Sackers

TPR publishes annual funding statement 2023

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Introduction

TPR's latest annual funding statement (the "statement") was published on 27 April 2023. With the majority of schemes estimated to have improved funding positions, TPR encourages trustees to consider if their long-term targets remain appropriate.

Key points

- Primarily aimed at schemes with valuation dates between 22 September 2022 and 21 September 2023 ("Tranche 18" or "T18"), the statement is also relevant to schemes "undergoing significant changes that require a review of their funding and risk strategies".
- Funding positions of DB schemes have improved in general, with around a quarter estimated to have sufficient funds to buy-out their liabilities with insurance companies. Notwithstanding the general improvements to funding, TPR stresses the importance of avoiding "complacency" when monitoring the employer's covenant.
- If trustees haven't agreed a long-term funding target ("LTFT") yet, they should do so "as a priority".
- The current DB funding regime applies until new regulations and TPR's revised DB code come into force. This is expected to be in April 2024.

General considerations for current valuations

DB schemes have seen significant changes over the last year. The substantial spike in nominal and index-linked gilt yields in autumn 2022, on top of the gradual rise throughout the earlier part of the year, was a "significant turning point" for most DB schemes. The speed and magnitude of the decreases in assets and liabilities of schemes will have surprised many. Long-term objectives set in an era of low interest rates, and their associated funding and investment strategies may now need to be reviewed.

While most schemes have improved funding levels, funding levels will have fallen for a minority of schemes, including some schemes invested in pooled funds and others unable to meet the necessary LDI collateral calls. These schemes will need to reset funding and investment strategies to meet their

long-term targets and should review their “operational governance processes” to ensure “future resilience”, in line with TPR’s recent LDI guidance.

Open schemes

Open schemes may have seen a material reduction in estimated liabilities and, given their immaturity, many have seen larger movements in funding levels. Whilst TPR acknowledges that these trustees are more likely to be focused on technical provisions (“TPs”) than long-term funding, the principles in the statement “should still prove useful” in helping trustees consider what actions to take in respect to market conditions and improved funding levels.

Economic uncertainty continues

While most trustees should be approaching T18 valuations from a “relatively healthy” funding position, they should still recognise the economic uncertainty that will continue to impact investments and employer covenant in different ways, including:

- **increases in interest rates** – could affect the scheme’s assets and liabilities, as well as increasing borrowing costs for the employer
- **high rates of inflation** – could have knock-on effects on liabilities and investment returns and affect employer costs (eg raw materials and operating costs)
- **volatile commodity and energy prices** – could affect the profitability of employers and fuel inflation in the wider economy
- **potential for ongoing or new geopolitical instability** – could affect supply and distribution chains for employer.

Trustees should understand the key risks for their scheme and employer. The effects of different risks will impact assets, liabilities and covenant in different ways both in the short and long-term. Scenario planning will provide trustees with insight into strategic de-risking journey planning and contingency plans.

Funding position

TPR divides its guidance on funding into three types of scheme.

Group I – funding level is at or above buy-out

Trustees of these schemes will need to decide whether they want to proceed to a buy-out (either outright or in stages) or whether they consider that running on the pension scheme is a better option for their members, eg if it offers them potential to benefit from future surpluses.

However, trustees should be aware that capacity issues in the insurance market could mean that their scheme is too large or too small for a viable buy-out in the short-term, in which case they will need to consider other options to protect the scheme’s funding position.

Whichever option trustees choose, they will need to consult with their employer, take advice about the risks and benefits of their choice and put in place suitable mitigation strategies.

Group II – funding level is between TPs and buy-out

If trustees have agreed a long-term objective with their employer then they should consider whether that objective remains appropriate. Exceeding TPs should trigger actions to keep the scheme on track to meet the objective, eg strengthening the TPs and reducing risk in the investment strategy.

TPR suggests it would be "good practice" to consider steps trustees can take now to align (even if broadly) with the key principles of the draft funding code, particularly those underpinning the concepts of "low dependency funding target", "investment allocation" and "funding basis".

If trustees haven't agreed an LTFT yet, they should do so "as a priority". The "direction of travel" in the draft funding code should help trustees to decide an appropriate LTFT and plan for reaching it.

Group III – funding level is below TPs

If the funding level is below TPs, then the trustees' focus should be on bridging this gap first. Trustees should revisit the TPs to ensure they are aligned to the LTFT. Any risk-taking should be supported by the employer covenant and should reduce as the scheme gets better funded or matures. Any deficit should be recovered "as soon as the employer can reasonably afford". TPR's guidance is in line with previous years and is repeated in the accompanying tables to the statement.

Investment considerations

Trustees should review their investment strategy in light of current scheme funding. It may be that trustees need lower returns from their investments in the future, in which case de-risking may be under consideration.

Leveraged LDI

Schemes' operational processes for collateral payments into leveraged LDI funds were tested in the autumn when gilt yields rose quickly and significantly. Impacted trustees should refer to TPR's recently issued guidance on using leveraged LDI.

Managing illiquid assets

Trustees may have found that illiquid assets are a greater proportion of scheme assets than originally envisaged. TPR suggests that the demand for illiquid assets may have fallen and the desire to sell has increased, so trustees should speak with their advisers about managing illiquid assets in light of the significant change in market conditions.

Covenant considerations

TPR reminds trustees that their scheme will remain "intrinsically linked" to the employer up to the point end game is reached. Even where funding levels have improved, volatile market conditions can mean that reliance on covenant quickly increases.

Scenario analysis of different economic environments and their impact on funding should help trustees understand the scheme's sensitivity to change and how quickly covenant dependency can increase.

Where there has been a large improvement in the funding position of the scheme, trustees may want to change the scope of covenant assessment to focus less on free cashflow (if no recovery plan is required) and more on the longevity of the covenant (eg the impact of ESG risks).

Even where covenant dependency is low, the employer should continue to provide trustees with financial projections and business plans to enable trustees to properly assess the covenant and to consider the impact of any changes.

Other considerations

Longevity

Over recent years, mainly due to the impact of COVID-19, mortality data has not followed past trends and there are differing views on what this means for longer-term mortality assumptions. TPR suggests that mortality in 2022 may be more indicative of future mortality, which suggests lower future life expectancies. However, this needs to be "interpreted with care" as it will take time to see new trends develop.

Inflation

TPR's views on high inflation remain the same as in last year's annual funding statement, with trustees expected to understand the impact it will have on benefits, scheme assets and covenant.

Revising recovery plans

If trustees are considering whether to reduce or stop deficit reduction contributions ("DRCs") as part of an actuarial valuation, TPR expects them to first:

- ensure the level of prudence in TPs remains appropriate if the covenant is weak or has weakened
- consider reducing the remaining length of the recovery plan, particularly if the plan is longer than six years
- reduce or remove any allowance for asset returns in excess of TP assumptions in the recovery plan.

As in previous years, if shareholder distributions exceed DRCs or covenant leakage is material, then TPR believes that it is "unlikely to be appropriate" to reduce DRCs while a TPs deficit exists (see 2020 annual funding statement).

If the employer requests any reduction outside of a formal valuation, TPR expects trustees to work through the above. And they "strongly encourage" trustees to put in place a mechanism to ensure that contributions recommence if there is a reversal in recent funding level gains.

Contingent assets

If a scheme's funding position has improved, the employer may seek to renegotiate the terms of any contingent assets. TPR expects the trustees to evaluate any proposal "critically" and understand the value being given up against a range of reasonable scenarios. If they conclude that the changes are not detrimental to members, they should make provision for the protections to be revised upwards should the funding position subsequently deteriorate.

Assessing refinancing risk

Interest rate increases and lower risk appetites of lenders may result in materially changed terms and conditions when existing debt facilities need refinancing. Re-financing risk should be incorporated into covenant analysis, as it could affect covenant support, potentially place more restrictions on management's actions and affect the scheme's position as creditor.

TPR's 2022 blog sets out what trustees should consider where refinancing is underway prior to completion of a valuation. TPR does not expect covenant analysis to be finalised until the terms of the refinancing become clear, so they can be factored in to covenant conclusions.

Where refinancing falls after the valuation date but within the short-term, eg three years, trustees should engage with management to understand the options and timetable for refinancing, including understanding any contingency plans if refinancing proves difficult.

What's next?

TPR expects the new funding regime (the new regulations and TPR's DB funding code) to come into force at the same time in April 2024. The existing regime remains in place until then.

A consultation on the information TPR plans to collect through the statement of strategy and related guidance will be issued "in due course", with changes to the covenant and other related guidance intended "later this year".

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