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TPR's 2022 Annual Funding Statement

The Pensions Regulator (TPR) has released its 2022 Annual Funding Statement (AFS) setting out its expectations for trustees and employers of Defined Benefit (DB) Schemes currently undertaking actuarial valuations. This update provides a summary of the key messages and possible actions for trustees and employers.

What are the key messages?

The Statement is for all trustees and sponsors of defined benefit schemes but is especially relevant for schemes with valuation dates between 22 September 2021 and 21 September 2022.

The 2022 statement focuses on the economic challenges and risks currently faced by pension schemes and their employers. TPR identifies a number of potential risks including the situation in Ukraine, high inflation, market volatility and slowing economic growth. As expected, there is a 'call to arms' to ensure risk management is joined-up and effective across asset, liability and covenant risks. TPR also urges trustees to review progress towards their long term targets and consider whether journey plans need to be revised in light of the current challenges.

The key messages are:

- Ensure your risk management framework is effective – understand the key risks for your scheme and make sure you have effective strategies to monitor and manage those risks.
- Consider your long term target and journey plan – is the target still appropriate? Is any action needed to keep the scheme on track to reach the target? Are any additional measures needed to manage new risks?
- Be alert to funding and covenant changing very quickly – Markets are volatile and inflation is very high, trustees should consider scenario planning to understand the potential impact of key risks and ensure the scheme is protected.
- For current valuations – use the valuation as an opportunity to reassess funding targets, contribution levels and risk management strategies.
- Contributions, covenant and security – focus on removing any technical provisions deficit and ensuring the scheme is treated fairly when dividends are paid.

"In the current environment, trustees should be alert to the scheme's funding position and the employer covenant changing very quickly… … It is important to understand the key risks and have strategies to manage them"

What about the new funding code?

A second consultation on the new funding code is "expected to be launched later in 2022". There is no firm steer on when it will come into force but our own view is that the new code will not be in force until late 2023, at the earliest.

If you have a valuation date between 22 September 2021 and 21 September 2022 this will be carried out under the current funding regulations.

What are the key areas and actions?

Funding levels and current valuations

TPR notes that investment conditions have been favorable over the last 3 years, meaning that funding levels for many schemes may be ahead of plan. However, TPR also notes there will be a wide range of funding positions depending on inflation exposure and hedge levels.
TPR identifies the following specific issues and events for trustees and employers to consider in addition to usual valuation work.

Current issues for specific consideration

- High inflation – consider the impact on the employer covenant and on the scheme liabilities.
- Oil, gas and energy prices – consider the impact of significant price increases on the employer covenant.
- Interest rates – consider the potential impact of higher interest rates on the employer and on the scheme assets and liabilities.
- Ukraine conflict – consider the impact of the conflict and associated sanctions on the employer covenant, especially where there is exposure to Russian assets and/or Ukrainian commodities.
- Covid-19 and Brexit – some business may still be affected by Covid-19. Trustees should consider whether the employer is affected by issues related to Covid-19 and Brexit.

Covenant – which category is your employer in?

TPR notes that businesses are becoming more polarised in terms of how they have been able to react to the above events, with some thriving and others struggling. TPR suggests trustees should consider the impact of these events and classify employers into one of the following 3 categories:

- Limited impact
- Material impact, recovering strongly
- Material impact – recovery uncertain

Trustees should consider obtaining independent specialist advice especially if the covenant is complex, deteriorating, or has been impacted by current market events. Trustees should also consider undertaking stress testing or scenario planning to understand the impact on covenant (including affordability) of possible future economic scenarios.

Affordability and recovery plans

When assessing the impact of current market challenges on an employer's ability to contribute, trustees should consider the following based on the 3 covenant categories above:

- Limited impact – take a 'business as usual' approach, which generally means do not reduce Deficit Recovery Contributions (DRCs) or extend recovery plan terms.
- Material impact, recovering strongly – consider any employer request to reduce short term contributions with higher payments in later years.
- Material impact – where employers request that DRCs are reduced or deferred, trustees should obtain suitable mitigation.

Shareholder distributions and covenant leakage

TPR notes an increase in employers making payments to shareholders via dividends and share buybacks. TPR notes that trustees should be alert to shareholder distributions and should ensure fair treatment for the scheme in accordance with the 2019 AFS.

https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-annual-funding-statement-2019.ashx.

TPR also notes that trustees should be alert to other forms of covenant leakage.

https://www.thepensionsregulator.gov.uk/en/document-library/statements/annual-funding-statement-2020#d0a97bfdfc5c4e15a3f92e81dfe47a4c

Corporate transactions

Trustees should also be ready to act quickly in the event of corporate activity and should take a rigorous approach when assessing the impact of a proposed transaction. Trustees should document their considerations and seek mitigation for any detriment.

Actuarial and investment considerations

TPR highlights the following issues for trustees to consider with respect to the impact on assets, liabilities, funding strategy and liquidity:

- Interest rates – understand the impact of interest rate increases on liabilities and assets, including collateral requirements associated with LDI funds. Review hedging levels and ensure there is sufficient liquidity.
- Inflation (current) – understand your scheme's exposure to short term inflation and ensure it is allowed for correctly in valuation calculations. Trustees should also consider how inflation is hedged and the impact of any caps and collars.
- Inflation (long term) – consider the impact of the alignment of RPI with CPIH from 2030. Trustees should also consider the level of any inflation risk premium assumptions and ensure consistency across assets and liabilities.
- Mortality – TPR's view is that it will take more time for the long term impacts of Covid-19 to emerge in mortality rates. Any changes to pre-covid mortality assumptions should be justifiable and any reduction in liabilities should not be more than 2% unless supported by very strong evidence.

Managing risks

- Long term targets – TPR notes that under the new funding code, it will be a legal requirement for schemes to have a long term objective and a strategy to deliver it. In the 2022 AFS, TPR urges trustees to take steps now to adopt a long term target and put a journey plan in place. This should include consideration and management of short and long term risks over the period to expected wind up.
- Monitoring and contingency planning – trustees should have an integrated risk management plan in place with clear limits and actions to get the scheme back on course if risks materialize. In current (more volatile) conditions, trustees should monitor funding and covenant on a sufficiently regular basis.
- Surplus – where schemes are in surplus on a technical provisions basis and no contributions are currently payable, trustees should consider liquidity needs and investment implications. Trustees should also ensure that a long term target is in place and the scheme remains on target to reach that target.

Know your scheme and know what TPR expects

TPR's expectations are unchanged from last year. Essentially, manage your scheme according to its circumstances.

The key factors determining what TPR expects of trustees are employer strength, funding strength and maturity. Please see the table at the bottom of the following link to identify your group.

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If you would like to discuss how your scheme is affected, please get in touch with your usual contact at Cartwright or email our Head of Pension Strategy using the address below.

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