XPS Pensions Group

XPS Insights

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The Pensions Regulator's Annual Funding Statement 2021

What you **need to know**

- The Pensions Regulator (TPR) published its Annual Funding Statement on 26 May 2021. It is aimed at both trustees and sponsors, particularly those with triennial actuarial valuations between 22 September 2020 and 21 September 2021.
- The statement confirms that current valuations will be regulated under existing legislation and guidance, since the new defined benefit (DB) funding code of practice is expected in late 2022 at the earliest.
- TPR continues to encourage schemes to set a long-term funding target, if they have not already done so. This is seen to be good practice and will help schemes prepare to comply with the Pension Schemes Act 2021.
- TPR has highlighted important areas to consider for current valuations. These include inflation, mortality (and the impact of COVID-19 on this), investment liquidity, covenant and contribution affordability in light of the pandemic and BREXIT, and allowing for post-valuation experience.
- To understand how assumptions can change and to reflect the above, TPR encourages the use of scenario analysis not just for investments but also covenant and mortality.

Actions you can take

- **Check** you understand how your sponsor has fared during the COVID-19 pandemic and consider how this might impact your funding and investment strategy.
- **Commission** scenario analysis to better understand your scheme's risks, to refine your scheme's long-term journey plan and to develop your risk management framework.
- **Choose** your inflation assumptions carefully in light of the planned alignment of the price indices RPI and CPIH in 2030 and ensure inflation assumptions are consistent with any inflation hedging within your investment strategy.
- **Ensure** mortality assumptions are balanced and evidence-based, since the longer-term impact of COVID-19 is uncertain.

TPR expectations based on covenant recovery from COVID-19

COVID-19 impact on sponsor	TPR expectations
Limited impact	Deficit contributions should not usually be reduced, nor recovery plans lengthened. Where employers are reporting strong cash flow generation, trustees are expected to try to reduce the length of recovery plans.
Sponsor is recovering following initial material impact	Lower contributions should usually only be accepted in the short term, with higher contributions in subsequent years to limit any extension to recovery plans. Lower contributions should not be accepted if shareholder distributions continue. Consider down-side scenarios if covenant recovery does not progress as expected. Implement necessary risk mitigations.
Impact continues to be material and the pace of recovery is uncertain	Funding and investment strategies should reflect updated views on the covenant and the uncertainty. Trustees should not assume there will be a full recovery. Trustees should consider obtaining specialist independent covenant advice. Ensure the sponsor focuses on protecting the pension scheme (and other creditors) and look to TPR guidance if the employer becomes distressed.

The finer detail: Key items covered by the Annual Funding Statement 2021

DB funding rules	Current valuations will be regulated under the existing legislation and guidance. Although the Pension Schemes Act 2021 has received Royal Assent, the new DB funding code of practice that implements the requirements is not expected until late 2022 (at the earliest). We feel it is still important to be aware of the principles that are likely to underpin the new DB code of practice.
Long-term funding target (LTFT)	As part of the risk management of schemes and in preparation for the implementation of the Pension Schemes Act 2021 when the LTFT will become mandatory, trustees are strongly encouraged to set up an LTFT if they have not already. Schemes should be able to evidence how their shorter-term funding and investment strategies align with the target.
Scenario analysis	Scenario analysis is encouraged to consider the range of outcomes for a scheme. The statement highlights the benefits of scenario analysis for decision-making, risk management, assessing covenant, understanding the materiality of actuarial assumptions and setting mortality assumptions.
Inflation assumptions	The planned alignment of RPI and CPIH in 2030 means trustees need to consider changes to their inflation assumptions, ensuring consistency with any inflation hedging within the investment strategy.
Mortality assumptions	The long-term impact on mortality from COVID-19 (both size and direction) is highly uncertain. Trustees should ensure that their mortality assumptions are justified by being balanced, evidence based and derived using a sound methodology.
Post-valuation experience	Trustees are reminded that post-valuation experience (negative and positive) can be taken into account, but a date must not be 'cherry-picked' to get a favourable recovery plan.
Covenant	Employers should have detailed financial projections and updated business plans. Trustees should include scenario analysis, aligned with the employer's scenarios, to consider how covenant support and recovery may vary. Trustees should also consider obtaining independent specialist advice.
Covenant monitoring	Most trustees have increased the frequency and intensity of covenant monitoring and are encouraged not to reduce this too early given the remaining economic uncertainty.
Affordability	If affordability is a concern and recovery plans are to be adjusted, trustees should ensure that the scheme is treated fairly versus shareholders. Contingent contributions, contingent assets and parent company guarantees could be considered.
Corporate transactions	Corporate transactions may increase as the economy recovers from COVID-19. Trustees need to assess the impact of any transaction on the scheme and negotiate suitable mitigations to protect members and ensure the scheme is treated fairly.
Own risk assessment (ORA)	A separate TPR consultation proposes that all schemes with 100 or more members carry out and document an ORA, where trustees assess their management of risk. TPR reminds trustees that during their next inter-valuation period they may be required to carry out and document their first ORA.

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