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March 2019

Legal Update

DB pension scheme funding – Pensions Regulator annual statement

The Pensions Regulator has published its 2019 annual DB funding statement. The statement will be relevant to all DB pension schemes, but is targeted at schemes undergoing a valuation with an effective date between 22 September 2018 and 21 September 2019, and schemes undergoing significant changes that require a review of their funding and risk strategies. The statement sets out the Regulator's views on various funding issues and what the Regulator expects from trustees and employers.

Long-term funding targets

The Regulator expects trustees and employers of all schemes to agree a long-term funding target for the scheme and a journey plan for reaching that target. The target should be consistent with how the trustees and the employer expect to deliver the scheme's ultimate objective, and trustees and employers should be prepared to demonstrate that the scheme's shorter-term funding and investment strategies are aligned with it.

Balancing risks

In addition to focussing on the integrated management of employer covenant, investment and funding risks, the Regulator expects trustees to take into account risks arising from scheme maturity. When reviewing a scheme's funding plans, the Regulator assesses the scheme's overall risk profile using a range of factors including:

- The level of cash contributions being paid to the scheme.
- The additional deficit that could arise from the scheme's investment strategy in the future and whether the employer covenant could support it.
- The strength of the scheme's technical provisions relative to a prudent valuation of the scheme's promised benefits, the strength of the employer covenant, and the scheme's maturity.
- The length of the recovery plan relative to the level of the deficit, the strength of the employer covenant, and the scheme's maturity.
- The steps taken by the trustees to challenge covenant leakage and secure a fair deal for the scheme.
- The quality of any agreed contingency plans.
- Any risks to members which do not appear to be supported by the employer covenant.
- The evidence presented regarding the analyses carried out and the scheme's understanding of the risks.

The statement includes tables setting out the key risks that the Regulator expects trustees to focus on and the actions it expects trustees to take for ten different categories of scheme. The categories are based on the scheme's covenant strength, funding position, and maturity.

Dividend payments and equitable treatment

The Regulator expects schemes to be treated equitably when compared to shareholders. It remains concerned about the disparity between dividend growth and stable deficit reduction contributions (DRCs), and about other forms of covenant leakage which may be occurring at the cost of higher DRCs and shorter recovery plans. The Regulator's expectations in relation to dividends and other shareholder distributions are that:

- Where shareholder distributions exceed DRCs, there should be a strong funding target and a relatively short recovery plan.
- Where the employer is tending to weak or weak, DRCs should be larger than shareholder distributions unless the recovery plan is short and the funding target is strong.
- Where the employer is weak and unable to support the scheme, shareholder distributions should have ceased.

Regulator intervention

The Regulator plans to engage in a broader and more visible way with a larger number of schemes, and will intervene where it is concerned about certain characteristics of the scheme's funding and investment plans in the context of the employer covenant and scheme profile. In particular, the Regulator will engage with schemes in situations where it is concerned about inequitable treatment of the scheme compared to shareholders, and where it considers the scheme's existing recovery plan to be unacceptably long.

The Regulator also notes that, while it is often able to achieve appropriate outcomes without recourse to its formal scheme funding powers, it will commence formal investigations where necessary and has several current investigations underway.

New code of practice

The government's 2018 white paper announced that the Regulator would issue a revised code of practice on DB scheme funding which would contain new funding standards, in particular around:

- how prudence is demonstrated when assessing scheme liabilities;
- what factors are appropriate when considering recovery plans; and
- ensuring that a long-term view is considered when setting the statutory funding objective.

The Regulator will consult this summer on options for a revised funding framework under the new code, and will consult on the new code itself shortly after that.

If you have any questions about the issues raised in this legal update, please get in touch with your usual Mayer Brown contact or Richard Evans at +44 20 3130 3606 or Katherine Carter at +44 20 3130 3901.