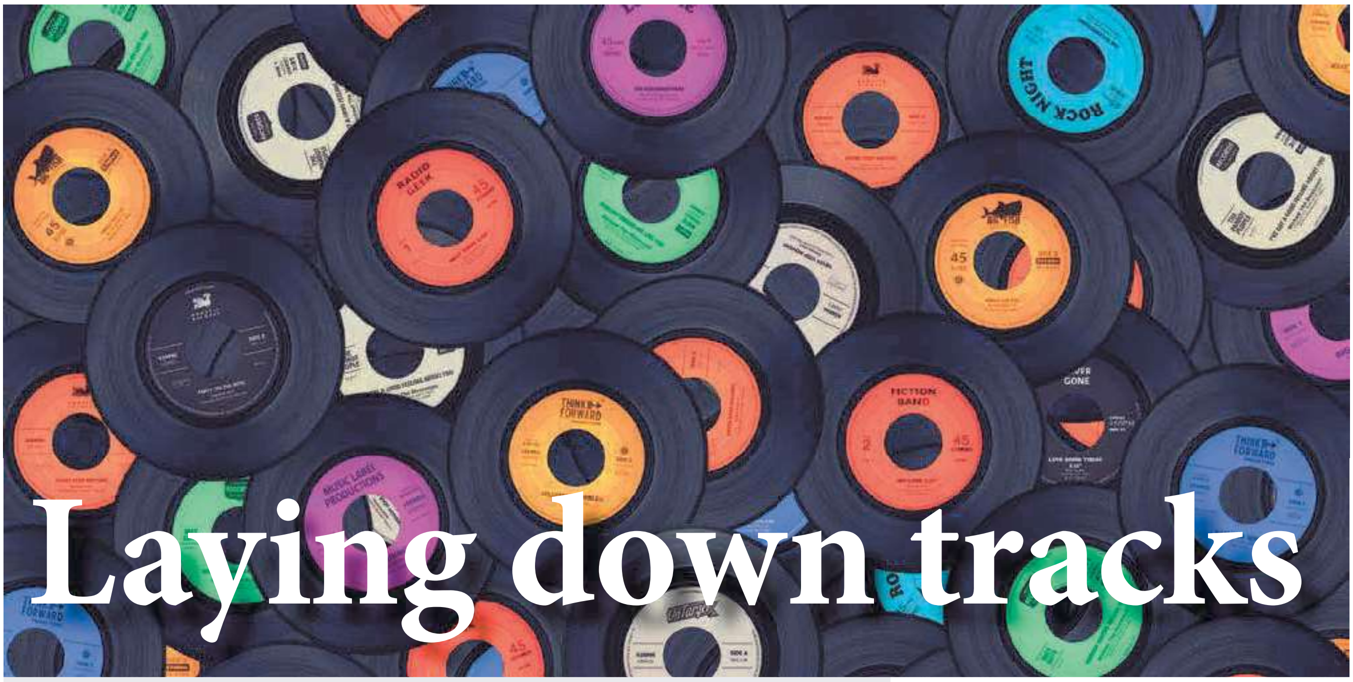

Laying down tracks

Summary

- While support is strong for the principles behind the proposed funding code, there are concerns about pressuring schemes into the fast track compliance route.
- Another major concern is that a lack of flexibility in this route will refocus schemes onto 'box-ticking' rather than protecting member benefits.
- Schemes need to be thinking about the future, but attempting to get a headstart on complying with the code at this stage could amount to wasted time.

Duncan Ferris sounds out where the pensions industry stands with TPR's proposals for its DB funding code and which issues to look out for in the regulator's second consultation

We are currently in the defined benefit (DB) funding code waiting room, sitting around while The Pensions Regulator (TPR) work on their preliminary code equivalent of a 'difficult second album'. The industry enjoyed quite a few of the tracks on the first release, but some facets of the decision to split DB funding compliance into fast track and bespoke routes have raised concerns. The proposal would mean that some schemes would qualify for a standardised approach or 'fast track', while those on the bespoke route would be assessed on a case-by-case basis. Those who opt for the latter would have to justify this choice.

With the interim response to the first consultation released in January, TPR has confirmed that a second consultation will take place in the second half of 2021. But will it be music to our ears?

Concerns

In its interim response to the feedback, TPR said it had received "general support" but noted that some concerns had been raised about the proposed twin track routes.

ACA Pension Schemes Committee chair, Peter Williams, says: "On the first consultation, we were generally supportive of the proposals, whilst noting that many of the key details had not yet been defined – and those details are likely to make a difference to the success of the new regime. The second consultation, now expected in the second half of this year, should provide the extra details.

"We were concerned that there could be too much pressure for fast track equivalence, even under the bespoke approach, with the risk that TPR might use its powers if the divergence from fast track was deemed too significant."

Similarly, XPS Pensions consulting actuary, Heidi Webster, also states she is "supportive of the principles proposed to regulate the expected changes to government rules on long-term funding strategy", but raised concerns about "the focus on fast track as a 'yardstick' against which a bespoke submission would be tested".

She explains: "Whilst there will be merits of this in some circumstances (for example those schemes who are relatively close to a fast track position, but who perhaps do not meet one of the criteria), this may not be appropriate in all cases.

"For example, trustees of a scheme with a robust cashflow-driven investment funding strategy would be required to test this against a set of criteria that may not reflect their funding strategy. If trustees are expected to carry out the analysis relative to fast track, this could result in additional (perhaps unnecessary) costs."

Additionally, Society of Pension Professionals president, James Riley, says he had been concerned by the watering down of covenant, which is "an integral part of scheme funding and we want that to be retained" and called for "some allowance for covenant over the long term".

TPR acknowledged these issues and more in its interim response to the consultation, but stated that some of the concerns raised "stemmed from misunderstandings around what we had proposed" and added that this confusion would be cleared up during the second consultation.

Flexibility

Perhaps the most notable concern raised by the industry was a perceived lack of flexibility afforded by the proposed fast track route, something that is available under the current regime. This is made even more problematic through the already mentioned concerns that the bespoke route would be 'benchmarked' against the fast track.

Williams explains: "Maintaining the current scheme specific funding flexibility is vital to support the sustainable economic growth of employers. It is important that fast track is not seen as the default option and that the bespoke approach to demonstrating compliance offers a genuine and viable alternative, without being overly onerous.

"This is even more important now, as the economy recovers from the impact of Covid-19."

Looking at the broader picture, Lincoln Pensions director, Emily Goodridge, says: "A more regimented approach risks shifting the focus from protecting member outcomes to 'box-ticking'. The bespoke track still offers flexibility but the increased costs of explaining a non-standard approach may mean smaller schemes ultimately have less flexibility than the larger schemes."

Riley states that the need for flexibility goes beyond the simple issue of scheme size, noting that otherwise identical schemes might have different priorities based on factors such as their sponsors and their investment strategies.

Outlining the investment ramifications of the loss in flexibility, he comments: "There is a risk that some of the investment parts of the code push people to invest in particular ways that are not optimal in terms of an economic perspective, but are optimal in terms of the regulatory perspective.

"You've seen this with Solvency II in insurance, where insurers all invest in a certain way because the regime requires them to. Now actually, there are lots of assets out there that might be attractive to insurers but they simply can't invest in them because of Solvency II. What you don't want is to push pension schemes into investing in a particular way to meet the requirements rather than how they think is right."

The key issue here is that schemes face unique issues, so using the same parameters for large portions of the landscape could undermine the individuality of each different scheme and the circumstances which they face.

Again, TPR appeared to touch upon this issue in its interim response, showing consideration for the difficulty of individual situations in its recognition of "the significant impact that Covid-19 has had on employers and schemes during 2020 and beyond", adding that it would "certainly take account of the impact of Covid-19 when we carry out our impact assessment and develop fast track guidelines for consultation".

Preparation

While there are still concerns about the content of the funding code, is it worth pension schemes taking action now to get ahead of the game when it comes to complying with a new funding code?

Webster says: "Whilst the new funding requirements are not yet in force, we know that it may be advantageous to start setting longer-term goals and the journey plan early, particularly as TPR has suggested there may a fixed timeframe for schemes to get to their target. Starting to plan early means trustees and sponsors may have more flexibility and choice."

Williams agrees: "It is sensible for trustees to consider the long-term objectives for their scheme. Under fast track we agree that aiming for low dependency once the scheme is significantly mature is reasonable."

Goodridge comments: "A legally binding long-term objective sends a clear message that 'kicking the can down the road' cannot continue indefinitely, and that additional sponsor support may be required if risks in a strategy crystallise."

However, this issue of it being legally binding is of vital importance for any trustees or sponsors looking to jump the gun, as it is worth noting that this is not a 'fastest finger first' situation.

Consequently, Riley is less than enthusiastic about rushing to prepare before the reveal of the final version of the code. He first notes that it "makes sense" for "the vast majority of schemes" to be looking at their long-term targets, but emphasises that doing this for regulatory reasons might be unwise because "we don't really know what is expected of us".

He adds: "There runs a risk that you go down a route of selecting your long-term objectives and when you read the new code of practice you might need to revisit it. Yes, people should be doing it, but I would be a little bit nervous about anyone documenting anything too formally until I had actually seen the code of practice."

Written by Duncan Ferris