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A guide to the new funding code

Consultation on a new more prescriptive DB code of practice on scheme funding will begin this year. With key objectives and principles flowing from last year's DB White Paper[1], it will implement measures which will "optimise" scheme funding in the wake of several high profile corporate failures. This will be accompanied by new and improved regulatory powers for The Pensions Regulator (TPR) to intervene when expectations are not met.

Read on for our quick guide to what we know, what to watch out for and how you can get prepared.

1 More direction, with minimum standards defining what's "prudent" and "appropriate"

What we know

Whilst TPR doesn't intend to pursue a 'one size fits all' funding framework, it proposes a move towards 'fast track' or 'bespoke' routes. An actuarial valuation will either need to demonstrate compliance with minimum standards; or trustees will have to explain and justify why it is reasonable they take a different approach. The latter will be subject to greater regulatory scrutiny.

Importantly, this shifts the onus to trustees and employers to convince TPR that they are compliant, rather than TPR needing to prove they're not.

Watch out for

The impact for most schemes is likely to rest on where the bar for the 'fast track' route is set. Too low and TPR risks levelling down. Too high and too many schemes may be forced towards the regulatory onerous 'explain' route.

A lot rests on TPR being able to pin down an industry-wide consensus of what 'good' looks like to drive the behaviours intended. Expect this to be a key focus of the upcoming consultations.

Action – While we await further technical detail later this year, refer to TPR's latest Annual Funding Statement[2] for an indication of the direction of travel.

2 The requirement to set an appropriate long-term objective (LTO)

What we know

Trustees and sponsors will need to consider their ultimate goal and set a clear plan for getting there within a realistic timescale.

This should recognise how the balance between investment risk, contributions and covenant support would be expected to change over time. Triennial valuations will become staging posts on the journey.

Watch out for

Further consultation and guidance is likely to focus on how trustees will demonstrate they have met requirements. There will be more to come on how to evidence that technical provisions and recovery plans are aligned with this long-term view and what TPR see as suitable LTOs, as well as how to apply for open schemes.

Action – Review your scheme's longer-term aspirations. Whilst many will already have a long-term plan in place, there are advantages in taking early steps to comply if this isn't the case.

3 A focus on managed risk taking

What we know

TPR has been advocating a more holistic approach to risk management for some time. Expect to see a push for integrated risk management to become standard industry practice, with emphasis on:

- quantifying the level of downside risk and evidencing this can be supported by covenant;
- planning for risk to decrease over time;
- linking scheme maturity to funding, investment and covenant considerations;
- recovering deficits quickly; and
- putting in place appropriate mitigation strategies and contingency plans.

[1] Protecting Defined Benefit Pension Schemes, March 2018
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/693655/protecting-defined-benefit-pension-schemes.pdf

[2] https://www.hymans.co.uk/news-and-insights/research-and-publications/publication/sixty-second-summary-db-annual-funding-statement-2019/

Watch out for
We await more detail on what best practice will look like, and whether certain approaches or measures will be mandated or encouraged. Expect to see more on issues such as when and how schemes can account for contingent or non-cash security.

Action – If your scheme is undergoing or approaching a valuation, ensure you're alive to TPR's expectations and take the appropriate steps. For example, increasing deficit contributions and/or implementing more formal downside protections.

4 More regulatory scrutiny, oversight of corporate transactions and stronger penalties

What we know
The Government has already consulted[3] and confirmed plans to strengthen TPR's arsenal wit:

- civil penalties of up to £1 million for 'serious breaches', e.g. failure to comply with support notices or notifiable events rules;
- criminal offences for 'wilful or reckless behaviour', facing an unlimited fine and/or up to seven years' imprisonment;
- boosted information-gathering powers;
- enhanced anti-avoidance powers to issue contribution notices and financial support directions; and
- expanded notifiable events framework, together with a new 'Declaration of Intent' and updated clearance guidance.

Watch out for
Whilst proposals are reasonably well developed, most of the changes require primary legislation to come into effect. Further engagement and refreshed guidance on notifiable events and the clearance process will help fill in some of the missing detail around key definitions and practicalities.

TPR is already committed to a 'clearer, quicker and tougher' approach and has begun to make increasing, and more innovative, use of its powers to intervene where funding problems have emerged.

Following the report on Southern Water, trustees and sponsors will watch with interest to see if further examples emerge of TPR in action.

Action – Watch out for legislation implementing these changes and the exact form any new penalties and powers will take. Sponsors will need to understand their obligations in respect of corporate activity and sharing information with TPR ahead of changes.

5 Reporting to the Regulator in the form of a Chair's Statement

What we know
The White Paper signposted the requirement for trustees to appoint a chairperson and produce a Chair's Statement. This will be integrated into the triennial valuation process. Intended primarily as a governance tool, it will also be provided to TPR.

Watch out for
The consultation on the funding standards will drive the content of the Chair's Statement. It is expected to require an assessment of the main funding risks and how they are being managed, how the long-term funding objective is set, and reflections on past decisions, governance and value for money.

Action – With the DB Chair's Statement requiring schemes to demonstrate a good system of governance is in place, it is a timely opportunity to review. All trustees should be aware of TPR's requirements outlined in the recent 21st Century Trusteeship campaign and ensure compliance.

Trustees and sponsors will be watching closely for more on the exact form the new framework and powers will take. Further consultation is expected this year (to coincide with the Pensions Bill), with a second consultation on the draft code in early 2020 once there is more clarity on the intended primary and secondary legislative package.

Whilst many schemes will find that their current funding and investment plans map over quite neatly, all trustees and employers are, to some extent, going to have to work harder to demonstrate that a clear plan is in place and the risks they are running can be supported by the sponsoring business. We would encourage trustees and sponsors to start preparing now.

[3] https://www.hymans.co.uk/news-and-insights/research-and-publications/publication/protecting-db-schemes-a-stronger-pensions-regulator/