The Pensions Regulator is consulting on a proposed new regulatory approach to funding for defined benefit (DB) pension schemes. This represents the most fundamental shift in the scheme funding regime since it was introduced in 2005.

For sponsoring employers and trustees of DB schemes keen to understand the impact on the future funding of their scheme, this is compulsory reading. But the true impact won’t become clear until the Regulator consults on the draft DB funding code of practice itself later in the year.

**A new regulatory approach: fast track and bespoke**

The Regulator is proposing that trustees should choose either a “fast track” or a “bespoke” approach to completing and submitting their scheme valuation:

> **Fast track**: The Regulator plans to set straightforward quantitative compliance guidelines, covering key aspects of funding and investment arrangements. These will include the funding target and timing to reach this; technical provisions (including discount rates and possibly other assumptions); recovery plan length and structure; investment risk; and future service contribution rates (where relevant).

The plan is that these parameters will be regularly reviewed and updated. If trustees can demonstrate their valuation meets the guidelines, trustees will be able to follow the fast track approach and can expect minimal regulatory involvement.

> **Bespoke**: Trustees who cannot (or choose not to) follow the fast track guidelines will need to explain how and why they have differed from the fast track guidelines and how any additional risk is being managed. They will need to submit more supporting evidence and may receive greater regulatory scrutiny. But the Regulator has stressed that a bespoke approach is not a “bad” or second-best option and is equally compliant with the legislation.

Trustees won’t be expected to maintain a previous approach (i.e. fast track or bespoke) at a future valuation.

**Overarching principles**

The Regulator is also consulting on a number of overarching principles that it believes should apply to all valuations, regardless of whether schemes choose the fast track or bespoke approach. These include:
Compliance and evidence

• The Regulator expects trustees and employers to understand their scheme-specific funding and investment risks, and either explain how and why they have assessed these risks as remote or minimal or how they propose properly to manage them.

• When demonstrating how risks are managed, trustees should compare the risks they have taken to a tolerated risk position and then demonstrate the mitigation or support available.

Long-term objective

• By the time they are significantly mature, the Regulator expects schemes to have a low level of dependency on the employer and be invested with high resilience to risk. The Regulator thinks that “significant maturity” will be 15 to 20 years from now for a scheme of average maturity and has suggested a low dependency discount rate in the range of gilts +0.5% pa to gilts +0.25% pa for schemes following the fast track approach.

Journey plans and technical provisions

• The Regulator expects trustees to develop a journey plan to achieve their long-term objective (LTO).

• Trustees should plan for investment risk to decrease as their scheme matures and reaches low dependency.

• Technical provisions should have a clear and explicit link to the LTO and, over time, should converge to the LTO as evidenced by the journey plan.

Scheme investments

• The actual investment strategy and asset allocation should be broadly aligned with the scheme’s technical provisions and recovery plan.

• Trustees must ensure their investment strategy has sufficient security and quality, and can satisfy liquidity requirements based on expected cash flows, as well as making a reasonable allowance for unexpected cash flows.

• The Regulator expects the asset allocation at significant maturity (see above) to have high resilience to risk, a high level of liquidity and a high average credit quality.

Reliance on the employer covenant

• Schemes with stronger employer covenants can take more risk and assume higher returns.

• However, trustees should assume a reducing level of reliance on the covenant over time, depending on its visibility. The Regulator thinks covenant visibility doesn’t typically extend beyond the short to medium term (three to five years).
### Reliance on additional support

- Schemes can account for additional support when carrying out their valuations provided that it:
  - provides sufficient support for the risks being run;
  - is appropriately valued; and
  - is legally enforceable and will be realisable at its necessary value when required.

### Appropriate recovery plan

- Deficits should be recovered as soon as affordability allows, while minimising any adverse impact on the sustainable growth of the employer.

- Schemes should be treated fairly compared with other stakeholders, particularly where payments to other stakeholders represent “value leakage”, such as dividends, intercompany loans that are unlikely to be repaid or material management bonuses.

### Open schemes

- Members’ accrued benefits in open schemes should have the same level of security as members’ accrued benefits in closed schemes.

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**What happens next?**

The consultation closes on 2 June 2020. Later in the year, the Regulator plans to run a second consultation on the draft DB funding code of practice. The new code is expected to come into force at the end of 2021.

For more information, please speak to your usual Linklaters contact.