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# The pensions regulator's annual funding statement 2019

## Briefing

March 2019

## Introduction

On March 5, 2019, 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, 2018, and September 21, 2019 (referred to by TPR as tranche 14, or T14, 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.

TPR's preliminary analysis of the cohort of T14 schemes suggests funding levels compared to those of the previous valuation could be marginally better or worse depending on the exact date of the valuation and other scheme-specific circumstances. However, TPR notes that hedged schemes are likely to have fared better on the whole and it remains concerned about the disparity between dividend growth and employer contributions.

TPR states that it will regulate T14 schemes under the approach set out in the 2019 funding statement, which should be read in conjunction with TPR's current code of practice on scheme funding. TPR's intention is to review and update the scheme funding code following consultation during summer 2019 on various options for a revised funding framework. However, until the revised code comes into force, trustees and employers should continue to refer to the existing code and guidance.

This briefing looks at the key messages from TPR in the 2019 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

TPR makes reference to the continuing Brexit uncertainty and reminds trustees and employers of its related statement published on January 24, 2019, which we analysed in our January Stop Press. TPR's 2018 statement followed a Parliamentary enquiry into the collapse into the collapse of Carillion and now, in 2019, TPR continues to expect trustees to focus on the integrated management of covenant and investment risks with scheme funding plans.

The key themes from TPR for this year are

- The introduction a long-term funding target (LTFT) for all schemes, not just those in T14.
- Balancing risks and the segmentation of schemes by maturity as well as by covenant strength.
- What TPR expects from trustees and employers in terms of the scheme's LTFT and balancing risks.
- TPR's approach regarding the scheme's equitable treatment in comparison with other stakeholders. Concern remains over the disparity between dividend growth and contributions and other forms of what TPR terms covenant "leakage" (by which it means value leaving the sponsoring employer).

These principal areas are each considered separately below.

## What TPR expects of trustees

Paying the promised benefits is the key objective for all schemes and this requires schemes to look ahead and set out clear plans on how this is to be delivered. TPR expects trustees and employers to agree a clear strategy with this long-term goal in mind, while balancing investment risk, contributions and covenant support.

### Long-term funding targets

The Government's March 2018 White Paper *"Protecting Defined Benefit Pension Schemes"* noted that schemes' funding plans sometimes had an inappropriately short-term focus. In due course, legislation is expected to set out a requirement for DB schemes to have an ultimate objective, such as buy-out, consolidation or self-sufficiency, in line with the scheme's maturity profile. In advance of the new law and the revised DB funding code, TPR expects all schemes to set a LTFT "journey plan" consistent with how the trustees and employer expect to deliver the scheme's ultimate goal, and to be able to show that their short-term investment and funding strategies are aligned with the LTFT.

### Comment

TPR is setting expectations now in advance of any legislation that may appear in 2019. Central to these expectations is the issue of scheme maturity and, with most DB schemes closed, reliance will need to centre on funding and investment to secure members' benefits. The LTFT is distinct from, and sits above, the scheme's technical provisions (TPs). It will need to be considered for all schemes (not just those in T14) ahead of the appearance of the revised DB funding code later in 2019.

## Balancing risks arising from scheme maturity

As in recent statements, TPR continues to expect trustees to take an integrated approach to managing the three main areas of risk – those relating to investment, funding and covenant. To this ongoing focus on integrated risk management (IRM) is now added a requirement for trustees to take into account an added risk which may arise from scheme maturity as an increasing proportion of the membership reaches retirement age and draws benefits.

A large portion of the statement sets out in detailed tabular form TPR's expectations of 5 categories of scheme according to covenant strength, with each class then segmented further according to scheme maturity. TPR describes what should be the considerations for trustees and employers as regards covenant, investment and funding in each case. In brief, the categories are:

| | Strength of Covenant | Funding position |
|---|---|---|
| A | Strong or tending to strong. | Scheme's funding position is considered to be strong. TPs are strong and recovery plan is shorter than average (less than 7 years). |
| B | Strong or tending to strong. | Scheme's TPs are weak and/or recovery plan is long (over 7 years). |
| C | Weaker employer with limited affordability. | Scheme funding on track to meet LTFT, TPs are strong and contributions are reducing deficits at a slower but affordable pace. |
| D | Weaker employer with limited affordability. | Scheme's TPs are weak and/or recovery plan is long (over 7 years). |
| E | Weak employer unable to provide support. | Stressed scheme with limited or no ability to use flexibilities in the funding regime. |

The statement sets out detailed risk analysis for each category of scheme, although it is recognised that a given scheme might wish to take an alternative action where employer cash may not be available. TPR accepts, for instance, that contingent assets might be more appropriate where cash-flow is constrained but security is available, and suggests that trustees might wish to obtain evidence and justification to support their chosen action.

Investment expectations are new to the tables and include setting an asset allocation consistent with the scheme's LTFT. Trustees are also expected to quantify the impact of adverse investment performance, as well as testing and evidencing the ability of the covenant to support funding without extending the recovery plan.

### Comment

In the 2018 statement, TPR built on one of its central themes of recent years – that of IRM. This continues in the 2019 statement, but in more detail and with the added requirement that risks relating to scheme maturity are taken into account. As the number of pensioners increases, benefit outflows will exceed contributions, impacting on assets and the scheme's ability to close any shortfall in funding.

However, while last year's statement placed greater emphasis on deficit funding in the priority order of allocation of the employer's financial resources, this year sees an increased focus on long-term funding, particularly as schemes mature. TPR also sets out specific expectations in relation to scheme investment strategy and how this should evolve in time.

It is interesting to note that TPR now considers a recovery period in excess of seven years (the current median length) as long. Trustees and employers should assess their scheme according to TPR's 10 sub-categories and consider in detail the messages in the statement relating to each of the 3 key areas of funding, covenant and investment.

## TPR's new approach and what schemes can expect it to deliver

TPR notes that it contacted several schemes in 2018 ahead of their valuations where it was concerned about possible "inequitable treatment" of the pension scheme. This theme continues in the 2019 statement where TPR repeats the need for the scheme to be treated equitably compared with other stakeholders.

### Dividend payments and equitable treatment

In the context of dividends or shareholder distributions, TPR has set out more stringent requirements

- If the employer is tending to weak or weak, that contributions should be higher than shareholder distributions unless the recovery plan is short and the funding target is strong.
- Tf the employer is weak and unable to support the scheme, payments of shareholder distributions should have ceased.
- Where shareholder distributions exceed contributions, for a strong funding target to be in place with a relatively short recovery plan.

TPR remains concerned about the disparity of dividend growth and contributions. While the Government's February 2019 response to the White Paper consultation confirmed that it did not intend to extend the notifiable events framework to cover payment of dividends, there was a statement that TPR would consider whether the level of dividend payments was appropriate in relation to a scheme's funding position. The DWP is working with the Department for Business, Energy and Industrial Strategy on proposals to strengthen the UK's framework relating to dividend payments.

### Comment

The proposed strengthening of the dividend payment framework could result in more stringent requirements being imposed in future. TPR now seems to have clear "red lines" as far as the payment of dividends is concerned. In 2018, TPR intervened in several cases in advance of scheme valuations where it considered schemes were possibly not being treated fairly in comparison to shareholders. It remains to be seen if this year's Pensions Bill contains any hard-and-fast regulatory power in this area.

## Long recovery plans and TPR interventions

TPR promises to engage with schemes over the coming months ahead of their 2019 valuations where it considers recovery plans to be unacceptably long. The schemes selected for this engagement will cover the whole spectrum of covenant strengths, with TPR examining both the maturity and the employer's covenant in assessing whether the recovery plan is of an acceptable length.

TPR's approach is still developing to allow engagement where it is concerned about other characteristics of a scheme's funding and investment plans in the context of their covenant and scheme profile. It states that trustees are employers must be fully aware of TPR's expectations as set out in the 2019 statement and the wider guidance.

## Comment

TPR has made clear in this statement what its expectations are for the various categories of scheme. With this in mind, trustees and employers should heed the warning that they may well be called upon to justify to TPR their approach to IRM, with evidence of robust negotiations having taken place.

## Late valuations

TPR reminds trustees that they should not agree an inappropriate valuation and funding plan merely because the deadline is imminent. Early engagement with TPR is expected if there is an indication that the deadline may be missed and TPR may choose not to apply a penalty if there is a genuine reason why the valuation cannot be finalised in time. TPR's preference is that the best outcome is reached for the scheme, rather than a valuation agreed under pressure simply to meet the deadline.

## Comment

As in the 2018 statement, there is a warning that TPR may impose penalties for the 15-month statutory deadline being exceeded. However, in the 2019 statement TPR confirms its preference for an appropriate valuation to be agreed and helpfully states that it will support trustees where they are unable to meet the time constraints for valid reasons.

## Regulatory powers

TPR reminds trustees and employers of its suite of powers in relation to DB schemes. It emphasises that it may not need to use its power to direct how a scheme's TPs are calculated and how its deficit should be funded, where there is timely engagement between the trustees, employers and TPR.

## Comment

In a publication that has become something of an annual convention, TPR's latest statement delivers a more detailed analysis of its view on the general DB funding picture than those of past years. The statement is essential reading for all trustees and employers, not merely those in T14 undertaking valuations this year. The LTFT requirements are more far-reaching than funding considerations set out in previous statements, and exceed the technical provisions funding basis. Although the LTFT does not yet have legal force, TPR expects employers and trustees now to have in mind the delivery of their scheme's ultimate objective.

TPR has given clear indications of how it envisages its powers and their usage developing in the immediate and short-term future and all those involved with DB schemes should take heed. There is also an explicit warning that TPR it will commence formal investigations where necessary and appropriate, which is a clear reminder of TPR’s intention to be a “clearer, quicker and tougher” regulator.

As for actions to be taken in the short term, trustees and employers need to take advice from their actuary on the level of scheme maturity. Consideration must also be given to which of the 10 categories of risk level applies. A LTFT will need to be devised which is consistent with the scheme’s end-goal and discussions should be held on how to address any recovery plan which may now be considered excessively long. Forms of “covenant leakage” affecting the scheme’s funding position may attract unwanted attention from TPR and trustees and employers should be able to evidence robust negotiations, and should be prepared to justify their decisions and approach. It is likely that the new DB funding code will “up the ante” still further and it will need to be read closely when it is available for consultation later this year.

View the funding statement.

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

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