First Briefing, May 2023
TPR's 2023 Annual Funding Statement

The Pensions Regulator (TPR) has published its 2023 Annual Funding Statement. This will be of particular relevance to:

- Schemes with valuation dates between 22 September 2022 and 21 September 2023
- Schemes undergoing *significant changes that require a review of their funding and risk strategies*.

Key points

TPR notes that most schemes have seen improved funding levels following the significant changes in investment markets in late 2022. Where funding levels have improved significantly, trustees should consider reducing the level of risk in their funding and investment strategies.

A small number of schemes will have seen a deterioration in funding levels. Trustees of these schemes are expected to review their funding and investment strategies, as well as their operational governance processes. **Read TPR's recent liability driven investments (LDI) guidance** for more information.

TPR notes that schemes whose funding level has improved due to recent falls in asset and liability values may appear less reliant on the employer's covenant. However, TPR cautions against complacency, warning that this can change quickly in volatile economic conditions. Trustees should consider obtaining independent specialist advice to help them monitor the covenant.

As in recent years, the statement includes a set of tables outlining TPR's expectations according to scheme characteristics. This year's tables are similar to last year's, but with new encouragement in places to consider longer-term risks, including environmental, social and governance (ESG) risks, when reviewing covenant, and references to TPR's recent LDI guidance.

Read the full Annual Funding Statement

Funding

TPR has grouped schemes into three groups when considering funding strategy:

Group I: Funding level at or above buy-out

TPR estimates that around a quarter of all Defined Benefit (DB) schemes may now have sufficient assets to buy out their liabilities with insurance companies. For these schemes, trustees are encouraged to consider whether the best approach is to proceed with a buy-out (either outright or in stages) or to run the scheme on.

Group II: Funding level above technical provisions but below buy-out

TPR encourages these schemes to consider whether their long-term objective and timescale for reaching it remain appropriate. It also suggests that good practice is to consider steps to align with the key principles of the draft funding code. Where trustees have not already done so, they should agree a long-term funding target (LTFT) as a priority.

Group III: Funding level below technical provisions

TPR encourages trustees of these schemes to focus on bridging the gap to technical provisions, while making sure any risk-taking is supported by the employer's covenant. It suggests that risk-taking should be reduced as the scheme matures or its funding level improves. Deficits should be recovered as soon as the employer can reasonably afford to do so.

Investment

TPR notes that for many schemes, events in 2022 mean that their current asset allocation is now materially different from where it was expected to be. Trustees of such schemes should consider reviewing their investment strategy. Trustees should also consider whether it is appropriate to de-risk investments.

For some schemes, there is now a greater proportion of scheme assets that are illiquid; trustees should consider whether these should be retained or sold.

Covenant

TPR accepts that many schemes may now appear less reliant on the employer covenant, where funding levels have improved. It does, however, caution that this can change quickly in volatile economic conditions, and urges trustees and employers to continue to share information. Trustees should consider obtaining specialist advice, particularly where the covenant is complex or deteriorating.

Other considerations

Inflation

TPR acknowledges the continued challenges from high inflation rates, and states that its views are unchanged from those in last year's statement.

Longevity

TPR notes the observation of the Continuous Mortality Investigation (CMI) that, over the last year and a half, mortality rates have begun to stabilise at a higher rate than before the pandemic. Mortality from 2022 onwards may suggest lower life expectancies in future. However, some caution is needed, and it will take time to see trends develop. TPR expects that many trustees will revise their mortality assumptions – they should ensure that changes are appropriate and justifiable.

Revising recovery plans

TPR acknowledges some trustees will be considering reducing or stopping employer contributions, either as part of an actuarial valuation (where funding levels have improved) or following a request from the employer, and sets out points for trustees to consider.

Key risks and TPR expectations

In recent years, TPR has set out its expectations in tables of the key risks that trustees and employers should focus on and actions to take, according to scheme characteristics. There are five scheme types:

	Covenant	Funding
A	Strong or tending to strong employer	Funding level on track to meet LTFT, or ahead; technical provisions are strong and recovery plan is shorter than six years.
B	Strong or tending to strong employer	Funding level behind plan, and/or technical provisions are weak, and/or recovery plan is longer than six years.
C	Weaker employer with limited affordability	Funding level on track to meet LTFT, or ahead; technical provisions are strong and contributions are reducing deficits at an affordable pace.
D	Weaker employer with limited affordability	Funding level behind plan, and/or technical provisions are weak, and/or recovery plan is longer than six years.
E	Weak employer unable to provide support	Stressed scheme with limited or no ability to use flexibilities in the funding regime.

Each table is then further subdivided according to whether the scheme is relatively immature or mature. This year's tables are similar to those published last year, but with added references to reviewing LDI strategy under investment and understanding longer-term risks, including ESG factors under covenant (the latter only for immature schemes with stronger employers).

Trustees are asked to find the table closest to their situation and consider the key risks identified as well as the features of the funding plans expected. Trustees are also encouraged to consider the draft DB funding code, which is now expected to come into force in April 2024 (although it is accepted that this is not yet a requirement).

Further information

For further information, please contact your usual First Actuarial consultant.