Broadstone

Funding Code Insight:

What are Fast Track and Bespoke Valuations?

April 2023

Introduction

We continue our overview of the proposed new world for the funding of defined benefit pension schemes with a look at the second consultation paper that the Pensions Regulator (TPR) issued in December – relating to Fast Track and Bespoke categorisation of valuation submissions.

Much of the focus (including our previous notes on low dependency (BN235) and funding and investment strategy (BN236) which can be accessed here) is understandably on the requirements and implications of the new Funding Code itself, which as a reminder is currently intended to come into force for all valuation dates on and after 1 October 2023. However, for some the question of how the Regulator will perceive and treat these new submissions is critical.

Interestingly, these aspects were an integrated part of the draft funding code in the original consultation back in 2020. However, this regulatory assessment element has now been separated out, making a much clearer (and to our mind more helpful) distinction between the requirements of the Code of Practice and the Regulator’s benchmarks for potential further regulatory engagement.

Key definitions

The two key terms ('Fast Track' and 'Bespoke') are all about the filtering mechanism that the Regulator will use to assess valuation submissions under the new regime. The Regulator has been at pains to emphasise that both approaches are equally valid, and schemes can (and will) move between them at different valuations.

As the name suggests, 'Fast Track' valuations will move quickly through the Regulator's valuation review process, receiving little further scrutiny, whilst 'Bespoke' cases might anticipate further engagement.

To get the light touch treatment, a 'Fast Track' valuation submission will have been certified by the Scheme Actuary as meeting certain defined criteria, which we summarise below. It will then be deemed low enough risk to be ignored by the Regulator, with further engagement "unlikely". The Regulator emphasises that satisfying this benchmark of 'tolerated risk' does not mean the approach is risk-free, or even compliant with the new regime, this is all about helping them to prioritise cases for further engagement.

Any other (acceptable) valuation submission would be categorised as 'Bespoke' and the trustees can expect the Regulator to review their explanation of the funding and investment strategy and level of risk being adopted. In reality, detailed engagement will not follow for most 'Bespoke' cases – the Regulator is still resource constrained and simply would not have the capacity – but you might expect to at least provide some additional justification or answer some follow up questions.

Fast Track Parameters

The proposed approach is that the Scheme Actuary will be required to certify that the scheme is satisfying the Regulatory targets in three key areas:

1) Technical provisions are sufficiently strong.

This is measured by comparing the technical provisions to an (at least partly) specified 'Fast Track' low dependency basis'. (Note: this is the relative strength of these measures, not about your scheme's funding level in either case.)
It varies based on the duration of the scheme, with more mature schemes expected to be closer to their 'low dependency' state. For a scheme with a duration of 15 years, the technical provisions must be at least 96% of the low dependency figure. This reduces to 90% if you have a duration of 17.7 years.

There are additional rules to allow open schemes to incorporate future accrual within their duration calculations (thereby increasing the duration and lowering this hurdle) and full yield curve valuations are required for all schemes with more than 100 members.

2) There is not too much investment risk.

This is measured using a stress test, initially based on the PPF stress test. If the difference in funding level in a stressed and unstressed scenario is less than the specified amount (again based on duration, with more leeway for less mature schemes) then the scheme is 'Fast Track' compliant in this regard.

3) The recovery plan does not raise any red flags.

The recovery plan must:

- be no longer than six years from the valuation date (three years if already classed as 'significantly mature')
- involve deficit contributions that increase by no more than CPI each year (to prevent back end loading).
- not rely on future investment outperformance (although it will be acceptable to allow for known post valuation experience).

We suspect these may be refined slightly in response to the consultation to iron out some practical difficulties, but the broad principles seem clear.

We have seen in the past the herding instinct of schemes towards any specified benchmarks (with potential for levelling down as well as pushing up) and these hurdles are therefore likely to influence behaviour near the borderline. They may also provide political motivation or a benchmark for negotiation in other cases. However, ultimately, undertaking fast track testing and certification is yet another element of additional work and cost under the new regime.

What about covenant?

Despite the emphasis on employer covenant within the draft funding code, there is no reference to covenant strength within the 'Fast Track' criteria. It appears this was too subjective (and complex) to fit into the model.

This is understandable but potentially leaves a tempting grey area for trustees who know they are fast-track compliant – can they afford to be less thorough in their covenant analysis if, in all probability, no-one is going to look at their work?

Which path – Fast Track or Bespoke?

The Regulator intends for ‘Fast Track’ to provide more direction and clarity on the level of risk that will be tolerated. They also hope that it will encourage more schemes to aim for this as a minimum. However, they have identified that strong employers who are keen and able to justify taking more risk, and weaker employers whose affordability constraints mean that a short recovery plan is not achievable are amongst those likely to favour the bespoke route.

The fact that ‘Fast Track’ parameters are to be set outside the Code, provides the Regulator with the flexibility and ease to amend the parameters in the future. It is likely that these will be reviewed periodically or in reaction to market conditions.

At this stage it is difficult to predict how many schemes will use the ‘Fast Track’ route. The Regulator is perhaps optimistically anticipating that around half of schemes will do so but would still lack the resource to examine most of the remaining cases. We therefore expect to be in much the same situation as now, where many trustees might have one or more aspects of their valuation that are not entirely to the Regulator’s liking, but further action is unlikely.

With this in mind and knowing that many of our clients may well find the ‘Fast Track’ route simply unattainable, we emphasised to TPR in our consultation response that there should not be a much higher governance burden simply as a result of being ‘Bespoke’. Given both routes are described as equally valid and the Statement of Strategy will document to a large extent the trustees’ valuation process, a (potentially very brief) cover note should be sufficient. It is yet to be seen, however, exactly what will be required.

Broadstone comment

Transparency regarding key criteria that will almost guarantee your valuation submission a free pass through the Regulator’s ‘security’ checks will no doubt be attractive to some. However, for those with more unusual scheme specific circumstances or where these boundaries are simply too expensive to use as a target, the exact parameters will be irrelevant and this entire area of guidance could arguably be ignored.

It is important to remember that a bespoke categorisation doesn’t necessarily mean Regulator intervention (they don’t have the resource) and, fast track compliance in itself doesn’t absolve the trustees of their wider duties and requirements under the funding regulations or necessarily equate to compliance with the code. For example, whilst covenant does not feed into the fast track parameters, responsibilities in this

area remain (at least in theory) a core part of setting a compliant strategy.

In particular, we can see that a scheme with a very weak employer would need to go well beyond passing the fast track ‘hurdles’ to comply with the regulations. It will be interesting to see whether the Regulator picks out this group for additional attention given they have already highlighted this as a key risk category, or what the repercussions are if/when a sponsor fails and falls into the PPF despite having previously been cleared through ‘Fast Track’ and ignored by TPR.

Overall, we would urge our clients not to worry unduly at this stage whether they are likely to be ‘Fast Track’ or ‘Bespoke’. Whilst there may be the temptation to shortcut aspects of the Statement of Strategy if no one is looking, there is a chance you would simply be creating more work for the future – after all, ‘Fast Track’ cases are still subject to random sampling and being ‘Fast Track’ this time provides no guarantee of the position in future valuation cycles.

Nevertheless, if you are concerned, or simply want to know how you might measure up to the (provisional) ‘Fast Track’ criteria, then our Broadstone actuaries will be happy to help.

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Find out more

For more information on how Broadstone can help you, please contact your Broadstone consultant or use the details below.

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