Defined Benefit Funding Code Consultation

Summary

What is in the consultation package?

Across more than 200 pages, there is:

- the consultation document (with 54 questions to respond to);
- the draft Funding Code;
- a separate Fast Track parameters consultation document (with a further 29 questions to respond to); and
- TPR's response to their first consultation

What is the overarching aim of the proposed new regime?

TPR intends for each scheme to put in place a Long-Term Objective ("LTO") with a clearly mapped out journey plan, demonstrating how the scheme will get to a low-dependency funding and investment strategy at the point of Significant maturity.

The strategy needs to be detailed by the trustees in a new document - the "Statement of Strategy" - which must be signed by the trustee chair. The funding and investment strategy within the Statement will need to be agreed between the trustees and sponsors (although it is made clear that trustees' statutory rights to decide investment strategy are not compromised).

Trustees can choose to comply with the new rules via a Bespoke or Fast Track approach, with schemes who adopt Fast Track expected to receive minimal TPR scrutiny.

What are the key elements of the LTO?

The Code covers the following:

- **Significant maturity:** The draft Code sets this as the point when duration reaches 12 years, in line with the draft Regulations. However, the consultation document highlights that both DWP and TPR may look to revisit this, particularly given the recent increase in long-term interest rates.
- **Low-dependency investment strategy:** The Regulations require a highly resilient and broadly cashflow matched investment strategy to be adopted at the point of Significant maturity. TPR have interpreted this more generously than the draft Regulations may have indicated, with explicit reference to holding up to 25%-30% in growth assets for mature schemes.

  TPR is interpreting highly resilient as considering a one year '1 in 6' stress scenario. At the point of Low-dependency this stress should see no more than a change in funding level of 4.5%. TPR also expects this investment strategy to be at least 90% hedged against interest rates and inflation movements.

  Although the Code anticipates that Significantly mature schemes will invest in line with the Low-dependency investment strategy, this is not a requirement and a different strategy could be justified, e.g. if the scheme had a large surplus.

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- **Low-dependency funding strategy:** This is the prudent funding strategy used at the point of Significant maturity, reflecting the Low-dependency investment strategy. Whilst assumptions have not been prescribed, TPR has seen fit to set out detailed expectations on most areas.

  TPR also expects a reserve for future running expenses after the point of Significant maturity to be included, unless the scheme rules require the employer to meet such costs.

- **Long-term funding target:** Trustees must determine the funding level they intend to ultimately target, calculated with reference to the Low-dependency funding basis (with a minimum of 100%).

- **Covenant:** TPR is looking to embed existing good practice into the Code, moving from its existing 4 covenant ratings towards an evidence-based assessment of the levels of supportable risk (based on cash, prospects and contingent assets). Trustees will need to consider covenant visibility over one to three years and over the long-term – with an anticipation that cashflows cannot be relied upon forever (although could be longer for certain industries).

  Covenant reliability under the new rules will be a key area of focus for trustees as it drives both the level of investment risk that can be supported during the journey plan and the shape of any Recovery Plan. Trustees will have to gather detailed information from their sponsor and share their assessment with TPR.

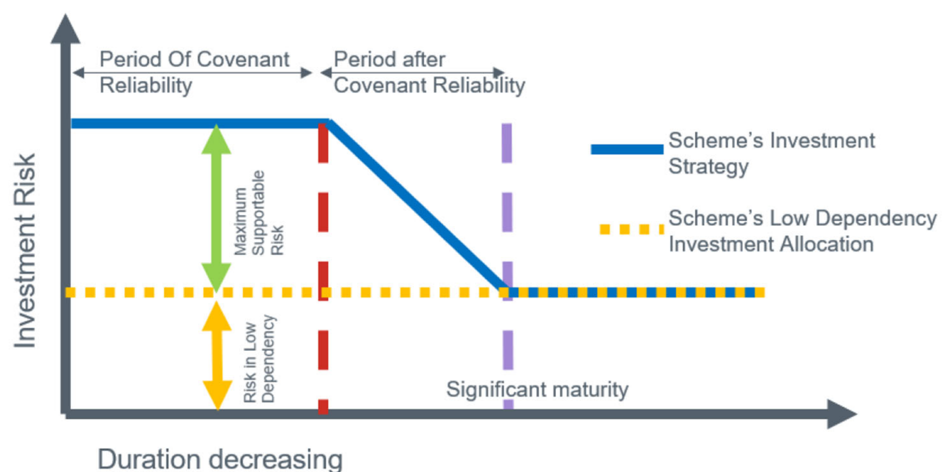
- **Contingent assets:** Robust contingent assets would allow higher levels of risk to be supported.

What is an acceptable journey plan under the draft Code?

The Code envisages three stages to the journey plan, the "period of covenant reliability", the "de-risking period" and the "significantly mature period".

The initial covenant reliability stage (which for Fast Track purposes would be set at 6 years) would allow the maximum level of investment risk to be taken, with this being set in relation to the affordability of a downside stress test. The final stage (from the point of Significant maturity onwards) sets the Low-dependency investment strategy as the maximum level of investment risk. The de-risking period - between the end of the first and final phase - would generally see a linear reduction in the maximum level of investment risk between these points.

The downside stress test should assume at least a '1 in 6' downside scenario.



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How is affordability assessed in setting the journey plan?

Affordability is based on the trustees' assessment of the maximum the sponsor can afford to pay, plus an allowance for contingent assets.

TPR does include additional commentary on multi-employer and not-for-profit sponsors to highlight the additional risks that trustees need to consider when assessing their covenant reliability and affordability. However, no explicit easements in complying with the Code have been granted to not-for-profit sponsors.

How is all this reflected in how Technical Provisions ("TPs") are set?

The TPs will need to be set in such a way that they use a prudent discount rate that follows the trustees' journey plan. The maximum investment risk level set out across the journey plan would therefore provide an upper limit on justifiable TPs, although it is not expected that this is how they would be set in practice. Other assumptions should be chosen consistently and prudently, allowing for a margin for adverse experience.

For schemes currently setting their TPs using a discount rate that models a planned, or notional, transition to lower risk assets over the next 6-10 years, the proposed new TPs regime will feel quite similar to the current one.

If there is a deficit, what does an acceptable Recovery Plan have to look like?

Trustees will need to consider reasonable affordability, any adjustment for post-valuation date experience and supportable investment outperformance (where it can be justified by the covenant) when setting their Recovery Plan. Reasonable affordability should be assessed looking at available cash, the reliability of that cash and the possible alternative uses (including investing in growth, other DB scheme commitments, paying down debt and other covenant leakage, e.g. dividends). This places an increasing onus on trustees to fully understand their sponsor's plans.

TPR have not set any benchmark for the length of Recovery Plans under the Code. However, 6 years is used for Fast Track and they have hinted that this is the maximum they would expect to be supported by covenant reliability.

What are the "off-the-shelf" requirements to meet Fast Track compliance?

TPR has proposed the following features of Fast Track:

- Low-dependency funding discount rate of no more than Gilts +0.5
- TP liabilities above a minimum level of Low-dependency depending on duration – e.g. above 72% for immature schemes (30 year duration), increasing to 100% at Significant maturity (i.e. 12 year duration)
- A stress test will also be carried out to ensure the investment strategy is not targeting an excessive level of risk. This will be based at outset on the approach used by the PPF.
- Any deficit will have to be recovered over a maximum of 6 years if below Significant maturity and 3 years if after.

Duration	30	24	18	12 & below
Minimum TPs: % of Low-dependency	72%	78.5%	89%	100%
Stress test	18.7%	15.4%	12%	1.9%

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The Fast Track parameters are based upon a Low-dependency investment strategy of 15% growth and 85% matching, with any LDI subject to a low level of leverage (x2 max) and high collateral. No allowance has been made for covenant strength under Fast Track as TPR deemed this too subjective, but also to minimise the number of parameters.

Fast Track Recovery Plans can make allowance for post valuation experience and be slightly back end loaded (i.e. inflation linked), but no allowance for investment out-performance is permitted.

For schemes that meet most, but not all, of the Fast Track requirements, TPR still expects them to be Bespoke submissions. However, they should expect a lighter touch assessment as they only have to consider the non-Fast Track compliant elements, e.g. if they comply with all Fast Track requirements apart from the Recovery Plan.

How many schemes does TPR expect to use Fast Track?

TPR are keen to stress that complying via Bespoke is equally valid as Fast Track having previously indicated they expect about 50% of schemes to go down either approach. They expect this to allow them to focus more of their limited resources on engaging with schemes taking a Bespoke approach, with Fast Track schemes having limited review. It is worth noting that TPR's analysis indicates that 50% of schemes met all of the Fast Track parameters at 31 March 2021, with 95% complying with at least one of the main elements.

What does the Code say about open schemes?

Open schemes are allowed to reflect the longer timeframe to reaching the points of Significant maturity in their journey plan. This would be based on the period that there is high confidence that the scheme will remain open and the sponsor covenant will support ongoing accrual. However, for the purposes of setting contribution rates for future accrual, this period should be limited to 6 years.

Additionally, when setting these contribution rates, trustees should be satisfied that this does not compromise the security of accrued benefits. Also, it is recognised that schemes that are in surplus may use this to subsidise the cost of accrual.

Will these rules also apply to small schemes?

The Code applies to all Schemes, regardless of size. However, there are two minor easements, for those with less than 100 members under Fast Track. These are to allow the use of a simplified calculation of projected duration and a single-equivalent discount rate (rather than a yield curve approach).

What about situations where the required contributions can't be afforded?

The Code recognises that while TPR expects most schemes not to run downside risks that can't be afforded by the sponsor's covenant, there will be schemes where this isn't possible. TPR have considered two situations - short-term stress (e.g. the impact of the COVID pandemic) and long-term incompatibility with the funding regime – and provides guidance on how trustees should weigh up competing demands. In these circumstances, trustees should follow the funding rules as much as possible and minimise covenant leakage, but they anticipate trustees may decide to take greater levels of unsupportable investment risk and/or longer Recovery Plans.

Is there more to come?

Yes. If this batch of 200 pages wasn't enough to digest, TPR will publish their impact assessment and revised covenant guidance in the new year.

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