



# Defined Benefit Funding Code of Practice

Briefing analysis | Last updated: August 2024



# 1. Executive summary

## Overview

The Pensions Regulator (TPR) has now published the long-awaited new Code of Practice for funding Defined Benefit (DB) pension schemes. Alongside the Code, TPR has confirmed the details of its new twin track approach to assessing valuations - the two valuation submission options are known as Fast Track and Bespoke.

The publication of the final Code follows the Department for Work and Pensions' (DWP's) release of the new funding regulations in early 2024, that set out further detail to the Pensions Scheme Act 2021. TPR has confirmed that the new Code and funding regulations will apply to valuations with effective dates on and from 22 September 2024.

### Key points

Under the new legislation, trustees of DB schemes must agree a funding basis that targets, as a minimum, low dependence on the sponsoring employer by the time the scheme is 'significantly mature'.

A low dependency target means that schemes must be funded in a low-risk way, such that further employer contributions are not expected. Schemes are also required to develop a strategy to be in a position to invest in a low dependency investment allocation - an allocation that is highly resilient to short-term market movements - after significant maturity.

For most schemes, significant maturity means that a scheme has a 'duration' of ten years or less, as measured using market conditions as at 31 March 2023. This will be around fifteen years away for a typical scheme, though some schemes will be much closer to reaching, or have already reached, this point.

Funding and investment strategies that target low dependency are common, and many schemes are already well funded on a low dependency basis. For these schemes, the new regime should not lead to significant changes, although trustees still need to consider how to comply with the detailed requirements. For some schemes – particularly those close to or at 'significant maturity' – the new regime may require more material changes, possibly resulting in higher costs for employers.

## 2. Introduction

### Legislation

The Pension Schemes Act 2021 requires trustees of DB pension schemes to determine a **long-term strategy** for providing pension benefits. The Funding and Investment Strategy Regulations 2024 add further detail to this new requirement. In particular, as a minimum, the long-term strategy must incorporate the requirement for schemes to be funded on a **low-dependency basis** by the time they are **significantly mature**. We discuss this in subsequent sections.

### The DB Funding Code

TPR's Codes of Practice provides practical guidelines on certain requirements of pension legislation. The DB Funding Code of Practice expands on the legislative principles that relate to funding DB schemes. TPR first consulted on a revised Code in March 2020. The long awaited second consultation was published in December 2022 and included a draft new Code. The final Code was laid before Parliament in July 2024 and will apply to schemes with effective valuation dates from 22 September 2024.

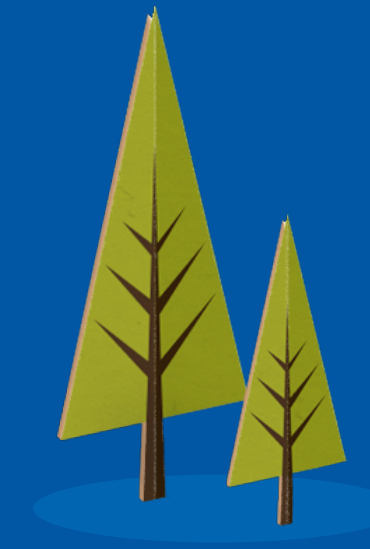
### Statement of Strategy

The new legislation also requires all schemes to prepare a new document called the 'Statement of Strategy'. This will be in two parts. Part 1 sets out the scheme's funding and investment strategy, detailing their plan for delivering benefits over the long term, and must be **agreed** with the sponsoring employer. Part 2 will include supplementary details, including details relating to the risks faced and the employer covenant, and is subject to **consultation** with the sponsoring employer. Click on the [pop-up box below](#) for further details of what needs to be disclosed.

Overall, the requirements appear to be onerous. However, TPR has the power to use its discretion when deciding how much information schemes must submit for part 2 of the statement. TPR has indicated that schemes that do a Fast Track valuation submission will be required to submit less information than schemes that do a Bespoke submission (see sections 8 and 9 for details of Fast Track and Bespoke). Furthermore, TPR are still yet to confirm the final form of the new statement after seeking industry views in a March 2024 consultation.

The statement must be updated and submitted to TPR at each valuation, with trustees explaining how well the funding and investment strategy is being implemented.

### 3. Long-term planning: long-term objectives and low dependency funding targets



#### Does the Code require employers to fund schemes to a buy-out level?

It is expected that most schemes will buy-out benefits at some point. As such, buy-out may seem like a natural long-term objective for many schemes. However, the Code **does not** require employers to fund schemes to buy-out levels. The minimum requirement is that schemes must target low dependency at the point of significant maturity, and the employer **must** pay contributions to maintain full funding on this basis. Trustees and employers may decide to adopt buy-out as a higher funding target, but in most cases the strategy will be to achieve this through a combination of investment returns and by waiting for buy-out pricing to reduce as a scheme's membership ages i.e. many schemes may choose to adopt run-off as their formal long-term objective, with buyout being a secondary (aspirational) objective.

#### Low dependency funding

Regardless of the long-term objective (see the pop-up box above), the new funding regulations introduce a requirement that schemes **must** target a **low level of dependency** on the employer in their funding basis by the time the scheme is significantly mature. In short, this means that the scheme must be funded, in a low-risk way, to the extent that further contributions from the employer would not be expected.

Schemes also have a new objective to be invested in accordance with a low dependency investment allocation by the time they are significantly mature. TPR expects that most schemes will invest in such a low dependency investment allocation in practice, though trustees can choose not to do so if they believe this is in the best interests of members.

The concept of "low dependency" therefore effectively replaces the "self-sufficiency" terminology that many schemes have historically used. **Click on the white pop-out box in the top right corner to read more about TPR's expectations for low dependency investing and funding.**

Many schemes' existing funding strategies will already tend towards a low dependency type target over time, and so will only need to make relatively small tweaks to their current plans. However, the new low dependency requirement will be a significant change for those schemes that were planning to run higher levels of risk over the long-term with the support of their employers and may increase costs to employers.

## 4. Timescales to reach low dependency

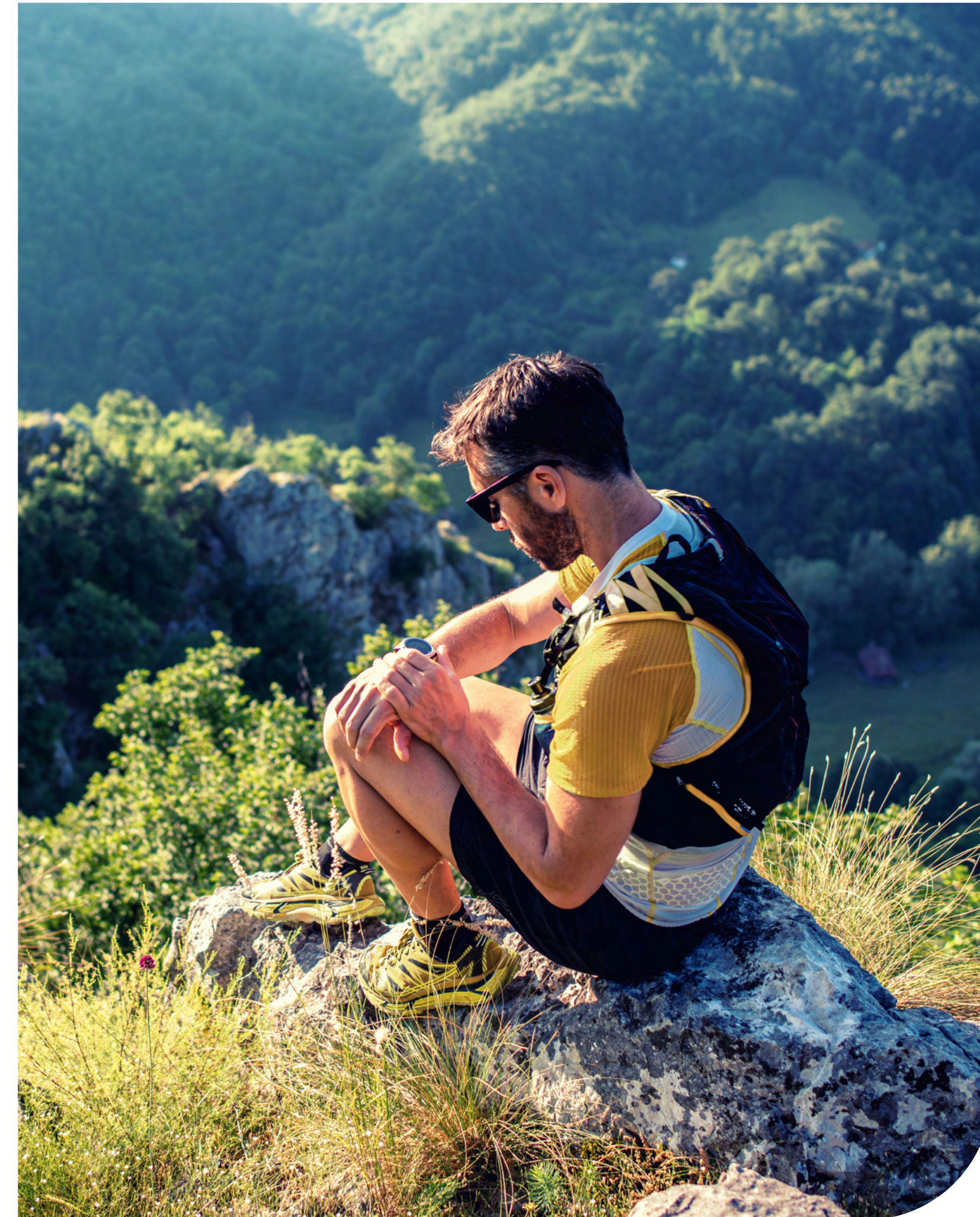
### Significant maturity and duration

The funding regulations require schemes to reach the minimum low dependency target by no later than '**significant maturity**' – defined in the Code as when the '**duration**' of the scheme's liabilities is ten years or less, as measured using 31 March 2023 market conditions. The chosen date is referred to as the '**relevant date**'.

For cash balance schemes, the duration is 8 years, rather than 10 years. For schemes that provide a mix of cash balance and other benefits, the duration is between 8 and 10 years.

### What is duration?

Duration is a measure of the weighted average time to payment of future cashflows. Broadly, schemes that have more pensioner members will have shorter durations – and so will have less time until they reach significant maturity.

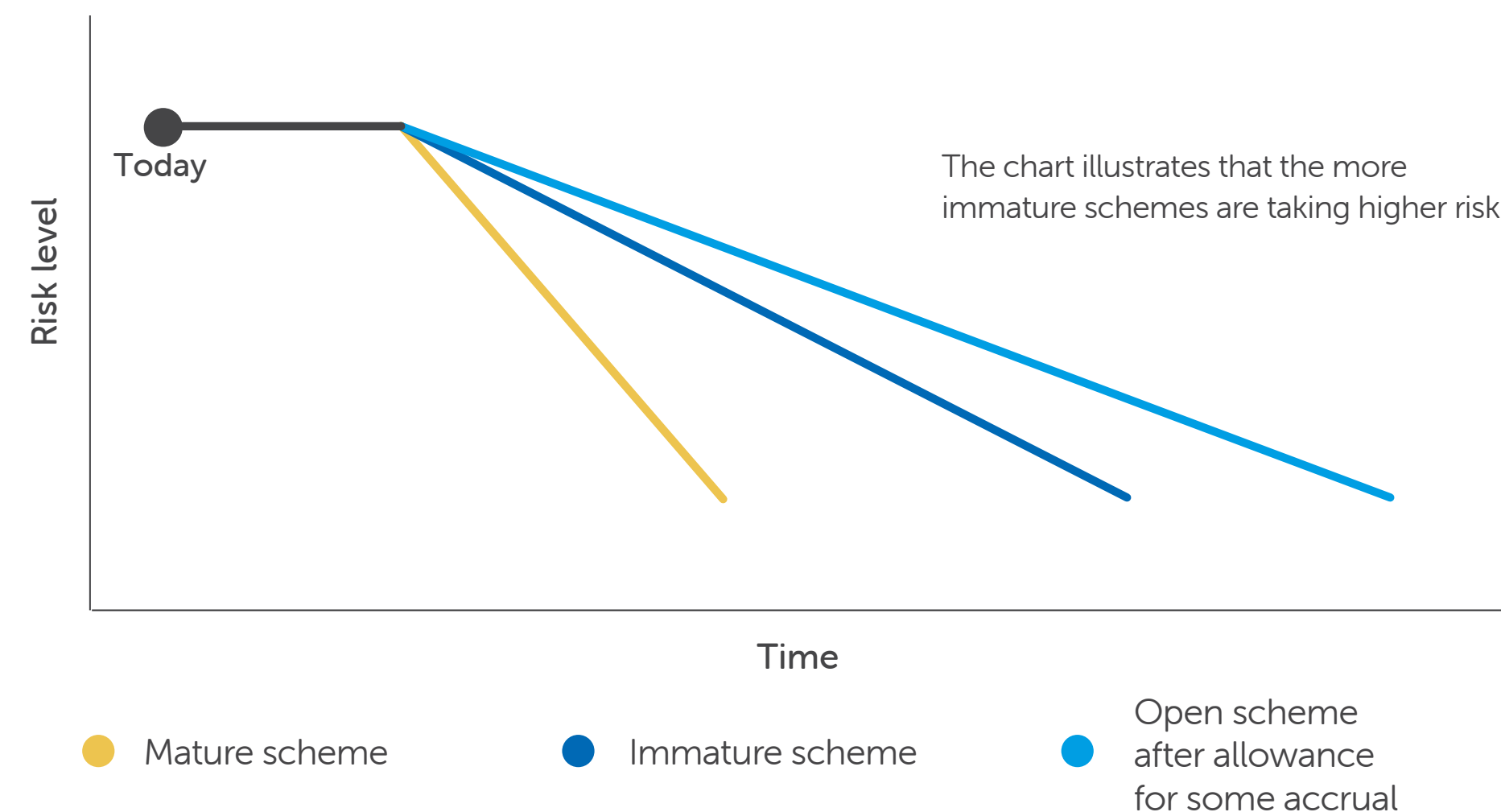


## 5. Journey planning

Under the regulations, the trustees and sponsoring employer(s) must agree a funding journey plan towards low dependency at significant maturity – effectively bridging the gap between:

- a scheme’s current funding strategy; and
- a scheme’s low dependency funding target.

The funding journey plan will be underpinned by an investment journey plan, which supports the derivation of the discount rate assumptions.



The key principles set out in the regulations/Code are that the amount of risk that schemes can assume in their journey plans should depend on the strength of the employer covenant and how far from the relevant date they are.

With regards to considering the covenant support available during the journey plan period, TPR expects trustees to consider two distinct periods – namely the period over which trustees can be reasonably certain of the employer’s cash flow to fund the scheme (the period of ‘covenant reliability’) and the period after. The Code also sets out TPR’s expectations for how trustees should assess whether risk is supportable, which includes the expectation that schemes undertake stress test analyses.

While the Code introduces jargon and expectations that may be new to some schemes, the overarching journey plan principles will be familiar to most. That is, the Code effectively requires schemes to plan for their investment and funding strategies to de-risk over time towards the long-term target – something that most schemes are already doing in practice.



**All things being equal, an open scheme can have a lower funding target and plan to take more investment risk than a comparable closed scheme.**



## 6. Open schemes

The long-term strategy concept that is central to the new funding regime is arguably better suited to schemes that are closed to new members. Indeed, schemes that are truly open may never mature at all – and so will never need to de-risk towards a low-dependency target. As such, there has been concern in the industry that the new requirements will increase the cost of providing benefits in open schemes and/or require work that is of little practical benefit.

The Code incorporates several relaxations for open schemes that aim to ensure such schemes are not forced into funding unnecessarily faster than would otherwise be the case. TPR makes it clear that open schemes may make an allowance for future accrual and new entrants which will delay the time the scheme is assumed to reach significant maturity. All things being equal, this means that an open scheme can have a lower funding target and plan to take more investment risk than a comparable closed scheme.

Trustees of open schemes should take the employer covenant into account when determining how much allowance to make for future accrual in the calculation of the projected duration. TPR expects that no allowance should be made beyond the period of “covenant longevity” (see the next section).





## 7. Employer covenant and recovery plans

TPR plans to consult on updated comprehensive covenant guidance later in 2024, though the Code gives a clear indication of TPR's revised expectations in this area. Under the new regime, trustees are directed to consider the three pillars of "cash flow", "contingent assets" and employer "prospects" when determining the strength of the employer covenant. Furthermore, when assessing employer support, the Code emphasises two time periods that trustees should consider in depth.



The period of covenant **reliability**, covering the period in which trustees have reasonable certainty over the employer's cash flow to fund the scheme. This will be key in determining the level of risk to take at the start of the journey plan (see section 5) and the length of any recovery plan (see right).



The **longevity** of the covenant; i.e. the maximum period for which the trustees can reasonably assume the employer will remain able to support the scheme. This may also be important when determining the timescale in which to achieve the low dependency funding target and any other long-term objectives like buy-out.

## Recovery plans and assessing reasonable affordability

Where the funding valuation shows a deficit at the valuation date, the Code (consistent with the new Funding and Investment Strategy regulations) makes clear that trustees must follow the overriding principle that funding deficits should be recovered "as soon as the employer can reasonably afford". The Code contains guidance on how trustees should assess available cash. When assessing what is reasonably affordable, trustees are expected to consider "reasonable alternative uses" for any available cash, focussing on the below.

TPR sets out the following principles for considering reasonable alternative uses:

- In general, investment in the employer's sustainable growth may be a reasonable use of available cash where the trustees are confident of the resulting benefit to the scheme and employer.
- The lower the funding ratio and the more funding risk, the less reasonable it will be to use available cash for discretionary payments or to effect covenant leakage.
- Available cash should not be used for discretionary payments or to effect covenant leakage where this would require deficit reducing contributions to be paid after the reliability period.
- The more mature the scheme, the greater the need for available cash to be paid to the scheme in the near term.

## 8. TPR's new twin track approach to assessing valuations

### Fast Track vs Bespoke

TPR has introduced a new 'twin track' approach to assessing valuations – 'Bespoke' and 'Fast Track'.

### What is Fast Track?

The Fast Track approach is effectively a filter on actuarial valuation submissions, representing TPR's view of "tolerated risk" rather than specifying a minimum level of compliance. If the valuation submission meets a series of objective, quantifiable tests (the "Fast Track parameters"), TPR will view the scheme as low risk and is unlikely to scrutinise the submission further or engage with the scheme's trustees. Passing the tests is not, however, an automatic guarantee that the trustees' funding strategy is compliant with either the regulations or Code (i.e. in some cases, it may yet be necessary for the funding strategy to be more prudent than the Fast Track parameters).

The Fast Track parameters specify minimum funding targets, maximum levels of investment risk to be assumed for funding purposes and maximum recovery plan lengths – see overleaf for a detailed discussion of each test. The criteria have deliberately not been specified in the Code but will be set out in a separate regulatory approach document. This is to ensure that TPR can adapt its policy to rapidly changing market conditions if necessary.

### What is Bespoke?

Where the funding approach does not meet the Fast Track criteria, the valuation submission will be assessed by TPR under the 'Bespoke' route to compliance. The Bespoke compliance route is intended to offer trustees and employers the flexibility to agree a funding approach that suits the specific circumstances of their scheme, and is likely to be appropriate if:

- The trustees and employer want to take more risk than available under Fast Track – and can demonstrate that this risk is supported by the employer covenant and is in line with the maturity of the scheme.
- The scheme is unable to meet all of the Fast Track criteria – for example, if affordability means that recovery plan length criteria cannot be met.
- There are "genuinely unique" employer circumstances that mean a different approach is necessary.

TPR nevertheless sets out clear boundaries that schemes going down a Bespoke submission route must follow, and points out that legislative requirements and the general principles of the Code must still be followed, regardless of whether a Fast Track or Bespoke route is sought. TPR will require schemes to submit more detailed evidence and explanation as part of a Bespoke valuation submission, and will take a 'risk-based' and proportionate approach to further detailed scrutiny and engagement. Where engagement is sought, the scope of TPR's engagement is likely to be limited to the individual Fast Track criteria that have not been met. So, for example, if a scheme's valuation meets all the Fast Track parameters, save for recovery plan length, then TPR will focus its engagement on how affordability has been assessed.

## 9. Fast Track tests – further details

Click on the boxes below to see further details of the Fast Track parameters.





## 9. Fast Track tests – further details (cont.)

Click on the boxes below to see further details of the Fast Track parameters.





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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:

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