In Touch technical update

March 2019

Regulator publishes its annual funding statement

- Increased focus on long-term funding targets and scheme maturity
- Scheme scenarios expanded, to include TPR's expectations for investment strategies
- More contact with schemes expected in future, to identify potential risks

The Pensions Regulator (TPR) has published its annual funding statement (AFS) for defined benefit (DB) schemes. It is aimed at arrangements with valuation dates between 22 September 2018 and 21 September 2019, as well as schemes undergoing significant changes that require a review of their funding and risk strategies.

Long-term funding targets

Last year's white paper on protecting defined benefit pension schemes signalled an increased focus on long-term strategic thinking. This is expected to be a key part of the new Code of Practice on scheme funding, to be consulted on later in 2019.

The AFS states that TPR expects all schemes to agree a long-term funding target (LTFT) consistent with how the trustees and employers 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. Trustees should take steps to incorporate this approach into their thinking, and agree it with the employer, if they do not do so already.

TPR suggests a LTFT would, for instance, be to reduce the scheme's dependence on the employer, in order for it to be managed with a high degree of resilience to investment risks, once it has reached a level of maturity.

Balancing risks

TPR reiterates its long-standing expectation for schemes to consider integrated risk management. There is a particular focus this year on risks that arise from scheme maturity.

TPR states that it does not assess appropriateness of technical provisions based on predetermined relationships to gilt yields or other indices, but assesses the overall risk profile of each scheme using factors such as:

- Level of cash contributions, considering maturity, funding level and covenant;
- Additional deficit that could arise from the investment strategy and whether the covenant could support this; and
- Recovery plan length – schemes with strong covenants should generally have plans significantly shorter than the average of seven years.

The scheme scenarios set out in previous years' statements have been significantly expanded. The 2019 AFS sets out a series of tables covering 10 scenarios, identifying the key risks for trustees to focus on, and the actions to take, depending on the scheme and employer characteristics.

For the first time, the tables include TPR's expectations for investment strategies in the various scenarios.

The tables distinguish between 'mature' and 'immature' schemes, and TPR explains that maturity issues will assume greater significance in the future. The important consideration is the interaction between (a) the level of assets, the degree of underfunding and the amount of benefits paid out and (b) the scheme's ability to close the funding gap from investments and new contributions in a reasonable timeframe. TPR also notes that high levels of transfer activity can increase the risks associated with scheme maturity.

Equitable treatment

TPR remains concerned about the disparity between dividend growth and stable deficit reduction contributions (DRCs). It is also concerned about other forms of covenant leakage, and notes that it is actively intervening where it believes that schemes are not being treated equitably.

Its expectations are:

- Where dividends and other shareholder distributions exceed DRCs, it expects a strong funding target and short recovery plans;
- For weak or 'tending to weak' employers, it expects DRCs to be larger than distributions unless the recovery plan is short and the funding target is strong; and
- If the employer is weak and unable to support the scheme, it expects distributions to have ceased.

TPR intends to engage with schemes in 2019 to "broaden our grip in this area", including covering a greater range of schemes (regardless of covenant).

Long recovery plans

TPR will engage with a number of schemes ahead of their 2019 valuations, where it considers existing recovery plans to be too long, setting out its expectations for the upcoming valuation. TPR intends to look at both maturity and the covenant of the employer in forming a view on acceptable plan length and the selected schemes will cover "the whole spectrum of covenant strengths".

Other interventions and late valuations

TPR is continuing to develop its approach and will engage with other schemes during 2019 where it is concerned about other characteristics.

TPR again highlights that it can take enforcement action where the 15-month deadline for valuations is not met. However, it will support trustees if they cannot agree a valuation for valid reasons and they should not agree an inappropriate valuation and funding plan merely because the deadline is imminent.

Trustees and employers should be prepared to justify their approach with evidence of robust negotiations having taken place.

Brexit uncertainty

TPR continues to monitor the Brexit situation and will issue further guidance if necessary.

TPR powers

The AFS concludes by noting the powers available to TPR, including a power to direct how a scheme's technical provisions should be calculated and how its deficit should be funded. TPR notes that there are several investigations currently underway where these powers might be used.

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