Sackers

2017 funding statement - TPR gets tough

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Introduction

TPR published this year's annual funding statement on 15 May 2017. While primarily aimed at those carrying out valuations with effective dates in the period 22 September 2016 to 21 September 2017, it is relevant to all DB pension scheme trustees and employers.

Key points

- The funding statement highlights TPR's expectations of trustees going through the valuation process, with particular messages for schemes with different risk profiles, such as stressed or smaller schemes.
- Maintaining its focus on integrated risk management (IRM) from the 2016 funding statement, TPR reminds trustees that if their scheme is in a worse funding position than anticipated, they should consider acting on their contingency plans.
- However, where previously TPR strongly recommended contingency planning for schemes, it now states that "*All* schemes [our emphasis] need to put contingency plans in place in the event a downside risk materialises".
- In what appears to be a hardening of its approach, TPR intends to take a more proactive stance, intervening early in the valuation process where it perceives the biggest risks to members and where it believes schemes are not being treated fairly.
- TPR explains that it plans to "quickly escalate" its actions to ensure compliance by trustees and employers with their scheme funding duties. As such, it plans to be clearer in its expectations of trustees and employers.

A different economic environment

Despite good performance in most asset classes, market conditions have generally led to an increase in scheme liabilities compared with three years ago. Consequently, TPR expects many schemes to show larger funding deficits than projected in their last valuation. And with uncertainty over future economic conditions set to continue, TPR refers trustees and employers to the DB code, as well as its guidance on IRM, assessing and monitoring the employer covenant and new DB investment guidance, for help navigating the valuation process.

TPR has segmented schemes based on their risk profile, which it assesses based on factors including the level of underfunding (taking account of the strength of the employer covenant and scheme maturity compared to the current cash contributions being paid) and the additional deficit that could arise from the investment strategy in the future. Its analysis indicates that around 85-90% of schemes undertaking 2017 valuations have employers with the ability to manage their deficits and no long-term sustainability issues. But around 8% of schemes are taking too much risk, "which does not appear to be supported by the strength of the statutory employer".

Key considerations

The statement reminds trustees and employers of their duties, as well as TPR's expectations in relation to a number of key steps in the valuation process. These include:

- the duty for trustees and employers to notify TPR about certain circumstances or decisions ("notifiable events") which may affect the long-term security of the scheme
- the need for trustees to consider, with their advisers, "the extent to which changing market conditions affect the longer-term view of expected risk and returns, and how this interacts with the scheme's funding plans and risk appetite"
- the need for trustees to have a sound rationale, whether they are changing or retaining a scheme's existing method for setting the discount rate, and to document the reasons for their decision.

Risk management and contingency planning

As TPR notes, risk management is a dynamic process, with trustees needing to monitor risks and take action when required, irrespective of a scheme's funding position. TPR's IRM guidance is designed to provide practical help for trustees on what a proportionate and integrated approach to risk management might look like and how to go about putting one in place.

Where schemes find themselves in a worse funding position than anticipated, TPR expects trustees to take action to implement their contingency plans, with a view to recovering the funding position and mitigating against any further downside events. TPR now expects all schemes to have a contingency plan in place – a strengthening of its previous position. It remains to be seen whether the IRM guidance will now be updated in the light of the 2017 statement.

TPR explains that having a contingency plan is "particularly important for trustees who decide to continue to run significant risk levels" and that the "contingency plan needs to be agreed with the employer in advance and should be legally enforceable".

Stressed schemes

According to TPR's analysis, around 5% of schemes in the current valuation cycle have an employer which is "tending to weak" or "weak" (being two of the covenant categories used by TPR in its DB funding policy). It appears that these employers are at risk of becoming unable, or are already unlikely to be able, to adequately support the scheme.

Most of these employers will not be "inevitably insolvent" within the next 12 months and, as such, it will not be possible for them to apply to TPR to sever their scheme using a regulated apportionment arrangement. TPR therefore expects trustees of such schemes "to reach the best possible funding outcome taking into

account members' best interests and the scheme's specific circumstances".

Trustees of stressed schemes will need to provide evidence to TPR of the steps they have taken, such as:

- closing the scheme to future accrual (if not already done)
- maximising non-cash support and security from the employer and, where appropriate, the wider group, and
- considering whether the scheme can and should be wound up.

TPR's approach

TPR will increase its focus on proactive casework and "early intervention" (ie before recovery plans are submitted) with schemes that it perceives present the biggest risks to members.

Fair treatment between schemes and shareholders

TPR explains that it is "likely to intervene where [it believes] schemes are not being treated fairly". For example, where recovery plan end dates are being extended unnecessarily or the employer covenant "is constrained and total payments to shareholders (including dividends and share buy backs) are being prioritised" in a way that restricts or reduces scheme contribution levels.

In particular, TPR expects schemes "where an employer's total distribution to shareholders is higher than deficit reduction contributions being paid to the pension scheme to have a relatively short recovery plan and that the recovery planned is underpinned by an appropriate investment strategy that does not rely excessively on investment outperformance". TPR will consider opening an investigation where schemes do not stick to this approach, to assess whether scheme contribution levels are too low and the level of payments to shareholders suggests that the employer can afford to pay more. If necessary, TPR may then take steps to "ensure that an appropriate balance is struck between the interests of the scheme and shareholders by the employer".

Late valuations

As part of its drive to raise governance standards, TPR also plans to take a tougher approach with schemes that fail to submit their valuations on time. (In 2016, approximately 10% of DB schemes failed to meet the statutory deadline.)

Trustees should therefore plan ahead to avoid unnecessary delays. Where they are having difficulties meeting the deadline, trustees should engage with TPR regarding the factors causing the delay and provide a clear timetable for completing the valuation, which has been agreed by all parties.

TPR notes that it is more likely to take enforcement action in relation to late valuations when delays could have been predicted, or where trustees do not engage with TPR regarding the breach.

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