# BROADSTONE

# The Pensions Regulator's fair and balanced Annual Funding Statement 2022

## Introduction

The Pensions Regulator (TPR) issued it's latest Annual Funding Statement on 27 April 2022 – you can access it in full here: [www.thepensionsregulator.gov.uk - Annual Funding Statement 2022](www.thepensionsregulator.gov.uk)

TPR walks a tightrope; it knows it and we all know it. On one hand TPR is duty bound to protect the benefit security of millions of members' pension savings. On the other it has moral hazard powers to ensure sponsoring employers stand by their legal and moral obligation to support pension schemes. However, it must balance this cognisant that those sponsors have similar obligations to their current employees, shareholders and customers. It must walk this tightrope of obligation carefully to ensure it does not tip one side so much that it requires a safety net to catch the fallen.

The latest Annual Funding Statement 2022 has this balance writ large throughout as TPR discusses the macro-economic and geopolitical issues with which schemes in Tranche 17 ("T17" – those with valuations due between 22 September 2021 and 21 September 2022) are expected to cope. TPR has made it clear that trustees and sponsors are expected to treat each other with fairness when conducting their respective businesses. Trustees should consider the challenges the sponsor is experiencing and sponsor's should consider the pension scheme when deciding whether to pay dividends (or making other payments) out of the business and treat the scheme in a similar manner.

The tone struck by TPR is a well-constructed one and it should be commended for that.

The following is a brief summary of the issues raised and how this may effect T17 and other pension schemes over the next 12 months.

## Valuation considerations

If you are involved with a T17 scheme you will no doubt already be mindful of the ongoing impacts of war in Ukraine and the Covid-19 pandemic on the economy and in particular the current high and rising inflation rate we are seeing. We also know from Office of Budget Responsibility (OBR) statistics that this inflation rate is due to peak towards the end of 2022. Interest rate rises are also anticipated and this has an impact on funding, investment performance and increased sponsor costs that may impact covenant strength.

This is clearly a volatile time – although one could argue when recently hasn't there been major global issues affecting pension schemes?

TPR's expectation is that trustees are mindful of these global issues and how they impact the pension scheme and it's sponsor. You may have seen our checklist on Ukraine related impacts which runs through potential risks to consider. If not please discuss this with your usual Broadstone contact. Risk awareness with mitigation and control elements is central to TPR's message and something trustees should be factoring into their scheme's day-to-day operations.

## Covenant

Short-term experience

TPR acknowledges that for smaller schemes covenant issues are difficult to assess – because there may not be adequate budget for trustees to seek specialist advice. TPR places an emphasis on information provided directly from the sponsor to enable trustees to assess its resilience to economic uncertainty. Trustees could consider how the sponsor fits in three broad categories:

1. There has been limited impact from current market events but the sponsor remains strong.

2. There has been a material impact and recovery.

3. The negative impacts on the sponsor have been, and continue to be, material.

Trustees approaching or in the third category should remind themselves of the guidance TPR has issued on distressed employers and also seriously consider commissioning specialist advice.

Deficit recovery contributions

TPR also refers to the three categories mentioned above in the context of the attitude to recovery plans and how the sponsor can afford to make good deficits.

For schemes with sponsors in **Category 1** this is the business as usual position for the trustees.TPR does not expect contributions to be deferred or reduced and recovery periods should not be extended and indeed reduced if possible.

For the those in **Category 2,** TPR notes that trustees should be mindful of short-term affordability issues and where contributions are deferred these should be repaid via increased repayment contributions not extended recovery periods. Any deferred deficit recovery contributions should also be made before shareholder distributions.

For **Category 3** schemes where there is longer term deferral, trustees should be obtaining mitigation. We would expect this to be via other contingent asset agreements such as security over property.

<u>Dividends and other distributions</u>

As in previous years, TPR takes a very dim view of dividends or other payments from the sponsor if the pension scheme is also not benefitting from the business' upside. Trustees are expected to have a short recovery plan and put in place strong funding assumptions where dividends exceed deficit recovery contributions.

Where the sponsor is weak or tending to weak the dividends should not exceed the deficit recovery contributions payable to the scheme. Indeed no dividends should be paid if the sponsor is unable to support the scheme.

## Actuarial and investment issues

Here TPR gives a brief summary of a hit list of issues:

**Tranche 17 expected funding position** – based on TPR's data it expects the aggregate funding level for all T17 schemes to be ahead of that anicipated three years previously. However, the position for individual schemes will vary greatly compared with the aggregate estimates and depend on scheme-specific factors, including hedging levels.

**Interest rate** – interest rates have risen and gilt yields have been volatile and this can have an impact on funding and investments. This is particularly the case where schemes have been hedging their interest rate risk using LDI products. For these schemes funding levels will have been impacted less but they will not have benefitted from improvements due to gilt yield increases. As many of our clients have already seen, rising rates can result in collateral calls to maintain hedging ratios and this liquidity requirement is something trustees should be prepared for.

**Inflation** – as noted earlier, inflation is currently very high, although long-term expectations are generally more important for funding purposes. The impact will depend on how scheme benefits and assets are linked to inflation. Long-term inflation expectations are also being impacted by the Government's decision to align RPI with CPIH from 2030. Of course, we should note the judicial review being heard this summer.

**Mortality** – TPR recognises this is a difficult area with the latest Continuous Mortality Investigation (CMI) core model disregarding 2020 and 2021 data in projecting the future course of mortality rates. This means it does not currently reflect the impact of Covid. However, users can choose to apply weighting to the data for these years. Trustees may have a particular view and this should be discussed with their Scheme Actuary. However, TPR would not expect a change to the mortality assumptions to result in a liability reduction of more than 2% without strong evidence.

## Other issues

**Long-term funding targets** – there is a reminder that while the legal requirement for LTFTs to be in place is not yet in force it soon will be. Trustees should be having these discussions with advisers and sponsoring employers and setting journey plans.

**Longer term covenant view** – having a LTFT does place an emphasis on the sponsors longer term viability. TPR encourages trustees to discuss with the sponsor and understand the risks that could impact their continuing ability to support the pension scheme.

**Integrated risk management (IRM)** – IRM type monitoring and contingency planning should be something that schemes have discussed and trustees should have a framework in place. If not TPR again reminds Trustees to ensure they understand the risks and the possibility that things can happen very quickly and without regular monitoring they may miss the opportunity to respond.

**Schemes in surplus** – this is something not many schemes will have considered for many years but it is becoming increasingly common. The key consideration for TPR is how schemes ensure their cash flow needs are met without the regular cash contribution.

## Overall expectations of TPR

**Corporate distress** – TPR will get involved in situations of corporate distress. However, we need to be mindful that TPR's resources are finite. This means the onus is on trustees to protect members' benefits by being alert, preparing and planning to act as necessary.

As noted above TPR has previously issued guidance for distressed employer scenarios

**Powers** – TPR also reminds all involved that they have the power to set technical provisions and recovery plans if it does not believe the ones in place are in accordance with the law.

## Future Funding Code and covenant

As you will know, the much awaited new DB funding code remains MIA. However, phase two on the consultation is expected later this year. In addition, TPR will also be setting out proposals to update the covenant guidance, last updated in 2015.

## Five scheme types – where do you fit?

TPR has again included a detailed table of scheme types according to covenant strength and funding position, with further sub-division by maturity. Depending on the scheme type, TPR sets outs key risks and its expectations.

| Label | Covenant | Funding position |
|---|---|---|
| A | Strong/tending to strong | Strong Technical provisions (TPs).<br>Recovery Period (RP) less than six years. |
| B | Strong/tending to strong | Weak TPs.<br>RP longer than six years. |
| C | Weaker employer with limited affordability | LTFT on track.<br>Strong TPs<br>Affordable DRCs. |
| D | Weaker employer – limited affordability | TPs weak and/or RP longer than six years. |
| E | Weak employer unable to provide support | Stressed scheme with limited or no ability to use flexibilities in funding regime. |

## Broadstone comment

There is little new under the sun and this statement is more consistent messaging from TPR - not meant as a criticism! To some extent we remain in a holding pattern waiting for the revised funding code and are also now awaiting amendments to the covenant guidance, which will make for interesting reading.

The key issues for schemes through 2022 and 2023 are the choppy waters caused by issues larger than the schemes. Major issues such as war, pandemic recovery, Brexit etc all pose significant risks and have an impact on the three key elements of pensions: Funding, Investment and Covenant.

Trustees are expected to be able to understand, mitigate and, where possible, control all the risks posed in those areas and this is what should be central to their discussions. Undertaking suitable scenario testing, monitoring and contingency planning may feel like no mean feat, particularly for those managing smaller schemes, but is ultimately the lot of the modern day Trustee.

A covenant heavy statement also recognises that sponsors may be having a tough time and trustees should continue to be cognisant of that. TPR is mindful (although not included in the statement) that 2021 has seen record low levels of corporate failure thanks to the steps taken by the Government to protect companies who experienced difficulties. All these easements have now fallen away and the expectation is that more sponsors will get into difficulty, hence covenant visibility and understanding is crucial to placing the scheme in the right risk bucket.

However, where sponsors are recovering well Trustees should not be at the back of queue to share some of that upside and for the increasing number finding themselves at or above full funding on their technical provisions basis, TPR continues to encourage looking beyond this measure to Long Term Funding Targets and low dependency

Ultimately TPR's statement strikes a reasonable and proportionate tone that seems to be looking to achieve fair outcomes for all. Let's see if that works.

## Actions for Trustees

Below is a summary of actions for Trustees to consider:

1. Consider the short-term impact on the sponsor's covenant caused by the current market conditions and the knock on effect for funding and investment strategies.
2. Be aware of short-term market movements and impact on hedging positions and liquidity.
3. Review the 5 scheme types to determine where your scheme sits and understand TPR's expectations.
4. Discuss long-term funding targets with appropriate journey plan across funding and investment together with a longer-term assessment of sponsor covenant.
5. Be aware of TPR guidance on employer distress.

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