ALLEN & OVERY

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Annual funding statement: tough times ahead

Speed read

In normal years, the Pensions Regulator's annual funding statement is directed at DB schemes with imminent valuation processes, but is to some degree relevant to all. This is not a normal year. TPR says that it is 'vitally important' for all DB schemes to follow this guidance, together with its additional Covid-19 guidance, 'to strengthen their position for the tough times which lie ahead'.

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Key risks and actions for trustees and employers

Schemes conducting valuations with effective dates between 22 September 2019 and 21 September 2020 (Tranche 15) are a particular focus of the 2020 annual funding statement, but so are 'schemes undergoing significant changes that require a review of their funding and risk strategies' – which in current circumstances is a much wider group.

Key risks for schemes in different circumstances/segments of the DB landscape, together with TPR's expectations of trustees and employers, are set out in the statement, and trustees should review and consider the material most relevant for their scheme. This will be based on their understanding of how the sponsor covenant has changed because of Covid-19, how it might be impacted by Brexit, and how strong their funding position is, in the context of the scheme and their long-term objectives.

Funding positions generally; valuation issues

TPR suggests that the funding position of many DB schemes that have low exposures to equity markets and good levels of hedging should be stronger than might be expected in the current climate. Schemes that were more heavily invested in equities should have contingency plans in place that can now be implemented.

Around 50% of the Tranche 15 group of schemes have valuation dates at or near 31 March 2020, and TPR notes that March and April 2020 valuations will be challenging. It may be difficult for trustees to form a reliable view on long-term future returns from investments and/or covenant and affordability issues, and they may need to delay taking decisions about technical provisions assumptions until they have greater clarity. The statement includes commentary on a range of valuation issues (see also TPR's Covid-19 guidance on DB scheme funding and investment).

Covenant issues

On covenant assessment, TPR again refers trustees to its Covid-19 guidance and emphasises the need for independent specialist advice, noting that some sponsors may be subject to both Covid-19 and Brexit uncertainty. As covenant strength can change materially in a very short period, particularly in current conditions, TPR expects trustees to significantly increase the frequency and intensity of covenant monitoring.

TPR also suggests that trustees should be particularly vigilant about, and seek to understand the implications of, employer covenant leakage – not only in the form of dividends paid out, but also cash pooling and inter-company lending or group trading arrangements, transfers of business or assets, and excessive executive remuneration.

Timing of regulatory changes

The statement notes that the new DB funding code is not now expected to come into force until late 2021 at the earliest. TPR encourages trustees to agree a long-term funding target with the scheme sponsor – this is due to become a legal requirement via the Pension Schemes Bill, and TPR suggests that trustees should be ready to comply with that change.

Comment

The statement is very much in line with TPR's previous guidance (both pre-pandemic and the more recent flexibilities it has announced). However, the statement provides more detail in a range of areas and trustees should review the implications in light of their own specific circumstances.

TPR also sounds a note of caution, commenting that 'while we have adopted several easements due to the impact of COVID-19, we will be ensuring these are not abused' and that trustees and employers should be fully prepared to justify and explain their overall risk profile (particularly in connection with valuation submissions) with supporting evidence.

Contact information

Helen Powell

PSL Counsel, London

+44 203 088 4827

helen.powell@allenovery.com