Sackers

New DB funding code laid in Parliament

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Introduction

After months of speculation, the final draft DB funding code ("the Code") was laid before Parliament today, with TPR hailing it as "a key milestone in delivering the significant package of work to improve the security and sustainability of DB pensions".

Key points

- Aimed at trustees, sponsoring employers and advisers, the Code sets out TPR's guidance and expectations on how to comply with the new funding and investment strategy (F&I Strategy) requirements.
- Reassuringly, the Code has been updated to dovetail with essential changes made to the final regulations so as to better reflect the flexibility already built into existing funding and investment requirements. **These changes are summarised under "The Code – what's new?"** below.
- Once in force, the Code will replace the existing DB funding code for valuations with effective dates on or after 22 September 2024. However, with the Code needing to be before Parliament for 40 days, there will be a gap between the new scheme funding regime starting and the Code coming into force. Schemes with effective valuation dates that fall in this interim period must comply with the new requirements set out in the legislation, which is already in force.
- While a draft has been laid, TPR assures trustees that the Code is "a clear indication of what [it] intends the final code to be". In addition, it promises that if "the code is to change as a result of the parliamentary process, [it] will take this into account when assessing valuations".
- TPR has also published responses to its consultations on the new Code and its twin-track regulatory approach ("the Response" and the "RA Response" respectively).
- TPR's regulatory approach and a consultation on revised employer covenant guidance will follow "in due course".

Background

In brief, the PSA21 and the Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2024 ("the Regulations") require trustees to determine an F&I Strategy.

Focusing on how trustees will deliver benefits over the long term, the F&I Strategy will set out the trustees' plan to transition from the scheme's current funding position to low-dependency funding (minimal reliance on the employer covenant) by the time the scheme is "significantly mature" (see below). During the transition, risk must be supportable by the employer covenant and the maturity of the scheme. Once trustees have determined or revised the F&I Strategy, they must produce a statement of strategy outlining their approach to funding and risk management.

TPR issued its second consultation on the Code in December 2022, as part of a funding package which also included its consultation on the parameters for submitting Fast Track valuations.

The Code – what's new?

Against the backdrop of the then Government's Mansion House reforms, the DWP revised the Regulations so as to more explicitly reflect the flexibilities already embedded within the existing funding regime. Those changes have now been echoed in the Code, alongside other revisions to address key issues, including:

Stability in long-term planning

Following concerns that the proposed approach for determining scheme maturity was too sensitive to market movements, and would create difficulties for long-term planning, the Regulations prescribe a fixed date on which assumptions to calculate future maturity must be based. In turn, **TPR reviewed and revised its definition of "significant maturity". It is now ten years for DB schemes and eight years for schemes with cash balance benefits**. There is also a proxy for smaller schemes adopting the Fast Track regulatory approach.

How the notional investment allocation impacts actual decisions

In light of concerns that the draft regulations might require trustees to invest in line with the investments set out in the F&I Strategy, changes were made to the final version. Similarly, **the Code is now clear that decisions in relation to the scheme's actual investment allocation are not constrained by the notional investment allocation**. This applies both at low dependency and along the journey plan.

That said, in most instances, TPR expects trustees to align their actual investment strategy with the F&I Strategy.

Replacing prescription with a principles-based approach

The definition of low dependency investment allocation ("LDIA") has been simplified to focus on being highly resilient to short-term adverse changes in market conditions. TPR has also **removed prescription around how trustees should test the high resilience of their LDIA, providing flexibility for trustees to carry out a suitable test for their scheme, provided they can be satisfied that it demonstrates low dependency on the employer**.

In addition, a formulaic approach for determining the maximum level of risk that can be supported by the employer covenant has been replaced with a principle-based approach, recognising the different ways trustees assess risk and the support for this risk. Trustees will need to demonstrate that the covenant can support the risk being run during the reliability period. With the intention of providing trustees with clarity as

to what might be appropriate, TPR plans to confirm the test it will apply as an initial trigger for a regulatory risk assessment.

Recognising open schemes' unique characteristics

The Code provides greater differentiation between the way trustees intend to provide benefits (the long-term objective) and the requirement for trustees to set a journey plan to reach low dependency by significant maturity in the F&I Strategy. These may not align for all open DB schemes, so **trustees will be able to recognise that the scheme plans to remain open formally in the statement of strategy**. The Code also includes a new section that collates the guidance for open schemes and provides easy signposting to support trustees.

Further clarity on how to assess the employer covenant

The Code has been updated to align with the Regulations and to provide greater clarity on how to assess the reliability and covenant longevity periods. TPR also sets out its expectations on how long these periods should be for a typical scheme, while acknowledging that some employers may be able to demonstrate a longer period.

Proportionality

The Code sets out guidance on proportionality. For example, the level of detail required to assess the employer covenant will depend on the size of the scheme relative to the covenant support, the scheme's funding position, the level of funding and investment risk, as well as scheme maturity.

Fast Track and regulatory approach

TPR will adopt a twin-track approach to assessing DB scheme valuations. There will be two valuation submission routes, Bespoke and Fast Track.

The **Fast Track approach will act as a filter for its assessment of actuarial valuations**. If a valuation submission meets a series of Fast Track parameters (eg the low dependency funding basis, recovery plans), TPR is unlikely to scrutinise it further and it is less likely that it will engage with trustees. However, Fast Track is not risk-free, rather it represents TPR's view of tolerated risk.

In contrast, the **Bespoke approach will provide trustees with the flexibility to select scheme-specific funding solutions**, so long as the funding approach and actuarial valuation meet legislative requirements and follow the principles of the final Code. Broadly, trustees may make a Bespoke submission if they:

- want to take more risk than available under Fast Track and can demonstrate that the total risk run by the scheme is supportable by the employer covenant and in line with the scheme's maturity
- cannot meet all the Fast Track parameters, including the recovery plan parameters due to employer affordability constraints, or
- have unique employer circumstances that necessitate a different approach.

Following improvements in scheme funding positions between March 2021 and March 2023, **TPR estimates that 62% of schemes meet all the Fast Track parameters with a further 19% able to do so, at no extra cost**, were they to change their funding approach.

RA Response

As TPR's proposals were broadly welcome it has only made limited changes, excluding those to address the change to the Code's definition of significant maturity and market conditions.

What's next?

The **Code will come into force in the autumn** and TPR intends to communicate its approach to regulating DB schemes "in due course". This will include additional detail on its twin-track approach, and the regulatory filters it will use when assessing valuations to identify which schemes' statements of strategy to look at in greater depth or trustees to engage with to understand their funding approach in more detail. To retain flexibility to adjust its approach to the information it collects, the statement of strategy will not be included in the final code.

With less than two months to go before the new funding regime, other documents in the pipeline include:

- a consultation on updated covenant guidance "in due course", focusing on the main areas that trustees must consider when assessing the employer covenant under the final code, such as employer cash flows, prospects and covenant longevity periods. It will also provide guidance on maximum affordable contributions and affordability for recovery plan purposes

- guidance on the statement of strategy following TPR's March consultation, including the proposed templates reflecting the different information that will be required from DB schemes depending on their circumstances, with TPR expecting to publish the final statement of strategy and consultation response "in the autumn"

- a review of TPR's DB funding and investment-related guidance to consider whether any additional guidance is needed to support trustees as they approach the long-term funding of their scheme.

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