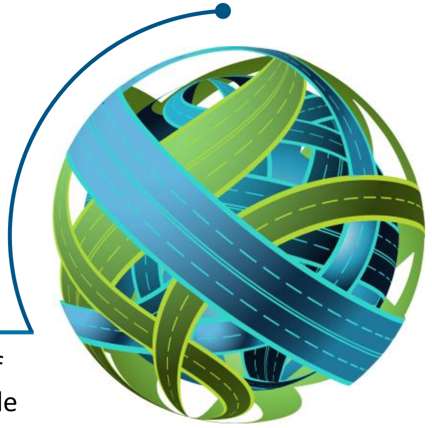
Defined benefit scheme funding

The new funding and investment Code



On 16 December 2022, the Pensions Regulator (TPR) published consultations on its new defined benefit funding Code of Practice and its approach to enforcement of the new funding regime. The consultations provide the detail underlying the new regime, as set out in the Pension Schemes Act 2021. It's expected that the new Code will come into force for valuations with effective dates from 1 October 2023 onwards. We'll be publishing our thoughts on the draft Code over the coming weeks. In the meantime, the main points are summarised below, together with some of the key things for pension scheme sponsors and trustees to consider.

What the draft Code and consultations say

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 each of these 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're likely to need to provide more evidence that you have complied and are more likely to see regulatory contact 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 the time it is "significantly mature".

By when – Significant maturity is defined as a duration of liabilities of 12 years. i.e. When most members have retired. *This definition applies for both Fast-Track and Bespoke*.

Investments/ Funding level – Having a broadly matched investment strategy that's highly resilient to short-term adverse changes in market conditions. Being fully funded such that "further employer contributions would not be expected to be required" in respect of accrued benefits.

Fast-Track – TPR has set out a stress test to apply to your investments at significant maturity. A scheme invested 85% or more in bonds should pass the test. TPR has specified some low dependency assumptions - discount rate of 0.5% pa above gilt yields; price inflation assumptions set using gilt yields; all other assumptions are scheme specific.

Journey Plan

Through the journey plan to significant maturity, a scheme's investments and funding need to be consistent with the long-term objective.

Investments/ Funding level – Investment risk and funding level should be consistent with 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.

Fast-Track - TPR's investment stress test allows more flexibility for immature schemes, with the most immature schemes passing the test with up to 60% growth assets. Prior to reaching significant maturity, schemes can have a funding requirement of lower than 100% using the low dependency assumptions above. The most immature schemes can use discount rates of 2.0% pa in excess of gilt yields.

Fast-Track rules *do not* vary according to employer covenant.

Deficits and Recovery Plans

If a scheme has a deficit compared to its Technical Provisions, it must agree a Recovery Plan with the sponsor. Deficits must be recovered "as soon as the sponsoring employer can reasonably afford."

Fast-Track – Recovery Plans must be 6 years or less (or 3 years or less if significantly mature). Contributions can increase in line with price inflation. No advance credit can be taken for future expected investment returns in excess of the discount rate Post-valuation experience can be reflected in the Recovery Plan.

Trustees and employers 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 rules.

Even though the Fast-Track rules are the same for schemes with both weak and strong covenants, all trustees are required to carry out a **review of employer covenant** and report the results to the Pensions Regulator.

The **Bespoke** approach allows more flexibility still. However, a scheme using this approach still has to comply with regulations and has to reach a low-dependency position by the time its liabilities have a duration of 12 years. We expect the Regulator will focus on how Bespoke approaches differ from Fast-Track.

Deloitte Insights

Recent volatility in the gilt market and the need to post substantial collateral to Liability Driven Investment (LDI) funds will have caused substantial changes to scheme's funding positions and the balance of scheme's investment strategies.

Now is a good time to take stock of the balance of your scheme's investment portfolio, in terms of liquidity, hedging percentage and expected return. It's also a good time to review your scheme's funding level and whether any changes to funding assumptions and recovery plans are warranted as a result of the market volatility. Is **accelerating your journey plan** to your endgame now possible?

In reviewing the above, it is important to **determine how your scheme stacks up** against the new Fast-Track rules.

What now?

The Code of Practice is subject to consultation so some of the details may change before it comes into force later in the year. In particular, the definition of significant maturity may still change. However, we suggest you:

- Take stock of your scheme's funding and investment strategy following the gilt market volatility and where you stand along the journey to your desired endgame.
- Estimate how your scheme stacks up against the Fast-Track rules. This is important even if you plan to take the Bespoke route as we expect the Regulator to focus on how these approaches differ from Fast-Track.
- Start the dialogue between trustees and sponsor on how you intend to approach the new regime.

Deloitte contacts

Deloitte have a specialist team of pensions advisors (covering actuarial, legal, covenant, risk transfer and investment issues) who support many companies and trustees in running pension arrangements. If you would like to discuss these issues further, feel free to get in touch with one of the team below or your usual Deloitte contact.

Corporate pensions

Lesley-Anne Brown
lesleybrown@deloitte.co.uk
020 7007 4503

Karen Parker
kaparker@deloitte.co.uk
020 7303 4626

Mark Jones
markjones@deloitte.co.uk
020 7007 2363

Trustees

Mark McClintock
mamcclintock@deloitte.co.uk
028 9053 1429

Richard Slater
ricslater@deloitte.co.uk
0131 535 7602

Risk transfer

Karen Gainsford
kgainsford@deloitte.co.uk
0207 007 8725

Designed by CoRe Creative Services. RITM1093909