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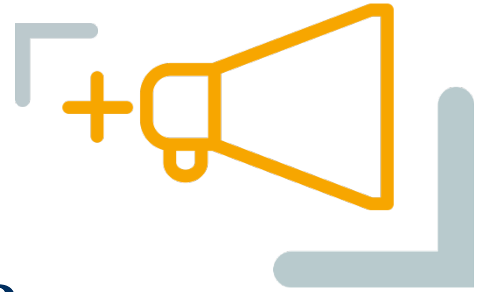

News Alert 2020/02

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Pensions Regulator sets out its new approach to DB funding

At a glance

On 3 March, the Pensions Regulator set out, in the first of two consultations, its proposals for how it intends to regulate DB funding, taking into account investment strategy and employer covenant. The lengthy consultation paper explores the application of eight principles, setting out a range of options on which the Regulator will need to come to a landing, including their quantification, before finalising its new "fast track" route to compliance. Alternatively, under this twin-track regime, trustees may be able to propose a "bespoke" approach, but this will attract greater scrutiny from and engagement with the Regulator.

The Regulator believes that this new regime will result in more efficient outcomes because at present "every valuation is 'Bespoke'" and so will help it to better target its resources.

There will be a second consultation focussing on the draft of the replacement DB funding Code of Practice, but this first consultation sets the framework that the Regulator intends to follow from which we can start to gauge its impact which is likely to be very scheme-specific.

Whilst the new funding regime will not become law until perhaps the end of 2021 we expect the statements made by the Regulator in this and subsequent consultations to increasingly influence the Regulator's view of "good practice" for current valuations, and therefore everyone involved in valuation and investment strategy discussions for schemes will need to closely follow the evolution of the new regime.

Key Actions

Trustees

- Consult with actuarial, investment and covenant advisers to assess how these proposals could impact the scheme's current approach to DB funding and investment – in particular in relation to the journey plan to get to the long-term objective and the speed by which investment risk may need to be reduced
- Where independent covenant advice is not taken regularly, revisit this decision
- Come to an initial view on whether the trustees are likely to want to go down the

"fast track" or "bespoke" approach and begin discussions with the scheme sponsor

Scheme sponsors

- Take early actuarial advice in relation to the extent to which the scheme's current approach to DB funding and investment will be challenged and the implications for the pace of funding, for dividends and other covenant leakage
- Weigh up the pros and cons of in future seeking a "fast track" or "bespoke" approach to compliance – in particular consider whether contingent assets under the bespoke route could be used to support more efficient cash outcomes

The Detail

The Pensions Regulator's consultation takes as its remit the conclusions from the March 2018 White Paper on "Protecting DB Pension Schemes" that there should be a new DB Funding Code of Practice along with associated legislation, backed up by a new DB Chair's statement (now referred to as the "statement of strategy" in both the Pension Schemes Bill and the consultation document). The package is intended to deliver greater clarity to stakeholders as to what is expected as the DB landscape matures, which in turn, thanks to the legislation, should make it significantly easier for the Regulator to take action where these expectations are not being met.

The proposals seek to deliver greater clarity as to the Regulator's expectations – and make it easier to take action against those schemes not following them

The consultation document seeks to achieve clarity through enunciating eight key principles that underpin the operation of the scheme funding legislation. The creation of a "fast track" approach under which all but one of these principles are engaged with clear boundaries set, along with a potentially pro-forma statement of strategy, turns the tables so that it is the trustees demonstrating compliance; not the Regulator seeking to prove the opposite. This should make it easier for the Regulator to consider bringing regulatory action where the trustees cannot or do not wish to prove that they are fast track compliant and are not able to mount a convincing argument that what they have done falls to be treated as an acceptable "bespoke" approach.

Our viewpoint

Fears that this ambitious remit will result in a new "minimum funding requirement" straitjacket will be tested as part of the consultation. However, our first impression is that the potential to adopt a bespoke approach, along with the nature of fast track, may allow a fair degree of flexibility to remain in the new funding framework.

The eight principles

The eight core principles developed by the Pensions Regulator by reference to legislative requirements (as currently known) will be at the heart of what is to be a short

There are eight core principles….

and focused DB Funding Code. The Code in turn will supplement the existing scheme funding legislation as modified by the Pension Schemes Bill and the regulations to come – in particular the new requirement for the trustees and employer to agree a long-term funding and investment strategy and to set it out in the statement of strategy.

Turning to each principle they can be summarised as follows:

1. **Demonstrating compliance and objective risk-taking:** The Regulator expects trustees and employers to understand their funding and investment risks and to objectively evidence that these risks are remote or minimal or can otherwise be properly managed. In relation to such management, trustees should be able to compare the risks they have taken to a tolerated risk position (which is expected to be the fast track parameters) and then demonstrate the mitigation and/or support available.

Trustees and employers will need to demonstrate that they have thought through the funding and investment risks

2. **Long-term objective:** The Regulator wants to see schemes set a long-term funding objective such that by the time they are "significantly mature" they have a "low level of dependency on the employer" and are invested with "high resilience to risk".

Schemes will be challenged to set a long-term funding objective…

3. **Journey plan and technical provisions:** Schemes should develop a journey plan to achieve their long-term objective and plan for investment risk to decrease as the scheme matures and reaches low dependency. Technical provisions should have a clear and explicit link to the long-term objective to which they should converge over time as evidenced by the journey plan.

…and set out how they intend to reach it

4. **Scheme investments:** Over time the actual investment strategy and asset allocation should be broadly aligned with the scheme's funding strategy, whilst the investment strategy should have sufficient security and quality and satisfy liquidity requirements based on expected and to an extent unexpected cash flows. Asset allocation at significant maturity should have a high resilience to risk, a high level of liquidity and a high average credit quality.

Schemes will be expected to steadily de-risk their investments and ensure that investments have sufficient security, quality and liquidity …

5. **Reliance on the employer covenant and covenant visibility:** Schemes with stronger employer covenants can take more risk (and assume higher returns in their technical provisions). However, trustees should assume a reducing level of reliance on the covenant over time, depending on its visibility (suggested to be three to five years for most schemes).

… and to place less emphasis on covenant with the passage of time

6. **Reliance on additional support:** For bespoke only, schemes can account for additional support (such as contingent assets and guarantee support) when carrying out their valuations, so long as such support is sufficient for the risks being run, is appropriately valued and is legally enforceable and realisable at its necessary value when required.

There will be rules governing reliance on additional support

7. **Appropriate recovery plan:** Technical provision deficits should be recovered as soon as affordability allows while minimising any adverse impact on the sustainable growth of the employer.

For many schemes, deficits will need to be recovered more quickly

8. **Open schemes:** Members' accrued benefits in open schemes should have the same level of security as members' accrued benefits in closed schemes.

Security for accrued benefits in open and closed schemes will need to be consistent

Our viewpoint

It can be argued that much of these eight principles is no more than the formalisation of good practice for DB schemes facing run-off, and as such will help to raise the game of those schemes that currently are not fully addressing their funding and investment risks. Nevertheless, had the consultation stopped at this point its effect would have been limited. It is when the Regulator starts to spell out its fast track framework that we start to see some real bite, with potentially far more schemes needing to revisit their current funding and investment approaches. A number of trustee boards may also be challenged to undertake a realistic assessment of the strength of the employer that stands behind their scheme.

The fast track framework

Under the fast track framework aspects of each of these principles will be constrained in a measurable way. So, for example:

Fast track sets clear boundaries on…

- "low dependency funding" may mean a discount rate on technical provisions at a point between gilts + 0.25% pa and gilts + 0.5% pa, some further constraints on other key assumptions, possibly through additional disclosure requirements, to ensure that they are no weaker than 'best estimate', ideally including an ongoing expense reserve including PPF levies, especially where self-funding expenses;

The long-term discount rate

- Liability duration is likely to be used to determine when a scheme is "significantly mature" with this point being reached when the discounted mean term of the future liabilities is within the range 14-12 years;

When maturity is reached

- One from a number of possible "shapes" to the journey plan will be adopted during which the level of investment risk reduces – to ensure that only acceptable risk taking is likely to be undertaken during this process;

The journey plan

- During the journey to low dependency funding, technical provisions will need to be within acceptable ranges that are likely to vary according to the scheme's maturity and the employer's currently assessed covenant (probably using the Regulator's CG1 to CG4 grading system). This will be expressed either by reference to discount rates or target technical provisions as a percentage of those on the low-dependency funding measure. There is also the possibility that the technical provisions will have to reflect declining covenant visibility;

Risk taking during the journey

Recovery plan lengths and other attributes

- Maximum recovery plan lengths could either vary by covenant strength (with the suggestion of 6 years or shorter for a strong covenant, and 12 years for a weak covenant), or not take account of covenant at all. Recovery plan lengths should also get shorter as the scheme gets closer to being significantly mature and achieving low dependency funding. There may also be limitations on recovery plan structure and the ability to reset the recovery plan at each valuation. Asset outperformance is likely to not be allowed (this could mean a significant increase in deficit contributions in some cases). There will also be clear expectations on the equitable treatment of the scheme compared with other stakeholders (for both fast track and bespoke);

Investment risk

- Investment risk relative to liabilities will need to fall below a maximum permitted threshold varying by maturity of the scheme and possibly the covenant of the employer. The Regulator's preference is to carry out this measurement via a stress test using that adopted by the PPF as a starting point (whilst also discussing with the PPF if a common stress test could be developed that works for both purposes). Such explicit measurement of investment risk may result in the scheme's investment strategy needing to be significantly adjusted in some cases (or the bespoke route being used), particularly where the scheme is mature or has a weaker covenant.

The same constraints are also likely to apply, in respect of technical provisions, to schemes that remain open to future accrual, with future accruals being treated separately.

If there is compliance with every aspect of the fast track framework, as evidenced in the statement of strategy, the Regulator is unlikely to raise any concerns and the valuation will be 'accepted'. But if there is a conflict with any of the fast track boundaries, the valuation will need to be treated as bespoke.

Our viewpoint

The precise details of the fast track framework will be key to the operation of the new regime, firstly because many schemes, especially the smaller ones, are expected to seek to comply through this route, secondly because this sets the point of departure for those who seek to propose a bespoke approach and thirdly because the Regulator could impose fast track on schemes if it is not satisfied with their reasons for bespoke.

Although the Regulator is unfortunately opaque when describing some of its proposals – most notably in quantifying the maturity and covenant matrix that will drive the journey plan – from our initial reading of the fast track proposals we can see a number of schemes needing to report higher deficits because of reduced discount rates and for schemes in deficit, higher recovery plan contributions

because of the shortened period over which deficits will need to be removed. Investment policy could also be impacted. Therefore, fast track may be a significant move away from how a number of schemes are currently operating funding and investment. For many employers, the extent to which these impacts can be mitigated will depend on access to the bespoke regime.

The bespoke approach

Bespoke is the approach if the scheme wishes to depart from any element of fast track

The eight principles also apply to the bespoke approach, but with the potential to operate outside one or more of the fast track boundaries. The consultation document sets out four criteria against which a bespoke valuation will be judged, namely: whether the proposed arrangements comply with relevant legislation, the extent to which the arrangement deviates from fast track, how any additional risk being taken is being managed and the need for the explanations in the statement of strategy to be supported by "robust evidence".

The Regulator envisages three main reasons why bespoke might be proposed:

- Where an aspect of the bespoke arrangement is different from its fast track equivalent, but the bespoke arrangement overall represents an outcome that is at least as good as fast track overall and the trustees can evidence that there is no additional risk being run in the bespoke arrangement;
- Where trustees consider it appropriate to take additional, but suitably managed and mitigated risk relative to the tolerated level of risk set out in fast track;
- Where trustees are unable to meet some or all of the standards expected in fast track (eg stressed schemes).

Then, through the use of examples, the consultation document looks at each of these in turn, showing how they can pass muster (with many examples also noting variations where they probably wouldn't) along with one example that will probably fail. Interestingly, it also shows how it may be possible for a 'stressed' scheme to be dealt with under the bespoke approach, by for example adopting a longer recovery period than permitted under fast track, but only if all covenant leakage (eg dividends) and future accrual have ceased and risk taking is limited.

The Regulator notes that in some situations the scheme may be so stressed that its funding arrangement is 'non-viable' and it will not be compliant with the Code and legislation, However it acknowledges that if no additional funds are available, it would not be appropriate to exercise its enforcement powers but hopes that the transparency of the new DB funding regime will *"shine a spotlight"* on these situations, enabling the Regulator to assess the extent of the problem across DB schemes and work with the Department for Work and Pensions and others to develop possible solutions.

Our viewpoint

Reassuringly for companies and trustees, examples included for the bespoke regime include many themes that will already be familiar – e.g. using evidence based on individual scheme experience analysis to support scheme specific assumptions, providing detailed financial analysis to support unusually strong covenant visibility, and justifying higher investment risk or longer recovery plans by using robust contingent support mechanisms. It is hoped that this new regime will promote best practice in these areas, without causing wide disruption for schemes already utilising such frameworks.

But bespoke is no free for all and the higher level of scrutiny that is promised might just tip the balance for some schemes towards fast track, depending of course on what its final parameters and shape look like.

What happens next

(Updated 24 April 2020)

Consultation was to close on 2 June 2020 (since put back to 2 September 2020) following which the Pensions Regulator is to analyse the responses. Its findings will feed into the necessary changes to secondary legislation that the DWP can only start work on in earnest once the Pension Schemes Bill receives Royal Assent. This legislation will contain the "teeth" that the Regulator will need in order to impose its new DB funding framework across all DB schemes. We understand that DWP will consult on these regulations.

There is more material to come before we have the complete picture

When the Regulator is in a position to consult on its new DB Funding Code, it seems that it will simply outline the twin-track compliance structure, the fast track parameters and the principles for those following bespoke. This second consultation will be important as only then will the full strength of the new regime be revealed (as well as its application to DB superfunds and other new innovative structures). The Regulator also promises to cover how it intends to regulate DB funding, including enforcement and how it proposes to ensure the framework and its guidance remain up to date.

The Code, once finalised, will need to be laid before Parliament for 90 days before it can come into force. It is likely that DWP's regulations will be laid at around the same time. When the Regulator launched its consultation it expected that the new regime would come into force in late 2021.

Ahead of all this, by the end of April / early May we expect the Pensions Regulator to publish its 2020 Annual Funding Statement which will provide further guidance on how it expects companies and trustees to act during what is set to be a long transition to the new regime.

Our viewpoint

This new approach promises to be the biggest overhaul of DB scheme financial management for 15 years, impacting both funding and investment strategies. Importantly, as the burden of proof will switch from the Regulator to the trustees before the Regulator is empowered to take regulatory action, this is much more than a simple recasting of Regulator expectations.

Although not saying so explicitly, the Regulator must be hoping that the outcome will be a tougher regime for employers, leading to safer pensions for members. The consultation certainly points in that direction but there is a fine balance to achieve. The Regulator will be keen to avoid inappropriately increasing the financial burdens on employers which could have a negative knock on impact on jobs and investment.

For some schemes the actual impact is likely to be limited, with just a simple new requirement to document their current approach in a newly required statement of strategy. For other schemes our expectation from the consultation is that the new regime could lead to requirements for much higher deficit contributions, lower risk investment strategies, and companies having to pay lower dividends as a result.

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Lane Clark & Peacock LLP
London, UK
Tel: +44 (0)20 7439 2266
enquiries@lcp.uk.com

Lane Clark & Peacock LLP
Winchester, UK
Tel: +44 (0)1962 870060
enquiries@lcp.uk.com

Lane Clark & Peacock Ireland Limited
Dublin, Ireland
Tel: +353 (0)1 614 43 93
enquiries@lcpireland.com

Lane Clark & Peacock Netherlands B.V. (operating under licence)
Utrecht, Netherlands
Tel: +31 (0)30 256 76 30
info@lcpnl.com

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