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Sixty second summary

DB annual funding statement 2019

The Pensions Regulator has published the 2019 edition of its annual funding statement for defined benefit (DB) schemes.[1] It provides guidance on the Regulator's expectations of trustees and sponsoring employers who are conducting valuation exercises at dates in the year to 21 September 2019, and what responses they might anticipate from it in return.

Revised Code of Practice

As the Department for Work and Pensions (DWP) announced, in March 2018, in its White Paper on *Protecting Defined Benefit Pension Schemes*, the Regulator is to revise its DB funding Code of Practice to clarify its assessments of issues such as the prudence of technical provisions and the appropriateness of recovery plans. The Regulator says that it will put forward options for a revised funding framework in the summer of 2019, and follow that up with a draft of the reworked Code. The existing Code and guidance should be followed until the revised version comes into effect.

Long-term funding targets

The White Paper also announced the DWP's plan to require trustees to declare their long-term funding objectives (probably in a new DB 'Chair's Statement'). The Regulator anticipates such a legislative development by expecting trustees and sponsors to agree on a suitable long-term funding target for their scheme, and to be able to demonstrate that their investment and funding strategies are consistent with it.

Balancing risks

In this annual funding statement the Regulator re-emphasizes the importance of integrated risk-management, but highlights scheme maturity in addition to the usual triumvirate of covenant, investment and funding risks. It is a theme that the Regulator returns to throughout this year's statement, saying that maturity issues will become increasingly significant, and that it expects trustees to take advice from their actuaries about the maturity of their schemes, and how it might develop.

The Regulator assures readers that it does not pass judgement on a scheme's technical provisions or discount rate mechanistically, based on any gilt-yield-based benchmark. Rather, it looks at their suitability in light of the various risks borne by the trustees, and how they are managed. It highlights several factors that are taken into account, most notably warning that, in its opinion, schemes with strong employers ought to have recovery plans '*significantly shorter*' than the seven-year average for all schemes: this is consistent with a recent Compliance and Enforcement Bulletin in which the Regulator indicated that the 5.9-year average recovery plan length for strong employers would be used as a yardstick.[2]

Segmentation by covenant

The Regulator has further developed its system of categorization of schemes by risk profile, setting out the actions that it expects from trustees and sponsors in each class. This year, as well as covenant and funding considerations, there is much greater emphasis on investment risk, and scheme maturity is used to create sub-categories (with the bar set higher for more mature schemes).

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[1] *TPR is clear about its expectations for DB schemes planning their long term strategy* (PN19-13, 5 March 2019) <www.thepensionsregulator.gov.uk/en/media-hub/press-releases/tpr-is-clear-about-its-expectations-for-db-schemes-planning-their-long-term-strategy>; *Annual defined benefit funding statement 2019* <www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-annual-funding-statement-2019.ashx>.

[2] See *Current Issues* March 2019 <www.hymans.co.uk/media/uploads/Current_Issues_-_March_2019.pdf>.

Treating schemes & shareholders even-handedly

The Regulator again voices concern about an imbalance between employers' dividend payments—as well as other forms of '*covenant leakage*'—and the deficit-reduction contributions (DRCs) made to DB pension schemes. During 2018, it pre-emptively contacted trustees of schemes that had valuations imminent to make those concerns clear, and says that in 2019 it intends to '*broaden* [its] *grip… to cover a larger number and greater range of schemes (regardless of covenant).*' It expects that—

- if distributions to shareholders are disproportionate to DRCs, the scheme should have a strong funding target and relatively short recovery plan;
- for weaker employers, DRCs should be larger than shareholder distributions, unless the funding target is strong and recovery plan short; and that
- shareholder distributions will have ceased if the employer is unable to support the scheme.

Recovery plan length

Where schemes put in place '*significantly long*' recovery plans as part of their last valuation exercise, they can expect to be contacted by the Regulator prior to their 2019 valuations. It will take account of scheme maturity and employer covenant when reaching a conclusion about a recovery plan is unacceptably long: it indicates, by way of example, that a recovery plan in excess of the seven-year average length will be taken to be overlong if the employer is strong and the scheme relatively mature.

Enforcement

The Regulator urges trustees not to allow themselves to be pressured into accepting unsuitable funding plans because of an impending statutory deadline, and to report any attempts to compel them to do so. Whilst noting that penalties can be imposed (and have been) for failure to finalize valuations within the fifteen-month limit, it says that it can exercise its discretion to waive any fines if trustees have taken all reasonable steps to comply and there it a genuine reason for the delay.

It also reminds readers of its powers to impose technical provisions and recovery plans upon schemes, and mentions the case of Southern Water, in which it threatened but did not ultimately have to do so. It says, ominously, that it has '*several investigations currently underway where* [it] *might decide to use this power.*'

The statement is in keeping with the Regulator's 'clearer, quicker, tougher' makeover, and an indication of the direction of travel for the revamped DB funding regime that is expected in 2020. It is unlikely to cause a major stir for those trustees who are already at the leading edge of best practice. They will already have a long-term plan for their scheme and be shifting into investments that match pension payments more closely. However, lots will need to 'up their game' to draw level, shifting their focus to how the scheme will be settled or run-off; and all trustees are to some extent going to have to work harder to demonstrate that the risks they are running can be supported by the sponsoring business.

Businesses with pension scheme valuations this year will be under considerable pressure to pay higher contributions if they have a long recovery plan or are paying high levels of dividends relative to deficit contributions. This will be unwelcome for those who are wrestling with tough trading conditions and Brexit-related uncertainty. If businesses are struggling, the Regulator will be highly likely to intervene to put the interests of pensioners ahead of investors'. According to our analysis one in five FTSE 350 companies with a final salary pension scheme is at risk of such intervention.