The Pensions Regulator

Consultation overview

Quick guide to our defined benefit funding consultation

March 2020

Contents

Foreword

In its 2018 white paper 'Protecting Defined Benefit Pension Schemes', the government noted that the defined benefit (DB) funding framework is working largely as intended. However, it also acknowledged that there was room for improvement in some key areas, for example the need for greater transparency and accountability around the risks being taken on behalf of members and employers, and for trustees to focus on the long-term strategic issues for their scheme as the landscape matures.

It also highlighted some grey areas in the existing framework relating to how DB trustees should set their scheme's technical provisions (TPs) prudently and an appropriate recovery plan (RP). This lack of clarity has enabled a minority of schemes and employers to misuse the flexibility in the system and made it more difficult for us to regulate DB schemes efficiently.

We are consulting on a revised DB funding code to address these concerns and to implement the new measures introduced in the Pension Schemes Bill[1] laid in Parliament in January 2020.

> **If you wish to learn more about the background to and purpose of this consultation, you can refer to Chapters 1 and 2 of the consultation document.**

1 https://services.parliament.uk/Bills/2019-20/pensionschemes.html

Introduction

We are consulting on a revised DB funding code of practice in two parts.

The first consultation considers our new proposed regulatory approach, the principles we think should underpin the new framework, and how they could be applied in practice to provide clearer guidelines.

The second consultation, planned for later in 2020, will focus on the draft code itself and what final guidelines might look like, informed by industry feedback to this current consultation, our impact assessment, and changes to legislation (Pension Schemes Bill and regulations). It is important to get things right and we are keen to involve the pensions industry as much as possible in helping us define 'what good looks like'. In particular, we are keen to understand if there are any practical issues or unintended consequences arising from our proposals.

We are seeking to create a sustainable framework, which provides the right balance between the security of member benefits and the costs to employers of running their DB schemes. Although the proposed framework may be a departure from our current DB code[2], many of the core principles are consistent with our messages over the last few years (integrated risk management and the importance of long-term planning) and the good practice that many schemes already apply.

We therefore don't expect our new proposed approach to be too onerous for most schemes to implement, but we appreciate there could be significant impact for some schemes, particularly those that have been running excessive and unjustifiable levels of risk.

This stand-alone document provides an overview of the first consultation document. The consultation document is long because we raise complex issues and need sufficient input to ensure the framework is fit-for-purpose. We do not expect all respondents to read everything and answer all the questions, but to focus on their areas of interest and expertise. In particular, our non-technical audience may wish to focus on our proposed regulatory approach (Chapter 3), key principles (Chapter 4) and Bespoke approach (Chapters 13 and 14).

2 https://www.tpr.gov.uk/en/document-library/codes-of-practice/code-3-funding-defined-benefits-

Key principles

We have identified a number of overarching principles that we believe should stand behind all scheme valuations. These are based on our experience from reviewing thousands of scheme valuations, ongoing engagement with a wide range of our stakeholders, and current and forthcoming legislation. The proposed principles are as follows:

Compliance and evidence
• We expect 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 (ie 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 (LTO)
• By the time they are significantly mature, we expect schemes to have a low level of dependency on the employer and be invested with high resilience to risk.
Journey plans and technical provisions (TP)
• We expect trustees to develop a journey plan to achieve their LTO. • We expect trustees to plan for investment risk to decrease as their scheme matures and reaches low dependency. • TPs should have a clear and explicit link to the LTO, and over time, should converge to the LTO as evidenced by the journey plan.
Scheme investments
• The actual investment strategy and asset allocation over time should be broadly aligned with the scheme's funding strategy (TPs and RP). • Trustees must ensure their investment strategy has sufficient security, sufficient quality, and can satisfy liquidity requirements based on expected cash flows as well as a reasonable allowance for unexpected cash flows. • We expect the asset allocation at significant maturity to have high resilience to risk, a high level of liquidity and a high average credit quality.

Proposed principles continued...

Reliance on the employer covenant
• Schemes with stronger employer covenants can take more risk and assume higher returns. • However, trustees should assume a reducing level of reliance on the covenant over time, depending on its visibility.
Reliance on additional support
• Schemes can account for additional support when carrying out their valuations provided 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 (RP)
• TP 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.

If you wish to learn more about why we are proposing these principles and what they mean, you can refer to Chapter 5 of the consultation document.

A new regulatory approach: Fast Track and Bespoke

The government's white paper highlighted the need for greater clarity around what we expect of trustees, for greater accountability around their decision-making, and clearer parameters around the use of the flexibilities in the regime. However, we do not intend to re-introduce a one-size-fits-all funding standard. Instead, we have sought to reconcile the need for greater direction with the scheme-specific funding regime by proposing a twin-track compliance route to carrying out valuations (referred to as 'Fast Track' and 'Bespoke'). We expect all the principles above to apply to both approaches.

Twin-track approach

Fast Track

- We set straightforward quantitative compliance guidelines for trustees to assess whether we would consider their valuation compliant with the legislation.
- If all aspects are satisfied, trustees can expect minimum regulatory involvement on DB funding.

Bespoke

- This option provides trustees and employers with more flexibility to account for scheme and employer-specific circumstances.
- Decisions in this route will need to be fully articulated and evidenced, and may mean higher regulatory involvement.

We anticipate the twin-track approach will introduce greater clarity for trustees and employers, so they can understand whether and why we may have concerns about their funding arrangements and what can be done to lessen those concerns. In addition, advisers will be able to provide advice to their clients with more certainty, and savers can be confident that those responsible for their pensions have acted appropriately and with more accountability.

Trustees opting for either route will have to submit evidence to us (to a greater degree in Bespoke) demonstrating their approach to managing their funding and investment risks as part of the new statement of strategy introduced in the Pension Schemes Bill. Receiving this information at the outset will help us assess valuations against our guidelines and avoid unnecessary engagement with trustees who have provided clear explanations and evidence.

Trustees would not be expected to maintain the previous approach (eg Fast Track or Bespoke) at future valuations. Funding arrangements understandably may have to change with employer and scheme circumstances.

Overview of Fast Track

- Relevant for trustees who can submit a valuation that is compliant with our code guidelines.
- Trustees can expect to have to provide less evidence and for their valuation submission to receive much less regulatory scrutiny.
- Expected to ease the process for well-funded and well-managed schemes.
- Will set clearer expectations and provide an easier route to compliance for trustees of smaller schemes.

We propose to set a series of objective and quantitative compliance guidelines and parameters which cover key aspects of funding and investment arrangements, such as:

- funding target (long-term objective or 'LTO') and timing to reach this
- TPs including discount rates and (possibly) other assumptions
- RP length and structure
- investment risk
- future service contribution rates (open schemes).

These would include some scheme-specific factors such as maturity and employer covenant strength. Schemes would have to satisfy all requirements individually to be Fast Track compliant.

The parameters would be developed in line with prevailing market conditions and we would regularly review and update them as necessary. Some parts of the Fast Track framework may be predicated on a covenant grade assessment, which may be subject to some checks by us (as is the case now).

The Fast Track framework would represent a baseline of 'tolerated risk' for schemes in different circumstances. We use 'tolerated risk' as an umbrella term that covers the multitude of risks, both scheme- and employer-related. We do not suggest that Fast Track would be a risk-free framework, so trustees would still be expected to exercise judgement and assess and manage their own scheme- and covenant-specific risks.

If you wish to learn more about our proposals for Fast Track guidelines, you can refer to Part 3 of the consultation document.

Overview of Bespoke

- Relevant for trustees who cannot or choose not to comply with Fast Track. They will submit their valuation, along with supporting evidence, explaining how and why they have differed from the Fast Track position and how any additional risk is being managed.
- Bespoke arrangements may receive more regulatory scrutiny, but it is not a 'bad' or second-best option.
- Bespoke and Fast Track approaches, if done correctly, are equally compliant with the legislation.

There may be many reasons why trustees choose to opt for the Bespoke route. Some may want to take additional, managed risk relative to the tolerated level of risk set out in Fast Track. Others may agree funding solutions that represent an outcome at least as good as Fast Track overall but do not satisfy all individual Fast Track guidelines. And finally, some trustees may not be able to meet some or all Fast Track guidelines, for instance those with employers facing significant affordability constraints.

We propose that Bespoke arrangements should meet the key principles and be assessed against the Fast Track standard. Our consultation considers how additional flexibilities can be integrated. For instance, if trustees take more risk in their funding arrangement and this risk has not been assessed as minimal or remote, they would have to provide evidence showing how that additional risk is managed. Good risk management can include additional support, such as contingent assets and guarantees. We would expect additional support to be assessed robustly, be of sufficient value to cover the risk(s) and be legally enforceable and accessible by trustees when needed. Employers with affordability constraints may not be able to provide additional support, so we would expect the trustees to mitigate the additional risk by taking action to reduce its severity if it were to materialise.

We do not know yet how many schemes might adopt Fast Track or Bespoke – this will depend on the final Fast Track guidelines, which we will consult on in our second consultation. This will also be informed by your responses to the first consultation on principles and concepts, prevailing market conditions and our assessment of impacts.

We recognise that the Fast Track framework may not be suitable for all schemes' funding arrangements. However, if Fast Track were to be extended to reflect a wider group of scheme funding arrangements, it would over-complicate what is intended to be a straightforward option. Therefore, we have tried to ensure that scheme-specific flexibility remains through the Bespoke option.

To find out more about how the Bespoke approach might work, including how Bespoke arrangements would be assessed, example scenarios and how we propose additional support should be integrated, you can refer to Part 4 of the consultation document.

A closer look at some key principles and options for Fast Track guidelines

Employer covenant

We ask in the consultation whether (and if so, how much) reliance should be placed on the employer covenant and the degree to which it is reasonable for DB scheme members to be subject to employer insolvency risk.

We conclude that fully insulating schemes from the impact of employer insolvency by requiring funding on a risk-free basis would be too costly and inconsistent with Part 3 funding. However, we think our proposal to allow trustees to embed some reliance on the covenant and more immature schemes to assume and take more investment risk on their way to low dependency funding, strikes an appropriate balance between the security of member benefits and costs to employers. Where exactly that balance lies will be the focus of our second consultation.

We also consult on options for how we should integrate covenant support, particularly in Fast Track guidelines. For the purpose of developing consultation proposals, we explain that assumed reliance could be placed on the covenant in Fast Track TPs via the discount rate (similar to current practice).

However, we propose some limits should be placed on that reliance based on covenant visibility, which we think does not typically extend beyond the short to medium term (three to five years).

Finally, we consider how the covenant can be assessed with as much clarity, objectivity and proportionality as possible and consult on two main options: retaining the current 'holistic' approach (but with further clarifications) or simplifying employer covenant to a formal calculation or metric.

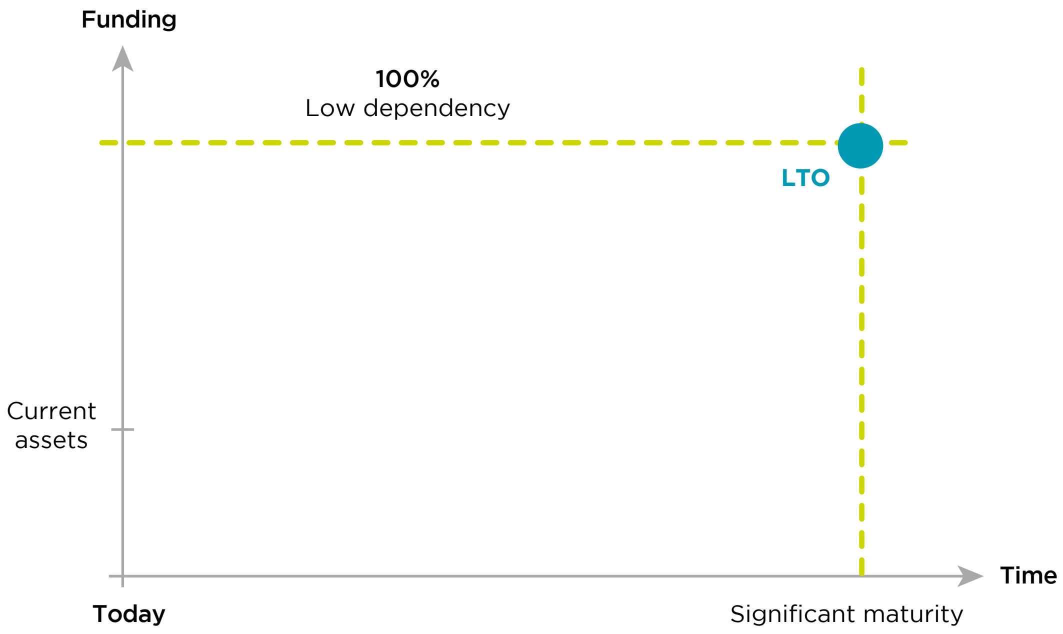
We propose retaining our current covenant grading system (CG1-4) for the purpose of setting Fast Track guidelines but recognise that there are arguments for increasing the number of ratings, and we welcome views on this as well.

To find out more about what we propose on the role and assessment of the covenant, you can refer to Chapter 4 of the consultation document.

Long-term objective (LTO)

An important part of the Pension Schemes Bill and our consultation is the requirement that trustees set a LTO (described as 'funding and investment strategy' in the Bill). We propose that schemes should seek to progressively reduce their reliance on the employer covenant over time to reach a position of low dependency[3] funding combined with investments that are highly resilient to risk by the time they are significantly mature.

Figure 1: How trustees could determine the scheme-specific long-term objective



Targeting an LTO should improve the resilience of the growing number of mature schemes at a time where they are increasingly vulnerable to investment underperformance and have shorter horizons to make good any shortfall in funding levels. By reaching this position, trustees and employers should have a good platform to pursue 'end game' strategies suitable for their circumstances, whether it is buying out, entering a consolidator or running off on a low-risk basis.

In this consultation we are seeking views on an appropriate LTO for Fast Track. While many of the Fast Track parameters are yet to be defined, we have set out our views on potential definitions of low dependency funding basis and significant maturity. We consider the low dependency discount rate to be somewhere in the range of Gilts +0.5% pa to Gilts +0.25% pa, and significant maturity to be 15-20 years from now for a scheme of average maturity[4].

3 Low dependency is where a scheme's funding and investment strategies are such that there is a low chance of requiring further employer support and, to the extent that such report is required, the amount of support is low relative to the size of the scheme.
4 In order to help form this view, we commissioned analysis from the Government Actuary's Department (GAD). See also Chapter 16 of the consultation document and the GAD report published alongside the consultation.

Long-term objective (LTO) continued...

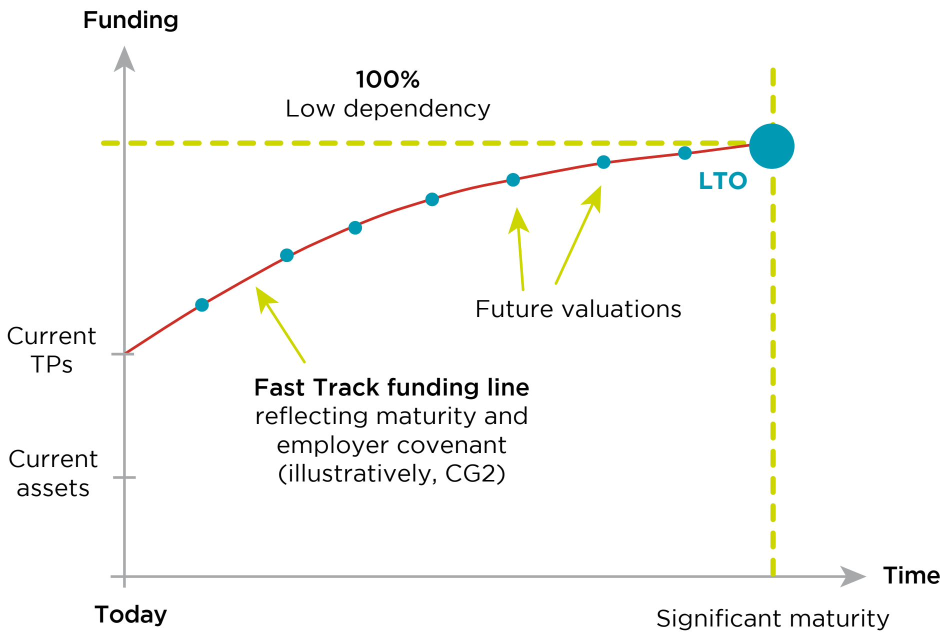
We are also consulting on other aspects of low dependency funding, such as whether we should define other assumptions relating to members' benefits and choices and set expectations around expense reserves. Additionally, we debate what measure of maturity we should use for Fast Track.

To find out more about what we propose on the LTO for Fast Track, you can refer to Chapter 8 of the consultation document.

Journey planning and technical provisions (TPs)

The Pension Schemes Bill will also require TPs to be set consistently with the LTO. Having a journey plan will help trustees demonstrate how they intend to achieve their LTO and to assess and manage key risks along the way.

Figure 2: How trustees could determine a journey plan to reach their long term objective (reflecting scheme maturity and reliance on employer covenant).



During initial stakeholder engagement, we have found there is a misconception that TPs should equate to the LTO for all schemes and that the LTO needs to be achieved within a short timeframe. This is not the case.

TPs are a way of measuring progress towards the LTO and intended to be a smooth path based on the agreed journey plan. The TPs will therefore reflect the discount rates during the journey and how the investment strategy is incorporated.

Journey planning and technical provisions (TPs) continued...

In terms of cash funding, we are not expecting employers to have to pay more once the scheme is fully funded on a TPs basis. However, once the scheme funding objective has been reached and the scheme is fully funded on a TPs basis, we would expect trustees to invest broadly in line with the journey plan and use investment returns to take them to a low dependency position, with employer contributions only necessary if a deficit arises on a TPs basis. In other words, the LTO is the destination, the TPs are the journey milestones, and the RP is the corrective measure to get back on track.

There are many different journey plans trustees can adopt. These reflect different approaches to risk-taking and de-risking on the journey to reaching the LTO. We are consulting on what shape of the journey plan we should assume to set Fast Track TPs and how much covenant reliance (and visibility) we should embed into the TPs. We also discuss how we should express Fast Track TPs (as discount rates or funding ratios by maturity and covenant grade) and how we should go about deriving these guidelines.

To find out more about what we propose on Fast Track TPs, you can refer to Chapter 9 of the consultation document.

Scheme investments

The investment strategy is an important factor in terms of the risk to member benefits. We are not seeking to direct how trustees should invest but would like to ensure that investment risk is appropriate and supported.

We are consulting on the principle that a scheme's investment strategy and asset allocation over time should be broadly aligned with the funding strategy, including consideration of the TPs and journey plan. At the point of significant maturity, the asset allocation should have a high resilience to risk along with sufficient liquidity and a high average credit quality.

We discuss how trustees need to ensure the investment strategy has sufficient security and quality, as well as being able to satisfy liquidity requirements.

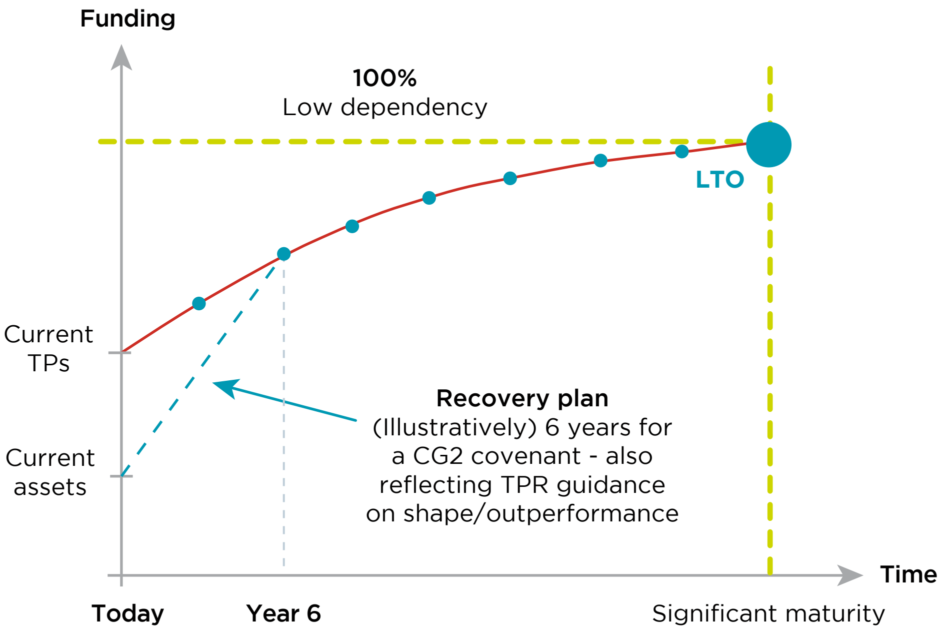
We set out proposals for how trustees could demonstrate whether the risk in their investment strategy is supported. In particular, we outline a few options for the reference point from which investment risk should be measured (eg liabilities or a reference portfolio), how to measure risk (for instance through a simple stress test, which we could seek to align to the PPF's own test), and how we would define an acceptable level of investment risk suitable for different maturities and covenant strengths. We also look at how we could define some Fast Track guidelines for credit quality and liquidity.

To find out more about what we propose on the investment strategy for Fast Track, you can refer to Chapter 10 of the consultation document.

Appropriate recovery plans (RPs)

We intend to be clearer about what constitutes an appropriate RP. Our view is that affordability should remain a key driver and that TP deficits should be recovered as soon as affordability allows, while minimising adverse impacts on the sustainable growth of employers. This means that, all other things being equal, we expect schemes with stronger employers to have shorter RPs. If an appropriately short RP cannot be agreed, we would expect affordability constraints to be evidenced, and for trustees to seek suitable and realisable mitigations.

Figure 3: How trustees could approach agreeing an appropriate recovery plan in line with their journey plan and long term objective.



We are consulting on options for Fast Track guidelines for RP lengths. For instance, should the trustees of all schemes aim for RPs of a standard length (eg broadly limited to the period over which there is good covenant visibility), or should different thresholds be set for different covenant grades?

We also consult on the appropriate mix of other flexibilities in RPs. Our aim is to achieve the right balance between managing scheme risks and employers having the flexibility to manage their cash flows efficiently and avoid unnecessary over-funding.

To find out more about what we propose on Fast Track RPs, you can refer to Chapter 11 of the consultation document.

Open schemes

It's good practice for open schemes to plan for the long term, but we recognise that they typically mature more slowly (or indeed not at all) compared to closed schemes.

We are consulting on a range of solutions for open schemes which take these factors into consideration and reflect the wide range of open schemes in the DB universe. However, we think it is right to expect that members' accrued benefits should have the same level of security as accrued benefits in closed schemes.

In our consultation, we propose to treat past service liabilities (TPs) and future accruals separately and for all schemes to have the same LTO of low dependency funding at significant maturity. For Fast Track, we consult on various options for how the TPs and the cost of future service benefits should be calculated for open schemes.

> **To find out more about what we propose on open schemes for Fast Track, you can refer to Chapter 12 of the consultation document.**

Next steps

We welcome your responses on any aspect of the consultation by 2 June 2020.

We would like to hear from any interested party, particularly trustees, employers, advisers, and members of DB pension schemes and their representative organisations. You can provide feedback in the online response form published alongside the main consultation document or by emailing: **DB.Consultation@tpr.gov.uk**.

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