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Sixty second summary

Revising the DB Funding Code (phase one)

The Pensions Regulator has initiated the first phase of consultation on a revised Code of Practice for the funding of defined benefit (DB) schemes.[1] This phase solicits comments on TPR's proposed approach and underlying principles. The headlines are a twin-track route to valuation compliance, with the focus on a long-term objective. It puts the onus on trustees to demonstrate compliance and could lead to major overhauls in funding and recovery plans.

Consultation details

The Regulator is using a two-stage consultation process: the first (current) stage is about the approach to be taken and the principles to be applied. A draft Code will then be exposed at the second stage, which is likely to be held toward the end of 2020 (once the *Pension Schemes Act 2020* and supporting regulations are in place). The second phase will include the Regulator's plans for enforcement and keeping the Code up-to-date. Responses to the first consultation should be submitted by 2 June 2020.

Overarching principles

The Regulator puts forward a proposed list of principles that should underpin funding valuations:

- trustees and sponsors should understand their funding and investment risks and be able to demonstrate how they have been evaluated and managed;
- trustees should be able to compare their risks to a '*tolerated risk position*' (more on which later) and provide evidence of any risk-mitigation or support available to them;
- as a long-term objective (LTO), schemes are expected, by the time they are significantly mature, to have low levels of sponsor dependency and investment risk;
- trustees should have a plan for reaching their LTO;
- technical provisions (TPs—the amount, calculated as part of an actuarial valuation, to provide for a scheme's liabilities) should be clearly and explicitly linked to the LTO and converge upon it over time[2];
- a scheme's investment strategy and asset allocation should (in the long run) be broadly aligned with its funding strategy;
- investment strategies should be tailored to the scheme's security, credit quality and liquidity needs (making reasonable allowance for unexpected cash flows when considering liquidity);
- the asset allocation at significant maturity should be highly resilient to risk, highly liquid, and have high average credit quality;
- schemes with stronger employer covenants can take more risk and assume higher returns (whilst still assuming that reliance on that covenant will decrease over time);
- non-cash forms of sponsor support can be taken into account in valuations so long as they support the level of risk being run, are appropriately valued, and are reliable (legally and with realizable values);
- valuation deficits should be eliminated as soon as possible without adversely affecting the sponsor's sustainable growth prospects; and
- benefits still building up in open schemes should be as secure as those in closed schemes.

[1] <www.thepensionsregulator.gov.uk/en/document-library/consultations/defined-benefit-funding-code-of-practice-consultation>.

[2] In the Regulator's analogy, '*the LTO is the destination, the TPs are the journey milestones, and the RP* [recovery plan] *is the corrective measure to get back on track.*'

Fast Track vs Bespoke

The Regulator says that a lack of clarity over the expected prudence of technical provisions and the appropriateness of recovery plans has permitted misuse of the flexibility in the scheme-specific funding regime. As a means of supplying clarity without losing that flexibility altogether, it proposes to establish a '*twin-track*' route to valuation compliance, allowing trustees to choose either the '*Fast Track*' or the '*Bespoke*' path for each valuation.

Fast Track is a more prescriptive, but less demanding route to compliance, as regards the requirement to provide supporting evidence and the expected level of regulatory scrutiny. Under it, the Regulator will set (and keep up to date with market changes) parameters for funding and investment features like the LTO, discount rates for technical provisions, recovery plan length and structure, investment risk, and future-service contribution rates in open schemes. These are essentially a series of pass/fail tests, tailored to a scheme based on its maturity levels and the strength of the sponsor's covenant. The appropriate balance between benefit security and costs—how high the Regulator 'sets the bar'—will be covered in the second consultation phase, whereas this phase is focused on the structure of the framework.

As the name suggest, the Bespoke route will permit more freedom to (for example) take additional, managed risks, but the *quid pro quo* will be a higher evidential burden and closer regulatory scrutiny. The Fast Track measures will be used to establish a benchmark for '*tolerated risk*', against which schemes using the Bespoke route will be assessed. TPR's starting point is to ask trustees using the Bespoke route to demonstrate how their strategy is equivalent to Fast Track; or if not, why not.

Long-term objective (LTO)

Trustees will be expected to formulate a LTO (a '*funding and investment strategy*', in *Pension Schemes Bill* parlance) by which they will aim to have reduced their dependence on the sponsor covenant and be invested in risk-resilient assets by the time their scheme reaches significant maturity. The Regulator gives its current thoughts on how '*low dependency*' and '*significant maturity*' might be defined in the context of the Fast Track route to compliance. Top billing goes to the potential Fast Track LTO discount rate in the range 'gilts+0.25%' to 'gilts+0.5%'. Schemes are to target this when most or all of their members have retired (in technical terms, a remaining liability duration of 12-to-14 years, which is assumed to be 15-to-20 years away for typical schemes).

Technical Provisions

Under Fast Track, technical provisions could be set using a grid of percentages of LTO based on the scheme's maturity (dovetailing to 100 per cent of LTO over time). Stronger employers (using TPR's four covenant-assessment groups) will be allowed to take more risk and to set lower TPs than weaker employers. The Regulator is considering whether to set other assumptions too (such as longevity), but expresses a preference for leaving the responsibility with trustees.

Investments

The Regulator reassures readers that it is not trying to dictate how trustees invest; its interest is in ensuring that they take on an appropriate, and appropriately supported, level of investment risk. Fast Track includes a simple stress test to govern this.

Recovery plans

All other things being equal, schemes with stronger employers are expected to have shorter recovery plans. Fast Track could set maximum recovery periods ranging from 6-to-12 years. If the employer cannot afford the sort of recovery plan that the Regulator considers appropriate, supporting evidence is required and alternative methods of support must be explored.

Open schemes

Significant thought is devoted to how open schemes comply with the new Code without making future service unaffordable.

The new Code will not take effect until 2021 at the earliest. It is likely to be very different from the current document, but will encapsulate and amplify many of TPR's recent messages about good practice. The principles expounded are common practice for well-run schemes; however, the Regulator warns that '*there could be significant impact for some schemes, particularly those that have been running excessive and unjustifiable levels of risk.*'.