Broadstone

Funding Code Insight: What is low dependency and why it matters

February 2023

Introduction

The Pensions Regulator’s draft defined benefit funding Code of Practice and DWP’s draft regulations have low dependency at their heart.

It becomes the target objective for all schemes once they reach maturity (their ‘significant maturity date’) and indeed technical provisions calculated in the intervening years will be measured relative to the low dependency position to assess whether schemes are taking a tolerable level of risk. Schemes can set a higher bar of course but aiming for low dependency is to be the default position.

Understanding what is meant by low dependency will be crucial for all Trustees and employers when discussing funding and investment matters. Those with more mature schemes will need to get there immediately (or at least as soon as possible), for others it will be the ultimate destination of their new journey plan.

Where does low dependency come from?

Low dependency was first used by the Pensions Regulator as a progression from ‘self-sufficiency’ in the Pensions Regulator’s initial consultation on the funding code.

Schemes may have considered a self-sufficiency basis in the past and there are similarities between this and low dependency but the change in wording is presumably to highlight there is always likely to be some continued reliance on the sponsor if risk is being taken within a scheme (e.g. to help with unforeseen expenses or extreme adverse events). It also helps to emphasise that the Regulator is not requiring schemes to take a 'no risk' position.

Low dependency is going to be used in the new funding rules to describe two key elements – a funding basis and an investment strategy – with these being defined such that there is a low chance of requiring further employer support. To the extent that such support is required, the amount should be small relative to the size of the scheme and employers are expected to be able to restore full funding very quickly.

> "...under reasonably foreseeable circumstances, the scheme is not expected to need further employer contributions..."
>
> **The Pensions Regulator – December 2022 Draft DB Funding code**

Principles of low dependency

There are two key elements in the low dependency position – funding and investments.

Low dependency funding basis

The draft code explains that a low dependency funding basis must use actuarial assumptions which are **sufficiently prudent** so that if the scheme was fully funded on that basis and the scheme's assets were invested using the low dependency investment allocation (see below), then **no further employer contributions** would be expected to be required.

Trustees are expected to assess that funding using this low dependency basis would be adequate under most "reasonably foreseeable scenarios", which poses some interesting challenges when considering aspects such as mortality or the potential future expenses that could arise over the remaining lifetime of a scheme.

> “[Unless the employer is required under the rules to meet expenses] We expect the low dependency funding basis to include a reserve for expenses. That expense reserve should be the value of all non-investment related expenses of the scheme, including annual levies and adviser fees, expected to be incurred on and after the relevant date.”
>
> **The Pensions Regulator – December 2022 Draft DB Funding code**

There is, ultimately, latitude in the assumptions that schemes may adopt, and the degree of prudence needed in the low dependency funding basis. The separation of the Regulator’s new ‘fast-track’ regime from the code itself (more on this in a later Funding Code Insight) should help to distance it from a ‘gilts + 0.5%’ default assumption and the Regulator has been at pains to emphasise the flexibility available within the approach.

The emphasis is on risk control and understanding, particularly with regard to the scheme’s investment holdings. There is however strong encouragement for greater sophistication, with yield curve valuations now expected for all schemes with over 100 members. Ultimately Trustees “should ensure that the assumptions are chosen prudently” and “be confident it [uncertainty in key assumptions] would not undermine the low dependency test”.

This naturally brings us on to the second key element of the low dependency definitions:

Low dependency investment allocation

In order to satisfy a low dependency investment allocation there are two overarching principles for how schemes must plan to invest in the low dependency position. They must incorporate broad **cashflow matching** and high **resilience** to market movements.

Cashflow matching forces trustees to consider the payments from their schemes to match benefit payments. There is a fair amount of flexibility in the regulations around what asset classes should be used but Trustees are encouraged to think about the timing of expected cashflows and having assets to broadly correspond with the these rather than being exposed to significant duration risk. (Holding liquid assets so that you can meet unexpected cashflows is also covered in the draft code but outside of the specific low dependency definition.)

The concept of resilience relates to the ability of the scheme to withstand market shocks:

> " the assets of the scheme are invested in such a way that the value of the assets relative to the value of the scheme's liabilities is highly resilient to short term adverse changes in market conditions "
>
> **The Pensions Regulator – December 2022 Draft DB Funding code**

Here short-term impacts on the assets and liabilities will need to be assessed via stress testing although there is an explicit expectation that schemes should have at least 90% hedging of inflation and interest rate risk.

The draft code states that, as a minimum, schemes should undertake a **stress test** using a 1 in 6 Value at Risk assessment and suggest that using the stress tests currently used by the PPF might be a way to achieve this. This is useful (particularly for smaller schemes) in terms of adopting a consistent and established industry calculation approach, although more is expected in terms of sensitivity analysis and scenario testing. Also, many schemes will be used to considering much more extreme events (1 in 20 Value at Risk calculations are not uncommon when discussing investment strategy) and may feel that 1 in 6 does not cover 'most reasonably foreseeable scenarios'.

The choice of the acceptable stress level (a 4.5% change in funding level over one year under the proposed stress test) is interesting. On the one hand, it offers significant flexibility and allows the Regulator to suggest that schemes might hold as much as 25-30% of assets in equities, even in their low dependency portfolio. On the other, the thought that every couple of valuation cycles you might expect a funding swing of more than 5% in a year feels at odds with the low dependency mantra. More importantly, given the need for the employer to then restore 100% funding on this measure as soon as it can afford, we suspect many Trustees and employers to adopt more prudent interpretations.

Finally, it is worth noting that whilst schemes must set a funding and investment strategy that is based on the above low dependency measures in maturity, the Regulator is at pains to emphasise that schemes do not actually ever have to invest in line with this. Whilst it is expected (and strongly encouraged), there is greater flexibility in theory for those who wish to pursue it.

Broadstone comment

Most schemes will have discussed setting and working towards a long-term objective with their scheme actuary at some point in the past three years. Therefore, the broad principle of aiming towards a lower risk position is not new. However, the draft code and regulations make this a lot more formal, restrictive and costly.

What is new is the requirement to be 100% funded on this low risk basis by the time you reach maturity, and the expectation that you will stay there (or higher). In general, the employer is expected to meet the cost of any market falls in short order following each valuation, and would also need to address other strains (such as concerns regarding greater future life expectancy, or even an increased expense burden due to additional regulatory requirements).

We anticipate many employers will be understandably frustrated by a regime which requires more prudent funding and actively encourages overfunding on a low dependency basis. After all, much of the extra cash demanded from them is likely to simply advance the path to buyout rather than be returned to them at a later date. However, we should acknowledge that much of this is a result of the underlying regulations rather than the draft code itself.

Where the code adds to the burden is in the amount of analysis, supporting evidence, additional advice and documentation that will be required. Whilst there are references to proportionality in the code, the number of elements that the trustees must do (not to mention those that are expected / 'should' be done) is significant. Whilst it is hard to argue that any of the suggestions are completely unreasonable in principle, it will be interesting to see to what extent all of the additional work and analysis genuinely adds value and influences decision making in the majority of cases.

We have particular sympathy for smaller schemes (and those with 100-250 members who will not qualify for the limited specific 'small scheme' exemptions) where the additional advisory costs are proportionately higher.

Finally, in a world where we have recently faced what might once have been considered relatively extreme events, the range of 'reasonably foreseeable circumstances' is arguably much wider than it might once have been. Trustees and employers will need to think carefully exactly how much caution is needed to comply with the new regime and employers will be understandably concerned if they are expected to provide sufficient funding to cover all eventualities.

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Find out more

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