XPS Pensions Group

XPS Insights
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The Pensions Regulator's Annual Funding Statement 2022

What you **need to know**

- The Pensions Regulator (TPR) published its Annual Funding Statement (AFS) on 27 April 2022. It is aimed at both trustees and sponsors, particularly those with triennial actuarial valuations between 22 September 2021 and 21 September 2022.
- TPR highlights the uncertainties for scheme funding and employer covenant driven by significant recent events: the conflict in Ukraine, the COVID-19 pandemic and Brexit. This is alongside the current background of high inflation, high energy prices, rising interest rates, slower economic growth and greater market volatility.
- Favourable investment conditions over the last three years may mean that, for many schemes, funding levels are ahead of plan. TPR also comments on key considerations for schemes at or approaching full funding on their technical provisions basis and the importance of robust risk management.
- Where trustees consider it appropriate to adjust their mortality assumptions, TPR have confirmed it expects any reduction to liabilities to be no more than 2%, unless there is strong evidence supporting a larger reduction.

Actions you can take

- **Understand the impact on covenant** of recent events and monitor how it changes – consider independent advice especially for a complex or deteriorating covenant and ensure dialogue between trustees and employers is ongoing.
- **Plan for the long term**, looking firstly to recover any technical provisions deficit then continue the journey to a long-term funding target (LTFT), all whilst managing risk in an integrated way.
- **Choose key actuarial assumptions**, such as inflation and mortality assumptions, carefully in light of current understanding of the position. Consider carrying out scheme-specific analysis to robustly determine the impact of COVID-19 on your scheme members.

Impact of significant recent events on schemes and employers

Event	Potential impact
Current economic uncertainty	Current high price inflation may increase employer costs which, in turn, could impact covenant if the higher costs cannot be passed on to customers. High inflation may also significantly increase scheme liabilities, or materially affect asset values. Higher energy and fuel prices could affect the profits of employers that use significant amounts of energy. Further increases in interest rates could affect schemes' assets and liabilities, as well as increasing borrowing costs for employers.
Conflict in Ukraine	For most schemes, holdings in Russian assets are likely to be small/negligible. However, there could be indirect effects on inflation, interest rates and asset values, as well as volatility and liquidity of assets. Employers could be indirectly affected e.g. by effects on customers/suppliers. Trustees should also be aware of the possibility of sanctions impacting on liquidity and covenant.
COVID-19	Disruptions caused by the pandemic could still affect employers (e.g. impact of lockdowns in China on supply chains). Removal of government support means that some employers may see pressures on working capital, which might be worsened by the need to repay COVID-19 loans.
Brexit	The true impact of Brexit may not be fully understood for many impacted businesses until regulatory issues are clear and the impact of COVID-19 has been normalised.

The finer detail: TPR's 2022 AFS – key items

Employer covenant considerations	
Covenant strength	TPR considers that employers may have become more 'polarised' in how they have coped with recent significant events – some may have thrived but others may be significantly negatively impacted. Trustees should consider taking specialist advice to understand their employer's covenant, particularly if materially impacted by current market events. It is also fundamental to ensure an open and ongoing dialogue with employer management.
Affordability	Where recent events have been assessed to have had limited impact on the employer, TPR expects a 'business as usual' approach to recovery plans. Trustees should carefully consider requests for a temporary contribution holiday where the employer has a short-term affordability issue and obtain suitable mitigations.
Shareholder distributions	After a break due to the pandemic, TPR has seen an increase in employers making distributions to shareholders (such as via dividends or share buybacks). Trustees should be alert to this and consider whether their scheme is being treated fairly. Where stakeholder distributions are greater than DRCs, TPR expects a strong funding target and a relatively short recovery plan. For weak covenants, TPR expects distributions to cease.
Corporate transactions	Levels of corporate activity remain high. Trustees should be ready to act quickly, with a rigorous approach to assessing and recording the impact on their scheme. They should consider corporate events independently from the valuation and seek mitigation for any detriment.
Monitoring & contingency planning	Trustees should identify key covenant (and other) risks to monitor against appropriate metrics. Contingency plans should be in place in case metric thresholds are breached.
Other considerations	
Interest assumptions	Long term interest rates have risen recently and gilts yields are volatile. The impact on funding depends on a scheme's funding and investment strategies, including hedging levels.
Inflation assumptions	Recent high levels of inflation will have a scheme-specific impact. Trustees should carefully consider their inflation assumptions pre- and post-2030 (when RPI is currently planned to be aligned with CPIH). TPR expects inflation assumptions to be set consistently with the exposure to inflation within the scheme's investments.
Mortality assumptions	The immediate impact of COVID-19 up to a scheme's valuation date will be reflected automatically. TPR acknowledges the existence of more data compared to last year, but notes this needs to be interpreted with care and there remains uncertainty about the long-term impacts of COVID-19. Where trustees consider that changes to their mortality assumptions now are 'appropriate and justifiable', TPR expects the reduction in liabilities to be no more than 2%, unless there is strong evidence supporting a larger reduction.
Forthcoming changes to DB funding rules	Current valuations will continue to be regulated under the existing legislation and guidance. TPR reconfirms that the second consultation on the new DB funding code of practice is expected to be launched 'later in 2022', after reflecting on the results of DWP's upcoming consultation on funding and investment regulations.
Long-term funding target (LTFT)	In advance of the Pension Schemes Act 2021 requirements coming into force, trustees are firmly encouraged to adopt an LTFT, if they have not done so already, and also set a journey plan towards the LTFT. Trustees should consider the extent of their reliance on the employer's covenant over time when setting their journey plan.

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

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