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Briefing note

Funding Code, reprised & revised

The Pensions Regulator’s Code of Practice on Funding Defined Benefits has been laid before Parliament for approval. It provides important practical detail on how the new funding regime is intended to operate for valuations on and after 22 September 2024. The Regulator has also published its response to the consultation on its regulatory approach, which includes the finalised ‘Fast Track’ parameterisation.

Backdrop

The Code is the fruit of a process lasting more than four years (the initial consultation exercise began in March 2020)—or even longer, if traced back to Government green and white papers in February 2017 and March 2018, respectively. Legislatively, the project culminated in the *Pension Schemes Act 2021*, which supplements the existing funding rules so that, in addition to obtaining point-in-time actuarial valuations of their schemes, trustees will be required to formulate and pursue longer-term goals; and the *Funding and Investment Strategy Regulations*[1], which put the flesh on the bones of the Act’s new obligations.

The first draft of the Code, published in December 2022, tried to achieve a balance between establishing the Regulator’s expectations, embedding best practice, and allowing schemes sufficient flexibility to suit their own circumstances. However, we were concerned that the Regulator’s proposals were out of tune with the DWP’s draft Regulations, which were, initially, considerably more prescriptive. Those fears were largely allayed when the Regulations were finalised, in January 2024.

The questions then became what the Code would finally say about how the Regulator would exercise its oversight and enforcement powers, including the accompanying Fast Track parameterization, and the extent to which it would address issues raised in the initial consultation.

Scheme maturity

The legislation says schemes should aim, by the time they reach ‘*significant maturity*’, to be funded and invested so that dependency on sponsor support is low. A scheme’s maturity is to be measured by its ‘*duration of liabilities*’ on the low-dependency basis: in broad terms, this is the weighted average time until benefits are expected to come into payment. Duration will therefore reduce as a scheme matures—as more and more of its members become pensioners.

[1] The *Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2024* (SI 2024/462).

The legislation provides for Regulator to specify in the Code the duration at which a scheme reaches significant maturity (it can be different for different schemes); in the first draft of the Code, it was to be set at 12 years. However, concerns were raised about the potential volatility of the measure. It is sensitive to interest-rate changes, a fact that was illustrated by the gilt-market turmoil of late 2022, which slashed many schemes' durations by several years, virtually overnight. The DWP answered this concern about the potential instability of duration as a measure of maturity by fixing a date (31 March 2023[2]) for the economic assumptions used in the calculation. Now, in the finished Code, the Regulator has re-evaluated its definition of 'significant maturity', and has set it at 10 years (8 years for cash balance schemes).

Covenant

The new rules make employer-covenant assessment an explicit requirement. Answering concerns that the draft Code required much more-detailed covenant analysis, the Regulator has made some changes to clarify its expectations, remove some extraneous material on covenant visibility (now an input to reliability), and to stress that the assessment should be proportionate to the risks involved. Its policy, however, does not appear to have changed and trustees will need to form a view on the reliability period and covenant longevity. The Code suggests that covenant reliability for most employers will only extend to the short-to-medium term (three-to-six years), whilst reasonable certainty over covenant longevity will typically not exceed ten years. However, some employers may be able to demonstrate longer periods.

The Regulator expects to consult on separate covenant guidance later in the summer.

Open schemes

Open schemes remain subject to the same overarching legislative requirements as closed schemes. However, the DWP's revised legislation allows trustees to take openness to new entrants and future accrual of benefits into consideration in the evaluation of scheme maturity. This will mean that an open scheme can be expected to take longer to reach significant maturity than an equivalent closed scheme. The trustees' assumptions must be reasonable and consonant with their assessment of the employer covenant. The finished Code provides flexibility for trustees to assume that accrual and admission of new entrants persists for a short period beyond the end of the time span over which the elements of the covenant (such as cash flows) can be reliably forecast which is more accommodating than the draft Code. For Fast Track, the allowance for future service can be no more than nine years (previously six years) and the assumed number of new entrants should not exceed the previous three-year average.

The Code now also contains a separate, more prominent, chapter on open schemes, in which the Regulator has compiled the relevant items of guidance that appear elsewhere in the document.

[2] The Code acknowledges that this could be interpreted in different ways, but indicates that the Regulator generally expects that the economic assumptions at each valuation will be set based on the conditions that applied on 31 March 2023, as if that were the valuation date.

Low-dependency investment allocation

There was concern that the requirement to assume a 'low-dependency investment allocation' (LDIA), once a scheme has reached significant maturity, would inappropriately constrain trustees' investment discretion. The DWP, in response: amended the LDIA definition to remove reference to asset cash flows being 'broadly matched' to benefit payments, and demoted the LDIA from a 'principle' (which must be followed) to an 'objective' (that must simply be taken into account). The Code reflects those changes, acknowledging that trustees are not required to invest in line with the LDIA when significantly mature, and although it expects that the actual investment allocation will often closely track LDIA, it recognises that it will not always be so.

It also contains guidance on the ways in which assets can support the low-dependency principle, and says that trustees should determine the appropriate combination depending on their scheme's circumstances. Having assets that are sufficiently liquid to meet expected cash flows is still highlighted as an important factor. Whilst earlier guidance included example asset allocations, stress tests and risk thresholds, the final draft Code is more principles-based. The formulaic test to assess maximum risk along the journey plan is replaced with flexibility to accommodate the different ways trustees assess risk, and the support for this risk. The final draft Code does however, retain the expectation that an LDIA targets interest rate and inflation hedges of at least 90% of the scheme's low dependency liabilities.

Actuarial valuations & recovery plans

If a scheme is in deficit on a technical-provisions basis at its valuation date, trustees must continue to put in place a recovery plan to restore the scheme to full funding. Whilst the finalised Code is clearer on expectations, the overriding principle remains that steps must be taken to recover deficits as soon as the employer can reasonably afford, taking account of (among other things) the sustainable growth of the employer. Affordability of recovery plans should be assessed on a year-by-year basis, and steps to reduce the deficit set accordingly. There is scope to consider allowing for (a proportion of) post-valuation experience and investment outperformance to the extent that it is supported by the employer covenant (including contingent assets).

Fast Track & regulatory approach

The Regulator has laid out 'Fast Track' and 'Bespoke' routes to compliance. Fast Track is framed as the tolerable level of risk in normal circumstances and will be a 'filter'. The Regulator is unlikely to scrutinise a valuation further if a scheme's strategy meets each of the Fast Track parameters. However, trustees must also follow the legislation and consider the Code's principles.

Finalised Fast Track parameters were published alongside the Code. In broad terms, they confirm that technical provisions would need to converge towards gilts + 0.5% p.a. and that recovery plans must be shorter than six years (three years after significant maturity), with limits on investment risk. Annual increases to deficit contributions should not exceed either CPI inflation or (new) fixed increases at a rate of 3% p.a. No allowance can be made for future investment outperformance. The parameters will be reviewed at least annually for changes in market conditions and other factors, with a comprehensive review every three years.

The Regulator estimates that, in March 2023, 62% of schemes were within Fast Track parameters, and a further 19% could have met the parameters at no extra cost by changing their funding approach.

At long last, we have a clear indication of the final Code. As expected, there are no huge changes or surprises. However, it is welcome that the Regulator has reflected on and updated its expectations in the wake of the significant changes in the DB landscape over the lengthy period for which it has been in development. We are particularly pleased to see that our calls for some rowing back towards a more principles-based approach have been answered. Nevertheless, at more than 100 pages, the detail to work through is extensive.

Trustees and sponsors will now be in a position to understand what the new funding framework means for their scheme. Those with the earliest in-scope valuations can follow the new Code, reassured that the Regulator will take '*a reasonable regulatory approach*' whilst the remaining i's are dotted and t's crossed. The sooner this happens the better.

Amongst the final pieces to watch out for is the Regulator's consultation on updated covenant guidance. It will also publish more on its regulatory approach, including the information and evidence required in the statement of strategy for the Fast Track and Bespoke submission routes, as well as the regulatory filters it will use when assessing valuations (it sought feedback in April on the data it's asking trustees to provide, and its proposed templates, and expects to publish a response in the autumn).

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