Sackers

TPR consults on its new DB funding code

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Introduction

On 16 December, TPR delivered its long anticipated second consultation on a new draft DB funding code. The draft code is designed to form an essential double-act with the DB funding and investment strategy regulations consulted on by the DWP earlier this year. In a nod to the impending festive season, the consultation will last 14 weeks, closing on 24 March 2023.

Key points

- **Four key documents** have been published by TPR as part of a funding package:
  - the second consultation
  - the draft code itself
  - a consultation document on the parameters for submitting Fast Track valuations, and
  - TPR's response to part one of the consultation on revising the draft code dating back to March 2020.
- There is also a press release and a blog from TPR's David Fairs. Finally, we can also expect TPR's covenant guidance to make an appearance at some point in the new year.
- DWP's draft regulations being introduced under the PSA21 will require DB schemes to have a funding and investment strategy ("**the F&I Strategy**"), and to submit a written statement of that strategy ("**the Statement"**) to TPR.
- Mirroring the above significant shift in the scheme funding legislation, and TPR's own direction of travel in its recent annual funding statements, the draft code requires DB schemes "to set a long-term objective and a journey plan to get there". The "there" being the long-term objective.
- Key concepts from the draft regulations are expanded on in the draft code – see below – and in many ways the code shows more flexibility than the draft regulations appeared to contain. Also, open DB schemes do get some specific paragraphs of the draft code focusing on how TPR sees them being accommodated.
- Unusually, the draft code is based on the DWP's draft F&I Strategy regulations as originally consulted on which received a lot of industry interest. As they are not yet final, further changes to the draft code in light of industry feedback are consequently a possibility.

- As noted above, the consultation is open up to 24 March and schemes should consider going back on this because, once the consultation is closed, the plan is for both the code and regulations to be in force from October 2023.
- We have said in our webinars and comments on scheme funding before that the draft regulations and code need to operate like a good duo such as the ice pairing Torvill and Dean, and support each other and be read together. It seems like the draft regulations set high level concepts with artistic impression (such as flexibility on how you interpret the key requirements of the regulatory dance) being left to TPR in the code, which suggests more Christmas reading to mull over what it all means.

The F&I Strategy

The PSA21 sets the scene for a new requirement for DB schemes to have an F&I Strategy, with the draft regulations making clear that this is a journey plan towards low dependency at significant maturity. The scheme's "technical provisions" under the statutory funding regime will need to be calculated "in a way that is consistent with" this strategy. As soon as reasonably practicable after determining or revising the scheme's F&I Strategy, the trustees will have to prepare the Statement, capturing the detail in writing.

Employer agreement to the F&I Strategy, as set out in the scheme's Statement, must be obtained. Sponsoring employers must also be consulted on certain issues, including "the main risks faced by the scheme in implementing" the F&I Strategy, and how the trustees intend to mitigate or manage them.

The principles trustees will need to follow for achieving "a state of low dependency on their sponsoring employer by the time they are significantly mature" home in on the level of investment and funding risk (both dependent, primarily, on the strength of the employer covenant), as well as liquidity. The process envisaged for achieving this involves trustees:

- firstly determining the date of "significant maturity" on actuarial advice
- then pinpointing a relevant date, and
- finally, determining a "low dependency asset allocation" they intend the scheme to have achieved by that date, and a "low dependency funding basis" consistent with that asset allocation.

The "low dependency funding basis" will also be used by the actuary to estimate the scheme's funding level as at the effective date of the relevant actuarial valuation.

Expanding on some of the key F&I Strategy concepts

As with the existing DB funding code, the draft code aims to interpret key elements of the funding legislation and how they will apply in practice.

Significant maturity

Maturity is a measure of how far a scheme is through its lifetime. The draft regulations provide for maturity to be measured in years using a "duration of liabilities" measure, on the basis that it is "well understood" by the pensions industry. In summary, this measure is the "weighted mean time until the payment of pensions and other benefits under the scheme, weighted by the discounted payments". A scheme reaches "significant maturity on the date it reaches the duration of liabilities in years".

In line with the DWP's consultation on the draft regulations, significant maturity is being defined in the draft code as the point at which a DB scheme reaches a duration of liabilities of 12 years. However, recognising recent market volatility, other options are explored as part of the consultation.

For **open DB schemes**, reassuringly, TPR believes it can be appropriate to assume "a reasonable allowance for future accrual and new entrants which will delay the time the scheme is assumed to reach significant maturity". Open schemes were waiting on the draft code to see how the prescription of the draft regulations would be applied by TPR in the code. Such schemes will take a keen interest in what is said about their particular technical provisions, security of past accrual and use of surplus (paras 272-282 of the draft code).

Low dependency

Broadly, a scheme has low dependency on its employer under the draft regulations when:

- it has sufficient assets invested in a low dependency investment strategy to provide for accrued pension rights, and
- it is not expected, under reasonably foreseeable circumstances, to need further employer contributions.

This definition intentionally steers clear of "self-sufficiency", given that "unexpected circumstances, which are materially different from those assumed" may prompt the need for additional employer funds.

The draft code avoids taking a prescriptive approach when it comes to setting the actuarial assumptions for the low dependency funding basis, with TPR believing "this is best left at the level of principle, given the scheme-specific nature of many of the assumptions needed for an actuarial valuation". However, trustees should "have a prudent and evidence-based approach to setting the assumptions", combined with "a check that the overall level of prudence across the assumptions is appropriate".

Assessing the strength of the employer covenant

Aligning employer covenant strength with the risks a scheme is taking already underpins much of the current DB funding code and is also a key element of TPR's integrated risk management approach. However, the draft regulations will represent the first time that the need to carry out such an assessment has been set out specifically in legislation.

The draft code breaks employer covenant support down into:

- the employer's financial ability to support the scheme, including its cash flows and prospects, and
- contingent asset support.

That support will need to be considered across three separate time periods:

- **Visibility** – over employer's forecasts over the short-term, typically a period of between one to three years
- **Reliability** – where trustees have reasonable certainty over the employer's available cash to fund the scheme. When assessing reliability, trustees should consider employer forecasts where available and "deemed reasonable", and "the employer's prospects (including its capital structure and overall resilience, and the market in which it operates)". TPR expects most employers will only have reliable periods over the medium term, although for some employers this may extend to the longer term

- **Longevity** – being "the maximum period trustees can reasonably assume that the employer will remain in existence to support the scheme".

There is more detail in the draft code, including the factors likely to affect the performance and development of an employer's business. TPR is also updating its covenant guidance to supplement the principles and approaches set out in the draft code, so we can expect more examples to help trustees in carrying out their assessment against all three covenant limbs.

TPR's twin track approach

In TPR's March 2020 consultation on revising the DB funding code, TPR put forward a twin-track compliance route to carrying out scheme funding valuations: **Bespoke and Fast Track**. Originally intending to embed the twin track into the draft code, TPR has backtracked on this idea, presumably because Fast Track is not in the legislation itself and leaving it outside of the draft code provides greater flexibility to change it.

The Fast Track approach is intended to act as a filter for TPR, reflecting its view of a "tolerated level of risk". Where the Fast Track parameters are met, TPR is therefore unlikely to scrutinise a valuation further or to engage with trustees. In contrast, the Bespoke route will offer trustees "greater flexibility and scope to select an approach that suits the specifics of their scheme". For example, trustees may wish to take the Bespoke route if they want to take more risk than that 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 maturity of the scheme".

Key parameters for assessing the Fast Track include setting the technical provisions test as a percentage of the low dependency funding basis liabilities, and imposing a maximum recovery plan length of six years for a scheme that has yet to reach significant maturity or three years where it has. These mathematical tram lines to using Fast Track have been estimated by TPR as meaning around 50% of schemes may fit within it – if a scheme doesn't then the scheme will be in the Bespoke (no automatic approval) lane and need to have more covenant advice to support its approach.

What's next?

The consultation on the draft code and accompanying documents closes on 24 March 2023. The new regime is expected to come into force for actuarial valuations with effective dates on or after 1 October 2023 at the earliest. To meet this timescale, the final code is expected to be laid before Parliament in mid-June 2023, alongside the DWP's final regulations. This is a fairly ambitious timetable and, perhaps unsurprisingly, TPR acknowledges that this may yet change.

With much detail to digest, DB scheme trustees and employers should begin discussing the impact of the new requirements on their schemes with relevant advisers as soon as possible. If you would like to discuss any of the above, **please speak to your usual Sackers contact**.

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