The defined benefit funding code of practice

Overview

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DB funding code overview

Five key themes

The Pensions Regulator (TPR) has released the final version of the new defined benefit (DB) funding Code of Practice, which will apply to all valuations with effective dates from 22 September 2024 onwards. TPR have also finalised their Fast Track guidance and published their revised covenant guidance.

We now have a full picture of the requirements under the new regime. This note provides an overview of the new funding requirements, together with some of the key areas for pension scheme sponsors and trustees to consider.

Fast Track and Bespoke	Low dependency by significant maturity	Reframing employer covenant	Journey plan and long-term objectives	Deficits and recovery plans

Fast Track and Bespoke

Every scheme will need to decide which route it wishes to take to comply with the new regime. There are two routes: Fast Track and Bespoke.

- **Fast Track** – rules set by TPR governing all of the aspects of funding and investment. Meet all of the rules and your scheme passes Fast Track. Effectively, you get TPR's seal of approval and you're unlikely to see any regulatory contact.
- **Bespoke** – follow your own approach to meet the new regulations. You will need to provide more detailed evidence to explain how you are complying and are more likely to receive scrutiny from TPR if you choose this route.

Whichever option you choose, it's important to understand where your scheme stands versus the Fast Track rules. Note that the Fast Track rules are not in the Code itself but in a separate TPR document.

Low dependency by significant maturity

Every scheme needs to reach a position of low dependency on the sponsor by its "relevant date", which must be by the time it is "significantly mature" at the latest.

By when – Significant maturity is defined as a duration of liabilities of 10 years, i.e. when most members have retired. This definition applies for both Fast Track and Bespoke.

Low dependency investment strategy – The investment strategy should be highly resilient to short-term adverse market changes. This is a 'notional' strategy at the point of significant maturity, with trustees being able to adopt a different strategy in practice.

Low dependency funding strategy – Being fully funded on an approach that is aligned with the low dependency investment strategy such that "no further sponsor contributions are expected to be required" in respect of accrued benefits.

Fast Track – TPR has set out tests to apply to both the strength of your current funding liabilities and risk in your investment strategy. TPR also specifies low dependency assumptions for use in Fast Track, including a discount rate of no more than 0.5% pa above gilt yields. There are also requirements on the length and shape of any Recovery Plan.

Employer covenant

Trustees will be required to carry out an assessment of employer covenant in order to understand the sponsor's ability to support the scheme now and in the future.

The code specifies a more principles-based approach than the previous four gradings approach, setting out in more detail the areas which trustees will be expected to consider in their assessment.

An assessment of the employer covenant must consider two areas:

The financial ability of the employer to support the scheme

The reliability period

How long they have reasonable certainty over the employer's cash flow to fund the scheme

Covenant longevity

How long they can be reasonably certain the employer can continue to support the scheme

The expected support from any contingent assets

These assets are expected to be legally enforceable and sufficient to provide the specified level of support when required

Journey plan and long-term objectives

Now is a good time for trustees and sponsors to discuss their thoughts on the eventual endgame for their scheme. Will member benefits be secured with an insurer or a superfund or would the trustees and sponsor prefer to run the scheme on and potentially look to improve member benefits and distribute surplus?

It is likely that your preferred endgame will inform your low dependency objective and may vary through time as commercial and economic conditions change, so it is important to keep the position under review.

Investment strategy – Investment risk should be consistent with the strength of employer covenant and time to significant maturity. Immature schemes with strong covenants have the most flexibility, mature schemes with weak covenants the least.

Funding strategy – The low dependency basis should reflect the long-term objective of the scheme that the trustees will want to achieve at the point they are significantly mature.

Fast Track – TPR's investment stress test allows more flexibility for immature schemes, with the most immature schemes passing the test with a much higher allocation to growth assets. Prior to reaching significant maturity, schemes can have a funding requirement that is lower than 100% of the low dependency Fast Track assumptions.

Expenses – TPR requires trustees to include an expense reserve in their low dependency liabilities which is consistent with the long-term strategy adopted by the trustees.

An important consideration is how your investment strategy is expected to evolve in the period to significant maturity. Your strategy should be mindful of risk/return efficiency, liquidity requirements and transaction costs.

When you approach your low dependency or endgame objective, you do not want to experience any unpleasant surprises. You will want to have a high degree of confidence in your data quality and on the benefits that are payable to members.

Perfection is rarely possible, so the focus should be on correcting any known issues and completing a 'health check' on areas where issues tend to arise, e.g. equalisation and closure to active members.

Having confidence in your data and benefits now will also allow greater confidence to explore opportunities that may arise along the journey, e.g. taking advantage of positive market movements, attractive pricing from new insurers/superfunds.

Deficits and recovery plans

If a scheme has a technical provisions deficit, the trustees will need to agree a recovery plan with the sponsor. Deficits must be recovered "as soon as the sponsoring employer can reasonably afford".

Under the Fast Track requirements, the recovery plan must satisfy the following requirements:

- must be 6 years or less (or 3 years or less if significantly mature)
- annual increases should not exceed CPI or 3% p.a.
- no advance credit for future expected returns above the discount rate
- post-valuation experience can be reflected

In the current climate of higher gilt yields and potentially improved funding levels since previous valuations, should sponsors continue to pay deficit contributions which could result in trapped surplus? The answer to this is likely to be finely balanced with the obligation for trustees to protect members' interests.

As a result, we expect this may lead to an increased use of contingent assets, such as escrow accounts, to mitigate the risk of trapped surplus whilst protecting members. For example, as a short-term measure, sponsors may seek to pay contributions into an escrow account until the next funding valuation when the funding position can be properly assessed.

The key alternative funding options fall into three groups:

Immediate non-cash funding options – options which can immediately enhance the funding position in the pension scheme without upfront cash requirements, e.g. direct transfer of assets owned by the sponsor or Asset-Backed Contribution (ABC) structures.

Contingent cash funding – options whereby cash is provided to the pension scheme in certain circumstances and in some cases, is ringfenced outside of the pension scheme to protect against trapped surpluses, e.g. escrow, reservoir trust, performance-related contributions, funding corridors.

Contingent support – additional support is provided to the pension scheme from outside of the direct sponsor covenant net, e.g. security over assets, letters of credit, surety bonds, parent company guarantees.

The Bespoke compliance route is expected to provide flexibility to account for scheme/sponsor specific circumstances, but will require additional supporting evidence and could result in greater regulatory involvement. As part of justifying a Bespoke approach, we anticipate a greater need for alternative funding options, as set out below.

Immediate non-cash funding	Contingent cash funding	Contingent support
Direct asset transfer	Escrow	Security over assets
Asset-Backed Contributions (ABCs)	Reservoir trust	Letter of credit or Security Bond
	Performance related contributions	Parent Company Guarantee
	Funding corridors	

What actions should trustees and corporate sponsors take?

1

Review any current deficit reduction contributions in payment

Trustees and sponsors should look to understand the impact of the introduction of the new funding regime on the level of deficit reduction contributions that will be needed. This includes those schemes that are currently in a surplus under the existing regime, where deficit reduction contributions may have to be restarted to comply with the new code.

They should consider the likely contributions required under both Fast Track and Bespoke approaches for their next valuation. Under Bespoke there will be greater ability to recognise the impact of using alternate funding options to deliver better outcomes.

2

Trustees and sponsors will need to agree a scheme's long-term funding and investment strategy and record it in a Statement of Strategy

The Fast Track rules are relatively simple. The general principle is the less mature a scheme is, the more flexibility it has to set investment and funding strategy and still pass the Fast Track tests.

Even though the Fast Track rules are the same for schemes with both weak and strong covenants, all trustees are required to review the strength of employer covenant to ensure contributions are appropriate and downside risks are affordable.

The Bespoke approach allows more flexibility. However, a scheme using Bespoke still must aim to reach a low-dependency position by the time they are significantly mature. This will include providing more detailed evidence to show their approach complies with the regulations.

3

Your first valuation under the new regime is going to be more involved

Given the significant market movements in late 2022, schemes with triennial valuations due in late 2024/early 2025 will have been expecting a different backdrop compared to their last valuation – reflecting a higher interest rate environment, revised investment strategies and (on average) higher funding levels.

Complying with the new regime is going to require greater trustee and sponsor engagement, additional training and more support throughout the process. For schemes that already had clear objectives and comprehensive journey plans in place this compliance pain may be minimal, but for those who had only ever focussed on their technical provisions it would make sense to get started on this work now.

In either situation it will be important to determine how your existing approach scheme stacks up against the new regime and the Fast Track rules.

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