BARNETT WADDINGHAM
beyond the expected

Briefing

2019 actuarial funding valuations

RISK | PENSIONS | INVESTMENT | INSURANCE

Headline actions

- Analyse how your funding position has changed, why and which factors are likely to impact it going forward.
- Consider your requirements and objectives, as sponsor, of a long term funding target.
- Decide on the balance between contributions and so called "covenant leakage" (e.g. dividend payments).
- Check TPR's expectations and possible areas of attention for your scheme.

TPR’s annual funding statement 2019

The Pensions Regulator (TPR) has published its annual funding statement for 2019, aimed at trustees and sponsoring employers 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. It provides guidance on the Regulator’s expectations and indicates how they intend to step up their oversight, including contacting schemes where they “have concerns on specific aspects of their funding or investment approach.” The key messages in the statement, which will impact sponsors, relate to:

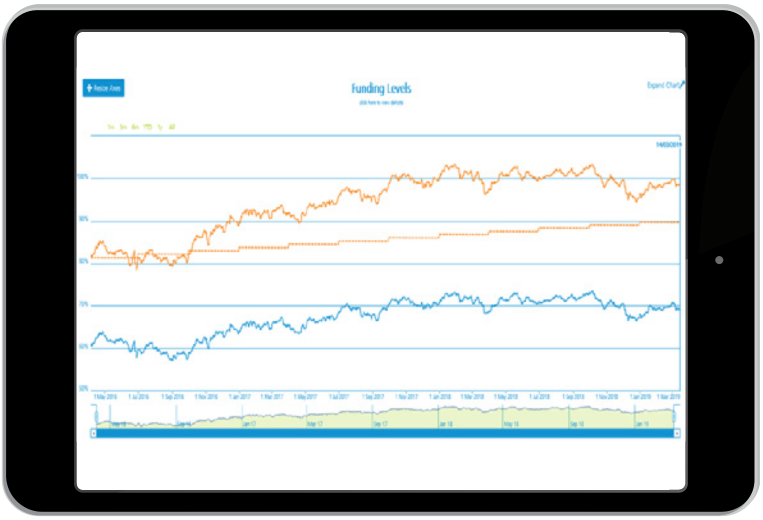
- The expectation that Trustees will consult with the sponsoring employer regarding their “Long Term Funding Target” before the anticipated legislation is enacted.
- A marker that “scheme maturity issues” are expected to assume greater significance in future integrated risk-management discussions.
- The interaction between payments which dilute covenant (including but not limited to dividend payments) and deficit reduction contributions (DRCs).
- A reminder of TPR’s power to impose technical provisions and recovery plans, noting that it has a number of investigations currently underway where it might decide to use this power.

Market background

TPR's preliminary analysis suggests Tranche 14 valuation results may be "marginally better or worse than at the previous valuation."

Our own analysis suggests an improvement is more likely although the picture is clouded as a number of schemes are either implicitly or explicitly de-risking and consequently are not considering the position on a like for like basis from one valuation to the next and, of course, financial market conditions might change materially before the effective valuation date.

As ever, a variety of factors affect the funding level of a scheme including the valuation date, the scheme's funding and investment strategies and the extent to which the scheme hedges its interest rate and currency risks. Only by monitoring the position will you truly gain an insight into where you might be. Below is an indication of funding progress based on the profile of schemes across the FTSE350.



The Solvency position is shown in blue whilst the Technical Provisions are shown in orange: actual with a solid line and expected with a dotted line.

How companies should approach a valuation

Long Term Funding Target

TPR has indicated that trustees and companies should have a journey plan for their DB pension schemes. In particular, it should look at what is a reasonable and achievable long-term target (buy-out, consolidator, self-sufficient run-off etc.) for the scheme, given the covenant strength and funds available. There should also be a plan for reaching that target.

For a significant number of sponsors we expect this to form a secondary target, in the short to medium term at least, to retain flexibility with regard to both the timescale and ultimate destination. This is slightly at odds with TPR's view although they are mindful of justifications for variation. As such, a framework which is robust and can respond to changing circumstances and one-off shocks is key.

Regardless of the attention of TPR, we have been advocating an achievable end game plan for several reasons:

- Contributions are set with regard to a targeted outcome rather than being seen as a price for complying with legislation
- Valuation discussions become less adversarial as progress against the end game plan can be monitored and contributions adjusted accordingly
- Having an agreed and achievable end game plan enables the company to justify a sensible reinvestment and distribution policy. It will provide evidence that the balance between the scheme's needs and investing in the company and/or rewarding shareholders is reasonable.

Identify your objectives

The process of setting the valuation assumptions and contributions usually requires the agreement of the trustees and the employer. The employer should therefore be clear on what it is trying to achieve both at this valuation and also over the medium to long-term for the pension scheme (see above).

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 should be focussing on the integrated management of the three broad areas of risk (i.e. employer covenant, investment risk and scheme funding) and it is important that sponsors engage early in these discussions to ensure they are aligned with their expectations.

TPR has also pointed out that it does not "assess the appropriateness of schemes' Technical Provisions (TPs) based on predetermined relationships to gilt yields", but instead judges how risks are managed in funding and investment strategies. (Although there have been unconfirmed rumours of "tramlines" with assumptions falling outside of these being more likely to attract attention!) 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 and the quality of contingency plans (which aren't necessarily supported by the employer covenant)
- The strength of the TPs relative to TPR's own prudent assessment of the liabilities (potentially this may be better defined in the new funding Code of Practice, possibly coming later this year).
- The length of any recovery plan relative to the deficit, with strong employers expected to have "significantly shorter" Recovery Plan lengths than the average scheme (quoted as 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 sponsor should seek to understand the trustees' viewpoint to enable a mutually acceptable solution to be reached with minimal conflict or debate.

Employer covenant – getting the balance right

Employer covenant is defined by TPR as the extent of the employer's legal obligation and financial ability to support the scheme now and in the future. The assessment of employer covenant forms an important part of the trustees' valuation process.

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 within the annual funding summary.

The expanded assessment matrix now explicitly sets out expectations in relation to trustees' investment strategies, including that trustees should:

- set asset allocations consistently with schemes' long term funding target
- 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.

Having a strong covenant, or being able to demonstrate an improved covenant since the previous valuation, will allow the trustees to be more flexible in the assumptions they determine for the valuation. This may result in a lower deficit, allowing the existing recovery plan to continue. Care should be exercised as TPR has expressed a robust view (as noted above) that sponsors with strong covenant should address this deficit with a shorter than average recovery plan.

Investment – setting the strategy

A scheme's investment strategy is one of the key drivers of the ultimate cost of the scheme to its employer. It is the trustees who have the responsibility for setting the strategy, but the employer should recognise that it has an important role to play and should maintain an active interest, particularly as the employer's objectives may differ from the trustees'.

It is always worth considering at the valuation date whether the current investment strategy is still relevant and this should be a discussion between the trustees and the employer. This is particularly relevant if you are also looking to agree or revise the long term funding target.

TPR – more proactive, less accommodating

TPR will review the funding plans of schemes when they are submitted and, in addition, are looking to sit alongside some schemes throughout the valuation process. In the coming months, TPR 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.

Our experience of acceptable funding approaches, valid justifications for divergence and alternative funding solutions enables our clients to limit the scrutiny placed on their valuation process. Recognising TPR's requirements early in the valuation process can prove cost-effective and enable a swift conclusion to be reached.

Enhancing the way valuation advice is delivered

Our funding tool, Illuminate®, can help employers and trustees explore the complex relationships between funding, investment, employer covenant and benefit settlement. Illuminate enables employers to make informed decisions and avoid the delays usually associated with valuation negotiations. All key variables can be adjusted to see the effect these changes will have on the liabilities and potential recovery plan contributions including the interaction with the long term funding target.

Illuminate also incorporates a funding tracker which monitors changes in the assets and estimated liabilities of the scheme over time, updating daily on a range of different bases and can also be used to illustrate projected outcomes. This will allow the employer, as well as the trustees, to understand any significant changes that may have occurred since the valuation date and the impact of planned exercises or strategic changes compared to the expected position and long term funding target.

You can find out more about Illuminate on our website – please contact us for access details to take a closer look.

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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