

First Briefing, May 2020 – Annual Funding Statement

The Pensions Regulator (TPR) has published its 2020 Annual Funding Statement. This will be of relevance to

- schemes carrying out valuations between 22 September 2019 and 21 September 2020 (known as Tranche 15 schemes), and
- schemes undergoing significant changes that require a review of their funding and risk strategies.

The Statement looks at how the impact of COVID-19 can be allowed for in the valuation, recognising that valuations may be at different points in the process.

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

TPR recognise that given COVID-19, these are very challenging times and it is important that trustees and employers work together. They also recognise that it is not possible to predict how long the current situation will continue and what further impact it may have on pension schemes and their sponsors.

In its Statement, TPR give an indication of the funding positions they were expecting to see, depending on valuation date, how post valuation experience can be taken into account when finalising the valuation and other matters to consider when preparing recovery plans.

Valuation dates around 31 December 2019

Around 25% of Tranche 15 schemes have a valuation date around 31 December. Those schemes that had hedged interest rate and inflation rate risk are expected to be marginally above target, others below.



Schemes with these valuation dates (or earlier) may already be well advanced with their valuation, for example they may have provisional valuation results. TPR suggest that these schemes should consider taking account of the following post valuation experience when preparing the recovery plan:

- impact on assets
- impact of significant change in market conditions on technical provisions; and
- impact of any change to employer covenant.

Valuation dates around end March, early April

Around 50% of Tranche 15 schemes have a March or April 2020 valuation date.

For schemes with low exposure to equities and good levels of hedging, TPR expect the funding position to be above target or marginally below. However, those schemes with significant exposure to equities and not sufficiently hedged against interest rate risk, will have experienced a sharp fall in funding levels.

TPR also recognise that these valuations may be particularly challenging as many trustees will not have sufficient information to form a reliable view on long term future investment returns and to fully understand the impact of COVID-19 on the employer covenant.

TPR suggest that trustees should consider a range of possible outcomes when considering assumptions used to set technical provisions, which consider different paths for economic recovery. They also encourage trustees to challenge their actuary on the models used to derive assumptions and whether they will need to be changed.

TPR also suggest that trustees may be happy to work with an initial set of valuation results, which is refined over the valuation period as trustees' confidence grows in forming views on the financial assumptions. Allowance can be made for post valuation positive experience without setting a precedent for subsequent valuations.

Some schemes may think of changing their valuation date to a time when market conditions were more normal. TPR say trustees should consider whether this would be in the best interests of members and warn that trustees who take this approach can expect questions from TPR as to their reasons.

Recovery plans

Trustees need to understand the impact that COVID-19 has and could have on the strength of the employer covenant.

When structuring the recovery plan trustees should focus on affordability for the employer, whilst also ensuring the scheme is treated fairly and equitably compared to shareholders and other creditors and balancing the sustainable growth (or recovery) of the employer.

TPR suggest that where there are issues on affordability, the recovery plan structure should include appropriate step ups in contributions, payable as the employer's financial health improves. Additional contributions could also be linked to investment returns.

Ensuring equitable treatment

This year's statement goes into more detail about different forms of covenant leakage, that is where money leaves the employer reducing the ability of the employer to support the scheme. Examples include:

- dividends paid to shareholders
- cash pooling and inter-company lending arrangements
- group trading arrangements
- management fees, royalties and similar charges
- transfers of business or assets at undervalue; and
- excessive executive remuneration.

TPR suggest that trustees should consider seeking independent advice where the covenant is complex, deteriorating, or where there is a large funding deficit and as a result a high degree of reliance on the employer.

TPR go on to say that where employers are struggling and trustees have agreed to a significant reduction in deficit reduction contributions, that legally enforceable agreements should be put in place. For example, reintroduction of dividend payments would trigger payment of a contingent contribution to the scheme, or the agreement would set out a formal block on dividend payments for the period that the agreed reduction in contributions applies.

TPR expectations

As in previous years, TPR have 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.

As last year, TPR have set out the key risks and actions using 10 different groups, which cover a combination of

- strength of employer covenant (strong/tending to strong or a weaker employer with limited affordability, or unable to provide support),
- strength of funding strategy (technical provisions are deemed strong or weak and/or length of recovery plan), and
- scheme maturity (relatively immature or 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 expect, which are too numerous to cover here.

To identify the appropriate group, TPR suggest trustees first consider the impact COVID-19 and Brexit will have on the employer covenant, and then consider the impact on scheme funding.

The key risks and actions for each group are unchanged from last year. However, for an individual scheme the group now appropriate may be different to last year.

Further information

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