HERBERT SMITH FREEHILLS

PENSIONS REGULATOR STRESSES INFLATION AND GEOPOLITICAL RISKS IN LATEST ANNUAL FUNDING STATEMENT

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Legal Briefings

Trustees should consider the impact of rising costs and fast-moving sanctions regimes on their schemes, regulator warns

The Pensions Regulator has published its latest **Annual Funding Statement**. Most of the messages are consistent with those contained in last year's statement but this year's statement emphasises the need for trustees to assess the impact on their scheme and sponsor covenant of high inflation, the prospect of higher interest rates and the impact of the war in Ukraine and related sanctions. The guidance also reflects the fact that the average recovery plan length for defined benefit (**DB**) schemes has fallen to less than six years.

Looking ahead, the regulator confirms that we can expect the second consultation on the new DB Funding Code to take place later this year, after the DWP has consulted on regulations that will underpin the new funding requirements contained in the Pension Scheme Act 2021.

BACKGROUND

The Annual Funding Statement is relevant for trustees and sponsors of occupational DB pension schemes, as it highlights the Regulator's views on regulatory developments and current issues, which are expected to have a bearing on pension scheme management. The statement is particularly relevant for:

- schemes with "as at" valuation dates between 22 September 2021 and 21 September 2022, and

- schemes undergoing significant changes that require a review of their funding and risk strategies.

KEY THEMES

While recognising that the impact of current economic and political conditions on individual schemes and sponsors will vary, the statement identifies a number of issues that trustees and sponsors ought to be considering and contains guidance on how to approach current valuations. As you might expect, the statement urges trustees to consider the impact of global events and economic conditions on their scheme and their sponsor covenant. This includes assessing the current and potential future impact of:

- high inflation
- the prospect of further increases in interest rates
- the war in Ukraine and Russian sanctions
- higher global fuel and energy prices
- increases in commodity prices
- ongoing supply chain issues
- Covid-19 and how sponsors are faring in the recovery, and
- Brexit.

MONITORING COVENANT

When assessing the impact of current conditions on their sponsor covenant, trustees are reminded of the importance of conducting scenario analysis and testing forecasts produced by scheme sponsors. Scenario analysis should not only consider the impact of different scenarios and events on the sponsor covenant but also consider how these events would impact the scheme's investments and liabilities. Suitable contingencies should be in place to deal with adverse events.

The statement reminds trustees of the need to be alert to covenant leakage. The regulator notes an increase in employers returning cash to shareholders through recommencing dividends, paying ‘special’ dividends and share buybacks. It also reminds trustees of the need to be vigilant of other forms of covenant leakage – such as cash pooling arrangements, group trading arrangements and management fees. In each of these scenarios, trustees should consider whether their scheme is being treated fairly compared to other stakeholders.

Trustees also need to be prepared to act quickly in the event of corporate mergers and acquisitions They are expected to take a rigorous approach to assessing the impact of any transaction on their scheme and sponsor covenant and to record the considerations made in respect of the scheme. Corporate events should be dealt with independently from a scheme’s valuation, with suitable mitigation being sought for any detriment caused.

Where trustees place reliance on contingent assets or asset-backed contribution arrangements for scheme funding purposes, they should consider the impact of current market conditions on the value of this support, and whether it is still sufficient to cover any additional risk being taken.

As part of its second consultation on the new DB funding code, the regulator will set out proposed changes to its August 2015 guidance on **Assessing and Monitoring the Employer Covenant** and other related guidance. The updates to this guidance will include providing:

- more detail on how to treat guarantees for scheme funding purposes, and
- more information on how environmental, social and governance issues can be factored into covenant assessments.

RECOVERY PLANS AND AFFORDABILITY

When agreeing recovery plans, trustees are expected to consider the impact of current market challenges on their scheme’s sponsor(s) and how their sponsor(s) are responding to these. The approach expected will vary depending on the extent of any impact.

The regulator continues to view shareholder distributions as being inconsistent with a scheme receiving lower contributions, and it expects any deferred deficit recovery contributions to be repaid – ideally before any shareholder distributions recommence.

ACTUARIAL CONSIDERATIONS

INFLATION

Given the current high inflationary environment, trustees are reminded to:

- carefully consider how to build recent and short-term inflation rates into their valuation calculations to ensure benefit increases are being modelled correctly
- discuss any salary increase assumptions with employers to ensure they remain appropriate and realistic, given the current conditions, and
- understand how any inflation hedging they have put in place works in the context of the current environment, and the impact of any caps and collars that may apply to benefits.

Long-term inflation expectations have risen recently, and all other things being equal, building this expectation into funding bases is likely to increase liabilities for many schemes. Some trustees adjust market-implied inflation measures (such as allowing for inflation risk premiums) and the regulator expects these to be consistent with the scheme's exposure to inflation within their investment strategy.

MORTALITY

The immediate impact of the pandemic on a scheme's actual mortality experience over the period to its valuation date will be accounted for in the scheme's valuation data. However, the statement recognises that there remain divergent views on the impact of Covid-19 on the course of future longevity improvements.

When using the latest base mortality tables and projections available, suitably adjusted for scheme specific factors where appropriate, consideration will be needed on the weighting given to recent data. The Continuous Mortality Investigation model enables schemes to choose the weighting applied to the data for 2020 and 2021, although their core model disregards the data for both years.

The regulator remains of the opinion that the long-term impacts from Covid-19 will take more time to become apparent. Where trustees feel that changes to their mortality assumptions at this stage are appropriate and justifiable, the regulator expects any reduction in liabilities due to such changes to be no more than 2%, unless accompanied by strong supporting evidence.

LONG-TERM TARGET

Although the legal requirement for trustees to set a long-term funding target (**LTFT**) for their scheme is not yet in force, the regulator encourages trustees to incorporate this approach into their thinking, to the extent they have not done so already, by adopting a LTFT, agreeing it with their scheme sponsor(s) and setting their journey plan accordingly.

Trustees are also reminded to consider how current and potential future interest rates and inflation changes may impact on any LTFT, or end game strategy for their scheme.

SCHEME SPECIFIC GUIDANCE

As in previous years, the statement contains tables which set out the regulator's expectations for different schemes depending on the scheme's funding position, covenant strength and maturity. The expectations set out in the tables are the same as in last year's statement, with the notable exception that the reference to the length of the recovery plan (which is used to determine the strength of a scheme's funding position) has been changed to six years (down from seven). This reflects the fact that recovery plan lengths have decreased over recent years (with the average now being less than six years across all valuation tranches).

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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