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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. Whereas past messaging has focused valuation prudence and deficit repair, the Regulator's thinking has turned to long-term planning, protecting gains and getting buy-out ready; even uses of surplus and consideration of discretionary increases warrant a mention. The AFS helpfully acknowledges that running a scheme on may be a valid choice for a small subset of trustees (although buy-out will remain compelling for most as funding levels continue to improve).

Investment issues feature heavily, with sensible encouragement to accelerate de-risking plans (if affordable), review liquidity and ensure robust LDI governance. Whilst we support the steer to get assets 'buy-out ready', trustees should not conflate the practices of holding assets that insurers prefer with holding assets that hedge insurer pricing.

The warning against employer-covenant complacency is timely, and re-financing risk is a live issue for highly leveraged or financially weak sponsors. The Regulator stops short of endorsing any particular adjustments to pre-Covid longevity assumptions, but many will be eyeing the CMI 2022 mortality projection model, which could shave 2% off funding liabilities.

New obligations to encourage DC illiquid investments

Amending Regulations have made changes designed to facilitate and promote investment in illiquid assets by schemes providing money purchase benefits. The alterations will affect charge-cap calculations and statements of investment principles for default investment arrangements, as well as the contents of trustees' annual governance (Chair's) statements and online disclosures. Most of the alterations came into force on 6 April 2023, but compliance deadlines will vary in practice, according to circumstance.

The Occupational Pension Schemes (Administration, Investment, Charges and Governance) and Pensions Dashboards (Amendment) Regulations 2023[1] exclude '*specified performance-based fees*' from the scope of the 0.75% cap on charges under default investment arrangements in defined contribution (DC) schemes that are used for automatic-enrolment compliance. The change took effect on 6 April 2023. The Regulations also remove October 2021 provisions for performance-fee smoothing, though with transitional rules that can retain those old measures until as late as 5 April 2028 for trustees who had already made use of them.

Trustees of relevant schemes[2] will need to update the statements of investment principles (SIPs) for their default arrangements to explain their policies on illiquid investments. The requirement will bite on the first occasion on which the default SIP is revised after 1 October 2023, or on 1 October 2024 if that comes first.

The trustees' annual governance (Chair's) statement for the first scheme year ending after 6 April 2023 will need to record and assess the amount of any performance-based fees incurred. For their Chair's statement for the first scheme year to end after 1 October 2023 will also need to report on their allocations to specified asset classes. Once they apply to a scheme, these new Chair's-statement items will be added to the growing list of disclosures that must be made freely available online.

The Regulations include parallel provisions for collective money purchase schemes. They also correct an error in the deadlines for connection to the pensions dashboards system, though the entire 'staging profile' is now subject to revision as the Government seeks to allow more time for the necessary technical developments.

The Department for Work and Pensions (DWP) has published statutory guidance on the new asset-allocation and performance-based-fee requirements. Regard must be had to it when seeking to comply. The DWP will need to review the impact of the Amendment Regulations every five years, with the first report due before 6 April 2028.

As we've said before, we're supportive of the Government's efforts to broaden the range of investment opportunities, and of the requirement for trustees to have formal policies on illiquid assets. However, we are not in favour of extensions to the already burdensome Chair's statement requirements, and don't think that the desired behavioural changes will be achieved by this package of changes.

[1] SI 2023 No. 399.

[2] Occupational schemes that provide DC benefits, but not executive, small self-administered, or public-service schemes, and not if the only DC benefits are attributable to additional voluntary contributions.

Regulator sketches out work programme

The Pensions Regulator published a Corporate Plan for 2023/24. Its to-do list includes:

- development of a value-for-money framework with the Financial Conduct Authority (FCA) and Department for Work and Pensions (DWP);
- enhancing its data collection on liability-driven investment;
- combatting scams;
- improving the efficiency of auto-enrolment supervision;
- a new approach (already trialled) to engagement with scheme administrators;
- further work on equality, diversity and inclusion (EDI) and climate change;
- reviewing its superfunds guidance;
- dashboards preparations;
- professional trustees (including considering whether all schemes should have one, and whether they ought to be accredited or authorised); and
- improving its digital capabilities and services.

The Plan mentions readiness for the launch of the new defined benefit (DB) funding framework in April 2024, without going into the reasons for the delay. It keeps its cards even closer to its chest about the likely timing of the new General Code.

More on LDI from the regulators

The Financial Conduct Authority (FCA) published *Further guidance on enhancing resilience in Liability Driven Investment* (LDI). It contains recommendations for liability-driven investment (LDI) providers, on risk management and stress testing, operational arrangements, communications and client-relationship management.

The Pensions Regulator issued guidance on practical measures that can be taken by trustees using leveraged LDI to manage their risks. It covers investment strategy, collateral buffers, resilience testing, governance and monitoring. In particular, it says that trustees are only expected to invest in arrangements that have an operational buffer for day-to-day changes in addition to a 250 basis-point minimum market-stress buffer to provide resilience during severe events.

Meanwhile, the Chairman of the House of Commons Work and Pensions Committee has written to the Pensions Minister and Economic Secretary to the Treasury to ask whether they agree that:

- the Regulator should have its remit extended to cover financial stability considerations;
- a new scheme notifiable event is the best way to provide the Regulator with the means to assess compliance with guidance on minimum levels of resilience in LDI funds; and
- re-collateralisation trigger points in some funds might pose financial-stability risks.

Warning on ex-pats' DB pensions

The Financial Conduct Authority (FCA) is concerned about overseas advisers targeting members of UK defined benefit (DB) schemes who are living abroad. It has highlighted the issues for UK-based financial advisers who might be recruited by overseas advisers to provide the '*appropriate independent advice*' necessary for transfers of over £30,0000 to proceed.

First CDC scheme receives imprimatur

The Pensions Regulator announced the authorization of the UK's first collective money purchase (AKA collective defined contribution, or CDC) scheme. As expected, the distinction belongs to the scheme set up by Royal Mail Group, whose interest in CDC provided the Government with the initial impetus to facilitate the new benefit type.

There is now an official list—though for the time being an exceedingly short one—of authorized CDC schemes, on the Regulator's website.

HMRC newsletters: April 2023

Pension Schemes Newsletter 149, from His Majesty's Revenue and Customs (HMRC):

- confirms that HMRC has reconsidered its policy on the procedure for paying post-6 April 2023 lump sum death benefits that exceed the member's lifetime allowance, so that scheme administrators should pay them in full, without applying PAYE deductions—HMRC will collect the tax after liaising with the deceased's personal representatives (the process after abolition of the allowance on 6 April 2024 has yet to be decided);
- says that HMRC expects that its annual allowance calculator will be updated for tax year 2023/24 during the summer;
- gives some recent registration and pension flexibility statistics;
- advises that new or amended pension scheme returns relating to the tax years 2022/23 and earlier may still be submitted in the Pension Schemes Online (PSO) system, but that third-party software cannot be used to do so;
- warns that HMRC is changing some of the questions asked in pension scheme tax returns—details are given in the Newsletter—and that scheme administrators should migrate to the new Managing Pension Schemes (MPS) service in time to complete any 2023/24 returns; and
- says that it will be possible to create event reports in MPS for the tax year 2023/24 from the summer (earlier reports can still be submitted in PSO, but not with third-party software).

And Finally…

Depending on one's perspective, this is either the best or worst statutory instrument title ever:

> *The Pension Fund Clearing Obligation Exemption and Intragroup Transaction Transitional Clearing and Risk-Management Obligation Exemptions (Extension and Amendment) Regulations 2*.[3]

It's a very long name for a very short set of Regulations. They extend the transitional exemption from the central-clearing obligation under the European Market Infrastructure Regulation (or rather its post-Brexit UK variant), until 18 June 2025, and another transitional exemption relating to intra-group transactions until 31 December 2026.

But you'd have got most of that just from the title…

Whilst on the subject of naming things, we saw that the Government plans to allow parents to acquire National Insurance credits, retrospectively, if they've missed out because they didn't claim Child Benefit. The announcement was made as part of Tax Administration and Maintenance Day, or TAMD 2023, which must be in the running for the named-day event least likely to involve bunting…

[3] SI 2023 No. 472.