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DB funding changes move closer

A new framework for funding defined benefit pension schemes will come into force later this year. Where are we now and what detail is still to come?

The Department for Work and Pensions (DWP) published its final regulations governing occupational pension schemes in January 2024, after consulting on the draft in July 2022. They came into force with effect from 6 April 2024, and will apply to valuations with effective dates from 22 September 2024 onwards.

The Pensions Regulator (TPR) expects to publish the final, revised version of the accompanying DB funding code in the summer, so it can be in force in the autumn. TPR will also publish the final Fast Track parameters, having considered industry feedback and changes in market conditions. The TPR guidance is crucial to how the regulations will work in practice.

No wholesale changes to the overarching principles and framework are expected. The revised regulations align much better with the draft code than they did, but schemes with the earliest in-scope valuations (later this year) need the final details to be confirmed so they can prepare meaningfully. Some important detail is still to come.

Changes to the draft regulations

- Removal of 'broadly matched' from the low-dependency investment allocation, and added flexibility for surplus assets
- Clarity that the power to set the actual investment strategy remains with trustees
- A less volatile maturity measure (market inputs fixed at 31 March 2023)
- Confirmation that open schemes can make a reasonable allowance for new entrants and future accrual
- Requirement for trustees to consider the impact of recovery plans on the employer's sustainable growth

Detail to come

- Duration for defining significant maturity
- Guidance on the low-dependency investment allocation
- Covenant assessment guidance
- Fast Track parameterisation
- Open scheme assumptions
- Statement of strategy and TPR's regulatory enforcement approach

Duration for defining 'significant maturity'

The regulations confirmed that maturity will be measured using scheme duration. Fixing the market conditions for the calculation at 31 March 2023 addresses the concern that timeframes could jump around with market conditions.

But we still don't know what duration is to be used for defining 'significant maturity' (the point by which schemes need to reach a low-dependency position). It's an important driver of strategy that is left for TPR to set.

Next: The draft code proposed a significant maturity duration of 12 years, meaning that a typical scheme would take 15–20 years to reach low dependency. However, higher gilt yields through 2022 and 2023 shortened scheme durations significantly, and we expect the 12 years will be reset to return timeframes to those initially envisaged. The final parameter and calculation details will come as part of TPR's code.

Guidance on the low-dependency investment allocation

By the time a scheme is significantly mature, it should be fully funded on a low-dependency basis consistent with a low-dependency investment allocation. It would be unlikely to need sponsor contributions.

The regulations originally mandated this low-dependency investment allocation 'broadly match' cash flows and be 'highly resilient' to short-term adverse changes in market conditions.

This was simplified in the final regulations, and 'broadly matched' was dropped. The regulations still imply significant matching assets and hedging, but they're now clearer that there's scope to invest a meaningful allocation to growth assets. Schemes are expected to have more flexibility with surplus and investment decisions.

Next: Low-dependency investment guidance will be rewritten in the final code, but we don't yet know to what extent. Earlier guidance included example asset allocations and hedging levels, stress tests and risk thresholds.

The code already took a broader interpretation than the regulations, but it is likely to be updated to align with the revised regulations and the Mansion House agenda.

Covenant assessment

Generally, covenant gets much more attention than it did previously. The regulations explicitly require, for the first time, that trustees consider employer covenant.

Trustees will need to give more consideration to factors affecting the employer's future capacity to support the scheme. Trustees will need to conclude how long the covenant is 'reasonably certain'.

TPR's draft code identified three horizons to assess: visibility, reliability and longevity. Trustees were expected to determine maximum risk levels that the employer covenant can support before and after reliability, using a reasonably formulaic test.

Next: The code will confirm how schemes are expected to assess supportable risk. TPR will publish more covenant guidance later this year.

Fast Track parameterisation

TPR has proposed 'Fast Track' and 'Bespoke' routes to compliance. Fast Track is framed as the tolerable level of risk in normal circumstances and will be a 'filter' for TPR. TPR is unlikely to scrutinise a valuation further if a scheme's strategy meets each of the Fast Track parameters.

In broad terms, the draft code set out that technical provisions would need to converge towards a gilts + 0.5% basis and recovery plans must be shorter than six years, with limits on investment risk. We've written more about the routes to compliance in **our briefing note last year**.

Next: TPR is to publish its final parameters alongside the code. The specific Fast Track parameters will sit in a separate document to the code itself.

Open scheme assumptions

The regulations now explicitly clarify that open schemes can take account of new entrants and future accrual when determining significant maturity. This detail was previously left to the code.

The regulations also make clear that the assumptions are based on the employer covenant, but the code will set out more detailed expectations.

Next: The final code is expected to confirm when it's reasonable to assume accrual or entrants will continue. The earlier draft suggested these would be limited to the period of covenant reliability and six years for Fast Track.

Statement of strategy and enforcement

TPR has started consulting on the statement of strategy that schemes will need to submit as part of the valuation. TPR can set the statement's form and how much detail some components need.

This extra compliance may be the biggest change to schemes' valuation process.

The proposed statement has two parts. Part 1 is the funding and investment strategy, which requires employer agreement. Part 2 covers supplementary matters and requires consultation with the employer. These matters include views on implementation and risks, details of the latest actuarial valuation and any resulting recovery plan, scheme maturity, investment risk levels and the strength of the employer covenant.

TPR plans to require standard templates, which will ask for less information from small and 'Fast Track' schemes.

Next: TPR was consulting on the statement of strategy until 16 April 2024, seeking feedback on the data it's asking trustees to provide and its proposed templates. The consultation is accompanied by an example for a scheme that's not yet reached significant maturity and is going Bespoke. TPR will give more detail on how it intends to regulate, especially for 'Bespoke' schemes.

All schemes need to start preparing for the code now. 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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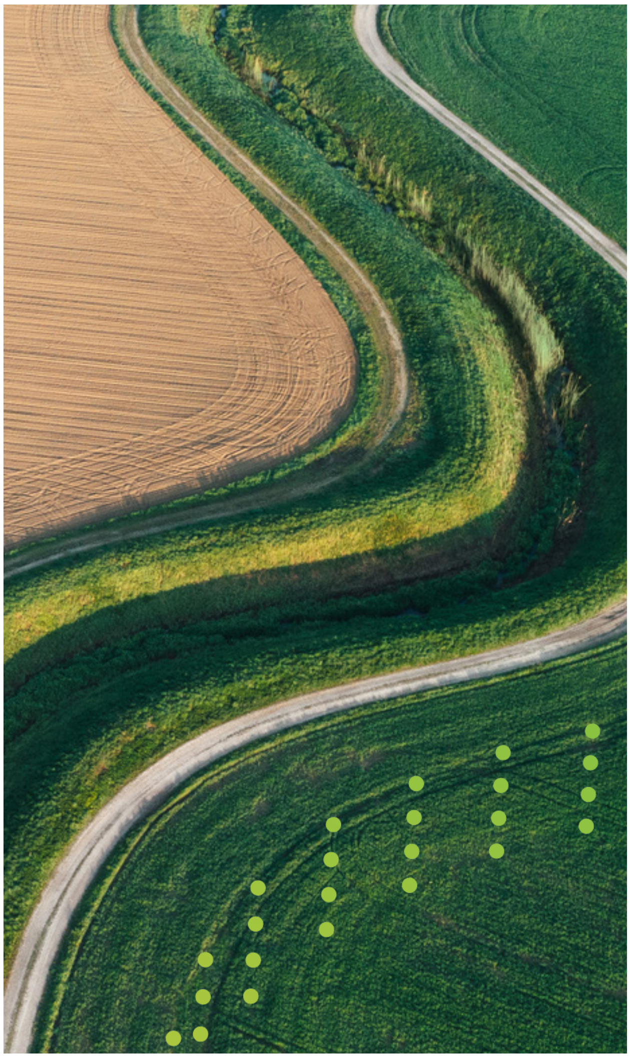

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