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Sixty second summary

Annual Funding Statement 2020: the one with COVID-19

The Pensions Regulator has published its annual funding statement for defined benefit (DB) schemes.[1] It is primarily for schemes with valuation dates in the period from 22 September 2019 to 21 September 2020, giving them guidance on how to conduct the valuation and set their recovery plans. Unsurprisingly, COVID-19 looms heavily over the guidance. The Regulator encourages close trustee – employer cooperation in the months to come in response to the pandemic, but reminds them not to neglect longer-term planning and risk management.

COVID-19's effect on funding levels

Funding positions are believed to have been better, generally, on 31 December 2019 than at 31 December 2016 (valuations usually being triennial), because of strong investment performance. Funding levels at 31 March 2020 were diverse, but may not have fallen as far as the markets given recent moves toward de-risking. Schemes that are well-hedged and with low equity exposures have fared better, and are encouraged to remain focused on the longer term. Those that have suffered sharp falls in funding levels should be implementing contingency plans (where they have them), or developing strategies to put them back on course.

As in its COVID-19 guidance, the Regulator says that the assumptions underlying valuations that are close to completion need not be revisited. The impacts (positive and negative) of post-valuation events on assets and liabilities and the employer covenant should, however, be considered when setting recovery plans. March and April valuations will be '*challenging*', but it is reasonable to delay decisions on assumptions until more clarity on long-term investment prospects and the employer covenant is available; in the meantime, schemes should do as much of the preparatory work for their valuations as is possible. Trustees should consider the different possible rates and periods of economic recovery, as well as potential longer-term effects. The use of scenario planning, which many schemes already use as part of their integrated risk management (IRM), is encouraged.

The Statement sounds a warning note for any trustees thinking of pushing their valuation date back a few months to a time before the crisis. They should '*consider very carefully*' why they believe that would be in members' interests, take legal and actuarial advice, consider taking post-valuation investment and covenant changes into account, and expect the Regulator to question their assessment.

Recovery plans

When setting recovery plans, trustees are expected (having carried out additional due diligence on the employer covenant) to focus on affordability, bearing in mind the need for fair treatment of the scheme and the employer's prospects for sustainable growth. Where possible, plans should make provision for incremental increases to contributions, linked to corporate health (using indicators such as free cash flow and payments to other creditors), especially where the trustees have shouldered additional funding risk to support the employer's recovery. If the investment return assumed in the recovery plan is more optimistic than the one used for the valuation, plans could incorporate additional contributions linked to investment performance, or involve contingent security.

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[1] <www.thepensionsregulator.gov.uk/en/document-library/statements/annual-funding-statement-2020>.

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Dividends, etc.

The Regulator anticipates that those employers that have suspended or reduced their dividend payments and other shareholder distributions will continue to do so until affordability and liquidity have been largely restored. It says that recovery plans should reflect that expectation. Any additional liquidity made available to companies through deferral of deficit-reduction contributions should not be use to support associated companies unless that is in the interests of the scheme. Cessation of shareholder distributions should be a legally enforceable condition of the trustees' agreement to defer DRCs, and trustees need to understand how the suspended contributions will eventually be paid.

The Statement also considers other sources of potential 'covenant leakage', such as cash pooling and inter-company lending, group trading arrangements, fees and royalties, transfers at undervalue and executive remuneration. These become matters for concern if the employer is seeking a long recovery plan because of limited affordability. In general, the advice is that trustees should understand the intentions behind the arrangements and the implications for the covenant, for which they might require specialist advice, and for them to seek suitable mitigation of adverse effects through contingent security or agreements whereby they receive increased contributions in the event of improved employer performance.

Covenant assessment & contingency planning

The Regulator suggests that trustees might need specialist employer-covenant advice, especially if they are highly reliant on the covenant, or if it is complex or deteriorating. They should only undertake the assessment themselves if they have sufficient expertise, and should be prepared to justify that conclusion. The potential for conflicts of interest should be considered. Detailed records of deliberations should be made and retained.

Frequency and intensity of monitoring should be elevated whilst uncertainty persists, and trustees and employers should have contingency plans in place for adverse changes. The Regulator may ask trustees for evidence that such discussions occurred.

The Statement encourages trustees and employers to agree contingency plans so that, for example, additional contributions are triggered if the funding level deteriorates by more than a specified amount.

Segmentation

As with the 2019 Statement, the Regulator has set out over several tables its expectations for different schemes based on their funding, covenant and maturity characteristics. Pending a decision on the definition of maturity that is to be used for the revised funding Code, trustees should interpret the term in a convenient way, based on advice from their actuary. The Regulator suggests that trustees decide on the extent to which their covenant has been affected by COVID-19, and the possible implications of Brexit; how their funding position compares with their long-term funding target given the period over which they aim to reach it; and use their conclusions to identify the most appropriate table for their circumstances.

Next steps

The analysis behind the Statement will be published in the summer, and more guidance may be issued in the autumn. The Regulator also says that it is unlikely that a revised funding Code of Practice will come into force before late 2021.

This year's Statement balances the desirability of maintaining a long-term outlook with recognition of the immediate need to help employers weather the current crisis. We welcome the Regulator's realism and its avoidance of an overly prescriptive approach.