THE PENSIONS REGULATOR'S 2020 ANNUAL FUNDING STATEMENT

Please contact one of the BDO team if you would like to discuss any of the topics raised in more detail.

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Introduction

The Annual Funding Statement (AFS) provides guidance on how to approach valuations under the current COVID-19 conditions and what The Pension Regulator (TPR) expects from trustees and employers. It also gives an update on the new Defined Benefit (DB) funding code.

Trustees and employers need to work together to manage the immediate impact of COVID-19. They should also make sure they retain a focus on the long-term, specifically around planning and risk management. It is not possible to predict how long the current environment will continue, or what further impact it will have on pension schemes and the businesses supporting them, but TPR will issue further COVID-19 guidance as necessary.

Six Key Guidance Areas

Scheme Funding

Trustees and employers will need to consider how far they may have strayed from their longer-term objective and develop strategies to put them back on course.

- **Post-valuation experience:** TPR does not expect schemes close to completing their valuations to take account of post-valuation experience and change valuation assumptions, but this should be considered in the recovery plan.

  Schemes with later valuation dates can reflect post-valuation experience, applying this consistently taking account of both positive and negative experience.

- **Changing the valuation date:** TPR will challenge trustees who look to move their valuation date to a point where financial conditions were more stable, or favourable.

- **Calculating technical provisions:** March and April 2020 valuations will be challenging. Trustees should identify the key economic variables, the extent to which results are sensitive to these, the timing of any recovery and the long-term impact.

  Preliminary valuation results can be refined as a clearer picture emerges. Scenario planning can align business strategy with pension funding.

- **Recovery plans and affordability:** The current circumstances highlight the need for trustees to understand their employer covenant and work collaboratively with employers, ensuring their scheme is treated fairly.

  If affordability is constrained, TPR expects trustees to have mechanisms in place to increase contributions e.g. linked to an improvement in employer health, liquidity and/or payments to shareholders or creditors. Additional contributions could also be linked to investment performance.

Long-Term Funding

Trustees should continue to have a long-term horizon and work with the employer to agree a clear strategy for achieving a long-term funding target to deliver scheme members' benefits in full.

This should recognise how the balance between investment risk, contributions and covenant support may change over time as schemes get better funded and more mature.

As schemes reach maturity they should have lower exposure to investment volatility and less reliance on the sponsor covenant.

As the Government intends to introduce a legal requirement for schemes to have a long-term funding target, trustees should be getting ready to comply.

Employer Covenant

TPR is clear that a strong employer is the "best support for a pension scheme". COVID-19 has highlighted the importance of understanding and monitoring the employer covenant.

The focus should be on the ability of the employer to make cash contributions to the scheme to achieve and maintain full funding over an appropriate period, including addressing downside risks.

When assessing covenant strength, it may be appropriate for trustees and employers to undertake additional stress testing or scenario planning (e.g. for a December 2020 Brexit on WTO terms).

- **Covenant assessment:** Trustees should consider obtaining independent specialist advice to support covenant assessment. This is particularly important where the covenant is complex, deteriorating, or where the scheme has a high degree of reliance on the covenant, for example because it has a large deficit.

Trustees should only undertake their own covenant assessment where they have sufficient expertise. Where trustees undertake their own covenant assessment, they should fully document their reasons for not taking professional advice, as well as their own assessment and conclusions reached.

Objectivity is also important. Trustees who also have roles within an employer may find it difficult to exercise sufficient objectivity when assessing the employer's ability to support the scheme.

TPR expects trustees to have a full audit trail of their considerations and decisions.

- **Covenant monitoring and contingency plans:** Monitoring should be "significantly increased" until covenant visibility has been restored.

Working with the employer, trustees should identify key employer risks, trigger points and actions to be taken where these are breached.

- **Covenant leakage:** Trustees should be "vigilant to employer covenant leakage" (e.g. cash outflows from dividends, cash pooling, intercompany lending, payment of management fees) and seek protections to prevent this constraining affordability, potentially including security over assets and/or "upside sharing".

Shareholder Distributions

Many employers have ceased shareholder distributions (such as dividend payments) to preserve liquidity. TPR expects this to continue while employers rebuild their balance sheets and invest in their recovery.

Where employers recommence shareholder distributions, TPR also expects liquidity and affordability to have been largely restored and recovery plans to reflect that position.

TPR has given guidance where a suspension of DRCs is sought. Trustees should be sure that additional liquidity is not used to support associated companies unless this benefits the scheme, that there are legally binding commitments not to make shareholder distributions until DRCs are resumed and an agreement on how deferred payments will be repaid.

Managing Risks

TPR expects trustees to have an IRM framework bringing together covenant, funding and investment risks.

Scheme maturity is expected to be increasingly relevant for funding and investment strategies since most schemes are now closed.

DB Funding Code Consultation

The new code will be clearer on funding approaches and recovery plans.

The first consultation on principles and regulatory approach has now been extended to 30 September 2020.

A further round of consultation will follow next year with the new DB Funding Code not expected to be issued until late 2021/early 2022.

For further information please review the following link:

The Pensions Regulator's 2020 Annual Funding Statement