

Briefing

TPR consultation on DB funding Code of Practice

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The Pensions Regulator (TPR) has launched a [consultation](#) and accompanying [quick guide](#) on its plans to revise the Code of Practice on Defined Benefit (DB) Scheme Funding. The Code provides practical guidance to trustees and sponsors of DB pension schemes on complying with scheme funding legislation.

It is TPR's intention that this will be the first of two consultations on the new Code, in which TPR is seeking views on its broad approach to regulating scheme funding. Given the challenges facing UK businesses as a result of the Covid-19 outbreak, TPR's consultation on a new funding regime is understandably taking something of a backseat for the time being. Eventually however, the attention of companies and trustees will return to managing long-term funding and investment strategies in a new regulatory regime. In its [2020 annual funding statement](#), TPR has confirmed that an extension of consultation period to September will mean the new Code will not formally come into force until "late 2021 at the earliest".

At a glance

- TPR has issued a wide-ranging consultation on regulating DB scheme funding which runs until 2 June 2020.
- Responses will inform a second, follow-up consultation in due course which will include a draft of the new Code, expected to come into force in late 2021 at the earliest.
- Key principles of the Code will reflect recent themes:
 - Trustees and Sponsors must formalise a "Long Term Objective" (LTO)...
 - ...which should be reflected in the Scheme Funding basis...
 - ...by assuming investment risk and reliance on the sponsor reduces as the scheme matures.
- When demonstrating compliance with the Code, Trustees can opt for:
 - "Fast-Track" compliance – where all specified criteria are met (including, for example, the long term discount rate being no greater than a defined amount, requiring the Technical Provisions to converge to the LTO in a particular pattern, and the level of investment risk being no greater than a specified amount); or
 - "Bespoke" compliance – where not all fast-track criteria are met, but trustees can provide evidence that additional risk is managed appropriately.
- TPR says the Bespoke compliance route not a "second-best" option and that both compliance routes allow the flexibility to adopt a scheme-specific approach.
- Benefits in open schemes should have the same level of security as those in closed schemes.

Background

TPR's consultation follows the Government's March [2018 White Paper](#) in which it was noted that there are some "grey areas" in the existing regulatory framework. For example, it is not formally defined what it means for schemes' liabilities to be assessed "prudently" and what "appropriate" recovery plans look like.

The White Paper also set out plans to improve "transparency and accountability" around the risks being taken in DB schemes, and to ensure that trustees "focus on the long-term strategic issues" as their DB scheme matures.

TPR has already been directing trustees and sponsoring companies (for example in their [annual funding statements](#)) to consider what their scheme's "Long Term Objective" looks like – whether that is ultimately buying out with an insurance company or continuing to run the scheme with "low-dependency" on the sponsoring employer and low investment risk, or something else entirely.

All of this comes at a time the Regulator is due to obtain enhanced enforcement powers – thus enabling it to be [clearer, quicker, tougher](#) – when the current Pension Schemes Bill gets Royal Assent later this year.

Key principles

In the consultation, TPR sets out the key principles it believes should "stand behind" all scheme funding valuations. Many of these principles are already enshrined in the Regulator's current Code of Practice, or have been established in its more recent communications. In particular:

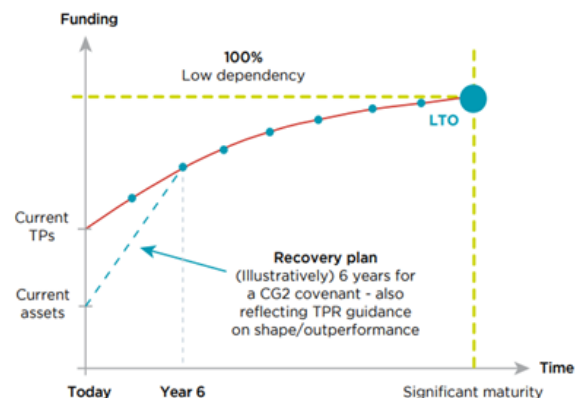
- Trustees and employers need to understand their scheme-specific funding and investment risks and must be able to evidence how these are being mitigated or managed.
- As schemes reach 'significant maturity', they should transition to a low level of dependency on the employer and a high resilience to investment risk.
- Investment strategy and asset allocation should be broadly aligned with the scheme's funding strategy. The investment approach should have sufficient security, quality and liquidity to meet expected cashflows.
- Schemes with stronger sponsoring employers may take more risk (and therefore allow for higher investment returns in their funding strategy), but trustees should assume reducing reliance on employer covenant over time. Trustees must take "covenant visibility" into account when agreeing a funding strategy.

- Schemes' funding approaches may include allowance for additional support (for example "contingent assets"), provided that they offer sufficient support for the risks being run and are legally enforceable at meaningful value.
- Deficits should be recovered as soon as sponsor affordability allows (taking into account any impact on the employer's "sustainable growth").
- The security of accrued benefits should not differ between open and closed schemes (all else being equal).

The long term objective

All trustees will be required to agree a "Long Term Objective" (LTO) with sponsoring employers. TPR confirms that this means that schemes should be funded on a basis that is consistent with a "low dependency" on the employer covenant and with being invested in a "highly resilient" way by the time they are "significantly mature".

While schemes may be able to take more investment risk when they are immature, this means that the schemes will need to plan for the level of investment risk to reduce over time. This "Journey Plan" to the LTO position should also be reflected in the choice of Scheme Funding assumptions (i.e. allowance should be made for the assumed investment returns to reduce over time to low dependency levels).



(Source: The Pensions Regulator. March 2020)

Twin-track compliance (Fast Track vs Bespoke)

As has been widely reported, TPR is intending to give greater direction within the scheme funding regime and is proposing a “twin-track” route for demonstrating compliance:

“FAST TRACK” COMPLIANCE:

TPR will set out a series of “objective and quantitative” compliance guidelines and parameters which cover key aspects of funding and investment arrangements, for example in relation to:

- How the Long Term Objective is measured;
- How Technical Provisions are calculated (including the choice of the discount rate and other assumptions);
- Recovery Plan lengths and structures;
- The level of current investment risk; and
- Future service contribution rates (in open schemes).

Trustees who submit a valuation which is Fast Track compliant (see below) can expect a lower level of scrutiny from TPR and will be required to submit less evidence alongside their valuation.

“BESPOKE” COMPLIANCE:

For schemes where trustees are unable to (or choose not to) meet the Fast Track guidelines. This may be because either:

- The agreed funding plan is overall as strong as Fast Track, but individual Fast Track parameters are not met.
- Trustees wish to reflect additional (but appropriately managed) risk being taken.
- Affordability constraints mean they cannot meet some or all of the Fast Track guidelines (although this option should be a last resort).

Bespoke funding approaches should not be viewed as “a bad or second-best option”, and both approaches are “equally compliant” with the legislation (if done correctly).

Trustees who submit a valuation under the Bespoke compliance route will be required to submit more evidence to justify their approach.

TPR sets out in the consultation how some of the principles for Fast Track compliance might develop under six key headings. Many of the principles here will also apply under a Bespoke compliance route.

Fast Track – The detail

TPR sets out in the consultation how some of the principles for Fast Track compliance might develop under six key headings:

1. EMPLOYER COVENANT

TPR says assumed reliance on the employer covenant could continue to be reflected in Technical Provisions and is consulting on the options for doing so.

However, the Regulator is proposing to limit the reliance based on “covenant visibility” which it does not believe usually extends beyond the “short to medium term” (ie three to five years). TPR is also considering whether sponsor covenant should be assessed “holistically” (as it is currently, but with additional clarifying guidance) or via formal calculations or metrics.

2. LONG TERM OBJECTIVE (LTO)

All schemes (whether seeking to obtain TPR approval under Fast Track or Bespoke approaches) are going to be required to set a LTO by law. Schemes will be required to “progressively reduce” their reliance on the Employer Covenant, reaching low dependency and high resilience to investment risk by the time they are “significantly mature”.

Under Fast Track, TPR suggests that measures of “low dependency” funding could be based on a discount rate at the point of significant maturity (which it suggests is around 15-20 years from now for the average scheme) of Gilt yields plus a margin of between 0.25% and 0.5% pa. TPR may also establish parameters for other assumptions and expense allowances as part of the Fast Track principles.

3. JOURNEY PLANNING AND TECHNICAL PROVISIONS (TPs)

For all schemes, TPs should be viewed as a way of measuring progress towards the LTO – and trustees should formally plan for the level of investment risk to reduce as schemes mature, reflecting this in assumed discount rates for example.

TPR is consulting on whether this progression should take a particular shape when setting TPs under Fast Track – and how much covenant visibility should be incorporated into those calculations.

The Regulator is also considering how Fast Track schemes will be required to measure TPs at each valuation in relation to scheme maturity and employer covenant.

4. SCHEME INVESTMENTS

TPR has said it will not be seeking to direct how trustees should invest. However, the Regulator notes that, at the point of significant maturity, schemes’ asset allocations should have high resilience to risk, sufficient liquidity and high average credit quality.

To assess Fast Track compliance, trustees will also need to measure such risks against a reference point – TPR is suggesting this may be via a simple “stress test”.

5. RECOVERY PLANS

TPR will be clearer on what constitutes an appropriate Recovery Plan, and that affordability will remain a key driver. Fast Track funding approaches may be required to aim for Recovery Plans of a standard length (broadly limited to the period over which there is good “covenant visibility”) – which for the strongest employers could be six years. TPR has also said that it will address “excessive back-end loading” within Recovery Plans and, under Fast Track, allowing for asset outperformance in the Recovery Plan (above that used in calculating Technical Provisions) will not be possible.

6. OPEN SCHEMES

Members’ benefits in open schemes should have the same level of security as benefits in closed schemes. Therefore open schemes will be required to set a LTO, and plan to reach it by the time they are “significantly mature”, in exactly the same way as a closed scheme. However, in practice an open scheme will mature more slowly and this can be taken into account.


Requirements for the calculation of future service contribution rates will be incorporated into the Fast Track framework with TPR likely to focus on the assumptions used and their consistency with the rest of the valuation.

Action Required

Schemes should have already begun to consider what their LTO looks like following TPR’s [2019 and 2020 Funding Statements](#).

For schemes with valuations underway or with effective dates in the near future, some forward planning is advised, even if the Code hasn’t formally come into force by the time the funding approach is due to be finalised. Schemes whose valuation is close to being finalised are unlikely to want to revisit the process in full at this stage, though it would be prudent to consider how and whether the Regulator’s key messages about Long Term Objectives are reflected in the agreed funding and investment strategies.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

 info@barnett-waddingham.co.uk

 0333 11 11 222

www.barnett-waddingham.co.uk

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