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Understanding TPR's new DB funding code – practical implications for your scheme

This publication summarises some of the key themes and Q&A from our recent webinar, *Understanding TPR's new DB funding code – practical implications for your scheme*. You can find a recording of the webinar here.

During the session, Laura McLaren (Head of Scheme Actuary Services), Stephen Jasinski (Senior Investment Consultant), and Lauren Branney (Actuarial Consultant) were joined by Matthew Gibson (Head of Pensions Covenant Advisory) from BDO LLP.

Together, they explored the implications of the new code for funding, covenants, and investments, providing insights into the key changes and future valuation approach for your scheme.

Funding and valuations

Lauren Branney
Actuarial Consultant
Hymans Robertson

For schemes that have valuations underway at the moment, to what extent should we aim to adopt the new Code?

There is no strict requirement for schemes with a valuation date before 22 September 2024 to comply with the Code. However, it makes little sense to agree a funding framework without an eye on how it works with the new Code. The new Code sets out the Pension Regulator's (TPR) expectations for DB funding and best practice would be to ensure ongoing valuations are aligned as far as possible.

Schemes that incorporate the Code's principles within their valuations now will be in a better place for their next valuation (which will be under the new regime).

As the Fast Track requirements are not in the Code, when will we know what they are?

The Fast Track 'filtering' criteria are indeed separate from the Code itself and are to be reviewed by TPR at least once every three years (or earlier if there are significant changes in market conditions or the wider pensions landscape). This provides more flexibility for TPR to amend the parameters in response to changing conditions without requiring the same levels of parliamentary approval as the Code itself.

However, we do already have the first set of Fast Track parameters. They were released at the same time as the final Code was laid before parliament on 29 July 2024 and can be found on TPR's website here. This set of parameters will apply to valuations with effective dates from 22 September 2024.

How does the Code apply to schemes that are fully bought-in?

The Code still applies to schemes that are fully bought in, although such schemes are likely to be in a very strong place to comply. Trustees will still need to prepare a Statement of Strategy and demonstrate that they are meeting the Fast Track requirements, but are likely to need minimal (if any) re-shaping of their plans in order to comply.

For schemes with partial buy-ins, the Code now explicitly states that these insured assets and liabilities should be included within the total scheme assets and liabilities to the extent that these are valued in the scheme accounts. In particular, the insured liabilities should be included in the duration calculations and the insured assets included in the investment stress calculations for the purposes of Fast Track testing.

To what extent does the Code support scheme run on (in your opinion)?

The Mansion House proposals focus on running DB pensions schemes on to create value for members, employers and the UK economy.

Though there was some perceived tension between the new Funding Code and the Mansion House reforms, they are not as incompatible as you might think.

Whilst the Code requires schemes to target a low level of sponsor dependency over the long term with an investment strategy that is de-risked to be highly resilient to short term market movements:

- The low dependency asset allocation still gives schemes scope to invest a meaningful allocation to growth assets.
- There's more flexibility for surplus on the low dependency funding basis – this does not need to be invested in line with the low dependency investment allocation.
- The Code will require schemes to formalise a long-term objective for paying benefits, and is clear this can be buy-out or run-on (or an alternative endgame option such as superfunds). Indeed, in the latest annual funding statement TPR was strongly encouraging trustees to review the full range of options for a scheme's long-term future.

TPR describes the Code as providing 'important building blocks' when it comes to improving outcomes and driving innovation such as frameworks that would support surplus sharing.

The final regulations and Code are much less prescriptive than the initial drafts, and give added flexibility for schemes targeting run on, value sharing and/or greater investment in growth in line with the ex-Chancellor's Mansions House speech.

Investment

Stephen Jasinski
Senior Investment Consultant
Hymans Robertson

Q Under the new Code, is there any relative change in powers between trustee and employer, in particular investment strategy? Is the requirement still to consult employers on investment strategy changes, and what are requirements in terms of agreement on long-term strategy (basis/notional investment allocation)?

Trustees and sponsors must agree the Funding and Investment Strategy (FIS) of the scheme, and document this in the Statement of Strategy. The FIS is the objective of the scheme to achieve full funding on a mutually agreed basis by the time of significant maturity and to be invested in line with a mutually agreed low dependency investment allocation.

This investment strategy however is a notional portfolio only and it is for trustees alone to decide on the actual investments made.

This gives trustees the freedom to invest the actual assets of the scheme however they choose, should there be a reason that they no longer believe investing in the notional portfolio agreed with the sponsor is in members best interests. TPR expect most trustees to invest in line with the notional low dependency investment allocation, but the freedom to do something different is protected to ensure the Code and the underlying regulations don't change trustees' powers in respect of investment decisions.

Covenant

Matthew Gibson
Head of Pensions
Covenant Advisory
BDO LLP

To what extent should trustees be concerned about a change in sponsor circumstances, such as loss of funding?

Trustees need to assess the risks to the sponsor covenant caused by the loss of funding. Does this leave the sponsor with insufficient liquidity and cause an insolvency risk? They also need to try and understand what steps management are taking to rectify the position and the likelihood that new funding will be obtained.

The Code required trustees to try and establish if any weaking of the sponsor covenant is temporary or there is an insolvency risk.

If the trustees think that any funding gap is temporary, then they may decide to maintain their existing investment strategy and may make this decision contingent on obtaining some additional support for the scheme such as a contingent asset.

The trustees should monitor the position (either themselves or through a covenant adviser) and if it appears that insolvency is likely then they should take steps to reduce investment risks.

Could you provide more detail as to how the period of covenant reliability is determined?

Essentially, to determine the covenant reliability period it is expected that the trustees will obtain profit and cash flow forecasts for the sponsor and where possible review sensitivity analysis to form an opinion as how reasonable they are and for how long they can be relied upon. For example, In the short-term forecasts may be underpinned by firm customer orders, but over the long-term they may be based on management's assumptions.

The trustees are then expected to undertake an assessment of the employer's 'Prospects' by considering the areas I set out in the presentation, including market position, strategic position and sector outlook to determine how these factors might impact on the reliability of the cashflows during the period of covenant reliability. This will also inform the trustees' view of covenant longevity – the period over which they employer may be expected to provide some level of support to the scheme.

TPR guidance suggest unless there are exceptional circumstances, the reliability period will normally be no more than six years. In most cases the approach will be to undertake analysis as outlined above and give an opinion by exception if a six year reliability period is inappropriate. For example, in our discussions with management we have not identified any factors that might be inconsistent with a covenant reliability period of less than six years.

Could you provide more detail as to how the period of covenant reliability is determined?

Yes. Some level of dividend payment is accepted as a reasonable alternative use of cash. It is important to assess how reasonable dividends are relative to DRCs, particularly if recovery plans are expected to go beyond the covenant reliability period. Some companies have a dividend policy eg to distribute, say, 50% of PAT and others have a planned profile of dividends both of which could be modelled in a cash forecast. Others are ad hoc and we would need to discuss with management what dividend we should factor into our analysis.

If the scheme already has a low risk investment strategy and security and does not need to rely on the covenant, do the covenant tests still have to be done?

The Code now recognises that low dependency is not no dependency, and the scheme could still suffer a loss on an employer insolvency. In terms of ongoing covenant assessment, the Code recognises that covenant assessments for schemes that are fully funded on a low dependency basis can be lighter touch.

If the scheme already has a low risk investment strategy and security and does not need to rely on the covenant, do the covenant tests still have to be done?

It is a legal requirement to carry out covenant assessment, but the law and the Code stop short of prescribing this must be an independent covenant assessment. However, the Code (and likely future covenant guidance) is complex and trustees will also need to compile covenant information for Part 2 of their Statement of Strategy. With this in mind we expect that many schemes that have not taken independent covenant advice before will now do so.

However, the Code does specify that the approach to covenant assessment should be proportionate to a scheme's circumstances, including the extent of reliance on the sponsor.

What happens to the approach to prospects analysis if there are no sponsor forecasts available?

This will be a challenge. For complex/challenging cases it may be necessary that forecasts are prepared. If this is not viable/cost effective then the next approach would be to work with management to create a proxy cash flow forecast based on historical information. The covenants assessment could still work through the Prospects areas to check if there is anything coming out of that which would undermine the proxy cash forecast. As the quality of information gets weaker the trustees should become more cautious and may have to assume a reliability period of, say, three years and revisit this at each covenant assessment.

Is there a clear sense of how 'proportionality' applies for less well-funded smaller schemes with smaller, potentially stressed sponsors?

No. I think that a practical approach will be needed for smaller poorly funded schemes with weak sponsors. As long as insolvency is not seen as likely then it is possible under the Code to run unsupported risk but the trustees will need to push hard to obtain protections such as a contingent asset and to request that covenant leakage and discretionary payments are curtailed and DRCs are prioritised. The ability of the trustees to negotiate these protections will depend on their powers in the trust deed and rules, the 'threat' by the trustees that they might derisk the investment strategy and the extent to which TPR are prepared to support the trustees.

Our DB Funding Code hub has resources to help you plot a route through the regulatory changes. It includes an interactive tool that helps you quickly identify whether your current strategy is more suited to the Fast Track or Bespoke route.

To find out how we can help you prepare for the new Funding Code, please get in touch.

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