Not so fast track - Pensions Regulator consultation on the new funding code

An early Christmas present for the pensions industry appeared on Friday 16 December when the Pensions Regulator published its second and final consultation on the new funding code for DB schemes. Under the consultation, trustees, advisors (and anyone involved in the pensions industry) have until 24 March 2023 to respond to the consultation questions, with the new funding regime currently expected to come into force in October 2023.

We have set out our initial comments below and will follow up in January with more detailed analysis of what it will mean for scheme funding and investment strategies.

What is the consultation about?

The draft code of practice provides the practical detail on how the new funding regime will be applied. As with DWP's consultation on the associated draft regulations in July 2022, the draft code is largely what we've been expecting. That is:

- Schemes will be required to set a low risk long term funding and investment strategy
- The approach to demonstrating compliance with the requirements for funding, investment and risk management can either be on a 'Fast Track' basis where key parameters are all within ranges defined by the Regulator, or on a 'Bespoke' basis where the approach can be tailored but more evidence will be needed to support the approach used and schemes may be subject to greater scrutiny.

The new consultation is based on the DWP's draft regulations. It acknowledges that these have yet to be finalised, and so includes details of possible different approaches if the final regulations change.

What would the new code mean?

Under the new code, there will be a twin track approach to demonstrating compliance with the new funding regime where schemes can either adopt a 'Fast Track' approach and work within the Regulator's parameters or they can adopt a 'Bespoke' approach.

A key part of the consultation is how Fast Track would work. In short, regardless of how mature your scheme is, Fast Track would mean pre-defined limits at every stage of your journey from now to low dependency. The key proposals are:

- The low dependency assumptions – here the key assumption is a proposed discount rate of gilts plus 0.5%.
- Low dependency investment strategy – the Regulator does not define a particular strategy and does not rule out some investment in growth assets (potentially up to 30%).
- The funding position – there will be a benchmark level for the strength of a Scheme's Technical Provisions, expressed as a percentage of the low dependency basis for every stage of your journey.

- Significant maturity – based on the draft DWP regulations, the draft code states that a duration of 12 years will be the point at which a scheme is deemed to have reached significant maturity (and therefore must be fully funding on a Fast Track compliant low dependency basis with corresponding investment strategy). However, it is widely expected that this definition may change when the regulations are finalised.

- Investment Risk – will be measured using pre-defined stress tests under which assets and liabilities are stressed and the potential drop in funding level is assessed against a benchmark. This will be similar to the investment stress test applied by the Pension Protection Fund (PPF) when calculating PPF levies. The acceptable level of funding level volatility will reduce as schemes mature.

- Recovery Plan – there will be a maximum recovery plan length of 6 years, reducing to 3 years once a scheme becomes significantly mature.

- Expenses – the low dependency target will need to incorporate an allowance for scheme expenses.

The "Fast Track" approach takes no account of the strength of the Employer covenant or the availability of additional support such as contingent assets. For those following the "Bespoke" approach there is guidance on how covenant can be assessed in the context of journey planning including a new concept of covenant longevity

What should we be doing?

Trustees and Employers should start to prepare now, including training on what the new requirements would mean and benchmarking of your current funding and investment arrangements against the expected Fast Track requirements.

If you want to discuss any of these areas, please get in touch with your Cartwright contact.

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