The DB Funding Code Handbook

2024

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Introduction: What is the DB Funding Code?

The Defined Benefit (DB) Funding Code is intended to provide practical guidance for trustees on how to comply with legislation in relation to scheme funding, including the recently updated Funding and Investment Strategy Regulations 2024. It applies to scheme valuations with an effective date on or after 22 September 2024.

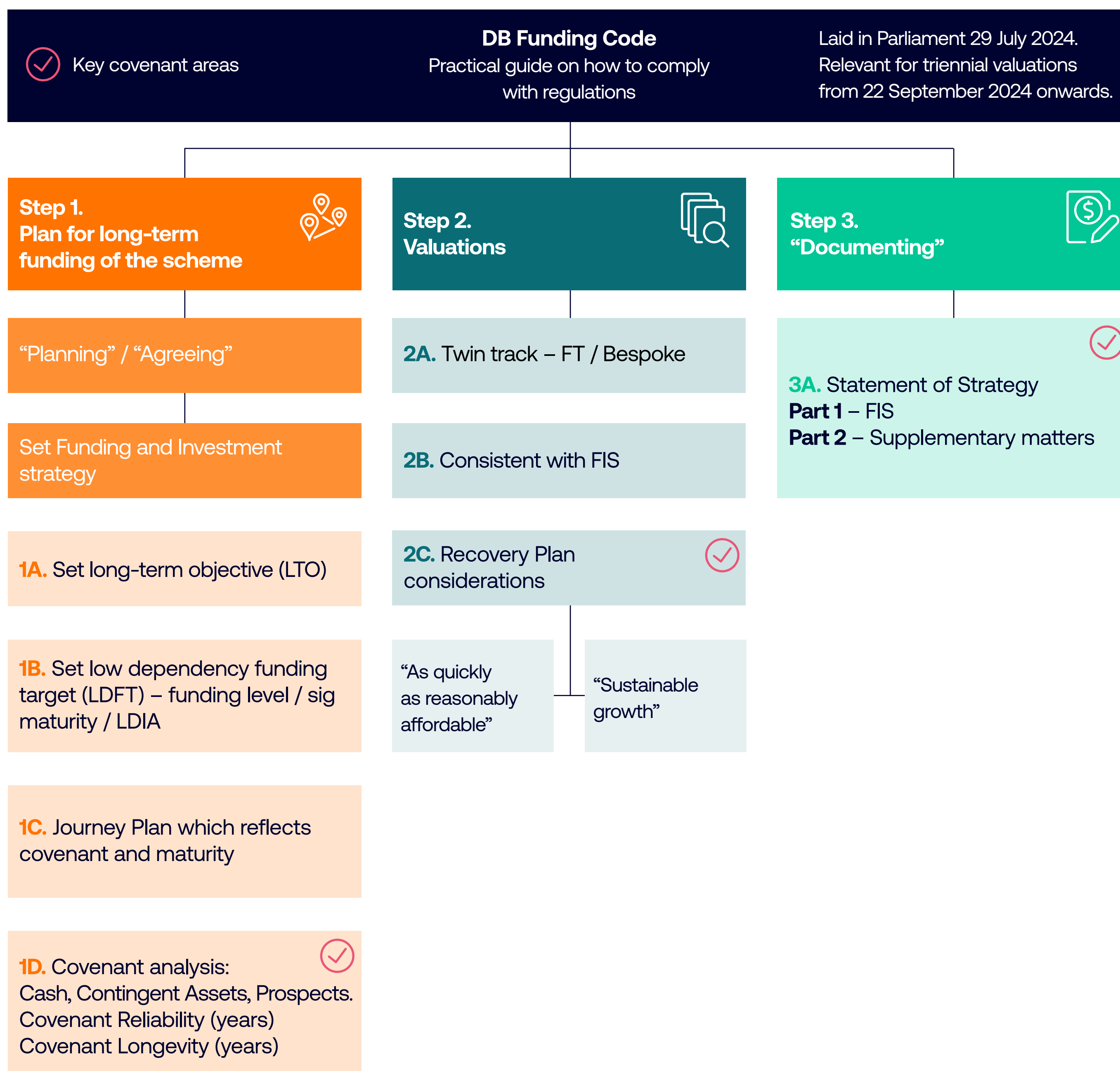
The Code will be supplemented by further detailed guidance, for example Covenant Guidance.

It is important to understand that the Code places increased focus on long-term planning and managing risk over the entirety of a scheme's journey, regardless of the valuation track that is chosen (Fast Track or Bespoke).

From a covenant perspective, this includes proportionate analysis as a crucial input into that risk profile, as is reflected in the new legal requirement to consider covenant within the Regulations.

Throughout a scheme's journey, it will be important to be clear on the distinction between 'box-ticking' and 'best practice', particularly when commissioning external covenant advice, to ensure the security of members' benefits remains at the heart of decision making.

In this guide, we have laid out the key steps for trustees as they navigate the requirements of the new Code, following the summary flow chart set out below.



Step 1: Planning and agreeing the long-term funding and investment strategy of the scheme

For the purposes of setting their funding and investment strategy, trustees must determine:

a) how they intend the scheme to provide benefits over the long-term (their long-term objective)

b) the low dependency funding target, which will include the funding level they intend the scheme to have reached on a low dependency funding basis at a particular date (known as the relevant date)

c) the investment strategy that would notionally support the funding target at the relevant date; and

d) the funding journey plan from the current funding position to the low dependency target, where the relevant date is in the future.

Importantly, trustees must obtain the employer's agreement to the funding and investment strategy, unless the trustees have specific powers to determine the rates of contributions without the employer's agreement.

As is clear within the Regulations, covenant is a fundamental input into this process.

AI summary

Trustees of defined benefit pension schemes must establish a long-term objective, set a low dependency funding target, plan the investments to hold at a specific future date, and create a funding journey plan, all while obtaining the employer's agreement unless they have the authority to decide contribution rates independently. The covenant is a crucial factor in this process.

1A Long Term Objective or "LTO"

Trustees are required to plan for the long-term funding of schemes, with a funding and investment strategy on how benefits are intended to be provided to scheme members over the long term – the long-term objective (LTO).

Benefits can be provided by schemes in a number of ways, depending on the circumstances of the scheme, including:

a) running off the scheme as it matures, paying the benefits from the scheme as they fall due;

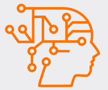
b) buying out members' benefits with an insurer; or

c) transferring the scheme assets and liabilities to a defined benefit (DB) superfund or another consolidation vehicle.

The way trustees intend to provide benefits over the long-term should be taken into account when considering the other elements of the funding and investment strategy. For example, if the strategy is to buy out benefits, the trustees may adopt a higher low dependency funding target at the relevant date.

However, it is recognised that there may be scenarios where the long-term objective does not align with the low dependency target set out in the funding and investment strategy.

This may be different for schemes that are open to new entrants and future accrual, for example, who may have no intention of ever closing the scheme to new entrants or future accrual. In these situations, trustees need to consider how they would provide accrued benefits for existing members over the long-term if the circumstances of the scheme were to change in the future, and comply with the legislative requirement to set the scheme's low dependency target. In practice, at each valuation, that notional date that a scheme will reach that low dependency target will keep being pushed back if the scheme remains open.



AI summary

Trustees must develop a long-term funding and investment strategy to provide benefits to scheme members, considering various methods such as running off the scheme, buying out benefits, or transferring to a DB superfund.

1B Low dependency funding target or "LDFT"

The funding and investment strategy must plan for schemes to reach full funding on a low dependency funding basis by the relevant date – this is no later than the end of scheme year in which a scheme is expected to become significantly mature.

Beyond this point, trustees should set an objective that a scheme's assets are invested in accordance with a low dependency investment allocation – which reflects a level of risk that means "it would be expected that no further contributions would be required".

Importantly, trustees have a legal duty to choose investments that are in the best financial interests of scheme members and, in a deviation from the original drafting of the Regulations, are not *required* to invest in line with the low dependency investment allocation on and after the relevant date.

It is possible and maybe likely that the scheme's actual investment allocation will often be the same or similar to the scheme's low dependency investment allocation, as significantly mature schemes have less capacity to make good negative investment outcomes. However, this will not always be the case.

There may be good reasons not to do so, for example if an employer refuses to agree to a strengthening of the low dependency investment allocation that the trustees consider appropriate being recorded in the funding and investment strategy, or where a scheme has a material surplus after the relevant date.

Trustees must ensure that assets invested on and after the relevant date are sufficiently liquid, for example to meet expected cash flow requirements, with a reasonable allowance for unexpected cash flow requirements also.

It's worth noting that the Regulations require trustees to target low dependency on the employer, not no dependency. Even schemes that are fully funded on a low dependency funding basis at and after the relevant date remain exposed to covenant risk if funding levels deteriorate or if there were to be an unexpected employer insolvency event.

AI summary

Trustees must plan for defined benefit pension schemes reach full funding on a low dependency basis by the time the scheme becomes significantly mature, and invest assets in a way that minimizes the need for further contributions. They must also choose investments in the best financial interests of members, maintain sufficient liquidity, and manage covenant risk, even after achieving low dependency funding.

1C Journey plan

In the funding and investment strategy, trustees must plan how they intend the scheme to reach its low dependency funding target from the current funding position. This is referred to as the funding journey plan. This effectively connects the "dots", represented by the current position, the LDFT and the LTO, as agreed with the employer; and it encompasses the evolution of the actuarial assumptions used to calculate the scheme's liabilities as it progresses towards the relevant date.

When determining a scheme's journey plan to – and beyond – low dependency, trustees must ensure the level of funding and investment risk is dependent on both the employer covenant and the maturity of the scheme.

When considering the level of risk that is appropriate for the journey plan, trustees should consider separately the following two periods of time:

a) the period over which trustees can be reasonably certain of the employer's cash flow to fund the scheme (known as the reliability period).

b) the period from the end of the reliability period and up to the relevant date (known as the post-reliability period).[1]

TPR expects trustees to make an assessment of whether the scheme has access to sufficient employer cashflows and contingent asset support over the reliability period to recover both the existing deficit (if any) and any further deficit that could arise from a scheme-related stress event during this period.

After the reliability period, trustees will need to consider what level of risk is appropriate, and the timing and pace at which the scheme should transition to low dependency by the relevant date. To do this, they should consider the following factors:

a) The extent to which the employer will be able to continue to support the scheme in the future.

b) The level of risk being taken during the reliability period.

c) The extent to which the scheme can rely on contingent asset support in the post-reliability period.

d) How close the scheme is to the relevant date.

AI summary

Trustees must create a funding journey plan to reach the scheme's low dependency funding target, considering the employer covenant and scheme maturity. They should assess funding and investment risks over two periods: the reliability period, where employer cash flow is certain, and the post-reliability period, ensuring sufficient support and appropriate risk levels as the scheme transitions to low dependency.

1 The Covenant Longevity period (defined as "the period over which the trustees can be reasonably certain that the employer will be able to continue to support the scheme along its journey plan") will likely incorporate the Covenant Reliability period and some/all of the post-reliability period.

1D

Funding Code – Key covenant elements

The key covenant elements referenced in the Code are set out within this section, with more detail to be provided within TPR's Covenant Guidance. All covenant analysis should be proportionate to the specific circumstances of the scheme and relevant employer(s). For more guidance on approach, it may be worth consulting with your independent covenant adviser.

Cash

An assessment of the employer's current and future cash flow will help trustees to determine:

- The level of cash that could be paid to the scheme to remedy a deficit from a downside scenario (i.e. what level of risk is supportable by the employer covenant) – "maximum affordability"
- What deficit repair contributions are "reasonably affordable"

This should primarily be based on management forecast cash flow information and should consider free cash flow generated by the employer after taking account of reasonable operational and committed finance costs, but before deficit repair contributions and other uses of free cash.

Other uses of free cash might include investment in the sustainable growth of the employer, discretionary creditor payments and other forms of covenant leakage.

Trustees and their advisers should be mindful of the employer's position in its wider group, its interactions with other group companies (for example through transfer pricing, intragroup trading and/or intragroup financing) and the impact this may have on cash flows.

It's also important to consider the appropriateness of management assumptions underpinning the employer's cash flow forecasts (relative to the risks and opportunities identified when assessing the employer's market and overall prospects, as discussed below) and the sensitivity of these assumptions to future events, making appropriate adjustments where necessary.

Where cash flow information is not produced for the employer (or it is not proportionate to produce for covenant assessment purposes), it may be possible to find a suitable proxy (for example, earnings before interest, tax, depreciation and amortisation (EBITDA), profit before tax or consolidated cash flow), adjusted as necessary to best reflect the employer's cash flow position.

Contingent assets

Contingent assets are not defined in the Regulations or the Code, but the following are set out as common examples:

a) charges over cash, real estate and securities

b) letters of credit and bank guarantees

c) guarantees from related and third parties, such as parent and group companies

d) contingent funding mechanisms from related and third parties, such as parent and group companies

The Code makes clear that a contingent asset contributes to covenant support only to the extent that it is reasonably expected to be both legally enforceable and sufficient to provide the specified level of support when required Trustees should consider the scenarios in which any contingent assets provided to the scheme could be called upon and determine an appropriate method to assess the realisable value of the contingent asset.

The method by which a contingent asset is valued will primarily be driven by the type of asset; trustees must determine the most appropriate valuation methodology with consideration of the scenario and timing in which any asset value is likely be realised.

A contingent asset's legal enforceability is determined by the terms and conditions of the relevant agreement and the applicable law. Trustees should be satisfied that they have sufficient legal advice in relation to the enforceability of proposed contingent assets for both the UK jurisdiction and any relevant overseas jurisdictions. They should then consider whether, on balance, taking into account any qualifications in the legal advice, if this supports taking additional risk.

It is TPR's view that "asset backed contributions (ABCs) should not be used to take additional funding or investment risk, on the basis that they enable a scheme to increase its asset position and therefore reduce or eliminate the scheme's technical provisions (TPs) deficit".

To understand whether a contingent asset will provide a particular level of support when required, trustees should identify the following:

a) The scenario in which the contingent asset is likely (or able) to be called upon (for example in the event of insolvency of the employer).

b) An appropriate method to assess the expected realisable value of the contingent asset. This will primarily be driven by the type of contingent asset, such as whether it's a security arrangement (for example security over an asset, cash in escrow, letter of credit) or a group or parental guarantee.

More detail will be provided in the covenant guidance to be released later this year, but the Code does provide some more detail regarding the valuing of security arrangements, guarantees and contingent funding frameworks:

Security arrangements:
Some assets have clear, demonstrable, readily recoverable value (for example, cash in escrow), allowing trustees to recognise this value in full, subject to any limitations in the scheme's legal access.

Other assets have less certain value. For example, the value that would be returned to the scheme from security over a tangible asset such as a building or machinery will depend on the market value for that asset and its condition at the time it is called upon. Trustees must determine the most appropriate valuation methodology, considering the scenario and the timing in which any asset value is likely to be realised (for example insolvency). They must also consider how the relevant market is likely to develop for that asset in the future.

Where the contingent asset is provided by the employer (rather than a third-party), trustees must be mindful of the impact enforcing the security may have on the employer's continued performance and financial ability to support the scheme. Where enforcement will have a material negative impact on the employer's financial ability to support the scheme, trustees must also factor that cost into its valuation.

Trustees should reassess the value of a security arrangement at each valuation as a minimum.

Guarantees:
Some guarantees are structured in such a way that they largely replicate the obligations placed on a statutory employer. This includes providing a formal look through to the guarantor for affordability purposes. These guarantees provide an ability for trustees to claim against the guarantor in respect of all monies owed by the employer to the scheme without restrictions or qualifications once a trigger event has taken place. They cannot be revoked without trustee agreement. These are referred to as 'look through' guarantees.

Where trustees benefit from a look through guarantee, when assessing the employer covenant, they should assess the guarantor's financial ability to support the scheme as if it was a statutory employer.

However, if a guarantee doesn't meet the criteria of a look through guarantee, trustees should determine the level of support a guarantee can provide by considering the following factors:

a) The guaranteed amount (including whether the amount is capped and, where the amount is calculated by reference to the scheme's funding position on a particular basis, how that funding position may develop over time).

b) The duration of the guarantee and any termination clauses.

c) The circumstances in which a claim can be made under the guarantee (or, where the guarantee provides for a variety of triggers, the most likely scenario in which the guarantee would be called upon).

d) The guarantor's financial ability to provide that support at the time it may be required.

Generally, the level of reliance trustees can place on a guarantee that can only be triggered by an unexpected future event, such as employer insolvency, will reduce the more unlikely the event is, unless trustees can demonstrate with reasonable certainty what value would flow to the scheme

Contingent funding mechanism:
A related or third-party contingent funding mechanism comprises a legally binding arrangement where a related party, such as a parent or group company or third party will commit to make a payment into the scheme under certain pre-defined triggers. This might be, for example, where the scheme's funding position falls below a set threshold.

When determining the level of support a related or third-party contingent funding mechanism can provide, trustees should consider the following factors:

a) the quantum of the agreed payments

b) the circumstances in which the scheme will have access to these payments (for example, a trigger event to provide access to value in advance of an employer insolvency)

c) the likelihood of the additional payments being triggered

d) the third-party's financial ability to make the payments when required

Whilst a legally binding contingent funding mechanism from a sponsor can be valuable, Trustees should ensure that they do not double count the support provided by a contingent funding mechanism, particularly where the arrangement is with the employer or another party (such as a look through guarantor) whose cash position is already factored into the trustees' covenant assessment or supporting the value of another contingent asset.

Prospects

Trustees should use an assessment of employer prospects to determine the extent and duration of reliance that can be placed on the employer to continue providing scheme support, and highlight the potential risks to that support. Trustees should consider the following matters when assessing prospects:

- Market outlook
- Market position
- Strategic importance within the group
- Diversity of operations
- ESG factors
- Employer and group resilience
- Insolvency risk
- Other relevant macroeconomic and geopolitical factors

Covenant reliability

When assessing the cash flows, contingent assets, and prospects of an employer, trustees must determine the period over which they can be reasonably certain that they can rely on an assessment of the employer's cash flows and prospects, and in doing so determine the period over which they have reasonable certainty over the employer's cash flow to fund the scheme (the reliability period).

The Pensions Regulator (TPR) expect most employers to have only short-term reliability periods (three to six years), with trustees expected to take a proportionate approach to assessing the reliability period based on the recovery plan length and level of funding and investment risk relative to the level of covenant support.

Covenant longevity

Beyond that, trustees must determine the period over which they can be reasonably certain that the employer will be able to continue to support the scheme along its journey plan to low dependency and beyond (the longevity period).

TPR expect most employers to have covenant longevity periods not exceeding ten years, with trustees expected to take a proportionate approach to assessing the longevity period, particularly when this period is expected to exceed the relevant date.

Multi-employer schemes

Schemes frequently have more than one employer. While the Regulations don't make any special provision for multi-employer schemes, it is recognised that it may be unnecessary for many multi-employer schemes to carry out a full assessment for each employer to comply with the legislation.

Trustees must consider the extent to which it is appropriate to analyse the financial ability of every employer to support the scheme and how to reach an overall view on the covenant provided by the pool of employers as a whole.

Where trustees determine it is not proportionate to review all employers, they should consider if alternative approaches are appropriate. For example, this could include pooling employers into sub-groups with varying levels of review for each.

In considering which employers to assess in detail and the weight to be given to each, trustees should consider the following factors:

a) The number of members of the scheme attributable to each employer, and an estimate of the size of each employer's liability to the scheme.

b) Whether the scheme is classed as an associated multi-employer scheme or non-associated multi-employer scheme.

c) The position of the scheme in the event of an insolvency or withdrawal of an employer, for example whether the scheme has segregation provisions or 'last man standing' arrangements.

d) The trustees' powers under the trust deed and rules to impose contributions.

e) The likelihood of employer withdrawal and its impact and the treatment of any orphan liabilities.

f) Any restrictions that might apply under the trust deed and rules to the allocation or payment of contributions due to the scheme, for example where member contribution rates constrain the level of overall contributions to the scheme.

Not for profit schemes

Not-for-profit organisations are entities that engage in non-commercial activities and rely on donations or subscriptions for funding. If they have significant commercial operations, these should be assessed using general principles, while non-commercial operations should follow specific modifications.

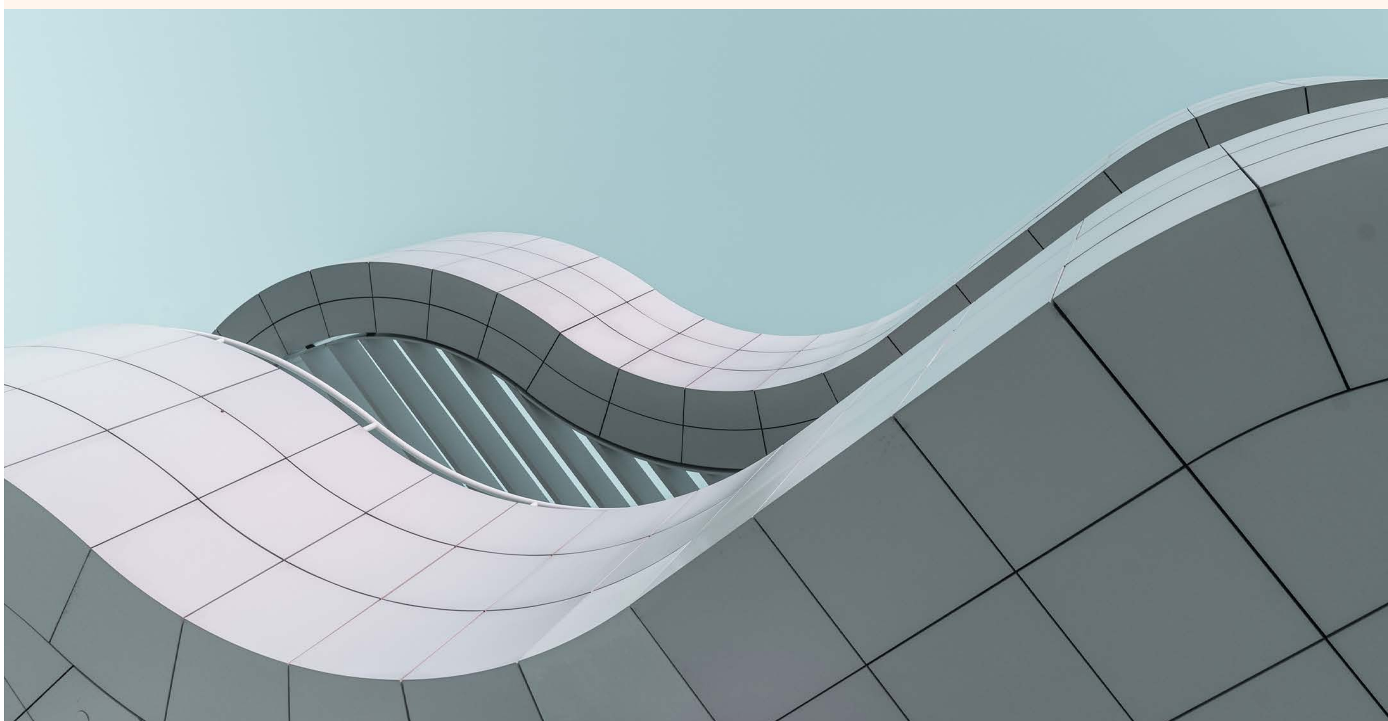
When assessing cash flow, additional considerations should include:

- Volatility and Risk: Cash flow from donations can be volatile and subject to reputational risk.
- Restricted Funds: Trustees need to identify any restrictions on the use of funds and determine if these can be used for contributions to the scheme. Restricted funds that cannot be used should be excluded from financial assessments.

When assessing prospects, additional considerations should include:

- **Reputation and Public Profile:** The impact of the employer's reputation on future donations.
- **Governance Quality:** Efficiency, management of reputational risks, and contingency plans for income shocks.
- **Competition:** The level of competition for income from other organisations.
- **Service Demand:** The demand for services offered, influenced by government policy and social factors.
- **Macroeconomic Environment:** Overall economic conditions affecting the organisation.

When assessing contingent assets, trustees should evaluate if there are any restrictions on contingent assets that could prevent them from realising value from these assets.



Step 2: Triennial valuations

2A Twin track (Fast track vs Bespoke)

TPR are adopting a twin track approach to assessing DB scheme valuations. There will be two valuation submission routes, Bespoke and Fast Track.

TPR consider both Bespoke and Fast Track to be equally valid. Following either of these approaches does not automatically equate to compliance, and in both cases, the legislative and code principles will need to be followed – as set out in the long-term section above.

Where the Code sets out expectations for compliance with the legislation, Fast Track provides more direction and clarity on the level of risk that TPR will tolerate.

As a result, the Fast Track approach will act as a filter for TPR's assessment of actuarial valuations that are submitted. If a valuation submission meets a series of Fast Track parameters, the Regulator is unlikely to scrutinise it further and it is less likely that they will engage with trustees on that valuation.

The Fast Track parameters cover the following:

- the low dependency funding basis
- TPs
- funding and investment risk
- recovery plans

Fast Track parameters do not include a filter for covenant – which makes it all the more important to have considered covenant separately (ideally as part of the long-term planning stage).

Alternatively, the Bespoke approach allows trustees to have the flexibility to select scheme-specific funding solutions if the funding approach and actuarial valuation meet legislative requirements and follow the Code principles.

AI summary

The Pensions Regulator (TPR) has introduced two routes for assessing defined benefit scheme valuations: Bespoke and Fast Track. Fast Track provides clear guidelines and less regulatory scrutiny if parameters are met, while Bespoke offers flexibility for scheme-specific solutions, with both requiring adherence to legislative and code principles.

2B Consistent with the funding and investment strategy

As is the case currently, at each valuation a scheme's technical provisions ("TPs") must be determined. The assumptions for the TPs are determined by the trustees but must be consistent with the scheme's funding and investment strategy.

2C Recovery plans

When setting a scheme recovery plan, trustees should assess an employer's reasonable affordability with consideration of the employer's need to invest for sustainable growth.

Trustees should assess an employer's reasonable affordability when setting a recovery plan, with reasonable affordability determined by an employer's cash flows and liquid assets, the reliability of the employer's cash flows, and whether any available cash has a reasonable alternative use, such as investment in employer growth, discretionary creditor payments, or other forms of covenant leakage.

Trustees should set recovery plans with consideration of the reliability period, and plan to achieve a fully funded position on a technical provisions basis by the end of the reliability period; while recovery plans can extend beyond the reliability period, this presents an increased risk that the employer may not have sufficient available cash to meet the funding needs of the scheme.

In general, investment in the employer's sustainable growth may be a reasonable use of available cash where the trustees are confident of the resulting benefit to the scheme and employer – even if this results in the recovery plan exceeding the reliability period.

However, covenant leakage and discretionary payments are unlikely to be reasonable alternatives used of available cash if that would result in deficit repair contributions being required outside the reliability period (unless a suitable contingent asset is provided).

AI summary

Trustees must assess an employer's reasonable affordability, considering cash flows, liquid assets, and the need for sustainable growth when setting a scheme recovery plan. They should aim for a fully funded position by the end of the reliability period, while recognising that extending beyond this period increases risk, and avoid covenant leakage and discretionary payments unless supported by a suitable contingent asset.

Step 3: Documenting the funding and investment strategy

3A Statement of Strategy

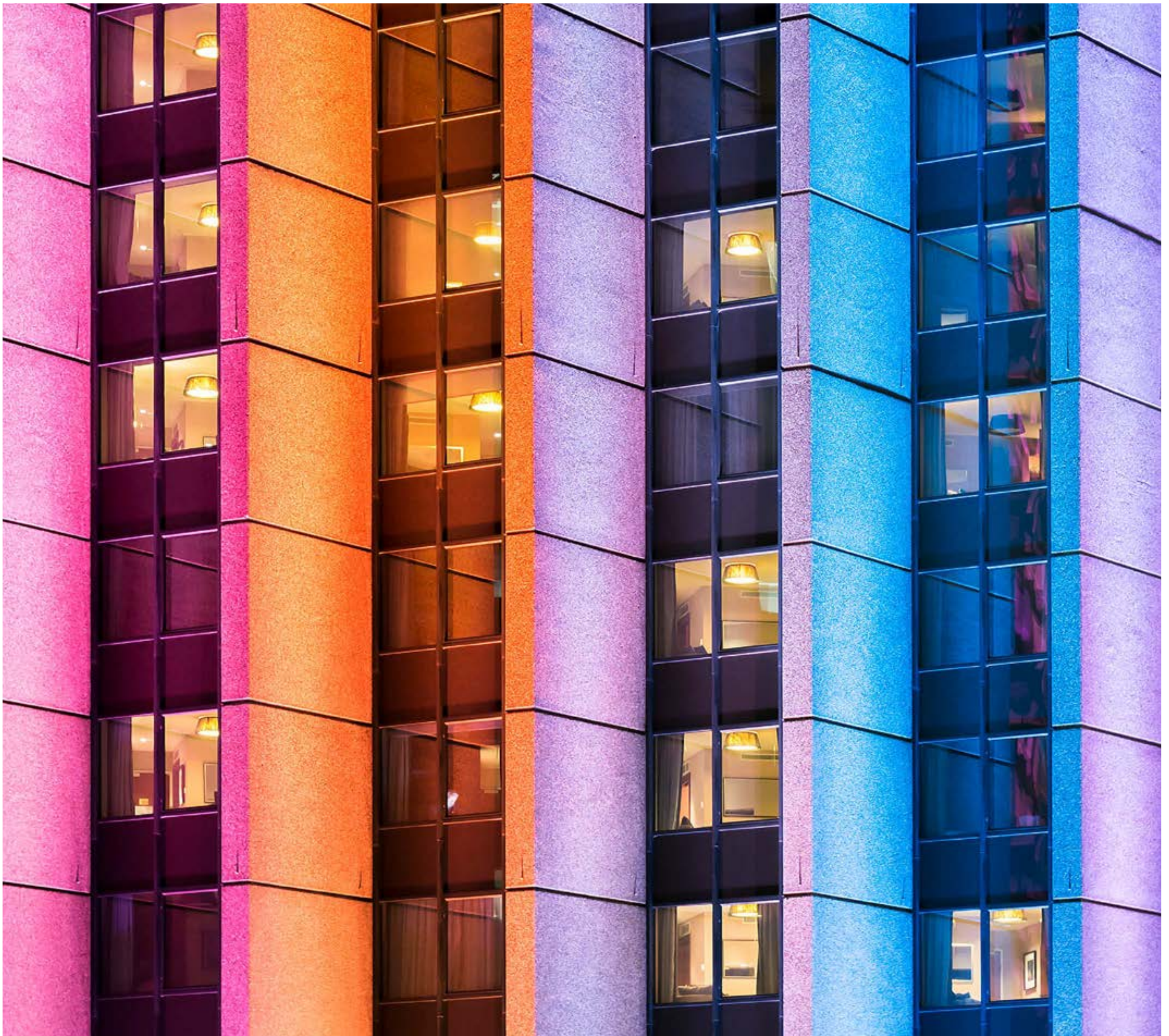
To comply with the new funding and investment strategy requirements, trustees must prepare and submit a written statement of strategy.

Part 1 will set out the funding and investment strategy, how benefits will be provided and the assumptions in determining the low dependency funding basis.

Part 2 will contain supplementary matters including the extent to which the funding and investment strategy is being successfully implemented, the main risks faced by the scheme, and details regarding the assessment of the strength of the employer covenant and how long it is reasonable to rely on this assessment.

TPR has provided illustrative templates that outline the statement of strategy data requirements for each scheme circumstance.

It is important to be aware of the potentially significant data submission requirements, which may require additional information to be provided by advisers or employers.



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