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Pensions briefing

The Pensions Regulator's annual funding statement 2018

Briefing

May 2018

Introduction

On April 5, 2018, the Pensions Regulator (TPR) 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, 2017, and September 21, 2018 (referred to by TPR as tranche 13 schemes). However, given its wide implications, the statement is relevant to all DB schemes, and its contents should be noted particularly where schemes face significant changes and, as a consequence, require reviews of their funding and risk strategies.

While TPR's analysis suggests marginally improved funding levels for tranche 13 schemes compared to three years ago at the time of their last valuations, hedged schemes will generally have fared better. The statement flags concerns about what TPR describes as the growing disparity between dividend growth and stable deficit reduction contributions (DRCs).

The statement should be read in conjunction with TPR's code of practice on scheme funding, which will be updated "over the next two years" and which, according to the recent White Paper on DB scheme sustainability, may become mandatory.

This briefing looks at the key messages from TPR in the 2018 statement, compares them with some of the themes in TPR's earlier statements, and suggests some key actions for trustees and employers engaged in or approaching a valuation.

The statement's main themes

Of late, the pensions landscape has been dominated by corporate failures: TPR's 2017 statement followed a Parliamentary enquiry into the collapse of BhS; the 2018 statement follows a Parliamentary enquiry into the collapse of Carillion. It is therefore unsurprising that TPR's key messages for this year centre on

- The affordability of scheme benefits and the management of funding deficits.
- The "fair treatment" of schemes compared with dividend payments made to shareholders.
- The prioritisation and effective quantification of risks with an underlying theme of integrated risk management (IRM), together with contingency planning.

These principal areas are each considered separately below.

Affordability of benefits and managing deficits

As in the 2017 statement, TPR has segmented schemes according to sponsoring employer characteristics (strong, tending to strong, or weak). However, the 2018 statement places more emphasis on covenant strength and TPR has also split weaker employers into three subsets, while the 2017 set out only one such category. TPR has provided in tabular form what is expected of trustees, depending on the group into which their scheme falls

- Those schemes with a strong or tending to strong employer should consider strengthening their technical provisions, increasing contributions or reducing the length of recovery plans. Where dividends or other forms of "covenant leakage" are disproportionate to DRCs, TPR expects a short recovery plan, although there is no indication of what TPR considers long or short in this context. Schemes with weak technical provisions and/or long recovery plans should look to strengthen their short term security through mechanisms such as contingent assets and parent company guarantees.
- Schemes with weaker employers with limited affordability are expected to prioritise scheme liabilities over shareholder returns. Trustees should monitor covenant risk and limit member risk by maximising support for the scheme by determining what cash, contingent assets and formal group support may be available and should also seek opportunities to reduce risk in order to protect members' benefits.
- Trustees of schemes with a weak employer that is unable or unlikely to provide adequate financial support are expected to seek the best possible funding outcomes for members in the circumstances and should be prepared to show evidence of the appropriate measures they have taken.

Comment

In the 2018 statement, TPR actively encourages trustees of schemes with strong employers to seek additional financial support where a sufficiently robust employer may be in a position to provide it. This is a change in emphasis from the 2017 statement, which focussed more on stressed situations. Those with weaker employers should bear in mind that TPR could well seek confirmation of any measures taken to improve their scheme's position and members' benefit security.

Fair treatment for the scheme

TPR is concerned about the “growing disparity” between dividend growth and stable DRCs. It states that a strong covenant should not of itself prevent trustees from insisting on higher contributions where the employer can afford them and, where dividends are disproportionate to contributions, TPR will consider that affordability is not an issue. There is no defined dividend/contribution ratio but the statement highlights that the trustees’ key objective is to ensure the scheme is able to pay benefits as they fall due and, with this in mind, TPR expects robust negotiations to achieve a fair deal for the scheme.

Trustees should also be alert to other forms of “covenant leakage” (that is, value leaving the sponsoring company) when considering the affordability of contribution payments and fair treatment of the scheme. Alternative types of covenant leakage could include intra-group loans, intra-group transfers of business assets at below market value and, for some smaller employers, high levels of executive remuneration. TPR’s view is that employers with weak or tending to weak covenants should normally retain cash within the company to fund sustainable growth and any pension deficit in preference to paying dividends.

Comment

It is unsurprising in the light of recent high-profile corporate failures that TPR is placing greater emphasis in this statement on what it considers to be the rightful place of deficit funding in the priority order of allocation of the employer’s financial resources. Trustees who fail to take a strong stance in their funding negotiations with the scheme sponsor may be called upon to explain their actions where recovery periods are considered by TPR to be too long or where dividend payments are seen as disproportionately generous.

Risk management and contingency planning

In the 2018 statement, TPR builds on one of its central themes of recent years – that of the integrated management of three key risks; investment risk; funding risk and covenant risk (IRM). Trustees should take a balanced approach in monitoring risks and tailor their actions to suit the scheme’s circumstances. However, scheme size should not be a barrier to, or an excuse for, poor risk management or scrimping on adviser fees. Trustees, even those of smaller schemes, should work with their advisers to manage and prioritise risks. They should use appropriate tools, including risk-attribution charts, stress tests and scenario-planning exercises, examples of which are available in TPR’s quick guide to IRM and also the DB scheme investment guidance. Short term risks, such as a downturn in the employer’s business, should also feature on the trustees’ radar.

TPR states that effective IRM requires documented and workable contingency plans. Its view is that the best protection for schemes lies in contingency plans setting out legally enforceable rights where possible, such as those over secured assets. Where this is not possible, trustees should at least agree the actions to be taken if identified risks materialise. Where trustees are not satisfied that they have a reliable, legally enforceable contingency plan, they should consider a different overall strategy which leaves the scheme less exposed.

Comment

TPR's approach on contingency planning appears less prescriptive than that in the 2017 statement, in which it advocated that all schemes should put in place contingency plans "which should be legally enforceable". Trustees are expected to work with the employer in a collaborative fashion to assess how and what form of support could best be provided to the scheme.

The statement's further highlights

The statement highlights several other areas of risk, which are considered below.

Transfer activity and transfer values

Reflecting reported high levels of transfers out, TPR says that if trustees wish to include an allowance for future transfers in their technical provisions, they must review their scheme's experience and likely trends very carefully. TPR is concerned that assumptions made about increasing numbers of transfers out, which reduce technical provisions, may not actually be borne out. Therefore, TPR expects assumptions to be evidence-based and there is a new requirement for records to be kept of transfers, with details of advisers involved and of the receiving scheme.

Contingency plans should be in place if expected levels of transfer activity do not materialise, and trustees should be alert to large transfers which could have a significant effect on scheme funding (while remembering that some large transfers are notifiable to TPR).

As regards transfer values, TPR is working closely with the Financial Conduct Authority (FCA) to improve the quality of information available for members and advisers. If trustees have concerns over the level of transfer activity, they are expected to report these to the FCA or TPR, underlining the importance for trustees of maintaining written evidence of how scheme risks are being managed. TPR expects advisers to alert trustees to the funding and investment risks from increasing scheme maturity, particularly in light of an increase in transfer numbers.

Brexit uncertainty

Where appropriate, TPR expects trustees to have "open and collaborative discussions with their sponsors" about the potential impact of Brexit. If sponsors wish to extend recovery plans because of Brexit-related uncertainty, trustees should ensure shareholders are sharing the burden proportionately and seek other forms of security from sponsors. The potential impact of Brexit should be kept under review.

Demographics and assumptions

The themes of IRM and documentation recur in TPR's consideration of discount rates used in scheme valuations which should be chosen with long term funding and investment targets in mind. Trustees should document the rationale for chosen discount rates, even where these are unchanged from the previous valuation. Where trustees assume that interest rates will rise, they should agree now with the employer any necessary action should this not happen.

Mortality assumptions should be evidence-based, appropriate for the membership of the scheme, and derived using reliable methodology.

While market conditions, together with the impact on scheme funding of low bond and gilt yields, were discussed at length in the 2017 statement, they are not specifically mentioned in the 2018 statement except in the context of discount rates.

TPR reiterates its intention to fine trustees where valuations are not agreed within the 15-month statutory timeframe, and TPR has already shown its willingness to impose such penalties. However, it is stressed that trustees should not agree an inappropriate valuation merely because the deadline is imminent or has been missed.

Comment

TPR's future approach will be tougher and it intends to increase its level of supervision. This is a developing area and it will be interesting to see how the promised newly revised funding code of practice, to be produced "over the next two years" in the light of the DB White Paper, will address funding and valuation issues. It is clear that TPR will fine trustees for late valuations if "reasonable" steps have not been taken, and trustees should ensure that TPR is kept informed if they are at risk of missing the statutory deadline. That said, the prospect of a late valuation should not be cited as an excuse for trustees' acceptance of a poor scheme funding deal from the employer.

As for transfer values, there is obvious concern about the appropriateness of some transfers (which is unsurprising, given the FCA's recent surveys). Trustees should remain vigilant and highlight to TPR or the FCA any concerns they may have about member transfers.

TPR's future approach and case interventions

TPR's intention to seek documented evidence of the advice trustees have taken will enable it to intervene promptly where actions are taken which are not considered to be in members' interests. Using its powers under section 231 of the Pensions Act 2004, it is possible for TPR to direct how a scheme's technical provisions should be calculated and how (and over what period) its deficit should be funded. Although TPR has not actually used these powers to date, the statement says they could be implemented in some cases which are currently under consideration. The approaches used can vary from one-to-one supervision through to the use of an improvement notice or a full anti-avoidance investigation. A proactive approach has been taken in respect of small schemes, with TPR contacting those affected.

TPR confirms that its proactive casework has increased by 90 per cent and it warns that if a skilled person report is commissioned (under section 71 of the Pensions Act 2004) it may well require the employer or the trustees to bear the cost of producing that report.

Comment

The 2018 statement contains no fundamental changes in approach but the focus has switched from “stressed schemes” in earlier statements to strong covenants in the current publication. Even schemes with strong covenants are encouraged to strengthen their technical provisions and shorten recovery plans where possible. There is increased emphasis on contingency planning and, where covenants are weak, trustees need to manage the associated risks proactively.

It is possible that there may be significant changes in the revised DB funding code as the White Paper suggested that it may become mandatory. There is even a hint that TPR may be considering introducing some sort of formula for the calculation of the dividend/contribution ratio in future.

The 2018 statement highlights the importance for trustees of using documentation to evidence decision making, and such evidence may well be scrutinised by TPR in the event of funding difficulties, or risk to the financial sustainability of the sponsor.

TPR is keen to confirm that it will not hesitate to use its powers where necessary but still emphasises a collaborative approach between trustees and employers. For schemes currently carrying out or nearing a valuation, trustees would be well advised to consider the 2018 statement carefully, and a change of strategy might be required to avoid the possibility of TPR scrutiny.

View the funding statement.

View TPR’s summary of key messages from the funding statement.

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