The Pensions Regulator

Annual funding statement 2019

for defined benefit pension schemes

March 2019

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Introduction

This statement is for trustees of all occupational defined benefit (DB) pension schemes and their sponsoring employers. It is particularly relevant to schemes with valuation dates between 22 September 2018 and 21 September 2019 (Tranche 14, or T14 reviews), as well as schemes undergoing significant changes that require a review of their funding and risk strategies. It sets out specific guidance on how to approach a valuation, as well as our view on some of the topical issues, along with sections on what we expect from trustees and employers and what they can expect from us.

> We expect all funding and risk reviews to fully incorporate the principles in our DB code of practice and associated guidance. You should therefore read this statement alongside the following:
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> - **Code of Practice no. 3: Funding defined benefits:** www.tpr.gov.uk/code3
> - **Guidance on DB investment:** www.tpr.gov.uk/investment-guidance
> - **Guidance on assessing and monitoring the employer covenant:** www.tpr.gov.uk/covenant-guidance
> - **Guidance on integrated risk management (IRM):** www.tpr.gov.uk/irm
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> Supplementary guidance aimed at trustees of smaller schemes with limited resources, highlighting the benefits of integrated risk management (IRM) and how to meet their main objectives through its application:
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> - **Quick guide:** www.tpr.gov.uk/-/media/thepensionsregulator/files/import/pdf/irm-quick-guide
> - **Checklist:** www.tpr.gov.uk/-/media/thepensionsregulator/files/import/pdf/irm-checklist

We have recently completed a review of our entire approach to regulation and we continue to roll out a new regulatory model to drive up standards and improve our effectiveness by engaging in a broader and more visible way with a larger proportion of the schemes we regulate. To address the range of risks we see affecting schemes, we are tailoring our approaches to the specific risks and circumstances in order to be clearer in our expectations, quicker to respond and tougher where we need to be[1].

1 https://www.tpr.gov.uk/en/document-library/corporate-information/corporate-plans

The Government's white paper, 'Protecting defined benefit pension schemes'[2], published in March 2018, set out a package of measures to improve trustees' focus on long-term strategic thinking, and explained our intention to review and update our DB funding code as part of this initiative.

The new code will be clearer about funding approaches (in particular around the prudence of technical provisions (TPs) and appropriateness of recovery plans). We will be consulting in summer 2019 on various options for a revised funding framework under the new code, and shortly after we will consult on the revised code. Until the revised code comes into force, trustees and employers should continue to refer to our current DB code and guidance. In particular, we will regulate T14 valuations under our current approach set out in this statement.

Market conditions

Our preliminary assessment of funding positions of T14 schemes in aggregate suggests the results of individual schemes could be marginally better or worse than at the previous valuation, depending on the exact date of the valuation and other scheme-specific circumstances. In particular, schemes that did not hedge their interest rate and inflation risks are likely to have done worse than others who did.

Brexit uncertainty

We remind trustees and employers of the statement we published on 24 January 2019, outlining the Brexit-related steps they can initiate[3]. We continue to monitor the situation and will issue further guidance if necessary.

2 https://www.gov.uk/government/publications/protecting-defined-benefit-pension-schemes
3 https://www.tpr.gov.uk/en/document-library/statements/exit-from-the-eu-statement

What we expect of trustees

Long-term funding targets

Paying the promised benefits is the key objective for all schemes. This requires schemes to look ahead and set clear plans for how the objective will be delivered. Good practice we have observed among schemes who appear to do this well[4] often involves trustees and employers agreeing a clear strategy for achieving their long-term goal, which recognises how the balance between investment risk, contributions and covenant support may change over time as the scheme gets better funded and more mature.

Typically, this leads to a long-term funding target (LTFT) being agreed between trustees and employers. This target would, for instance, be for the amount of assets the scheme would need by the time it has reached a level of maturity when it would be prudent to reduce the scheme's dependence on the employer, in order to allow it to be managed thereafter with a high degree of resilience to investment risks. Investment and funding strategies in the interim period are then aligned to the LTFT via journey plans which look beyond becoming fully funded on a TPs basis, to becoming fully funded up to the LTFT. This is consistent with our guidance on IRM.

We expect all schemes to follow similar practice and set a LTFT consistent with how the trustees and employers expect to deliver the scheme's ultimate objective, and then be prepared to evidence that their shorter-term investment and funding strategies are aligned with it. The Government's policy intent, as set out in its March 2018 white paper[5], is to introduce a requirement for schemes to have a specific long-term destination. Readiness to comply with any such change is another reason why trustees should take steps to incorporate this approach into their thinking, and agree it with the employer, if they do not do so already.

4 See, for example, Aon Pension Risk Report 2017: https://www.aon.com/getmedia/b04d38b2-fc55-46d6-aaa5-458b4f00bc29/UK_GPR_Survey_Finalv2.aspx and Mercer European Asset Allocation Survey 2018: https://www.uk.mercer.com/our-thinking/wealth/european-asset allocation-report-2018.html

5 https://www.gov.uk/government/publications/protecting-defined-benefit-pension-schemes

Balancing risks

We expect trustees to focus on the integrated management of three broad areas of risk: the ability of the employer to support the scheme (known as the covenant), investment risks, and scheme funding plans. We also expect them to take into account risks that arise from scheme maturity. A scheme will get progressively more mature as more of its members become pensioners. Consequently, the benefits paid out increase as a proportion of scheme assets or liabilities and this can put a different complexion on the risks that need to be managed, especially investment volatility.

Parliament has given us a mandate to protect pension savers and the Pension Protection Fund (PPF), while balancing the needs of employers to invest in and grow their business. When reviewing funding plans, we take this into account. We do not assess the appropriateness of schemes' TPs or discount rates based on predetermined relationships to gilt yields or other indices. Instead, we judge their suitability on the risks in their funding and investment strategies and how trustees appear to manage them.

We apply an integrated approach to assess the overall risk profile of each scheme using a number of factors[6], including the following:

- The level of cash contributions being paid, which takes into account the scheme's maturity and funding level, and the strength of the employer covenant.
- The additional deficit that could arise from the investment strategy in the future, and whether the covenant could support it.
- The strength of the scheme's TPs relative to a prudent valuation of the promised benefits, the strength of the employer covenant and the scheme's maturity.
- The length of the recovery plan relative to the level of deficit, the strength of the employer covenant, and the scheme's maturity. Our data indicates the median recovery plan length to be seven years, so we take the view that the schemes with strong covenants should generally have recovery plan lengths which are significantly shorter than this.
- The steps taken by trustees to challenge covenant leakage[7] and secure a fair deal for the scheme.
- The quality of any agreed contingency plans[8].
- Any risks to members, which do not appear to be supported by the employer covenant.
- The evidence presented regarding the analyses carried out and the scheme's understanding of the risks.

6 Defined benefit funding: Regulatory and enforcement policy, Appendices B and C at: www.tpr.gov.uk/docs/db-funding-regulatory-enforcement-policy.pdf
7 Covenant leakage happens when value leaves the company. See our Annual Funding Statement 2018: www.tpr.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-annual-funding-statement-2018
8 See our Annual Funding Statement 2018.

We have set out in the following tables our expectations but we recognise that individual scheme circumstances might mean alternative action is appropriate. Trustees may wish to consider obtaining evidence and justification for doing so. We recognise that contingent assets or asset-backed funding might be appropriate more widely, for example, where cash flow is constrained but security is available, or if the employer has concerns over trapped surplus. Each table identifies the key risks we expect trustees to focus on, and the actions we expect them to take, depending on their scheme and employer characteristics. It is not intended to be exhaustive for each category, and is not a substitute for reading the remainder of this statement.

Since the majority of schemes are now closed to new members, we expect scheme maturity issues to assume greater significance for setting funding and investment strategies in the future. Scheme maturity can be measured in different ways and in each there is a spectrum between mature and immature. In the following tables we refer to scheme maturity in relative terms, but we expect scheme actuaries to advise trustees on the broad position of their scheme within this spectrum now, and how it may change in the future. In the context of scheme funding, the important consideration is the interaction between (a) the level of assets, the degree of underfunding and the amount of benefits paid out, and (b) the scheme's ability to close the funding gap from investments and new contributions in a reasonable timeframe.

Accordingly, and particularly in those schemes with high levels of transfer activity, we expect advisers to alert trustees to the risks to funding and investment from increasing scheme maturity. As schemes approach high levels of maturity, trustees should ensure the employer is funding to a level where these risks are being appropriately managed.

Key risks trustees and employers should focus on and actions to take

Group	A1
Characteristics	• Strong or tending to strong covenant. • Scheme's funding position is considered to be strong, TPs are strong and recovery plan is shorter than average (less than seven years). • Scheme is relatively immature.
Key risks	• Employer exposed to market risk if scheme is not cash flow matched/hedged. • Covenant weakens at the same time as investments underperform. • Lack of long term covenant visibility. • TPs may not be aligned to the scheme's LTFT.
What we expect from trustees and employers	
Covenant	• Where there is a high level of covenant leakage, consider proportionately increased deficit repair contributions (DRCs) and shorter recovery plans. • Proportionate covenant monitoring. • Clear IRM strategy, with realistic contingency planning for key downside risks.
Investment	• Set a long-term asset allocation consistent with the scheme's LTFT. • Establish a journey plan to move towards the long-term asset allocation. • Quantify the impact on funding of adverse investment performance. • Test and evidence the ability of the covenant to support downside investment risk (supportable investment risk) by means of additional cash and non-cash funding, without extending the length of the recovery plan.
Funding	• Agree your ultimate goal for the scheme and set a consistent LTFT. • Establish a plan for progressing from your current TPs to your LTFT within a realistic timescale. • Ensure TPs can be evidenced to be consistent with the journey plan to reach the LTFT. • If concerned about risk of trapped surplus, consider using escrow, asset-backed contributions[9] (ABCs), and contingency planning.

9 An asset-backed contribution arrangement ('ABC') is a contractual arrangement between trustees and one or more entities within the sponsoring employer's group, and can involve regular payments to the scheme, for the duration of the arrangement, derived from an underlying asset: https://www.tpr.gov.uk/en/document-library/regulatory-guidance/asset-backed-contributions

Key risks trustees and employers should focus on and actions to take continued...

Group	A2
Characteristics	• Same as group A1, but a relatively mature scheme.
Key risks	• Same as A1, but with increased risk to employer from greater sensitivity to investment volatility and shorter timescales for correction.
What we expect from trustees and employers	
Covenant	• Same as A1, with more focus on the resilience of the employer to withstand downside risks over a shorter time horizon.
Investment	• Same as A1, but investment and funding plans to be structured to recognise the shorter time horizon, as well as the interplay between volatility in asset prices, investment returns and benefit outflows. • Consider your forward looking liquidity requirements in the light of expected transfer value activity.
Funding	• Same as A1, and for schemes in surplus or close to surplus on the TP basis, test adequacy of TPs against assets needed to satisfy your LTFT. • Extending recovery plan end dates to make good any negative investment returns is unlikely to be acceptable, given the strength of the employer.

Group	B1
Characteristics	• Strong or tending to strong covenant. • Scheme's TPs are weak and/or recovery plans are long (more than seven years). • Scheme is relatively immature.
Key risks	• Same as A1, but with a focus on reducing scheme risk by strengthening TPs and recovery plans in the knowledge that the employer has the ability to provide a better overall funding agreement.
What we expect from trustees and employers	
Covenant	• Proportionate covenant monitoring. • Where there is a high level of covenant leakage, proportionately increased DRCs and/or shorter recovery plans should be the norm. • In addition to enhancements to the recovery plan, strengthen short-term security through other means such as contingent assets and guarantees where available.
Investment	• Same as A1, but with a focus on trustees to understand, quantify and justify the reliance on investment returns versus DRCs to repair a worse than anticipated deficit.
Funding	• Same as A1. Strengthen TPs, increase DRCs and reduce recovery plan lengths. • Extending recovery plan end dates to make good any negative investment returns is unlikely to be acceptable, given the strength of the employer.

Group	B2
Characteristics	• Same as B1, but a relatively mature scheme.
Key risks	• Same as B1, but with increased risk to employer from greater sensitivity to investment volatility, and shorter timescales for correction.
What we expect from trustees and employers	
Covenant	• Same as B1, priority being to ensure the scheme is receiving sufficient cash contributions to meet its needs and is being treated equitably, plus a greater imperative to bolster security through contingent assets and contingency plans.
Investment	• Same as A2, priority being to protect the scheme and employer from further downside while improving funding position by further cash and/or contingent assets.
Funding	• Same as B1, with a stronger focus on improving TPs and recovery plans to align with the scheme's LTFT.

Group	C1
Characteristics	• Weaker employer with limited affordability. • Scheme funding on track to meet LTFT, TPs are strong and contributions are reducing deficits at a slower but affordable pace. • Scheme is relatively immature.
Key risks	• Same as A1 but a weaker covenant, which may be more susceptible to adverse future events. • Risk of the employer being unable to pay increased contributions if a downside investment event occurs, or in the event of sustained adverse investment experience.
What we expect from trustees and employers	
Covenant	• Maximise DRCs without risking sustainable growth plans of the employer. • Ensure fair treatment of scheme over all sources of covenant leakage. • Consider non-cash funding options, eg ABCs, guarantees to strengthen security. • Proportionate covenant monitoring, with documented evidence of whether trustees consider independent covenant advice is necessary. • Where employer is part of a stronger group, seek wider group support through cash and non-cash support.

continued over...

Group	**C1**
What we expect from trustees and employers continued…	
Investment	• Same as A1, plus the following: – Review the extent to which investment risks are expected to be rewarded, and reduce where appropriate through suitable hedging/risk mitigation strategies and/or changes to asset allocation. – Focus on diversification to reduce downside investment risk. – Use funding level improvements to reduce the level of risk that is not supported by the covenant (set funding based triggers/flags to monitor). – Where there is no (or inadequate) group support, consider reducing the current level of investment risk and running it for longer to slowly reduce the deficit over time. – Monitor transfer value activity and consider liquidity issues for the scheme if accompanied by a fall in market value of investments.
Funding	• Same as A1, but recognising that the employer may have less resilience to cope with volatile contributions – stress and scenario testing will help you to understand exposures.

Group	C2
Characteristics	• Same as C1, but a relatively mature scheme.
Key risks	• Same as C1, but with increased risk to employer from greater sensitivity to investment volatility, and shorter timescales for correction.
What we expect from trustees and employers	
Covenant	• Same as C1, but with the additional constraint of a shorter time horizon.
Investment	• Same as A2, plus the following: – Review the extent to which investment risks are expected to be rewarded and reduce where appropriate through suitable hedging/risk mitigation strategies and/or changes to asset allocation. – Focus on diversification to reduce downside investment risk. – Use funding level improvements to reduce the level of risk that is not supported by the covenant (set funding based triggers/flags to monitor). – Ensure asset allocation provides sufficient income and liquidity to cope with expected and unexpected benefit cash flows. – Consider the volatility of the assets used to provide liquidity to avoid significant selling of assets at lower than expected prices. – If expecting high transfer value activity, take action now to protect the scheme against liquidity issues in the event of a market downturn.
Funding	• Same as C1, but with the additional constraint of a shorter time horizon. Therefore, the LTFT and consistency with TPs is ever more important.

Key risks trustees and employers should focus on and actions to take continued...

Group	D1
Characteristics	• Weaker employer with limited affordability. • Scheme's TPs are weak and/or recovery plans are long (more than seven years). • Scheme is relatively immature.
Key risks	• Same as C1, but more urgent need to improve funding and reduce member risk.
What we expect from trustees and employers	
Covenant	• Same as C1, with a greater focus on securing wider group support where available. • Prioritise the scheme over all forms of covenant leakage. • Trustees should give serious consideration to obtaining independent covenant advice to assist them in maximising the support available for the scheme. If trustees decide not to do so, they should be prepared to justify why such an approach is appropriate.
Investment	• If adequate formal group support has been conferred, treat as Group B1, otherwise treat as Group E1.
Funding	• If adequate formal group support treat as Group B1, otherwise treat as Group E1.

Group	D2
Characteristics	• Same as D1, but a relatively mature scheme.
Key risks	• Same as D1, plus increased risk of sudden or sustained adverse investment performance.
What we expect from trustees and employers	
Covenant	• Same as D1, with a focus on maximising support for the scheme and prioritising scheme liabilities over all forms of covenant leakage.
Investment	• Same as D1, with a focus on minimising unsupported risks.
Funding	• Same as D1, with a focus on improving scheme funding.

Group	E1
Characteristics	• Weak employer unable to provide support. • Stressed scheme with limited or no ability to use flexibilities in the funding regime. • Scheme is relatively immature.
Key risks	• Crystallisation of unsupported investment risk and/or employer affordability weakening further.
What we expect from trustees and employers	
Covenant	• Where trustees consider that further support is possible (from the employer or wider group), independent covenant advice can support the trustees in negotiations to improve the scheme's position. • Focus on mitigations against further covenant weakening, including cessation of dividend payments, and maximisation of non-cash support (be prepared to show the evidence). • Proportionate covenant monitoring using independent experts able to advise on areas where mitigation could be sought, and appropriate mechanisms to detect early signs of further deterioration. • If there is a high risk of employer insolvency, trustees should fully explore their options and consider which ones might be deployed to best enhance member outcomes. PPF guidance[10] on insolvency and restructuring should help you.
Investment	• Same as C1, if there is a reasonable likelihood of the employer continuing as a going concern. • Where there are concerns over the financial position of the employer, ensure there is an appropriate investment structure and sufficient liquidity to reduce investment risk quickly if the covenant deteriorates further.

10 https://ppf.co.uk/restructuring-guidance

Group	E1
What we expect from trustees and employers continued...	
Funding	• Seek best possible funding outcome for members in the circumstances. • Consider the appointment of a professional trustee with experience of stressed schemes, especially in circumstances where the company is already distressed even without the pension scheme. • Be prepared to show evidence of appropriate measures, including review of any generous options and discretionary benefits, cessation of future accrual, consideration of winding up, managing your conflicts, awareness of future funding risks and ability to manage them. • Monitor transfer value activity, the assumptions and consider any reductions you believe are appropriate to protect all members.

Group	E2
Characteristics	• Same as E1, but a relatively mature scheme.
Key risks	• Same as E1, but limited time for recovery.
What we expect from trustees and employers	
Covenant	• Same as E1, but recognising that the time horizon is shorter.
Investment	• Same as C2, if there is a reasonable likelihood of the employer continuing as a going concern. • Where there are concerns over the financial position of the employer, ensure there is an appropriate investment structure and sufficient liquidity to reduce investment risk quickly if the covenant deteriorates further.
Funding	• Same as E1 but recognising that the time horizon is shorter. • Be prepared to evidence good reasons for not reducing transfer values for underfunding.

What you can expect from us

Equitable treatment

As the pension scheme is a key financial stakeholder, we expect to see it treated equitably with other stakeholders. In last year's annual funding statement we highlighted our concerns about inequitable treatment of schemes relative to that of shareholders. We remain concerned about the disparity between dividend growth and stable DRCs. Recent corporate failures have highlighted the risk of long recovery plans while payments to shareholders are excessive relative to DRCs. We are also concerned about other forms of covenant leakage which may be occurring in preference of higher DRCs and shorter recovery plans for schemes.

In 2018, we contacted a number of schemes ahead of their upcoming valuation, where we were concerned about possible inequitable treatment. The trustees of these schemes were asked a number of questions about their previous and current funding approaches and negotiations. These interventions continue and we are committed to continue our interventions on those schemes where we do not believe that their valuations reflect an equitable position relative to other stakeholders. We will continue to focus on this area when engaging with schemes in 2019. Our intention is to broaden our grip in this area to cover a larger number and greater range of schemes (regardless of covenant).

We emphasise the key principles behind our expectations as follows:

- Where dividends and other shareholder distributions exceed[11] DRCs, we expect a strong funding target and recovery plans to be relatively short.
- If the employer is tending to weak or weak, we expect DRCs to be larger than shareholder distributions unless the recovery plan is short and the funding target is strong.
- If the employer is weak and unable to support the scheme, we expect the payment of shareholder distributions to have ceased.

11 In practice TPR's response will be proportionate having taken into account the relative size of the sponsor and the scheme deficit.

Long recovery plans

We will be engaging with a number of schemes ahead of their 2019 valuations where we consider their existing recovery plans to be unacceptably long. Therefore, trustees and employers who had significantly long recovery plans at their previous valuation may receive a communication from us in the coming months. We will set out our concerns, asking relevant questions and setting out our expectations for the upcoming valuation. The schemes selected for this engagement will cover the whole spectrum of covenant strengths. While some trustees may not consider their current recovery plan to be long, we will be looking at both the maturity and the covenant of the employer in forming a view on what we consider to be an acceptable recovery plan length. As an example, if a relatively mature scheme with a strong employer has a current recovery plan in excess of the average length for the universe of schemes, we will consider that to be too long.

Other interventions

Our approach is continuing to develop to allow engagement with other schemes during 2019 where we are concerned about certain other characteristics of their funding and investment plans in the context of their covenant and scheme profile. We will also continue to risk assess all valuation submissions that we receive. These risk assessments look at the overall risk profile of a scheme relative to the ability of the sponsor to support it. It is therefore imperative that both trustees and employers are fully aware of our expectations as set out in this statement and in our wider guidance. Furthermore, trustees and employers should be fully prepared to justify their approach with evidence of robust negotiations having taken place.

Late valuations

As noted in previous statements, we expect all trustees to start their valuation process in good time and to follow a project plan that leaves sufficient time for advice, analysis and negotiation with the employer. Trustees should not agree an inappropriate valuation and funding plan merely because the deadline is imminent or has been missed and should contact us if they are pushed to do so by the employer or a third party.

If the deadline is missed we expect trustees to report to us in good time and work with employers to make every effort to agree an appropriate valuation and recovery plan as soon as possible. We have the discretion to impose a penalty, and have brought enforcement proceedings against some trustees who have not submitted their valuations within the 15-month statutory timescale. However, where trustees have acted responsibly and taken all reasonable steps to finalise their valuation, but there remains a genuine reason why it cannot be finalised, we may choose not to apply a penalty. Our preference is for the best outcome to be reached for the scheme, rather than one agreed under pressure simply to meet the deadline. We will support trustees if they cannot agree a valuation for valid reasons.

Our powers

Our suite of powers[12] includes the scheme funding power to direct how a scheme's TPs should be calculated and how (including over what period) its deficit should be funded. We can use this power when there has been a failure to agree or when the valuation assumptions or recovery plan do not appear good enough to meet the standards required by law. Often, we are able to achieve appropriate outcomes following engagement with the trustees and employer without recourse to this power. However, we will commence formal investigations wherever necessary and appropriate, as was the case with Southern Water[13]. We have several other investigations currently underway where we might decide to use this power. Such investigations may also involve consideration of the use of a skilled person's report[14], the cost of which may have to be borne by the trustees or the employer.

We can intervene in other ways if a scheme is not being treated appropriately. We can choose from a selection of interventions from our regulatory toolkit, depending on the risk posed by the scheme. These can vary from one-to-one supervision, through to, where appropriate, use of an improvement notice, the issuance of penalties or an anti-avoidance investigation.

12 See the DB code and also the governance sections in the investment guidance and covenant guidance
13 https://www.thepensionsregulator.gov.uk/en/media-hub/press-releases/southern-will-pay-50m-more-into-pension-with-accelerated-payments-following-tpr-investigation
14 See the DB code and also the governance sections in the investment guidance and covenant guidance

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