Sackers

2020 funding statement – trustees and employers must work together

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Introduction

Unsurprisingly, a key focus of TPR's annual funding statement (published on 30 April 2020) is the current pandemic. The statement stresses the need for trustees and employers to work together to manage the impact of COVID-19. However, TPR does not expect this to be at the expense of pension scheme security, with the statement continuing the drive towards long-term funding targets ("LTFT").

Key points

- Whilst primarily aimed at schemes with valuation dates between 22 September 2019 and 21 September 2020 ("Tranche 15"), the statement also applies to schemes undergoing "significant changes that require a review of their funding and risk strategies".
- There is a strong emphasis on collaboration between trustees and employers. Trustees should balance deficit recovery and equitable treatment of the scheme with the sustainable growth of the employer.
- Schemes should also still be pursuing an LTFT, with suitable short-term modifications to reflect the current economic situation.
- Trustees should have increased covenant assessment and monitoring in place, and discuss contingency plans with the employer. TPR may ask for evidence of these discussions.
- The approach to risk management largely follows that of previous years, with schemes asked to identify which of 10 broad categories they fall into (taking into account both COVID-19 and Brexit) to identify their key risks and actions.
- TPR also provides an update on the timing of its DB funding code, with the deadline for responding to the first stage of a two-part consultation having been extended until 2 September 2020 (this date will be kept under review). TPR confirms that the second stage of the consultation will now be published next year, and that it does not expect the new code to come into force "until late 2021 at the earliest".

COVID-19 - impact on current valuations

Regardless of whether a current valuation is in progress, TPR recognises that many schemes will have been impacted by COVID-19, and it expects trustees to read its COVID-19 guidance alongside the statement. The statement provides further guidance on certain scheme-specific considerations affecting current valuations.

Post valuation experience and recovery plans

Schemes close to completing their valuations are not required to take post valuation experience into account and to revisit their assumptions, even though they may have been set under very different conditions than those prevailing now. However, TPR does expect trustees to consider post valuation experience in their recovery plans, with a specific focus on employer affordability.

Recovery plans and affordability

TPR notes that there will be varying degrees of impact on corporate health in the current climate, with some employers “experiencing only a partial deterioration in trade” whilst others will “have seen a complete shutdown of operations and total loss of income”.

Trustees should carry out additional due diligence to assess the employer's covenant. Trustees should use this analysis in negotiating recovery plans, balancing affordability and fair treatment of the scheme with the sustainable growth of the employer.

In addition to deficit repair contributions, where possible, TPR expects trustees to consider requesting appropriate incremental increases in contributions, which track the recovery in corporate health. This is especially the case where a scheme has taken on additional funding risk while supporting the employer’s recovery. Additional contributions should be based on appropriate triggers such as free cash flow, payments to other creditors, and investment performance.

Changing valuation dates

Some trustees with effective valuation dates on or around 31 March 2020 may be concerned about the impact of the unusual market conditions at that time. As such, some may consider (or may be asked to do so) bringing forward the effective date of their valuation to a date when conditions were considered more normal (eg December 2019). TPR advises caution here. Trustees should take legal and actuarial advice and consider “very carefully” whether this is in the best interest of members.

Trustees who decide to press ahead and make a change can expect TPR to question their reasons for doing so.

Calculating technical provisions (“TPs”)

TPR acknowledges that, in the current circumstances, many trustees will not have sufficient information to form a reliable view on investment returns, employer covenant and affordability. TPR believes it is therefore reasonable to delay taking decisions about TP assumptions until more clarity emerges. However, TPR expects schemes to proceed with as much of the preliminary valuation work as possible, preparing and validating the data, programming and the background analysis on the data.

Trustees should discuss key assumptions with their advisers, using scenario planning to understand the impact of different potential economic outcomes to inform their decisions around discount rates and other assumptions. TPR warns that these should not be overly influenced by short-term fluctuations.

TPR’s expectations of trustees

Long-term funding targets

Whilst acknowledging the need to manage the immediate impacts of COVID-19, TPR emphasises that schemes should be adopting an LTFT. The messaging here largely mirrors that set out in the 2019 Annual Funding Statement (“the 2019 Statement”). In other words, trustees and employers should agree a “clear strategy for achieving their long-term goal” (paying the scheme’s promised benefits), which “recognises how the balance between investment risk, contributions and covenant support may change over time as the scheme gets better funded and more mature".

Schemes with LTFTs already in place should be able to continue to focus on them, "with suitable short-term modifications" in light of COVID-19. Schemes that have not already set an LTFT are encouraged to do so, and to "be prepared to evidence that their shorter-term investment and funding strategies are aligned with it".

Finally, TPR reminds schemes of the forthcoming legal requirement to set long-term strategies in the Pension Schemes Bill.

Covenant assessment and monitoring

The statement includes guidance on assessing covenant, in particular in light of COVID-19 and Brexit (which should not be forgotten despite the current crisis).

Trustees and employers should consider undertaking stress testing or scenario planning which reflects possible future economic environments. In relation to Brexit, TPR expects trustees of schemes with employers who stand to be particularly affected to understand the potential impact of the different outcomes of the trade agreement negotiations on employer covenant.

TPR recommends that trustees obtain independent specialist advice to support covenant assessment, particularly where the covenant is complex, deteriorating, or where the scheme is highly reliant on the covenant (eg because it has a large deficit).

Trustees should only undertake their own covenant assessment where they have sufficient expertise. Where trustees rely on their own analysis, they should fully document their reasons for doing so, as well as their own assessment and conclusions reached.

In the current climate, TPR expects the frequency and intensity of covenant monitoring to be "significantly increased" until covenant visibility and strength is restored. Trustees should identify the key aspects of the covenant to track and decide when action is required based on appropriate triggers or thresholds (for example, additional cash contributions being paid if the scheme's funding level deteriorates beyond a specified level). Where monitoring identifies adverse changes, trustees should have contingency plans in place – ideally developed in conjunction with the employer – so they can react appropriately.

TPR expects trustees to be able to demonstrate that key risks and actions have been discussed with the employer, and may ask to see relevant documentation.

Covenant leakage

In line with the 2019 Statement and its COVID-19 guidance, the statement focuses on schemes being treated fairly in comparison with other stakeholders. TPR asks trustees to "be vigilant of employer covenant leakage", which could take the form of dividends to shareholders, group trading arrangements, or excessive executive remuneration. TPR expects trustees to look behind such arrangements to make sure they understand the impact on the employer covenant.

Where trustees consider covenant leakage is not justified, TPR expects them to seek suitable protection (eg security over employer assets) to compensate the scheme.

Managing risks

TPR continues to expect trustees to focus on IRM, covering employer covenant, investment and funding plans. It recommends that trustees work with their advisers to develop an IRM framework and associated governance, providing trustees with pragmatic and useful information for their decision making.

Following the approach of previous years, TPR segments schemes based on their risk profile (funding strength, covenant and maturity) dividing schemes into 10 categories. As the majority of schemes are now closed to new members, it expects scheme maturity to assume greater significance, in particular for schemes with high levels of transfer activity.

The tables are the same as those introduced in the 2019 Statement, and set out the key risks and actions for each category of scheme to focus on. Schemes should first consider how COVID-19 and Brexit may affect their covenants, and how good their funding position is relative to their LTFT, to decide which category now best reflects their situation.

What trustees can expect from TPR

In light of the current situation, TPR has temporarily suspended its regulatory initiatives. Instead, it will be focusing its engagement on understanding and supporting trustees in responding to the impact of COVID-19, and ensuring that recent easements adopted as a result are not abused.

The statement also notes that TPR will risk assess valuation submissions it receives “in a proportionate way”.

Next steps

As the “duration and impact of the current economic uncertainty evolves”, TPR will consider issuing further funding guidance in the autumn.

While the statement includes a large amount of guidance targeted at addressing the current crisis (and the impact of Brexit on the horizon), it is broadly consistent with the messaging of the past few years, encouraging a long-term focus and ensuring that schemes are treated fairly.

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