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TPR publishes annual funding statement 2022 in "turbulent times"

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Introduction

TPR's latest annual funding statement was published on 27 April 2022. As you would expect, TPR focuses on the current period of "significant economic uncertainty" and how this may impact schemes. The statement follows themes from previous years; an integrated approach to risk management, an emphasis on long term planning and the importance of an open dialogue with the employer.

Key points

- Primarily aimed at schemes with valuation dates between 22 September 2021 and 21 September 2022 ("Tranche 17" or "T17"), the statement is also relevant to schemes "undergoing significant changes that require a review of their funding and risk strategies".
- TPR stresses the importance of an integrated approach to managing and monitoring risk, and urges trustees to remain alert to their scheme's funding positions and covenant changing very quickly in the current environment. In particular, they will need to consider the impact of higher inflation, potential increases to interest rates and the ongoing conflict in Ukraine.
- Trustees should continue to work towards agreeing a long term funding target and journey plan with their employer.
- The consultation on the revised DB funding code is expected "later in 2022", allowing enough time to learn from the DWP's consultation on the draft regulations.

Considerations for current valuations

The current period of economic uncertainty could impact employer covenant, scheme assets and investments in a variety of ways, including:

- **inflation** – high rates of inflation could increase employer costs and increase pension scheme liabilities, depending how benefits are linked to inflation. Trustees with inflation hedging in place will need to understand how these arrangements work in the context of the current environment
- **interest rates** – further rises in interest rates could increase borrowing costs for employers, as well as impact scheme assets and liabilities

- **higher energy prices** – the shortage of oil and gas is causing higher energy and fuel prices, which could impact the profits of employers who are heavy energy users
- **Ukraine conflict** – the ongoing conflict could impact certain sectors, as well as having a more indirect impact on the wider global economy over time
- **COVID-19** – the impact of the pandemic continues with some operations globally particularly affected (eg the current lockdown in China) and there will be employers in the UK who are still struggling in the aftermath, such as those who have to repay coronavirus loans.

Mortality assumptions

There are differing views on the impact of COVID-19 on mortality for pension schemes, so trustees will need to interpret data "with care". TPR does not expect any reduction in liabilities due to changes in mortality assumptions to be more than 2%, unless accompanied by strong supporting evidence.

Covenant considerations

TPR expects trustees to consider the overall impact current market conditions may have on their employer. Trustees should consider obtaining external covenant advice, particularly if their employer is materially impacted by the current economic climate, or if the covenant is complex or deteriorating. And for all trustees, TPR views an open and ongoing sharing of information with the employer as "fundamental" in these uncertain times.

Recovery plans and affordability

When considering how the employer can support the scheme, trustees should follow the same approach as previously:

- where market conditions have had limited impact on the employer's business, trustees should take a "business as usual" approach to setting recovery plans
- where employers are experiencing short-term affordability constraints, trustees should carefully consider any requests to accept a temporary reduction in contributions. Any such request is expected to be short term, with higher contributions in subsequent years rather than longer recovery plans
- where employers continue to request liquidity support from the scheme through deficit recovery contributions ("DRC") deferrals and/or lower ongoing DRCs as part of a revised recovery plan, trustees should obtain suitable mitigation, as set out in last year's statement.

Shareholder distributions and other forms of covenant leakage

Following a lull in the pandemic, there has been an increase in employers returning cash to shareholders through recommencing dividends, paying "special" dividends and share buybacks. Trustees need to be alert to this, and to consider whether their scheme is being treated fairly when compared with other stakeholders. The key principles of fair treatment are as set out in the 2019 annual funding statement. Very broadly, where shareholder distributions are being made, they should not be more than DRCs unless there is a strong funding target and short recovery plan in place and they should not be made at all where an employer is unable to support a scheme.

Trustees should be on the look out for other types of covenant leakage too, such as cash pooling arrangements, group trading arrangements and management fees which could reduce the ability of the employer to support the scheme.

Corporate transactions

TPR continues to expect trustees to be prepared to act quickly in the event of corporate activity and to consider any such events separately from the scheme's valuation.

Managing risks

Trustees should be using an IRM approach to identify key risks for their scheme, such as through scenario planning. Given the current economic environment, a scheme's funding position and covenant could change very quickly and trustees should have appropriate monitoring and contingency plans in place to allow swift decision making in the event of significant changes.

Following the approach of previous years, TPR has identified key risks for trustees to focus on, depending on the scheme's specific characteristics (looking at funding strength, covenant and maturity). The tables setting out its expectations are the same as last year, except the reference to the length of the recovery plan has been updated to six years. This is to reflect that recovery plan lengths have decreased over recent years (the average is now less than six years across all valuation tranches).

Long term funding target ("LTFT")

As in last year's annual funding statement, TPR notes that the PSA21 will require trustees to have a specific long term journey strategy to deliver an agreed long-term objective in place and that it expects trustees to take steps now to agree a LTFT with their employer. When setting their journey plan, trustees should consider the extent of their reliance on the employer covenant and engage with their employer to understand the short and longer term risks that could result in changes to it.

Where schemes are, or will soon be, fully funded on a technical provisions basis, trustees should consider how their liquidity needs may change when employer contributions cease and organise their investments accordingly. These schemes should ensure that their journey plan remains appropriate and focus on managing their risks through suitable contingency planning.

DB funding code

TPR confirms that its second consultation on the draft funding code is expected to be launched "later in 2022", but "allowing enough time" to learn from the DWP's consultation on the draft regulations, which is expected before the summer.

As part of its consultation, TPR will propose changes to the August 2015 covenant guidance as well as other related guidance. In particular, TPR intends to provide more detail on how to treat guarantees for scheme funding purposes and more information regarding ESG and how this can be factored into the covenant.

All T17 valuations will be regulated according to the requirements of the existing legislation and guidance currently in force.

Conclusion

While this year’s annual funding statement is largely focused on the current economic uncertainty, it is broadly consistent with the messaging of the past few years, encouraging a long-term focus and ensuring trustees are taking an integrated approach to risk management.

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