The Pensions Regulator Funding Code of Practice consultation

The Regulator's consultation is a weighty tome at 175 pages jam-packed with technical content, plus the handy 16 page "quick guide". But despite this it poses many more questions to the DB pensions industry – 108 to be precise – than it answers.

The Regulator sets out the key principles that should govern funding:

1. **Long-Term Objective (LTO)**: This is the cornerstone of the new code. In short, when schemes are "significantly mature" they should be fully funded and invested on a "low dependency" basis
2. **Technical Provisions (TPs)**: Must explicitly converge to the LTO over time, so the LTO is "baked in" to all valuations, with risk reduction over time from current levels
3. **Investment strategy**: actual investment risk taken must be consistent with the TP's and have sufficient liquidity and quality
4. **Employer covenant**: Strong covenants can be reflected in TPs but only for a short period of time, maximum 3-5 years in most cases
5. **Contingent assets**: Can be relied upon but only if sufficient in size and quality and the trustees have legally enforceable rights and can realise the cash
6. **Recovery plans**: Back to "as soon as affordability allows" terminology, 6 years mentioned for strong covenants
7. **Open schemes**: Future benefits must have the same security as closed schemes hence the same rules apply

As well-trailed, the Regulator will allow Schemes to choose an off-the-shelf "fast track" set of valuation guidelines or justify their own "bespoke" route to the Regulator. The consultation is at pains to say that the bespoke option will not be an easy way out. But when it comes to the detail the Regulator sits on the fence, with lots of options and possible methodologies set out. There are some hints about their views here and there but all still subject to the consultation process.

Fast-track tests

A valuation that meets the fast-track requirements is expected to attract limited scrutiny and engagement from the Regulator. Fast track will require the trustees to meet all of the following four tests (five for open schemes):

1. **Long-Term Objective (LTO)**: a low-dependency target using a prescribed discount rate (to be decided) in the range gilt yields +0.25% to +0.50% and a timescale of c. 15 years on average (once duration of the scheme liabilities falls to 14 years). Inflation seems likely to be prescribed and possibly mortality improvements, others are likely to be scheme specific

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2. **Technical Provisions**: must bake-in the LTO and the Regulator envisages a matrix of prescribed outcomes depending on scheme maturity and (to a limited extent) covenant. It could be discount rate that is prescribed but the Regulator is leaning towards expressing TP's as a minimum percentage of the LTO, e.g. at least 90% of the LTO liabilities for a given maturity and covenant
3. **Asset strategy**: Actual investment strategy and risk will have to meet new constraints. The preferred approach is a stress test in line with PPF requirements and a prescribed maximum scheme risk – again using a maturity and covenant matrix – supplemented by potential new tests around liquidity and bond credit quality
4. **Recovery Plan**: "as short as affordability allows", illustrated using 6 years for the top two covenant groups rising to 12 years for the weakest covenants. The LTO "significant maturity" date may also be a backstop date, and the Regulator is minded to prohibit any allowance for additional asset returns in recovery plans
5. **Future accrual cost (for open schemes)**: fundamentally the same LTO and TP's should apply hence future service cost should be based on prescribed TPs, possibly with an adjustment for the longer duration of future service liabilities

Bespoke option

Schemes will be able to diverge from the fast-track assumptions but will need to provide significant justification to the Regulator. Examples of acceptable bespoke valuations are schemes that cannot meet fast-track due to affordability, schemes that get to the same (or better) outcome but using different approaches, and those that have a different fact pattern or robust contingent assets that justify a different approach. All bespoke valuations will be scrutinised, and the outcome compared to the equivalent fast-track valuation result.

The Pensions Regulator believes that contingent assets have a key role to play, but they will need to be legally enforceable, of sufficient quality and value, and realisable by the trustees when needed. It appears that guarantees will be of limited value in valuation discussions although they may still provide valuable other protections.

Investment and covenant

Much of the content in the consultation was not a surprise, and perhaps the most interesting new information is what the consultation says about sponsor covenant and investment strategy. Investment risk is clearly getting a much higher profile and attention from the Regulator, whereas covenant appears to be becoming less influential in valuations:

- **DB sponsors are getting a covenant downgrade**: The Regulator indicates that too much credit is being taken for sponsor covenant and suggests that 3-5 years is the maximum period of covenant visibility for the vast majority of employers – and that's all that should be reflected in the valuation. So covenant may become less important in valuation discussions although clearly it will remain very relevant in transactions and in looking at affordability for weaker employers. Indirect group support is also dismissed as something trustees should place very limited reliance on.
- **Investment risk is coming under the spotlight**: The consultation suggests that the Regulator will tell Trustees of all schemes what it believes are acceptable levels of investment risk, liquidity and potentially even bond credit quality. The Regulator is particularly driven by a concern with maturity risks which means tighter controls for more mature schemes – this is despite little evidence that mature schemes are more problematic than immature and flying in the face of modern financial economics (for example why annuity buy-out pricing is relatively higher for non-pensioner liabilities)