Protecting defined benefit schemes – a new funding code

IFoA Seminar
13 November 2019

Outline

1. **Overview of consultation and approach**
   - White Paper remit
   - Scope of consultations and timeline
   - Fast track and Bespoke approach
   - Key principles
   - Questions

2. **Principles for the new code**
   - Setting and targeting an LTO
   - Journey planning
   - Recovering deficits
   - Investment strategy
   - Questions

Overview of consultation and approach

TPR's remit from DB White Paper on funding

The Pensions Regulator

Trustees focus on **long-term strategy** and risk management

- Greater **accountability** and **transparency**

- More efficient and **effective regulation** of funding

Revised code of practice

greater clarity on:

○ **prudent** technical provisions; **appropriate** recovery plan; **setting SFO** in the context of a long-term objective

DB statement submitted with valuation

Legislative change

Timetable & scope of TPR consultations

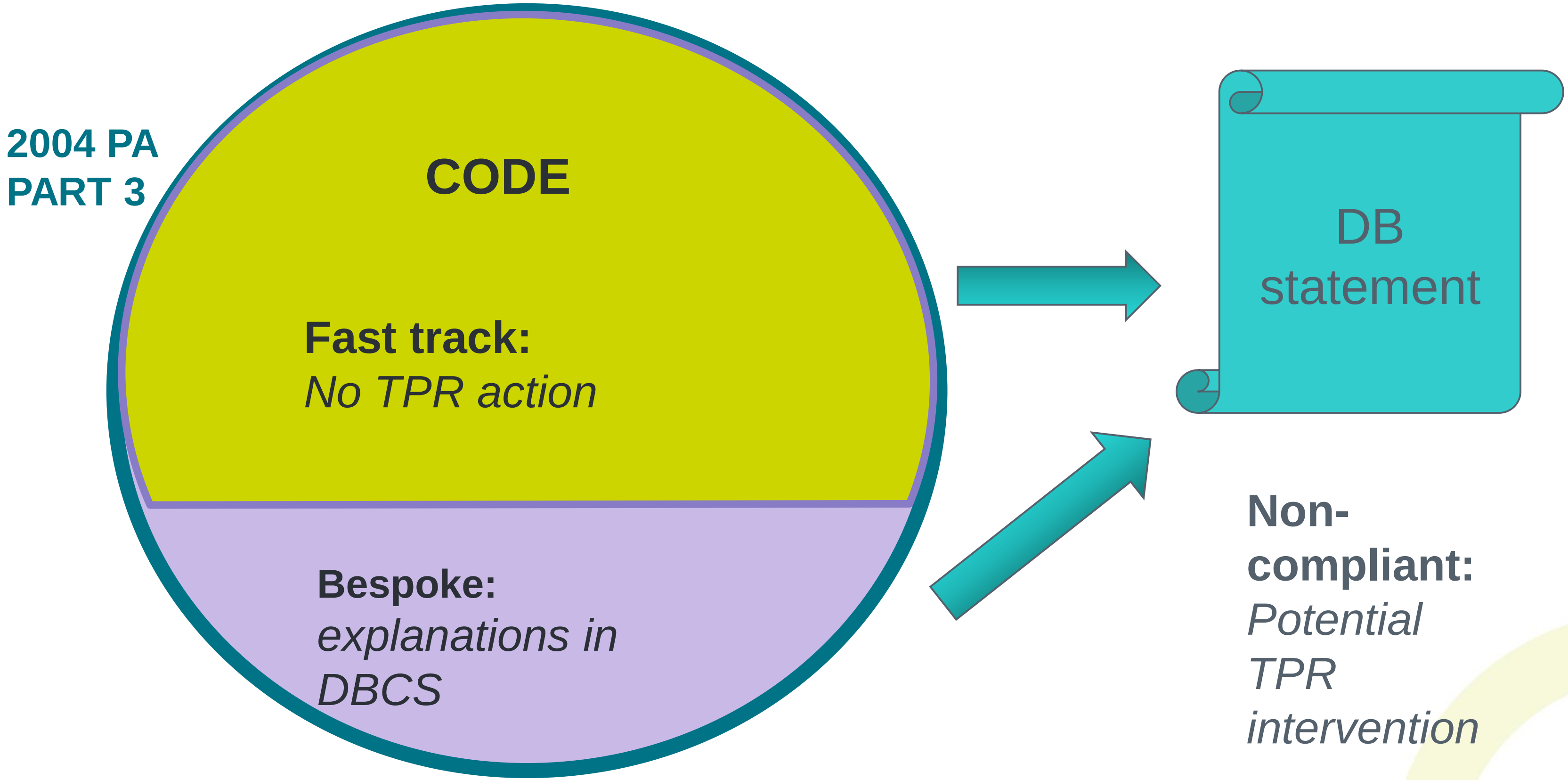
Timetable

- Pensions Bill?
- 1st TPR consultation – Autumn 2019
- DWP regulations?
- 2nd TPR consultation – Summer 2020

Scope

- Context
- Regulatory approach
- The framework (principles; Fast track options; Bespoke)
- Evidence/analysis

Comply or explain in practice



Principles

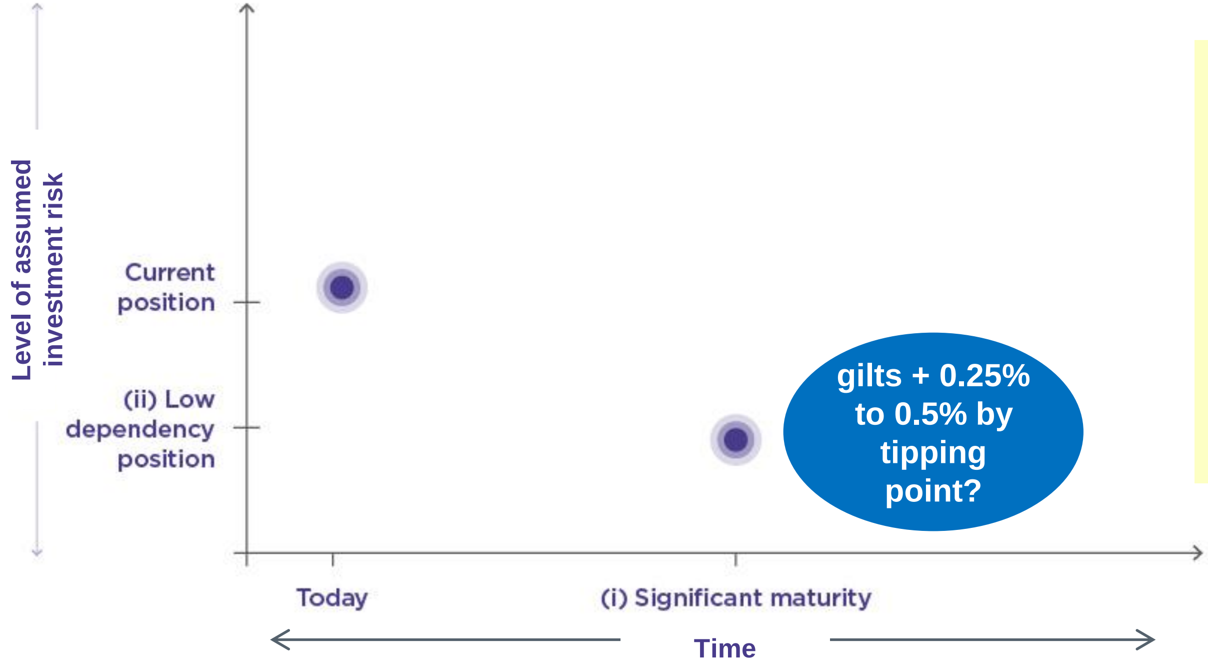
1. LTO specific to timing (maturity), funding basis (low dependency) and investment profile
2. TPs milestones on journey plan. Risks to decrease over time, linked to scheme maturity
3. Investment strategy broadly aligned with TPs
4. Reducing level of reliance on the covenant over time (based on visibility)
5. Account for contingent security robustly
6. Deficits paid off asap based on affordability
7. Same level of security on accrued benefits in open schemes
8. Understand risks in scheme and evidence how they are supported

Questions

Principles for the new Code

Principle 1: Setting a long-term objective (LTO)

By the time they are (i) significantly mature, we expect schemes to target (ii) low dependency funding and (iii) to be invested with high resilience to risk.

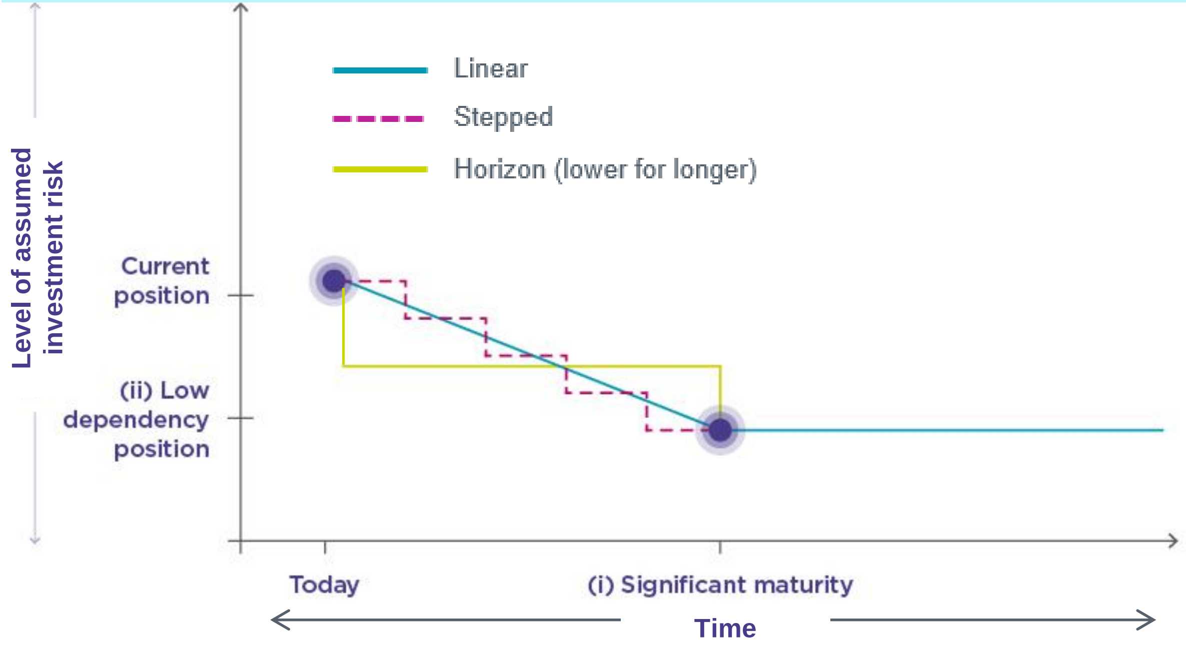


We will seek views on:

- LTO level (low dependency funding)?
- When to reach LTO (maturity point)?
- What measure of maturity?
- Other key assumptions, level of prescriptions?
- How to set expense reserve?

Principles 2: Planning to reach the LTO

- We expect trustees to (i) develop a journey plan to reach their LTO and (ii) plan for investment risk to decrease as the scheme matures and nears LTO.
- TPs should reflect the LTO and the level of all risks over time (explicit link between LTO and TPs).



We will seek views on:
- Shape of the journey plan?
- Role of the covenant?
- How should covenant be assessed?
- Covenant visibility? How would this be embedded in TPs?
- How should we prescribe Fast track TPs?
- Open schemes?

Principle 6: Setting appropriate RPs

Deficits should be recovered as soon as affordability allows and while minimising any adverse impact on the sustainable growth of the employer. Where affordable, recovery plans are expected to be time-limited to the short to medium term.

RP length:

- Affordability is key driver.
- Stronger covenants = shorter RPs?
- Contingent support to support longer RPs – more formalised approach

We will seek views on:

- **Length** – Max length for different CGs? Fast track TPs?
- ***Shape*** – No ‘back end loading’?
- ***Future*** – Can RPs be ‘rolled forward’ at future valuations?
- ***Asset outperformance*** – Should this be removed?
- ***Fair treatment***

Principle 3: Investment strategy

The Pensions Regulator

Schemes' long-term asset allocation should be broadly consistent with LTO. The actual investment strategy and asset allocation over time should be [broadly] aligned with the scheme's funding strategy (TPs and RP). Trustees should be able to demonstrate that the investment risk being taken can be supported.

- So far, the principles have covered the setting of the funding target, based on **assumed** levels of current and future investment risk, not the **actual** investment strategy that should be followed.
- For a mature plan, at LTO, the **actual** investment strategy should be consistent with a high resilience to risk and a low dependency on funding.

We will seek views on:

- Reference point to measure risk from?
- How to quantify risk?
- What is acceptable level of risk?

In summary

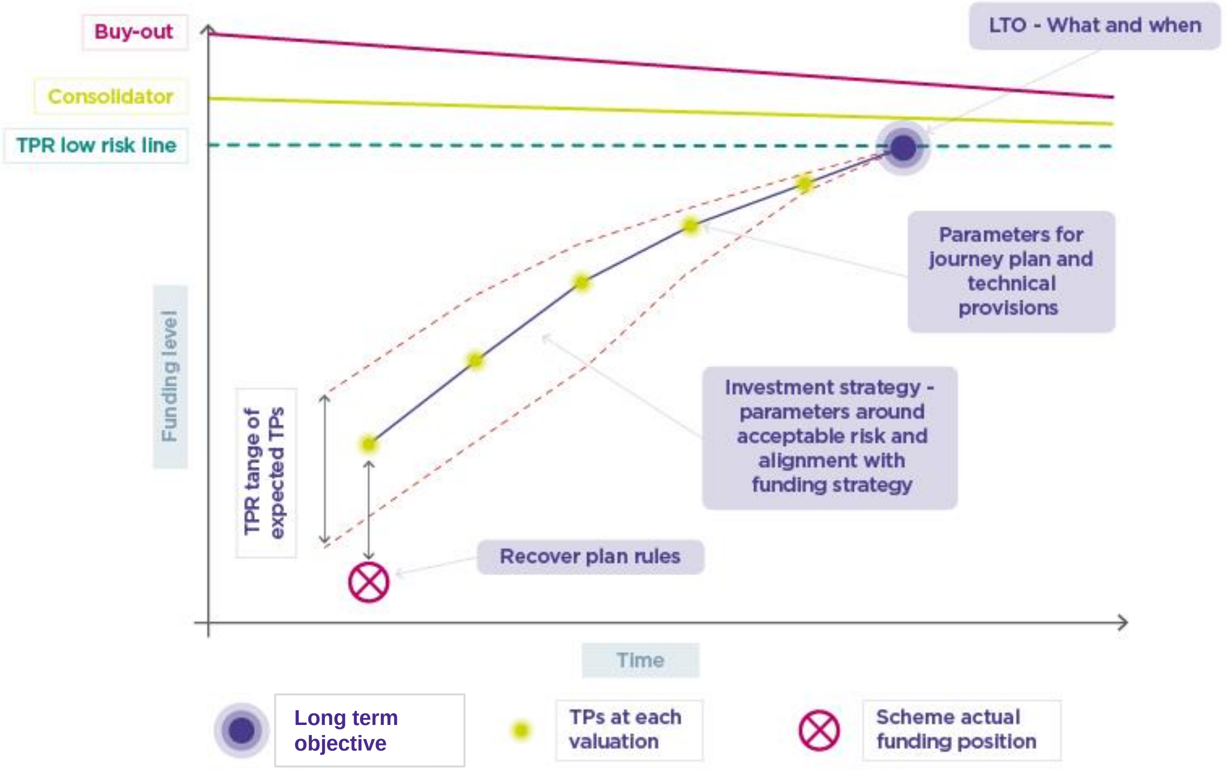
- Clarity of expectations and focus on long-term thinking.
- Proposing a twin-track approach to demonstrating compliance.
- First consultation on Principles; options for Fast track guidelines; Bespoke framework.
- Low dependency funding by the time scheme is significantly mature.
- Journey plan to reach LTO over time (TPs=milestones).
- Recovery plans based on affordability.
- Investment risk: supportable; consistent with TPs; reduces with maturity.
- First consultation expected in Autumn?

You can contact us at: dbchange@TPR.gov.uk

Questions

Annex

Overview of framework (for consultation)

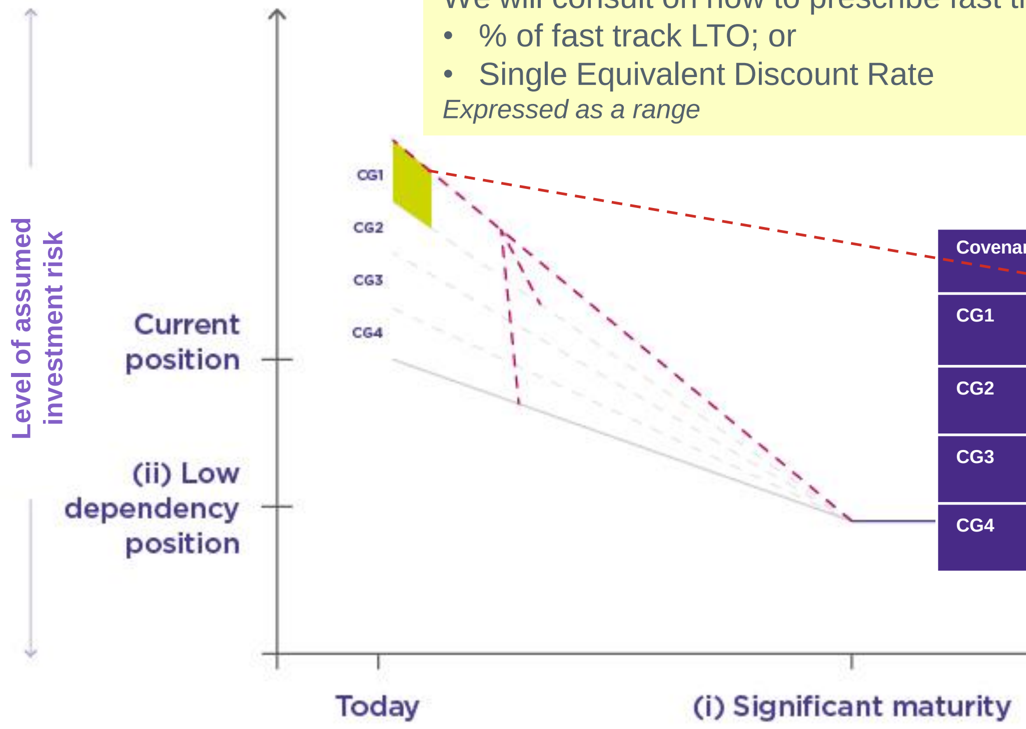


Fast track framework – Journey plan and TPs

We will consult on how to prescribe fast track TPs as
- % of fast track LTO; or
- Single Equivalent Discount Rate

Expressed as a range

Same TPs for open schemes

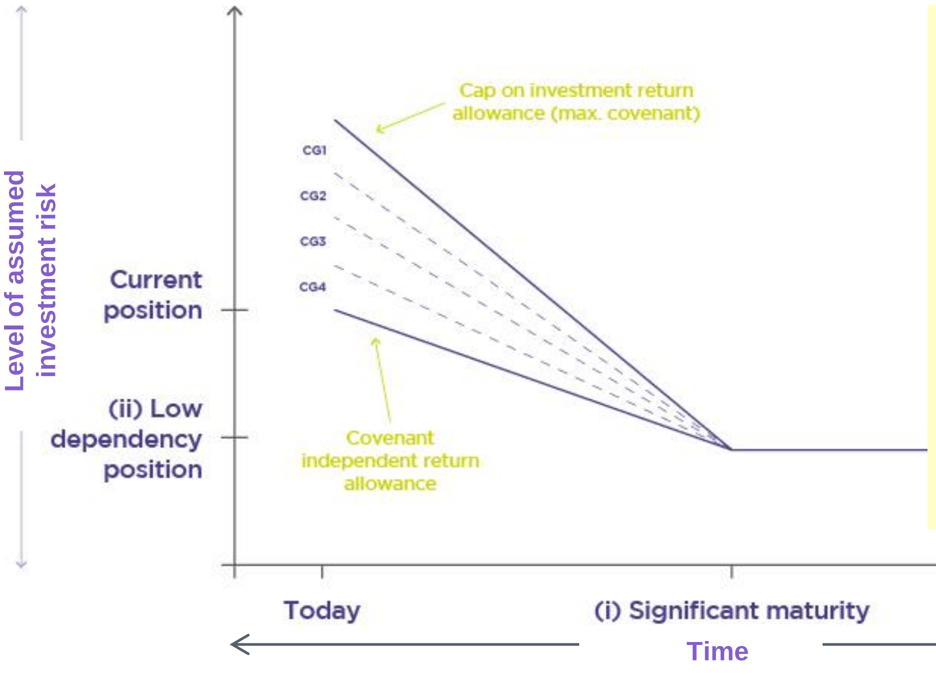


	Maturity *(Years to LTO)*				
Covenant	**Immature** *30 to 25*	*[...]*	**[...] [...]**	**Mature** 5 to 0	**LTO Point** *0*
CG1					
CG2					
CG3					
CG4					

Journey to LTO | LTO

Principle 4: Reliance on employer covenant (1)

Schemes with stronger covenants can take more risk (and assume higher returns) **but** trustees should assume a reducing level of reliance on the covenant over time (depending on its visibility).



Role and assessment of covenant?

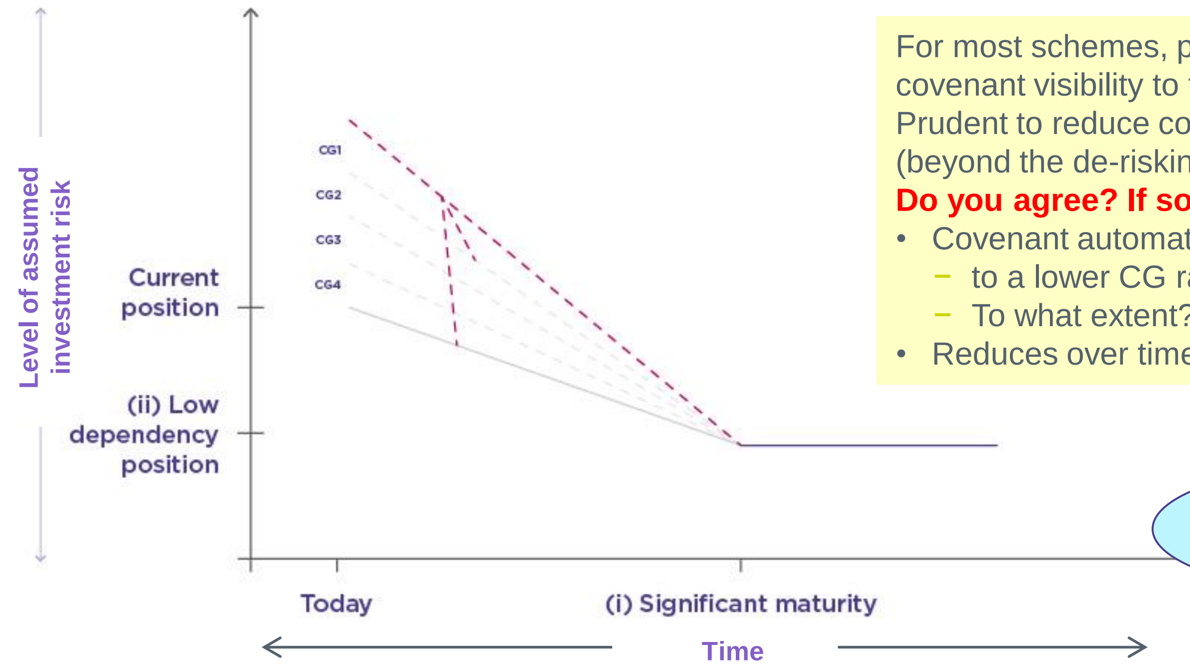
Expect to consult on three broad options:

1) **No covenant allowance**
2) **Retain current qualitative approach** with clarifications for (eg) how covenant converts to TPs; RP expectations
3) **In a different way**
   - Quantitative assessment?
   - Covenant 'value'?
   - Covenant included as outperformance in RP, rather than in TPs?

Proposal: retain 4 'CG' ratings for code guidelines

Principle 4: Reliance on employer covenant (2)

Schemes with stronger covenants can take more risk (and assume higher returns) **but** trustees should assume a reducing level of reliance on the covenant over time (depending on its visibility).



For most schemes, practical considerations will limit covenant visibility to the medium term (ie 3 to 5 years). Prudent to reduce covenant reliance after this time (beyond the de-risking implied in the journey plan).

Do you agree? If so, what then?

- Covenant automatically reduces:
  - to a lower CG rating?
  - To what extent?
- Reduces over time?

NB: would be rolled forward at next valuation

Principle 5: Contingent security

Schemes can account for contingent security in carrying out their valuations provided that the assets are appropriately valued, and realisable when required.

Two main types of contingent support:

Guarantee support (from associated or 3rd party) **Scheme can rely on another party**	**Asset backed support** (eg Property, cash, IP etc) **Scheme can rely on an asset**
Improves the covenant	**Underpin longer RPs**

- Reliance only where asset/guarantee has **robust**, **realisable** and **legal binding** value (if required).
- Consider **stressed recoverable** value (particularly where support is closely related to employer).

Open schemes

Principle 8: Members in open schemes should have the same level of security on their accrued benefits as members in closed schemes. The provision of future accruals should not compromise the security of accrued benefits.