First Briefing, March 2020 – defined benefit (DB) funding

The Pensions Regulator (TPR) has published a consultation on DB funding, preparing for a revised Code of Practice (Code). This may be of interest to trustees, employers, advisers and members of DB pension schemes.

This is the first of two consultations before the Code is released. It covers how TPR proposes to regulate funding, the principles it thinks should underpin the new framework and how these principles could be applied in practice.

This briefing only covers the key messages. Trustees and employers should consider reading the full consultation document[1] (all 175 pages of it) or, more realistically, the 16-page 'Quick guide'[2].

The consultation closes on 2 June 2020.

Regulating funding

TPR say they don't think there should be a 'one-size-fits-all' standard when it comes to DB scheme funding and instead propose a 'twin-track compliance route' to carrying out valuations (referred to as 'Fast Track' and 'Bespoke').

Fast Track

- TPR will set quantitative guidelines for trustees to assess whether their valuation is compliant.
- If all aspects are satisfied, trustees can expect minimum regulatory involvement on DB funding.

Bespoke

- This option provides trustees and employers with more flexibility to account for scheme and employer-specific circumstances.
- Decisions under this route will need to be fully articulated and evidenced and mean higher regulatory involvement.

A Fast Track approach is expected to be easiest for schemes which are well-funded and well-managed. TPR will set guidelines in some of the key aspects of funding and investment (such as funding target, recovery plan length, discount rates and investment risk). These guidelines will be reviewed and updated at least every three years. TPR will also consider scheme-specific factors such as maturity and employer covenant strength when deciding whether a scheme meets Fast Track compliance.

A Bespoke approach is not intended to be a 'bad' or second-best option, but an alternative which trustees choose to (or have to) follow. More work will be required though, to explain how and why this approach is appropriate.

However, TPR will still expect all the key principles that underpin the new framework to apply to both approaches.

[1] https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-funding-code-of-practice-consultation.ashx

[2] https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/quick-guide-db-funding-consultation.ashx

Key principles

TPR have suggested a number of key principles for DB scheme valuations.

Compliance and evidence

- Trustees and employers should be able to understand their scheme-specific funding and investment risks and objectively evidence how these risks have been assessed as remote or minimal or can otherwise be properly managed.
- When demonstrating how risks are managed, trustees should be able to compare the risks they have taken to a risk position tolerated by TPR and then demonstrate the mitigation and/or support available for the difference.

Long-term objective (LTO)

- By the time they are significantly mature, schemes should have a low level of dependency on the employer and be invested with high resilience to risk.

Journey plans and technical provisions (TP)

- Trustees should develop a journey plan to achieve their LTO.
- Trustees should plan for investment risk to decrease as their scheme matures and reaches low dependency.
- TPs should have a clear and explicit link to the LTO, and over time, should converge to the LTO as evidenced by the journey plan.

Scheme investments

- The actual investment strategy and asset allocation over time should be broadly aligned with the scheme's funding strategy.
- Trustees must ensure their investment strategy has sufficient security, sufficient quality, and can satisfy liquidity requirements based on expected cash flows as well as a reasonable allowance for unexpected cash flows.
- The asset allocation at significant maturity should have high resilience to risk.

Reliance on the employer covenant

- Schemes with stronger employer covenants can take more risk and assume higher returns.
- However, trustees should assume a reducing level of reliance on the covenant over time, depending on its visibility.

Reliance on additional support

- Schemes can account for additional support from contingent assets when carrying out their valuations if it supports the risks being run, is appropriately valued and is legally enforceable and realisable at its necessary value when required.

Appropriate recovery plan (RP)

- TP deficits should be recovered as soon as affordability allows, while minimising any adverse impact on the sustainable growth of the employer.

Open schemes

- Members' accrued benefits in open schemes should have the same level of security as members' accrued benefits in closed schemes.

Journey planning and technical provisions (TPs)

A key part of the new Code is the requirement for trustees to have a LTO and to develop a journey plan to achieve their LTO.

Under the new Code, TPs will be a way of measuring progress towards the LTO and are intended to be a smooth path based on the agreed journey plan. TP deficits will need to be recovered as soon as affordability allows.

However, once the scheme funding objective has been reached and the scheme is fully funded on a TPs basis, trustees can invest in line with the journey plan and use investment returns to take them to the LTO, with future employer contributions only necessary if a deficit arises on a TPs basis.

"In other words, the LTO is the destination, the TPs are the journey milestones, and the RP is the corrective measure to get back on track."

Further information

We are still analysing the detail of the proposals and will share more over the course of the consultations. In the meantime, please contact your usual First Actuarial consultant if you want further information.

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