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CASE STUDIES

# DB funding code: what it means for you

**The Pensions Regulator (TPR) has been consulting on its new DB funding code for some time. The industry expects to see the final regime later this year. TPR will then say how it will take account of feedback and reflect changes to the DB pensions landscape, including funding improvements and sentiment on issues such as open schemes and systemic risks. The code is due to come into force on 1 April 2024.**

The principles and expectations of the new regime have been several years in the making. However, it's the finer detail that will affect the code's ultimate success. We hope to see changes and clarity in some important areas. We have concerns about potential inconsistencies with the DWP's draft regulations, the legal framework that will underpin the code. The best outcome would be for the regulations to remain flexible and coherent with the current scheme-specific funding regime.

The content and format of the statement of strategy will also be important. We hope to see information requirements kept proportionate to the risk and the chances of improving member outcomes.

We've put together eight examples to show what the code could mean for various schemes, and some of the unintended consequences that could arise. We suggest changes we'd like to see in some areas, especially where these would keep compliance proportionate to risks.

| Type of scheme | Issues | What's needed |
|---|---|---|
| **1. Repackaging**<br>'Repackaging' plans in line with Fast Track | Disrupts well-planned scheme-specific approaches. Some schemes are pushed to 'level down' plans. | Clear guidance over when Fast Track may not be appropriate. |
| **2. Significantly mature**<br>Already significantly mature | The need to de-risk quickly and a shorter recovery plan materially increase contributions to reach low dependency. | Some transitional flexibility.<br>A recalibrated, less volatile measure of significant maturity. |
| **3. Flexible**<br>Adopting an atypical investment strategy | Schemes are herded towards similar gilts-based strategies. | Changes to DWP's regulations.<br>Less prescription on asset allocations and hedging levels. |
| **4. Insuring**<br>Well funded, de-risked and planning for insurance | Plans will need to be defined in this new language, adding to the compliance burden. | Compliance kept proportionate to risks. |
| **5. Constrained**<br>Weak sponsor covenant with limited affordability | More work to assess covenant and the focus on reliability could 'lock in' a bigger deficit with unaffordable contributions. | Room for sponsor specifics to be considered and less focus on a single date for reliability. |
| **6. Open**<br>Open to new entrants and future accrual | Ongoing viability may be at risk if costs of compliance rise. These schemes still need to map out a journey to significant maturity. | More differentiation between open and closed schemes, and an open scheme carve-out to reduce the compliance burden. |
| **7. Small**<br>Less than 100 members or less than £25m of assets | Compliance could be onerous and disproportionately expensive, meaning schemes are pushed towards consolidation. | Clear guidance on proportionality for small schemes. |
| **8. Large**<br>More than £5bn of assets | Lack of flexibility constrains innovation and supercharges systemic risks. | Less prescription on asset allocations and hedging levels, with credit given for contingent assets after significant maturity. |

## 1. Repackaging

**'Repackaging' plans in line with Fast Track**

### How might these schemes respond?

Fast Track may be attractive, as it offers lighter regulatory scrutiny. Schemes already close to the Fast Track requirements could repackage plans without much difficulty.

Going down the Fast Track route will strengthen funding packages for some schemes, but schemes with stronger longer-term plans in place could come under pressure to 'level down' to reduce the sponsor support they need.

### Concerns

Fast Track may be a sensible target for many schemes, but not for all, and choosing Fast Track won't necessarily improve outcomes by itself. Should valuations become an exercise in box-ticking, there's a risk that trustees lose sight of the underlying risks.

Some herding is inevitable. But it would be disappointing if Fast Track became widely regarded as the 'default' approach at the expense of well-planned scheme-specific approaches, and led to levelling down.

### What's needed?

- Clear guidance over when Fast Track may not be appropriate.
- Requirements to explain and justify changes to plans in the statement of strategy.
- Compliance for schemes using the Bespoke route to be proportionate to risks and not unduly onerous, so that trustees aren't discouraged from choosing this route.

## 2. Significantly mature

**Already significantly mature**

### How might these schemes respond?

The regulations require schemes to have a low-dependency investment strategy by the time they're significantly mature (when duration is 12 years). This implies these schemes would need to de-risk quicky. Together with a 'cliff-edge' halving of the recovery period for a scheme just after the point of significant maturity, de-risking could materially increase contributions, especially for schemes not yet on the path to low-dependency funding.

### Concerns

It's not clear what will happen to schemes that can't reach low-dependency funding by significant maturity, and there are no transitional arrangements.

The increase in gilt yields through 2022 and 2023 has led to scheme durations shortening, and schemes are likely to be much closer to significant maturity. If many schemes are deemed mature, a lot of pension scheme investments could move in a short time.

All else being equal, the timeframe needs to be recalibrated. More importantly, TPR needs to address the weakness of duration as a measure of maturity. Most schemes want to set a journey plan with a target date that doesn't jump around with market conditions. TPR has put forward some approaches to dampen sensitivity to market conditions (such as using fixed assumptions), but we favour more flexibility, with duration not the only permitted measure. TPR could then set and review any prescribed duration for Fast Track.

### What's needed?

- More transitional flexibility, especially for schemes with early valuations.
- A less volatile measure of significant maturity, with duration being a preferred metric but not the only one permitted.
- Recalibration of any duration measure (so if the calculation remained on current market conditions, the 12 years set as at 31 March 2021 would be more like 10 years).

## 3. Flexible

**Adopting an atypical investment strategy**

### How might these schemes respond?

The regulations and code mandate low-dependency investment allocations at or close to significant maturity 'broadly match' cashflows and be 'highly resilient' to short-term adverse changes in market conditions. These requirements could lead to schemes being herded towards similar gilts-based strategies.

### Concerns

Driving all schemes towards narrow strategies leaves no room for economically efficient investing, and will supercharge systemic risks. It's a particular concern given the prescription in the draft regulations, but may be exacerbated by the existence of Fast Track and the eventual format of the statement of strategy.

TPR's interpretation of a low-dependency investment strategy is encouraging: schemes have scope to hold a meaningful allocation of return-seeking assets, particularly if going Bespoke. However, there's still more prescription than we'd like on asset allocations and hedging levels, and DWP's draft regulations need updating so they don't undermine the policy intent. Trustees need to be sure that following the code means complying with the law – the code can't be used to paper over a lack of clarity in the law itself.

### What's needed?

- Changes to DWP's draft regulations.
- Less prescription on asset allocations and hedging levels. A principle of 'high' interest rate and inflation hedging is better than a firm minimum of 90%.
- A format of the statement of strategy that supports scheme-specific approaches.

## 4. Insuring

**Well funded, de-risked and planning for insurance**

### How might these schemes respond?

Many well funded schemes are already at or close to a suitable low-dependency funding target with a suitably low-risk investment strategy, though plans may not be defined in these terms. Nevertheless, these schemes will need to set out plans in the required form.

### Concerns

It's questionable how much long-term value the code delivers to schemes on a path to buy-out. The requirements will probably result in much higher advisory costs for many schemes, and setting out plans in the required form adds a compliance burden.

With many schemes now better funded than they have ever been, there's a delicate balance between TPR bringing a minority into line, and adding a layer of compliance for schemes already doing the right thing. It would be disappointing if the code distracts focus or disrupts well planned scheme-specific approaches.

### What's needed?

- Compliance kept proportionate to risks, including the format of the statement of strategy and approach to covenant.

## 5. Constrained

**Weak sponsor covenant with limited affordability**

### How might these schemes respond?

The code proposes the 'covenant reliability' period to determine investment risk and maximum affordability. In general, a scheme can take on more risk if the covenant is strong and the employer can afford to make good any downside risk.

For schemes with weak covenants and short reliability periods, being forced to de-risk quickly could 'lock in' a bigger deficit, and the employer could be asked for unaffordable contributions. This might lead to the scheme depending on the sponsor for longer. The code acknowledges that to have the best chance of paying benefits, schemes with weak covenants may need to take more investment risk than the covenant can support.

### Concerns

There's no easy answer for schemes with a weak covenant, especially where businesses are grappling with a challenging macroeconomic environment and inflationary pressures.

Trustees and employers could spend a lot of time debating the covenant reliability period and affordable contributions. How involved are trustees expected to get in the employer's business plans? A prescriptive, formulaic approach risks oversimplifying or missing important specifics.

### What's needed?

- The flexibility to take sponsor specifics into account.
- A move from a single figure for covenant reliability to less subjective 'bands' (for example, three, six or nine years).
- Practical guidance on assessing employer covenant.
- Clarity on the format of the statement of strategy and its many covenant-related disclosures.

## 6. Open

**Open to new entrants and future accrual**

### How might these schemes respond?

Open schemes are required set a journey plan to low dependency. However, they can make some allowance for new entrants and future accrual to reflect a longer expected timeframe to significant maturity in their journey plans and technical provisions. This gives more scope to take investment risk.

Accrual isn't allowed beyond the period in which there's a high likelihood of the scheme staying open and the employer supporting it. In Fast Track this is set at six years. Limiting the allowance for accrual could increase technical provisions and contributions. Schemes will need to justify assuming longer periods.

### Concerns

We're encouraged that open schemes will have flexibility to take risk. However, for an open scheme that's not maturing and has adequate ongoing sponsor support, the added governance feels disproportionate.

We recognise the challenge of differentiating between sponsors with long-term covenants and plans to keep their schemes open indefinitely, and those with less certain future prospects. However, there's scope for a carve-out. It seems unnecessary to map out a journey to significant maturity that the scheme doesn't expect to take. Anything that makes it more costly to run open schemes risks benefit redesigns and scheme closures.

### What's needed?

- Clearer differentiation between open and closed schemes. The requirements for open schemes could be packaged together in their own section of the code.
- An open scheme carve-out to exempt immature schemes from the requirement to set a low-dependency target (for example, where duration is above a certain threshold).

## 7. Small

Less than 100 members or less than £25m of assets

### How might these schemes respond?

Compliance is likely to be a bigger shift from the status quo for small schemes. Small schemes typically don't have the resources and budgets of large schemes for stress testing and in-depth covenant analysis, for example.

The challenge of applying large-scheme good practice in a small scheme's budget are obvious. Many may look to Fast Track for a streamlined compliance route, though the extra cost to be built into valuations could be significant. On top of this, the expense reserving requirements could add disproportionately to liabilities for some small schemes.

### Concerns

As a general rule, small schemes are held to the same requirements, although the consultation document has helpful references to proportionality. We welcome this, but how it plays out in practice is important. We don't think small schemes should be held to a lower standard, but a lighter touch would be warranted in some places.

Onerous and disproportionately expensive compliance might push small schemes towards consolidation, even when doing so wouldn't be the most beneficial outcome.

### What's needed?

- Clear guidance on proportionality for small schemes.

## 8. Large

More £5bn of assets

### How might these schemes respond?

Many large schemes already have well developed endgame plans, and often complex arrangements with access to a range of investment classes. They're also more likely to use contingent assets – such as escrows or asset-backed funding – to underwrite additional investment risk.

Narrowing target investment strategies could constrain innovation. If credit for contingent assets can't be easily recognised, these may also be less attractive.

### Concerns

By their nature, large schemes could drive a heavy movement of pension scheme investments. Influencing £1.5trn of assets towards one destination, using one approach and set of models can only heighten systemic risks.

If no credit can be taken of contingent asset support beyond significant maturity, this may lead to fewer contingent assets being offered. It could also increase the prospect of 'trapped surplus', so the retention of investment risk and run-off might look less attractive.

### What's needed?

- Changes to DWP's draft regulations and less prescription on asset allocations and hedging levels so that the largest schemes are free to consider strategies that are less systemically vulnerable.
- Credit given for contingent assets after significant maturity.

## Our proposals at a glance

- Clear guidance over when Fast Track may not be appropriate.
- Some transitional flexibility.
- A recalibrated, less volatile measure of significant maturity.
- Changes to DWP's regulations.
- Less prescription on asset allocations and hedging levels.
- Compliance kept proportionate to risks.
- Room for sponsor specifics to be considered and less focus on a single date for reliability.
- More differentiation between open and closed schemes, and an open scheme carve-out to reduce the compliance burden.
- Clear guidance on proportionality for small schemes.
- Less prescription on asset allocations and hedging levels, with credit given for contingent assets after significant maturity.

## Next steps

TPR says it 'will continue to engage closely with the DWP and industry throughout 2023', ahead of the new code coming into force for valuations from 1 April 2024. The government recently suggested that further updates on the code, including the draft statement of strategy and covenant guidance, can be expected in the autumn.

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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