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WorkLife 2.0: The overhaul of the defined benefit pension scheme funding regime: closer regulatory supervision and mandatory journey plans

Major changes are on the medium-term horizon for the regulatory regime for defined benefit pension (***DB***) schemes. This includes:

- New provisions under the Pension Schemes Bill (the ***Bill***) for funding and investment plans which are likely to encourage active journeys towards self-sufficiency or buy-out, as well as powers for the Government to impose a more prescriptive approach to deficit recovery plans.
- A new defined benefit funding Code of Practice (the ***New Code***), about which a consultation document (the ***Consultation Paper***) was issued by the Pensions Regulator (***TPR***) on 3 March 2020. The Consultation Paper discusses the broad framework for TPR's proposed regulatory approach to funding and principles for the forthcoming New Code.

The proposed changes were developed during relatively benign economic conditions before the COVID-19 crisis hit. Yet the speed and magnitude of the crisis has put DB schemes under increased pressure as their funding commitments represent significant demands on cash that many employers cannot, or are not prepared to, meet at present. It is now more important than ever for trustees and employers to work together in order to weather the current storm and to make their schemes fit for the upcoming changes in the regulatory regime.

This briefing considers the implications of the funding provisions of the Bill and the Consultation Paper. They are complementary and form part of an overall package of measures. Both reflect a move towards a long-term funding target for pension schemes, with the Bill providing a requirement for scheme trustees to put a funding and investment strategy in place that sets out that target, and the Consultation Paper proposing that TPR, in the New Code, will set out principles for setting that target in the form of a "long-term objective" that essentially envisages self-sufficiency funding being reached by a certain level of scheme maturity, and for a "journey plan" for achieving this over time.

Many schemes will already have some form of journey plan and long-term funding target in place, but the Bill envisages that these will become mandatory. The Consultation Paper also shows a move from TPR towards achieving greater objectivity and transparency about what, in its view, such plans should look like. This would be done by providing criteria in the New Code for a "Fast Track" regulatory approach to valuations and funding arrangements, with a more interventionist "bespoke" approach for arrangements that will not meet those criteria.

There will be debate as to whether, as a matter of regulatory practice, the New Code will move too far away from the flexibility that characterises the funding regime, which was designed to be "scheme specific" in that valuation assumptions and deficit recovery plans (as well as a scheme investment strategy) would be determined by reference to the particular circumstances of a scheme and its employer, especially the employer's covenant strength. The flexibility in the post-2005 regime has been helpful for many schemes, and TPR still sees flexibility as an important safety valve. However, political concern in the wake of the BHS and Carillion insolvencies that the current regime is not rigorous enough led to the proposals in the 2018 White Paper (*Protecting Defined Benefit Pension Schemes*), on which the measures in the Bill and the Consultation Paper are largely based. The New Code appears intended to act as a strong influence on schemes' trustees and sponsors to adopt approaches which reflect TPR's expectations in key areas.

But TPR's guidelines for Fast Track valuations will not have direct legal effect, and neither the Fast Track criteria nor the New Code itself will be a resurrection of the Minimum Funding Requirement which preceded the current regime. The "one size fits all" funding target it provided for schemes was subject to significant criticism and its limitations were the main reason that it was replaced with a scheme-specific approach in 2005. Furthermore, many trustees and sponsors will welcome the greater transparency that is now proposed, and the New Code may already be broadly consistent with the current aims of many of them. However, this will not always be the case, and some will disagree with the proposition that TPR's views of a long-term objective are appropriate for every scheme.

The pension scheme funding regime and the proposed changes to it have taken on even more importance for corporate sponsors and scheme trustees, considering the ongoing impact on economic conditions of the COVID-19 pandemic. The immediate implications of the pandemic on scheme funding, and TPR's March 2020 statements on the crisis, are discussed in our COVID-19 **briefing** on actions which employers and trustees can take in the short term, including in relation to scheme valuations that are already under way. We have also prepared a separate briefing which considers the implications of the COVID-19 crisis and the sharp increase in scheme deficits it has caused for valuations yet to come, which will be carried out under the existing regime but for which TPR's current thinking on its regulatory approach, as disclosed by the Consultation Paper, will be relevant.

The Consultation Paper was issued on 3 March 2020. The period for responses was originally intended to close on 2 June 2020, but following the COVID-19 disruption TPR has announced that this deadline will be extended to 2 September 2020. Interested sponsors and other stakeholders in the pensions field should be preparing to respond to the Consultation Paper over the coming months.

Key proposals in the Bill and for the New Code – and how they relate to each other

Pension Schemes Bill	New Code	
	Fast Track supervision	Bespoke supervision
Funding and investment strategy:		
• Funding target	Long term objective (LTO)	
	• Adherence to broad TPR view of LTO	• Broad TPR view of LTO – non-binding
	• Use of prescribed basis for determining LTO?	• Flexibility to choose LTO and basis for determining it
• Strategy for achieving funding target	Journey plan	
	• Adherence to guidelines for journey plans?	• Flexibility to determine journey plan
Requirements in regulations for "appropriate" recovery plans	Adherence to fixed guidelines for recovery plans?	Flexibility in recovery plans, subject to new regulations
	• Bounded by covenant "visibility"	• Chosen/agreed by trustee and employer
	• 6 year limit?	• No fixed limits on length?

The Pension Schemes Bill and the scheme funding regime

Following the general election in December, the Bill reintroduced into Parliament during its current session. We have covered the criminal offences regime under the Bill **separately**. However, the Bill also includes a framework for important changes to the scheme funding regime. The two main changes that it introduces are:

- The requirement to adopt a funding and investment strategy for the scheme; and
- The taking by the Government of powers to impose requirements relating to deficit recovery plans for pension schemes.

Much of the detail for the new regime remains to be determined. The Bill includes several powers for the Department of Work and Pensions to produce more detailed regulations, some of which are discussed below. These delegated powers reflect the intention to allow the legal requirements to be easily revised over time, in the light of operational experience and evidence. According to the Consultation Paper (see below) these areas of detail are also matters that are expected to be

covered in the New Code.

Requirement for a funding and investment strategy

If the Bill is passed as drafted, the trustees of defined benefit pension schemes will be required to put into place (and revise from time to time as necessary) a funding and investment strategy. This is a strategy for ensuring that pensions and other benefits under the scheme can be provided over the long term.

The funding and investment strategy must specify:

- A funding level that the trustee intends the scheme to achieve by a certain date.
- The investments that the trustee intends the scheme to hold as at a certain date.

Relationship of funding and investment strategy with technical provisions and journey plans

The requirement that a particular funding target must be defined in the funding and investment strategy would seem to cover similar ground to the existing regime's "statutory funding objective", which is that the pension scheme must have sufficient and appropriate assets to cover its technical provisions. The latter means "the amount required, on an actuarial calculation, to make provision for the scheme's liabilities". This amount is in turn calculated in accordance with assumptions set out in the scheme's statement of funding principles (***SFP***). On its face this suggests that the technical provisions together with the SFP should already define the funding level that the scheme trustee and employer sponsor are aiming to achieve over time.

However, in envisaging seemingly distinct roles for the technical provisions and SFP on the one hand, and the target set out in the funding and investment strategy on the other, the Bill to a large extent reflects and adopts an existing practice which has become more widespread over time. This is to have in mind a long-term funding target or "journey plan", usually initiated and drawn up by trustees and often without legal force and not expressly agreed by employers. Technical provisions will be treated as a moveable goal that is revised from time to time, and a particular technical provisions basis will be a milestone in the longer journey towards that long-term target. Under such an approach:

- A trustee and a sponsor may agree on the content on an SFP and hence on technical provisions in the context of a particular valuation, informed by the specific circumstances and constraints in which that valuation is carried out, such as the performance of the scheme's investments, the current state of economic factors such as gilt yields and interest rates, the ability of the employer to afford a particular level of contributions and the recovery plan duration which TPR, investors in the employer and other stakeholders are prepared to accept.
- The longer-term funding target is typically more aspirational, identifying the position that (usually) the trustee wants to attain over time, with the funding to be achieved when circumstances allow, including when favourable investment returns occur and as and when the employer's financial position changes. For example, a major disposal by the employer could give the trustee the opportunity to extract a large amount of one-off funding. The technical provisions basis and the SFP can then be revised to move towards the long-term funding target, and employer contributions and/or investment returns will then be targeting that higher basis, which may not yet correspond to the long-term funding target.

The Bill will make such long-term funding targets and journey plans mandatory. This will be reinforced by the corresponding guidance in the New Code that each scheme should have a journey plan and a "long-term objective". This may have significant consequences for the conduct of future valuations. The need to agree on a longer-term strategy may well bring to the forefront major differences in the objectives of employers and trustees. A trustee may wish to explicitly target the buy-out of the scheme by a certain point in time. By contrast an employer, particularly one with a strong covenant, may have doubts as to the value for money of a buy-out, and instead be of the view that a run-off of the scheme over time, supported by that covenant but funded at a safe level, is a more appropriate use of capital.

Power to determine the funding and investment strategy

Given the potential for differences in objectives, it is important and logically consistent that the Bill provides that the existing balance of powers under a scheme in relation to funding matters will apply to the determination of the funding and investment strategy. That balance of powers depends on a scheme's own rules and their interaction with overriding legislation. Therefore, if a trustee must agree with an employer on the choice of actuarial assumptions for a valuation and on the terms of the deficit recovery plan and schedule of contributions, it will also have to agree with the employer the scheme's funding and investment strategy. If a scheme's rules give the trustee unilateral funding powers, the trustee is only required to consult with the employer over the strategy.

For schemes with shared trustee and employer powers, the need to agree on the funding and investment strategy will force employers and trustees to reach a mutually acceptable position as to the long-term target. Some will already be well aligned but others may find reaching agreement difficult. In line with its existing powers in relation to other funding matters, the Pensions Regulator will have the power to give a direction to revise the strategy if agreement cannot be reached. This will make its views as to an appropriate journey plan and "long-term objective" (which are likely to be

reflected in the New Code, as discussed below) significant.

Interaction with scheme investment strategy

In one respect, the funding and investment strategy may represent an important shift in the balance of powers in favour of employers. If a trustee is required to agree the strategy with the employer, this has important implications for the investment of the scheme assets over time, which means that the employer will effectively need to agree on the scheme's long-term investment strategy. Currently, the trustees of all defined benefit schemes are only required to consult with employers on investment strategy, as set out in the statement of investment principles (the ***SIP)***. It should be acknowledged, however, that the interaction between a SIP and a funding and investment strategy, and the demarcation of the distinct roles of each, has not been fully clarified. It may in time be determined by the approaches taken in practice by trustees and employers, informed by expert advice.

Statement of strategy

The Bill provides that trustees must, as soon as reasonably practicable after determining or revising the scheme's funding and investment strategy, prepare a written statement to be signed by the trustee chair and setting out:

- The scheme's funding and investment strategy.
- The extent to which the strategy is being successfully implemented and, if the strategy has not been fully implemented, the steps proposed to remedy the position (including their timing), i.e. the journey plan and potentially the recovery plan.
- The main risks faced by the scheme in implementing the strategy and how these will be mitigated or managed.
- Any significant decisions taken by the trustees in the past which are relevant to the strategy (and any lessons learned from these decisions).

Once the Bill has become law, regulations are intended to cover:

- The content of the funding and investment strategy, such as how to address scheme maturity and the employer covenant.
- More details on the content of the chair's statement of the funding and investment strategy.

A trustee may be subject to a civil fine if it has failed to take all reasonable steps to comply with these requirements.

New requirements relating to deficit recovery plans

The Bill provides the Government with a new regulation-making power that may be very significant in practice. This relates to recovery plans, which set out the agreed period and timetable over which a deficit must be remedied by contributions (and in some cases, to a limited extent, by investment performance).

The legislation currently provides that a recovery plan must be "appropriate" having regard to the nature and circumstances of the scheme. As noted in the 2018 White Paper, the meaning of "appropriate" is not defined so it is possible for trustees and employers to agree on a potentially wide range of outcomes, without giving TPR a clear basis for challenging any of the choices that may be made. (This contrasts with the choice of actuarial assumptions to be used in the scheme valuation, which TPR can challenge if that choice does not comply with certain conditions, including the broad requirement that the assumptions be chosen prudently.)

The Bill will potentially impose constraints on what can be agreed. It will enable regulations to set out principles that must be followed when determining whether a recovery plan is "appropriate". The regulations could, for example, set out legally binding guidelines as to the length of recovery plan, or the way in which deficit repair contribution levels can vary over time, reducing the scope to "back-end load" contributions. As discussed below, the Consultation Paper asks whether the trustees of all schemes should aim for recovery plans of a standard length (e.g. broadly limited to the period over which there is normally good covenant visibility, typically 3-5 years). If this becomes TPR's policy objective, then it could be made legally binding under this new regulation power, which will remove scope for variation.

The Consultation Paper: a new framework for TPR's approach to scheme funding

The release of the Consultation Paper is the first stage of a two-stage consultation process. This process will run alongside, and be informed by, the development of Bill and the secondary legislation that will be made under it when it becomes law.

The Consultation Paper covers eight broad principles underpinning the New Code, discusses how these might be applied in practice, and invites further comments. As an overall observation, there is a definite move towards clearer funding standards. This is despite an apparent move away from the proposal in the 2018 White Paper that aspects of the New Code itself would be legally enforceable. It is still possible however that the regulations issued under the Bill could make parts of the New Code enforceable, for example the parts that deal with recovery plans or the choice of actuarial assumptions.

The long-term objective

The Consultation Paper says that all schemes should have a long-term objective (***LTO***), in order to reflect and comply with the requirement under the Bill to have a funding target that would be identified by the funding and investment strategy for the scheme. However, while the target envisaged by the Bill is not defined, which reflects the scheme specific nature of the funding regime, TPR intends to define its LTO in the New Code – in broad terms for all schemes, and in more specific terms for schemes that make use of its "Fast Track" regulatory approach.

TPR's proposed broad LTO for all schemes is that "significantly mature" schemes should have a low level of dependency on the employer, and be invested with high resilience to risk. This goal corresponds to the concept of "self-sufficiency", a term already widely used in funding practice albeit with a significant degree of variation as to what this means in practice. TPR anticipates in the Consultation Paper that for most schemes of average maturity, "significant maturity" will be reached in about 15-20 years from now. This means there will not be a significant immediate de-risking requirement for the average scheme. However, for some schemes significant maturity would occur well in advance of that time and not all of them will be able to conform to the LTO in that shorter timeframe.

It is important to note that the level of funding required for the LTO as proposed by TPR is not buy-out level funding or even necessarily the level of funding required for a transfer to a commercial consolidator. TPR's LTO could simply be a safe basis on which to run off the scheme obligations over time. The selection of the actuarial assumptions for a specific LTO will be a trustee/employer decision, and many may aim for LTO outcomes that require a higher funding level than TPR's low dependency. But TPR's view of the LTO would give a good platform from which to achieve an eventual buy-out or transfer to a consolidator.

The journey plan

The Consultation Paper says each scheme should also have a journey plan, which shows how to get the scheme's technical provisions and funding level to the LTO. This reflects the requirement in the Bill for the funding and investment strategy to show how its funding target will be achieved over time and over a specified period. As discussed above, and in line with the increasingly common use of journey plans in the industry, this suggests that technical provisions will therefore become funding level milestones along the journey to the LTO. The journey plan will be distinct from a recovery plan, which is required when there is a deficit on a TP basis.

The "twin track" supervisory approach

The Consultation Paper also introduces the concept of a "twin track" funding approach. Schemes' trustees and employers can choose between a Fast Track approach and a Bespoke approach to TPR supervision of funding arrangements. The approach that will apply to a scheme will depend of the elements of the valuation and funding package that are proposed.

The Fast Track approach is an off-the-shelf option, aimed at better funded and (in TPR's view) well-run schemes. Schemes which take the Fast Track approach can expect less regulatory scrutiny. This approach involves alignment with objective and quantitative metrics. These may include:

- The LTO and journey plan targets – the Consultation Paper asks for comments in what a suitable set of actuarial assumptions would be for a Fast Track LTO.
- The technical provisions. In the Fast Track, "acceptable" technical provisions might be benchmarked using a range of discount rates. Alternatively, they might be benchmarked as a percentage of a low dependency basis defined by TPR (e.g. 85%-88% of low dependency) along the journey plan.
- The length of the recovery plan. The affordability of contributions for the employer remains a key consideration, but the Consultation Paper asks whether the trustees of all schemes should aim for recovery plans of a standard length (e.g. broadly limited to the period over which there is normally good covenant visibility, typically 3-5 years). Alternatively, different thresholds could be set for different covenant grades. It is not yet clear how this would interact with the provision in the Bill for new regulations (discussed above) setting out mandatory factors to consider when assessing whether a recovery plan is "appropriate".

The alternative to Fast Track is the "Bespoke" track. This is significantly more flexible and is aimed at schemes which will not meet all Fast Track criteria. This might be due to a weak employer covenant. But the Bespoke track can also be used by schemes which might want to take additional, managed risks, or schemes which wish to take a different approach which is in aggregate no riskier than Fast Track. Schemes which have unusual covenant arrangements (i.e. where sponsors are not-for-profit organisations) may also find the Bespoke track more suitable than Fast Track.

Schemes opting for Bespoke will have to explain and evidence the decisions to support their submission of their valuation documents to TPR. Opting for Bespoke is likely to mean higher regulatory involvement and close scrutiny of the proposals by TPR. For this reason, the twin track approach has sometimes been described as a "comply or explain" model, though this is not truly accurate given that TPR's Fast Track criteria will not be legally binding requirements, but rather signposts for its supervisory approach. Furthermore, the intention stated in the Consultation Paper is that when used appropriately, the Bespoke track will not be a 'bad' or second-best option and would be as compliant with the legislation as Fast Track. Schemes can also switch between Fast Track and Bespoke between valuations. Hence, the flexibility that is inherent in the

scheme specific funding regime will continue.

That said, coming within the Fast Track regime will clearly require the valuation and funding proposals, including the LTO itself, to come within prescriptive parameters. Many trustees and employers will want to avoid an interventionist engagement by TPR with a proposed valuation package under the Bespoke approach, given the potential need for additional management time and advisor costs in justifying their proposals. If they can come within the Fast Track parameters without too much additional cost or disruption to their preferred strategy, they are likely to do so. This will mean that TPR will have a powerful regulatory tool for influencing (or "nudging") the substantive outcomes of valuations and the deficit recovery arrangements and bringing about a greater degree of consistency over time.

The employer covenant

The Consultation Paper reflects current normal practice in stating that a stronger employer covenant will allows scheme trustees to take on more risk and assume higher investment returns in a valuation. But it also says that under a journey plan for reaching the LTO, reliance on the employer covenant should reduce over time. TPR's view is that reliance on employer covenant beyond the period in which there is "good visibility" of that covenant – typically 3-5 years – will need to be explained through the Bespoke track. This would represent a significant change in approach for many schemes.

The Consultation Paper asks whether:

- Covenant should be factored into both Fast Track and Bespoke approaches, or just Bespoke.
- A formulaic, objective approach to covenant reviews, where employer covenant is standardised to a formal calculation or metric, would be appropriate for the Fast Track or even the Bespoke track. The alternative would be to retain the existing, "holistic" approach, though TPR has said the flexibility in the holistic approach can result in inaccuracy and even misuse, so TPR would at least seek to tighten and clarify its guidance. Either way, the current 1-4 grading approach is expected to be retained.

Helpfully, TPR says its current practice (under the current code of practice on funding) is that trustees can consider wider group support (or "indirect" covenant) when assessing the covenant of the statutory employer, and that this practice will continue. However, TPR believes that some scheme trustees are over-reliant on group support that is not legally binding. It proposes that:

- in line with its most recent guidance, reliance on wider group support this should be limited to the short term – one or two years, or, at most, the period to the next valuation;
- there should also be corresponding clear and tangible benefits to relying on indirect covenant, such as increased deficit-reduction contributions and a shortened recovery plan; and
- any reliance beyond the short term should be legally enforceable (e.g. through use of a guarantee or contingent assets).

TPR's initial view is that actuarial valuations using the Bespoke track can build in reliance on legally enforceable "additional support", such as guarantees, provided that the additional support is sufficient for the risk(s) being run, is appropriately valued, and is realisable at its necessary value when required. The Consultation Paper asks for feedback on this point (as one of TPR's eight principles in respect of funding). TPR takes the view that longer term risks are better underpinned by contingent asset support (e.g. asset-backed funding using real estate), rather than guarantees which could have reduced value beyond the covenant visibility period (typically 3-5 years).

Even under a Fast Track review, a scheme's covenant reliance would need to be checked to some extent by TPR. The second consultation process to be conducted by TPR will cover the balance to be given between scheme member and employer interests when placing reliance on the employer covenant.

Dividends and equity of treatment under the New Code

As covered in our recent **briefing on pension schemes and dividends**, TPR is increasingly focused on what it considered to be "equity of treatment" in the context of dividends between shareholders and defined benefit pension schemes.

The Consultation Paper says TPR proposes to set clear expectations on scheme equitability for both Fast Track and Bespoke approaches for dividends (and other forms of "value leakage", such as intercompany loans that are unlikely to be repaid and material management bonuses). This guidance is likely to be qualitative rather than quantitative, but with reference to scheme-specific considerations, particularly employer covenant strength.

- For stronger employers, "value leakage" can be proportionately high provided that the covenant remains strong and the recovery plan is not subsequently extended.
- For weaker employers, DRCs should be maximised or, often, prioritised over forms of covenant leakage unless such leakage can be demonstrated to be absolutely necessary to the employer's sustainable growth.

The future

After the period for responses to Consultation Paper close, the DWP is expected to issue draft regulations on funding requirements under Bill.

After this, TPR will issue a second consultation, which is expected to be more concise and cover the draft New Code. The New Code itself is also expected to be short and focused, simply outlining the twin-track compliance structure, and the principles for the Fast Track principles and the Bespoke track. This will be informed by industry feedback on the Consultation Paper, an impact assessment, and any changes to the Bill as well as new regulations that are made by the DWP.

These developments are expected later this year. The new funding regime (including the funding aspects of the Bill, the regulations, and the New Code) is expected to come into force in late 2021. We will issue further updates in the future as the regime develops.

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