HYMANS # ROBERTSON

CASE STUDIES

# What the new DB funding code means in practice

## The Pension Regulator's (TPR's) draft DB funding code is expected to come into force for valuations from 1 April 2024.

The code sets out how pension schemes should de-risk towards a low-dependency funding basis and investment allocation by the time of 'significant maturity', taking into account scheme maturity, the pace of funding, investment risk – and covenant reliability.

Employer covenant is essential for meeting the requirements in the code. The covenant must support investment risk, and will affect not only the investment strategy, but the route to compliance with the code.

The code includes a 'Fast Track' route to compliance that enables TPR to automatically filter out valuations that require no further scrutiny. Schemes that do not meet the Fast Track requirements have to use the 'Bespoke' route to compliance.

To explore how onerous the Fast Track requirements might be, we set out a base case that meets them, and explored variables that could make doing so more challenging. We then explored ways to resolve the challenges while remaining compliant with the broader requirements of the code.

**CASE STUDY 1**

### Fast Track base case

This base case meets the Fast Track requirements. Covenant does not affect these requirements, but it affects the maximum risk requirement in the code. The code includes compliance tests, and we've applied each test to the base case.

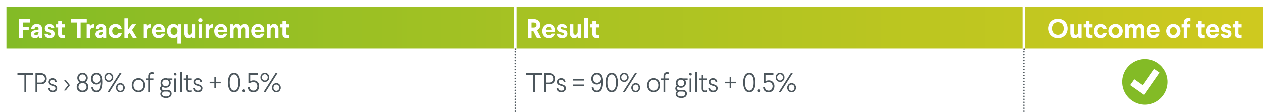
| | |
|---|---|
| **Scheme funding:** | |
| Assets | **£165m** |
| Technical provision liabilities (TPs) | **£180m** |
| Low-dependency objective liabilities (LDO) | **£200m** |
| **TPs discount rate** | Gilts + 1.5% pa for 6 years, phasing to gilts + 0.5% pa at a duration of 12 years |
| **LDO discount rate** | Gilts + 0.5% |
| **Recovery plan** | £2.5m pa for 6 years |
| **Duration** | 18 years |
| **Covenant reliability period** | 6 years |
| **Maximum covenant affordability** | £5m pa |
| **Asset allocation** | 35% in LDI (2x leveraged), 30% in investment-grade credit and 35% in equities |

### Fast Track Test 1

**Strength of TPs**

Fast Track requires a minimum level of TPs relative to LDO liabilities. This level is duration-based and converges towards the LDO level as the scheme matures so that the TPs equal the LDO at significant maturity.

TPR and the Department for Work and Pensions (DWP) are still to confirm the definition of significant maturity. It is currently proposed as the point at which a scheme reaches a duration of 12 years on its LDO liabilities. In the base case, the strength of the TPs is tested against the LDO liabilities calculated using gilts + 0.5%. With a duration of 18 years, the requirement is that TPs must be greater than 89% of LDO liabilities, which is the case for the scheme.

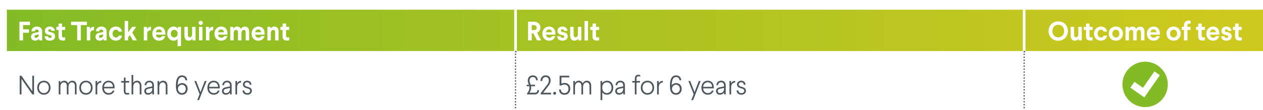


| Fast Track requirement | Result | Outcome of test |
|---|---|---|
| TPs › 89% of gilts + 0.5% | TPs = 90% of gilts + 0.5% | ✓ |

### Fast Track Test 2

**Length of recovery plan**

The recovery period needs to be no more than six years for a scheme not yet at significant maturity, or three years for a scheme at significant maturity. In the base case, the recovery plan is £2.5m pa for six years, so the scheme meets this test.



| Fast Track requirement | Result | Outcome of test |
|---|---|---|
| No more than 6 years | £2.5m pa for 6 years | ✓ |

### Fast Track Test 3

**Investment stress**

The investment risk assessment is based on the PPF's tier 1 test, and requires the scheme's funding position to fall by less than the maximum risk parameter when applying an investment stress. As with Fast Track Test 1, it is based on duration: less mature schemes can take on more investment risk.

In the base case, the scheme has a duration of 18 years, so the funding level can't fall below 12% under the prescribed stress test. Based on the asset allocation, the funding level falls by 5.5% under a stress scenario and so meets the requirements.

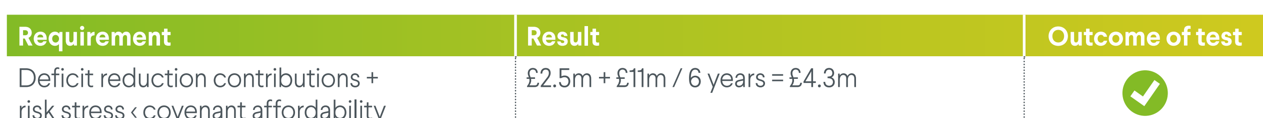
| Fast Track requirement | Result | Outcome of test |
|---|---|---|
| Funding level fall ‹ 12% | Funding level fall = 5.5% | ✓ |

### Maximum risk test

For all schemes, including those not using Fast Track, the employer covenant must be able to support a stress scenario. The employer must be able to fund a 1-year 1-in-6 Value at Risk (VaR) event over its covenant reliability period. This stress equates to how much the TP deficit would increase in the worst 17% of outcomes over a year.

A stronger covenant can support more investment risk. The covenant reliability period is the period over which there is reasonable certainty over employer cashflows (typically expected to be around six years). The stress must be supportable by the employer's 'maximum affordable contribution', which the code explains.

In the base case, the investment stress is £11m, requiring funding of £1.83m pa over a six-year covenant reliability period. Together with deficit reduction contributions of £2.5m pa already payable by the employer, the total funding requirement amounts to £4.3m pa, which is less than the maximum affordable contribution of £5m pa (including deficit contributions).



| Requirement | Result | Outcome of test |
|---|---|---|
| Deficit reduction contributions + risk stress ‹ covenant affordability | £2.5m + £11m / 6 years = £4.3m | ✓ |

# Changes in circumstances

## A shorter covenant reliability period

In this scenario, the covenant reliability period halves from six years to three years because of a large future revenue source falls away. The shorter period affects the Fast Track and maximum risk tests.

### Fast Track Test 1

**Strength of TPs**

With a shorter covenant reliability period, the TPs discount rate is gilts + 1.5% pa for three years, phasing to gilts + 0.5% pa at a duration of 12 years. This results in the TPs increasing from £180m to £183m. The scheme still meets the test, as TPs are now 92% of LDO liabilities.

### Fast Track Test 2

**Length of recovery plan**

The TPs deficit is now £3m larger, at £18m, which requires deficit reduction contributions of £3m pa for a six-year recovery plan. The scheme passes this test, although its recovery plan is longer than the covenant reliability period.

### Fast Track Test 3

**Investment stress**

The shorter covenant reliability period does not change the investment stress, and the scheme remains compliant.

### Maximum risk test

The maximum supportable investment risk falls, because it needs to be recovered over a shorter covenant reliability period. The deficit reduction contributions have also increased, using up further headroom. The maximum risk is now £3m pa + £11m / 3 years = £6.7m pa. This is above the maximum affordable contribution of £5m pa. The scheme therefore does not meet the requirements of the code under this scenario.

## A solution: adjust the investment risk and LDO discount rate

If a scheme is failing the maximum risk test, it needs to dial down its investment risk. For example, the scheme could de-risk by reallocating assets from equities to investment-grade credit and LDI. The scheme would then need to reduce the TPs discount rate to reflect the lower expected return. However, if the TPs discount rate trends to an LDO discount rate that's higher than in the base case, the TPs could be similar. For example, a discount rate of gilts + 1.2% pa tapering down after a three-year covenant reliability period to gilts + 0.75% pa (compared with gilts + 0.5% in the base case) still gives TPs of £183m.

### Fast Track Test 1

**Strength of TPs**

The TPs remain 92% of the LDO liabilities, and the scheme therefore passes this test initially. However, it will fail this test in the future as the discount rate trends to an LDO that is less prudent than what Fast Track requires.

### Fast Track Test 2

**Length of recovery plan**

The TPs deficit is still £18m, requiring deficit reduction contributions of £3m pa for six years. The scheme passes the Fast Track test, although the recovery plan is longer than the covenant reliability period.

### Fast Track Test 3

**Investment stress**

The lower-risk investment strategy reduces this stress from a funding level fall of 5.5% to a funding level fall of 2.5%, so the scheme still passes the test.

### Maximum risk test

The lower-risk investment strategy reduces the investment stress from £11m to £5m, which is supportable within the shorter covenant reliability period. The maximum risk is now £3m pa + £5m / 3 years = £4.7m pa. This is less than the maximum affordable contribution of £5m pa.

CASE STUDY 3

## Using the Bespoke route to compliance

In this modification of the Fast Track base case, the scheme takes more investment risk to shrink the TPs deficit from £15m to £5m, reducing expected cash costs by £10m. TPs are now too weak to meet the Fast Track filter, so the scheme must use the Bespoke route. The strategy remains compliant with the code as long as the covenant can support the higher investment risk. It could do so through the employer providing contingent security to the scheme.

| **Scheme funding:** | |
|---|---|
| Assets | **£165m** |
| Technical provision liabilities (TPs) | **£170m (down from £180m in the base case)** |
| Low-dependency objective liabilities (LDO) | **£200m (unchanged from the base case)** |
| **TPs discount rate** | Gilts + 2% pa for 6 years, phasing to gilts + 0.5% pa at a duration of 12 years |
| **Recovery plan** | £0.8m pa for 6 years |
| **Duration** | 18 years |
| **Covenant reliability period** | 6 years |
| **Maximum covenant affordability** | £5m pa, plus non-cash support |
| **Asset allocation** | 20% in LDI (2.5x leveraged), 20% in investment-grade credit and 60% in equities |

### Fast Track tests

The scheme fails the TPs and investment stress tests, so is not eligible for Fast Track.

### Maximum risk test

The higher-risk investment strategy gives a stress of £27m, compared with £11m in the base case. However, the deficit reduction contributions of £0.8m pa are lower because of the smaller TPs deficit.

The maximum risk is £0.8m pa + £27m / 6 years = £5.3m pa. This exceeds the maximum affordable contribution of £5m. However, the gap could be bridged with non-cash support such as a contingent asset, in which case the scheme would meet the requirements of the code.

## How you can prepare for the new funding code

These case studies illustrate how much of a role covenant plays in the new code, and how it can affect investment strategy, discount rates, timelines and even the route to compliance with the code. You should take steps to prepare for the new code to ensure no surprises when it comes into force.

1. Consider your long-term strategy and endgame, and how the code affects them.
2. Understand your covenant requirements and discuss them with the trustees, focusing on the cashflow reliability period and maximum affordability.
3. Assess what to do if meeting the Fast Track filter is not viable or consistent with your endgame strategy.
4. Maintain clear communication with the trustees.

## Want to find out more?

To find out how we can help you prepare for the new funding code, please get in touch with your usual Hymans Robertson contact or one of our experts on employer strategy:

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