Defined Benefit Funding Principles (Part 2)

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Agenda

- Full valuation process
  - Statutory Funding Objective (SFO)
  - Purpose of the SFO
- Measures of liabilities
- Potential Funding Risks
- Employer covenant
- Statement of Funding Principles
- The role of the Pensions Regulator
- Draft DB Code

Full Valuation Process

Preparatory work

Review Rules and understand the balance of powers. Identify any conflicts. Consider existing funding principles.	Assess employer covenant and review funding objectives/target	Consider interaction of key risks including investment strategy

Core process

Decide on initial assumptions	Calculations	Trustees' proposed basis

Meetings and negotiations with employer

Agree funding assumptions	Agree recovery plan contributions and length if required	Negotiate additional security if necessary

Finalisation (15 month deadline from effective date)

Documentation – Revise Statement of Funding Principles / Recovery Plan / Schedule of Contributions	Submission to the Pensions Regulator	Report to members – Summary Funding Statement

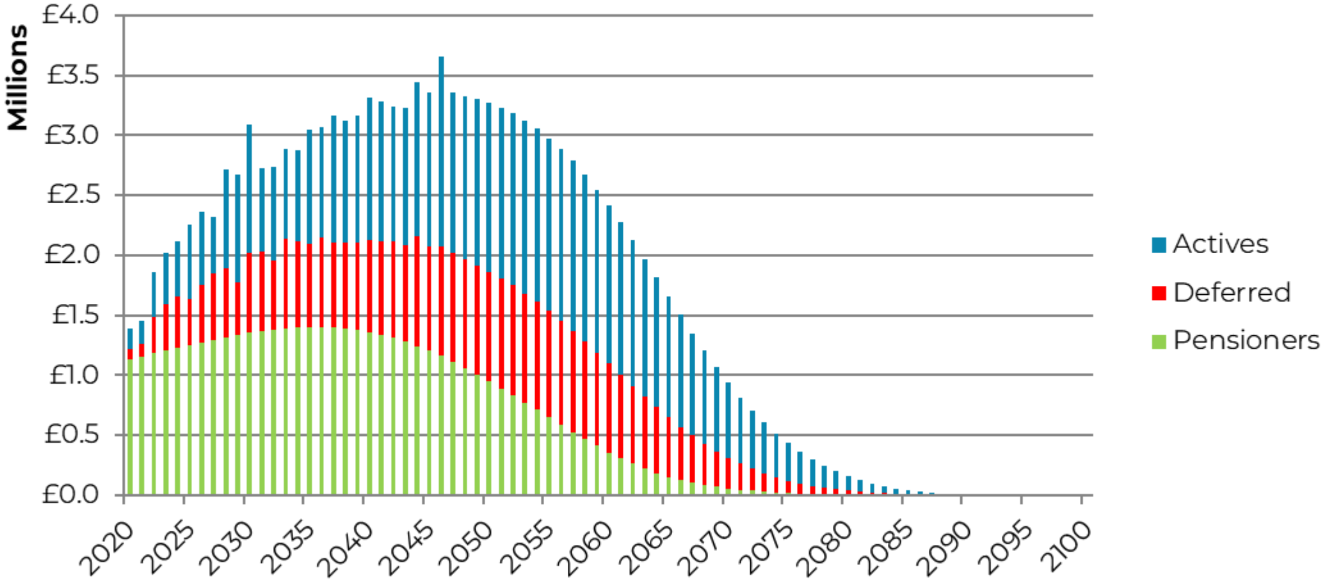
Statutory Funding Objective

Requirement to have sufficient and appropriate assets to cover
Technical Provisions (liabilities)

- **Technical Provisions, scheme specific, usually agree assumptions with employer**
- **Must be prudent and have regard to investment strategy**
- **Active members? – need to calculate the cost of future benefit accrual as a proportion of pensionable salary (as set out in the scheme Rules)**
- **Schemes in deficit will need a Recovery Plan, usually agreed with the employer – the Regulator prefers the length to be as 7 years or less but some out performance of asset returns above the discount rate is permissible**
- **Must review funding at least every 3 years – Formal Actuarial Valuation**
- **Scheme's with more than 100 members – annual Actuarial Funding Report required**
- **Pensions Regulator guidance (Code of Practice 3 - 2014) – New code was expected to be in force October 2023 – now April 2024 (more later)**

Purpose of the Statutory Funding Objective

- **To place a value on expected future benefit payments promised 'Technical Provisions'**
- **Technical Provisions are the Statutory minimum level of funding i.e. need to target a level of assets at this level (at least)**

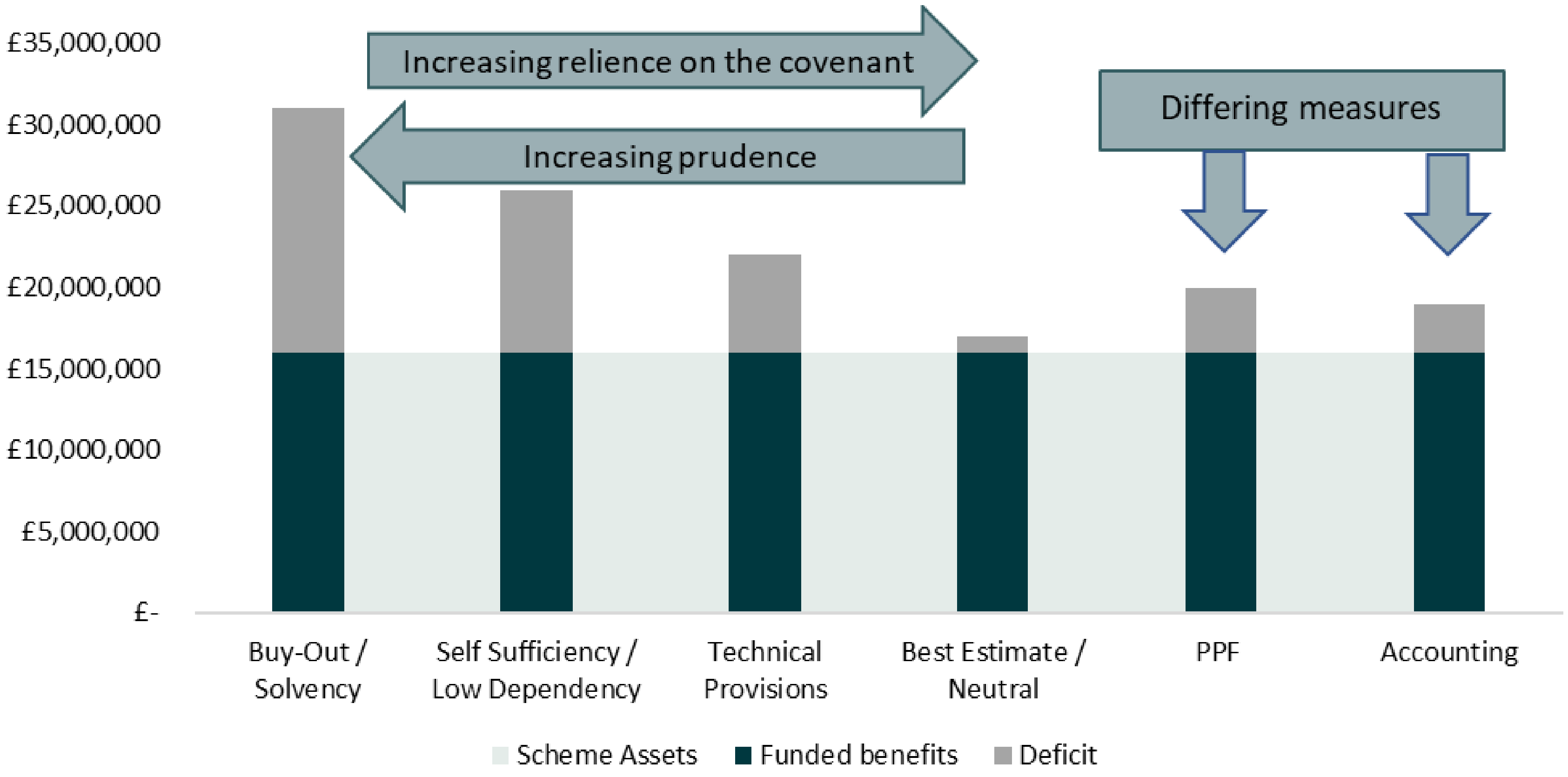


Technical Provisions are required to be a prudent estimation of the cost of paying out future benefits.

Trustees should ensure that key assumptions, such as, the discount rate and the future expected lifetime of members incorporate a sufficient level of prudence. For example, setting discount rates lower than the expected return on asset returns.

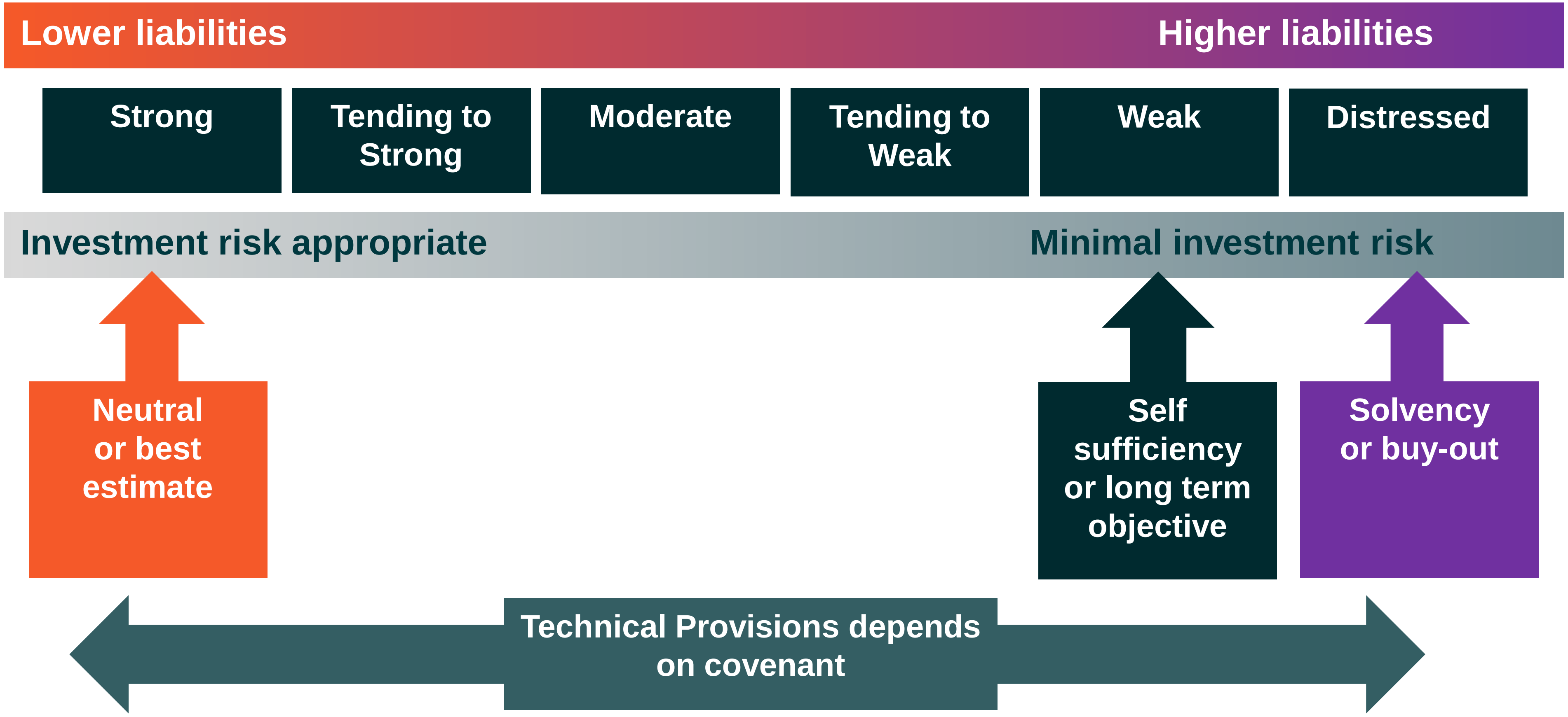
The level of overall prudence will be dependent on the risks faced by the scheme (employer covenant and investment strategy)

Measures of Liabilities (Technical Provisions)



The Pensions Regulator provides extensive guidance on employer covenant reliance and help on determining whether an external covenant assessment is required

Measuring Liabilities
Link to Employer Covenant



Potential Financial Risks

Covenant risks

Sponsor failure
The sponsor fails, triggering a wind up with insufficient assets to secure member benefits

Balance sheet strength
The scheme deficit is significant in the context of the sponsor's size reducing the ability to withstand risk

Affordability
Sponsor unwilling or unable to fund the scheme at suitable pace

Covenant leakage
Sponsor pays dividends or assets cease to be available to the scheme

Investment risks

Liability matching
Asset returns do not match changes in liabilities

Disinvestment
Scheme is a forced seller which could occur at times of market distress

Manager performance
Managers do not perform in line with expectations reducing the expected value of future assets required to meet benefit payments

Funding risks

Mortality
Members living longer than expected increasing the benefits paid

Inflation
Inflation is higher than expected increasing the size of the benefits paid

Member options
Certain benefit options can be more valuable than others depending on the basis they are valued. If members do not select the options expected or option terms are changed the value of the actual benefits may be different.

Employer Covenant

- **Risk which trustees have the least control**
- **Underpins the extent to which funding & investment risks are acceptable**
- **A covenant assessment should aim to understand:**
  - The significance of pension scheme to an employer's finances
  - The level of debt financing the employer engages with and where the pension scheme ranks in priority order for debt repayment in an insolvency event
  - The ability of the employer to pay deficit repair contributions
  - Future employer prospects and industry and sector outlook
  - Any covenant leakage – excessive dividend payments / inter company agreements etc
- **Additional security/contingent assets?**
- **Assessing employer covenant**
  - Use a professional covenant advisor?
  - Pensions Regulator guidance…

Employer Covenant

Current Guidance

Technical Provisions
High (Strong)
Low (weak)

A
- Strong or tending to strong covenant
- Recovery plan < 7 years
- Strong funding position
- Strong Technical Provisions

C
- Weaker employer with limited affordability
- Strong Technical Provisions
- Recovery plan contributions at affordable pace

E
- Weak employer unable to support
- Stressed scheme with limited abilities to use funding regime

B
- Strong or tending to strong covenant
- Recovery plan > 7 years
- Weak Technical Provisions

D
- Weaker employer with limited affordability
- Weak Technical Provisions
- Recovery plan >7 years

Strong covenant — Weak covenant

1 Relatively mature

2 Relatively immature

The new DB Code will move away from these covenant groupings focusing more on supportable risk considering:
- Cashflow
- Contingent assets & other factors
- Prospects

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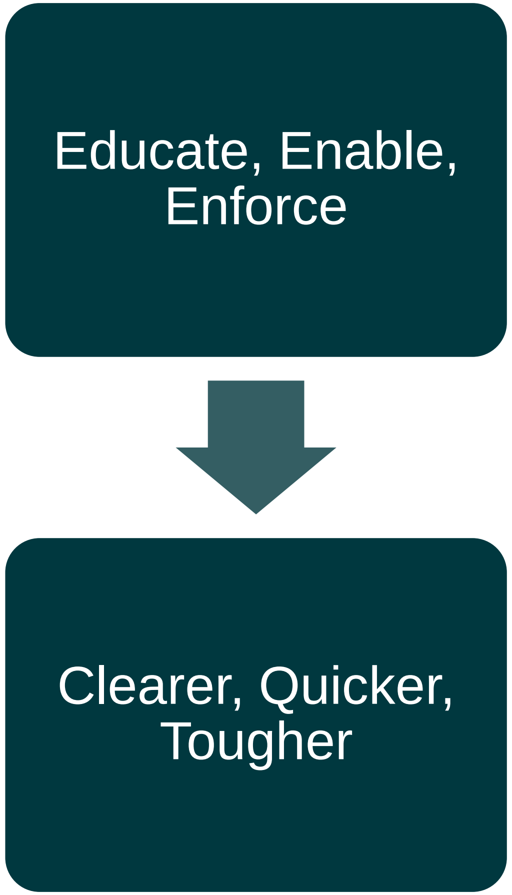
Statement of Funding Principles (SFP)

- **Formal document setting out**
  - The method and assumptions
  - Policy on discretionary benefits
  - Recovery Plan approach
- **Agree/Consult with employer**
- **Review at subsequent valuations**
  - Benefit, financial, demographic, legal or regulatory changes
- **Can be revised at other times if there is a change of circumstances**

New DB Code will still require all of the above but in addition a 2 part Statement of Strategy will need to be prepared;
Part 1: The Funding and Investment Strategy (FIS)
Part 2: Supplementary items – more granular details, risk assessments, covenant assessments and progression to long term low dependency target

The Role of the Pensions Regulator - Funding

- **Draft and review the Codes of Practice**
- **Code of Practice 3: Funding Defined Benefits**
  - New Code expected to be in force April 2024
  - Fast-track and ‘bespoke’
- **Review valuation submissions / engagement**
- **Annual funding statements / scheme funding analysis**
- **Setting out clear expectations and governance requirements**
- **Compliance through supervision and enforcement**
- **Research into DB pension schemes**
- **Online training – trustee toolkit / education**
- **Some limited pro-active engagement (meetings/questionnaires)**



DB Funding Code (expected April 2024)

Key Principles

Schemes must aim to be **fully funded** and **invested in a low risk manner** once they are considered to be **mature.**

All funding deficits must be addressed **as soon as the employer can reasonably afford.**

Level of risk prior to this point must be **supportable** based on strength of employer covenant.

Trustees must have **detailed plans** for this which will need to be documented and submitted with each valuation.

DB Funding Code (expected April 2024)

Definitions (1)

New phrase	Definition
Significant Maturity	When a scheme's duration reaches a level specified by the Pensions Regulator (expected to be a duration of 12 years).
Relevant Date	Set by Trustees but generally will be the end of scheme year when **Significant Maturity** is expected to be (or was) reached.
Low Dependency Funding Basis	A set of actuarial assumptions that are sufficiently prudent that further contributions are not expected to be required to fund the scheme, if it is 100% funded on this.
Low Dependency Investment Allocation	Two principles 1. Broadly cashflow matched to expected benefit payments; and 2. that funding level is "highly resilient" to short term adverse changes in market conditions.
Long-term objective (LTO)	How the trustees intend the scheme to provide benefits in the long term.

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DB Funding Code (expected April 2024)

Definitions (2)

New phrase	Definition
Journey Plan	Trustees' plan to travel from the current funding position to the **Long-term funding target**.
Long-term funding target	The funding level the trustees intend the scheme to have reached by the **Relevant Date** (this can be more prudent than the **Low Dependency Funding Basis**).
Statement of Strategy (SoS)	New written document to be prepared, reviewed and revised by the Trustees covering their Funding and Investment Strategy (FIS), **Journey Plan** and risk management aspects as well as other matters.
Fast Track and Bespoke	The Pensions Regulators categorisation of actuarial valuations to help them triage cases for further attention.
Covenant visibility, reliability and longevity	Measures to determine how long you can robustly rely on employer support.
Cashflow, contingent assets and prospects (CCAP)	The three key metrics that the Pensions Regulator expects Trustees to use in assessing covenant strength (**Covenant visibility, reliability and longevity**).

DB Funding Code (from April 2024)

Fast Track and Bespoke

A filter for The Pensions Regulator (TPR) assessment and engagement relating to valuations.

Both Fast Track and Bespoke are equally valid. The appropriate route for each case will depend on scheme specifics.

Scheme Actuary to certify if Fast Track has been met:

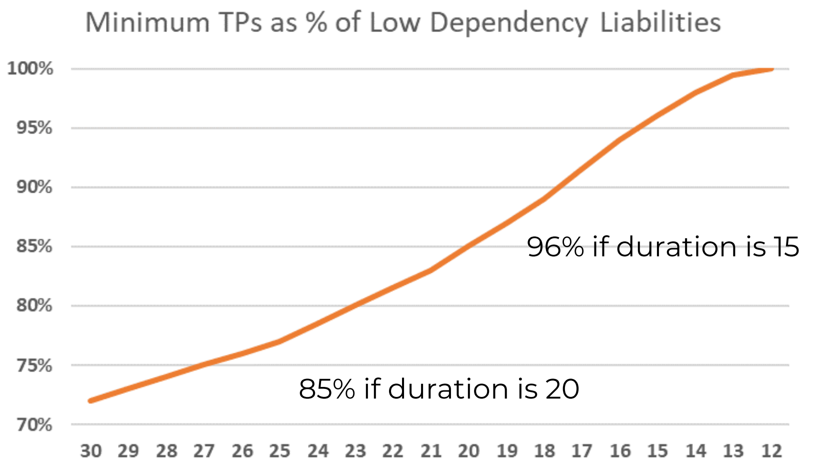
- Technical Provisions (TPs) must satisfy a minimum level (at least the % of 'Low Dependency Liabilities' shown).
- Investment strategy must satisfy a stress test (maximum fall in funding).
- Recovery plan must be sufficiently short.

TPR believes c.50% of schemes will meet these parameters.

For Bespoke cases Trustees should be prepared to explain their approach and justify how it meets the requirements of the legislation.

Fast Track is not risk-free for trustees. It represents our view of tolerated risk...it does not represent minimum compliance.

TPR Fast Track Consultation



DB Funding Code (expected April 2024)

Statement of Strategy - Content

Part 1 – records the long term strategy

- Long term objective, calculated duration and the expected relevant date
- Details on how low dependency will be achieved by the relevant date
- Assets intended to be held at the relevant date
- Low Dependency funding basis targeted by the relevant date

Part 2 – records the journey, including experience (must consult with Employer)

- Granular detail on the journey plan towards low dependency funding
- How well the implementation is going with actions and remedial steps
- Long-term target for scheme (buy-out/run off)
- Risk assessment of the strategy
- Assessment of the employer covenant
- Information on technical provisions assumptions
- Low dependency funding level and assumptions

In addition to this list of required content, the draft code also sets out an extended wish list of what TPR expects to see in this statement including more detailed covenant metrics, cash flow and liquidity information.

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