Sackers

2019 funding statement - TPR's long-term funding focus

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Introduction

Picking up the baton from last year's DB White Paper, TPR's annual funding statement (published on 5 March 2019, and running to 22 pages) includes a specific focus on long-term funding targets. The summary of key messages is only eight slides, so may be an easier way in for trustees. While primarily aimed at those carrying out valuations with effective dates in the period 22 September 2018 to 21 September 2019, it is relevant to all DB pension scheme trustees and employers.

Key points

- The statement includes TPR's favourite 'D' words – dividends and deficits (see 'Equitable treatment', below), and the intersection between shareholders and trustees.
- TPR notes that it continues to take a tough stance where it sees "inequitable treatment" of schemes relative to that of shareholders, as well as recovery plans that it views as unacceptably long.
- Recognising the importance of paying promised benefits, TPR is expecting trustees and employers to set a long-term funding target ("LTFT") consistent with achieving that objective.
- Dividing schemes into 10 distinct categories based on covenant strength, funding and investment, TPR sets out "more clearly and explicitly" the key risks and actions it expects trustees and employers to consider.
- With the annual funding statement having a much more technical focus than in the past, trustees and employers in Tranche 14 should seek early advice on how it affects them.
- Finally, referring to its recent review and new regulatory model involving greater one to one supervision, TPR notes that it has several investigations currently underway where it may use its powers in relation to scheme funding.

Current economic climate

The 2019 funding statement has been published earlier than in previous years to provide an update on TPR's "expectations around managing risks from the perspective of DB pension plans which will be relevant to Brexit and the wider economic environment."

The statement reminds trustees and employers of TPR's recent "Statement on the UK's exit from the EU", which outlined "the Brexit-related steps they can initiate". TPR notes that it continues to monitor the situation and will issue further guidance if necessary.

The statement does not offer much by way of analysis of current market conditions, but comments that schemes that did not hedge their interest rate and inflation risks "are likely to have done worse than others who did."

TPR's expectations of trustees

Long-term funding targets (page 5)

Paying the promised benefits is the key objective for all schemes, requiring clear plans for how this objective will be delivered. TPR notes that good practice observed amongst schemes that do this well "often involves trustees and employers agreeing a clear strategy for achieving their long-term goal, which recognises how the balance between investment risk, contributions and covenant support may change over time". TPR is therefore expecting all DB schemes to adopt a similar approach.

The LTFT should be consistent with how the trustees and employers expect to "deliver the scheme's ultimate objective", with "journey plans" looking beyond being fully funded on a technical provisions basis "to becoming fully funded up to the LTFT". TPR believes that this is consistent with its integrated risk management ("IRM") guidance. Trustees and employers should also be prepared to "evidence that their shorter-term investment and funding strategies are aligned with" the LTFT.

In its March 2018 DB White Paper, the Government announced its intention to introduce a requirement for schemes to have a specific "long-term financial destination", so the LTFT is merely an early adoption of this policy by TPR.

Balancing risks (page 6)

Consistent with its previous statements and guidance, TPR emphasises the need for an IRM approach, with trustees looking at covenant, investment risk and funding in the round.

TPR also sets out the factors it includes in its own "integrated approach" to assessing the risk profile of a scheme, including the level of cash contributions being paid and the additional deficit that could arise from the investment strategy in the future (including whether the employer covenant could support it). It will continue to risk assess all valuation submissions it receives.

As in previous years, TPR segments schemes based on their risk profile, dividing schemes into 10 different categories. But this year a scheme's maturity is a significant factor. Since the majority of schemes are now closed to new members, TPR expects scheme maturity issues to assume greater prominence when setting funding and investment strategies in the future. In particular, TPR advises that those schemes with high levels of transfer activity should be alert to the risks increasing scheme maturity poses.

The statement contains a series of tables, setting out the key risks and actions which TPR believes trustees and employers should focus on, depending upon the category into which their scheme falls. Whilst the tables set out TPR's expectations, it recognises that individual scheme circumstances might mean alternative action is appropriate (but notes that trustees may wish to consider obtaining evidence and justification for doing so). Clearly, expert advice will be essential for trustees and employers to understand the implications for their scheme.

Investment strategy expectations

Also for the first time, TPR spells out its investment strategy expectations in the tables, including:

- setting asset allocation consistent with LTFTs, and journey planning to get there
- quantifying the impact of adverse investment performance on funding, and
- testing and evidencing the ability of the covenant to support this without extending the recovery plan (supportable investment risk).

What trustees can expect from TPR

Equitable treatment – dividends and deficits (page 19)

TPR states that it expects pension schemes, as key financial stakeholders, to be treated "equitably" with other stakeholders, but it remains concerned about the disparity between dividend growth and stable deficit reduction contributions ("DRCs").

The statement sets out the key principles behind TPR's expectations:

- where dividends and other shareholder distributions exceed DRCs, TPR expects a strong funding target and short recovery plans
- if the employer covenant is tending to weak or weak, DRCs should be larger than shareholder distributions unless the recovery plan is short and the funding target strong
- if the employer is weak, TPR expects shareholder distributions to have ceased.

Long recovery plans (page 20)

Where a scheme's existing recovery plans are "unacceptably long", TPR may engage with it and set out its expectations for the forthcoming valuation. TPR plans to engage with schemes across "the whole spectrum of covenant strengths", but will consider both the maturity and the covenant of the employer in forming a view on what it considers acceptable.

Late valuations (page 20)

As noted in previous statements, TPR expects trustees to plan ahead so that their valuation process leaves sufficient time for advice, analysis and negotiation. If the statutory deadline is missed, TPR expects trustees to report this "in good time" and work with employers to agree an appropriate valuation and recovery plan as soon as possible.

However, TPR is clear that trustees should not agree an inappropriate valuation and funding plan merely because deadlines are imminent or have elapsed, and should contact TPR if pushed to do so by the employer or a third party. TPR says it will support trustees if they cannot agree a valuation for valid reasons.

Whilst TPR has discretion to impose penalties for late valuations, "where trustees have acted responsibly and taken all reasonable steps to finalise their valuation" but there remain genuine reasons why it cannot be finalised, it may choose not to apply a penalty.

Updated DB Code

TPR refers trustees and employers to the DB code, as well as its guidance on IRM, assessing and monitoring the employer covenant and DB investment, for help navigating the valuation process.

TPR confirms its intention to review and update its DB funding code as part of the package of actions stemming from the DB White Paper. The new code "will be clearer about funding approaches (in particular around the prudence of technical provisions…and appropriateness of recovery plans)". TPR states that it will consult in summer 2019 "on various options for a revised funding framework under the new code", and "shortly after" will consult on the revised code itself. Until the updated code comes into force, trustees and employers should continue to refer to the current DB code and guidance.

Closing remarks

All of which suggests, to paraphrase Q to Bond in *Skyfall*, TPR is aiming less at random uses of powers and more at a personalised funding strategy by schemes.

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