The DB Funding Regime

A practical guide to the new DB funding regime from The Society of Pension Professionals (SPP)

August 2024

Introduction

> *The Society of Pension Professionals (SPP) Covenant Committee has produced this document in response to member feedback that suggests a wide range of pension professionals, including Trustees, actuaries, pension consultants and lawyers, may benefit from additional clarity around changes to the Defined Benefit (DB) pension scheme funding regime.*

Jane Evans,
Chair, SPP Covenant Committee

Background

The Pension Schemes Act 2021 introduced a new requirement for Defined Benefit (DB) pension schemes to have a funding and investment strategy to ensure pension and other benefits under the scheme can be paid over the long term.

The Funding and Investment Strategy Regulations were issued in April 2024 and apply to valuation dates on or after 22 September 2024.

Under this new regime, Trustees must adopt a strategy for their scheme to be fully funded on a low-dependency basis by a specified date, no later than the point at which the scheme reaches "significant maturity".

"Low dependency" means that further contributions are not expected to be necessary. It is imperative that Trustees recognise that low dependency does not mean no dependency.

Trustees will be required to agree, or depending on their scheme rules, consult on, their proposed strategy with the employer.

The accompanying Code of Practice from The Pensions Regulator (TPR) was laid before Parliament on 29 July 2024.

The Code cannot be formally approved before 22 September 2024, because it must lay before Parliament for 40 days before taking effect – 40 days in which Parliament is sitting. TPR recognises there will be a gap between when the requirements of the Funding and Investment Strategy Regulations start applying and the new DB funding code is in force and states that, "schemes with valuation dates in this period can use the new DB funding code as the base for their approach. TPR will be communicating with affected schemes and will take a reasonable regulatory approach to them"[1].

Alongside the Code, TPR has also published its response to the 2022 consultation on Fast Track and its regulatory approach[2], including final fast track parameters. A more detailed regulatory approach document, including further details on its regulatory approach and covenant guidance, are expected in the coming months.

The starting point for any funding and investment strategy is to decide the way in which the benefits will be provided over the long term (referred to in the Code as the Long Term Objective). The Trustees and employer will need to review the funding and investment strategy and if appropriate change their Long Term Objective if there is a material change in covenant.

Long-term journey planning and integrated risk management are now on a statutory footing.

There is also a change in focus around the need for a scheme's journey plan to better reflect the covenant resources that are available to it.

The biggest changes will perhaps be for those schemes that do not have external covenant advice, commonly smaller schemes. That said, changes to governance and documentation requirements will apply to all, with limited easements for the very smallest schemes.

It is also worth noting that there is no "one-size fits all" solution. Most schemes are now well funded, but some may not be, some are receiving good advice, some are receiving none.

Whilst each scheme will need to factor in its own unique situation, most will want to reflect on whether what they have previously assumed still works under the new regime. Furthermore, if Trustees choose not to follow the Code, they must not only be comfortable doing so, they must also be able to clearly justify why deviating from the Code was the best thing to do for their particular scheme whilst demonstrating they are complying with the legislation.

With so much uncertainty and speculation, the SPP hopes that this guide proves helpful in clarifying matters.

1 TPR Press Release, 29 July 2024: https://www.thepensionsregulator.gov.uk/en/media-hub/press-releases/2024-press-releases/new-db-funding-code-laid-in-parliament

2 TPR, Response to Fast Track and regulatory approach consultation, 29 July 2024: https://www.thepensionsregulator.gov.uk/en/document-library/consultations/draft-defined-benefit-funding-code-of-practice-and-regulatory-approach-consultation/response-to-fast-track-and-regulatory-approach-consultation

What has changed?

It is worth Trustees considering that their existing strategies may need to be changed as regulatory changes may require them to:

1. adjust the amount of risk that they are carrying to ensure that the risk being taken is supportable based on covenant and maturity of the scheme;
2. change the date at which they aim to get to their long-term funding target because their covenant does not support it – the relevant date must be before significant maturity, in most cases the covenant will not impact this date, but rather influence how much risk there is (and its profile) over the journey plan to the relevant date.
3. change the eventual long term funding target if the covenant does not appear to support it – this should be reflective of low dependency and therefore covenant might not influence it (unless there are concerns about longevity of the employer i.e. short term insolvency risk, in which case running-on might not be a sensible option.

What should you do if you have a valuation before 22 September 2024?

Valuations with effective dates before 22 September 2024 will fall under the existing funding regime, with the existing code continuing to apply.

These schemes may find it prudent to consider how their current valuation may or may not align with the new legislative framework, although there is no requirement to do so.

Valuations soon after 22 September 2024

Current legislation permits up to 15 months for the valuation process, which means a valuation dated 30 September 2024 would not need to be completed until the end of 2025. This makes delays to the implementation of the Code less of a concern but still something to be mindful of.

As stated previously, TPR has confirmed that there will be a gap between when the requirements of the Funding and Investment Strategy Regulations start applying and the new DB funding code is in force and that it should use the Code as the basis for their approach and that they will take a reasonable regulatory approach to them.

All post 22 September 2024 valuations

Requirements for all post 22 September 2024 valuations (unless a scheme is already at significant maturity):

- A long-term 'low-dependency objective' for funding and investment must be agreed, together with a journey plan for achieving this;
- Either meet the 'Fast Track' tests or go down a 'Bespoke' route to compliance;
  TPR is unlikely to scrutinise valuations if the strategy meets the necessary parameters
  It is worth noting that there is a risk that Trustees going down a fast track route may believe that they do not have to do much around covenant, especially if pressured by sponsors, but covenant should still be uppermost in their thoughts because this should be the starting point as it feeds into the long term strategy, valuation and journey planning; and
- Plans must be submitted to the Regulator in a 'statement of strategy' using their standard templates;
- A recovery plan for any deficit in respect of the scheme's technical provisions based on an overriding principle that the deficit should be recovered as soon as the employer can reasonably afford.

A scheme's relevant date, set by the Trustees, must not be later than the end of the scheme year in which the scheme is expected to reach (or did reach) significant maturity – where a scheme has reached significant maturity, the relevant date is the date set out in the actuarial valuation to which the FIS relates (FIS Regulations 2024, Reg 8(4).

Issues to consider

Preparing the groundwork

The new Regulations give the first definition in law of covenant:

- the financial ability of the employer to support the scheme, specifically;
  - the cash flow, and expected future cash flow, of the employer;
  - other matters which are likely to affect the employer's future ability to support the scheme including the performance, future development and resilience of the employer's business, and the likelihood of an insolvency event;
- the expected level of support for the scheme from any contingent assets.

This is likely to require fundamental change to the output and interpretation of covenant assessment processes for many schemes, moving away from covenant grades (Strong, Tending to Strong, etc.) and instead focusing on quantifying future cash and documenting business risks. The information to be considered will vary depending on the individual journey plan and covenant commitments but in most circumstances is unlikely to be limited to publicly available information.

The right kind of information flows between companies and Trustees are essential and to help achieve this it is important that Trustees engage with employers as early as possible to advise that change is coming and to start relevant conversations.

In parallel with their analysis of the factors referred to in the Regulations, Trustees should continue to take into account other matters relevant to the outcome of their valuation discussions, such as the analysis of the balance of powers under the scheme documents and the potential for covenant enhancement from new contingent assets.

Valuation

Every DB scheme is subject to the statutory funding objective, which is to have sufficient and appropriate assets to cover its technical provisions (TPs).

Under the Pensions Act 2004, Trustees must obtain actuarial valuations every year although Trustees can choose to obtain valuations at up to triennial intervals, provided that they obtain an actuarial report for each intervening year.

A forward-looking assessment of the employer's financial ability to support the scheme

The new Regulations require Trustees to consider covenant reliability and longevity to establish the risk that the employer covenant can support.

Reliability of the covenant – maximum period in which Trustees can reasonably certain that they can rely on an assessment of cash flow and business risk. Trustees should consider:

- the forecast cash flows ;
- the forecasting process;
- the historical accuracy of management forecasts ;
- the appropriateness of the assumptions underpinning these forecasts; and
- the employer(s)' prospects e.g. the likelihood of an employer insolvency event occurring

Longevity of the covenant - the maximum period in which Trustees can reasonably assume that the employer will remain in existence to support the scheme.

Contingent assets

It is important that Trustees have a good understanding of their contingent assets as these contribute to the strength of the covenant.

Trustees should consider obtaining legal advice in relation to the enforceability of existing and proposed contingent assets.

They must also be sufficient to provide a level of support when required. The draft funding code suggests that Trustees should identify, "the scenario in which the contingent asset is likely (or able) to be called upon (for example in the event of insolvency of the employer)" and "An appropriate method to assess the expected realisable value of the contingent asset. This will primarily be driven by the type of contingent asset, i.e. whether it is a security arrangement (for example security over an asset, cash in escrow, letter of credit) or a group or parental guarantee."

Journey planning

A scheme's journey plan explains its progress in line with its funding and investment strategy as it progresses towards the relevant date. In deciding which journey plan is appropriate, Trustees must consider the strength of employer covenant and should be collaborating with the employer to ensure common ground on respective targets. Trustees should ensure that any risk along that journey plan reflects the employer covenant which may change over time.

Proportionality

The journey planning assessment must be proportionate to the individual nature of the scheme and employer.

Employers prospects

The likelihood of an employer insolvency event occurring.

At the start of this process (2B)

1. What is the covenant rating?
2. What cash is affordable to fund the deficit/underwrite risk?
3. What is the period of covenant reliability?
4. What is the period of covenant longevity?
5. To what extent do contingent assets support the covenant?
6. What are the key risks to the above?

(1) Decide Long Term Objective (buy-out, run-on, consolidation)

(2) Consider long term strategy ("journey plan")

2B **Consider covenant strength and associated risks**

INPUT

2C **Understand latest funding position**

2D **Set or change funding & investment strategy – "journey plan"**

TO ULTIMATE DESIRED END POINT (LOW DEPENDENCY/NO DEPENDENCY)

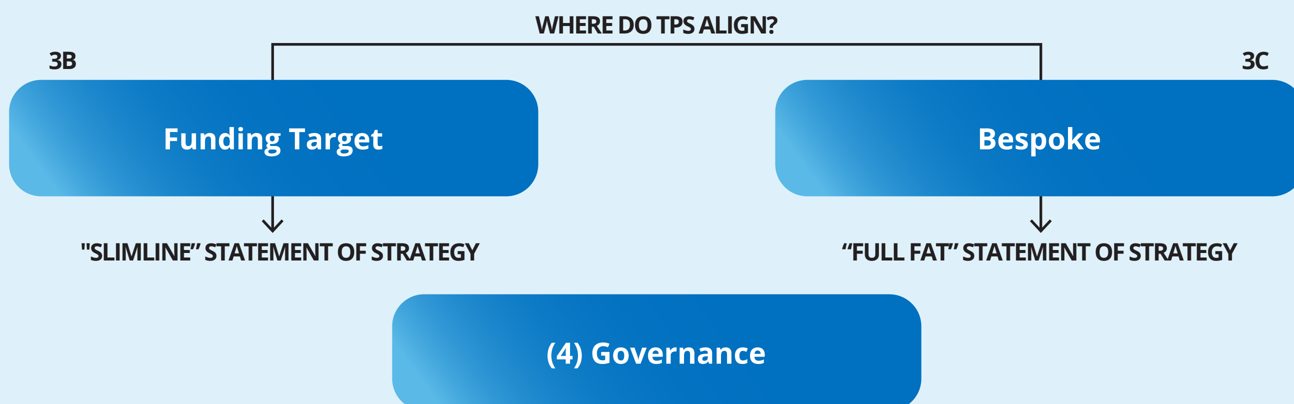
(3) Triennial valuation

Technical Provisions (TPs) need to change to fit new/updated strategy

No change to TPs needed

Towards the end of this process (3B/C)

1. Is the valuation result consistent with the covenant rating?
2. Is the outcome affordable for the sponsor?
3. Is the level of scheme risk and period over which it is being run consistent with the Trustee's risk appetite, given the covenant?



Distressed covenants and not-for-profits

The SPP notes that distressed covenants and non-associated schemes may need to apply a different lens to these issues.

Open schemes

Although TPR has highlighted that just 4% of DB schemes remain open to new members, TPR states that the revised DB funding code has necessary flexibilities to be relevant and supportive of all DB schemes, including open ones.

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About The Society of Pension Professionals

Founded in 1958 as the Society of Pension Consultants, today SPP is the representative body for a wide range of providers of pensions advice and services to schemes, trustees and employers. These include actuaries, accountants, lawyers, investment managers, administrators, professional trustees, covenant assessors, consultants and pension specialists.

Thousands of individuals and pension funds use the services of one or more of the SPP's members, including the overwhelming majority of the 500 largest UK pension funds.

The SPP seeks to harness the expertise of its 85 corporate members - who collectively employ over 15,000 pension professionals - to deliver a positive impact for savers, the pensions industry and its stakeholders including policymakers and regulators.

Further information

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