In Touch technical update

TPR publishes its annual funding statement

The Pensions Regulator (TPR) has published its annual funding statement (AFS) for occupational defined benefit (DB) schemes.

This is aimed at schemes with valuation dates between 22 September 2022 and 21 September 2023 ('Tranche 18'), as well as schemes undergoing significant changes that require a review of their funding and risk strategies. It also applies to schemes receiving requests for reduced contributions, amendments to contingent asset arrangements, and proposals for other uses of surplus.

TPR now expects the revised DB funding code of practice to come into force, along with revised legislation, in April 2024. The current regime will apply to valuations with earlier effective dates.

Why bring you this note?

The Pensions Regulator has published its annual funding statement.

Next steps

Trustees and scheme sponsors should discuss the latest statement with their advisers and take it into account when making decisions on scheme funding.

The revised DB funding code of practice is now expected to come into force, along with revised legislation, in April 2024.

At a glance…

- Statement significantly revised from previous years, reflecting improved funding levels and schemes moving closer to buy-out levels.
- Focus on re-thinking strategies for funding, investment and covenant.

General considerations

Most schemes show improved funding levels and many are expected to have exceeded buy-out funding levels. Trustees will need to consider if their long-term targets remain appropriate.

Where funding levels have improved significantly, trustees should consider whether the level of risk in their existing funding and investment strategy remains appropriate. The level of risk should be supported by the employer covenant.

TPR notes that economic uncertainty will continue to impact investments and employer covenant in different ways. It cites the possibility of further increases in interest rates, high rates of inflation, volatile commodity and energy prices, and geopolitical instability.

Prepared for: Aon clients
Prepared by: Aon's In Touch Group
Date: 27 April 2023

Re-thinking strategy - funding

TPR's analysis shows that most schemes have improved funding levels; around a quarter may now have sufficient assets to buy out their liabilities with an insurance company and many of the remaining schemes are ahead of their funding plans. The funding levels of a minority of schemes are estimated to have fallen. It comments on three distinct groups.

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

Trustees will need to consider scheme rules and whether proceeding with a buy-out, either outright or in stages, is the best way to lock in funding gains – or whether running on the scheme is a better option for members. Employers may also have concerns over trapped surplus or prefer an ongoing arrangement to use surplus to fund expenses, future accrual or – depending on the legal structure – a DC section.

If buy-out is the preferred route, trustees will want to be in the best possible position to approach the market.

TPR also notes that trustees may wish to examine other endgame options.

Group II: funding level is above technical provisions but below buy-out

Trustees should consider whether their long-term objective remains appropriate. If the scheme has experienced a significant improvement in its funding level, trustees should consider accelerating their journey plan, by taking actions like strengthening the technical provisions and reducing risk in the investment strategy. TPR notes that it would be good practice to align (even if broadly) with the key principles of the draft funding code of practice.

Schemes that are close to a buy-out funding level should consider getting 'insurance ready'.

Trustees who have not agreed a long-term funding target (LTFT) should do so as a priority. TPR suggests that, if trustees then find that funding already exceeds the chosen LTFT, they should consider reducing ongoing reliance on the employer.

Group III: funding level is below technical provisions

Any deficit should be recovered as soon as the employer can reasonably afford.

If the funding level has improved significantly, trustees should consider applying funding gains towards a less risky funding and investment strategy. If the scheme has regressed significantly, trustees should seek to understand the reasons for this and re-build their strategy.

Re-thinking strategy - investment

Many schemes' current asset allocation may be materially different to where it was expected to be, following the rise in long-term global interest rates. In addition, lower returns may be acceptable in the future, so de-risking is likely to be a consideration. TPR suggests this might include selling growth assets for bonds and other cashflow matching assets, and reducing leverage in geared liability driven investment (LDI) arrangements.

TPR highlights its leveraged LDI guidance, published earlier this week. It also notes that a scheme's illiquid assets could be a greater proportion of its assets than originally envisaged, and that trustees should discuss this with their advisers.

Re-thinking strategy - covenant

Trustees should not overlook the short-term impact of the current economic environment and they should understand the key factors affecting their employer's resilience.

Although employer covenants may appear proportionately stronger given reduced scheme sizes, trustees should avoid complacency when monitoring the employer covenant, and should consider obtaining specialist advice, particularly where the covenant is complex or deteriorating, or if it has been materially affected by recent market events.

Covenant assessment could be less focused on the uses of free cash flow if no recovery plan is required, and more on the longevity of the covenant and the potential impact of environmental, social and governance (ESG) risks.

Key risks tables

TPR again sets out “Key risks and our expectations”. This is the series of tables included in previous years’ AFSs - considering different covenant strengths, maturities, and funding levels (covering ten scenarios) – with some minor amendments from last year.

Other considerations

Longevity

Mortality in 2022 onwards may suggest lower future life expectancies although the data needs to be interpreted with care and a degree of caution.

TPR expects many trustees will be revising their mortality assumptions after taking advice.

Inflation

In its 2022 annual funding statement, TPR noted challenges raised by current high inflation, It states that its views remain unchanged this year.

Revising recovery plans and contingent assets

TPR sets out matters it expects trustees to consider before reducing or stopping deficit reduction contributions (DRCs). In summary:

- If covenant has weakened, or was already weak, is the level of prudence in technical provisions appropriate and the level of investment risk supported by the covenant?
- Consider reducing the length of the recovery period, rather than the level of DRCs.
- Consider removing any allowance for asset returns in the recovery plan that are in excess of the technical provisions assumptions.
- If shareholder distributions exceed DRCs or covenant leakage is material, it is unlikely to be appropriate to reduce DRCs.

If a request to reduce DRCs is made outside of a formal valuation, in addition to the above considerations, TPR strongly encourages a mechanism to recommence contributions if there is a reversal of recent funding level gains.

If the employer is in distress, TPR expects trustees to obtain suitable mitigations.

Employers may seek to renegotiate the terms of contingent asset arrangements in the light of improved conditions. Requests should be evaluated critically against a range of reasonable scenarios. If it is concluded that the changes are not detrimental to members and changes are made, TPR encourages provision be made for the protections to be revised upwards in future, should the funding position subsequently deteriorate.

Assessing refinancing risk as part of covenant assessments

Interest rate increases and tightened risk appetites of lenders may result in materially changed terms and conditions when existing debt facilities require refinancing. So, re-financing risk should be incorporated into covenant analysis, and information sharing agreements and monitoring.

Where re-financing is expected to be well progressed prior to completion of the valuation, TPR does not expect trustees to finalise their covenant analysis until the terms of the refinancing become clear.

Where the re-financing will fall after the valuation date, trustees will need to consider how it could affect future covenant support. This will include:

- Engaging with company management to understand the options and timetable for refinancing.
- Ensuring potential changes in interest rates are factored into management forecasts based on current market conditions.
- Understanding management contingency plans if refinancing is difficult.
- Keeping open communications with management, documented through an information sharing agreement to ensure timely information is provided.

What to expect from TPR

TPR now expects the revised DB funding code of practice to come into force, along with revised legislation, in April 2024. The current regime will apply to valuations with earlier effective dates. Updated guidance on covenant assessment will be set out later this year.

TPR will be engaging with schemes if it has concerns over corporate distress.

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

Aon plc (NYSE:AON) exists to shape decisions for the better - to protect and enrich the lives of people around the world. Our colleagues provide our clients in over 120 countries and sovereignties with advice and solutions that give them the clarity and confidence to make better decisions to protect and grow their business.

Follow Aon on LinkedIn, Twitter, Facebook and Instagram. Stay up-to-date by visiting the Aon Newsroom and sign up for News Alerts here.