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DB annual funding statement 2021

The Pensions Regulator has published its *Annual Funding Statement 2021*, guidance for those currently or soon to be involved in actuarial valuations.[1] As well as the expected recognition of COVID-19 issues, topics for discussion include the effects of Brexit, anticipated changes to the Retail Prices Index, climate change and liquidity risk. Its key theme is perhaps the importance of sustained focus on long-term planning and risk management.

The AFS is intended primarily for schemes with triennial valuation dates falling in the range 22/09/2020 to 21/09/2021. This is 'Tranche 16' (T16), using the Regulator's nomenclature. The Regulator says that it may also be of interest to trustees and others who are reviewing their funding and risk strategies following significant changes.

Funding positions

The average funding level for T16 schemes at the close of 2020 was broadly unchanged from their position three years earlier, and is expected to have improved over the three years to March 2021. The averages mask considerable individual variation, which may depend on whether schemes had hedged their inflation and interest-rate risks.

Assumptions

The Regulator says that trustees should explore a range of possible outcomes when setting their valuation assumptions, and encourages the use of scenario planning to inform decisions, risk assessments and mitigation strategies. Special mention is made of the UK Statistics Authority's intention to swap out the internal workings of the RPI with those of the CPIH: any adjustment to market-implied inflation should be consistent with the extent of the scheme's exposure to inflation via its investment strategy. The Regulator also singles out COVID-19 mortality experience and its uncertain effects on longevity trends. It says that trustees must be able to justify amendments to assumptions, and that they should plan for the possibility that their views fail to match actual experience.

Post-valuation experience

Trustees must not cherry-pick only favourable post-valuation developments, or the effective dates of their recovery plans and schedules of contributions. Once they have taken credit for positive post-valuation experience in one valuation, consistency dictates that they consider any relevant negative post-valuation events at future valuations. Allowance for favourable post-valuation events should reduce the length of the recovery plan rather than the sponsor's contributions.

[1] https://www.thepensionsregulator.gov.uk/en/document-library/statements/annual-funding-statement-2021.

Covenant

The Regulator thinks that trustees are now better able to judge the short-term effects of COVID-19 on the employer covenant. They are encouraged to consider taking specialist covenant advice, especially if the employer is in distress or experiencing acute affordability constraints.

The use of stress testing or scenario planning is encouraged, especially for those sponsors that have been and continue to be materially affected by COVID and for which the prospects for recovery are uncertain. In such cases the trustees should consider whether there has been a material deterioration in the covenant, and should not assume a full recovery without justification. The Regulator expects employers to provide trustees with the up-to-date financial projections and business plans that they need to assess the covenant, and for any covenant leakage to be minimized.

Affordability of recovery plans

The Regulator's expectations depend on how the employer has weathered COVID-19 and Brexit. For example, if the impacts were minor, there should not generally be any reduction to deficit-recovery contributions or extension of recovery plan periods. For employers with good cash flow, the anticipation is that trustees will try to reduce the recovery plan length.

Trustees should carefully consider requests for lower DRCs if there are short-term affordability constraints whilst businesses recover. The Regulator prefers back-end loading of contributions over extension of recovery plan periods.

It views any resumption of shareholder distributions as inconsistent with requests for lower contributions, and says that any deferred DRCs should be repaid in that case. It also raises the prospect of employers requesting DRC deferral for reasons other than short-term affordability constraints, noting the Government's Budget 2021 corporation tax announcements. Trustees should treat such requests like any other and seek suitable mitigation, such as contingent assets.

As in previous years, there is additional guidance on the salient risks and expected actions in particular cases, depending on sponsor covenant strength and scheme characteristics.

Corporate transactions

The Regulator urges trustees to be prepared for increased corporate activity, pointing to the importance of early involvement, the ability to identify detrimental events, and rigour when assessing the implications for their schemes. They should maintain an audit trail of their deliberations and evidence of how they managed the situation. Although ongoing valuation work can provide trustees with extra leverage in negotiations over a corporate transaction, the trustees are expected to seek mitigation for any detriment independently, and then make such changes to their funding decisions as are appropriate.

Risk-management

The Regulator continues to stress the importance of integrated risk management. This year's AFS urges trustees to seize the initiative on climate risks. It encourages agreement of a suitable long-term funding target, and alignment of funding and investment strategies with it, as a way of preparing for new rules contained in the *Pension Schemes Act 2021*.

The trustees of Tranche 16 schemes will have to complete their first 'own risk assessment', in accordance with the consolidated Code of Practice (expected to come into force later this year), at some point between the present valuation and the next. The Regulator says that if they document their key risks and how they will be managed as part of this valuation it will simplify the task.

Code

The Regulator is waiting for the conclusion of an expected DWP consultation on scheme funding regulations before publishing its draft revised DB funding Code of Practice '*towards the end of 2021*'. It says that the new Code will not be in force before '*late 2022 at the earliest*'.

Many of the issues will be familiar, though the 'heads up' on corporation tax and the prod to make a head start on own-risk assessment reflect more-recent developments. More generally, the moral is to formulate a plan for reaching one's longer-term destination, and manage the risks that might be encountered along the route so as to increase one's chances of arriving safely.

Draft specs for simpler annual DC statements

The Department for Work and Pensions (DWP) has published draft rules for 'simpler annual benefit statements' from workplace defined contribution (DC) pension schemes.[2] It is likely that some providers would have to revise their statements to comply with the new length and lay-out specifications.

Scope

The draft legislation would apply to schemes that are used for auto-enrolment compliance *and* which provide only money purchase benefits. Its effect would be that the information that must already be provided to members about those benefits, under the current disclosure legislation, has to be given in future in a way that, when printed, occupies no more than two sides (one double-sided sheet) of A4-sized paper.

Defined benefit schemes and those providing a mix of benefit types would not be affected by the draft regulations. The draft statutory guidance says, however, that the underlying principles of concision and jargon-free language may prove helpful when designing benefit statements for other schemes; and that voluntary adoption is encouraged.

Statement template & guidance

The legislation would be supplemented by statutory guidance to which benefit-statement providers would be obliged to have regard. Draft guidance is included in the consultation bundle, and aims to enable members to easily comprehend:

- the current value of their funds;
- how much they saved (e.g. by member and employer contributions) during the statement year;
- how much they could have at retirement; and
- things they might do to provide themselves with more.

The guidance contains, amongst other things, a template that shows how information should be presented. The DWP's goal is to establish some consistency in the statements provided by different schemes. The template has five sections:

1. member and scheme details;
2. the value of accrued rights;
3. the statutory money purchase illustration;
4. what the member could do to provide him- or herself with more money in retirement; and
5. details of how to find further information.

Most of the information contained in those sections is already required, so that it is the form of future benefit statements rather than their contents that would be most affected by the draft legislation and guidance. Benefit-statement providers would be allowed to use their own branding and colour schemes, provided it does not hinder the conveyance of information, or cause their statements to exceed the maximum length. Fonts should be chosen with legibility in mind.

The guidance says that the new rules are not intended to prevent providers from supplying additional information that complements the statement, but that they should consider whether it would be better given in a separate document. If part of a package of information, the statement should be the first substantive document (following immediately after any covering letter, for example).

The draft Regulations provide an exception to the 'two pages' rule if a member asks for the information in another format and the providers has to meet the request to comply with its equality-law obligations.

Timeline

The consultation period is from 17 May to 29 June 2021. The changes are set to come into force on 6 April 2022. The DWP would be obliged to review the effectiveness of the new requirements by 6 April 2025, and at three-yearly intervals thereafter.

[2] *Simpler Annual Benefit Statements: Consultation on proposed regulations and accompanying statutory guidance introducing simpler annual benefit statements for use by Defined Contribution pension schemes used for Automatic Enrolment* (May 2021) <www.gov.uk/government/consultations/simpler-annual-benefit-statements-draft-regulations-and-statutory-guidance>.

The press release about the consultation exercise also says that a working group is investigating whether public interest in retirement saving might be boosted if a part of the year is designated as the 'statement season' for pension schemes.[3] The group had its first meeting in May 2021.

Simpler annual statements will provide some much-needed standardization in a world (or at least the UK corner of it) that is set up for a proliferation of money purchase pension pots. Trustees who have not voluntarily adopted the approach will have some work to do in advance of next year's benefits statements.

Qualifying the right to transfer

The Department for Work and Pensions (DWP) has circulated draft legislation intended to block scam pension transfers.[4] It would prevent trustees or managers from carrying out a member's transfer instructions unless one (at least) of four conditions is met.

The first three conditions are concerned with aspects of the receiving scheme. They would be satisfied if it is—

- a public service, master-trust, or collective money purchase scheme, or one operated by an insurer with the necessary authorizations;
- one with which the member has a demonstrable and substantial employment link; or
- a qualifying recognized overseas pension scheme (QROPS), and the member has been continuously resident in the same financial jurisdiction as the scheme for at least six months.

The fourth condition is met if there are no '*red flags*' present in the circumstances of the proposed transfer.

More information on the conditions is given in the following sections.

Employment links

- To fulfil the employment-link condition, the member must be able to demonstrate that:
- his or her employer is a sponsor of the receiving scheme;
- the employment has lasted for at least three months;
- during the last three months of employment the member's salary was at least as much as the National Insurance lower earnings limit; and
- the member and employer both contributed to the scheme during those last three months.

To meet those requirements, the member will need to provide evidence in the form of a letter from the employer confirming continuous employment of sufficient duration and sponsorship of the receiving scheme, its schedule of contributions or payment schedule, and the last three months' payslips and bank statements. Alternatively, the test can be met by written evidence of a previous transfer into the same receiving scheme during the last year.

Overseas residency

For the QROPS-related condition, the member will have to provide written evidence of residency, including the formal documentation for the jurisdiction in question. Temporary absences will be overlooked provided they do not exceed thirty days in total. Again, evidence of a historical transfer during the preceding twelve-month period will be sufficient as an alternative.

Danger signs

The draft legislation contains a list of '*red flags*' that would preclude satisfaction of the fourth condition, including—

- the failure of the member to respond to the trustees' requests for information about the circumstances of the transfer;

[3] *Simpler information to transform pension understanding for savers* <www.gov.uk/government/news/simpler-information-to-transform-pension-understanding-for-savers>.
[4] *Pension Scams: Empowering Trustees and Protecting Members (Consultation on The Occupational and Personal Pension Schemes (Conditions for Transfers) Regulations 2021)* (May 2021) <www.gov.uk/government/consultations/pension-scams-empowering-trustees-and-protecting-members>.

- financial advice or recommendations from an adviser without the necessary [UK] regulatory permission (provision is made for the involvement of an overseas adviser if the receiving scheme includes overseas investments);
- a transfer request prompted by unsolicited contact by a previously unknown party;
- the offer of an incentive to transfer (this includes for example the lure of a free pension review); or
- pressure exerted on the member to make the transfer quickly (within a month or less).

There is also a list of '*amber flags*' that, if raised, must prompt the transferring trustees to request evidence that the member received guidance about transfer scams from the Money and Pensions Service (MaPS). According to the consultation document, the required evidence will be a 'unique identifier' that the MaPS will supply to those who have completed a guidance appointment. If such evidence is not forthcoming, the amber flag will effectively transform into a red flag.

The amber flags are—

- high risk or unregulated investments;
- unclear or high fees;
- unclear, complex or unorthodox investment structures;
- overseas investments or investment advice from an overseas adviser;
- a high volume of requests for transfers from the transferring scheme to the same receiving scheme, or involving the same adviser or advisers.

The draft Regulations contain instructions for the interpretation of the red- and amber-flag provisions. Transferring members could be required to provide the trustees with relevant information about the circumstances of the requested transfer. A list of questions for trustees to put to transferring members is appended to the consultation document. The standard expected of the transferring trustees would, in most cases, be a '*reasonable belief*', based on the available evidence, that the circumstances constituting a red or amber flag are present.

The consultation period is from 14 May to 9 (or 10—the webpage and consultation document are inconsistent) June 2021. The draft Regulations are set to come into force immediately after section 125 of the *Pension Schemes Act 2021* (the provision empowering the DWP to legislate) is activated. The Government says that it intends to introduce the new legislation '*at the earliest opportunity*' and '*in Autumn 2021*'.

The draft legislation would close the door to some of the more blatant scams of recent years, whilst green-lighting most legitimate transfers. They would provide trustees and scheme managers with a solid statutory position from which to plant warning flags on suspicious transactions, whilst giving members a route to take if they wish to proceed, once counselled as to the risks. That is not to say that there are no kinks that need to be worked out of the proposals; and, of course, the scam artists will read the consultation documents too, and have doubtless already begun scripting 'correct' responses for transferring members to provide.

'*Pervasive failures*' in DB scheme audit

The Financial Reporting Council (FRC) publicized adverse findings made against an accountancy firm and one of its partners for '*pervasive failures*' in several areas of their audit work for a client company.[5] One of the problem areas was the company's liability toward its defined benefit (DB) pension scheme, the audit of which '*in several respects fell far short of what was required.*' Most of the issues identified concerned lax scrutiny of the IAS 19 valuation produced by the company's actuarial adviser.

The FRC has for some time been concerned about inconstancy in audit quality, identifying a worrying tendency among auditors to corroborate the assumptions made by audited entities rather than challenge them.[6] Its supervisory approach has evolved in response. This has led some auditors to intensify their efforts.

The Association of Professional Pension Trustees wrote recently to the Institute of Chartered Accountants in England and Wales to express the concerns of its membership about the time and resources required to respond to enquiries from the auditors of DB scheme sponsors.[7] Requests are often addressed to scheme administrators and investment managers who, like the trustees, have no obligation to provide the company auditor with information directly.

We have noticed a significant step-up in the level of IAS 19 audit queries over the last couple of years. It is being driven by increased pressure from the FRC. The case discussed at the top of the article will no doubt be held forth as evidence of the need for enhanced audit scrutiny, so neither the pressure nor the volume of queries is likely to abate. Companies may find that their audit proposals now come with a wider scope, a larger fee, or both; and that there is a greater planning focus on pensions.

DC charges consultation

The Department for Work and Pensions (DWP) has published details of how it plans to introduce a minimum fund-size condition for charging structures involving flat fees in auto-enrolment default arrangements, with effect from 6 April 2022.[8] However, it also indicates that it is inclined to abolish such combination-charge structures, from a date yet to be determined, so that the only permitted arrangement would be a single, fund- value- based charge based on a percentage of the member's rights.

Background

The charge cap applies to the default investment arrangements for money purchase benefits in schemes used for compliance with the automatic enrolment rules. The standard cap is set at 0.75 per cent per annum of the value of the member's rights, when only a fund- value- based charge is employed; there are caps prescribed for structures in which a (lower) fund- value- based charge is combined with either a flat fee or a per-contribution charge.

In January 2021, the Government announced the outcome of a review of the cap. It voiced concern about the application of flat fees to small, deferred pension pots that are subject to combination charging structures. Its conclusion was that it should legislate to prevent the application of fixed fees to pension pots worth less than £100.

Draft legislation

The new consultation exercise unveils the draft legislation necessary to implement the new '*de minimis*' charging requirement. The Government plans to introduce the *de minimis* for both active- and deferred-member pots. As expected, it is to be set at a 'default arrangement' pot size of £100, initially (the amount will be kept under review). It would affect only the flat-fee element of the combination charge: the percentage charge cap based on the value of the member's funds under management would be unaffected (and could continue to be charged on pots of any size). The result would be that the flat-fee charge could only be levied where the value of the member's rights in the default arrangement is more than £100. If a member has multiple pots invested under the same default arrangement, their values would be aggregated for assessment against the *de minimis*. In a case in which the flat-fee charge, if levied in its entirety, would reduce the value of the member's rights to less than £100, the charge would be limited so that it does not reduce the value below £100. The

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[5] <www.frc.org.uk/getattachment/09c1a506-d36e-4b42-9e43-54edeb02fb97/Haysmacintyre-Decision-Notice.pdf>.
[6] *Developments in Audit 2020* <www.frc.org.uk/news/november-2020/covid-19-strengthens-need-for-audit-improvement>.
[7] *APPT writes to ICAEW on Auditor Requests for Information* (20 April 2021) <appt.org.uk/appt-writes-to-icaew-on-auditor-requests-for-information>.
[8] *Permitted charges within Defined Contribution pension schemes* (May 2021)<www.gov.uk/government/consultations/permitted-charges-within-defined-contribution-pension-schemes>.

value of the member's rights would be calculated for *de minimis* purposes after deduction of the percentage-charge element. There are illustrative examples in the consultation paper.

The legislation to implement the change is intended to come into force in April 2022 '*subject to other parliamentary priorities'*.

Future restrictions

The Government is also seeking feedback on a proposed '*universal charging structure*' for the default funds of defined contribution (DC) schemes used for auto-enrolment. It would mean that charges would have to be expressed as a percentage of the member's fund, and that combination charging structures would no longer be permitted. The Government believes that this would help members to understand the charges that apply to their pensions and more easily compare them with others. No date has been set for the change to take place.

The consultation period is from 24 May to 16 July 2021.

Readers might question whether there is any point in members being able to compare charges across schemes, without the freedom to switch and still keep the minimum auto-enrolment employer contribution. The DWP '*would like to better understand employers' policies*' in this respect, but it is unclear whether it is considering the radical step of allowing the employee to dictate the provider to which their employer contributes.

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