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TPR's draft Funding Code – What are the key takeaways and can you be doing anything?

Consistent with the draft regulations published by DWP, TPR is putting covenant at the heart of setting the level of supportable risk in a journey plan, and the period over which that risk can be taken. While certain points of detail may change, the broad principles are expected to remain consistent. As with all material regulatory changes, we would recommend reaching out to advisers to understand the key details. Trustee training sessions can be an excellent tool to bring everyone up to speed together.

For now, what are the key takeaways and what could you be doing?

1. Covenant is at the heart of journey planning
The Draft Funding Code sets out a funding regime broadly split into two important stages – long-term planning and triennial valuations.

As a starting point, trustees are expected to satisfy themselves that the risks inherent in a journey plan are supportable by the strength of the employer covenant, by considering both the likelihood and impact of covenant risks crystallising, as well as the ability and time period over which the employer could repair any resulting deficit.

Action: Further covenant guidance will be coming in 2023 but we encourage trustees to start thinking about covenant as the underpin for scheme risks over a journey plan, rather than just a point-in-time rating.

2. Low Dependency is not the same as "no dependency"
Low Dependency investment and funding principles are defined by the Draft Funding Code such that a need to call on a sponsor for contributions is unlikely, but there remains scope for risk. Employer covenant remains the ultimate underpin for scheme risks and, while a solvent employer is needed to ensure members receive their benefits in full, there is a degree of covenant reliance.

Action: Trustees should consider plausible downside scenarios that may lead to members suffering a shortfall, and continue to think beyond the Low Dependency basis to their end-game.

3. Covenant assessment is still required even if a scheme is Fast Track compliant
Covenant has been excluded as a Fast Track metric for practical reasons, including the fact that covenant ratings are relatively subjective and analysis by TPR suggests a current lack of correlation between covenant ratings and valuation assumptions.

TPR has been clear that Fast Track is not a legislative tool, nor does it represent the "gold standard"; it is a means to proportionately filter valuations on a risk basis. All trustees are expected to evaluate covenant in accordance with the Draft Regulations and Funding Code, regardless of whether they meet Fast Track requirements, to ensure scheme risks are supportable.

Action: Trustees should continue to consider their specific circumstances when undertaking valuations, particularly in light of the legislative requirement to set out these considerations within the Statement of Strategy.

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Datawatch: Gilt yields

The September 2022 'mini budget' was the catalyst for a volatile period for gilt yields, causing havoc for pension schemes with LDI portfolios as they worked hard to post collateral to support hedging positions. With gilt yields remaining at 10-year highs, the funding position of many schemes has materially improved, which might mean schemes are closer to reaching their desired "end-game" than was previously projected. In the context of recent events, we would recommend that trustees discuss their position relative to their journey plan, including the pros and cons of end-game options, and consider taking action if needed.

There were winners and losers in the recent gilt crisis, with some schemes questioning the resilience of their LDI mandates. Now may be a suitable juncture to consider a 'Cardano LDI Healthcheck'. To find out more, please contact **Sinead Leahy,** Managing Director leading Cardano's strategic investment advisory offering. E: S.Leahy@cardano.com

Ask the Analyst: How should covenant be linked to investment strategy?

The covenant of a scheme should be central to its investment strategy as it drives the maximum level of supportable risk that could be taken. Understanding sponsor affordability will often be key to assessing the covenant; with a strong sponsor, for example, more able to cover underperforming investments with funding support, if needed.

Schemes may also decide to run a higher-risk investment strategy for other reasons such as the immaturity of the scheme, the desire to reach an end-game position quicker or the influence of a sponsor in investment decision-making. However, should this investment risk crystallise, it will ultimately be the covenant that has to stand behind this increased deficit, which might require significant funding from the sponsor.

Monitoring the covenant and understanding key risks remains vital, particularly in the context of the draft Funding Code and for schemes that are running a higher risk investment strategy.

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Regulatory developments: Solvency II insurance regulatory reform

In a recent speech made to the Association of British Insurers, the head of the Prudential Regulation Authority (PRA) signposted to some key next steps in the Government's reform of Solvency II, specifically that:

1. The Government's proposed reforms to Solvency II would be part of the Financial Services and Markets bill being discussed in Parliament. Subject to Parliamentary approval, the changes will be implemented into legislation

2. A number of other changes (increased Matching Adjustment asset eligibility and the streamlining of rules for insurers' internal models for capital requirement calculations) will go through industry consultation later this year

Previously, the PRA and Bank of England warned that the proposed overhaul of Solvency II, as a whole, increases risks to policyholders, as it would allow insurers to hold less capital. This, along with heightened macroeconomic and capital market volatility, and continued developments within the UK insurance regulatory landscape, mean that insurer counterparty risk is on the rise.

Insurer counterparty risk is a key consideration that trustees should continue to explore in their insurer selection process during buy-in and buy-out transactions.

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