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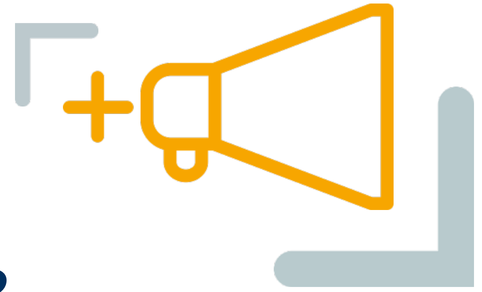

News Alert 2019/03

6 March 2019

The Pensions Regulator's annual funding statement 2019

At a glance

An important statement on DB funding has been issued by the Pensions Regulator

The Pensions Regulator has issued its latest funding statement setting out its key messages for trustees and sponsors who are undertaking valuations. The statement continues the direction of travel of previous statements and is now more one of integrated risk management than funding.

Key Actions

Trustees and sponsors, especially those currently carrying out or approaching a valuation

- Read the statement, establish which scheme type your scheme most closely resembles and assess whether the statement affects the approach currently being taken in relation to covenant, investment and funding issues.
- If not already done so, draw up a long-term goal for paying the promised benefits, set a consistent long-term funding target (LTFT) in relation to this goal, and establish a journey plan for progressing to the LTFT, ensuring that investment and funding strategies in the interim period are also aligned.
- Check whether the scheme is being treated equitably, in particular when considering the relative levels of deficit repair contributions and shareholder distributions.

The Detail

On 5 March 2019 the Pensions Regulator issued its annual funding statement, aimed primarily at trustees of DB schemes, but given the role that employers play in the process, of significance to them too. The statement is focussed on valuations with effective dates between 22 September 2018 and 21 September 2019 as well as schemes undergoing significant changes that require a review of their funding and risk strategies.

This lengthy statement is divided into two parts, with the bulk of the document comprising a segmentation of DB schemes containing the key risks that trustees and employers should focus on and actions they should take depending on the characteristics of the scheme and sponsor.

What the Pensions Regulator expects of trustees

The Pensions Regulator states that paying the promised benefits is the key objective for all schemes and that it is important for trustees to look ahead, set clear plans for how this objective will be delivered and balance the risks that they will face in doing this.

Long-term funding targets

Ahead of the Government's intention to legislate requiring DB schemes to have a specific long-term destination (such as buyout, entering a consolidator vehicle, or achieving "self-sufficiency"), the Regulator wants all DB schemes to set a long-term funding target (LTFT) consistent with that destination, which is distinct from and higher than technical provisions, and be prepared to evidence that their shorter-term investment and funding strategies are aligned with their LTFT via journey plans.

Trustees are now expected to set long-term funding targets in addition to technical provisions

Our viewpoint

This is an unsurprising, but new departure for the Pensions Regulator in its annual funding statements. It will be quite some time before the legislation will be in place to enforce long-term destinations and their associated journey plans, but that is not stopping the Regulator from setting expectations now.

Balancing risks

The Regulator continues to expect trustees to focus on the integrated management of three broad areas of risk – covenant, investment, and funding – and to take into account specific risks that arise from scheme maturity.

Integrated risk management remains key – covenant, investment and funding

The Regulator reprises messages in previous statements that it applies an integrated approach to assess the overall risk profile of each scheme using a number of factors. After listing these – and in a lot more detail than in previous years – it goes on to set out in tables its expectations which, as with last year's statement differ according to the scheme's and sponsor's characteristics – as follows:

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

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The five main groups are virtually identical to last year, though some defining characteristics are specified more clearly (for example, we learn that the Regulator is framing a recovery plan length of seven years as the long end of what it considers to be acceptable). However, this year's funding statement reveals a further step in a journey – with each of the A to E segments from last year's statement being divided into two sub-groups: relatively immature and relatively mature schemes. Expectations for each of the now ten sub-divisions of scheme are arranged separately under the headings of covenant, investment and funding and there is more emphasis on undertaking risk analysis along with a focus on the long-term funding target where this is possible. The Regulator is also more specific on investment considerations than previously, seeking to focus minds on how the investment strategy should evolve as the scheme matures, and to look specifically at issues such as volatility, income and liquidity for more mature schemes.

DB schemes are effectively divided into ten types ...

… with detailed expectations for each under the headings of covenant, investment and funding ...

… and much more on investment than before

The Regulator accepts that the actions it expects according to these tables may not always be appropriate, but in such a case it suggests that trustees may wish to consider obtaining evidence and justification to support alternative action, such as using contingent assets.

The Regulator anticipates that scheme maturity issues will assume greater significance for setting funding and investment strategies and expects scheme actuaries to advise trustees on the broad position of their scheme and how it may change in the future. The Regulator also expects advisers to alert trustees to the risks to funding and investment from increasing scheme maturity, in particular for those schemes experiencing high levels of transfer activity.

There is greater emphasis on maturity – as most schemes are closed to new entrants

Our viewpoint

There is a lot of detail in the Regulator's tables which trustees and sponsors would be advised to study closely once a scheme has established which of the ten buckets it thinks it falls into. The expectations are much more granular than before and are likely to be consistent with the "comply or explain" regime being developed for the DB Chair's statement.

The messages show how the Regulator's thinking is developing – with many of the expectations referencing the new focus on long-term funding targets, (proportionate) covenant monitoring and the potential risks associated with high transfer activity. The other themes are of more prudence in technical provisions, and lower investment risk in schemes, particularly as schemes mature. The move to consider relatively mature schemes separately and set out expectations specific to these schemes in each group is a useful development in addressing the specific risks such schemes face. And as all of this is now linked to the almost certainly higher long-term funding target, inevitably there will be an element of ratcheting up in funding expectations over time compared to last year's statement.

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What the Pensions Regulator promises to deliver

In the second part of the statement the Regulator reprises messages about the need for schemes to be treated equitably with other stakeholders, promising to continue to intervene where it has concerns. It also mentions its concerns with long recovery plans and late submissions.

Equitable treatment

Naturally, the Regulator expects the DB scheme to be treated equitably with other stakeholders. It remains concerned that this is not always the case relative to shareholders – as flagged in last year's statement – and is concerned with other forms of "covenant leakage" which may be occurring in preference to higher deficit repair contributions (DRCs) and shorter recovery plans.

The Regulator is to continue with its 'ahead of valuation' interventions first signalled in 2018, where it has concerns about possible inequitable treatment, promising to broaden its grip in this area to cover a larger number and greater range of schemes (regardless of covenant). The key principles behind its expectations are as follows:

- Where dividends and other shareholder distributions exceed DRCs, the Regulator expects a strong funding target and recovery plans to be relatively short.
- If the employer's covenant is tending to weak or weak, the Regulator expects DRCs to be larger than shareholder distributions unless the recovery plan is short and the funding target is strong.
- If the employer is weak and unable to support the scheme, the Regulator expects the payment of shareholder distributions to have ceased.

There is more precision on what shareholder distributions are acceptable when schemes are in deficit

Our viewpoint

These are clear "rules" compared to last year's statement where the focus was on trustees to assess whether they were being treated fairly and to negotiate robustly if they felt that was not the case. But there will need to be further Government intervention in this area if the Regulator is to have its way.

Long recovery plans and other interventions

The Regulator promises to engage with a number of schemes ahead of their 2019 valuations where it considers that their existing recovery plans are unacceptably long. Schemes selected for this engagement will cover the whole spectrum of covenant strengths and the Regulator will be looking at both the scheme's maturity and the covenant of the employer in forming a view on what it considers to be acceptable.

Lengthy recovery plans are to be targeted for intervention …

The Regulator will also engage with DB schemes during 2019 where it has concerns about certain other characteristics of their funding and investment plans in the context of their covenant and scheme profile. It goes on to say that it is imperative that both

… as will other situations where the Regulator has concerns

trustees and employers are fully aware of its expectations as set out in the statement and in its wider guidance – and that both should be fully prepared to justify their approach with evidence of robust negotiations having taken place.

Our viewpoint

This is a clear warning that the Regulator is not stopping just at this statement but will be engaging with schemes to the extent that its limited resources allow. What perhaps is different this time round is that the Regulator has made clearer what its expectations are of schemes according to their characteristics and so one might expect that those selected for scrutiny will be subject to a more challenging enquiry.

Late valuations

Trustees are reminded that they should not agree an inappropriate valuation and funding plan merely because the deadline is imminent or has been missed and should contact the Regulator if they are pushed to do so by the employer or a third party.

Trustees should not rush valuations that would otherwise be “late”

If the deadline is missed the Regulator expects trustees to report to them in good time and work with employers to make every effort to agree an appropriate valuation and recovery plan as soon as possible. The threat of penalties for late submission is mentioned, but the Regulator does not wish this to drive inappropriate behaviour and is prepared to support trustees if they cannot agree a valuation for valid reasons.

Our viewpoint

The Regulator is clearly concerned that by tightening the screws on late valuations it could end up seeing timelier funding plans which it is uncomfortable with, but on which its options to do anything other than send messages about future improvement are limited. This is a clear message that on matters of funding trustees should seek to do the right thing, engaging with the Regulator where necessary, and not feel hidebound by the letter of the law.

The Regulator’s powers

The statement concludes with a reminder of the Regulator’s current suite of powers in the DB funding space. In relation to its power to direct how a scheme’s technical provisions should be calculated and how its deficit should be funded, it says that often it is able to achieve appropriate outcomes following engagement with the trustees and employer without recourse to this power. However, it will commence formal investigations where necessary and appropriate, as was the case with Southern Water.

The threat remains to start formal investigations where “informal” persuasion does not work

Our viewpoint

As has become apparent, the Regulator's extensive current powers do not map well against the behaviours that it is now seeking to engrain within DB schemes. The Regulator's much vaunted "nuclear" power to direct the valuation calculations, which it has had for many years but has yet to use, may in fact be unusable. But once the Pensions Bill promised for this year completes its passage through Parliament, the Regulator ought to be properly equipped to enforce its will on those schemes that ignore its expectations.

This latest funding statement from the Regulator is essential reading for trustees, employers and their advisers ahead of undertaking valuations, with much greater clarity than before on what it will take to stay the right side of the Regulator. As the messages are consistent with how the regulation of scheme funding is likely to develop over the months and years to come, we encourage trustees and employers to take this statement on board.

The statement is essential reading for trustees, employers and their advisers

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