Government Actuary's Department

March 2020

Technical Bulletin

The Pensions Regulator (TPR) issued a consultation to seek views on principles for a new code of practice on defined benefit pension scheme funding. This technical bulletin looks at the main proposals in the consultation and what will happen next.

Consultation background

In the Department for Work and Pensions (DWP) 2018 white paper 'Protecting Defined Benefit Pension Schemes' the government noted the defined benefit (DB) pensions funding framework is working largely as intended but acknowledged the need for improvement in a number of key areas and in particular:

- The need for trustees to focus on long term strategic issues as schemes mature
- A lack of clarity about how to set prudent technical provisions (TPs) and an appropriate recovery plan (RP)
- The need for greater transparency and accountability around the risks being taken

Much of the current funding regime will remain, such as three yearly valuations and the requirement to determine TPs and maintain an RP, however the Pensions Schemes Bill introduces new requirements to help address the areas requiring improvement. The Pensions Regulator's consultation document is the first of two such consultations intended to inform a new DB funding code of practice to replace the existing code[1] and reflect the legislative changes and provide trustees and sponsors with greater clarity on what is expected.

This first consultation sets out the key principles TPR think should underpin the new framework. The second consultation, planned for later in 2020, will consider a draft code with more specific details reflecting feedback received from the first consultation.

Regulatory approach

TPR propose a two-tier approach to regulation: fast track and bespoke. Under the fast track approach TPR would set specific guidelines in the areas summarised below and if a scheme meets all the requirements it might expect minimal regulatory involvement. If the trustees choose not to follow the fast track approach, or the scheme is unable to meet the fast track requirements, then the bespoke approach offers more flexibility but will inevitably attract greater regulatory scrutiny. In this case trustees will need to document and evidence why they have opted not to comply with a fast track approach and how any additional risks have been appropriately mitigated. But both approaches should be equally valid if done correctly.

[1] https://www.thepensionsregulator.gov.uk/en/document-library/codes-of-practice/code-3-funding-defined-benefits-

Long-term objective (LTO)

The cornerstone of the proposals is that trustees should identify a scheme specific long-term objective (LTO) for funding. This would mean that by the time a scheme is *significantly mature* it would need to reach a position of *low dependency* on the employer. Additionally, it would be expected to hold an investment strategy *highly resilient* to risk with sufficient liquidity and a high average credit quality.

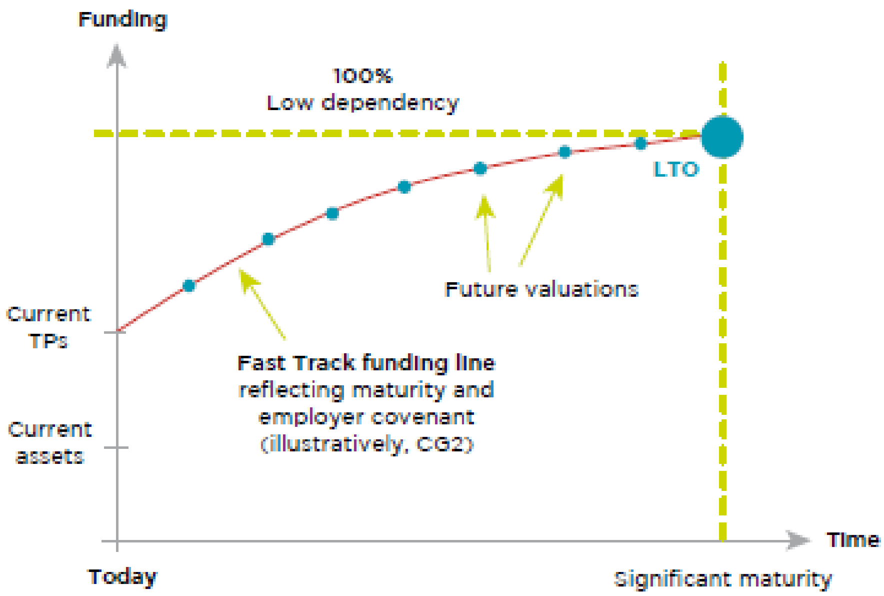
Low dependency funding means there is a low risk of requiring additional employer support and that any required support would be small in relation to the scheme. TPR consider a low dependency discount rate to be in the range of current yields on gilts plus 0.25% to 0.50%, reflecting an assumption of scheme investments primarily in high quality assets of sufficient liquidity providing a good match to a scheme's expected cashflows. Significantly mature would be in around 15-20 years for a typical closed scheme i.e. when most members will have expected to have retired.

GAD supported TPR in their development of the proposals for the LTO through technical modelling and advice. The GAD report published alongside the consultation documents illustrates the relative risk to member benefits from different levels of low dependency discount rates and definitions of significant maturity, as well as the impact of several different investment strategies.

Journey plan and technical provisions (TPs)

TPR expects trustees to set a journey plan to achieve their LTO. TPs at each future valuation would provide steps along the way to reaching the LTO. TPR were keen to dispel any misconception that TPs should always equal the LTO. Rather, TPs should reflect an appropriate funding target at a particular time, but as the scheme matures the TPs should converge towards the LTO. An example of the journey plan approach is shown below, but the way this is achieved in practice is a main area of the consultation.

Figure 1: How trustees could determine a journey plan to reach their long term objective



Source: TPR, March 2020

Investment approach

TPR propose the current and future investment strategy should be aligned with the funding strategy and LTO. In particular, the trustees should plan for reducing investment risk over time as the scheme approaches low dependency funding. The scheme would also need to maintain adequate liquidity at all times based on expected cash flows and a reasonable allowance for unexpected cash flows e.g. CETVs.

Employer support

The strength of the employer covenant has been an important consideration for TPR when reviewing the level of risk being taken in funding approaches. The consultation maintains the view that schemes with a stronger employer covenant can take more risk and assume higher investment returns. However, the consultation also questions the period over which a typical employer covenant can reasonably be assumed to remain the same and proposes that beyond the next 3-5 years it would not be appropriate for trustees to continue to rely on the same strength of covenant. There are some categories of employer where the covenant position is more complex, such as not-for-profit organisations, which TPR identify as requiring further guidance on covenant assessment.

Recovery plans (RPs)

TPR believe that affordability should still be a key driver in determining appropriate RPs. However, TPR would expect schemes with stronger covenants to have shorter RPs all things being equal. If a longer RP is required then affordability constraints would need to be clearly evidenced and documented and trustees would be expected to seek other mitigations for example realisable contingent assets or enforceable guarantees.

Next steps

The closing date for responses to the consultation is 2 June 2020. Scheme trustees and sponsors should consider the questions raised in the consultation and decide whether they wish to respond and provide views on the proposals.

TPR anticipate their new code of practice will come into force in late 2021 so it is unlikely to apply to funding valuations with an effective date in 2020. Nevertheless, trustees and sponsors should be aware of the proposals when considering their funding approach. If you would like to discuss the consultation in more detail or have any questions, then please email matt.gurden@gad.gov.uk or get in touch with your usual GAD contact.