New funding code

Late last summer, our *Investment Perspectives* article 'A journey plan towards the ultimate destination' [2] provided a 'heads-up' on the new, more prescriptive DB code of practice on scheme funding that The Pensions Regulator (TPR) was busy working on and what that meant for schemes' investment strategies. At that time, I was heading off on summer holidays and the article provided a light-hearted analogy of setting a long term objective to planning a summer trip – for obvious reasons, planning the summer holiday this year feels less certain if March 2020 is anything to go by.

On 3 March 2020, TPR's first consultation on the new, more directive funding code was released[3]. This is the first of two planned consultations being run by the Regulator and focuses on their proposed approach, the principles of the new code and how these could be applied in practice. The new code is expected to come into force in 2021, with valuations submitted after that being subject to the revised code.

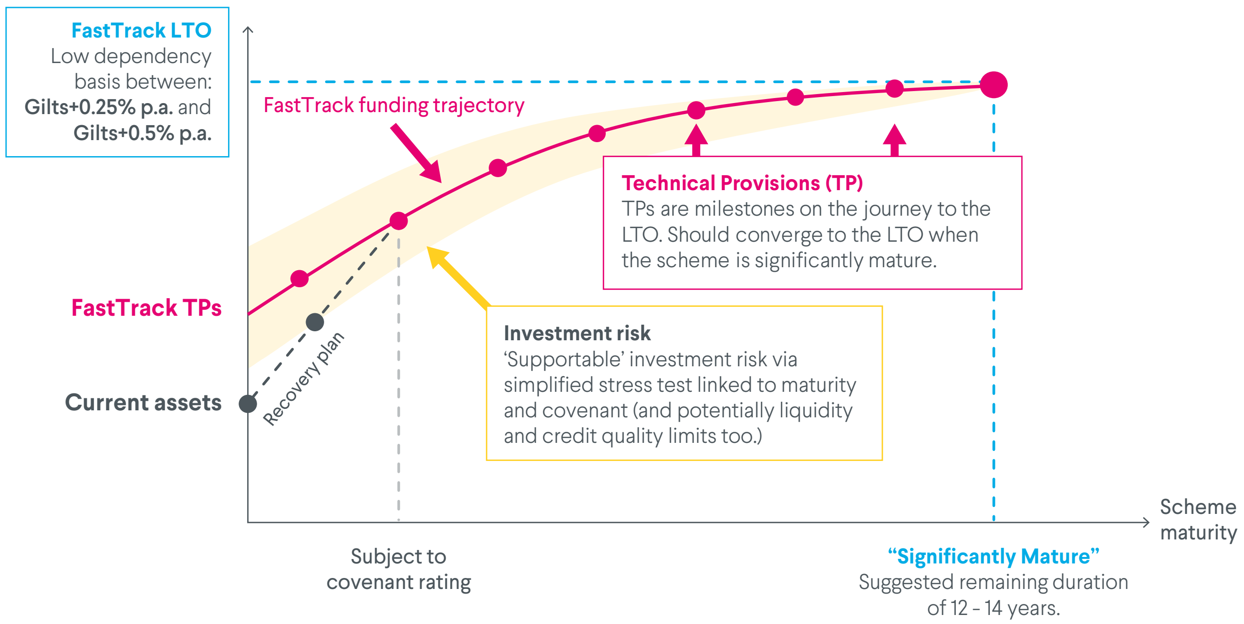
2 https://www.hymans.co.uk/insights/research-and-publications/publication/investment-perspectives-journey-plan-towards-the-ultimate-destination/

3 https://www.thepensionsregulator.gov.uk/en/media-hub/press-releases/2020-press-releases/major-consultation-on-clearer-db-funding-standards-launched-by-tpr

The key principles of the code are summarised and illustrated in Diagram 1 below:

- A twin track compliance approach for valuations – 'FastTrack' vs. 'Bespoke'.
- More clarity on how sponsor covenant is allowed for within a scheme's funding plan and further specifics on appropriate recovery plans (shape and length) based on sponsor strength.
- The submission of valuations to TPR via a 'Statement of Strategy'.
- A requirement for schemes to set a Long Term Objective (LTO).
- Once 'significantly mature', schemes are expected to target full funding on a low dependency basis – this range is currently set at Gilts + 0.25% p.a. to Gilts + 0.5% p.a. under FastTrack.
- Technical Provisions (TPs) should be linked to the LTO with a clear journey plan for getting there and removing deficits over the short term.
- A more direct reference to investment risk, which should be supportable - the consultation sets out details of a potential stress test of the asset strategy, similar to that currently used by the PPF.

Diagram 1: Key principles of the revised funding code



So what does all this mean for investment strategy?

Setting the long term target… and the target investment portfolio

It's clear that trustees need to be able to articulate their long term objectives and the anticipated timeline. However, few may have articulated what that means for their target investment portfolio when their schemes start to de-risk or become significantly mature (possibly when the remaining duration is 12-14 years) and those that have will want to test whether this still remains relevant under the proposed FastTrack regime.

The consultation is pretty clear that TPR expect the investment strategy at the point of significant maturity to have a high resilience to investment risk and adopt a strategy broadly aligned with the FastTrack funding basis. However, TPR accept there is no single definitive investment strategy and there are many variants - they helpfully provide some examples:

1. **'Barbell' strategy –** majority of assets in gilts and LDI providing a good match for scheme cashflows and hedging liability risks, with the remaining small proportion of assets invested in a diversified 'growth' portfolio – 20% in growth assets is suggested as the maximum level of investment risk supportable.

2. **Credit-based strategy –** 100% invested in bonds, the majority of which are high-quality and liquid to generate some additional return over the funding basis to provide a buffer against adverse future experience – a strategy which includes a mixture of gilts, corporate bonds and including some illiquid and multi-asset credit is suggested.

3. **Cash flow-driven-investment strategy –** an extension to the credit-based strategy above, which invests in a portfolio of assets which deliver cashflows closely matching the liabilities – a strategy with more gilts, high-quality corporate bonds and other secure income assets is expected.

However, schemes may choose to adopt a different strategy and justify this through the bespoke route.

Why is maturity important?

Maturity is key because the more mature schemes are, the greater the impact of benefit outgo and the less time they have to recover from a fall in funding. Hence, the less resilient they are to downside shocks, so exposure to investment risk should reduce over time. Schemes mature at different paces, depending on their age profile and benefit structure and this may not be a smooth progression. A greater understanding of the emerging maturity in your scheme will give an idea of when the LTO should be targeted and sets the timescale for successfully incorporating any de-risking that is needed. This glidepath should also link in with the TP target, given that TP funding is to some extent a staging post along the way.

Investment risk considerations

To determine whether schemes remain within the permitted risk profile of FastTrack, TPR are consulting on the use of a standard stress test of the asset strategy (similar to that used in the PPF assessment), which will incorporate the scheme's maturity and strength of sponsor covenant. While a more mature scheme will be expected to run a lower risk investment strategy and may also be required to meet liquidity and credit quality criteria, a less mature scheme with a strong employer covenant is expected to be able to take more investment risk within the FastTrack regime.

Potential next steps

Areas where trustees should consider taking action include:

- Engaging with sponsoring employers to facilitate discussions on jointly suitable LTOs or reviewing whether any current LTO remains appropriate alongside the investment strategy path and funding support.
- Starting to map out a plan for how the investment strategy may be expected to evolve alongside the LTO path.
- Stress testing the plan, and thinking about contingent actions you would take; does this mean more money, more risk or more time is required to meet the target LTO.

For schemes which may be at risk of falling outside the FastTrack regime due to too much reliance on 'growth' assets or too little resilience to investment risk given their maturity and/or covenant support, trustees may decide to:

- Take no action because they have a genuine rationale for the bespoke route (which will be seen by TPR as equally compliant as FastTrack with suitable supporting evidence); or
- Begin to reduce the level of investment risk in their strategy and increase the resilience to adverse investment outcomes in order to meet the FastTrack criteria.

Incidentally there may be schemes which find themselves ahead of progress against the FastTrack criteria and there may be a temptation, at least on the part of some sponsors, to 'level down'. While TPR note that there is little to stop a levelling-down approach, their view is that schemes in such healthy (and enviable) positions, would be keen to maintain that additional cushion to withstand any future 'bumps in the road', such as the current market volatility from COVID-19.

We recently hosted a client webinar which sets out some worked examples of the proposed new approach. Our special guest David Fairs (Executive Director at TPR) answered questions from many of our clients in relation to the consultation which can be found here.[4]

Further guidance from TPR acknowledges that some DB schemes may need to defer pension contributions in the current COVID-19 climate. Our follow-up webinar discussed the suspension of DB pension contributions and the impact this may have on schemes. The link to this is also provided here.[5]

4 https://www.hymans.co.uk/insights/research-and-publications/publication/webinar-replay-what-does-the-new-db-funding-code-mean-for-you/

5 https://www.hymans.co.uk/insights/research-and-publications/publication/webinar-replay-a-guide-to-deferring-pension-contributions/

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