XPS Pensions Group

XPS Insights

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The Pensions Regulator's Annual Funding Statement 2023

What you **need to know**

- The Pensions Regulator (TPR) published its Annual Funding Statement (AFS) on 27 April 2023. Aimed at both trustees and sponsors, it provides guidance to schemes with valuations between 22 September 2022 and 21 September 2023, reviewing funding and risk strategies and considering reducing contributions or contingent support.
- TPR recognises that many schemes will have seen significant changes to their funding levels, particularly following the spike in gilt yields at the end of 2022. As a result, trustees should review the continued appropriateness of their funding and investment strategies to reach their long-term targets. Investment governance processes should also be reviewed.
- Some schemes may now have sufficient assets to consider proceeding to buyout or to develop alternative end game strategies. Other schemes may be able to significantly reduce risk, whilst maintaining their long-term goal.
- Wider economic challenges remain, meaning funding and covenant can change quickly. It is important to ensure that the employer is still able to support the level of risk being taken.
- TPR has confirmed that the new funding regime is now expected to come into force in April 2024.

Actions you can take

- Understand the impact of the 2022 market volatility on your scheme, review the current funding position and consider whether your long-term funding target and journey plans remain appropriate.
- If buyout is now viable, prepare in advance of obtaining quotes or consider other end game options. If funding has worsened, reset journey plans and ensure LDI governance processes are reviewed.
- Review covenant in light of current economic conditions and assess longer term viability. Where covenant is complex or deteriorating consider seeking specialist advice.
- Carefully consider requests for reduced contributions. Consider shortening the recovery period and removing any allowance for investment outperformance ahead of reducing contributions.

Reviewing strategy following significant change

Funding positions have changed materially due to market trends and in particular, market volatility in 2022. Schemes may have done so already, but TPR says the following should be considered:

Funding

- Consider executing previously agreed end game plans.
- Where funding is ahead of target, review pace of funding and level of risk-taking. Consider setting a more ambitious long-term target.
- If funding is behind target, understand why and re-test governance arrangements.

Investment

- Strategy may need to be reviewed if the funding level has changed materially, and asset allocations may need to be rebalanced.
- Any de-risking will depend on scheme maturity, funding level and long-term objectives.
- The resilience of LDI strategies should be tested.

Covenant

- Following funding gains, schemes may appear less reliant on the employer, however covenant monitoring remains key due to ongoing uncertainty.
- If a recovery plan is no longer required, covenant assessment could now be more focussed on the longevity of the covenant including ESG and less on uses of free cash.

The finer detail: TPR's AFS 2023 – key items

Reviewing strategy depending on current funding position

Funding at or above buyout: Consider whether buyout is right for the scheme and the powers available to the trustees. Running a scheme on can avoid trapped surpluses. For schemes wishing to buyout, TPR stresses the importance of being "insurance ready" by considering investments held, data quality and getting advice on the best way to approach insurers.

Funding above technical provisions: Review your long-term objective and your plans for getting there. Recent funding improvements could trigger strengthened technical provisions and reduced investment risk. Consider aligning with the draft funding code, particularly the low dependency funding target, investment allocation and technical provisions basis.

Funding below technical provisions: Remain focused on reaching technical provisions. Any funding shortfall should be recovered as soon as the employer can reasonably afford. If funding has improved significantly following recent market movements, consider reducing funding and investment risk to smooth the journey plan.

Funding deteriorated: Seek to understand the reasons for this, e.g. being unable to meet LDI collateral calls towards the end of 2022. Review operational governance for investment management and build strategies based on the scheme's current position.

Current valuations

In most cases, TPR expects funding positions to be ahead of plan, due to recent market movements, and schemes are encouraged to review strategies in accordance with the above categorisations. Open schemes may see their future service costs reduce but must consider that they have a reliance on their employer for much longer, which brings its own risks.

As in previous years, TPR sets out what it sees as the key risks and its expectations depending on the characteristics of a scheme, i.e. covenant strength, funding position and maturity.

Requests to reduce contributions or other employer support

Schemes may be, or may already have been, asked to reduce or stop deficit contributions, or change contingent support. Trustees should understand the value being given up and consider making provisions to revise support upwards in the future if funding deteriorates. Where a recovery plan is still required, first consider reducing the recovery plan length or removing any allowance for asset outperformance.

Understanding employer resilience due to continued uncertainty

Following improvements to funding levels, schemes may appear less reliant on the employer covenant. However, current economic conditions are still volatile, with high interest rates, inflation and energy costs all putting a strain on businesses. Understanding the employer resilience is vital to understanding the ability of the sponsor to support the scheme in a variety of scenarios.

Employer covenant remains key over the long-term

Even near buyout there is still a reliance on the employer; covenant remains important until the end game is reached. Avoid complacency when monitoring the employer covenant, by ensuring effective information sharing protocols are adhered to, and assessing the impact of any changes.

Refinancing risk in covenant assessments

Due to the rise in interest rates, employers who need to refinance existing debt facilities may find new terms are not as favourable. Covenant analysis should include this risk, as it may impact on future covenant support. Discussions and information sharing with management are key to understanding this risk.

For further information, please get in touch with Graeme Foster or Elen Watson or speak to your usual XPS Pensions contact.

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