Broadstone

The Pensions Regulator

Annual Funding Statement 2023

May 2023

Introduction

Each year The Pensions Regulator (TPR) issues a statement summarising their views on the funding of defined benefit (DB) schemes. This year's edition is particularly aimed at trustees and employers involved with schemes that have their full triennial actuarial valuation effective between 22 September 2022 and 21 September 2023 although it is relevant to all.

Our note summarises the key points but there is no substitute for reading the full statement (6 pages plus a series of summary tables) and this can be accessed here.

The statement's focus is on the impact on schemes of the events of 2022 which overall saw increases in interest rates from January through to the summer before the dramatic rise in late September and early October. The rise in interest rates has meant the present values of liabilities became much lower than at the beginning of 2022 and the unexpected scale and speed of the change will have forced many to rapidly change their approach.

However, as the impact on funding position will depend on the trustees' investment strategy it is not possible to assume that all schemes have fared well over this period. Changes in investment risk and employer covenant may also need bespoke consideration. TPR has, therefore, divided their statement into separate messages for schemes depending on their experience and circumstances. We'll summarise the key points in a similar way.

Guidance by funding position

TPR has divided schemes into 3 broad groups.

1. **Funding level is at or above buy-out.**
2. **Funding level is above technical provisions but below buy-out.**
3. **Funding level is below technical provisions.**

Key points for schemes where funding level is at or above buy-out

TPR believe that around a quarter of all DB schemes may now be able to afford buy-out. Schemes at this stage will have a choice to make - whether to move to buy-out (either in a single transaction or in stages) or to run on the scheme.

If buy-out is the preferred route TPR notes that:

- Schemes should focus on getting themselves in the best possible shape to approach the market. This includes investment in suitable low-risk assets and improving data. Unprepared schemes may struggle to get interest from insurers or be quoted higher premiums.
- The buy-out process can take a number of years and so the investments should have the resilience to withstand market movements in the meantime, with minimal reliance on the employer for additional support.
- Capacity issues may be a particular challenge at this time, especially for very large and small schemes. Schemes may also find current pricing unattractive. Such issues may require the scheme to run on until (better) buy-out opportunities arise. and risks (particularly investment risk) should then be carefully managed.

Key points for schemes where funding level is above technical provisions but below buy-out

Schemes are encouraged to review any long-term funding target, as the timescales for reaching that objective could well have changed. Agreeing a long-term target and de-risking plan (if these are not already in place) is described as a priority and using surplus to reduce risk and reduce reliance on the employer are key themes.

Trustees may wish to consider:

- Strengthening technical provisions and reducing investment risk.
- Starting to align with key principles from the draft funding code and assess funding on a low dependency basis; and/or
- Taking steps to be buy-out ready, particularly if buy-out funding is close.

Where funding is below technical provisions

Schemes should continue to focus on reaching full funding on technical provisions whilst ensuring their strategy is consistent with their long-term targets. Employer covenant is more relevant, and deficits should be recovered “as soon as the employer can reasonably afford”.

Schemes that have done well over the past year (e.g. due to an unhedged position) are encouraged to consider locking in some of these gains and de-risking in order to create a strategy that can provide a "smoother and more predictable transition to your long-term funding target". Those who've seen a funding deterioration should understand why and re-build as needed.

Investment considerations

TPR highlights the following for schemes thinking about their investments:

- For many schemes, following the events in 2022 the requirement for growth assets may be diminished and de-risking is a consideration. This could include:
    - selling growth assets (e.g. equities) for bonds and cashflow matching assets
    - reducing leverage in geared LDI
- Trustees should refer to the recent guidance on leveraged LDI.
- Trustees should review the liquidity of their portfolio and improve their understanding of how any illiquid assets are valued, fit in with the scheme's objectives and whether they could be a barrier to buy-out.

Covenant considerations

TPR is mindful that for many schemes the funding improvements will have reduced the reliance on their sponsor(s). However, things can change quickly and TPR is keen to guard against complacency.

It is important to continue to obtain appropriate financial information and take advice where needed. However, the appropriate scope or nature of covenant assessment may have changed over the past year. In particular:

- Short term pressures of higher interest rates and inflation, together with ongoing trading volatility may be impacting on the strength of the sponsor.
- Where there is no longer a recovery plan, focus could shift to covenant longevity and the impact of Environmental, Social and Governance (ESG) risks.
- Where there is distress or affordability restrictions, Trustees should refer to TPR's guidance on protecting schemes from sponsoring employer distress. TPR will engage with schemes if they have concerns over corporate distress.

Other considerations

Longevity/Mortality – Mortality figures appear to have stabilised since the pandemic but with lower life expectancy than before and your scheme actuary may recommend revised assumptions, but caution is advised, and changes should be justifiable.
Inflation – Inflation remains high, and this will need to be factored into inflation assumptions as well as considering impacts on benefit payments.

Revising recovery plans and contingent assets – there is some guidance/warnings on revising recovery plans where schemes are ahead of schedule:

- Ensure if the covenant is weak (or weakened) that the valuation assumptions and investment strategy reflect this.
- Recovery plan length should generally be reduced before payments are reduced.
- Revised investment strategies should be reflected and any asset outperformance in the recovery plan should be reduced before contributions are reduced.
- Where shareholder distributions exceed deficit contributions or covenant leakage is material, deficit contributions should not normally be reduced.
- If reducing contingent assets or contributions, then put suitable provisions in place to reinstate these in future if the funding position deteriorates again.

Refinancing – Refinancing risk should be considered, and trustees should be engaged in the process. Terms should be understood as part of covenant assessments and the potential implications of upcoming refinancing should be considered.

What to expect from TPR

Finally, in a useful section TPR summarises its agenda for the DB funding space.

DB Funding Code delay – As recently announced by TPR in their corporate plan, the expected effective date of the revised funding code and new funding regulations has been moved from October 2023 to April 2024. There will also be a further consultation on the statement of strategy and related guidance later this year.
Employer covenant assessment guidance – the guidance last updated in August 2015 will be updated "later this year".
Regulation of valuations – TPR emphasises that they will regulate this year's valuations in accordance with existing legislation and guidance. They will operate "in a proportionate way" but remind us of their powers to intervene. Trustees and employers should be fully aware of this statement and guidance and be prepared to "justify and explain their approach with supporting evidence."

Broadstone comment

The key themes from the statement are similar to ones before – carefully managing risk and understanding employer covenant - and the summary tables for schemes to refer to (split by covenant, funding position and maturity) are included as in previous years. However, the statement for 2023 is very different from the one for 2022.

Funding levels are, in general, improved in comparison to the position in January 2022 and some schemes have seen a material shift in fortunes. Investment strategies have been adapted for a number of reasons and many schemes' longer-term prospects are being fundamentally reassessed. TPR is understandably keen to therefore capitalise on improved funding by encouraging schemes to de-risk, whilst at the same time wanting to make sure that Trustees' strategic planning, governance and risk-management are keeping up to date with these revised circumstances.

The increased focus on buy-out is understandable as it moves from an aspirational target to an affordable one for many schemes, and it is reassuring to see a note of realism with TPR acknowledging that this will generally be a multi-year process (given market capacity and the current level of preparedness for many schemes).

There is also some realism in TPR's acknowledgement that trustees of small schemes may struggle to access cost-effective covenant advice. It will be interesting to see if this translates into pragmatic and proportionate expectations for such schemes when the new covenant guidance is issued later in the year.

Overall though, the general tone remains undeniably cautious, with warnings to trustees about the dangers of funding gains being reversed, continued threats to employer covenant, and the need to carefully manage aspects such as leverage and liquidity. Employers hoping to see reductions in deficit contributions or other benefits from their improved funding position may well be disappointed.

Finally, despite the reassurances that the new DB funding code will not be in force until April 2024 at the earliest, and therefore does not apply to this year's tranche of valuations, there are a few clear signs that its key principles cannot be totally ignored. For example:

- long term targets are clearly expected to be on trustees' radar, including plans for investment de-risking.
- the need to reduce reliance on the employer (low dependency) is mentioned several times.
- the expectations for trustees to have a more detailed understanding of employer covenant is reiterated (the simplistic 1-4 rating is not enough); and
- the statement emphasises that any technical provisions deficit should be recovered as soon as the employer can reasonably afford, suggesting greater weight is already being applied to this aspect.

We will work with you to try and prioritise the most important aspects for your scheme – navigating through all the guidance in a proportionate and cost-effective manner and, where practical, spreading this work over the valuation cycle. For some schemes this will involve making and monitoring more detailed longer-term plans, whilst others will start to work with our specialist SM&RT team in preparation for buy-out. Whatever your status, and whatever the timing of your next valuation, it is clear that there is plenty for trustees and employers to be thinking about.

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Find out more

For more information on how Broadstone can help you, please contact your Broadstone consultant or use the details below.

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