Briefing

TPR: Annual Funding Statement 2019

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The Pensions Regulator (TPR) has published its annual funding statement for 2019, aimed at trustees of Defined Benefit (DB) pension schemes undertaking scheme funding valuations with an effective date between 22 September 2018 and 21 September 2019 – referred to as Tranche 14 schemes.

The key messages in TPR's statement relate to:

- The interaction between dividend payments to shareholders and deficit reduction contributions (DRCs).
- A forthcoming legal requirement for trustees to set a "Long Term Funding Target" in consultation with the employer, and that where valuations are due now Trustees ought to be discussing this before legislation is enacted.
- "Scheme maturity issues" which TPR expects to assume greater significance in future
- "Equitable treatment" or length of recovery plans, and TPR will be contacting schemes where it has concerns over these taking a "tough stance" where appropriate.
- TPR's preliminary analysis suggests Tranche 14 valuation results may be "marginally better or worse than at previous valuations", though in some cases there are still a number of months until the effective date during which time financial market conditions might change materially.

Long-term Funding Target

The Pensions White Paper (March 2018) promised schemes would be required to establish a "specific long-term destination" in relation to funding. Whilst the legislation underpinning this has not yet been written, TPR is guiding trustees to factor a Long-term Funding Target (LTFT) into their thinking now, particularly if they are in the process of agreeing a Scheme Funding valuation with sponsors.

LTFTs will be influenced by the trustees' (and sponsors') views on how the scheme's "ultimate objective" is to be delivered. TPR gives one example of a LTFT as to have achieved self-sufficiency by the time the scheme reaches a suitable level of maturity, but all LTFTs are likely to be scheme-specific.

The Regulator has now warned schemes that they need to be prepared to justify (with evidence) whether and how shorter-term investment and funding strategies are "aligned" with their LTFT.

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Balancing Risks

TPR recognises that the majority of DB schemes are now closed to new entrants and, as a result, "maturity issues" will become a more significant part of the funding and investment strategy-setting process. Trustees are reminded that they should be focussing on the integrated management of the three broad areas of risk (i.e. employer covenant, investment risk and scheme funding).

The Regulator has also pointed out that it does not "assess the appropriateness of schemes' TPs [Technical Provisions] based on predetermined relationships to gilt yields", but instead judges how risks are managed by trustees in their funding and investment strategies. In particular, they will look at:

- The scheme's cash outflow relative to its maturity and funding position
- Whether sponsor covenant can support deficits that might arise from the investment strategy in future
- The strength of the Technical Provisions relative to TPR's own prudent assessment of the liabilities
- The length of any recovery plan relative to the deficit. TPR expects schemes with strong employers to have "significantly shorter" Recovery Plan lengths than the average scheme (around seven years).
- What trustees have done to challenge "covenant leakage" (value leaving the sponsoring company in the form of dividends or inter-group payments for example) in order to secure a "fair deal" for the scheme.
- The quality of contingency plans and risks which aren't necessarily supported by the employer covenant.

The statement includes a matrix for trustees to use, along with an assessment of maturity from their Scheme Actuary, to determine where their scheme sits and therefore what TPR expects of them.

DRCs vs Dividends

TPR is clear that it will "broaden its grip" in the area of inequitable treatment - i.e. where company shareholders and other stakeholders are unduly favoured over the DB pension scheme. In particular, TPR remains concerned about the disparity between dividend growth and stable DRCs, as highlighted by "recent corporate failures".

The statement summarises TPR's expectations:

- If shareholder distributions exceed DRCs, TPR expects "a strong funding target" and "relatively short" recovery plans.
- For weaker employers, DRCs should normally exceed shareholder distributions.
- In extreme cases, TPR has said it expects the payment of shareholder distributions to have ceased.

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TPR's expectations

What TPR expects of trustees depends on the strength of employer covenant. This is not new, but a more detailed classification of employers has been published. Furthermore, the expanded assessment matrix now explicitly sets out TPR's expectations in relation to trustees' investment strategies, including that trustees should:

- set asset allocations consistently with schemes' LTFTs
- undertake some form of 'journey planning' for the longer-term
- quantify the impact of "adverse investment performance" on scheme funding and test whether the sponsor's covenant could support the existing funding approach without extending the Recovery Plan.

The Regulator has conducted its usual assessment of market conditions, concluding that most Tranche 14 schemes will see funding positions improve or worsen "marginally". However, schemes that have not hedged inflation or interest rate risks are likely to have fared worse than those that did.

Trustees are also reminded that they should not agree an inappropriate valuation merely because the statutory deadline is approaching. Instead, they are encouraged to engage with TPR as soon as possible.

What next?

In the coming months, the Regulator will be contacting schemes where they "have concerns on specific aspects of their funding or investment approach", in particular with regard to equitable treatment of the scheme (relative to shareholders) or the length of their recovery plans. TPR is clear that it will "continue to take a tough stance" where appropriate, citing the recent Southern Water case.

TPR remains on course to adopt a new funding Code of Practice later this year, though consultation on this will follow wider consultation in the summer on "options for a revised funding framework".

Finally, TPR reminds trustees that there are steps they should consider ahead of 'Brexit' this year. In particular, trustees are pointed towards TPR's January 2019 statement – with further guidance to be issued "if necessary". In the meantime, Trustees with Scheme Funding valuations underway, or coming up, should discuss with their advisers how to set a Long-term Funding Target and how their current strategy will align with it.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

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