First Briefing, December 2022
An early Christmas present: TPR's draft DB funding code

On 16 December 2022, the Pensions Regulator (TPR) launched its long-awaited second consultation on its draft defined benefit (DB) scheme funding code of practice. As well as the draft revised code, TPR is also consulting on its proposed new 'twin track' regulatory approach. The consultation runs until 24 March 2023.

This briefing only covers the key messages from the consultation. We plan to issue at least one further briefing in the New Year that will look at the draft code and twin track proposals in more detail.

Background

The Pension Schemes Act 2021 set the framework for the new DB funding regime, requiring trustees to produce a funding and investment strategy (FIS) that:

- sets a 'long-term funding target' that they intend to have reached by a particular date; and
- the assets that they intend to hold at that point.

It is to be produced and updated as part of the triennial scheme funding valuation. It must be agreed with the employer and documented in a written Statement of Strategy.

In July 2022, the Department for Work and Pensions consulted on draft regulations, which gave more detail. A key principle that trustees must follow when preparing a FIS is

'a requirement for schemes to be in, at least, a state of low dependency on their sponsoring employer by the time they are significantly mature'.

Broadly speaking, low dependency means that no further employer contributions are likely to be needed. This means a scheme must be fully funded on a low dependency funding basis and its assets must be invested in a low dependency investment allocation – one that is low risk relative to the scheme's liabilities.

The draft code defines 'significant maturity' in terms of a scheme's liability duration, which is a measure in years of the average time to payment of the scheme benefits, to be calculated by the scheme actuary.

Draft code of practice

The draft code of practice includes TPR's main expectations of trustees, including how they should:

- set a journey plan to reach a state of low dependency on the employer
- set their funding assumptions consistently with this plan
- assess the employer covenant
- assess reasonable affordability when deciding on the appropriateness of a recovery plan

Low dependency funding basis

TPR states that it *'does not intend to take a prescriptive approach relating to the actuarial assumptions for the low dependency funding basis'.* Instead, it has adopted an approach of providing principles and guidance in the code.

Trustees will not be expected to model assumptions stochastically. Assumptions should be chosen prudently, and trustees should understand the risk in the basis so that they are satisfied that no further employer contributions should be needed once the funding target is reached. Where relevant, assumptions should refer to statistically credible data. Trustees should pay closer attention to the level of prudence included in assumptions that may be more uncertain and have a greater effect on the liabilities than others.

Low dependency investment allocation

In a low dependency investment allocation, the cash flow from investments must be broadly matched with the pension payments from the scheme. The draft code sets out the nature of the assets that TPR considers acceptable for cashflow matching and what it means by 'broadly matched'. The value of the assets compared with the value of the liabilities must also be highly resilient to short term adverse changes in market conditions. TPR expects trustees to use a stress test to satisfy this requirement.

Significant maturity

The draft code defines significant maturity as being reached when a scheme's duration has fallen to **12 years**.

Open schemes can allow for future accrual and new entrants, which will push back the point they are assumed to reach significant maturity.

Trustees must aim to meet their long-term funding target by a date (referred to as the 'relevant date') no later than the end of the scheme year in which they expect their scheme to reach significant maturity.

Journey planning

The journey plan to a low dependency position should reflect the circumstances of the employer and the scheme. Trustees should separately consider their journey plan both during and after the period of 'covenant reliability' (meaning the period over which they feel they have confidence in their assessment of available employer support).

TPR sets out a 'stress' test for schemes to assess the maximum risk that they should assume in their journey plan.

Setting scheme funding assumptions

These must be actuarially consistent with the low dependency funding basis and the journey plan. Where the valuation date is:

- **after** the relevant date, the scheme funding assumptions **must** be at least as strong as the low dependency funding basis
- **before** the relevant date, they must be consistent with the journey plan.

Recovery plans

The draft code sets out TPR's expectations for how trustees should approach the proposed new legislative principle that, when determining whether a recovery plan is appropriate, **funding deficits should be recovered as soon as the employer can reasonably afford**.

Assessing the employer's covenant

When assessing the financial ability of the employer to support the scheme, trustees should consider the employer's cashflow, the likelihood of an employer insolvency event and other factors likely to affect the employer's business. The code also sets out what trustees should consider when valuing contingent assets.

Trustees should assess the strength of the employer in a way that is proportionate to the specific circumstances of the scheme and the employer.

Twin track: Fast Track and Bespoke

TPR plans to use a Fast Track approach as a filter for valuations submitted to it. If a valuation meets a set of Fast Track parameters, then TPR is unlikely to scrutinise it any further and less likely to engage with the trustees. TPR emphasises that Fast Track does not set a minimum or maximum level of risk.

Trustees who wish to have greater flexibility and follow an approach that suits the circumstances of their scheme, will be able to use a Bespoke approach. In fact, the Bespoke approach will be the only option for schemes that are not sufficiently well placed to meet the Fast Track parameters. The Bespoke approach is equally as valid as the Fast Track approach – the funding legislation must be complied with, and the principles set out in TPR's code followed, if the Bespoke approach is adopted.

Fast Track parameters

These cover various matters including:

- the low dependency funding basis and investment strategy
- the scheme funding basis
- investment risk; and
- recovery plans.

Certain assumptions used in the low dependency funding basis must be no less prudent than a specified level. In particular, the discount rate should be based on a gilt yield curve with an addition not exceeding 0.5% pa.

A scheme's funding basis must be strong enough that its ongoing funding liabilities are no less than a specified percentage of its low dependency funding liabilities.

This minimum percentage varies depending on the duration of the scheme. For example, if the duration of the scheme is 20 years, then the scheme funding basis must result in ongoing funding liabilities of least 85% of the low dependency funding liabilities. At duration 30 years, the minimum is 72%, and at duration 12 years or lower (significant maturity) the minimum is 100%.

Recovery plans must be no longer than 6 years for schemes that have not yet reached their relevant date and 3 years for schemes that have. There should be no allowance for future investment outperformance in the recovery plan.

Commencement

According to the consultation, the **earliest** date that the new scheme funding regime can come into force is **1 October 2023**. It will only apply to valuations with effective dates **on or after** the date that it comes into force. As the FIS regulations have yet to be finalised, the draft code might have to be revised in light of any changes in the final regulations.

Further information

For further information, please contact your usual First Actuarial consultant.