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UK Pensions briefing

The Pensions Regulator's annual funding statement 2020

Introduction

On April 30, 2020, the Pensions Regulator (the Regulator) published its latest annual funding statement. The statement is aimed at trustees and sponsoring employers of defined benefit (DB) schemes with valuation dates between September 22, 2019, and September 21, 2020 (which the Regulator refers to as tranche 15, or T15, schemes). However, the Regulator appreciates that times are challenging for all businesses as they deal with the effects of the COVID-19 pandemic, and thus the statement is relevant to all DB schemes.

The Regulator urges trustees and employers to work together to manage the impacts of the pandemic and to maintain a focus on the long term, particularly in terms of planning and risk management. The statement notes that trustees and employers found helpful the tables the Regulator produced in last year's statement, setting out different segments of the pensions landscape. With this in mind, it has reproduced the tables in the same format, and with the same content, as in 2019. However, the Regulator does stress that although its guidance on the key long-term risks remains relevant for T15 valuations, the tables are not intended to be exhaustive and are not a substitute for reading the 2020 statement.

The Regulator recognises the uncertainty of the COVID-19 crisis and that its effect will bear heavily on both the short-term impact of the lockdown on businesses and the longer-term effect on the economy and stock markets.

Feedback to the Regulator suggests that funding positions vary depending on the exact funding date between September 2019 and September 2020, a trend which is even more apparent this year. While there was a general improvement at December 31, 2019 compared with three years earlier, this was followed by UK equities and the yield on gilts falling sharply during the first quarter of 2020, mainly as a result of the COVID-19 virus. However, funding positions at March 31, 2020 were very variable and the Regulator does not expect all schemes' funding positions to deteriorate to the same extent as the markets. Schemes with low exposure to markets and good levels of hedging remain around target, and are likely to be those that have generally been active in de-risking, and have become better funded as they mature.

Where schemes have been heavily exposed to markets, and were insufficiently hedged, they have experienced a sharp fall in funding levels. Where the risks were considered within a framework of integrated risk management (IRM) the Regulator expects any contingency plan to be implemented where possible. If schemes have strayed from their longer-term objective, they will need to develop strategies to put them back on course.

The Regulator has made clear its intention to continue with its publication of a new DB funding code, although this will probably not come into force until late 2021 at the earliest. The period for responses to the current consultation has been extended until September 2, 2020, although this will be kept under review, and will be followed by a second consultation next year. However, the Regulator clarifies that all T15 valuations will be regulated according to the requirements of the existing legislation and guidance.

Scheme specific considerations

The Regulator sets out the five areas of analysis and these are outlined below.

Post valuation experience

In its COVID-19 guidance, the Regulator stated that it does not expect schemes close to completing their valuations to change their assumptions to take account of post-valuation experience. However, those with valuation dates around December 31 or earlier should consider post-valuation experience when preparing their recovery plan, taking account of both positive and negative experience. This is particularly relevant where trustees are considering requests to take account of negative changes in the employers' affordability.

Changing the valuation date

The Regulator notes that some trustees are being requested to change valuation dates to a time when conditions were considered more normal, for example from March 31, 2020 to December 31, 2019. They should consider whether any such requests are likely to be in the best interests of members and may affect security of members' benefits, particularly if the current crisis should prove to be prolonged. Any change in the valuation date should not be effected without legal and actuarial advice and the Regulator is likely to question the reasons for the change.

Calculating technical provisions

The Regulator recognises that it is reasonable to delay taking decisions about assumptions on technical provisions until there is more clarity on long-term future returns on scheme investments. March and April valuations will be challenging and trustees should discuss with their actuary how key assumptions may be affected, and how sensitive the valuation results may be to different outcomes. The Regulator expects schemes to progress as much of the preliminary valuation work as possible, taking its COVID-19 guidance into account.

Recovery plans and affordability

Collaboration between trustees and employers is key in the current circumstances. Trustees should carry out their own assessment of the employer covenant and plan to recover deficits with a focus on the affordability, while maintaining fair treatment and balancing the sustainability of the employer. Where possible, the Regulator expects trustees to *"incorporate appropriate incremental increases in contributions"* based on appropriate triggers such as free cash flow and payments to other creditors, especially where the scheme has taken on added funding risk to support the employer's recovery.

Shareholder distributions

The Regulator expects any suspension or reduction of shareholder distributions, such as dividends, to continue while employers invest in their recovery. Where shareholder distributions are recommenced, the Regulator expects liquidity and affordability to have been restored and for the recovery plan to reflect this. Where significant deficit repair contributions (DRCs) have been agreed, the Regulator expects trustees to restrict the use of this additional liquidity, to agree (and properly document) contingent contributions on the reintroduction of shareholder distributions, and understand how the repayment of deferred contributions and any protections operate.

Comment

The Regulator clearly expects trustees to be front and centre of plans to deal with scheme funding and the employer's consideration of the actions it needs to take in to weathering the COVID-19 storm. It emphasises that trustee-employer collaboration is essential. It also warns that it fully expects trustees to ensure that the scheme is remembered as a creditor when employers begin to rebuild their balance sheets, having been supported financially by a deferment of scheme contribution payments.

What the Regulator expects of trustees

Having detailed its scheme specific considerations, the Regulator turns next to trustees. Paying the promised benefits is the key objective for all schemes and this requires schemes to look ahead and set out clear plans on how this is to be delivered and managed within an IRM framework. The Regulator expects trustees and employers to agree a clear strategy with this long-term goal in mind, recognising how balancing investment risk, contributions and covenant support may change over time as the scheme matures.

These principal areas are each considered separately below.

Long-term funding targets

In its 2019 statement, the Regulator noted that legislation would be expected in due course to set out a requirement for DB schemes to have an ultimate objective, such as buy-out, consolidation or self-sufficiency, in line with the scheme's maturity profile. In advance of the new law and the revised DB funding code, the Regulator expects all schemes to set a long-term funding target (LTFT) "journey plan" consistent with how the trustees and employer expect to deliver the scheme's ultimate goal, and to be able to show that their short-term investment and funding strategies are aligned with the LTFT.

The Regulator continues this theme in the 2020 statement, and says that good practice involves trustees looking ahead and setting clear plans, and agreeing with the employer a long-term goal, as set out in the Pension Schemes Bill. This, the Regulator envisages, is typically in the form of a LTFT, and reduction of dependence on the employer. The Regulator encourages schemes with LTFTs to continue that focus, with suitable short-term modifications. Other schemes are urged to follow this practice, and set a LTFT consistent with how benefits are expected to be delivered. Trustees and employers should then be prepared to evidence that their short-term investment and funding strategies are aligned with the LTFT.

Comment

The Regulator is setting expectations now in advance of any future legislation. Central to these expectations is the issue of scheme maturity and, with most DB schemes closed, reliance will need to centre on funding and investment to secure members' benefits. The LTFT is distinct from, and sits above, the scheme's technical provisions. It will need to be considered for all schemes (not just those in T15) ahead of the appearance of the revised DB funding code, whenever that may now be.

Scheme covenants

The Regulator deals in some depth with covenant issues under the headings considered separately below.

Covenant assessment

With the considerable uncertainty surrounding COVID-19, the Regulator suggests trustees consider obtaining independent covenant advice, particularly where the covenant is deteriorating or where there is a high scheme reliance on it in circumstances of a large funding deficit. Trustees should only undertake their own covenant assessment where they have sufficient expertise as objectivity is important, and then should fully document their reasons for not taking professional advice. The Regulator expects trustees to have a full audit trail of their considerations and decisions, and may ask to view that documentation.

Covenant monitoring and contingency plans

The Regulator expects the frequency and intensity of covenant monitoring to be significantly increased in the current climate until covenant visibility and strength is restored. Trustees should identify and track the key aspects of the covenant so they can determine to take action based on trigger-activated changes which could have material impact on funding and investment strategy. Ideally, contingency plans should be drawn up with the employer, not necessarily covering all eventualities, but key risks and potential options. Again, the Regulator expects trustees to be able to show that such discussions have taken place with the employer and it may ask for evidence.

Covenant leakage

The Regulator outlines several forms of what it considers to be covenant leakage in addition to that in the obvious form of dividend payments. These include inter-company lending arrangements and transfers of business or assets at undervalue. It urges trustees to be vigilant of covenant leakage in its various guises, as this impairs the ability of the employer to fund the scheme. Where employers seek long recovery plans due to limited affordability, trustees should ensure there are agreements in place to prevent covenant leakage to the wider corporate group. Where trustees consider covenant leakage is unjustified, the Regulator expects them to seek suitable scheme protections, for example, in security over employer assets.

Comment

The Regulator has set out its clear expectations that in return for the trustees' bolstering of employers under financial pressure, the scheme should ultimately not be disadvantaged. It recognises that ongoing employer support is essential to enable trustees to realise the scheme's objectives of paying benefits to members but employers must play their part and compensate the scheme when their financial position improves in future.

Managing risks

Echoing previous statements, the Regulator continues to expect trustees to take an integrated approach to managing the three main areas of risk – those relating to investment, funding and covenant. This year, although focus on integrated risk management (IRM) continues, the Regulator expects scheme maturity issues to assume greater significance in setting future funding and investment strategies, as an increasing proportion of the membership reaches retirement age and draws benefits.

A large portion of the statement sets out in detailed tabular form the Regulator's expectations of five categories of scheme according to covenant strength, with each class then segmented further according to scheme maturity. These tables are identical to those produced in the 2019 statement but in the current situation, trustees' assessment of where their scheme now lies may well have changed. The Regulator specifically suggests that trustees decide how the covenant may have changed due to the impacts of both COVID-19 and Brexit so that they can judge which section of the table best reflects their scheme's situation. The table sets out what should be the considerations for trustees and employers as regards covenant, investment and funding in each case. In brief, the categories are:

	Strength of Covenant	Funding position
A	Strong or tending to strong.	Scheme's funding position is considered to be strong. Technical provisions are strong and recovery plan is shorter than average (less than 7 years).
B	Strong or tending to strong.	Scheme's technical provisions are weak and/or recovery plan is long (over 7 years).
C	Weaker employer with limited affordability.	Scheme funding on track to meet LTFT, technical provisions are strong and contributions are reducing deficits at a slower but affordable pace.
D	Weaker employer with limited affordability.	Scheme's technical provisions are weak and/or recovery plan is long (over 7 years).
E	Weak employer unable to provide support.	Stressed scheme with limited or no ability to use flexibilities in the funding regime.

The statement provides a detailed risk analysis for each category of scheme, although it is recognised that a given scheme might wish to take an alternative action where employer cash may not be available. The Regulator accepts, for instance, that contingent assets might be more appropriate where cash-flow is constrained but security is available, and suggests that trustees might wish to obtain evidence and justification to support their chosen action.

Investment expectations include setting an asset allocation consistent with the scheme's LTFT. Trustees are also expected to quantify the impact of adverse investment performance, as well as testing and evidencing the ability of the covenant to support funding without extending the recovery plan.

Comment

Elsewhere in the statement, the Regulator makes clear that the tables should not be read in isolation but that trustees and employers should use them in the light of the messages in the whole statement. They should also take into consideration both the current DB funding code and the Regulator's recently published guidance on COVID-19. The theme of IRM continues in the 2020 statement, but with the added requirement that risks relating to the current crisis, as well as scheme maturity are taken into account. As the number of pensioners increases, benefit outflows will exceed contributions, impacting on assets and the scheme's ability to close any shortfall in funding.

While last year's statement saw an increased focus on long-term funding, this year's statement emphasises the added responsibility of trustees to ensure that any employer support offered during the current crisis should be well documented and counterbalanced by reciprocal scheme support from the employer in future.

What schemes can expect from the Regulator

The Regulator acknowledges that it has suspended progress on its initiatives but that the principles behind them remain important and will be kept under review when the work is restarted.

It is continuing the regulation of schemes in relationship-managed supervision and it will be focusing its engagement on understanding and supporting trustees in responding to the impact of the pandemic, while ensuring the easements it has made available to employers are not abused.

The Regulator concludes by reminding trustees and employers that its suite of powers include directing how a scheme's technical provisions should be calculated, how a deficit should be funded and over what period. Such power can be used where there is a failure to agree the valuation assumptions or recovery plan, and it may instigate investigations where it takes the view that trustees or employers have not acted in line with the expectations set out in the statement, codes and other guidance.

Comment

The Regulator has made clear in this statement what its expectations are in the approach trustees and employers should be taking to scheme funding both during the current crisis and beyond. With this in mind, trustees and employers should heed the warning that they may well be called upon to justify to the Regulator their decisions in connection with their current valuation process, with evidence of robust negotiations having taken place.

The Regulator has reminded trustees and employers of its suite of powers in relation to DB schemes. It emphasises the need for schemes to be treated fairly in the current circumstances of employers seeking to avail themselves of the Regulator's published easements, and that it will be ensuring there is no abuse of the current relaxations. With this current focus, trustees need to be vigilant that the scheme is treated fairly with other stakeholders.

In a publication that has become something of an annual convention, the Regulator packs its usual punch in terms of setting out its expectations and what will, and will not, be considered compliance. It has given clear indications of how it envisages schemes should be treated in circumstances of a weakened employer covenant. As far as actions in the short term go, trustees and employers need to take advice from their legal and covenant advisers, as well as their actuaries in order to best cope with the economic fallout of the COVID-19 pandemic. Various forms of "covenant leakage" affecting the scheme's funding position may attract unwanted attention from the Regulator and trustees and employers should be able be prepared to justify their decisions and approach. It is likely that the eventual new DB funding code, together with the increased regulatory powers under the Pension Schemes Bill once it is enacted, will "up the ante" still further.

View the funding statement.

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