Sixty second summary

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, arising from (for example) scheme investment strategy and how the sponsor covenant has weathered COVID-19 and Brexit.

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. Rather than banking any savings today, the Regulator suggests that it may be more prudent to allow them to flow through at future valuations.

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.

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.

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

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 T16 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 key risks and how they will be managed as part of this valuation it will simplify the task.

New 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, which it expects to do '*towards the end of 2021*'. It says that the new Code will not be in force before '*late 2022 at the earliest*'. In the meantime, valuations will be regulated according to existing legislation and guidance.

This latest AFS provides useful insight into the Regulator's thinking. However, with many of the themes familiar from recent guidance, nothing should come as a huge surprise. For most trustees the starting point will be to assess the impact COVID-19 has had on the scheme sponsor and plan accordingly. Although the world is beginning to recover, ongoing uncertainty about investment markets, covenants and mortality rates means that robust monitoring and contingency planning will be vital.

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