

Briefing on the Pensions Regulator's draft DB Code of Practice

Introduction

The Pensions Regulator (TPR) has published the second consultation on its draft Code of Practice on the funding of defined benefit (DB) pension schemes. The draft Code provides practical guidance on how to comply with the scheme funding requirements set out in regulations and is of interest to trustees and sponsoring employers of private occupational DB schemes.

Summary of the new requirements

The draft Code continues to reflect a holistic approach to funding, investment and risk. TPR's aim is to ensure that each scheme has a plan to ensure benefits are payable over the long-term without needing to rely on the employer. The new Code is also intended to strengthen TPR's powers to enforce DB funding standards for those schemes which it believes are not doing the right thing.

The draft Code includes TPR's key expectations:

1. Trustees will need a plan for how they will achieve '*low dependency*' on employer contributions by the time the scheme is '*significantly mature*'. TPR defines this as when the majority of the scheme's liabilities will become payable within the next 12 years so will be at a point when the majority of pensions are in payment.
2. Schemes must set out a '*journey plan*' to reach their '*long term funding objective*' based on moving to a '*low dependency investment allocation*' so that the scheme will be fully funded on a '*low dependency funding basis*'. This is an asset allocation that "broadly matches" scheme cashflows and is highly resilient to short term adverse changes in market conditions. This essentially means a requirement for schemes to plan how to de-risk. It is intended that the long-term funding assumptions and investment strategy are such that by significant maturity no more employer contributions will be needed to pay benefits under reasonable circumstances.
3. Trustees will need to assess the employer covenant in more detail to justify the level of risk that can be supported, with an increased focus on cashflow.
4. The requirement for deficits to be recovered "as soon as the employer can reasonably afford".

Further detail on the definition of several new terms such as '*significant maturity*' and '*low dependency*' can be found in the [draft Code](#). Overall, the message is clear that DWP and TPR want schemes to be more independent of their employer's contributions by the time the bulk of their pensions are expected to fall due.

Employer covenant

The draft regulations set out a statutory definition of covenant for the first time. This is the financial ability of the employer to support the scheme and the support available from legally enforceable contingent assets. They also confirm the new statutory obligation on trustees to carry out an employer covenant assessment to understand the extent to which the employer can support the scheme now and in the future. This includes considerations such as cash flow, likelihood of insolvency, market outlook and other factors likely to affect the employer's business including Environment, Social & Corporate Governance factors.

Therefore, the focus on covenant assessment by trustees will increase significantly and trustees will need to demonstrate a much more in-depth understanding of the employer covenant. There is a focus on employer cashflow in particular and this will require trustees to undertake a detailed review of management information in order to assess the maximum level of employer affordability. This may require a very different approach to the one that employers and trustees take currently and could see different conclusions reached. PwC has called this "a quantum shift to covenant assessment".

The assessment of the employer's financial ability to support the scheme should be forward-looking and include the following 3 elements:

- **Visibility** over employer's forecasts, typically over one business cycle (anticipated to be one to three years). Not only cashflows but also profit and loss and balance sheet forecasts. When assessing the reasonableness of employer forecasts, trustees should consider the historical accuracy of management forecasts as well as the appropriateness of the assumptions used.
- **Reliability** of available cash, slightly longer than visibility, typically medium term, say, 6 years, where there is reasonable certainty of cash available to fund the scheme. This period is key in determining an appropriate recovery plan length (where required). Trustees will need to consider the employer's forecasts and prospects.
- **Longevity** of the covenant. The maximum period over which trustees can reasonably assume that the employer can be relied upon to support the scheme.

The trustee's view on the employer's covenant must be included in the funding and investment strategy. Trustees must "*bear in mind the strength of the employer covenant*" in determining the journey plan. TPR has stated that it will be consulting on updated covenant guidance in the coming months, and has indicated that it intends to move away from the current system of grading (the strong to weak ranking system) to an approach considering three fundamental "covenant pillars": cash, contingent assets and prospects.

In relation to contingent assets, support from any legally enforceable contingent security will also be relevant but trustees must identify when the contingent asset is able to be called upon and the method to assess expected realisable value.

While TPR has stated that the Code does not make fundamental changes to how covenant is assessed but has simply embedded existing good practice and developed the way TPR expects trustees to demonstrate covenant support, the additional analysis and documentation required is likely to see an increase in workload for schemes with associated costs. It may also require employers to share much more information about the business with the trustees than they have previously.

How does this affect the triennial valuation?

The draft Code states that the assumptions used to calculate the technical provisions must be chosen prudently, allowing a margin for adverse experience, and the technical provisions must be calculated in a way that is actuarially consistent with the funding and investment strategy. This isn't very different from the current funding regime.

There are still a number of areas where TPR intends to allow trustees some flexibility. Allowance for post valuation experience is permitted as well as allowance for assumed future investment outperformance (where this is supported by the employer covenant or contingent assets). While TPR and DWP require that any deficit "*must be recovered as soon as the employer can reasonably afford*", the Code does not set benchmarks for recovery plan lengths (but there is a six-year limit for Fast Track valuations – see below) and gives guidance as to how affordability should be considered and assessed by trustees. However we may see more robust discussions between trustees and employers where the employer would like a recovery plan significantly longer than the trustee's assessment of covenant visibility and/or reliability. For employers with more than one DB scheme, for example those with USS and a local self administered trust, allocation of available cash between DB schemes should be fair.

Trustees and employers can agree a recovery plan that takes into account the employer's need to invest in its own business and to use its available assets for appropriate means. These "*alternative uses of cash*" include investment in sustainable growth and discretionary payments to other creditors. This area may be tricky for universities where there is a general need to use funds for the benefit of students and also to meet charitable objectives as well as support the pension scheme, although TPR

has become more sympathetic to the circumstances of not-for-profits and charities and how their circumstances differ from commercial organisations. However all employers will need to meet the TPR's new principles and it may become more difficult to justify continuation of the current covenant assessment without significantly more information and evidence on the long term financial position of the employer.

Trustees will be required to determine a Funding and Investment Strategy (FIS) for ensuring that pension benefits can be provided over the long term. This will need to be set out in a Statement of Strategy and needs the employer's agreement. The FIS must set out how the funding and investments of the scheme are intended to look by the time the scheme will reach 'significant maturity' and how it will get there. Trustees must assume that, from the date of significant maturity, the investments would meet the requirements of a low dependency investment allocation and there would be sufficient liquidity in the assets to meet expected cashflow requirements. The draft Code explains that cash flows from investments must be "broadly matched" with benefit payments through matching assets but there can still be an element of growth assets. The Code gives the example of 85% bonds and gilts and 15% growth assets. Schemes should seek to have a minimum level of interest rate and inflation hedging of at least 90%. The investment strategy also needs to be highly resilient to short-term adverse changes in market conditions and the trustee is expected to test this.

The Statement must include a section setting out what action the trustees will take if the main risks faced by the scheme materialise, along with the current and future level of investment risk they will take. All schemes must submit a copy of the actuarial valuation alongside the Statement of Strategy to TPR. The statement must be signed off by the Chair of trustees. This is a significant change as previously trustees were only required to submit a copy of the actuarial valuation where a recovery plan was in place. It will also require a schemes to appoint a Chair of trustees if they don't have one already.

What about open pension schemes?

An open DB scheme, such as USS or SAUL, which continues to have new members joining will not be expected to reach 'significant maturity' any time soon and the Code states that schemes which remain open can make a reasonable assumption for new entrants based on average over last three years and/or future accrual (only up to six years as TPR believes this is the maximum time over which trustees have reasonable certainty over key aspects of covenant such as cashflow). Open schemes will be allowed to take greater investment risk for longer and this will feed through into the journey plan. It also means it is likely that these schemes will need to take the Bespoke valuation route (see below). However, TPR states that past service should have the same level of security as a comparable closed scheme, so trustees must be confident that this is possible within their assessment of the employer covenant. Trustees also need to consider to what extent it is reasonable to assume that DB pensions will continue to be offered.

'Twin track' valuation approach

TPR has also proposed a new twin track approach to valuations:

- **Fast track:** As long as the valuation meets all the requirements set by TPR it can be treated as Fast Track and trustees can expect minimal involvement by TPR as there are likely to be no concerns. The Fast Track parameters cover funding and investment strategy, technical provisions, investment risk and recovery plans. They include a maximum discount rate of gilts plus 0.5% and a maximum recovery plan of six years before a scheme reaches significant maturity and 3 years once it has. These parameters are the same regardless of the sponsor covenant. The use of Fast Track is intended to reduce cost for schemes as it reduces TPR involvement and the need for trustees to obtain additional covenant advice. Under Fast Track trustees simply adopt a progressively lower risk funding and investment strategy as the proportion of members drawing a pension increases.
- **Bespoke:** This will allow trustees and employers the flexibility to continue to adopt a scheme-specific funding approach provided it meets the new legislative requirements and the key principles set out in the Code. However it will require trustees to improve risk management

and provide greater evidence to support any additional risk they are taking and is likely to require greater involvement by TPR. For some schemes a Bespoke approach may simply be Fast Track with some small adjustments, such as a longer recovery plan, so TPR would focus it's engagement on those areas.

TPR has been clear that both approaches are valid and neither will be considered a better choice by trustees. In either case, trustees will be required to submit evidence to TPR of their approach to managing their scheme's funding and investment risks as part of the Statement of Strategy.

This new twin track approach will help TPR filter out schemes that require minimal engagement. As at March 2021 around two thirds of all DB schemes would have met the Fast Track requirements. This is ideal as it would leave TPR with greater time and resources to focus on schemes using the Bespoke approach or where there are concerns about non-compliance.

Comment

Whilst TPR emphasises that its aim is to embed good practice rather than to make fundamental changes to the funding regime, the level of detail in the draft Code and regulations means that there will be a significant burden on trustees to show that they meet TPR expectations, even if these schemes are already well governed and well funded.

While there have been some positive changes made since the first consultation, there are still some concerns, in particular, whether some of the flexibility proposed by TPR is compatible with the draft DWP regulations. For example, the DWP regulations state that all DB schemes will have to reach a state of 'low-dependency', but this might not be the best option for some schemes. Forcing schemes to implement a low risk investment strategy without being fully funded may lock employers into unaffordable contributions when the scheme may be better off continuing to take some investment risk. TPR recognises this issue and has stated that reasonable affordability is central to its approach and they do not wish to see employers being forced into insolvency, however it is not clear that this is compatible with the regulations as currently drafted.

For those schemes that are not sufficiently well funded (or may not be well funded by the time they reach maturity), there is concern that they may need to collectively de-risk their investment strategies over the next few years, and swiftly get up to full funding at the same time. This could lead to additional employer costs which would be payable immediately at the first valuation after 1 October 2023 and over a shorter term than anticipated. A transitional period, especially for mature schemes, and some flexibility in terms of getting to and maintaining full funding would be helpful for their first post October 2023 valuation.

There is also the requirement that schemes must "broadly match" benefit payments with cashflows from investments, and that funding is "highly resilient" to short-term adverse changes. TPR has stated that there is no requirement for cashflow matching between assets and liabilities once the scheme has reached significant maturity, which is a pragmatic approach, but what is said in the regulations appears to be stricter.

The draft regulations also require deficits to be recovered "as soon as employers can reasonably afford". The difficulty here is what is reasonable? This has been a broad TPR principle for some time, but it is now being put into law and will therefore be open to challenge in the courts if employers and trustees do not agree. How will this interact with TPR's statutory objective to minimise any adverse impact on the sustainable growth of an employer?

The regulations and draft Code require a low-risk approach to be adopted by the time a scheme reaches a 12-year "duration" (a technical measure of the maturity of a scheme). However duration is highly sensitive to market conditions, meaning schemes targeting a certain date for de-risking their assets to a 'low dependency' position can easily find that date having to be suddenly brought forward or pushed back by many years if long term gilt yields change (as has been seen recently). This could

make it very difficult for schemes to plan their de-risking journey. Specifying 12 years also means many schemes will need to de-risk much more quickly than they had previously anticipated potentially creating problems for bond markets. In light of this criticism, TPR has stated that the definition of the duration of the liabilities may yet change or an alternative measure may be introduced.

Next steps for trustees and sponsoring employers

- Employers and trustees who wish to understand more should look out for webinars or briefings from their advisers. There have been many commentaries on the new Code issued over the past few weeks as the industry digests the implications. Consider whether training on this topic is needed.
- Keep abreast of any changes made to the draft Regulations and consider whether to send a response to TPR's consultation. Look out for TPR's updated covenant guidance and TPR's new Single Code of Practice, expected shortly.
- Ask your actuarial and investment advisers for advice as to what extent the new requirements will affect future valuations, including whether Fast Track or Bespoke will be more appropriate for your scheme.
- There is a lot of detail in the Code and a lot of planning and analysis will be needed before the first valuation that takes place after 1 October 2023, however even if the next valuation date is before the new requirements come into force, schemes are advised to start the process early and consider how the new Code and regulations will fit with their current funding and investment approach and what might need to change to avoid a huge shift being required at the next valuation.
- Trustees will need to carefully consider the level of covenant advice they obtain and whether the Board has the skills available to undertake the appropriate level of detailed cashflow and prospect analysis required, particularly where management information is limited or complex, or where the Bespoke approach is to be adopted.
- Employers will need to be prepared to share more detailed information with trustees to enable this new, more rigorous assessment. This will include a review of any current contingent assets or security provided to the scheme to ensure that it will meet the new TPR principles regarding availability to the trustees.
- Employers and trustees should consider how the Code will alter the process for agreeing the valuation and required documentation. Changes may also need to be made to the sign off process given the new requirement for a Statement of Strategy including a funding and investment strategy that has been agreed by both the employer and trustee.

February 2023