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60-second summary

DB Annual Funding Statement 2023

The Pensions Regulator has announced the 2023 edition of its Annual Funding Statement. Following significant funding improvements for most, the Regulator's thoughts turn to long-term-planning reviews, protection of gains, and buy-out readiness.

Background

The AFS is primarily guidance for schemes with valuation dates in the year to 21 September 2023. It is also relevant when reviewing funding and investment strategies, or when trustees are asked to agree contribution reductions, revised contingent-asset arrangements, or uses for surpluses.

At the summit

Most schemes are now thought to have better-than-anticipated funding positions: indeed, the Regulator believes that 25% may have sufficient assets (on paper) to buy out their liabilities. It calls on them to review long-term targets and reconsider their end-game options. Unsurprisingly, the Regulator says that they should consider whether to lock in the gains by buying out. However, it also mentions the possibility of 'running on', if it would give members the prospect of benefit enhancements, or if it would facilitate use of surplus to cover expenses, further accruals, or defined contribution (DC) benefits. In those circumstances, the trustees are counselled to weigh up the associated risks.

Those for whom a buy-out is in reach are advised to optimise their position by investing judiciously, putting their records are in order, and protecting themselves against adverse market movements during the buy-out process.

Nearly there

Some similar considerations are applied to schemes that are in surplus on their scheme-specific ('technical provisions') funding basis but do not—yet—have sufficient assets to buy out. They too are advised to re-examine their long-term target (or make it a priority to agree one) and de-risking plans, and to think about improving their buy-out readiness where appropriate. The Regulator also encourages them to prepare for the advent of the new funding Code.

Still some way off

Those with funding levels below their technical provisions are, predictably, enjoined to concentrate on making up the shortfall. The funding basis should be aligned with the long-term target; risk-taking should be reasonable given the employer covenant and should tail off with improved funding or maturity. In keeping with past Regulator policy and the draft Funding and Investment Strategy Regulations, deficits should be recovered as quickly as reasonably affordable.

Little change in strategy may be required if the funding level has improved as anticipated and the covenant supports it. Those who have experienced greater gains should consider de-risking to some extent.

Trustees of the minority of schemes whose funding has deteriorated should examine the causes and amend their strategies accordingly.

Strategizing

The AFS includes advice on revising funding and investment strategies. Given recent and current market conditions, trustees should consider how their asset allocation may have diverged from expectations, and re-evaluate their illiquid-asset holdings in conjunction with their investment advisers. They should also review their LDI operational governance, having regard to the Regulator's guidance.

On covenant matters, the Regulator recommends scenario analysis, and awareness of the factors determining sponsor's resilience. Trustees should reconsider their covenant-assessment needs. They should also ensure that they are getting the required management information from the employer (especially for smaller schemes that are less able to afford expert advice) but be on guard against complacent acceptance of its forecasts.

Miscellaneous matters

On longevity, the Regulator is aware that trustees will be considering, with their actuaries, whether recent mortality statistics are indicative of a change in the longer-term trend. It recommends caution, reiterating that any revised assumptions should be appropriate and justifiable.

Trustees thinking about reducing their deficit-recovery contributions should first consider: the prudence of their funding basis and the investment risk that the covenant can support; reducing their recovery period rather than the contributions (especially if the remaining period exceeds six years, the scheme is mature, or the longer-term covenant is in doubt); toning down any allowance for returns in excess of those assumed for the funding basis (especially if the scheme has de-risked its investment strategy but has not yet amended the funding basis to factor in the lower expected returns); and whether the scheme is being equitably treated compared to other stakeholders in the sponsor's business. If contribution reductions are being considered as part of a valuation exercise, trustees should seek agreement for the resumption of higher contributions if funding deteriorates. Suitable mitigation should be obtained if the request is coming from an employer that is showing signs of distress.

Trustees should critically evaluate any requests for release from contingent-asset arrangements. If acquiescence is deemed appropriate, it should come with agreement to increase the protection again in the event of adverse changes to the funding level.

Trustees are advised to consider the risks from sponsor re-financing when monitoring and analysing their employer covenant. The recommendations are different depending on the relative timings of the re-financing and actuarial valuation.

Forthcoming changes

The Regulator confirms that the new Funding and Investment Regulations and revised Code of Practice are now expected to come into force in April 2024. It plans to consult about the requirements of the statement of strategy (no timetable is given), and updated covenant guidance ('later this year').

Overall, the tone of this year's statement is more (cautiously) upbeat than in recent years. For our views on the details, please see the commentary on our website.

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