TPR Annual Funding Statement - 2021

Introduction

The Pensions Regulator's (TPR) ever-useful guide to their current thinking and expectations on funding, investment and covenant matters for defined benefit pension schemes has been issued on 26 May 2021.

The full document is always worth reading and can be accessed here: https://www.thepensionsregulator.gov.uk/en/document-library/statements/annual-funding-statement-2021

The statement applies directly to schemes with effective valuation dates between 22 September 2020 and 21 September 2021.

To sum the statement up in two words these would be "Risk Management". What follows in this Note is a fairly comprehensive summary of the key risk areas for trustees to monitor, manage and mitigate.

New Funding Code

TPR has confirmed that they now expect the new funding code to be in force by the end of 2022 "at the earliest". This deadline has consistently slipped. The second part of the consultation on the code is still expected later this year after the government's consultation on the legislative framework closes.

As a brief reminder the new code is expected to provide guidance on the requirement to have a Long Term Funding Target, and introduce the Bespoke or Fast Track regulatory regime.

Comment – on the new code

The further delay to the new funding code coming into force is frustrating for many schemes as they are left in limbo trying to plan ahead and make the right decisions for the scheme, members and sponsor. Notwithstanding this, we still believe that schemes should be looking ahead and setting appropriate long term targets for funding. This is good governance and a sound way to plan ahead for pension schemes. However, the delay does make the details of that journey harder to predict.

Approach to actuarial valuations

Setting assumptions

TPR encourages trustees to work with their advisers to scenario test and consider different outcomes when setting technical provisions. This should be part of the scheme's Integrated Risk Management (IRM) framework and should consider impacts on employer covenant and mortality as well as investments.

Comment – on setting assumptions

Work done on IRM should not be a "one and done". TPR continues to encourage trustees to consider future outcomes and mitigating action that can be done to improve decision making and outcomes.

Inflation

If trustees haven't considered the impact of the alignment of Retail Prices Index (RPI) with the Consumer Prices Index including owner-occupier housing costs (CPIH), from 2030, then they are reminded to do so.

Mortality

TPR recognises there is a plurality of views on what account for COVID-19 should be made when setting mortality assumptions when accounting for future improvements. They briefly summarise the views and the potential impacts on funding. Their view is clear that any change to mortality assumptions should be balanced and evidence based.

Comment – on mortality

We are working on a Note for clients summarising some of the views and approaches that can be taken.

Post valuation quid pro quo

There is an acknowledgment that post-valuation experience can be taken into account when setting a recovery plan but this comes with a risk warning. This isn't an opportunity to cherry pick a date where the numbers look better, but rather that allowing for post-valuation experience should be justifiable and in members' interests. TPR expects that, where assumptions have been chosen because things look rosier at the date of signing the recovery plan, any future downturn will also be reflected. So if, at or before a subsequent valuation, conditions worsen, trustees should consider how to reflect this including potentially the need for an earlier valuation if there has been a significant deterioration.

Investments – liquidity

A reminder to stress test investment strategies for calls on derivative positions, adverse market movements and actions should there be a constraint on liquidity.

Covenant

TPR expects that independent covenant work should be undertaken where there is:

1. Complexity
2. Lack of clarity
3. Brexit implications
4. Deterioration in covenant
5. High reliance on covenant (e.g. large deficit or significant investment risk)

There is also a reminder of the work done by TPR to support schemes where the employer is in distress and that guidance can be accessed here: https://www.thepensionsregulator.gov.uk/en/document-library/regulatory-guidance/protecting-schemes-from-sponsoring-employer-distress

COVID-19 and covenant

TPR anticipates three broad categories for employers during the pandemic. This ranges from no material impact, some initial impact but with recovery, to continued impact on business and cash flow. TPR expects the information from the employer to be clearer than it was last year and so the continued impact to be well understood. Non-disclosure agreements and the like should be considered where information is deemed to be sensitive. TPR wants to see collaboration between trustees and employers, and espouses the value of trustees undertaking proportionate scenario testing on covenant support and affordability.

Comment – COVID-19 and covenant

Note that a number of measures open to employers from Government will be ending later this year and so an understanding of the reliance of the employer on Government easements should be understood.

Brexit

Trustees are reminded to have an understanding of the impact of Brexit on the employer's ability to the support the scheme.

Affordability and DRCs

We are all guilty of paraphrasing TPR's views on recovery plans and deficit recovery contributions. Here the mantra of previous statements is repeated. **Where there has been no change to covenant strength TPR does not, in general, expect recovery plans to lengthen and contributions to reduce**. This is the default position. Trustees should consider shortening recovery plans where possible or, where there are short term cashflow or affordability constraints, allowing short term reductions to contributions, but with a clear plan as to when these will increase and only where there is equitable treatment with other creditors.

It is interesting to note that only a small number of employers took advantage of the easements by deferring contributions in the last year. Where this continues, TPR's position is clear that mitigating action should be taken. This would include cessation of dividends, triggers for incremental increases in contributions as the employer's health improves, equitable treatment with other creditors, and other contingent assets.

Trustees are also reminded to be on the look out for covenant leakage, where value leaves the employer (not just through dividends but also e.g. group trading arrangements and excessive executive remuneration). Trustees should take action where the leakage is material and not justified.

Covenant monitoring and contingency

TPR is pleased to see the level of covenant monitoring has increased although contingency plans, drawn up with the employer with agreed trigger points, are still not as common as we believe TPR would like. The planning cannot take into account every situation that may arise but TPR would like to see where these conversations have taken place.

Trustees should consider with the employer what metrics and actions should be taken in various scenarios and be able to evidence this.

Corporate transactions

TPR notes the generally held view that corporate transactions are expected to increase as the country emerges from the pandemic with a number of different reasons for this; struggling employers and low interest rates being the main two. Trustees should be alert to this and mitigate any negative impacts on the pension scheme. Their considerations made and interactions with the corporate activity should be well documented.

TPR also notes new easements for distressed employers, plus the important role the PPF plays in these situations, and also the preferential treatment of Crown debt.

Comment – Corporate transactions

Trustees that face corporate restructuring and M&A transactions do so at a very difficult time and being aware of what is going on is key. TPR's new powers (still to come into force) are only briefly mentioned in the statement (see below) but it is in these areas, where actions are taken which reduce the ability of scheme deficits or member benefits to be paid, that the powers will be used.

General risk management

TPR also gives a run-down of a number of other risk areas that should be on trustees' agendas.

Climate Change – TPR recently published their climate change strategy which can be read here: https://www.thepensionsregulator.gov.uk/en/document-library/corporate-information/climate-change-and-environment/climate-change-strategy

Comment – Trustees are expected to be considering the impact of climate change as a key metric in the IRM framework.

Long-term Funding Targets – knowing where the scheme is going is key to setting strategy now. This thinking has developed from the early days of the IRM framework into the Long-term funding target (LTFT). One key goal is a significant (if not complete) reduction in reliance on the employer by the time the scheme has reached significant maturity. There should be a journey plan to such a position of resilience from investment and covenant risks.

This will become a legal requirement in line with the Pension Schemes Act 2021 provisions. Trustees that have not yet thought about their scheme's LTFT are encouraged to do so soon.

Scheme maturity – schemes with no active members and a high proportion of pensioners are deemed mature and bring with them unique challenges for funding, liquidity and cash flow. TPR is asking schemes in that space to be aware of their risks.

Own Risk Assessments – TPR is consulting on a "single-code" of practice and included in this is the new requirement for pension schemes (of 100 or more members) to conduct an Own Risk Assessment or ORA. This is still a new concept but given schemes in scope of this Statement will need to do this assessment in the inter-valuation period they are reminded to take note of it in the context of their IRM considerations.

Trustees are expected to detail:

- How they have identified, assessed and decided to manage the key risks of the pension scheme.
- How they have embedded their own risk assessment into the scheme's management and decision-making processes.
- How they are monitoring and assessing the effectiveness of the scheme's risk management system.
- The remedial actions they have agreed to take as necessary, and how they assess their effectiveness.

What we can expect from TPR

Engagement – where the covenant is in distress.

Supervision – valuations are risk assessed looking at the scheme and the covenant's ability to support it. Trustees are expected to be able to support their decisions and actions with evidence.

Use of Powers – TPR reminds us that they have the power to set technical provisions and funding contributions (although in our experience, this is rarely used). These can be used where there is failure to agree or where the funding plan does not meet the standard required by law. TPR's proposed new powers are not detailed, but the ongoing consultation is mentioned.

Where are you?

TPR has provided the now familar tables across a variety of scenarios that schemes will find themselves in.

Employer strength – strong or tending to strong, weaker, or weak.

Funding level – across metrics of strength of technical provisions and length of recovery plan (longer or shorter than 7 years is the marker).

Maturity – mature or immature.

We have not reproduced the tables, and they haven't changed markedly since last time. We would suggest trustees and employers take the time to find their position on the matrix and to understand TPR's expectations of you.

Broadstone view

The statement is a clear canter through the issues that will be on many trustees' and employers' agendas when considering their pension schemes.

The major themes are of:

- **Risk management** – understand the key risks of the scheme.
- **Collaboration with employer** – better flow of information between the parties will lead to better risk management, contingency planning and clearer decisions.
- **Understand where you are** – how has the covenant weathered the storms of Covid-19 and Brexit and what is the outlook.
- **Understand where you are going** – what is the scheme's LTFT and how are you going to get there.

Trustees and employers face a difficult time with the impacts of Covid-19 and Brexit still being felt and also a slew of initiatives from TPR and government to address issues including climate change and Own Risk Assessments.

The trustees' role is changing as risk assessment and management are the drivers for decisions and actions.

Much of the technical detail on funding, investment and covenant will not be news as they are certainly areas well rehearsed by TPR over recent years. The challenge for trustees is assessing how the risks that are posed to you are changing and how you address these.

As your advisers we are here to support you in this. If you would like to discuss the areas discussed in this note please contact your usual Broadstone contact.

Contact

David Brooks
Technical Director
David.brooks@broadstone.co.uk

www.broadstone.co.uk
100 Wood Street
London EC2V 7AN
UK