BROADSTONE

The Journey to Low Dependency

Introduction

The DWP has issued their consultation on the Funding and Investment Strategy (FIS) document that Trustees will need to produce and provide to The Pensions Regulator (TPR) in conjunction with their actuarial valuation.

The consultation began on 26 July 2022 and will run to 17 October 2022.

This consultation provides some of the 'meat on the bones' for how schemes should operate their funding and investment strategies. However, some of the detail has been pushed to TPR to include in part 2 of the Code of Practice and so some of this is still a little unclear.

The Government's message

The Government are clear that they believe these measures will improve member security in defined benefit pension schemes through "better and clearer funding standards". However, the emphasis remains that this shouldn't be a one size fits all approach and schemes can benefit from the flexibilities in the system if they enjoy sufficient ongoing sponsor support or are not maturing as quickly as the typical scheme.

However, with statements like this it is clear that for the remainder, schemes should be taking a low-risk approach to investment and funding risk.

The overall view is that a scheme should be able to set down a clear understanding of its journey towards a position of low dependency on employer contributions and investment returns. Exactly how it gets there will be scheme specific. Schemes will need to be able to demonstrate where they are going and how this relates to where they are now.

To be clear, there will need to be a physical document describing this journey for submission to TPR.

Key themes and concepts

The consultation discusses how the Department for Work and Pensions (DWP) defines, and will approach, various parts of a funding and investment strategy discussion.

Scheme maturity - this is a measure of the estimated age of the scheme based on a weighted average of the payment of future liabilities. DWP describes schemes as significantly mature where they have a duration of liabilities of 12 to 14 years. The DWP highlights this definition in its discussion of a potential "investment spiral" - a situation where a scheme needs to sell assets to pay benefits; should there be poor investment performance and unplanned disinvestments at this time, the funding position of the scheme could rapidly worsen.

Your Scheme Actuary may already have confirmed the age of your scheme within these terms. However, some further definitions will be provided by TPR regarding when a scheme is significantly mature, and how this may differ for open schemes.

Low dependency and sponsor/investment/funding – Low dependency replaces self-sufficiency and refers to a position where the scheme holds only low risk investments and enjoys a funding position where it does not expect to receive further contributions from the employer. Schemes will have a low dependency investment strategy if they are broadly cash flow matched and the assets also can demonstrate they are highly resilient to short-term adverse changes in market conditions.

Despite the ultimate goal being for the scheme to be able to stand alone, along that journey an ongoing employer will remain on hand to support the scheme in the unlikely event that further support becomes necessary.

Employer covenant – The language used here is the strongest we have seen in relation to a scheme's requirement to assess the employer covenant. Employer covenant is defined as the financial ability of the employer to support the scheme. The DWP outline some areas that should be considered including likelihood of insolvency, cashflow, expected future performance and business prospects plus size relative to the deficit in the scheme. TPR is expected to provide more detailed guidance on this.

Relevant date – When setting the strategy target, the relevant date is the point of significant maturity.

Investment and funding risk on journey plan – Here the government wants to ensure that the investment strategy in place on the scheme's

journey to the low dependency state is one that has risk levels that can be supported by the employer covenant. This is based on the view that the further away from the relevant date, the higher the risk that can be taken.

Similarly the regulations expect a consistency in setting actuarial assumptions as the scheme matures.

Liquidity – Schemes should make an allowance for liquidity to ensure that regular known payments can be met, together with a reasonable contingency reserve for unexpected payments.

Destination in the strategy – The DWP outlines their expectation for an indication of the path the scheme is likely to take after its relevant date. This could be running on (i.e. continuing with the scheme paying benefits) or buy-out via an insurance company or a consolidator.

Chair of Trustees – The statement should be signed by the Chair of Trustees and so schemes will be required to have designated one.

Recovery Plan – Schemes with a deficit should have a recovery plan in place to bring them to full funding. However, emphasis here has strengthened from TPR's recent sustainability announcements to paying off any funding deficit "as soon as the sponsoring employer can reasonably afford."

Broadstone comments

Many of the concepts and themes are by no means brand new to trustees, given they have been discussed regularly for the past three years. However, these regulations introduce the new regime where TPR will treat schemes according to their fast-track and bespoke funnels. The strategy described in the regulations may well set those parameters. We have long known that the Government wishes to limit inappropriate or unaffordable risks across the DB landscape. Schemes should avoid regulatory intervention if they justify their investment and funding decisions in a way that is consistent with their ability to withstand the risks they run.

However, the emphasis on low dependency and paying off deficits as quickly as possible could result in increased pressure on sponsors to pay higher contributions than they would otherwise choose. This could see some better-funded schemes seek to introduce escrow accounts or other contingency arrangements that minimise the risk of future trapped surpluses. The risk of overfunding will be on the minds of employers.

We note that this is a consultation and much still rests on the detail as specified by TPR in the second part of their consultation. We shall be responding to the consultation and will share our views when we have considered them over the summer.

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