HYMANS ROBERTSON

60-second summary

DB Annual Funding Statement, 2024

The Pensions Regulator has issued the 2024 edition of its Annual Funding Statement for private-sector defined benefit (DB) schemes. In recognition of other developments that are afoot—funding reforms and the Mansion House initiative—this year's Statement has been kept short, at around seven printed pages, and largely reiterates the points made in 2023. Where funding levels have improved trustees are urged to reconsider the strategies that they established in a period of low interest rates to ensure they remain in the best interests of members. Options include running-on to generate surplus, buy-out with an insurer or entering a consolidator. Meanwhile, the 'sizable minority' that are still in deficit on their scheme-specific funding basis are advised to plan to make up the shortfall as quickly as their sponsors can reasonably afford, with careful attention to covenant strength.

Schemes in scope

This year's Statement is aimed primarily at schemes with valuation dates in the range from 22 September 2023 to 21 September 2024—known as 'Tranche 19' in the Regulator's argot—which is expected to be the last group of valuations conducted before the introduction of requirements for funding and investment strategies. However, the Regulator says that the Statement is also relevant to schemes with valuations falling outside that range if the effect of recent market changes has been significant.

The state of the [DB funding] universe

Unsurprisingly, the Regulator notes the recent remarkable improvements in the funding fortunes of DB schemes. Although it acknowledges that the position for individual schemes will vary, it estimates that half of them have now exceeded buy-out level, and that less than a quarter are still in deficit relative to their 'technical provisions' (AKA scheme-specific funding basis).

That means that some trustees are in the happy position where they might consider running on to generate surpluses for members' benefit. However, the Regulator also recognizes that the same economic developments will be putting trustees under pressures from both sides, with employers requesting contribution reductions, and members asking for discretionary increases to pensions in payment. The improvement in funding positions may be especially notable for open schemes, whose employers may be hoping to use surpluses to offset their future-accrual costs. The Statement advises that trustees take a holistic view of their particular facts and circumstances (for example, whether the scheme has a history of awarding discretionary increases).

The Regulator warns trustees not to allow funding improvements to cause them to lose sight of the continued potential for economic and geopolitical uncertainty to affect investments and employer covenants. If reliance on the covenant remains substantial, trustees should be aware of re-financing risks, covenant leakage, and ensure that their schemes are treated fairly alongside other stakeholders. The Regulator counsels trustees to consider the implications of climate change and other sustainability issues for their strategies and journey plans. It also encourages them to consider the steps that could be taken now to align with the requirements of the revised funding code, due for publication this summer, even though it will only come into force formally for valuations at dates from 22 September 2024 onward.

Scheme-specific guidance

As in 2023, the Regulator has structured its expectations according to which of three funding categories schemes currently occupy:

at-or-above buy out

The moral for trustees of schemes that are fully funded on a buy-out basis is to be clear about their strategy and why it is in members' best interests; they should document their conclusions. If they decide to run on (which the Regulator notes is likely to be more practical for larger schemes), there are potential benefits from surplus generation, but trustees should be aware of the possible risks and costs—especially of any innovative solutions. Surplus could act as a buffer to mitigate risks. They should obtain suitable advice. If they are targeting buy out, they should think about the best way to go about it in terms of protecting members and price. The Regulator also encourages consideration of sustainability issues, recommending the Sustainability Principles Charter for the Bulk Annuity Process produced under the auspices of Accounting for Sustainability, the Church of England Pensions Board and Railpen. It also draws trustees' attention to the implications for future discretionary increases to pensions in payment.

in between scheme-specific and buy-out funding

Where schemes are fully funded on their technical-provisions basis, but do not yet have sufficient assets to buy out, trustees should review their long-term objective, as well as the associated timings and investment-strategy transitions (which they might be able to accelerate if there have been marked improvements in funding). They ought to prioritize setting a long-term funding objective (LTFO) if they do not already have one. They should consider members' best interests and the potential benefits of running on *versus* buying out *versus* emerging options such as those offered by commercial consolidators, the planned public-sector consolidator, and capital-backed journey plans. If they decide to wait and see how those emerging options develop, they should set dates for reconsideration and have appropriate funding and investment strategies in the meantime (the Statement obliquely points trustees to its guidance on Private Markets Investment for one potential payoff from some consolidation options). The Regulator expects that they consider when different consolidation options might become accessible to them; guidance on alternative arrangements for consolidation is coming '*later this year*'.

below technical provisions

Like X-Wing pilots assaulting the Death Star, the trustees of schemes that remain in deficit on their scheme-specific funding basis are admonished to stay on target. The Statement says that they should focus on eliminating the deficit as quickly as reasonably affordable. They should also make sure that their technical provisions are congruent with their LTFO, and that the risks they are running are sufficiently covered by the employer covenant and will taper off appropriately with funding improvements and scheme maturity.

With funding holding strong and a new code of practice imminent, the paring back of this year's statement is no surprise. Fewer schemes remain in the regulatory crosshairs, so it's mostly about encouraging trustees to develop their endgame strategies, echoing the shift to a world beyond solvency funding. The Regulator goes further in acknowledging the full (and growing) range of available options. It's good to see it directing trustees and sponsors not just to 'accept the status quo' but to explore their own scheme circumstances, objectives and beliefs, and to consider how the different options might affect member outcomes. Careful consideration is key to navigating this diverse landscape—to learn more, visit our Excellence in Endgames hub.