Broadstone

Annual Funding Statement 2024

Short and sweet

April 2024

Introduction

Each Spring the Pensions Regulator releases an Annual Funding Statement aimed, primarily, to assist trustees and sponsors in the tranche of schemes currently going through an actuarial valuation (in this case, valuation dates between 22 September 2023 and 21 September 2024, a.k.a. Tranche 19 schemes). The Statement this year is particularly short, with no urgent fallout from market shocks to manage (e.g. COVID-19 or 'Truss-onomics') as we've had in prior years.

The Statement paints a much rosier picture of pension scheme funding and reminds us (lest we forget!) that the new defined benefit funding code will be published in the summer. This will be accompanied by revised covenant guidance, which will be of great interest in understanding the expanded expectations in this area.

If you would like to read the statement in full please click here.

Three main groups

The Pensions Regulator has identified three key categories of scheme depending on their funding position.

- Funded beyond buy-out - the focus for these schemes will be on run-on, consolidation or insurance buy-out as the next step in their strategy. The Regulator estimates that half of schemes will have a surplus on a buy-out basis (although we have some scepticism about this number).
- Improved funding levels – many schemes will now be in a much better position than they may have estimated at their last actuarial valuation. The Pensions Regulator suggests schemes review their strategy, determine their longer term goals and consider whether the level of risk that may exist in the investment strategy is appropriate.

- Schemes in technical provisions deficit – this 'sizable minority' of cases (which they estimate to be around 25% of schemes) should continue to focus on recovery plans and ensure they are as short as possible, considering employer affordability.

Key themes

The Pensions Regulator goes on to flesh out a number of areas that trustees and sponsors should be considering, depending on the scheme's funding position.

Employer covenant reliance and affordability – Given the improved position of schemes, reliance on the employer covenant may have reduced. Trustees may be having discussions with sponsors about reducing or ceasing contributions but should ensure this ties in with longer term strategic plans and suitable levels of risk. For underfunded schemes, affordability is central to setting reasonable recovery plans. Pending the new covenant guidance, trustees are reminded to focus on re-financing, covenant leakage and schemes being treated fairly.

Discretionary increases – There have been calls in the popular press and from pensioner representatives to allow members to share in the recent improvements in funding, particularly in light of high inflation levels. Whilst acknowledging this, the Statement suggests an element of caution, encouraging trustees to consider the impact of doing so on its short- and longer term strategies, levels of investment risk and longer term reliance on employer support. They also urge trustees to consider scheme history and the interests of all members, not just those who will benefit, when deciding whether a discretionary increase is appropriate.

Members' best interests – there is a theme throughout the statement that the best interests of members need to be central in the trustees' decision making process. This applies to various decision-making processes including discretionary increases, long-term objectives, end game strategy (buy-out or run-on) and investment strategies. This is notable in its prominence, not least given wider rhetoric around running on schemes and using investment returns to generate surpluses for sponsors.

Investment strategies – Whilst (no doubt deliberately) ambiguous in places, there appears to still be a default emphasis on risk reduction in investment strategies. Risks and uncertainty are repeatedly emphasised as is the risk of funding levels deteriorating if the position is not properly managed.

Climate change – Climate change is recognised as a financially material factor that trustees should be actively considering when setting investment strategies. The largest schemes have legal obligations to report on this but all schemes with more than 100 members must consider climate change and environmental, social and governance matters. This also has implications for employer covenant.

Targeting insurer or consolidator – Many more schemes will now be considering a buy-out or alternative consolidator option sooner than anticipated. The Pensions Regulator highlights various points for trustees to consider including requirements in the rules and taking the right steps to get the best possible price. They also state, even ahead of the new funding regime, that they expect trustees "to document their strategy and explain why it is in the best interest of members".

Run-on – Some schemes may not be targeting buy-out, at least not in what might be seen as the medium term, and the trustees would need to be comfortable that is beneficial to members. It is noted that having a risk buffer sufficient to do this may be in the realms of the larger schemes. Where schemes are continuing for now because other options are not affordable, to trustees.

Long-term objectives – Trustees are urged to review (or set, as a matter of priority) their long-term objective and a clear timeline. There is continued emphasis on managing risks, as well as the need to make plans to determine when the position should be reviewed and ensure that opportunities to capitalise on progress are captured.

What's missing?

We note in this short statement there is little or no mention of these areas:

LDI resilience – A key part of the previous statement was concern around LDI resilience. Understanding the LDI strategies of schemes, we believe, is still a key part of investment governance and something that trustees should be considering.

Expenses and benefits – when considering long-term plans and potential future contributions to the scheme, treatment of expenses can be material. This cash-flow management is key to protecting funding levels, planning disinvestments and understanding the reliance on employer support. We therefore expect more on this to follow in the funding code.

Productive finance – There is only a very small nod to the government's productive finance agenda, with a brief comment around potentially increasing allocations to private markets as a means of creating returns to benefit members.

Broadstone Comment

On one hand we are slightly surprised by the brevity of the statement, although on the other hand very pleased. There is plenty of commentary and guidance on pension scheme management already and both the new funding code and revised covenant guidance are expected to be long and challenging documents.

Whilst we may question the Pensions Regulator's suggestion that 50% of schemes could currently afford to buy-out with a surplus, it is undeniable that for many pension schemes the conversations over recent months have been far more proactive and focussed on the eventual risk transfer of the scheme to an insurer or consolidator. We continue to work with many schemes looking to reduce the risks in their strategies and sensibly prepare for their eventual end-game. What remains uncertain is whether the insurance and consolidation market (even with the proposed new public sector consolidator) can grow quickly enough to offer most schemes a range of attractive and viable options.

It is notable the lack of focus on productive finance in the statement. From the initial loud noises of the Mansion House speech in July 2023 through to the recent consultation on the use of surpluses in pension schemes there appears to have been a softening of the expectation that many schemes will (or should?) be interested in re-risking in this direction. The message may be getting through that the majority of defined benefit pension schemes (and the trustees that manage them) will not necessarily be the place to find significant allocations to this asset class.

Finally, and perhaps related to this, we're particularly pleased to see the emphasis on ensuring that members receive their benefits as promised being central to decision making. This is not at the expense of the sponsor, as we are very sympathetic to their experience to date, but reins in some of the rhetoric suggesting that newly acquired funding security should be quickly given away in a rush of surplus distribution, discretionary payments and pursuit of (previously discouraged) investment risk.

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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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