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Sixty second summary

DB Annual Funding Statement 2022

In its *Annual Funding Statement 2022*, the Pensions Regulator encourages trustees of private sector defined benefit pension schemes to engage in open dialogue with their sponsors about immediate challenges and longer-term risks.[1] There is recognition of the current difficult economic conditions—including high fuel and energy prices and the war in Ukraine—as well as the lingering effects of COVID-19 and Brexit, and the implications for schemes and their sponsors. Robust risk management and long-term planning remain vital.

The AFS is primarily of interest to 'Tranche 17' schemes—those with valuations dates in the period from 22 September 2021 to 21 September 2022—with indications that their average funding level has improved since the last valuation round. It is also relevant to other schemes with circumstances meriting reassessment of the trustees' funding and risk strategies. This Summary highlights the key expectations and advice contained in the AFS.

Covenant considerations

Trustees should consider the aggregate effect of recent events on the employer's business, assessing the seriousness and the short- and medium-term prospects for recovery, obtaining expert advice if necessary. If the conclusion is that there has been little effect on the business, the trustees should, if anything, seek to reduce the recovery plan length. Where there are short-term affordability constraints, any requests for temporary contribution easements should be carefully considered, higher contributions should be paid upon resumption to limit extension of recovery plans, and employers should ideally make up any deferred deficit recovery contributions (DRCs) before resuming shareholder distributions. If the employer requests revision of a recovery plan to defer or reduce DRCs, the trustees should obtain suitable mitigations.

The Regulator stresses the importance of regular information sharing between trustees and their sponsor's management. The trustees should understand the crucial variables and assumptions underlying the employer's financial projections and business plans (avoiding over-reliance on a single set of forecasts). Stress testing or scenario planning will help them understand how possible developments (such as persistent high inflation and interest rates) could affect the covenant. They should compare projected versus actual performance and, if possible, agree contingency plans for detrimental covenant events.

Trustees should be alert for distributions to shareholders and ensure that the scheme is treated fairly, and dividend sharing agreements or negative pledges could be sought during valuation discussions. As a minimum, if distributions exceed DRCs, the Regulator expects the scheme to have a robust funding target and a '*relatively short*' recovery plan (hinting at less than five years). For a weak or tending-to-weak employer, DRCs should top shareholder distributions unless the recovery plan is short and the funding target strong. The Regulator does not expect to see any distributions made by weak employers that are unable to support the scheme.

[1] <www.thepensionsregulator.gov.uk/en/document-library/statements/annual-funding-statement-2022>.

Levels of corporate activity remain high. Trustees should assess the impact rigorously, keep records of the deliberations, and seek mitigation for any detriment prior to and separately from valuation discussions.

Actuarial & investment considerations

High inflation should prompt trustees to ensure that benefit increases are being correctly modelled, and that any salary increase assumptions remain appropriate. They should also understand how any inflation hedges are working in light of the current environment and any application of caps or collars on pension increases. Pending the expected High Court review of plans to align of the Retail Prices Index with the Consumer Prices Index including owner-occupier housing costs, pre- and post-2030 assumptions should reflect the current position. Any adjustment to market-implied inflation measures should be consistent with inflation exposure within the investment strategy.

Whilst of the opinion that the long-term implications of COVID-19 remain unclear, in a shift from last year, the Regulator indicates willingness to countenance appropriate changes to mortality assumptions. However, that is subject to the proviso that any consequential reduction to liabilities is no more than two per cent, in the absence of strong justifying evidence.

Managing risks

The Regulator again encourages trustees and sponsors to agree long-term funding targets and journey plans, in anticipation of the commencement of the *Pension Schemes Act 2021* requirements. In doing so they should engage with the employer to understand longer-term covenant risks, and factor that into their funding and investment strategies, monitoring arrangements and contingency plans. Scenario planning is once again highlighted as a useful tool for risk management.

Funding positions should be regularly monitored against asset and liability risks, and employer performance against forecasts and other thresholds. Contingency plans should set out the actions that employers and trustees should take when the threshold limits for funding, investment and covenant metrics are breached. Downside protection could be requested, where appropriate, to help manage the risks. Recognizing the increasing number of schemes that have attained or will soon reach full funding of their technical provisions, the Regulator stresses that regular monitoring and contingency plans remain just as important. Contingent contributions linked to funding and risk triggers can help manage ongoing risks whilst addressing concerns from employers about trapped surplus.

Trustees should consider updating valuations of any existing contingent assets or asset-backed contribution arrangements to ensure that they remain sufficient to underwrite any additional risk taken.

They should also consider their short-term liquidity requirements, including collateral calls on hedging portfolios. Trustees at or approaching full funding should consider how the absence of employer contributions will affect their liquidity needs, and make appropriate changes to their investments.

The Regulator has once again set out its risk-management expectations in the form of tables that categorize schemes according to funding strength, covenant and maturity. The only change from the tables in the AFS for 2021 is that the pivotal recovery plan length has been shortened from seven years to six, in recognition of a decrease in the average plan length.

New Funding Code

The Regulator remains on track to publish a consultation draft of a revised funding Code of Practice '*later in 2022*' (assuming that the Department for Work and Pensions' consultation on draft legislation takes place as expected). Details of proposed changes to the guidance on *Assessing and Monitoring the Employer Covenant* (published in 2015) will be released at the same time. They are expected to provide more information on the treatment of employer-group guarantees and environmental, social and governance considerations.

This year's AFS contains few surprises, echoing themes that the Regulator has been promoting for some time. Although investment performance has kept many schemes on track, perhaps even bringing them (close) to full funding, recent events are a reminder that things can, and do, change quickly; so we support the emphasis on development of robust long-term plans and integrated risk management.

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