First Briefing, March 2019
2019 Annual Funding Statement

Introduction

The Pensions Regulator (TPR) has published its 2019 Annual Funding Statement. This will be of relevance to

- schemes carrying out valuations between 22 September 2018 and 21 September 2019, and
- schemes undergoing significant changes that require a review of their funding and risk strategies.

This Statement sets out TPR's expectations more clearly and in more detail than previous years' Statements. And with consultation on a revised and enforceable Code of practice for scheme funding expected later this year, it provides a clear indication of TPR's current thinking. So, the 2019 Statement will also be relevant to schemes with their next valuation dates in late 2019, 2020 and beyond.

This briefing only covers the key messages. Trustees and Employers should read the Statement in full.

Long Term Funding Target

TPR expects trustees and employers to agree a long-term funding target (LTFT), which looks beyond being fully funded against technical provisions and reflects the scheme's ultimate objective. Examples of a LTFT include self-sufficiency, buying-out benefits with an insurer or transferring benefits to a new consolidator vehicle. For a scheme which is closed to future accrual, TPR does not regard a LTFT that relies on continuing employer financial support to be appropriate.

Schemes would be expected to evidence that investment and funding strategies are then aligned to the LTFT via journey plans (we call them 'flight paths').

Whilst it is not yet clear when the LTFT will be explicitly required by legislation, TPR is encouraging trustees and employers to incorporate this into their thinking now.

Key risks trustees and employers should focus on and actions to take

As in previous years, TPR has set out the key risks that trustees and employers should focus on based on the characteristics of their scheme. This builds on the TPR's Integrated Risk Management approach under which trustees and employer consider together risks related to employer covenant, investment and funding.

This year TPR have also differentiated by scheme maturity, resulting in 10 different groups.

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Group	Covenant	Funding	Maturity
A	Strong/Tending to strong	Strong technical provisions Recovery plan less than 7 years	A1: Relatively immature A2: Relatively mature
B	Strong/Tending to strong	Weak technical provisions and/or recovery plans more than 7 years	B1: Relatively immature B2: Relatively mature
C	Weaker employer, limited affordability	Strong technical provisions. On track to meet LTFT. Contributions reducing deficits at slower but affordable pace	C1: Relatively immature C2: Relatively mature
D	Weaker employer, limited affordability	Weak technical provisions and/or recovery plans more than 7 years	D1: Relatively immature D2: Relatively mature
E	Weak employer unable to provide support	Stressed scheme with limited or no ability to use flexibilities of funding regime	E1: Relatively immature E2: Relatively mature

Trustees and employers should identify which group best fits their scheme and refer to the Statement for detail on the key risks and actions TPR expects, which are too numerous to cover here.

However, some of the key messages from the Statement are:

Scheme maturity

With most pension schemes closed to new entrants, TPR expects scheme maturity to assume greater significance in setting both funding and investment strategies.

TPR says it is important to consider the interaction of the following, especially as a scheme gets more mature:

- The level of assets, degree of underfunding and the amount of benefits paid out.
- The scheme’s ability to close the funding gap from investments and new contributions in a reasonable timeframe.

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Expectations for investment advice

TPR have included in this Statement the actions they expect in relation to investment, including:

- Setting shorter-term asset allocation consistent with the LTFT.
- Journey planning to get there.
- Quantifying the impact on funding of adverse investment performance.
- Testing and evidencing the ability of the covenant to support this without extending the recovery plan (supportable investment risk).

For schemes with a higher level of transfer activity, trustees should also consider liquidity requirements and take action to protect the scheme in the event of a market downturn.

Dividends

TPR continues to stress the need for equitable treatment between the pension scheme (an unsecured creditor of the company) and shareholders. It remains concerned about the disparity between growth in dividend payments and deficit recovery contributions (DRCs).

In 2018 TPR contacted a number of schemes ahead of their actuarial valuation where they had concerns about possible inequitable treatment. These interventions continue, and TPR will continue to focus on this area in 2019. TPR says they intend to broaden their grip on this area to cover a larger number and a greater range of schemes (regardless of the strength of the employer covenant).

TPR’s expectations are as follows:

- Where dividends and other shareholder distributions exceed DRCs, they expect a strong funding target and recovery plans to be relatively short.
- If the employer covenant is tending to weak or weak, they expect 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, they expect the payment of shareholder distributions to stop.

Long recovery plans

The median length of recovery plans is 7 years, and as seen in the table, TPR appear to use this as a benchmark when assessing recovery plan length.

TPR intends to engage with a number of schemes ahead of their 2019 valuations where, having regard to the maturity of the scheme and the employer covenant, the current recovery plan is unacceptably long.

As an example, they say that if a strong employer with a relatively mature scheme has a recovery plan longer than 7 years, then that recovery plan is too long.

Intervention by TPR

TPR have reviewed their approach to regulation to improve their effectiveness.

In addition to proactively engaging with some schemes ahead of the valuation, TPR will continue to risk assess all valuation submissions they receive. The risk assessments consider the overall risk profile of a scheme relative to the ability of the employer to support it.

TPR says that it is imperative that trustees and employers are fully aware of their expectations as set out in the Statement and wider guidance. Trustees and employers should be fully prepared to justify their approach with evidence of robust negotiations having taken place.

One of TPR's powers is the "scheme funding power", which enables it to direct how technical provisions are set and how, and over what period, its deficit will be funded. Often TPR engagement has resulted in improved funding outcomes without TPR having to use the formal power, but they make it clear that they are prepared to use it. TPR also say that where formal investigations are commenced then this may require a "skilled person's report", the cost of which may have to be met by the trustees or employer.

New Code of practice

The Statement also sets out expectations for the new Code of practice for DB scheme funding

- Clearer about funding approaches, in particular around prudence of technical provisions
- Appropriateness of recovery plans.

But until the new Code comes into force, trustees and employers should continue to refer to the current Code of practice and guidance and TPR will regulate valuations being currently undertaken as set out in the Statement.

Further information

For further information, please contact your usual First Actuarial consultant.

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