheme is mature or there are concerns about the longer-term ability of the employer to support the scheme.
- If a scheme’s recovery plan makes an allowance for asset returns in excess of the technical provisions assumptions, trustees should first consider reducing the additional risk from this before

reducing DRCs. This particularly applies if the investment strategy has recently been de-risked and technical provisions have not been amended to take account of the lower expected returns from this.

- If shareholder distributions exceed DRCs or covenant leakage is material, it is unlikely to be appropriate to reduce DRCs while a technical provisions deficit persists.

The Regulator will expect trustees to also work through these considerations where a request to reduce, or stop, DRCs outside of a formal actuarial valuation is received.

Forthcoming Regulator materials

The revised DB funding code

As announced in its recent Corporate Plan for 2023/24, the Regulator is now expecting the revised code of practice to come into effect in April 2024, rather than October 2023 as originally planned. The DWP's draft funding regulations are expected to come into effect at the same time.

However, it is interesting that the Regulator comments in the statement that it would be good practice to consider the steps to take to align (even if broadly) with the key principles of the draft funding code, particularly those underpinning the definition of the low dependency funding target, investment allocation and funding basis (particular for pension schemes where the funding level is above technical provisions but below buy-out).

The existing code and guidance will remain in place until the new legislative requirements and the new code come into effect (when the revised code and regulations will apply to schemes with valuation effective dates from that point). This includes all Tranche 18 valuations. The Regulator will consult on the information it plans to collect through the statement of strategy and related guidance in due course.

Updated guidance on covenant assessments

In conjunction with the revised DB funding code, the Regulator also plans to set out the proposed changes to its existing guidance on employer covenant assessment and monitoring later this year.

The Regulator intends to provide more detail on covenant visibility, reliability and longevity, how to treat guarantees for scheme funding purposes and more information regarding ESG risks and how these can be factored into the covenant.

Buck comment

After the events of last autumn, the news about generally improved funding positions is welcome. Trustees should, however, heed the Regulator's commentary on reviewing long-term plans which were set in a different world to that we are currently experiencing.

Trustees should review their long-term funding target and ensure their investment strategies are aligned to it. As always, trustees need to be mindful of their obligation to act in the best financial interests of members and their beneficiaries, and the scheme investments should generate returns that enable the scheme to pay promised benefits as they fall due. The scope a scheme has for risk-taking will depend on its maturity and the support available from the employer to underwrite risk.

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