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COVID-19

The impact on pension scheme funding – implications for forthcoming scheme valuations and the Pensions Regulator's approach to funding

Key Highlights

- Forthcoming scheme valuations will be directly impacted by the increase in deficits and current economic conditions due to the impact of the coronavirus (COVID-19) pandemic.
- There are a variety of measures which sponsors could look to agree with trustees. These include longer recovery plans, allowance for longer-term investment experience (possibly backed with employer security) or bringing forward actuarial valuation dates.
- The approach of the Pensions Regulator (TPR) during the 2008 financial crisis provides a useful point of comparison, but recently TPR has indicated less willingness to accommodate certain measures, such as longer recovery plans.
- In agreeing to valuation matters with sponsors, trustees will need to act in accordance with their fiduciary duties.
- TPR's recent announcements on COVID-19 do not address the position of schemes whose actuarial valuations are not yet underway. However, TPR's Annual Funding Statement for 2020 will be published shortly and will address valuations with post-COVID-19 effective dates, up to 21 September 2020.

The impact of the coronavirus pandemic on UK defined benefit pension schemes' funding will be profound. Steep falls in the value of equities and other growth assets will have badly affected schemes' portfolios, though for many schemes increased holdings in gilts and bonds and hedging may have offset this to varying degrees. The fall in interest rates and gilt yields has also greatly increased the size of liabilities and hence funding deficits for most schemes, notwithstanding the increasingly widespread use of hedging arrangements. There is also significant volatility in asset classes (e.g. corporate bonds) which are important in measuring scheme liabilities.

Assuming that yields and funding levels will not bounce back in the short term, we can expect the effect of COVID-19 to reverberate well beyond the period in which businesses are hit by the severe effects of lockdowns and social distancing. The financial and market consequences are likely to be reflected in higher scheme deficits and in increased funding costs for many employers for a considerable time to come. This is expected to place the regulation of pension scheme funding under strain, at a time when the overall regulatory approach is undergoing major changes.

Our **recent briefing** on COVID-19 and pensions focused on the steps which employers and trustees could take in the short term to change pension scheme funding commitments, in order to deal with the immediate impact of the crisis on businesses, looking in a particular at points raised in the series of statements on COVID-19 issued in March 2020 by the Pensions Regulator (***TPR***). That briefing also discusses the effect of the disruption on scheme valuations already under way, which would normally have effective dates predating the current economic crisis. By contrast, this briefing looks ahead at medium term issues, including:

- the implications of the crisis for forthcoming scheme valuations with later effective dates, which will be directly impacted by the increase in deficits and current economic conditions;
- how employers may look to manage the cost of this; and
- what TPR's attitude to such measures may be.

Consultation on new funding Code of Practice

This will be a significant test of TPR's regulatory approach at a time when major changes are under way, with additions to the statutory funding regime being introduced by the Pension Schemes Bill currently before Parliament and with the release in March of TPR's consultation document on a new defined benefit funding Code of Practice (the ***Consultation Paper***), which sets out proposals for a new regulatory framework under which TPR will approach scheme valuations and employer's funding obligations. Our briefing discussing these changes can be found here.

The new Code is not expected to come into effect until late 2021, and that may be delayed since the consultation period under the Consultation Paper has been extended to 2 September 2020. But the Code has immediate relevance as the approaches that underlie it are already perceived to be informing TPR's thinking. How that thinking may be applied, or adapted, in a time of major stress is an important question for TPR.

TPR's Annual Funding Statement for 2020

As discussed in our accompanying briefing, while TPR's March 2020 statements on COVID-19 discussed scheme valuations in some depth, it mainly looked at valuations already under way. TPR has said that its Annual Funding Statement for 2020, which is to be published after Easter, will provide messages relevant to all defined benefit schemes including those with post-coronavirus effective dates, up to 21 September 2020. This will provide an early indication of the extent to which TPR will be adapting the approach to address the impact of COVID-19 and how consistent this is with the broader principles discussed in the Consultation Paper.

Coping with deficits in forthcoming scheme valuations

In the medium term, forthcoming actuarial valuations will increasingly be directly affected by the economic and market effects of COVID-19 summarised above, with the result that many will disclose much larger funding deficits. These valuations should not need to be rapidly resolved, as they can be dealt with over the normal timetable allowed by legislation, which imposes deadline for resolution which is 15 months from the effective date. It is hoped that during that period the immediate effects of the crisis on many businesses will recede and more clarity as to the strength of the employer covenant for each affected scheme will emerge, allowing trustees and employers to engage on an informed basis.

However, the prospect of substantially increased funding costs will present a significant challenge to many employers, who may be looking to conserve cash and repair the damage to their businesses in the wake of the pandemic. Some of the measures that employers may look to agree with trustees include:

- longer recovery plan periods, which would soften increases in deficit repair contributions (***DRCs***);
- deferrals to increases in DRCs that flow from the increased deficit. For example, DRCs could initially remain flat with increases reflecting the higher deficit being phased in over a reasonable period which may coincide with better business performance. Potentially, employers and trustees could agree automatic triggers for DRC increases that are based on improvements in business revenues or other key indicators;
- "back-end loading" DRCs in the expectation that liability measures and hence deficits will partly revert to earlier levels over time as financial conditions change and interest rates increase;
- allowing for some of the recovery plan to be met by anticipated investment outperformance;
- adopt higher discount rates, or reducing a fall in the discount rate, by offering security over company assets, reducing the risk to the scheme of employer default;
- using an asset-backed funding arrangement, so that the embedded value of an asset used in the business can be leveraged to generate cashflows for the scheme in place of DRCs paid out of earnings;
- taking into account experience after the valuation date if this is felt appropriate, to mitigate some of the more severe short-term impacts in conditions as at the valuation date;
- bringing forward the valuation date to reflect economic and market conditions prior to COVD-19, providing the 15-month deadline can be met. As with the exercise of any discretion, care will need to be taken to ensure that this is being done for a proper purpose and to avoid the appearance of improperly "manipulating" the date. A fair view that the current valuation conditions are temporary and distorting the real funding costs for the employer would be relevant and (among other considerations) would help arrive at a proper decision.

All of these techniques, and others, have been widely used in previous periods of difficulty, especially in the wake of the 2008 financial crisis. It remains to be seen is how receptive TPR will now be to their deployment in the wake of the pandemic.

Lessons from the aftermath of the 2008 financial crisis

The effect of the 2008 financial crisis and its aftermath played out in scheme valuations over several years. Similar issues arose to what we are seeing today, including investment volatility, falls in the value of assets, depressed gilt yields and including quantitative easing, giving rise to low interest rates, and pressure on employers' businesses, though with that pressure being less extreme than what is unfolding for many businesses now.

TPR's approach to valuations in that period, which may provide a useful point of comparison, showed a mixed approach to these issues:

- downplaying the importance of short-term investment volatility, despite its immediate impact on deficits, given that the investments were funding very long-term benefit obligations;
- consistently saying that technical provisions funding targets should be realistic and rigorous, and strongly discouraging moves to soften actuarial assumptions in order to lessen the impact of reduced yields on liability valuations, an approach which meant that employers and trustees should accept much larger deficits; but
- giving due allowance to what employers could afford to pay, and thereby accommodating some flexibility in the setting of deficit recovery plans, in particular the use of longer recovery plan timetables and back-end loading of contributions, to offset the impact of increased deficits, with the possibility that recovery plans could be revised as financial conditions changed.

This overall approach was consistent with TPR's oft-stated view that the most important element of flexibility in the UK pension scheme lies in the agreement of recovery plans, which could act as a "safety valve" for employers when dealing with the effects of volatility in assets and liabilities as well as changes in business performance and outlook. TPR also showed a cautious willingness to accept the use of collateralised structures such as asset-backed funding arrangements.

At the same time, the perception that increased deficits were acting as a drag on UK business and on economic recovery led to efforts at reform. Most notably, the statutory objectives of TPR were amended. Initially its objectives which were relevant to funding matters were those of protecting pension scheme benefits and reducing the risk of claims being made on the Pension Protection Fund (***PPF***). A change to its governing legislation added the objective of minimising adverse impact on the sustainable growth of an employer when regulating scheme funding – expressly requiring TPR to balance the interests of employers with those of scheme members and the PPF when carrying out this function.

Rebuilding scheme funding in today's regulatory environment

There was a retreat from that willingness to give more weight to employer business objectives in the wake of the BHS and Carillion insolvencies, which prompted intense political and media scrutiny of TPR and pension scheme trustees, and caused a general political shift to stricter and a more risk-averse approach to pensions regulation, most prominently in the Pension Schemes Bill and its introduction of more TPR powers and new, very widely drafted criminal offences.

That shift has also, to a large extent, influenced the design of the new Code and its regulatory framework. While the flexibilities that are inherent in the "scheme specific" funding regime will remain in place, the approach described in the Consultation Paper, with the introduction of "Fast Track" and "Bespoke" supervision processes, seems intended to discourage the agreement of valuation and funding packages that fall outside the narrow parameters needed to fall within the Fast Track process.

In its attitude to recovery plans, the Consultation Paper indicates that TPR will be less willing to accommodate some of the approaches to ensuring that DRCs would remain affordable for employers. For instance, TPR is consulting on whether fixed recovery plan lengths of around 6 years might be appropriate for the Fast Track, with recovery plans beyond this length requiring explanation under the Bespoke track. This is based on the maximum period of covenant visibility for most employers being 3-5 years (of course, in the current uncertainty the period of covenant visibility is likely to be significant less than this).

TPR is also concerned about a number of schemes with back-ended loaded recovery plans, which in some cases use extreme forms such as low or zero DRCs in the earlier years followed by steep increases or even a small number of bullet payments in later stages. This may have been used to minimise payments to schemes until the next valuation (in the hope that by then the funding shortfall will have reduced and contribution levels can be renegotiated) or artificially shorten the recovery plan length (so that the scheme does not appear as an outlier). The Consultation Paper asks for feedback on guidelines and restrictions on back-end loading.

The rigorous scrutiny that TPR intends to apply to valuations in the Bespoke process sends a signal that employers will need to push hard for divergent proposals to be accepted without TPR objection or challenge. This in turn will deter many trustees from agreeing to such proposals, as it will increase the perceived risk of doing so. Another concern here is the provision in the Pension Schemes Bill for new regulations that will set out mandatory factors to consider when assessing whether a recovery plan is "appropriate" and therefore one that complies with legislation. It is not yet clear what such regulations would say and we would expect the DWP to consult separately on such proposals before they are put into law, but these prescribed factors may have the effect of disallowing some of the approaches that were used in the past, or at least making them difficult to use.

The strict approach that emerged post-BHS may have been sustainable during a period of overall economic growth, in which many companies had sufficient cashflows and access to finance to meet pension scheme funding needs. Following COVID-19, many companies are likely to be in a fragile position. Some may see back-ended loaded recovery plans as a way of obtaining breathing space to rebuild the business until such time as it has the financial strength to support the scheme properly. An obvious danger for TPR is that in such an environment, less flexibility on DRCs could impair the recovery of businesses, restrict their access to finance or push them into insolvency.

The 2020 Annual Funding Statement will be an opportunity for TPR to signal its intentions. It is to be hoped that TPR will adapt its approach to the current environment, allowing the flexibility of the UK regime to operate so as to enable the sustainability of defined benefit pension schemes and the businesses which support them. This will allow employers and trustees to plan ahead for the challenging wave of valuations to come, and to come up with proposals that balance support for those schemes with business recovery.

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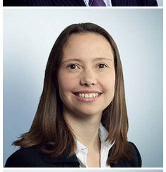

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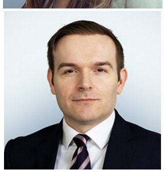

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