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Pensions regulator proposes huge shake-up for DB scheme funding

New two-way regime of **“fast track”** or **“bespoke”**

On March 3, 2020, the Pensions Regulator published the first of its two planned consultation papers on a revised DB funding regime.

This first consultation focuses on its new regulatory two-way approach for valuations and the eight principles underlying the new framework offering alternative **“fast track”** or **“bespoke”** routes to schemes for compliance. This consultation closes on June 2, 2020.

The second consultation is planned for later in 2020 and will focus on the revised DB funding code itself.

Background

The starting point for the Regulator has been the DWP's March 2018 White Paper "Protecting DB Pension Schemes" which questioned the lack of clarity in the existing framework on how trustees set their scheme's technical provisions and consequently decide upon any appropriate recovery plan.

The intention is now for the Regulator to define the expected approach as DB schemes approach maturity. As a result, the Regulator should find it easier to make decisions regarding when to take regulatory action under the new offences regime set out in the Pensions Schemes Bill 2019-21 currently making its way through Parliament.

The key principles underpinning all valuations

The Regulator has identified eight core principles which it believes should underpin all valuations. These have been based on its experience to date in reviewing thousands of valuations and bearing in mind both current and forthcoming legislation in the form of the new Pension Schemes Bill.

The principles can be summarised as set out below:

Compliance and evidence

The Regulator expects trustees and employers to 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 (by which it means supported and/or mitigated). Robust evidence should be provided when risks are genuinely unsupportable.

When demonstrating how risks are managed, trustees should be able to compare the risks they have taken to a tolerated risk position and then demonstrate the mitigation and/or support available.

Long-term objective

The Regulator expects schemes to set a long-term objective so that when they are significantly mature, they have a low level of dependency on the employer and the scheme's assets are invested with high resilience to risk.

Journey plans and technical provisions

The Regulator expects trustees to develop a journey plan to achieve their long-term objective and to plan for investment risk to decrease as their scheme matures and reaches low dependency. Technical provisions should have a clear and explicit link to the long-term objective and, over time, should converge to the long-term objective as evidenced by the journey plan.

Scheme investments

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

Reliance on 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. The Regulator thinks such reliance should not extend beyond the short- to medium-term and suggests a limit of three to five years.

Reliance on additional support

Where trustees opt for the bespoke approach, they can account for additional support (such as contingent assets and guarantees) when carrying out their scheme valuations, on condition that it provides sufficient support for the risk(s) being run, is appropriately valued, and is legally enforceable and realisable at its necessary value when required.

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.

Open schemes

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

The two-way approach:

“Fast” or “bespoke”?

The Regulator does not intend to reintroduce a one-size-fits-all funding standard. Instead, it seeks to introduce a previously trailed two-way compliance route which will enable schemes to choose between:

“Fast-track”

Available to schemes able to demonstrate compliance with a range of funding and risk criteria set by the Regulator.

“Bespoke”

Applying to schemes which either cannot meet all of the fast-track criteria or which choose to take additional risks where they can demonstrate the additional support of contingent assets or company guarantees.

It is anticipated that the twin-track approach should introduce greater clarity to trustees and employers as to why the Regulator may have concerns about their funding arrangements and what can be done to reduce such concerns. The Regulator is as yet unclear about how many schemes fall into each category but more detail on each of the approaches is set out below

The fast-track framework

Although aspects of the eight principles above apply to trustees opting for either route, under the fast-track approach trustees would be expected to submit a valuation that is compliant with the Regulator's measurable guidelines. Trustees could expect to have to provide less evidence and for their valuation to receive less scrutiny. The aim is that this approach will ease the process for well-managed and well-funded schemes. With the clearer expectations of fast-track, the Regulator hopes to provide an easier route to compliance for trustees of smaller schemes. The Regulator will set a series of objective and quantitative compliance guidelines for the fast-track long-term objective. These include:

Setting a low dependency funding target with high resilience to investment risk. The funding target will take account of discount rates, other assumptions relating to members' benefits, a reserve for future expenses and an assumed investment strategy that is consistent with low dependency.

Allowing trustees to embed some reliance on their covenant visibility (typically not extending beyond three to five years), with more immature schemes taking more investment risk on their way to low dependency funding. It is proposed to retain the current covenant grading system. The balance between reliance and risk will be the focus of the second consultation.

Schemes should have a long-term objective that seeks progressively to reduce their reliance on the employer covenant over time, combined with investments that are highly resilient to risk by the time the scheme is significantly mature.

The scheme's journey plan should set out how trustees intend to achieve their long-term objective and to assess and manage key risks along the way. Technical provisions are seen as a way of measuring progress towards the long-term objective.

The principle that a scheme's investment strategy and asset allocation over time should be broadly aligned with the funding strategy, and sets out proposals for demonstrating how a scheme's investment strategy is supported.

Schemes with stronger employers are expected to have shorter recovery plans. The consultation seeks views on options for recovery plan length and if an appropriately short recovery plan cannot be agreed, the Regulator expects affordability constraints to be evidenced (addressing such issues as "value leakage" where payment of dividends leaves schemes unable to support shorter recovery plans).

The Regulator recognises that open schemes typically mature more slowly and is consulting on a range of factors taking related concerns into consideration.

The parameters may also include some scheme-specific factors such as maturity and employer covenant strength and schemes would need to satisfy all requirements individually to be fast-track compliant.

The fast-track framework would represent a baseline of "tolerated risk" of scheme- and employer-related risks for schemes in different circumstances. However, the Regulator does not suggest that fast-track would be a risk free framework and trustees would still be expected to exercise judgment and assess and manage their own scheme- and covenant-specific risks.

If trustees can demonstrate across-the-board compliance with all aspects of the fast-track framework, the Regulator is unlikely to raise any concerns regarding the valuation. However, any deviance from the fast-track compliance elements would mean that the valuation would be treated as bespoke.

The bespoke approach

The eight principles apply to the bespoke approach as well as the fast-track system, with the difference that the boundaries outlined above for fast-track will not apply.

Where trustees opt for the bespoke approach, they will submit their valuation, together with supporting evidence, explaining why and how their position differs from that of fast-track and how any additional risk is being managed.

Where trustees wish to take additional risk to that outlined in the fast-track level, or where their funding solutions do not satisfy all the fast-track guidelines, the bespoke route may be a better fit for their scheme. However, because the valuation does not then meet some or all of the fast-track criteria, bespoke arrangements are likely to receive more Regulatory scrutiny.

Suggested timeline for the development of the new DB funding regime

The Regulator emphasises that it does not expect all respondents to the consultation to answer all the questions in the 170 plus pages, but to focus on areas of their particular experience and expertise.

It sees the proposed framework as striking the right balance between the security of member benefits and the costs to employers of running their DB schemes. It states that many of the principles are consistent with its messages over recent years of integrated risk management and the importance of long-term planning, and it is keen to receive input on defining "what good looks like".

The possible timeline for the implementation of the new DB scheme funding regime is outlined on the following page.

3 March 2020
First consultation paper published

2 June 2020
Current consultation closes

Early Summer 2020?
PSB receives Royal Assent, following which DWP sets to work on draft secondary legislation setting out new power for the Regulator.

Summer/Autumn 2020
Consultation on DWP's draft regulations

Autumn/Winter 2020
Regulator publishes its 2nd consultation revealing its proposed new DB funding code

Post second consultation
Finalised Code to be laid before Parliament for 90 days

Around the same time as Code laid – DWP Regulations laid?

Late 2021
Regulator expects the new funding regime to come into force

Comments

While TPR does not expect the new approach to be too onerous for schemes, there have been estimates that the proposals to curtail the lengths of recovery plans could cost companies sponsoring DB schemes as much as £5 billion. This tough line on tackling scheme deficits could see schemes with strong employer covenants being expected to bring schemes to solvency funding levels within a much shorter timeframe.

In allowing schemes to vary from the fast-track, low-risk approach to compliance, the Regulator has attempted to avoid the pitfalls of an entirely compulsory framework such as that which applied to the minimum funding requirement, which was ultimately scrapped as unworkable in 2005. However, where companies with strong covenants have sought to stretch the limits of the current regime by putting in place unreasonably long recovery periods, they may find the Regulator seeking assurance that their plans to reach future low dependency are credible.

In setting the parameters for the fast-track regime, the Regulator has sought to tread the line between it being an easily accessible route attracting most schemes and being so strict that it is rarely used. However, the choice for schemes as to which option to take may not be as binary as it first appears. On the one hand, some schemes may find it difficult to satisfy all the fast-track criteria in respect of each of the eight principles. On the other hand, where schemes opt for the bespoke route, whilst there will be flexibility for instance (as now), in putting in place a longer recovery period where there are stronger contingent assets the additional costs of evidencing compliance could outweigh the benefits.

View the DB funding consultation paper (175 pages).

View the Regulator's quick guide – recommended for everyone (15 pages).

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