REGULATOR'S ANNUAL FUNDING STATEMENT RAISES THE FUNDING BAR

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Legal Briefings – By **Tim Smith**

The Pensions Regulator has published its 2019 annual funding statement for defined benefit (DB) schemes. The statement:

- reflects the Regulator's tougher approach
- confirms the Regulator's focus on reducing the length of deficit recovery plans and requiring schemes to set a long term funding target, and
- makes clear the Regulator's intention to police the payment of dividends more closely.

For many schemes, this is likely to result in the sponsor being required to put more money into their scheme more quickly.

The statement is relevant to all DB schemes but it is particularly relevant to schemes preparing valuations with an effective date between 22 September 2018 and 21 September 2019. It sets out the approach that the Regulator expects to be taken in 10 different scenarios, with the expectations varying according to the financial strength of a scheme's sponsor, a scheme's funding position and its maturity. However, some key themes emerge.

A TOUGHER APPROACH

In recent years the Regulator has said repeatedly that it intends to be clearer, quicker and tougher.

This year's funding statement reflects this by setting out more clearly what the Regulator expects from schemes and sponsors in different scenarios. The statement emphasises the fact that the Regulator is intervening at an earlier stage in funding negotiations, particularly where it has concerns about a scheme's funding arrangements or feels that a scheme is being treated inequitably.

The statement refers to the Regulator's recent investigation which led Southern Water to pay an additional £50 million into its scheme, and points to other ongoing investigations, as examples of the Regulator's willingness to use its scheme funding powers to ensure that schemes are properly funded.

LONG TERM FUNDING TARGET

With DB schemes fast maturing, the Regulator wants trustees and sponsors to move away from focusing on their scheme's ongoing funding requirements and to focus instead on the end game for their scheme. With this in mind, the Regulator expects all schemes to set a long term funding target, which reflects the scheme's long term objective (which may be, for example, to secure members' benefits with an insurer or to reach self-sufficiency).

In most cases, the funding required to achieve this will be significantly higher than the current level of the scheme's technical provisions. Over time, the Regulator expects schemes to increase their technical provisions to enable them to meet this long term funding target. This is a subtle but important shift because for many schemes it means that the funding bar is being raised.

It is important that sponsors and trustees review the long term objective for their scheme in light of this and that they seek to agree upon the end game, taking account of the additional funding that will be required to achieve this. The option of transferring to one of the new DB consolidator vehicles as a means of discharging an employer's obligations to its scheme will no doubt feature in many of these discussions, given its emergence as a potential alternative solution for some DB schemes.

FOCUS ON DIVIDEND PAYMENTS

Having been stung by criticism following recent high profile corporate failures that have come hot on the heels of large dividend payments, the Regulator is increasingly determined to ensure that DB schemes are treated fairly alongside shareholders. This is reflected in this year's statement which makes clear that:

- where dividends and other shareholder distributions exceed deficit repair contributions, the Regulator expects a scheme to have a strong funding target and a relatively short recovery plan
- for financially weaker employers, the Regulator expects deficit repair contributions to be larger than dividend payments unless a scheme's recovery plan is short and its funding target is strong, and
- if an employer is financially very weak and unable to support its scheme, the Regulator expects dividend payments to have ceased.

Some sponsors may need to review their approach to dividend payments in light of this.

BREXIT

Schemes with valuation dates at the end of March could find that their valuation results are affected by short-term market volatility caused by Brexit. Despite this the statement provides no further guidance for such schemes. However, it leaves open the prospect of the Regulator issuing further guidance should this be needed.

A NEW FUNDING CODE

The Regulator is due to consult on a new funding Code of Practice for DB schemes later this year and this statement signals the tougher approach that we can expect to see adopted in that new Code.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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