First Briefing, February 2023
In-depth look at TPR's draft DB funding code

Shortly before Christmas, The Pensions Regulator (TPR) launched its second consultation on the draft Defined Benefit (DB) scheme funding code of practice and new 'twin track' regulatory approach.

Our December 2022 briefing (**An early Christmas present: TPR's draft DB funding code**) set out the background to the consultation, explained some of the new terminology in the code, and outlined its key messages.

This briefing looks at the draft code of practice in more detail. We will shortly issue a further **briefing covering the proposals for the Fast Track route for submitting valuations to TPR**.

Overview of the proposed DB funding regime

Once the new DB funding regime has been introduced, there will be two separate but linked requirements for trustees:

- The existing requirement for scheme funding valuations every three years
- A new requirement to plan for the long-term funding of the scheme.

Trustees will have to prepare, and in subsequent years revise, a funding and investment strategy (FIS). This sets out the trustees' planned long-term funding 'end game', as well as a journey plan setting out how they intend to get there from the scheme's current position.

The bulk of the requirements are built around the characteristics of closed schemes. There are some differences for open schemes that we'll look at later.

In setting their 'end game', trustees need to explain how they intend to provide benefits in the long term, for example by:

- 'Running off' the scheme, paying benefits as they fall due
- Buying-out members' benefits with an insurer
- Transferring the scheme to a consolidator.

When setting their 'end game', trustees must target, as a minimum, having a level of funding and holding investments that put the scheme in a state of 'low dependency' on the employer by the time it is 'significantly mature'.

Low dependency means that the scheme doesn't expect to need any further employer contributions. Trustees can set a tougher target than low dependency (e.g. buy-out, 110% funded on a low dependency basis). They can also plan to reach their target earlier than the point of significant maturity. The date by which trustees plan to reach their target is known as the 'relevant date'. It must be no later than the end of the scheme year in which significant maturity is reached.

TPR anticipates that trustees will consider the FIS and the actuarial valuation together. TPR expects trustees and employers to work collaboratively.

Significant maturity

It's useful to have an idea of the period over which a scheme's benefits will be paid. Once this period gets quite short, it will be important to have enough money in the scheme to pay the benefits and for that money to be held in secure investments. TPR is defining this point as when a scheme has reached 'significant maturity' and proposes measuring this by looking at the duration of the scheme's liabilities.

Duration is one measure (in years) of the maturity of a scheme's liabilities – and gives an indication of the average period into the future over which benefits will be paid. The shorter the duration, the more mature the scheme is. In its code, TPR takes the view that a scheme is significantly mature when its duration is 12 years or less. At each valuation, the Scheme Actuary will calculate the duration as well as the date that significant maturity is expected to be reached (or was reached).

It's usual to calculate average duration by weighting the payments by their liability value. This means that when yields rise, payments made a long time in the future carry less weight in calculating duration (as their liability is lower after being discounted at the higher yield). The market turbulence following the autumn mini-Budget highlighted that gilt market volatility could trigger volatility in duration. As part of its consultation on the new funding regulations, the Department of Work and Pensions (DWP) may be considering alternative ways of measuring maturity that are less volatile amid market instability.

Low-dependency investment allocation

For the purposes of the FIS, trustees must assume that scheme assets are invested in a low-dependency investment allocation (LDIA) on and from the relevant date. This means that:

- The cash flow from investments must be broadly matched with pension payments
- The value of the assets relative to the value of the liabilities must be highly resilient to short-term adverse changes in market conditions, and
- The assets must be sufficiently liquid to meet expected cashflows.

Broadly matching

TPR sets out asset classes it considers to be matching assets. These include cash, government bonds (gilts) and corporate bonds. TPR expects matching assets to be heavily weighted towards higher quality bonds of investment grade. Trustees may partially match cashflows if they also build in mitigations for long-term interest rate/inflation risks, e.g. by hedging.

High resilience

Trustees are expected to test that they meet the requirement to be resilient to interest rate and inflation changes. As a minimum, schemes should look at a one-year, 1-in-6 stress scenario. Assuming they are fully funded on a low-dependency basis, the test should show a change in funding level of no more than 4.5%.

Proportionate approach

TPR expects schemes to take a proportionate approach when setting their LDIA. But it also expects trustees to take a more detailed approach as the scheme reaches significant maturity.

Low-dependency funding basis

TPR states that it does not intend to take a *prescriptive approach* to assumptions for the low-dependency funding basis. Principles and guidance will be provided instead. (This differs from the Fast Track approach, which is more prescriptive.)

TPR believes that low dependency does not necessarily mean removing **all** risk. Low dependency means that, under *reasonably foreseeable* circumstances, further employer contributions are not expected to be needed. TPR comments that trustees might want to target a higher level of funding than low dependency.

Trustees should choose low dependency funding assumptions prudently. They should understand the level of risk that is being taken, so that they are satisfied that the low dependency test is met by their proposed assumptions.

Where relevant, assumptions should refer to statistically credible data. Closer attention should be paid to the level of prudence included in assumptions that may be less certain and have a greater effect on the liabilities than others. TPR does not expect trustees to model each assumption stochastically to check that the low dependency test has been met.

Discount rate

TPR expects trustees to follow one of these approaches when setting a low dependency discount rate:

- A risk-free rate plus a margin
- A dynamic discount rate
- A combination of the above.

Risk-free plus: An acceptable risk-free rate would be the gilt yield or the yield on swaps (if adjusted for the likelihood of default). The margin should be a prudent estimate of the return on the LDIA.

Dynamic discount rate: If a scheme has invested in matching assets, then the discount rate can be based on the expected return of those assets, adjusted to allow for a prudent level of default and downgrade.

TPR’s general expectation is that, when setting assumptions like the discount rate and the inflation rate, a yield curve should be used.

Expense reserve

Where scheme rules do not require the employer to pay expenses, TPR requires an appropriate expense reserve to be held. Even when the employer does meet expenses, TPR encourages an expense reserve to be held to lower the level of future dependency on the employer for meeting expenses.

Journey planning

Trustees must agree a plan on how they intend to achieve the following by the time the scheme is significantly mature:

- Move from the current investment strategy to a low dependency compliant one
- Reach at least 100% funding on a low dependency basis.

In formulating these plans, the level of risk taken should depend on:

- The strength of the employer covenant, i.e. more risk can be taken where the covenant is stronger and less when it is weaker
- The time taken to reach significant maturity, i.e. more risk can be taken the further away significant maturity is.

In particular, trustees will have to set out:

- The current level of investment risk, and the level of investment risk they intend to take along the journey plan
- The proportion of the scheme's assets to be allocated to different categories of investments along the journey plan
- The discount rates for the current scheme funding basis, and how they are expected to change along the journey plan.

As the employer covenant is key to the amount of risk that can be taken on the scheme's journey plan, trustees will be required by legislation to assess the employer's covenant. This doesn't necessarily mean that an independent assessment must be made.

When setting a journey plan, trustees should consider two periods of time separately: the period of covenant reliability and the period after covenant reliability. TPR's expectation is that most employers will have a period of covenant reliability of no longer than five to six years, or two valuation cycles. The concept of the period of covenant reliability is a new one and may be difficult to assess for some employers.

Assessing the employer's covenant

The draft code sets out TPR's expectations and general principles for trustees to follow when assessing the employer covenant. This is a significant move away from TPR's current approach of simply allocating covenant strength as strong, tending to strong, tending to weak, or weak. In particular, they should consider:

- The employer's cash flow
- The likelihood of employer insolvency and the potential outcome to the scheme
- The factors likely to affect the future of the employer's business.

As the draft guidance on covenant assessment is detailed, trustees may wish to start taking specialist covenant advice. Whether they take advice or not, trustees will need to document their assessment of covenant as part of each valuation, and send it to TPR as part of their valuation submission.

Recovery plans

A key change under the new regime, when deciding whether a recovery plan is appropriate, is that trustees will have to follow the principle that a deficit must be recovered as soon as the employer can reasonably afford. To do this, they must assess the available cash of the employer and the period within which that cash is likely to be reliable. They must also determine whether there are reasonable alternative uses of the cash that don't involve paying it into the scheme. Typically, these are:

- Investing in sustainable growth
- Covenant 'leakage', for example paying dividends
- Discretionary payments to other creditors.

In TPR's view, the lower the scheme's funding level and the closer the scheme is to significant maturity, the less reasonable the latter two uses of cash are.

Interaction between scheme funding and the FIS

The assumptions chosen for scheme funding must be consistent with the low-dependency funding basis and the journey plan. Where the valuation effective date is:

- **After** significant maturity, the scheme funding assumptions **must** be at least as strong as the low-dependency funding basis

- **Before significant maturity**, the assumptions must be calculated in a way that is consistent with the planned investment transition, as set out in the journey plan.

Open schemes

The draft code does acknowledge that things might be different in the case of open schemes. When carrying out journey planning for an open scheme, trustees can assume an allowance for new entrants and future accrual, which will delay the time that significant maturity is reached.

TPR accepts that an open scheme can take investment risks for a longer period of time than an equivalent closed scheme would be able to. However, TPR does expect any allowance made for new entrants and future accrual to be reasonable and expects that it should not be assumed to continue beyond the point of covenant reliability.

Next steps

TPR launched its consultation at a time when the Government has yet to finalise the forthcoming new funding regulations. The draft code may have to be amended if the finalised regulations differ from the draft ones.

According to TPR, the earliest date that the new regime can come into force is 1 October 2023. It will only apply to valuations with effective dates on or after the date on which it comes into force.

Our view

As it stands, the draft code is significantly longer than the existing one, and is detailed to the point of being overwhelming. Assuming that the new regime does come into force this October, there is a great deal for trustees, employers and advisers to get to grips with in a relatively short period of time.

If they haven’t already done so, trustees (and employers) will need to decide on their long-term funding objective for the scheme. Another key decision for trustees is whether to use the Fast Track route for submitting the valuation to TPR. (Please see our forthcoming briefing on Fast Track.) Trustees who are not already aware of their scheme’s current duration may wish to consider taking advice to gauge when their scheme might reach significant maturity.

Further information

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