HYMANS ROBERTSON

TPR's new DB funding code

Fast track or bespoke: A guide for employers

The Pensions Regulator (TPR) is consulting on a new, more prescriptive DB code of practice which introduces "fast track" and "bespoke" approaches to funding DB schemes.

Having a clearly articulated "fast track" route through the valuation process provides some clarity, but potentially comes at a much higher cost. For most schemes, passing the "fast track" hurdles will mean increased deficit contributions.

For employers, there is a risk that pension scheme trustees will default to the "fast track" option. The "fast track" funding target is expected to be 10-15% more prudent than a typical funding basis, and 15-20% more prudent that an IAS19 / FRS102 basis. It is also likely to accelerate and increase deficit contributions. The employer will be expected to pay deficit contributions, if necessary, right up to full funding on a "low dependency" basis (and will remain liable for any additional contributions should these be needed).

> TPR's new funding code is likely to increase pension scheme contributions for many employers

3 key changes proposed by the Pensions Regulator

1. An actuarial valuation will either need to demonstrate compliance with minimum standards (fast track), or trustees will have to explain and justify why it is reasonable to take a different approach (bespoke).

2. Schemes will be required to set a Long Term Objective (LTO) to be fully funded on a "low dependency" basis and invested in risk-resilient assets by the time they reach significant maturity (within around 15 years for most schemes).

3. Under Fast Track, the Regulator will set parameters for funding and investment features like the LTO, discount rates for technical provisions, recovery plan length and structure, investment risk, and future-service contribution rates in open schemes. These are a series of pass/fail tests, tailored to a scheme based on its maturity levels and the strength of the sponsor's covenant.

> Our interactive online tool helps you assess if your current funding and investment strategy is likely to comply with "fast track."
> Access the tool for free at www.hymans.co.uk/fast-track-or-bespoke/

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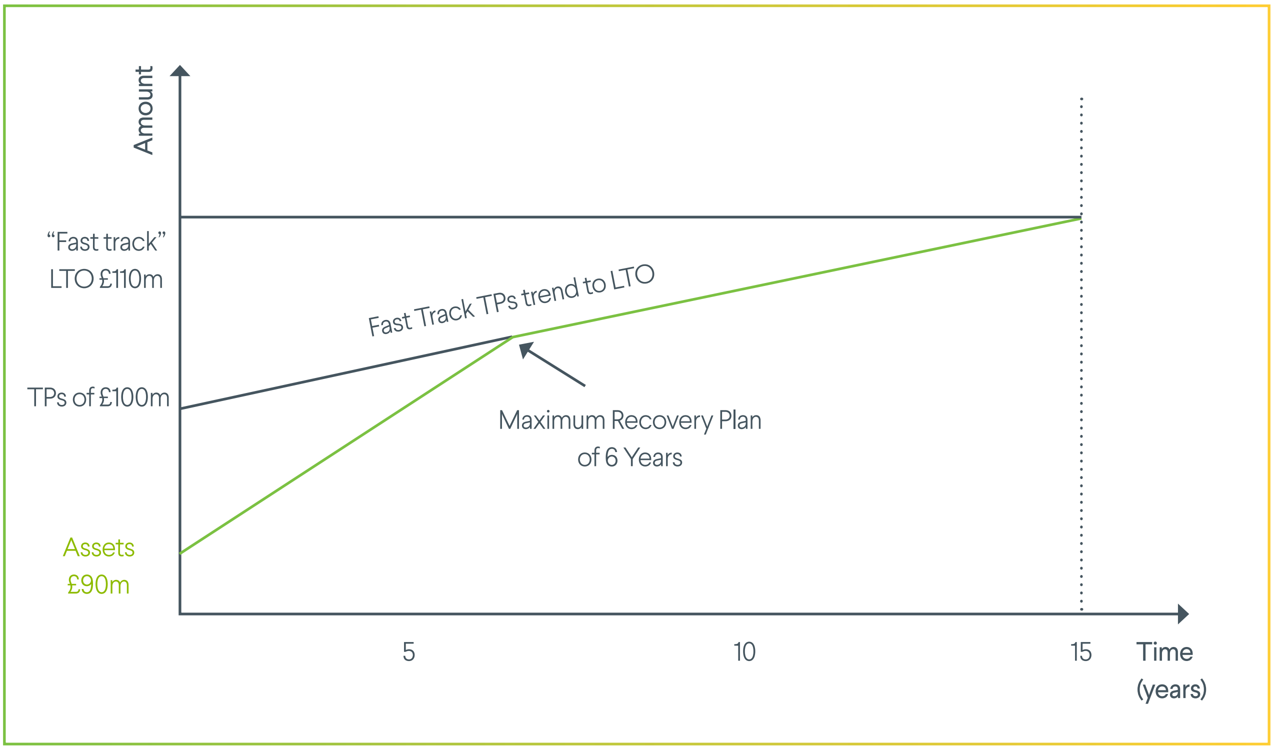
What does this mean for employers?

The chart below shows the funding plan required under the proposed "fast track" option. This is for a £100m scheme funded at 90% on technical provisions, that has an employer with a strong covenant. The employer needs to fund the technical provisions deficit within 6 years, and thereafter needs to pay deficit contributions if a deficit re-emerges on the path to the LTO. This is because technical provisions have to trend to the LTO over time.

> Under the "fast track" option, we anticipate around half of employers will need to shorten their recovery plans. As an indication, reducing the length of the recovery plan from 10 years to 6 years results in an increase in annual deficit contributions of around 70%.



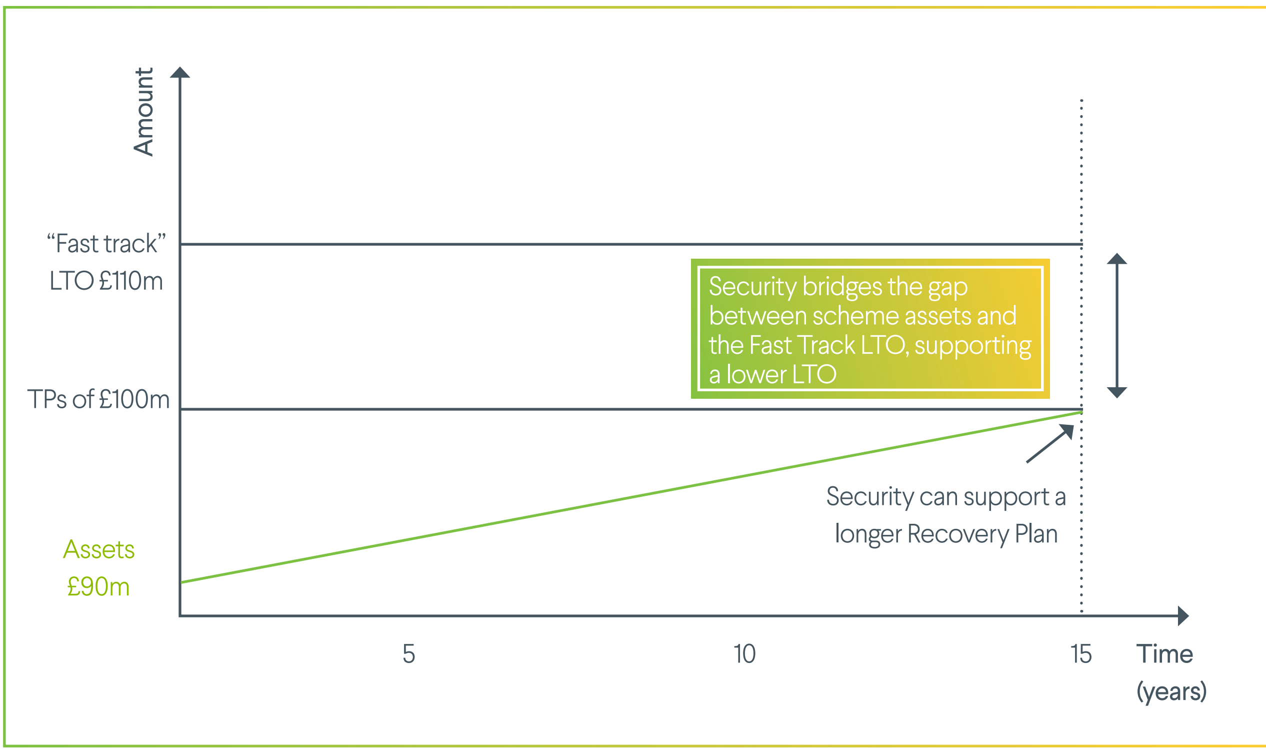
If a scheme goes down the "bespoke" route, it doesn't necessarily mean that regulatory intervention will happen. If TPR assesses that the "bespoke" approach is at least equivalent to their "fast track" approach, then they won't intervene. This leaves schemes with much needed flexibility, within parameters, to go down the "bespoke" route. Importantly, it now gives corporates clear value from providing security to their scheme because this can now explicitly support a lower funding target or longer recovery plan.

Employers can reduce cash costs by providing additional security to the scheme

"Fast track" may well suit employers who are seeking to reduce risk and ultimately remove the pension liabilities from their balance sheet. However, we expect some employers will want to retain some flexibility. We recommend that employers take a proactive approach to triennial valuations under the new funding regime. It's crucial to have clear views on your own preferred strategy, and to put these to your pension scheme trustees, rather than waiting for them to give you a proposal.

Our view is that "fast track" may be too restrictive for some employers and that "bespoke" may be the preferred approach. This allows a lower funding target and / or a longer recovery plan, therefore reducing annual cash costs, often by more than 50%. However, in many instances this approach needs to be supported by security to bridge the gap between the "bespoke" package and the "fast track" alternative. Providing security to your pension scheme will therefore now have real tangible value.

This is illustrated in the chart below for the same example £100m scheme. The asset value increases far more slowly over time meaning either lower cash contributions are required, or less investment risk is required, therefore giving more cost certainty. It also addresses the asymmetric risk that employers must fund any deficit but can't generally access any surplus.



Non-cash funding solutions

It's important to consider the range of security options that can be provided to the pension scheme. We've set out the main options below, with an indication of how each option addresses typical corporate objectives.

Solution	Support lower LTO	Support longer Recovery Plan	Flexibility for employer	Ease of implementation
Asset backed contributions				
Asset backed funding	🟡	🟢	🟡	🔴
Contingent cash contributions				
Escrow / reservoir trust	🟢	🟡	🟡	🟢
Matching mechanisms	🔴	🟡	🟡	🟡
Contingent support				
Surety bonds/ letters of credit	🟢	🟡	🟢	🟢
Charge over asset	🟢	🟡	🟡	🟢
Parent Company Guarantee	🟢	🟡	🟡	🟢

An area of interest at the moment is capital light security such as surety bonds and letters of credit. These can be provided even when there aren't unencumbered assets available to pledge to the pension scheme. The premium for these guarantees can be far lower than the cash contributions that might otherwise be payable to the pension scheme under "fast track." Alternatively, borrowing in the current low interest rate environment to place funds into escrow or a reservoir trust can look compelling relative to the cash contributions under "fast track."

How we can help

We work closely with employers to define a pension funding strategy that fits with your commercial objectives. By considering all the levers that impact funding, we ensure a well-balanced solution. We then work proactively and collaboratively to help you set the agenda with your trustees to implement your plans.

What we deliver

- **Tailored advice:** Based on what's right for you and with relevant, off-the-fence opinions and recommendations.
- **Win-win outcomes:** Seeking to ensure alignment of interests with trustees wherever possible, to create optimal and sustainable outcomes.
- **Commercially sensible strategies:** Focusing on the big picture rather than technical actuarial nuances.
- **End-to-end support:** Supporting you throughout the valuation process, from strategy and preparing a proposal through to your discussions with the trustees in finalising the valuation.

Our experience

Our mission is to create better futures for our clients, their members and our industry. We pride ourselves on finding the answers that deliver the right outcomes by putting forward fresh, innovative ideas. We work with a wide range of clients across our whole business, who benefit from our unwavering commitment to delivering excellent service and providing solutions that truly meet their needs.

We work with more than 260 private sector DB clients and schemes, including around a third of the FTSE350.

Get in touch

Contact Alistair if you would like to find out more about how we can help you.

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