Sackers

# 2021 funding statement – the continuing impact of a global pandemic

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## Introduction

TPR's latest annual funding statement was published yesterday. Unsurprisingly, the current pandemic (and its knock-on effect on covenant monitoring and contingency planning) remains a high priority. The statement also acknowledges the need for trustees and employers to continue working together to manage unexpected events, whilst retaining "a focus on the long term – most specifically around planning and risk management".

## Key points

- Primarily aimed at schemes with valuation dates between 22 September 2020 and 21 September 2021 ("Tranche 16"), the statement is also relevant to schemes "undergoing significant changes that require a review of their funding and risk strategies".
- As economic uncertainty continues, trustees need to be alert to the risks of weakening covenants (and covenant leakage) and remain engaged with employers.
- Schemes should also still be pursuing a long-term funding target ("LTFT"), with suitable short-term modifications to reflect the current economic situation.
- The approach to risk management largely follows that of previous years, with schemes asked to determine which of 10 broad categories they fall into (taking into account both COVID-19 and Brexit) in order to identify their key risks and actions.
- In future, under changes being made by the PSA21, DB scheme trustees will be required to produce a funding and investment strategy. With draft regulations to implement this change still pending, TPR provides a welcome update on the timing of its revised DB funding code. The second consultation on the draft code is now scheduled to take place "towards the end of 2021", with the code itself not expected to come into force "until late 2022 at the earliest".

## Considerations for current valuations

**Actuarial assumptions and scheme demographics**

Events over the last few years "have highlighted the importance of trustees understanding, with the help of their advisers, the key assumptions in the models used to advise them". Trustees should consider a range of possible outcomes when assessing the prudent technical provisions basis to adopt so as to understand "the key underlying variables and how sensitive the valuation results are to different assumptions". TPR also highlights the benefits of scenario planning as part of a scheme's IRM framework.

**Inflation**

Where pension increases are currently linked to inflation, TPR flags that trustees will have to choose their assumptions carefully both pre- and post-2030 (when RPI will be aligned with CPIH).

**Mortality**

TPR recognises that there are "divergent opinions among market participants on the impact of COVID-19 on the course of future longevity improvements". It therefore suggests that one way "to capture the uncertainty from recent events may be to retain a mortality assumption similar to previous valuations". If evidence supporting different assumptions then emerges, this can be recognised at future valuations. Using the latest base mortality tables and projections available, adjusted for scheme experience where appropriate, would be another reasonable approach.

**Post valuation experience**

TPR reminds trustees and employers that taking account of post valuation experience is not "an opportunity to simply pick the most favourable date for agreeing the recovery plan". TPR expects trustees who have previously allowed for positive post-valuation experience to also consider material negative post-valuation changes at future valuations.

**Investment considerations**

With so many schemes now closed to new members and gradually maturing, trustees are reminded to actively monitor and mitigate their liquidity risks alongside other risks (such as diversification). Liquidity risk analysis should be proportionate to the scheme, with TPR's expectation being that more robust analysis should include:

- stress testing for adverse simultaneous market shifts, and
- reviewing the assumptions that might apply in times of severe market stress and the impact they might have on the liquidity of assets and the values that might be realised.

TPR also reminds schemes using a swaps-based discount rate in their valuations to ensure there is no linkage to either "LIBOR" (London Inter-Bank Offered Rate) or its European equivalent ("EURIBOR") since these measures are being phased out.

**Covenant considerations and monitoring**

TPR acknowledges that the impact of COVID-19 and Brexit has varied depending on the employer's business sector. Alongside the annual funding statement, TPR expects trustees to read its COVID-19 guidance and its guidance on protecting schemes from sponsoring employer distress. Trustees should consider obtaining independent specialist covenant advice, in particular if:

- the covenant is complex or deteriorating, or the scheme has a high degree of reliance on the covenant (eg because it has a large deficit or a high level of investment risk)
- the outlook for any pandemic related recovery is unclear
- Brexit implications appear significant.

Covenant strength can shift materially over a short period of time, "even in the absence of profound events like those we have seen over the past year". As a consequence, TPR is pleased that most trustees "have increased the frequency and intensity of covenant monitoring", which it regards as good practice. Where monitoring identifies adverse changes in the covenant, trustees should have contingency plans in place to enable them to react appropriately. Ideally, contingency plans should be drawn up in conjunction with the employer and key risks discussed with them.

**Affordability and deficit repair contributions ("DRCs")**

Where external developments such as COVID-19 or Brexit have had limited impact on the employer, trustees should take a "business as usual" approach to setting recovery plans. TPR would not generally expect DRCs to be reduced, or recovery plans to be extended, in these circumstances.

In contrast, whilst acknowledging there could be some short-term affordability constraints where employers have been adversely impacted, TPR reminds trustees to consider any request to accept a lower level of contributions carefully. Any deferral of DRCs should be short-term and ideally repaid before shareholder distributions recommence. Examples of suitable mitigation that trustees would be expected to obtain where employers continue to request support include appropriate incremental increases in contributions which track the recovery in corporate health.

**Corporate transactions**

In the event of corporate activity, TPR warns trustees to "be prepared and ready to act". Trustees should be able to identify detrimental events that could affect the employer's ability to meet its scheme obligations. Where relevant, they should also seek specialist advice on the implications of the Corporate Insolvency and Governance Act 2020.

Whilst laying a suitable audit trail, trustees should take "a rigorous approach" to assessing the impact of corporate activity and negotiate mitigation (where relevant) so that the scheme is treated fairly. Where a valuation process coincides with a corporate event, trustees should obtain mitigation for any detriment independently of the valuation. TPR may ask for evidence as to how such scenarios have been managed.

# 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) into 10 categories. As the majority of schemes are now closed to new members, it expects scheme maturity to assume greater prominence, in particular for schemes with high levels of transfer activity.

Schemes should 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 best reflects their situation.

**Climate change**

Trustees will need to consider the impact of climate change on their IRM. Climate change considerations may also impact valuation assumptions, investment strategy and employer covenant.

TPR expects trustees to be aware of its climate change strategy. It will use disclosures in the scheme's SIP and implementation statement to monitor how trustees are using scenario analysis, stewardship and engagement activities to identify and manage climate change risk.

**LTFT**

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 and 2020 annual funding statements.

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 upcoming legal requirement to set long-term strategies being introduced under the PSA21.

**IRM and governance**

TPR recently consulted on its draft single code of practice. Once the new code has been implemented (expected to be late 2021) occupational schemes with 100 or more members are expected to carry out and document their first Own Risk Assessment ("ORA") within 12 months. TPR notes that documenting key risks at the present valuation should make this first ORA easier.

## What trustees can expect from TPR

TPR will risk assess valuation submissions in a proportionate way, and trustees and employers should be fully prepared to justify and explain their approach with supporting evidence.

TPR reminds schemes of its power to direct how a scheme's technical provisions should be calculated and how its deficit should be funded, and that TPR may investigate where it believes trustees and/or employers have not acted in line with its expectations, relevant policy statements, guidance and codes of practice.

## Next steps

While this year's annual funding statement is largely focused on COVID-19, it is broadly consistent with the messaging of the past few years, encouraging a long-term focus and ensuring schemes are treated fairly.

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