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The Pensions Regulator's (TPR) annual funding statement 2020

JUNE 2020

TPR published its latest annual funding statement (the Statement) on 30 April 2020 setting out its regulatory approach to DB funding for the coming year and beyond. The Statement is particularly relevant to those schemes with valuation dates falling between 22 September 2019 and 21 September 2021 (Tranche 15), however, other schemes will be interested in TPR's comments on integrated risk management and the impact of the pandemic.

Updated DB Funding Code

TPR intends to issue an updated DB funding code following the completion of two consultation exercises. The first exercise commenced in March and the consultation period was recently extended to 2 September 2020. The new code is not expected to come into force until 2021 at the earliest. In the meantime, schemes will continue to be regulated in accordance with the requirements of existing legislation, the current DB funding code and other relevant regulatory guidance.

Valuations, recovery plans and current market conditions

TPR does not expect schemes with valuation dates falling before the end of 2019 to revisit valuation assumptions, rather any post-valuation experience (such as the current depressed market conditions) should be considered when agreeing new recovery plans.

For schemes with valuation dates on or around 31 March 2020, there may be a temptation to bring forward valuation dates (to exclude the recent period of equity market volatility). However, TPR is clear that such a move is unlikely to be in the best interests of members saying '…trustees who take this decision [to change the valuation date]… can expect us to question their reasons for the change…'. Accordingly, if a sponsoring employer proposes to bring forward the valuation date, trustees should obtain legal and actuarial advice on the reasonableness of the request, document their decision and reasons for accepting the proposal, and be prepared to engage with TPR.

TPR recognises the challenge of setting valuation assumptions in the current climate and particularly for those schemes with valuation dates in March and April 2020. TPR says it is reasonable for such schemes to delay taking decisions about the assumptions until more clarity emerges. One approach may be to agree some initial assumptions for the purposes of preparing a preliminary set of results which are then refined during the valuation period as trustees' confidence grows in reaching a view on future investment returns etc.

When agreeing new recovery plans, TPR expects schemes to consider current economic circumstances, including:

- carrying out additional due diligence on the employer covenant in accordance with TPR's COVID-19 Guidance,

- addressing any changes in the scheme's funding position,

- recouping any suspended / reduced deficit repair contributions, and

- where contribution levels are linked to optimistic investment performance, prioritising the security of member's benefits and if necessary, obtaining adequate security.

In its COVID-19 guidance TPR announced that it would take a more relaxed approach to enforcement in relation to various reporting and compliance duties over the period March to June 2020. For example, where valuation deadlines are missed or there is delay in issuing annual benefit statements as a consequence of disruption caused by the pandemic. In the Statement, TPR warned that it will be monitoring schemes to ensure these easements are not abused. Trustees and employers should bear this in mind and ensure they report to TPR as promptly as the current situation allows.

Long-term funding targets

Consistent with last year's statement, TPR continues to encourage schemes to put in place long-term funding targets which assume a low level of dependency on the employer and are resilient to investment risk. Long term funding targets are expected to become a legal requirement following the enactment of the Pensions Schemes Bill and TPR suggests that schemes adopt these targets now in readiness for the new legislation.

Employer Covenant

TPR recognises that COVID-19 has resulted in considerable uncertainty over covenant strength and employers' ability to address funding deficits. The employer covenant may be further impacted by the UK's departure from the EU. The Statement urges trustees to keep the covenant under review and to consider taking specialist advice. This is particularly important for schemes that are poorly funded and / or where the covenant is complex or deteriorating.

TPR suggests trustees should only undertake the covenant assessment themselves where they have sufficient expertise and are objective.
TPR expects trustees to monitor the employer covenant closely and to work with employers to identify what action may be required in response to events such as a material weakening of covenant or deterioration in the scheme's funding position. Trustees should draw up contingency plans with employers for this purpose.

The Statement highlights 'covenant leakage' as a threat to the employer covenant and urges trustees to monitor any activity by the sponsor or group which could have the effect of reducing the ability of the employer to support the scheme. The payment of dividends is an obvious example of covenant leakage, but trustees should note the other examples given in the Statement:

- cash pooling and inter-company lending arrangements
- group trading arrangements
- management fees, royalties and similar charges
- transfers of business or assets at undervalue
- excessive executive remuneration

Trustees should be aware of the impact that such trading arrangements, charges and fees have on the employer and take advice where appropriate. In some cases, it may be necessary to revise the trustees' assessment of the covenant and affordability (with a knock on effect on the recovery plan), in others, it may be necessary to seek appropriate mitigation from the employer, for example, security over employer assets.

<u>Integrated risk management (IRM)</u>

TPR continues to expect trustees to focus on the integrated management of three broad areas of risk: the ability of the employer to support the scheme, the investment risks, and the scheme's funding plans. Trustees should work with their advisers in all these areas to develop an IRM framework and associated governance which focuses on providing trustees with pragmatic and useful information for their decision-making.

Last year, TPR's statement included a series of tables designed to illustrate TPR's expectations on IRM by reference to a scheme's characteristics. Following positive feedback, this year's Statement adopts the same tables but with "refreshed messages to recognise the significantly different current conditions". TPR advises schemes to select the table which best reflects the circumstances of the scheme (after reconsidering the employer covenant to take account of the impact of COVID-19, Brexit and any deterioration in the funding position) and follow the recommended actions.

Smaller schemes are highlighted in relation to IRM and scenario planning, with TPR providing links to its IRM quick guide and IRM checklist for smaller schemes. Smaller schemes are not excluded from the IRM framework and while larger schemes often hit the headlines, TPR is monitoring the engagement of trustees of smaller schemes. While TPR appreciates that smaller schemes have limited resources, it expects trustees of smaller schemes to engage with advisers to put in place an IRM programme which is both suitable and cost-effective.

Comment

In keeping with the themes of previous statements, TPR continues to highlight the importance of long-term funding targets, integrated risk management, and on-going covenant assessment as well as providing guidance to those schemes currently undergoing valuations and grappling with the uncertainty caused by the pandemic.

TPR notes that the relative maturity of many schemes coupled with the adoption of de-risking strategies is likely to have limited exposure to market volatility and protected funding positions to some extent. By far its greater concern is the impact of the pandemic on employer covenant. TPR delivers a strong message to trustees to continue monitoring covenant (specifically, urging trustees to take professional advice rather than relying on their own assessment), to put in place contingency plans and to follow the IRM framework.

On this last point, the targeted message to trustees of smaller schemes regarding IRM should be noted. Trustees of these schemes should be prepared to evidence what action they have taken to comply with the IRM regime or face engagement / criticism from TPR. The message is clear: no scheme is too small for IRM.

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