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UK Pensions Briefing

Pensions Regulator's 2021 Annual Funding Statement: What employers need to know

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The Pensions Regulator has published its annual funding statement for 2021. Although aimed primarily at defined benefit (DB) pension schemes currently undertaking valuations, as in previous years the statement also contains messages which are of more general relevance to trustees and employers.

In this briefing we draw out the key messages for employers to note.

These same messages will be in trustees' minds as they approach valuations or otherwise engage with employers over support for the scheme.

What are the key themes this year?

The main context to the statement is again the uncertainty caused by the pandemic, with the Regulator recognising that, *"COVID-19 continues to have a profound impact on the economy, which is challenging employers and the pensions industry."*

The Regulator's expectations are consistent with last year's annual funding statement and again focus on covenant and risk management. The Regulator has again provided a detailed set of tables at the back of the statement, which set out specific expected behaviours which differ depending on the scheme's and sponsor's specific characteristics. These are broadly the same as last year's tables.

The table below summarises the main messages from the Regulator that are likely to be of relevance to employers, explains what employers should expect to happen now and what action they should take.

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Key message	What the Pensions Regulator expects	What employers can expect now	Employer action points
Understand the impact of COVID-19 and Brexit	Trustees should assess whether there has been a material deterioration in employer covenant and what the future impact will be. They should review and update funding and investment strategies if necessary.	Trustee engagement about these issues at the next valuation.	Take advice as needed and engage early in the valuation process if trustees consider the covenant impact is material and longer-term.
Employer covenants need careful monitoring	Trustees should: • Monitor covenant and engage with employers more frequently as uncertainties continue. • Consider undertaking scenario planning. Employers should provide detailed financial projections and updated business plans to trustees "in a timely manner".	Trustees may request more detailed financial information and may do so more frequently. They may also ask for a formal, binding information sharing agreement.	Check trustee non-disclosure agreements are appropriate and robust. Ensure information can be provided promptly, e.g. by designating a point-person to liaise internally and with the trustee. If considering an information sharing agreement, take advice on appropriate scope and deadlines.
Beware of covenant leakage	Employers should focus on protecting creditors (including the scheme) if facing an uncertain outlook. Trustees should seek mitigation/compensation for scheme where covenant leakage is not justified.	Trustee scrutiny of dividends and other forms of covenant leakage, particularly if employer prospects are uncertain. Requests for mitigation from trustee. Potentially, Regulator involvement.	Consider "covenant leakage" activities – e.g. dividends or intra-group loans by the employer – carefully, taking into account upcoming changes to the Regulator's powers. Keep a written record of the rationale.
Undertake contingency planning	Best practice is for schemes to have a covenant monitoring framework with triggers and actions pre-agreed by the employer.	Trustees may want to agree a covenant monitoring framework.	Take advice on appropriate triggers and consequences.

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Focus on the long term	Trustees and employers are strongly encouraged to agree a long term funding target (LTFT) and a clear strategy to achieve it.[1] Where schemes are behind target, get back on course. Where schemes have a technical provisions surplus, remain focussed on the LTFT.	Trustee engagement to agree a LTFT and journey plan, if not yet agreed. Potentially, a request for additional contributions at the next valuation if funding has strayed off course.	Carefully consider the trustee's proposals for a suitable LTFT and journey plan, including options for correcting the funding level if there is deviation from the planned path. Take advice as needed.
The best support for a pension scheme is a strong employer	Where COVID-19 and Brexit have had a limited impact on the employer, it should be "business as usual" for scheme funding. Where employers are facing short-term affordability issues, trustees can consider lower deficit repair contributions (DRCs) in the short-term with a view to helping the employer's sustainable growth. The scheme must be treated fairly compared to other creditors – e.g. shareholder distributions must be paused. Requests from employers for lower DRCs to support investment or tax planning can be accommodated but the same principles apply.	Trustees will want detailed financial information to substantiate any employer request for lower DRCs. They may require mitigations, e.g. contingent assets. They will also want to understand the treatment of other creditors. Have they been asked for an extension/ payments restructuring?	Employers facing short-term affordability constraints or wanting to take advantage of the new 130% tax "super-deduction" could consider requesting a restructuring of DRCs. They will need to show a clear business case and that the scheme is being treated fairly.

1 The Regulator emphasises that the current DB funding regime (under Part 3 of the Pensions Act 2004) applies until the new legislation (under the Pension Schemes Act 2021) and the revised DB funding code come into force. The new code is not expected to come into force *"until late 2022 at the earliest"*. However, the Regulator considers it is good practice for trustees and employers to agree a LTFT and journey plan now. This will also make compliance with the new laws easier.

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Corporate transactions may require mitigation	Trustees should rigorously assess the impact of transactions and negotiate mitigation if needed. Employers should inform trustees early in the process and give them a "seat at the table". Trustees and employers should keep a suitable audit trail about scheme considerations.	Potentially, greater trustee engagement in relation to transactions and requests for mitigation.	Review governance processes for transactions. Seek advice on transactions as needed, with an eye to the Regulator's enhanced powers. Carefully consider at what stage to inform the trustee and whether there is a need for Regulator clearance.
Employers in distress should expect Regulator engagement	Trustees should increase frequency and intensity of sponsor engagement and covenant monitoring and review scheme's position in distressed scenarios. The Regulator will look to its powers, including to its scheme funding power if dissatisfied with funding arrangements agreed by trustees and employers.	Active trustee engagement, regular requests for information and updates, particularly in relation to any refinancing. Trustees looking to their available powers or taking steps under agreed contingency plans. Regulator scrutiny and engagement.	Be prepared (jointly with the trustee) to justify valuation approach to the Regulator, with supporting evidence. Keep careful records of the rationale for decisions, with an eye to the Regulator's enhanced powers.

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