Pensions Regulator consultation on the new funding code
What you need to know and what you need to do

When it comes into force, the new funding regime will bring significant change. All schemes will be required to have a documented long-term funding and investment strategy, along with a statement that explains how they are going to reach their low risk position. Covenant assessment metrics will be changed and schemes will need to show that risks can be supported by the employer.

But the most talked about part of the new regime is the Fast Track assessment. Put simply, if you meet the Fast Track tests, you can expect minimal engagement from the Regulator. On the other hand, if you use the 'bespoke' route you should be prepared for some regulatory involvement.

When will the code come into force?

Consultation starts	Consultation ends	Code to Parliament	Code into force
16 December 2022	24 March 2023	June - July 2023	1 October 2023*

*The Regulator has made it clear that 1 October 2023 is the earliest date the new code will come into force. Based on experience with other consultations, we expect the code to come into force very late 2023 or early 2024.

The new code will not be retrospective. Triennial valuations with effective dates on or after the code comes into force will be carried out under the new regime.

What are the key requirements?

Set a 'Funding and investment target' - all schemes will need to set a low risk funding and investment target and a clear strategy to show how and when they will get there.

Decide whether to adopt the 'Fast Track' or 'Bespoke' approach - under 'Fast Track', various tests have to be met but regulatory intervention would be minimal. Under 'Bespoke' there is more flexibility but expect regulatory involvement.

Meet the Fast Track tests - if you choose the Fast Track route, your scheme will have to pass the following three tests:

1. Your **Technical Provisions** must be at least equal to a defined minimum percentage of the Regulator's long term funding target, which is based on a discount rate of gilts plus 0.5% and other pre-defined assumptions. The minimum percentage increases steadily from 70% at 30 year duration to 100% at a duration of 12 years.
2. The level of **Investment risk** (expressed as funding level variability) must be at or below pre-defined limits at each duration (18.7% at 30 years reducing to 1.9% at 12 years).
3. **Recovery plan**: 6 years or less from effective date reducing to 3 years or less at significant maturity.

Another Fast Track requirement is the need for an **expense reserve** at significant maturity.

Don't let the tail wag the dog

First and foremost, be careful that the tail (the fast track constraints) doesn't wag the dog (the quality of your funding and investment strategy). For the vast majority of schemes, insurance is the target and, if you are already on track, then think very carefully before making any changes to your current strategy.

Checklist

While the code is subject to the outcome of the recent consultation, we do not expect any significant changes on the key issues, so our advice is don't wait!

The checklist below identifies the key areas that trustees and employers should be looking at now:

- Strategy – if you already have a strategy, then put it down in writing and check it includes all of the key parts that a good strategy should include. If you don't have a strategy then now is the time for the trustees and employer to agree one, no matter how small the scheme.
- Maturity – there will rightly be a greater focus on maturity. All trustees and employers of closed schemes should know how mature their scheme is and how far they are from significant maturity.
- Fast track – test your current funding and investment strategy against the key fast track measures and understand where and by how much you would not meet the tests. To be clear, we are not saying fast track is the right answer but if you meet the tests it will be the most efficient route to take.
- Covenant – look out for forthcoming guidance and, for employers, start to think about how you will demonstrate strength and longevity of covenant. The key metrics for demonstrating covenant strength will be cash, contingent assets and prospects.
- Funding update – carry out an up-to-date funding assessment and, if you can, include up-to-date insurer pricing. With market movements over the past 12 months and improved insurer pricing, you may be much closer than you think.
- Write the cheque number – trustees and employers should agree a number at which the employer would be happy to write a cheque to insure all benefits. For some schemes, this may seem premature but we are seeing an increasing number of cases where the cost of insurance is less than the total contributions due under the current recovery plan.
- Open schemes – are more likely to use the bespoke route. Start to think about the areas (which you probably already monitor) where formal evidence is likely to be required. These are likely to include covenant, investment strategy and new entrants.
- Get buyout ready – last but not least, start to get buyout ready. Make sure your data is complete, accurate and up-to-date. This includes spouses' pensions and, ideally, marital status. Prepare a full benefit specification and sort out any areas of uncertainty.

More about duration and significant maturity

Duration will be *the key metric* under the new regime. Funding level requirements and risk limits will be determined by Scheme duration. The critical value is a duration of 12 years; the point at which a scheme is deemed to have reached 'significant maturity'. From this point onwards, schemes are required to be fully funded on a low risk basis with assets mainly invested in cashflow matching funds.

The duration of a scheme at any given date is the discounted average term to payment of the remaining benefits at that date. If you think of a scheme as a series of benefit payments stretching out into the future, the duration reduces over time as we get closer to the point where the last expected benefit payment is made. Here it is important to note that the time taken for duration to reduce by one year is broadly two years (but will be longer at shorter durations and shorter at longer durations).

The main factors affecting duration include:

Gilt yields – higher gilt yields lead to a sharp fall in the value of longer term cashflows due to the compounding effect of discount rates. As a result, the longer-term cashflows have less weight in the duration calculation leading to a reduction in duration. The opposite is true when gilt yields fall.

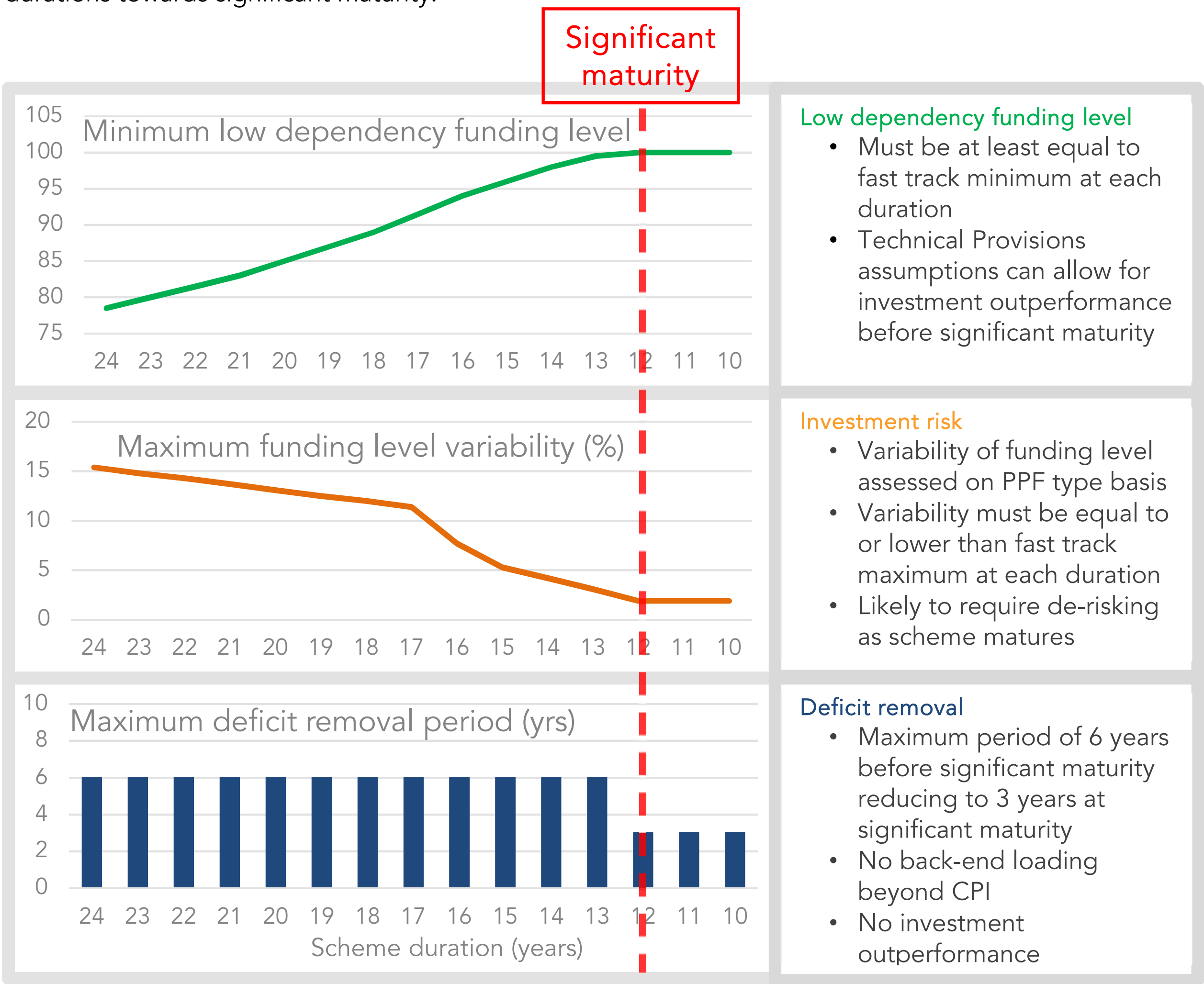
Pension increases (and inflation) – higher pension increases lead to higher benefit outgo in later years, resulting in longer duration compared to schemes with lower or non-escalating pensions.

Life expectancy – a reduction in life expectancy will reduce longer-term benefit outgo leading to a reduction in duration. Likewise, an increase in life expectancy will lead to an increase in longer-term cashflows and an increase in duration.

It's expected that duration calculations will be based on market conditions at 31 March 2021, when long term gilt yields were 1.2%. Any change in this reference date to a more recent date would lead to a sharp fall in duration for all schemes.

The Fast Track framework

The graph below shows how the Fast Track framework is expected to operate as schemes move from longer durations towards significant maturity.



For a scheme with duration of 20 years to meet Fast Track, the low dependency funding level must be at least 85% and the investment risk (variability of funding level) must be less than 13.1%. Finally, to the extent that the low dependency funding level is below 85%, the deficit must be removed over a period of six years or less.

For schemes who are likely to use Fast Track, investment will be a key area. As the graph shows, the level of risk a scheme can take reduces sharply from the 17 year duration point. By significant maturity, Fast Track limits the allocation to growth assets to 15%. Trustees should start to plan for this by considering how investment risk will be reduced as their schemes mature and approach significant maturity.

Other issues

The Regulator is at pains to point out that bespoke and Fast Track are equally valid. But it is clear that the level of regulatory involvement for bespoke schemes will depend on the extent to which they depart from Fast Track.

It's also clear that meeting Fast Track does not necessarily mean compliance with the code. For example, schemes with weak employers should consider whether they need to go beyond Fast Track to provide security for their members.

Trustees and Employers should start to prepare for the new regime. If you want to carry out a Fast Track assessment or discuss any issues relating to strategy, funding, investment or insurance please get in touch with your Cartwright contact.

Jonathan Seed
Head of Pension Strategy
Jonathan.seed@cartwright.co.uk

If you would like to discuss any of these matters further, please get in touch with your usual contact at Cartwright.

250 Fowler Avenue
Farnborough Business Park
Farnborough
Hampshire GU14 7JP

T: 01252 894883

E: enquiries@cartwright.co.uk

Marlborough House
Victoria Road South
Chelmsford
Essex CM1 1LN

T: 01245 293300

E: enquiries@cartwright.co.uk