Short-term cashflow crisis, ongoing pressures

TPR allowed sponsors to defer deficit recovery contributions (DRCs) as a short-term measure to ease the financial pressures created by the Covid-19 crisis. Two years on and new challenges mean deferrals may still be required, finds Gill Wadsworth

Summary
- The Pensions Regulator has kept the door open to deficit recovery contribution deferrals for short-term cashflow difficulties.
- Current economic conditions continue to place pressure on scheme funding post-pandemic raising possibility of an increase in requests to defer contributions.
- Deferrals will be assessed on a case-by-case basis and should not be granted where the sponsor's long-term financial stability is in doubt.

The risks facing UK defined benefit (DB) pension scheme funding levels listed in The Pensions Regulator's (TPR) 2022 Annual Funding Statement makes for alarming reading.

"Trustees will be approaching Tranche 17 valuations against an economic background of high inflation, high energy prices, higher interest rates and slower economic growth – all of which may impact on their pension scheme funding and employer covenant," the statement reads.

How all this will play out is "unclear" and any unpleasant outcomes may be compounded by "the lingering effects of Covid-19 and Brexit".

Given that employers are in the middle of a perfect storm, TPR has continued to allow them to defer deficit recovery contributions (DRCs).

"Where employers are experiencing short-term affordability constraints, trustees should carefully consider any requests to accept a temporary reduction in contributions," TPR states.

"We expect any such request to be short term, with higher contributions in subsequent years limiting any extension to recovery plan end dates. We will continue to view shareholder distributions as being inconsistent with the scheme receiving lower contributions, and we expect any deferred DRCs to be repaid – ideally before any shareholder distributions recommence."

Short-term cashflow

TPR introduced deferrals to DRCs at the height of the pandemic when the UK first went into lockdown in 2020 in cases where employers had "an immediate or demonstrable cashflow need for the foregone contributions".

Breaks in DRCs did not come without stipulations on trustees, such as ensuring the sponsor's long-term financial stability was not impacted and that they demand suitable protection and mitigations, including suspension of dividend payments and the scheme be treated equivalently to other creditors.

It was only a matter of months before TPR updated the guidance in June 2020 asking trustees to carry out greater due diligence into Covid-19's impact on employers' short-term cash flow before agreeing to DRC deferral.

As such, relatively few schemes took advantage of DRC referrals.

TPR reported just 10 per cent of schemes had asked for a support in the four months to June 2020, and in the *2021 Annual Funding Update* the regulator stated: "Our experience following the publication of last year's Covid-19 guidance shows that only a small proportion of employers have asked to suspend or reduce DRCs".

Grant Thornton head of pensions advisory, Paul Brice, says: "Our experience has been that employers took a responsible approach to requests for deferral, seeking concessions where there was a genuine case for needing support for the employer through turbulent and risky economic circumstances."

Careful consideration

For many trustees the Covid-19 pandemic was the first time trustees were put in a position where they had to assess short-term impacts and make a decision that allowed employers to reduce or halt contributions.

Legal & General Investment

Management head of fiduciary management, Tim Dougall, says: "If trustees were being asked to defer deficit contributions, they were having to make a decision based on not a lot of information. A lot of trustees will have gone through that stress test of whether their sponsor was going to run out of cash, and they will have learnt a lot."

Dougall adds that while some schemes may have been granted deferrals, plenty of schemes turned down applications.

"We saw schemes where trustees didn't accept requests to defer DRCs because they did not see the financial difficulty as a short-term issue and recognised there could be a long-term impact from the pandemic on their sponsor's business."

Brice agrees that trustees considered delays to DRCs "very carefully – and did not just 'roll over'".

He adds: "Requests needed to make strong commercial sense for the longevity of the sponsor and benefit of the scheme; involve appropriate contingent asset support for the amounts deferred; and be mindful of equitable treatment with other stakeholders."

Both Brice and LGIM say that, in their experience, sponsors have honoured DRCs agreements and that many employers have already paid back contributions in full.

Black swan event

The question now is whether TPR's willingness to keep the door open to DRC deferral means there is a chance more employers will attempt to use the flexibility for non-Covid related financial difficulty.

Eversheds Sutherland partner, Emma King, says: "The regulator guidance on DRC suspensions were all pandemic led, but actually we're coming up with yet another black swan event in terms of the energy supply situation and the crisis with Ukraine. Are there going to be new reasons for employers who weren't affected by the pandemic, to have to look to suspension of deficit repair contributions if they are affected by these issues?"

By way of example, this April, Mothercare, which went into administration in 2019, informed the pension trustees it would not pay the first instalment of the deficit recovery due to reduced cash generation following the suspension of its Russian business. Trustees have not agreed a new DRC schedule and discussions with the sponsor are ongoing.

As of 28 February 2022, the Mothercare scheme's deficit stood at £66 million, with total assets of £412 million and liabilities of £478 million. This represents an improvement on the scheme's last full actuarial valuation, as of 31 March 2020, when the deficit was £124.6 million, and February 2022's figure is £25 million less than the £91 million deficit recorded as of 30 October 2021.

Mothercare's deficit recovery reflects an overall picture of improved scheme funding post-pandemic. Figures from LGIM show the health of the UK's DB pension schemes has been gradually improving since March 2020, reaching a new high in the fourth quarter of 2021, with the average scheme expected to be able to fund 98.4 per cent of accrued pension benefits as of 31 December 2021.

WTW head of defined benefit funding, Graham McLean, says since most schemes are ahead of schedule when it comes to clearing deficits, there is no reason to open deferrals up further and a return to 'business as usual' by TPR makes sense.

"Where shortfalls remain, the regulator does not want employers to take their foot off the gas, except where they face specific challenges. Accordingly, it has returned to its pre-pandemic hymn sheet in warning that dividends should only exceed deficit contributions when funding targets are strong and recovery periods relatively short."

Yet the fact remains that the next 12 months will remain crucial for both pension schemes and other investor groups, as we move into an era of tighter monetary policy.

And Brice says sponsors' willingness and ability to pay DRCs will differ based on their sector and company type.

"The position is very company and sectoral specific. Some sponsors were broadly unaffected by the pandemic; others have needed to address financing and liquidity issues arising as their businesses were significantly curtailed. The situation for a number of employers has more recently been exacerbated by inflation, supply chain disruption or skills shortages."

However, he adds that Grant Thornton has observed "no systemic shift to requesting DRC deferrals; the circumstances of Covid were highly specific."

A TPR spokesperson told *Pensions Age* that DRC deferrals may be considered in any event that creates short-term financial challenges.

"Where schemes are in deficit against their technical provisions, trustees should focus on recovering the deficit. Where employers are experiencing short-term affordability constraints, trustees should carefully consider any requests to accept a temporary reduction in deficit repair contributions. TPR expects any such request to be short term, with higher contributions in subsequent years limiting any extension to recovery plan end dates, and will continue to view shareholder distributions as being inconsistent with the scheme receiving lower contributions," it states.

Whatever the driver for a deferral request, King says it critical that trustees carefully assess any delay proposals from their sponsor.

"Employer covenant advice from specialists is so much more important these days than it ever was," she says.

Written by Gill Wadsworth, a freelance journalist