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Sixty second summary

Revising the DB Funding Code (Phase 2)

The Pensions Regulator has launched its long anticipated second consultation on a new Code of Practice for funding defined benefit (DB) schemes. There are few real surprises, after nearly 2 years of TPR trailing its Fast Track and Bespoke compliance approaches. The new code and regulations are expected to come into force from 1 October 2023.

Consultation details

This second stage of TPR's consultation process builds on the overarching principles for scheme funding, which TPR covered in stage 1. It sets out in draft the Code TPR wishes to implement for valuations from 1 October 2023, along with the parameters for TPR's "Fast Track". The consultation runs until 24 March 2023.

Key details in the new Code

The Code sets out principles for how schemes comply with the DWP's new funding and investment regulations. Schemes must comply with the Code, but are encouraged to do so in a way that is suitable for their circumstances. This maintains the vital concept of scheme-specific funding from the Pensions Act 2004 (though we remain concerned that the DWP's draft regulations are overly restrictive and need revising).

TPR's 204 pages of material confirms most of what industry was expecting, but there are a couple of new points.

- Fast Track is reframed as TPR's tolerable level of risk in normal circumstances. It is not supposed to be risk-free nor the minimum that complies, but TPR is unlikely to scrutinise a valuation further if a scheme's actuary confirms its strategy meets each of the Fast Track parameters.
- Fast Track's parameters sit in a separate document, outside the Code. Although TPR expects to keep Fast Track stable over time, this means any changes from TPR's planned annual and triennial reviews can be implemented without needing to go back through Parliament.
- As expected, new legal requirements include setting a long-term Low Dependency Objective when a scheme reaches 'significant maturity', with a journey plan for how a scheme's allocation will become "broadly cashflow matched" and "highly resilient". This all needs to be summarised in a Funding and Investment Statement and Statement of Strategy, agreed by trustees and sponsors.
- The main easement for open schemes is factoring-in future accrual and new joiners when calculating the way a scheme's duration is expected to evolve. This will lead to longer journey plans than for closed schemes, providing more scope to take more investment risk.

- The onus is on trustees taking the Bespoke route to demonstrate how they comply with the principles of the Code. TPR's central concept is that risks are supported by the sponsor. Although there's little detail on how TPR will actually regulate Bespoke, TPR is at pains to say it won't be comparing them to Fast Track.
- Though there's one Fast Track for the whole range of sponsor covenants, covenant gets a much larger spotlight. TPR identifies three horizons trustees should consider – visibility, reliability, and longevity – with trustees expected to know what their sponsor's free cashflow is and how far into the future it is visible for. Trustees are also expected to consider the sponsor's long-term prospects (and their Environmental, Social and Governance credentials) and there is beefed-up clarity on using contingent assets.
- Recovery plans are to be set in the context of the sponsor's cashflow availability (in terms of annual amounts and length), and within the principle of 'reasonable affordability' there is room to take account of the sponsor's need to invest in its business (so long as the scheme is being treated fairly). So are journey plans articulating how investment strategies evolve as a scheme matures.
- Future scheme expenses are expected to be reserved for, either in full if expenses are paid by the scheme or beyond the sponsors visible cashflow period if expenses are paid by the sponsor.
- Unsurprisingly, there is detail on using leveraged LDI, with trustee's expected to maintain enough liquidity to cover a 3% to 4% rise in gilt yields, have clear collateral waterfalls and have strong operational controls.

Summary of Fast Track's main parameters

The proposed parameters are towards the soft end of the range TPR has managed industry's expectations towards:

- LDO discount rate of gilts+0.5% (with consistent inflation), when a scheme's remaining duration is 12 years.
- Technical Provisions at least a set % of LTO depending on its remaining duration (85% at 20 years).
- Recovery Plans up to 6 years (or 3 if past significant maturity). No asset out-performance and no more than CPI-linked in terms of back-end-loading is allowed, but trustees can allow for post-valuation experience.
- A funding stress test of up to 4.5% for asset risk, based on a 1 in 6 VaR using the PPF's methodology.
- TPR is content to leave trustees in control of setting demographic assumptions that suit their scheme.

An element of over-prescription in asset allocations?

TPR has worked pretty hard to avoid low dependency turning into no risk at all. The draft code sets out example asset allocations, hedging levels and what assets TPR thinks of as being "broadly cashflow matching". This follows-on from the DWP's draft regulations and is more prescriptive than we would like to see. The consultation pack speaks at length about systemic risks and the risks of 'herding'; which this level of detail may exacerbate.

What is the anticipated impact of the Code?

TPR has included an impact assessment of expected trustee behaviours (which could be paraphrased as "who's expected to level-up and level-down to Fast Track"), with a conclusion that it's likely to reduce funding targets by £5bn across the UK's 5,051 DB schemes. But neither this consultation, nor the DWP's consultation in the summer have put a figure on the cost of additional contributions that could be put on stressed sponsors and sponsors of very mature schemes. If TPR's vision for Bespoke compliance rolls out as they hope, then this may all be fine, but we remain concerned this won't be the case due to over-prescription in DWP's draft regulations.

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