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The Pensions Regulator consults on new funding code

January 2023

Background

Back in our July briefing we discussed how the Pension Schemes Act 2021 provided for a framework for a new defined benefit funding regime. In particular, the framework would require defined benefit schemes to have a funding and investment strategy for the purpose of ensuring benefits under the scheme can be paid over the long term. As part of this, trustees will be required to produce:

- A funding and investment strategy; and
- A statement of strategy.

Draft regulations added further detail but the industry has been waiting for a revised code of practice from the Pension Regulator (**Regulator**) to understand what much of this will mean in practice.

The Regulator has now provided a draft of this new code, on which they are consulting (**Draft Code**). The consultation period will close on 24 March 2023. The intention is that the Draft Code will come into force from October 2023.

Funding and investment strategy

The new regime will require trustees of defined benefit occupational schemes to have a funding and investment strategy.

Some of the key principles that will have to be covered in the strategy include:

- how trustees intend the scheme to provide benefits in the long-term;
- the funding level the trustees intend the scheme to have achieved as at specified date (not later than the end of the scheme year in which the actuary estimates the scheme is expected to reach significant maturity (**Relevant Date**)), known as the **Long-Term Funding Target;**
- the investments the trustees intend the scheme to hold at the Relevant Date; and
- how they intend the scheme to reach this Long-Term Funding Target (**Journey Plan**).

Trustees must obtain the employer's agreement to the funding and investment strategy.

Funding level by the Relevant Date

The Long-Term Funding Target the trustees intend the scheme to have achieved by the Relevant Date must be at least 100% funded on the low dependency funding basis. This means the scheme should not rely on further employer contributions to provide for accrued liabilities. This will be achieved by:

- scheme assets being invested in low dependency investments; and
- the scheme being fully funded on a low dependency funding basis.

Low dependency investments are those the cash flow from which will broadly match with the payment of benefits from the scheme. The investments will also be such that the value of the assets of the scheme relative to its liabilities is highly resilient to short-term adverse changes to market conditions.

The Draft Code sets out how the Regulator expects trustees to approach the main individual assumptions, as well as what low dependency investments and cash flow matching assets may look like.

There were concerns in the industry that the new approach would limit the investment opportunities particularly for mature schemes. The Regulator does not consider that the new requirements mean that a scheme should eliminate all risk in its investments. The Draft Code does state that in determining whether a scheme's investments are resilient to short-term adverse changes to market conditions, trustees should undertake a stress test for the scheme's low dependency investment allocation. The Draft Code proposes trustees carry out a "1 in 6 stress test" with resulting variations in funding levels due to market movements expected to be limited to 4.5%.

The Draft Code notes that whilst trustees may still hold some growth assets, these will need to be limited in order to meet the principles of a low dependency investment allocation. Those schemes with over 20%-30% growth assets will need leveraged liability driven investments to balance the risk of these assets in order to comply with the low dependency investment requirements.

What is the Relevant Date?

A scheme's Relevant Date is set by the trustees but it must not be later than the end of the scheme year in which the scheme is expected to reach significant maturity.

The Draft Code provides that the duration at which a scheme reaches significant maturity is 12 years. However, the Regulator notes that the recent volatility in the bond market has illustrated that maturity of a scheme based on duration of years is sensitive to gilt yields and can therefore change. It is therefore seeking views on alternatives for setting the Relevant Date.

The Journey Plan

Another element of the funding and investment strategy is the trustees' plan to move from the current funding position to the Long-Term Funding Target. This includes considering how they will move from their current investment strategy to one that would meet the low dependency investment allocation.

The level of risk that trustees can take during the Journey Plan will be dependant upon:

- The strength of the employer covenant. The stronger the covenant the more risk that can be taken; and
- The maturity of the Scheme. The Draft Code notes that it is generally reasonable for trustees of more immature schemes to assume higher levels of funding and investment risk (subject to the employer covenant assessment).

The Draft Code sets out in detail how the trustees can evaluate the strength of the employer covenant. The level of detail involved in the covenant and risk assessment during the Journey

Plan will be dependant on the characteristics of the scheme. The Draft Code notes that the approach taken to the covenant assessment should be documented and trustees should be able to justify why the approach taken is reasonable and appropriate.

The Draft Code also provides a test for schemes to assess the maximum risk they should be taking during their Journey Plan.

Statement of strategy

The trustees must also prepare a written statement of strategy which will set out the scheme's funding and investment strategy, as well as other supplementary matters.

The Draft Code provides details of the supplementary matters that must be included. These supplementary matters include an assessment the main risks faced by the trustees when implementing the funding and investment strategy and how these can be mitigated. The trustees must consult with the employer when preparing the supplementary part of the statement of strategy, but they do not need to the consent of the employer.

Recovery plans

The draft funding regulations require that when trustees are determining if a recovery plan is appropriate, they should follow the principle that the deficit should be recovered as soon as the sponsoring employer can reasonably afford.

The Draft Code sets out three key steps the Regulator expects the trustees to undertake to determine what is reasonably affordable as follows:

- Assess the employer's available cash;
- Assess the reliability of that available cash over the short, medium and long term; and
- Determine whether any of the available cash could used for 'reasonable alternative uses'. The Draft Code sets these out as:
  - Investment for sustainable growth;
  - Covenant leakage where value moves out of the employer and is not recoverable or expected to be repaid on demand; and
  - Discretionary payments to other creditors.

The Regulator notes that the principle of 'reasonable affordability' allows room for trustees and employers to agree recovery plans that take full account of the sponsor's needs to invest in its business and use its available resources for appropriate means.

Twin track valuations

The Regulator is also consulting on its proposed twin track approach to valuations. The proposal would see two options for schemes to take at valuation; bespoke or fast track. If a valuation meets the requirements for fast track, the Regulator is unlikely to scrutinise it further and less likely to engage with the trustees.

The bespoke approach gives trustees greater flexibility, for example over the risk they can take or recovery plan length.

The consultation sets out the parameters for schemes to meet which cover the areas of:

- The low dependency funding and investment strategy
- Technical provisions

- Investment risk
- Recovery plan

The maximum recovery plan for schemes pre-significant maturity is six years for those who wish to use the fast track approach.

Comment

Whilst the Draft Code may need to be amended following the finalisation of the new funding regulations, trustees should start considering the impact the new approach will have on the funding of their schemes and in particular their investment portfolio. Equally, employers will need to understand what impact the long-term funding and investment strategy will have on the funding position and requirements of the scheme as well as the length of their recovery plans.

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