Broadstone

Defined Benefit Funding Code Consultation

January 2023

Introduction

After nearly three years of delays (in part caused by a global pandemic) the Pensions Regulator has finally been able to present to the industry their second consultation on the Defined Benefit Funding Code.

Unusually it is based on regulations that are still in draft form. We can draw our own conclusions on the amount to which the draft regulations may yet be revised as a result of the consultation responses (you can read our submission here). Helpfully, it seems that some areas, including the use of a potentially volatile measure of duration to determine the key maturity date, are being given further thought. However, it is safe to assume that changes in the regulations will be limited – the direction of travel has been set.

With almost 200 pages of detailed, and often quite technical, content from the Regulator to cover, this first note is a high-level summary designed to set the scene. We will be following up with further bitesize analysis of specific elements in more detail over the coming weeks.

What has been published?

The Pensions Regulator has published:

- A draft code which can be accessed here.
- A consultation document which asks 54 specific questions about aspects of the draft Code.
- A further consultation on the Pensions Regulator's proposed approach to regulation of this area, including details of the proposed 'Fast Track' parameters.
- A response from the Pensions Regulator on the first consultation.

We also expect some revised guidance on employer covenant assessments in the next month or so.

When will the new code be in force?

The goal of the Pensions Regulator is to have this Code in place for full actuarial valuations with effective dates of 1 October 2023 onwards.

1 October 2023 is the earliest possible date the new code could be in force due to the legislative process involved. Furthermore, the consultation on the Code closes on 24 March 2023 and the DWP are still in the process of considering responses to their consultation on the underlying regulations which closed on 17 October 2022.

Addressing both sets of consultation responses and incorporating any amendments (noting the interaction between the regulations and the Code) means that 1 October 2023 is already a challenging target and may yet slip. Nevertheless, the Regulator is (for now) committed to laying the final code before Parliament in mid-June alongside the final regulations.

Key themes

There are a number of new areas for trustees and sponsors to understand. Many of these have been discussed in principle by the Pensions Regulator in their recent Annual Funding Statements and comments to the industry but we now have some detail to work with.

At a high level, the Pensions Regulator has now set out how the draft regulations might be enforced. We summarise this below and aim to cover all of the new requirements in future briefing notes.

Unsurprisingly, a key goal is to try and reduce the risk in defined benefit schemes, and it is hard to argue this would not be achieved through reduced asset and liability volatility, together with lower long-term reliance on the sponsor covenant. Reduced risk typically comes at a cost though, and it seems clear that the new requirements will provide an additional burden (and further frustration) for many sponsors.

As a reminder, the regulations set out that pension schemes should be **fully funded on a low-risk basis once they are 'significantly mature'**. Originally it was expected that the definition of this point would provide some breathing space for schemes to prepare for this. However, changes in market conditions over the course of 2022 mean that this cut off could potentially be much closer than many were envisaging and leave relatively little room for manoeuvre for schemes that are now only a year from their first valuation under the new regime.

Trustees will need to work with their actuary to determine their 'maturity date' and then design a funding strategy that will meet the low-risk objective by this point. Most schemes will also need to confirm/agree an appropriate short-term strategy and set out a clear path to get from this point to the low risk position.

Even before we get into the technical detail, including the risk analysis expected to accompany the work, it is clear that the detailed planning involved represents a significant shift from the current position.

The Pensions Regulator is at pains to emphasise that it does not wish to impose a herd mentality on schemes, either by diluting good work that trustees and schemes are already doing or by putting undue pressure on sponsors. It also refers repeatedly to proportionality and flexibility. However, it is hard to see at times how this might work in practice.

What is in the Code?

The following are our top 5 takeaways from the Code. We will expand on the detail over the coming weeks and months.

Journey Planning – Schemes will need to clearly set out their journey to low dependency. It is expected that a journey plan will be based on the scheme's maturity and (to a limited degree) covenant strength. If there is a deficit, trustees will be expected to work with sponsors to fill this as soon as the employer can reasonably afford.

Fast Track – Interestingly, this is no longer a separate funding measure nor a benchmark but clearly identified as the Pension Regulator's triage system for further engagement. If the Scheme Actuary can certify that the scheme's valuation meets the parameters for discount rate, level of investment risk and recovery plan length then it is expected that there will be very little regulatory involvement.

Statement of Strategy – Trustees will be expected to set out the details of how their funding and investment strategy will evolve to reach their low-dependency position, together with how risks are being managed in the interim, and formally document this in a two-part Statement of Strategy. This will need to be submitted to the Pensions Regulator and regularly reviewed and updated.

Yet more actuarial calculations – The valuation process will now additionally require maturity date calculations, low dependency funding calculations and funding projections. Investment stress testing will also need to be included, or extended, and will focus on a new 1-in-6 measure as well as more detailed understanding of hedging strategies. Finally, covenant discussions will typically involve quantifying the employer's free cash flow. All of this is likely to require additional expert advice and, for many trustees, an element of additional training to familiarize themselves with the new measures.

Small Schemes - The Code does include a few areas of easement for small schemes (those with fewer than 100 members), for example to allow for simplified discount rates and simplified stress testing. This will be welcome news for those schemes but only scratches the surface and potentially leaves many who are just over this threshold with a lot of work to do.

Comment

The details set out in the draft Code highlight the shift between the current approach and the proposed new era. Many trustee boards will find the goal posts have moved significantly in terms of funding levels, methodology, strategic planning, covenant assessment and documentation requirements.

This is the case even for well-run schemes who have been working closely with their advisers and actively discussing their longer-term objectives. Furthermore, even those Trustee boards that may have already given up on expectations of meeting the Regulator's fast-track 'gold standard', are unlikely to have anticipated the extent of work that the Regulator is expecting for compliance within the new regime. A key concern from our perspective is that this burden will be disproportionately expensive for the huge numbers of smaller DB schemes (those with assets under £30m).

Our chief actuary, David Hamilton, commented, "Whilst TPR does refer to proportionality, except for a few specific items for very small schemes it seems that this flexibility will only begin at a point when a significant amount of additional analysis and work has been undertaken. The cost burden (which also needs to be built into valuations going forward) will be significant and as plans will inevitably need to evolve in response to changing circumstances, it will be interesting to see how much of this additional planning delivers genuine long-term value for trustees.

"In terms of managing deficits, the requirement to make explicit advance allowance for all future expenses after reaching the maturity point means that whether schemes are planning a long-term run-off for the scheme or a buy-out, we are seeing a moving of the goalposts from a funding perspective. This will be a sting in the tail for some employers who may have finally been seeing some funding surpluses."

David Brooks, Head of Policy, added, "The pressure is on to bring this long running saga to a close and TPR's decision to issue the code on the eve of Christmas is evidence of this. We must also surely conclude that while the Code has been issued based on draft regulations, the government's mind is set on this direction of travel to lock down the risk in the defined benefit space.

"The losers in this are likely to be the sponsors, who will see increased cost and the new work involved could be considerable even with the exemptions for very small schemes. A saving grace may be the movement in gilt yields over 2022 which could mean that the current funding levels are improved, and we are not seeing this additional burden layered on top of already large deficits."

Find out more

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