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# Annual Funding Statement 2022 Key risks and actions

## Introduction

The Pensions Regulator (TPR) has just released its latest Annual Funding Statement (AFS).

AFS 2022 is particularly relevant to trustees approaching 'Tranche 17 valuations'[1] and recognises the pressures (e.g. the economic background) and uncertainties (e.g. Ukraine) that trustees are facing, and the potential impact of this on their pension scheme funding and employer covenant. TPR nevertheless expects trustees to "remain alert", to think about their long-term funding target and journey towards it and to consider risks in an integrated way.

Importantly each scheme is expected to "consider its position depending on its own circumstances".

This year's AFS, as with AFS 2021, is accompanied by helpful tables setting out key risks that TPR expects trustees and employers to focus on, and actions to take, depending on the scheme's funding strength, maturity, and strength of the employer covenant. The tables are the same as last year, except the reference to the length of the recovery plan has been updated to six years (to reflect that recovery plan lengths have decreased over recent years and the average is now less than six years across all valuation tranches).

### Key points from AFS 2022

- TPR expects all T17 valuations to fully incorporate the principles in the current DB code of practice, as well as associated guidance and relevant TPR updates.
- Current economic uncertainty and events will have an impact on pension scheme management, and this can manifest itself in a range of ways (the more apparent, such as changes in asset values, liabilities and employer covenant and the less obvious, such as the impact of the situation in Ukraine on cyber risks).
- In the context of significant events, the latest AFS (consistent with AFS 2021) states that trustees should consider the overall impact these may have on the employer's business and categorise this in one of three ways (taking advice and / or maintaining an open dialogue with management, as required):
    - Current market events have had limited impact on the business. There has likely been no balance sheet weakening and cash flow has remained strong.
    - Current market events have had a material impact, but trading has recovered or is recovering strongly, or some impact is anticipated but expected to be short-lived. Any weakening of the balance sheet can be repaired over a short period, and the medium-term prospects have not been negatively impacted.
    - The impact of current market events continues to be material. The pace of recovery is uncertain and could take years, or the business may never fully recover. Short-term affordability is stressed. The balance sheet has weakened due to measures taken to raise additional liquidity and to secure lender support. Medium-term prospects are unclear.

[1] Schemes with valuation dates between 22 September 2021 and 21 September 2022 (known as Tranche 17, or T17 valuations)

- Employers should provide trustees with financial projections and business plans, and trustees should continue to undertake stress testing or scenario planning to understand the impact of possible future economic environments.

- With regard to recovery plans and affordability, these should be considered in line with the categories mentioned above (e.g. as per AFS 2021, where employers are experiencing short-term affordability constraints, trustees should carefully consider any requests to accept a temporary reduction in contributions. TPR expects any such request to be short term, with higher contributions in subsequent years limiting any extension to recovery plan end dates).

- Following a hiatus during the pandemic, TPR has seen an increase in employers returning cash to shareholders through recommencing dividends, paying 'special' dividends and share buybacks. In line with previous TPR statements (see, in particular, AFS 2019), trustees are expected to be alert to this and consider whether their scheme is being treated fairly compared to other stakeholders. Trustees are also expected to remain vigilant of other forms of covenant leakage.

- As with previous years, trustees are expected to act quickly when faced with corporate activity and seek mitigation for any detriment.

AFS 2022 covers actuarial and investment considerations (interest rates, inflation and mortality) and, on managing risks, continues (as with AFS 2021) to recommend that schemes adopt a specific long-term strategy designed to deliver an agreed long-term objective. This will become a legal requirement under the Pension Schemes Act 2021 in due course, but TPR wants trustees to consider taking steps now to incorporate this approach.

As part of the second consultation on the draft DB funding code, to be launched later in 2022, TPR plans to set out proposed changes to its August 2015 guidance on Assessing and Monitoring the Employer Covenant and other related guidance. TPR will provide more detail on how to treat guarantees for scheme funding purposes and more information regarding environmental, social and governance (ESG) and how this can be factored into the covenant. TPR will also outline various examples to support trustees in understanding how to apply any updated guidance.

## Comment

As highlighted throughout this summary, the latest AFS (published around a month earlier than AFS 2021) is consistent with previous statements. We welcome this consistency in messaging from TPR, especially in the current environment where trustees have enough uncertainty to grapple with.

Trustees should take on board the key points above and review the 'key risks' document that accompanies AFS 2022, using this to match their specific scheme circumstances with TPR's expectations.

Finally, keep an eye out for the updated guidance and second scheme funding consultation mentioned above.