In Touch technical update

March 2020

Consultation issued on Scheme Funding Regime

- TPR has issued a consultation with details of a proposed new Defined Benefit funding code
- Range of principles proposed to bring greater clarity on what schemes must do and what flexibility is allowed
- Two-track compliance process, with Fast Track and Bespoke options
- Fast Track compliance expected to be tightly defined and provide greater certainty for trustees
- Bespoke compliance provides more flexibility.

The Pensions Regulator (TPR) has published the first of two anticipated consultations on its plans for a new funding code for Defined Benefit (DB) pension schemes, due to come into effect in late 2021. This consultation focuses on the high-level approach and there will be a further consultation on the details of the resulting Code of Practice later this year. The consultation runs until 2 June 2020.

Background

In the White Paper published in 2018, the Government noted that, while the DB funding framework is working largely as intended, some improvements are needed. It stated that TPR would publish a revised Code of Practice focusing on: how prudence is demonstrated when assessing liabilities; appropriate factors when considering recovery plans; and ensuring a long-term view is considered.

The consultation on the funding code attempts to address these issues, by giving greater clarity on what schemes are expected to do. It also proposes a two-track compliance regime, intended to provide a clear 'Fast Track' option for those schemes requiring greater certainty, as well as continued flexibility for schemes taking a 'Bespoke' approach.

A new set of principles

The consultation proposes a series of principles which schemes will be expected to comply with when submitting their funding plans.

The suggested principles are as follows:

Principle 1 – Compliance and evidence

Trustees and employers should understand their scheme-specific funding and investment risks and objectively evidence how material risks can be managed.

When showing how risks are managed, trustees should be able to compare the risks taken to a tolerated risk position and then demonstrate the mitigation/support available.

Principle 2 – Long Term Objective (LTO)

By the time they are significantly mature, schemes should have a low level of dependency on the employer and be invested with high resilience to risk.

Principle 3 – Journey Plans and Technical Provisions (TPs)

Trustees should develop a journey plan to achieve their LTO. They should plan for investment risk to decrease as their scheme matures and reaches low dependency. TPs should have a clear and explicit link to the LTO, and over time should converge to the LTO as evidenced in the journey plan.

Principle 4 – Scheme investments

Actual investment strategy and asset allocation over time should be broadly aligned with funding strategy (TPs and RP).

Trustees must ensure their investment strategy has sufficient security and quality, and can satisfy liquidity requirements based on expected cash flows as well as a reasonable allowance for unexpected cash flows.

Asset allocation at significant maturity should have high resilience to risk, a high level of liquidity and a high average credit quality.

Principle 5 – Reliance on the employer covenant

Schemes with stronger employer covenants can take more risk and assume higher returns. However, trustees should assume a reducing level of reliance on the covenant over time, depending on its visibility.

Principle 6 – Reliance on additional support

Schemes can account for additional support when carrying out their valuations provided that it is: sufficient for the risks being run; appropriately valued; and legally enforceable and realisable at its necessary value when required.

Principle 7 – Appropriate recovery plan (RP)

Deficits should be recovered as soon as affordability allows, while minimising any adverse impact on the sustainable growth of the employer.

Principle 8 – Open schemes

Members' accrued benefits should have the same level of security in open schemes as in closed schemes.

Two-track framework

The consultation proposes a two-track approach to compliance, which attempts to balance the need for greater clarity with continued flexibility.

The Fast Track approach involves a series of rules or tests, designed to demonstrate compliance with the principles. Although the tests are expected to be rigid, they will reflect scheme circumstances such as covenant rating and scheme maturity.

The Bespoke approach is available for schemes that cannot, or choose not to, comply with Fast Track. It will have more flexibility, to take account of the scheme's specific circumstances, but will require trustees to explain how and why they have differed from Fast Track and how any additional risk is being managed. Bespoke may receive more regulatory scrutiny but it is not a second-best option.

Importantly, both Fast Track and Bespoke, if done correctly, are equally compliant.

Fast Track compliance

The consultation proposes a number of options around the Fast Track tests, which fall into three groups: Funding, Investment and Long-term objective.

Funding Tests

1. TPs should either (a) be set using a discount rate that is no greater than that set out in Fast Track guidance, or (b), under an alternative proposal, be no lower than a stated percentage of the long term funding target.

   The thresholds are expected to vary by covenant and maturity, with lower discount rates (or higher technical provisions) for weaker covenants and more mature schemes, consistent with journey plan to long term target.

   If the discount rate approach is adopted additional guidance on other TP assumptions would be needed to ensure these are no weaker than best estimate.

2. The Recovery Plan should be no longer than a period set out in Fast Track guidance

   The maximum period is expected to vary by covenant rating, an illustrative example suggests 6 to 12 years thresholds, with shorter periods required for stronger covenants.

3. Recovery Plans should make no allowance for outperformance of assets above the discount rate and may not be able to include back end-loading or re-spreading of previous Recovery Plans to reduce contributions. Deficit contributions may also be tested against shareholder distributions.

4. Future service costs (where relevant) should be calculated using TP assumptions.

Investment Tests

5. Investment strategy should be such that, when a TPR-defined stress test is applied to assets and liabilities, the resulting fall in funding position is less than a limit set out in the Fast Track guidance. Additional restrictions on the quality and liquidity of the portfolio are expected to apply.

   The maximum stress permitted appears likely to vary by covenant and maturity, with less risk being permitted for weaker covenants and more mature schemes.

Long Term Objective Tests

6 Schemes should have a stated long term objective to be fully funded on a low dependency basis by the time the scheme is significantly mature.

For Fast Track purposes low dependency funding is expected to be based on a discount rate somewhere in the range of gilts plus 0.25% to 0.5% pa, plus a reserve for future ongoing expenses, regardless of covenant

Significantly mature is expected to mean that the objective should be to reach the target by the time the scheme has a maturity of somewhere in the range of duration 14 to 12 years (i.e. typically in 15-20 years from now).

The precise parameters of Fast Track are not yet known and are expected to be included in the second consultation – the principles are considered here. TPR are expected to review the parameters from time to time, as market conditions change.

Bespoke compliance

Compared to Fast Track compliance, less is known about bespoke compliance at this stage. The key knowns and unknowns are:

Known

- Bespoke compliance will be tested against the final principles – Trustees will need to explain how and why they have differed from the Fast Track position and how any additional risk is being managed.
- Contingent Assets may be used to justify additional flexibility – such as longer recovery plans.
- Bespoke compliance will continue to have flexibility, which will also mean greater likelihood of engagement with the Pensions Regulator.
- The degree of Regulatory involvement is expected to depend on how far schemes are away from the Fast Track tests.

Unknown

- How much regulatory oversight should be expected compared to the current position.
- How far away from Fast Track tests schemes will be able to move before being deemed to be "non-compliant".

Implications

It is unclear what proportion of schemes will opt for the Fast Track approach, although the Pensions Regulator has indicated that it expects the approach to be of most relevance to the 2,000 or so small schemes that have fewer than 100 members.

In practice we expect all schemes to want to understand Fast Track, as it provides a benchmark against which they will be tested.

- For schemes that can potentially meet all the Fast Track tests, understanding the tests is important to ensure that they do not fall back into a Bespoke approach unexpectedly - nudging the scheme over the line may have regulatory and other benefits.
- For schemes that don't expect to be using Fast Track, understanding the rules remains important if they are to be tested against them when they submit their bespoke approach.

Next steps

The consultation runs until 2 June. A further consultation is expected later this year on the details of the Code of Practice, with the final Code coming into force in late 2021.