The SPP member research series:

DB Funding Code

The first tranche of the DB funding code consultation was published on the 3 March 2020 and sets out what the Pensions Regulator ("tPR") will expect from trustees and employers in terms of funding defined benefit pension schemes in the future. This code, once implemented, will fundamentally change the way in which tPR will look at what is acceptable in pension scheme funding. In our latest SPP survey we asked our membership from a range of backgrounds about their views on the proposals set out in the consultation.

Background

TPR's proposals come off the back of a number of high-profile corporate failures where pension schemes had not been adequately funded over many years. The idea of kicking the deficit 'can' down the road is no longer seen as acceptable by the Government and tPR. There will also be greater pressure to fund pension schemes to a level whereby the trustees have minimal reliance on the ongoing employer covenant.

A key part of the new code is the requirement of schemes to have a long-term objective covering funding and investment strategy and to reach this low dependency position by the time the scheme is significantly mature. The focus on this long-term objective reflects the maturing DB pension landscape.

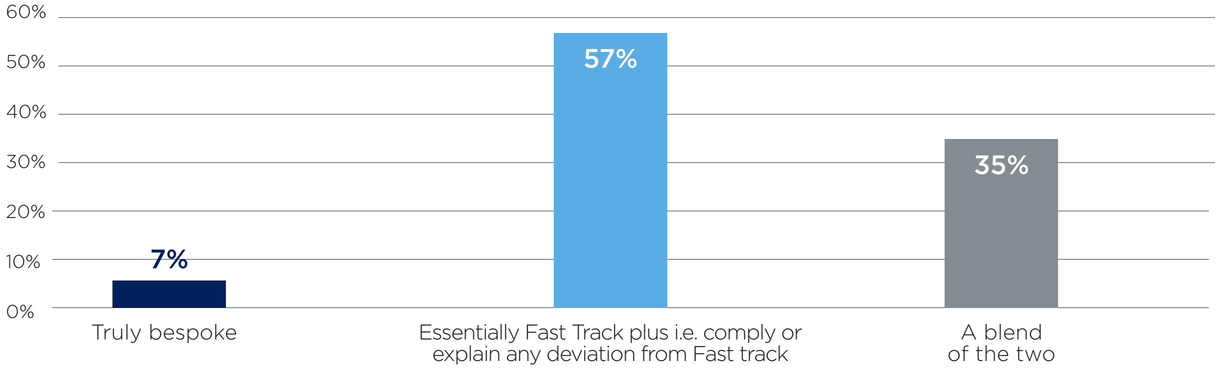
The draft code proposes a twin track approach to demonstrating funding compliance, Fast Track and Bespoke.

Under the Fast Track proposal, tPR would limit the valuation assumptions that could be used, the timing to reach low dependency, the term of the recovery plan, the level of investment risk being taken, and for open schemes the ability to take account of future membership and accruals.

For schemes that are unwilling or unable to meet the tests of the Fast Track option then there will be the Bespoke approach to funding. Under the Bespoke route trustees will have more flexibility in their approach to funding whilst still complying with legislation and the relevant codes of practice. Whilst the Bespoke route is intended to provide flexibility, tPR proposes to use Fast Track as a reference point and to examine where the proposed funding plan differs. This would result in trustees providing additional evidence to explain why they have deviated from the Fast Track route, what steps they are taking to manage risk and where relevant what mitigation they have secured.

Flexibility of the Bespoke Route

Fig. 1 Do you anticipate that the 'Bespoke' compliance regime will be:



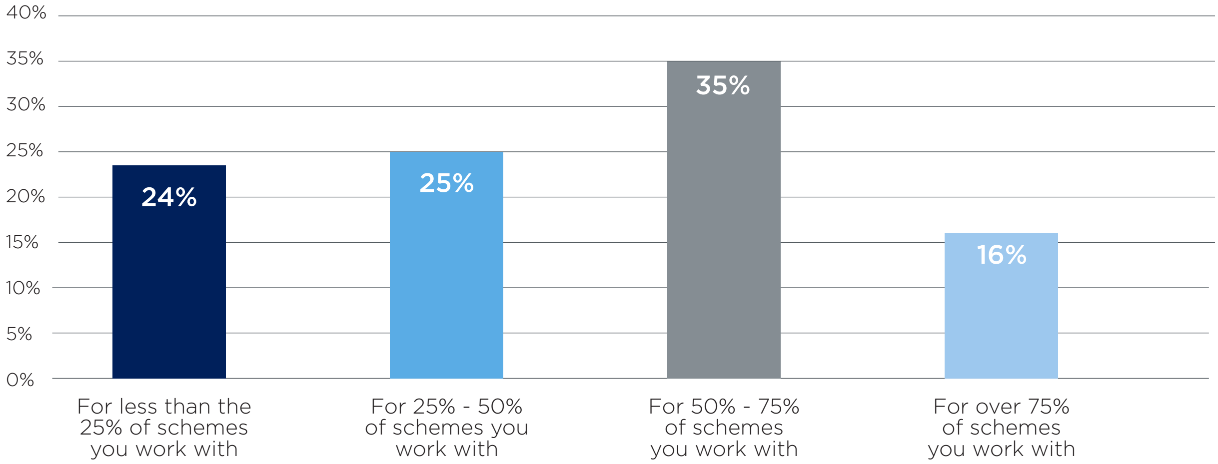
We asked our members their views on how bespoke they expect the Bespoke route will be. Only 7% of the respondents believe that there is true flexibility in the Bespoke approach, while the majority of respondents believe the new regime will fundamentally change the current scheme-specific funding approach to one where deviations from the one-size-fits-all route needs to be explained.

There is a fine balance for tPR here: to meet the needs of employers and trustees where full flexibility may be appropriate because of the circumstances of their scheme, and to provide a clear mechanism for tPR to monitor and take action where they believe the funding approach to be inappropriate.

Fast Track or Bespoke?

One of the advantages of having a Fast Track route is the ability for tPR to focus its energies on schemes that may be in more challenging circumstances. Clearly if a high proportion of schemes end up going down the Bespoke route then this focus will not be achieved. We asked our members how many of the schemes they advise will look to go down the Bespoke route rather than Fast Track.

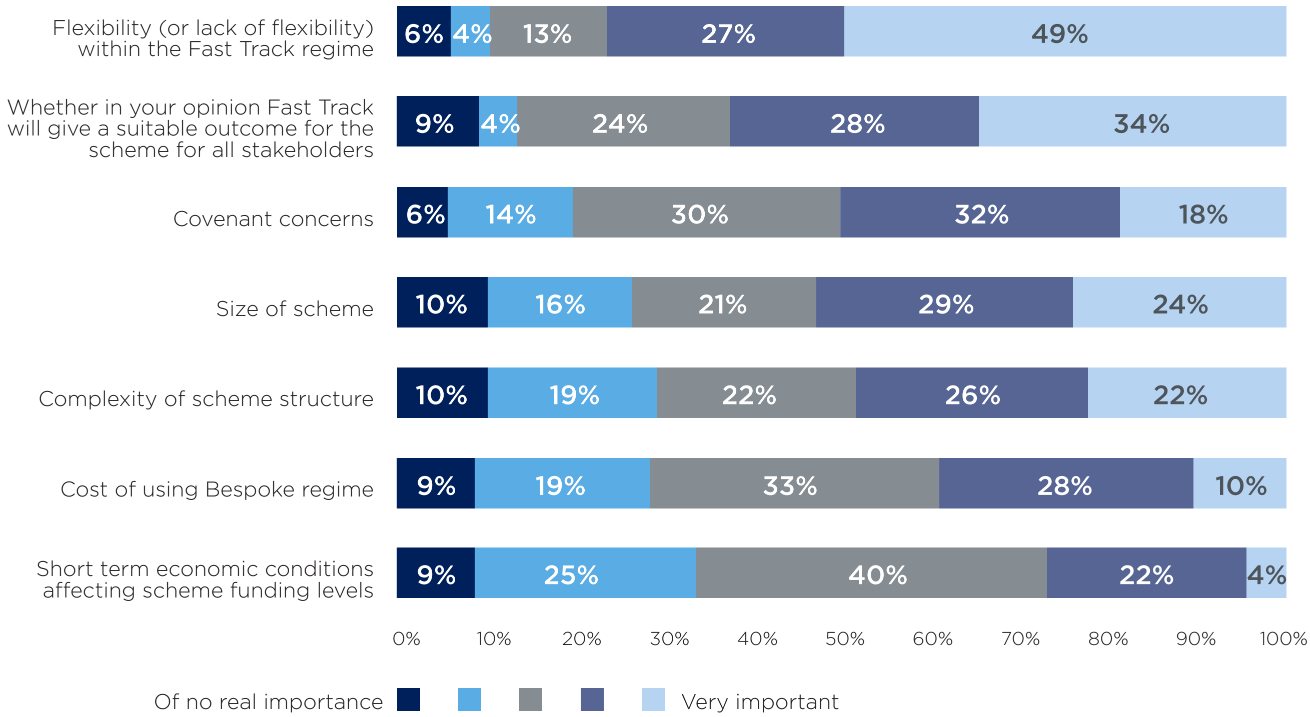
Fig. 2 Do you anticipate favouring Bespoke over Fast track?



The above results suggest that only around half of schemes expect to adopt the Fast Track route, not reaching a "significant proportion" anticipated by tPR. Interestingly, this is despite the majority of respondents believing that the Bespoke approach is not truly bespoke. This may stem from the fact that the Fast Track proposals are far from current industry behaviour: at a recent SPP event, attendees indicated that currently less than 50% of schemes they advised explicitly reflect covenant in their investment strategy, and less than a quarter of schemes have a formal long-term objective.

Given that trustees will have a choice about which route to take, we asked our members what the key reasons for advising clients to go down the Bespoke route would be.

Fig. 3 What are the key reasons you would advise your clients to adopt the Bespoke route?



Again there is a real range of responses although we can see that lack of flexibility within the Fast Track route seems to be a key reason why schemes may choose to go down the Bespoke route, with 76% of respondents stating this as important or very important. Suitability of Fast Track for all stakeholders is another key area of concern, with 62% of respondents stating this as important or very important. These, together with the large number of respondents favouring the Bespoke route, indicate that a substantial proportion of our members are concerned that Fast Track, as currently proposed, may not be a suitable funding regime for many of their schemes.

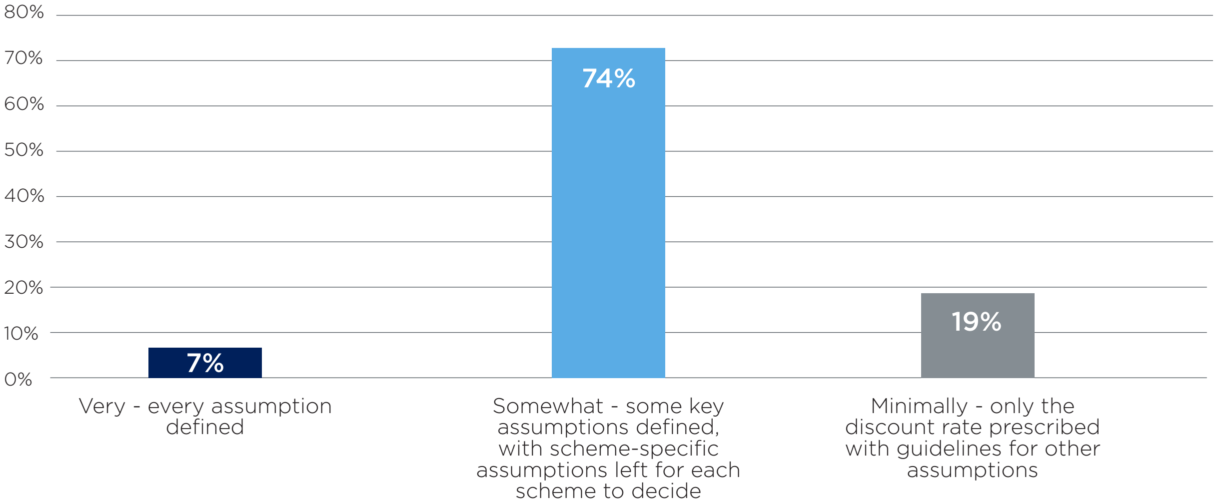
On the other hand, the size and complexity of schemes, covenant concerns, and cost of adopting Bespoke route, at this stage seem less of a concern for schemes deciding whether or not to adopt the Bespoke route. This may come as a surprise to tPR with its expectation Fast Track will "ease the process for many well-managed and well-funded schemes, as well as help the trustees of small schemes to understand what they need to do".

Finally, even with the current additional uncertainty that Covid-19 and the resulting economic volatility has brought, our members have indicated that their choice of Fast Track or Bespoke route is unlikely to be affected by short term economic conditions. This is good news for tPR as it shows industry confidence that tPR's proposed regime will withstand a certain level of market volatility.

Flexibility within Fast Track

Much of the choice between Fast Track and Bespoke hinges on what flexibility is available within the Fast Track route. To what extent do our members think tPR should prescribe Fast Track assumptions?

Fig. 4 How prescriptive should tPR be over the assumptions for Fast Track compliance regime?



Just under three quarters of the respondents agree that key assumptions should be defined, with scheme-specific assumptions left for each scheme to decide. This is good news for both schemes and tPR, as it represents a compromise between reducing advice costs and possibility of 'gaming the system', and providing sufficient flexibility. TPR will still need to carefully draw the line between "key" and "scheme-specific" assumptions, as this is likely to be the single most important decision on how many schemes it will end up having to scrutinise under the Bespoke route.

Conclusion

Our members' responses show a widespread belief that the new code will essentially move the funding regime from one that is scheme specific to one where any deviation from the Fast Track standard needs to be explained. Nevertheless, there seems the expectation that around half of all schemes will go down a bespoke route, something that if it occurred would seem to challenge the central premise of the new Code (that it allows tPR to target its resource on a small subset of schemes). Key to the decision whether to go Fast Track or Bespoke seems to be concerns about the lack of flexibility in the Fast Track approach and whether or not it will be suitable for their clients' schemes.

That said there is a great deal of uncertainty of how the new funding code will work in practice, particularly the calibration of the Fast Track assumptions and how bespoke the Bespoke route will be. However, our survey shows tPR has a very fine balance to strike between setting Fast Track assumptions at a sufficiently prudent level (requiring only limited regulatory scrutiny) and setting them such that the significant majority of schemes elect to go down the Fast Track route. Only time will tell whether this balance is struck.

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