# Defined Benefit Funding Code

## The long wait is finally over

**31 July 2024**

## Introduction

A full 4 years and 4 months after the first consultation on the subject, which in itself had been some time in the making, we finally have the final draft of the new defined benefit funding code sitting before parliament.

Given the summer recess and conference season, it will not be formally finalised until after the new funding regulations take effect on 22 September 2024 but schemes with valuations later this year can finally now start planning with much clearer visibility on the requirements. The Pensions Regulator has also promised to liaise with the early cases.

In the main, there is little change from the previous draft although some important refinements have been made in areas that were overly prescriptive and the cutoff for a 'significantly mature' scheme has been reduced to a duration of 10 years.

We also now have the Regulator's updated guidance around their plans for Fast Track and Bespoke regulation, although a large amount of critical detail, including the Statement of Strategy and covenant guidance, are still to come.

# The final code

As noted above, there are relatively few changes from the original code. In conjunction with the new funding regulations, trustees and sponsors will need to familiarise themselves with a glossary of new terms which (at a high level) include:

- Significant maturity: The point the scheme will have an (expected) duration of 10 years, measured using financial conditions at 31 March 2023
- Relevant date: The Trustees chosen date (in the year of hitting significant maturity or earlier) for targeting their low dependency funding position
- Low dependency: Scheme can pay out all benefits without expecting to require any additional funds from the employer (unless they are legally obliged under scheme rules to meet expenses directly)
- Low dependency investment allocation: a notional low risk investment allocation that means the funding position is highly resilient to short term market changes
- Covenant reliability: the period the trustees can be reasonably certain of the employer's cash flows to fund the scheme (usually 3-6 years)
- Covenant longevity: the period the trustees can be reasonably certain the employer can support the scheme (usually no more than 10 years)
- Statement of Strategy: two-part document signed by the trustee chair that documents the scheme's funding and investment strategy

Trustees will need to have a funding and investment strategy that targets being 100% funded on a low dependency basis when the scheme hits its relevant date (and at each valuation thereafter). They will also have to have an investment de-risking plan to move towards their low dependency investment allocation.

The new code expands on some elements, such as the notional low dependency investment allocation and the new covenant requirements. In addition, a new section has been added to specifically address open schemes and acknowledge their longer time horizons. There are also nods towards topical issues such as productive finance, climate change and consolidation.

Finally, it is worth noting that (not least due to the new employer covenant assessment requirements) the code emphasises repeatedly that trustees and employers should work collaboratively, with early engagement. Employers are required to provide trustees and their advisers with relevant information, which is likely to be more extensive than was required historically. They will also need to review (and agree part 1 of) the Statement of Strategy.

# Fast Track regulation

In conjunction with the new funding code, the Regulator has also confirmed its revised regulatory approach (subject to any final changes in the code). This is based around classing schemes as either 'Fast Track' (requiring minimal additional review or engagement) or 'Bespoke'.

They emphasise that both routes are equally compliant and this is simply a filtering tool. Their analysis also suggests that as many as 81% of schemes might now be able to pass their Fast Track criteria, which could help them to very quickly triage cases and focus resource where it is likely to be most useful.

They admit that Fast Track will not suit every scheme (e.g. those with extended recovery plans due to affordability constraints). They also emphasise that Fast Track does not equate to compliance with the Regulations - schemes should therefore focus on meeting the funding code and then check to see if they can certify themselves as Fast Track. The certification itself will be done by the Scheme Actuary and is a factual confirmation that the scheme's strategy meets three defined tests:

**Prudent technical provisions –** The funding liabilities will be compared to those on a low dependency basis. The required strength will then be based on the maturity of the scheme (e.g. 90% for a scheme with duration 16).

**Acceptable level of investment risk –** The scheme must pass a stress test, similar to that used for calculating PPF levies. If the funding level would drop by less than a specified percentage in the pre-defined stress scenario (again based on duration, with more risk tolerable for less mature schemes) then the test is passed.

**Acceptable recovery plan –** If the funding basis reveals a deficit, then the recovery plan must be short enough (no more than 3 years from the valuation date for a mature scheme, 6 years if not yet reached 'significant maturity') and not be reliant on investment outperformance or back end loaded.

# What next?

Whilst much has been made of the milestone of the code finally being laid before parliament, we are still awaiting a number of critical items. In particular, the following are yet to come:

- Statement of Strategy final template and consultation response ('in the autumn')

- Consultation on updated employer covenant guidance ('in due course')
- Review of existing defined benefit funding and investment-related guidance ('in line with new government policy')
- Additional actuarial guidance regarding Fast Track certification.

Both the Statement of Strategy document and the Fast Track requirements will be separate documents that sit alongside the funding code. This should make them easier to update (if/as needed).

# What about proportionality?

A key concern raised in previous consultations has been the apparent lack of proportionality in the proposals and the significant additional cost burden that would be imposed, particularly for smaller schemes.

The word proportionality is sprinkled liberally throughout the code and consultation responses, including a specific promise to be a proportionate regulator, but at this stage there is relatively little to show how this will feed through in terms of reduced workload. Much will depend on the final Statement of Strategy and how the Regulator actually polices the new regime.

Even for a 'minimum compliance' approach, there will be significant additional work compared to previous valuations including:

- getting trustees and employers up to speed with the new regime,
- calculation of significant maturity date and related duration figures,
- calculation of low dependency liabilities,
- need to determine appropriate de-risking plans and long term notional low dependency investment strategy,
- need to meet the revised employer covenant expectations,
- consideration if meet Fast Track tests / require certification, and
- need to agree and populate the Statement of Strategy.

The definition of a "smaller scheme", for the purposes of the funding regime, will be schemes with 200 members or fewer. These schemes should have a simpler Statement of Strategy submission and are permitted to use an average spot rate rather than full yield curves in their funding calculations.".

# Broadstone view

**At long last the funding code has made it over the line after a prolonged and torturous journey.  As widely acknowledged, the code has largely been overtaken by events and it remains a concern that there is a disproportionate burden associated with the new regime.  However, with the new regulations coming into force, at least we now have the tools to help those schemes with valuations shortly after the 22 September cut off.**

At 101 riveting pages (!), we doubt many trustees will be rushing to leap into the new funding code but there is some repetition / old ground and there are useful links between sections for those wanting to dip in to specific areas.

We expect those with valuations within the next 12 months might want to start familiarising themselves with the new requirements and terminology whereas others might wait a little longer to benefit from any learning points from those initial experiences.

At a technical level there have been some important clarifications, adjustments and flexibilities granted that addressed critical faults in the previous draft without changing any of the headline messaging.  It is explicit that trustee investment decisions are not being restricted and we have the welcome reduction in the 'significant maturity' cut off point to reflect the rises seen in interest rates.  Other changes, such as the additional commentary around open schemes, are arguably more political and (at least in some cases such as climate change) relatively superficial.

Unfortunately, for those hoping to now have some certainty as to what is required, we will need to wait a little longer – at least for the Statement of Strategy template.   It is only once we see what is required there that we might really see where proportionality within this new regime (and potential cost savings as a result) will come into play.

# Broadstone

# Find out more

**For more information on how Broadstone can help you, please contact your Broadstone consultant or use the details below.**

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