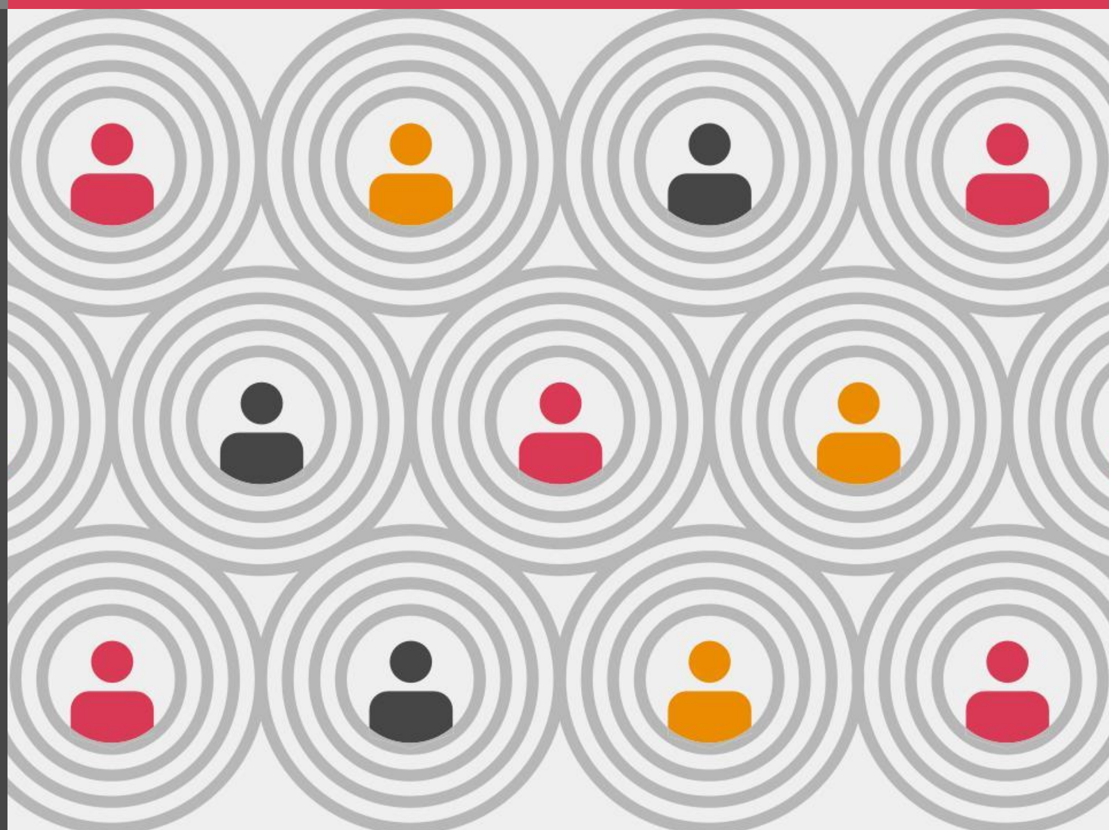
Defined benefit pensions

Regulation update: Code of Practice for pension plan funding
December 2022



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Defined benefit pensions

Regulation update

On Friday 16 December, The Pensions Regulator (TPR) issued its second consultation package on how it intends to regulate the funding and investment strategies followed by defined benefit pension schemes in the UK. The consultation lasts 14 weeks. The new framework and code of practice will apply to valuations with effective dates after they come into force (now expected to be October 2023) and not valuation processes that are in-flight at that time.

We recommend trustees and sponsors start considering how the new approach will impact their schemes immediately, given the potential need for a significant change in approach for some schemes. We expect the code will lead to the need for trustees and sponsors to work in a collaborative way to meet the new requirements.

At over 200 pages in total the consultation is a substantial read, so we have summarised the key points below.

The draft code of practice

The draft Code sets out the principles that all trustees are expected to follow to comply with their legal requirements. Following the principles in the code will allow trustees and sponsors to agree scheme specific bespoke funding arrangements but trustees will then need to provide TPR with evidence to justify the decisions they make. The alternative route is to submit a valuation that complies with the Fast Track parameters (see page 7) – here the code of practice will still apply but TPR is unlikely to require further information about the scheme's funding and investment arrangements (beyond the standard valuation submission requirements and the new disclosure requirements in the Statement of strategy – see page 7).

Summary: TPR's second consultation

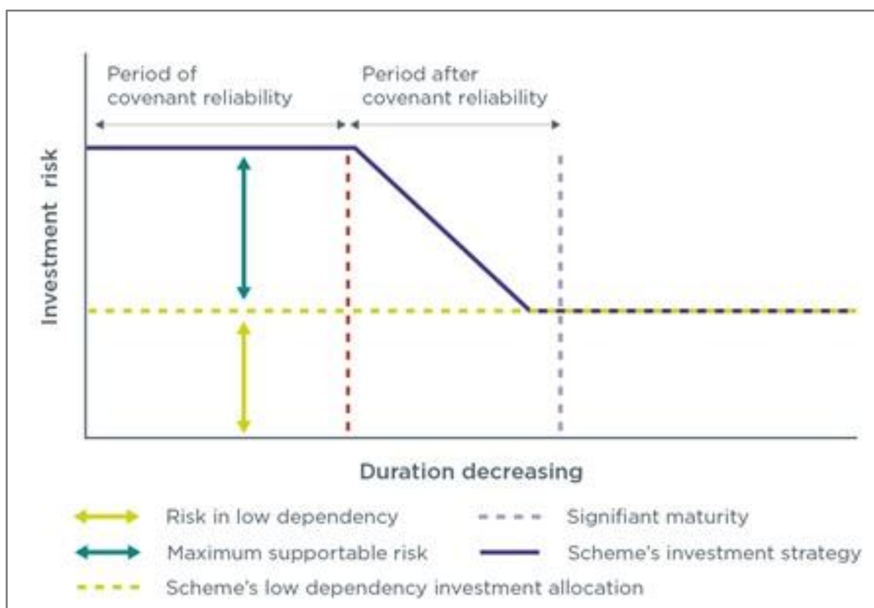
The second consultation builds on the March 2020 consultation exercise TPR conducted and sets out:

- The principles that TPR expects all trustees to follow when they:
  - Set long-term funding and investment strategies to have a 'low dependency' on their employer's covenant.
  - Determine when the pension scheme needs to reach this long-term objective.
  - Assess the employer's covenant and how much reliance should be placed on the covenant over the journey plan.
  - Determine how much risk should be taken in the short and long-term by reference to the employer's covenant.
  - Conduct valuations.
- A detailed summary of the information that trustees will need to provide to TPR in a new document – the statement of strategy.
- A set of 'Fast Track' funding and investment parameters that TPR considers sufficiently low risk to mean it would not need to investigate a valuation further.

Defined benefit pensions (continued)

Regulation update

What does TPR's proposed funding and investment risk framework look like?



The framework that trustees and employers will need to follow is summarised in the diagram above. In essence, trustees and employers will need to:

1. Identify an appropriate long-term investment strategy which will give the scheme a low dependency on the employer covenant.
2. Set a low dependency funding basis that is consistent with the low dependency investment allocation.
3. Then understand two key timeframes:
   a. The period that the trustees can reasonably rely on the employer covenant (the 'covenant reliability' period) – TPR proposes that this is the period in which the trustees can take a higher level of investment risk if they wish to.
   b. The point in time at which the scheme will become 'significantly mature' – this is the point at which the scheme should be invested in line with the low dependency investment allocation and therefore be unlikely to need further support from the sponsor.
4. Understand the maximum supportable level of risk that could be taken in the period of covenant reliability by reference to the employer's maximum affordability from cash generation.
5. Decide how much risk will be taken during the covenant reliability period and how the risk will be reduced as part of a 'journey plan' after the period of covenant reliability.
6. Document this plan in a statement of funding strategy.

Defined benefit pensions (continued)

Regulation update

What is a low dependency investment allocation?

DWP's draft regulations define the low dependency investment allocation as an allocation in which:

- 'Cash flow from the investments is broadly matched to the payment of pensions'.
- 'The value of the assets relative to the value of the liabilities is highly resilient to short term adverse changes in market conditions.'

The objective of this allocation is to minimise the expectation that the employer will need to make further contributions to the scheme.

In the draft code of practice, TPR gives more detail about what it expects from a low dependency investment allocation, which includes:

- High resilience to short term changes in market conditions, defined as the trustees demonstrating that the funding level of the scheme would fall by less than 4.5% in a 1-in-6 year stress test scenario.
- The type of 'matching' assets that would meet the requirement to 'broadly cashflow match', including: government and corporate bonds, some types of property and infrastructure assets plus illiquid and alternative credit assets where they are likely to produce predictable and stable payments.
- TPR also notes that 'broadly cash flow matching' doesn't require exact cash flow matching and trustees could reasonably continue to include an allocation to growth assets beyond the time of significant maturity. TPR gives examples in which the 4.5% funding level stress test is met with 15% to 30% of the assets allocated to growth assets.
- An expectation that schemes will have a minimum level of interest rate and inflation hedging of 90%.

The low dependency funding basis

This should be set to be consistent with the long-term investment allocation and set at a level so that if the scheme was fully funded on this basis no further contributions would be expected from the employer. Assumptions should be chosen prudently, with more prudence in the assumptions where there is more uncertainty.

Helpfully, TPR comments that discount rates can be set in a simplistic 'gilts plus' way or in a 'dynamic' way to reflect the yield on the actual assets held (adjusted for likely levels of default).

TPR expects trustees to include an allowance for expenses in the low dependency liabilities, particularly where there is no legal requirement in the scheme's rules for the employer to pay expenses. The expense loading should be consistent with the long-term strategy (e.g. the estimated expenses of buying out or running off the scheme).

Timescales

Covenant reliability: this is the period over which trustees can have 'reasonable certainty' that the employer will have available cash to fund the scheme. For most employers this is expected to be over the medium term (we expect this means no more than 5-6 years).

Significant maturity: significant maturity is the point in time when the majority of the pension scheme's members are in receipt of a pension. The DWP and TPR currently favour a technical measure of significant maturity referred to as a scheme's duration[1]. The draft code states that significant maturity is when a scheme's duration reaches 12 years measured on the low dependency funding basis.

The date at which a scheme is expected to become 'significantly mature', i.e. has a duration of 12 years, defines what is known as the 'relevant date' which must be no later than the end of the scheme year in which the point of significant maturity occurs.

[1] 'duration' is the weighted mean time until the payment of pensions and other benefits under the scheme, weighted by the discounted payments.

Defined benefit pensions (continued)

Regulation update

Maximum supportable level of risk

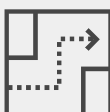
To determine the maximum levels of investment risk that are supportable during the period of covenant reliability (the maximum risk strategy), trustees will need to be comfortable that, as a minimum, the employer could repair any additional deficit over the period of covenant reliability that would result from a 1-in-6 stress test being applied to the assets and liabilities. Here the liabilities are the scheme's technical provisions and not the low reliance liabilities.

The journey plan and the period after covenant reliability

After the period of covenant reliability, trustees are required to set out a plan to bridge from the current funding and investment position to the low dependency position by the relevant date, known as the 'journey plan'.

If trustees are adopting a maximum risk strategy, TPR's view is that after the period of covenant reliability, investment risk should reduce in a linear way to the point of significant maturity. TPR expects that many trustees and sponsors will not want to adopt this maximum risk approach and comments that this approach may not be appropriate if the trustees have concerns about the longevity of the covenant.

At future valuations, the period of covenant reliability may remain unchanged and as a result will be closer to the relevant date. TPR accepts that this may mean that trustees conclude that the period before de-risking starts can be extended (but the scheme would still need to be invested in line with the low dependency investment allocation by the relevant date).



Covenant assessment

Covenant forms a critical underpin to TPR's proposed new approach, with maximum affordable contributions and the covenant horizon forming the basis for a key stress test. Covenant assessment will now be based on:

i. The employers' cash flow.

ii. The employers' prospects and the likelihood of an insolvency event.

iii. Any contingent assets available to the scheme.

Covenant should be assessed compared to the low dependency and solvency deficit (a shift from the previous focus on the technical provisions deficit), as well as the risk in the funding and investment approach.

To assess maximum affordable contributions, trustees will need to determine the employers' 'free cash flow' by reviewing management forecasts and making an assessment of other uses of cash including: investment in sustainable growth, 'covenant leakage' (such as dividends), and discretionary payments to other creditors.

The code will introduce three new covenant concepts for covenant period:

- **Covenant visibility:** length of employer forecasts (1-3 years).
- **Covenant reliability:** as previously noted, the period over which trustees can have 'reasonable certainty' that the employer will have available cash for a certain period (medium term).
- **Covenant longevity:** maximum period trustees can assume employer in existence to support the scheme – 10 years for most (or 15 if underpinned by long-term contracts for example).

Defined benefit pensions (continued)

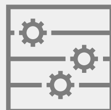
Regulation update

Covenant assessment (continued)

Contingent assets should only be recognised to the extent of the value they will provide in the scenario in which they might be called upon (e.g. insolvency of the employer). In particular, guarantees which allow for a 'look through' to the guarantor (i.e. evergreen and covering all monies owed by the employer) should be considered differently to guarantees limited by amount or duration.

TPR will require trustees to submit their assessment of a number of key measures, including:

1. The employer's cash flow and liquidity.
2. The covenant 'visibility' and 'reliability' periods.
3. The employer's prospects and an estimate of the covenant 'longevity'.



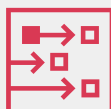
Recovery plans

The DWP's draft funding regulations state that deficits should be recovered as soon as the employer can reasonably afford. TPR sets out steps that trustees should follow in interpreting 'reasonable affordability', including assessing the:

- Employer's cash.
- The reliability of the available cash.
- Other reasonable other uses of available cash that the employer might have.

In agreeing a recovery plan with the employer, TPR clarifies that trustees can:

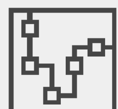
- Take account of post valuation experience.
- Make an allowance for investment out performance to the extent it is supported by the employer's covenant.



The statement of strategy

This is a new document that the trustees will need to prepare after each valuation and submit to TPR. Technically, it has two parts:

- **Part 1:** sets out the trustees overall funding and investment strategy and how they intend to achieve a low level of dependency on the sponsor by the relevant date. Part 1 must also include specific details of the assets the trustees intend to hold at the relevant date, and the way in which the trustees intend pensions to be provided over the long-term (e.g. via an insurance buy-out or run off). The trustees must also comment on how well the funding and investment strategy is being implemented. The employer is required to agree to the funding and strategy described in Part 1.
- **Part 2:** will require the trustees to set out the journey plan in detail, including: the main risks faced, the actions the trustees will take if the journey plan does not progress as expected, the trustees assessment of the strength of the employer's covenant, the current level of risk in the investment strategy, how the asset allocation will change over time, the assumptions used to calculate the technical provisions and how the discount rate will change over time, a calculation of the scheme's current duration, the funding level on a low dependency basis and the assumptions used, comments on how the investment strategy will provide significant liquidity to pay pensions, that the trustees have consulted with the employer on the plan set out in Part 2 and any comments the employer has asked to be included.



Defined benefit pensions (continued)

Regulation update

Fast Track

Fast Track will not be set out in the code of practice, rather it will be a set of filters used by TPR to determine which schemes to focus its regulatory resources on. The intention of Fast Track is that it represents a simple path for trustees to demonstrate compliance.

Whilst trustees are still expected to assess the strength of the employer's covenant, Fast Track will be independent of covenant and the parameters are simply a function of a scheme's duration. If trustees follow a Fast Track route to compliance, the scheme actuary will need to confirm that the valuation meets all of the Fast Track parameters.

The requirements of Fast Track include:

- A low dependency funding basis with a discount rate equal to the gilt yield curve plus an addition of no more than 0.5% p.a.
- At each duration TPR has defined a maximum percentage that the technical provisions can have relative to the low dependency liabilities and a maximum asset and liability stress test (based initially on the stress tests used in setting PPF levies).
- Maximum recovery plan lengths of no more than 6 years prior to a duration of 12 years and 3 years at shorter durations.
- Deficit reduction contributions can increase by no more than CPI.
- Asset and liability post valuation experience can be allowed for when setting recovery plans.
- No allowance for investment outperformance can be made in the recovery plan.

TPR provides some details on how it has set the Fast Track requirements, these include:

- An assumption that the investment strategy at significant maturity (12 year duration) is 15% growth and 85% bonds and cash.
- An investment strategy at a duration of 17 years or greater of 60% growth and 40% bonds and cash.
- A liability valuation basis that assumes a discount rate of 'gilts plus 2%' up to a 17 year duration and then reduces to 'gilts plus 0.5%' by a duration of 12 years.

Open schemes

Open schemes will need to comply with code of practice and will still be expected to have a journey plan and funding framework that assumes that investment risk and discount rates will reduce to the low dependency positions after the period of covenant reliability and by the time significant maturity is reached.

Trustees of open schemes will be able to make a reasonable allowance for future accrual and new entrants when calculating the scheme's duration. This allowance may increase the scheme's duration which may mean that a higher level of risk can be taken for a longer period of time. TPR would not normally expect any allowance for future accrual and new entrants to extend beyond the period of covenant reliability. TPR recognises that for some open schemes this will mean that the scheme does not get any closer to the point of significant maturity from one valuation to the next.

Open schemes that want to follow the Fast Track route to compliance will need to carry out the same tests as a closed scheme but when calculating their duration they can:

- Allow for up to 6 years of future accrual based on the current membership structure.
- If they are open to new members, the assumed number of new entrants can not exceed the average level over the three years preceding the valuation.

TPR notes that surplus in an open scheme could be used to fund future accrual if the trustees views this as being appropriate.

What about the DWP's funding regulations that are still in draft?

TPR is consulting on a draft code of practice that is compatible with the current, still in draft, funding regulations and acknowledges that any changes to the draft regulations will need to be incorporated in the final version of the code.

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