XPS Investment

XPS Funding Watch

The new funding and investment strategy regime – an in-depth look at the investment implications

A new strategy regime is set to bring about significant changes to the funding and investment plans of defined benefit schemes – all schemes will be required to target a status of low dependency on the sponsor by the time they are 'significantly mature'.

This note explores in detail what this means for trustees and sponsors and the investment approach that will need to be adopted in the long-term. While regulations and guidance are still in draft, trustees and sponsors should not wait for the final versions before thinking about how the new regime could affect them.

Key findings

1	Investment considerations will play a crucial part in the new strategy regime. Trustees and sponsors will need to understand and consider a new concept of a low dependency investment allocation.
2	Under the draft regulations, this new long-term target allocation is required to provide broad cashflow matching and be highly resilient to short-term adverse shocks.
3	All schemes will need to properly document a journey plan setting out how they intend to move towards low dependency. The level of risk taken on this journey should be influenced by covenant strength and maturity.
4	The Pensions Regulator's (The Regulator) funding code sets out a detailed and relatively prescriptive set of guidelines for how it expects schemes to meet the new requirements and, in particular, how it expects schemes to change their investment strategy as they become increasingly mature. The framework establishes clearly defined, albeit relatively wide, boundaries within which all schemes will be expected to operate.

We expect the new strategy regime to come into force no earlier than 1 October 2023.

Click here to see the actions trustees and sponsors should be considering.

Investment planning will play a pivotal role in the new regime and trustees and sponsors will have to quickly grapple with new concepts such as a low dependency investment allocation, covenant reliability and high resilience. Whilst there is a lot of detail in the 200+ pages of drafts and consultation documents, ultimately there may be more options and flexibility with your long-term investment strategy than you previously expected. The clock is already ticking for schemes and most will now have materially less time to get to their end targets than previously anticipated.

Adam Gillespie, Partner

What might surprise you

- There is a wide range of investment portfolios that could meet the requirements of a low dependency investment allocation.
- Schemes can allocate some assets to higher-returning growth investments, but the Regulator expects all to have at least 90% hedging / matching at their point of significant maturity.
- A concept of a 1-in-6 Value at Risk (VaR) metric has been introduced by the Regulator when considering strategy. Whilst appearing a slightly obscure choice, this equates to one standard deviation below expected. This is less prudent than a typical 1-in-20 scenario used by schemes which is broadly equivilant to two standard deviations.
- When a scheme is significantly mature the Regulator believes that the funding level should not be modelled to fall by more than 4.5% over a 12-month period with a 1 in 6 probability.
- Neither the draft code nor the draft regulations mention Fast Track, but this is covered in a separate consultation document provided by the Regulator and will form part of its approach to regulating schemes in future.
- Significant maturity is staying put (for now!) as defined as duration of 12 years. The Regulator suggests that any uncertainty around this could be addressed by aiming for an earlier point, say, 14 years duration. However the Regulator also considers some alternatives, but this is dependent on the final form of the regulations.
- Despite the introduction of a statement of strategy, and the requirement to agree a high level journey plan and low dependency investments with a scheme's sponsor, trustees retain their power to set investment strategy.

1. The legal and regulatory background – DWP draft funding regulations and the Pensions Regulator's draft funding code

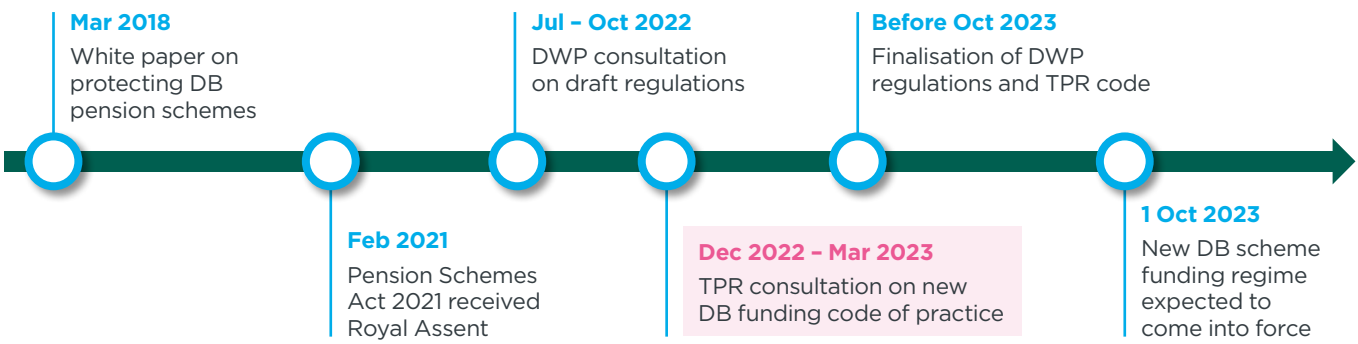
The new strategy regime for defined benefit pension schemes has been in the making since the Government's 2018 white paper. Whilst high-level principles of the new regime came into force via the Pension Schemes Act 2021, we have now received two important updates.

Firstly, the Department for Work and Pensions (DWP) published its draft regulations in July 2022, which provide much needed detail on the new legal requirements that will be put on trustees and sponsors.

Secondly, in December 2022, The Regulator launched its second consultation on its new code of practice for funding defined benefit pension schemes, which sets out the Regulator's interpretation of how to comply with the new legal requirements. It is important to note that the code is not a statement of the law, but clearly it is helpful for trustees and sponsors to understand how the Regulator will look to govern in the new strategy regime.

Schemes do not need to wait for the final version of the new code or regulations before thinking about how the new strategy regime could affect them. This is especially true given market conditions – the time until significant maturity will have reduced materially for most schemes during 2022 simply as a result of higher gilt yields. The clock is already ticking for schemes and many will have materially less time to get to their end point than previously expected.

We expect the new strategy regime to come into force no earlier than 1 October 2023.



2. High-level requirements of the new strategy regime

All schemes are required to target a status of low dependency on their sponsor by the time they are significantly mature. This target and the journey towards it will all need to be set out in a statement of strategy.

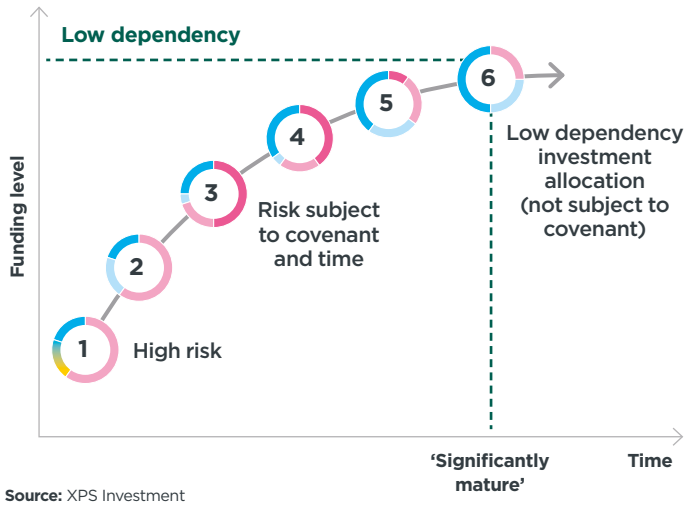
Expanding further, this means that once a scheme's duration reaches significant maturity (drafted to be 12 years):

- the scheme is expected to be fully funded on a low dependency basis
- further contributions 'would not be expected' to be needed 'under reasonably foreseeable circumstances'
- assets will be assumed to be invested in line with a low dependency investment allocation.

What does this mean for a scheme's asset strategy?

The Pension Schemes Act 2021 already set out the need for trustees and sponsors to set a long-term plan for the assets and to set this out in a new document called the statement of strategy (see page 10). The draft regulations have set out more detail regarding two key investment points:

1. **Long-term asset strategy** – This is the investment strategy schemes are required to assume they will hold when they are significantly mature.
2. **Risk levels** – The draft regulations provide principles of how much risk a scheme can take on its journey from today to the point of significant maturity.



Source: XPS Investment

3. What exactly is a low dependency investment allocation?

The draft regulations set out two requirements for a low dependency investment allocation.

1

Cashflow matching

Cashflows from the investments need to be '**broadly matched**' with pensions and other benefits.

2

Highly resilient funding

A scheme's funding (i.e. the combination of a scheme's low dependency investment allocation and its liabilities measured on a low dependency funding basis) must be '**highly resilient**' to short-term adverse changes in market conditions.

The quoted words in the boxes above are from the draft regulations and will require interpretation by trustees and sponsors as they are not defined further.

Cashflow matching

The cashflow matching requirement does on first glance seem relatively straightforward to interpret – a scheme's low dependency investment allocation will predominantly need to utilise assets that provide contractual income to 'match' the outgo of benefit payments to members.

At its simplest level this could be taken to mean investing in a mixture of UK gilts and sterling investment grade corporate bonds. Whilst we expect these assets to play a significant role, we believe there is a much wider range of appropriate assets that will serve to enhance return and diversify risk.

Cashflow matching is always approximate given that the liabilities are uncertain, but the extent of matching required is subject to interpretation of the term 'broadly matched'. When investing heavily in contractual assets, schemes often have more cashflow than they require in the early years, leading to reinvestment risk. These aspects will all need to be taken into account in determining a suitable asset allocation.

The Pensions Regulator's view on cashflow matching – how it expects trustees to interpret the legislative requirements

The Regulator does not expect schemes to be fully cashflow matched at significant maturity and mentions a pragmatic option of bucketing cashflows between short, medium and long durations.

However, the Regulator does expect schemes to have a minimum level of interest rate and inflation hedging / matching of 90% as part of low dependency. This can be achieved either by very high allocations to physical matching assets or through leveraged liability driven investment (LDI) solutions.

The draft code refers to partial cashflow matching (alongside high levels of hedging through LDI solutions) to be consistent with the broad cashflow matching requirements. This provides scope for schemes to still invest in more traditional growth assets if appropriate.

Matching assets are classified as those where income and capital payments are stable and predictable (and are either fixed or linked to inflation). The Regulator comments that whilst the main asset classes to meet its expectations would be cash, government bonds, corporate bonds and LDI, it notes that illiquid and alternative asset classes could also be used for matching purposes. Matching assets are expected to be heavily weighted towards investment grade or equivalent.

Trustees should also carefully consider the cashflows used to model the cashflow matching and to consider inherent sensitivities and risk (e.g. consideration of member options that may not be explicitly modelled by the scheme actuary).

Highly resilient to short term adverse shocks

The second requirement under the draft regulations appears more subjective, prompting a number of questions:

- **What does resilient mean?**
- **What satisfies the requirement of highly resilient?**
- **Over what period are shocks considered short-term?**
- **How severe a shock is an 'adverse shock'?**

The term resilient is not defined and so relying on a dictionary is not unreasonable – such definitions suggest that funding could fall, but that being resilient means it has the ability or likelihood to recover.

Funding and investment strategies are not an exact science and so there must be some sort of materiality corridor within which the funding level can deviate and also tolerance for how quickly it recovers. It may be that this crucial phrase 'highly resilient' ends up in the same category as 'prudence' under scheme funding – left for the advisers and trustees to interpret.

The Pensions Regulator's view on high resilience – how it expects trustees to interpret the legislative requirements

The minimum 90% level of hedging in the cash matching requirement means most of the sensitivity will be around volatility in non-matching assets and in particularly any growth assets.

The Regulator has specified that any scheme's funding level should not be expected to fall by more than 4.5% in a 12-month period (based on a 1-in-6 Value at Risk calculation; assuming 100% funded on the low dependency basis). As a basic illustration, we estimate this translates to a scheme having a maximum of 25% of its assets allocated to equities with the rest in gilts/LDI (assumes 12 year duration; minimum 90% liability hedge and 100% funded on low dependency).

As well as the 1-in-6 test, trustees should be considering a wide range of risk management tools such as: deterministic scenario analyses; default rate stressing for matching assets; LDI collateral calls impacts; cashflow sensitivities; curve risk and liquidity resilience.

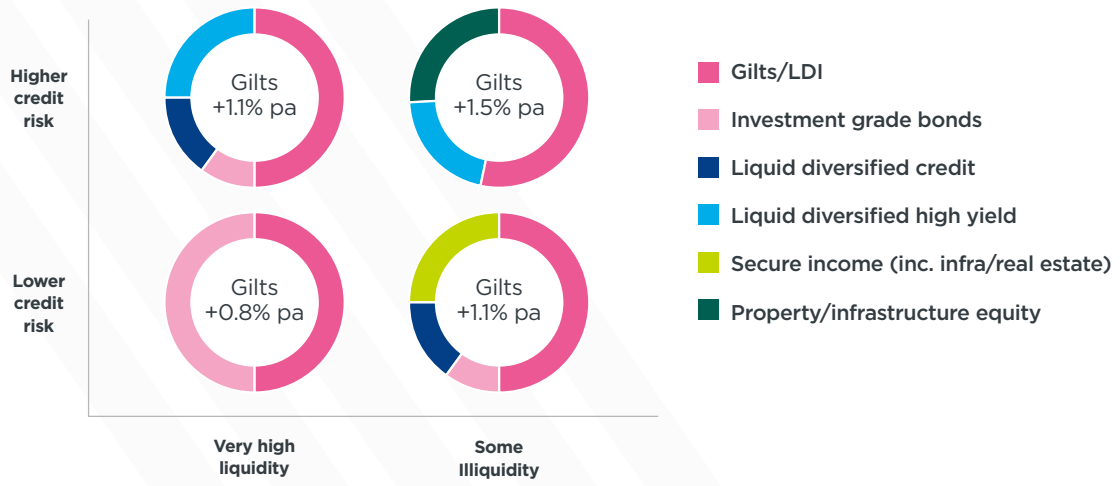
4. What asset classes can I actually use in my low dependency investment allocation?

Regardless of the new regime, many maturing schemes have been moving towards credit-based contractual assets with hedging over time. This is consistent with how insurance companies invest to manage their significant book of mature pension liabilities.

In terms of actual assets classes, schemes will need a minimum core holding in LDI (typically at least 40%, potentially considerably more depending on use of leverage, but this could increase further if LDI capital requirements increase again during 2023). There is a wide range of other contractual income investments that may fill the remaining 60%. We don't think this means schemes should just be invested in UK government and UK investment grade corporate bonds. Gilts are very low returning assets and sterling corporate bonds are relatively concentrated to a small number of issuers at longer maturities, in particular utilities and housing associations. Therefore, we see considerable benefit in broadening the assets considered to include dollar and euro denominated debt, high yield and emerging market debt along with loans, asset backed securities, private debt and property and infrastructure investments. Equity investment is not necessarily to be ruled out either.

We note that the 'highly resilient' requirement represents an upper threshold of risk meaning there is scope for trustees to pursue a lower risk strategy if desired. How trustees and sponsors will set their low dependency investment allocation will therefore depend on two key parameters: risk and liquidity. The diagram below sets out four high-level example strategies that schemes could adopt depending on their willingness to take credit risk and willingness/ability to accept some illiquidity. We have illustrated some possible return targets but would highlight the range of actual returns that will be achievable will be highly dependent on wider financial conditions at the time of implementation.

Example low dependency investment allocations



Source: XPS Investment

Schemes close to buyout: Trustees looking to buyout in the next five years will not want any long-term illiquidity issues. Whilst secondary markets do sometimes exist for private market assets, there is no guarantee that assets can be sold within any reasonable timeframe, let alone at a reasonable price. With the insurance market becoming more saturated with potential buyers, trustees of such schemes need to be able to quickly take advantage of insurance opportunities as they arise. Therefore these schemes would be likely to be pursuing highly liquid strategies.

Schemes with less immediate focus on buyout: For Trustees looking to run on their schemes in the medium term or where buyout is still a way off on the horizon then accepting some illiquidity can be a profitable approach. The trustees of these schemes will be able to lock away some of their money in, say, private markets to generate some higher returns and so may be leaning towards incorporating some illiquidity.

There are two points of note around what the draft regulations mean for schemes – relevance of covenant and the role of equity growth assets.

1

Can trustees allow for covenant in the low dependency investment allocation?

It is interesting to note that there is no allowance for covenant when setting a low dependency investment allocation. Whilst under the draft regulations, schemes with strong sponsors will be permitted to take more risk on their journey to significant maturity, once there, all schemes need to meet the same two requirements regardless of their covenant strength. This may not be a surprise as we are targeting low dependency (although noting it is low, not no-dependency).

In effect, pension schemes will shift from thinking about risk in pound note terms, to thinking in percentage terms as reliance placed on the size of the scheme relative to sponsor reduces on reaching significant maturity.

2

Does this mean schemes can't invest in equities or multi-asset funds?

Our view is that the draft regulations don't stop you from investing an allocation in more traditional assets like equities or multi-asset, provided a scheme can demonstrate that its overall assets and liabilities are highly resilient to short term adverse shocks. We expect a number of trustees will want to make this case. This is consistent with the Regulator's view in its draft funding code.

As a side note, as schemes start to use more credit investments then actuaries and investment consultants will need to think carefully about the appropriate actuarial discount rates – in particular incorporating both corporate bond and government bond yields into the calculation of the liabilities. This is already a tried and tested approach as part of so called Cashflow Driven Investment (or CDI) strategies although not without its practical challenges which need to be navigated carefully.

We expect this approach will become much more commonplace over the coming years and will become a very important aspect of helping to meet the 'highly resilient' test. This is supported by the Regulator – that recognises in its guidance that funding assumptions based on the return of cashflow matching assets held is one of the main approaches it expects schemes to take in low dependency.

5. De-risking along the journey to significant maturity

The draft regulations set out two principles about the level of risk schemes should be taking today and once at their significant maturity point:

1. As schemes get closer to significant maturity then they should take less risk.
2. However, schemes can take risk provided this is supported by the covenant.

1

Covenant

More risk can be taken when covenant is **stronger**

2

Time

More risk can be taken when scheme is **further away** from significant maturity

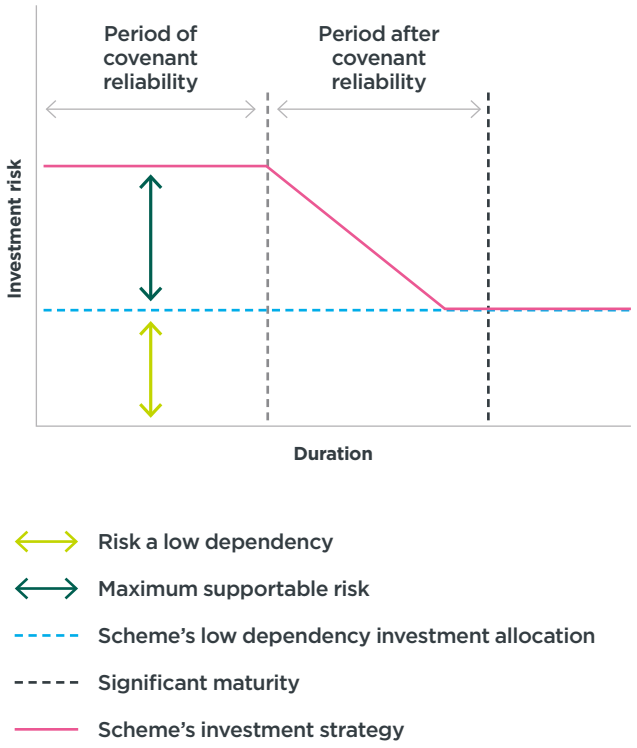
The Pensions Regulator's view on de-risking – how it expects trustees to interpret the legislative requirements

During the period up to significant maturity, the Regulator expects trustees to understand the ability of a scheme's sponsor to support the scheme when assessing the level of risk and therefore the ongoing asset strategies. The Regulator expects trustees to split their journey plans into two key covenant-related periods:

(i) Period of covenant reliability – when trustees can be reasonably confident about the level of support available. For this period the Regulator expects, as a minimum, for trustees to use a 1-in-6 VaR stress test on the technical provisions to assess viability for risk taking (although it does note that many scheme currently use more prudent 1-in-20 tests).

(ii) Period after covenant reliability – the Regulator expects trustees to consider to what extent de-risking is needed between this point and significant maturity.

The Regulator sets out a maximum risk test for the period between now and significant maturity. This 'maximum risk' is calculated by assuming schemes take the maximum level of risk in the period of covenant reliability (using the 1-in-6 test) followed by a period of linear de-risking to the low dependency investment allocation.



Source: The Pensions Regulator

Schemes taking on materially less risk relative to their sponsor in the earlier years will be able (if appropriate) to do less (or potentially even no) de-risking as they approach significant maturity. Schemes may also want to consider the scope for 'rolling-forward' the covenant reliability window at each valuation. Although, ultimately, all schemes need a plan to de-risk to their low dependency investment allocation by significant maturity.

6. Fast Track – The Pensions Regulator's filter

A scheme that satisfies a set of the Fast Track requirements for its funding and investment strategy is unlikely (but not guaranteed) to be selected for further scrutiny and engagement by the Regulator. The second regulatory route, Bespoke, provides greater flexibility for schemes, but will require trustees to provide further evidence of suitability of risk taking, affordability constraints or other relevant circumstances.

Despite it being absent from the draft regulations and the draft code, details of the Fast Track route (set out in draft by the Regulator in a separate standalone document) provide an important insight into the Regulator's governance approach. One reason for its absence from the draft code is to provide the Regulator with greater flexibility for future updates.

The three Fast Track parameters are based on maturity and are independent of covenant. In broad summary:

1

Technical provisions

A scheme's technical provisions must converge to Fast Track low dependency liabilities as it matures. The technical provisions must be at least 85% of the Fast Track low dependency liabilities for a scheme with 20 year duration converging to 100% at 12 year duration. Low dependency liabilities are calculated using a gilts+0.5% discount rate (with guidance given on other assumptions as well).

2

Recovery plans

Scheme deficits to be repaid within 6 years before significant maturity (or 3 years after significant maturity). There are also some other restrictions on the recovery plan construction.

3

Funding and investment stress test

A scheme's funding level must not fall by more than a set percentage under the Regulator's prescribed stress test, which is currently consistent with the The Pension Protection Fund (PPF) tier 1 approach set out in their recent 2023/24 consultation response). The maximum funding level fall is 13.1% for a scheme with 20 year duration or less; 1.9% for a scheme with 12 year duration. One of Regulator's supplemental documents sets out details of the prescribed stress tests. As a basic illustration, this implies a maximum equity holding of 52% (at 20 years duration) falling to 30% (at 12 years).

The fixed PPF-style stress test to be used by the Regulator is different to the risk tests suggested for all schemes in the draft code, which will typically be VaR based on a scheme adviser's own financial models.

The Regulator's analysis (from March 2021) suggests that 51% of schemes would be fully compliant with Fast Track, with a further 21% consistent with the funding and investment stress (but not fully complaint with Fast Track overall).

Fast Track funding and investment stress tests (extract of assumptions)

Liability value stress	Asset value stress
Interest rates -0.74% pa	Other or private equity -19% Equities -16% Diversified growth -10%
Inflation – 0.11% pa	Sub investment grade bonds -6% Property -4% Investment grade corporate bonds +3%

Statement of strategy – a more detailed look

Trustees will need to set out their new funding and investment strategy in a new document called the 'statement of strategy'. This will be done as part of the usual triennial valuation process (and following any other changes to the strategy).

Statement of strategy

Part 1 | Funding and investment strategy	Part 2 | Supplemental matters
1. Agree a long-term objective 2. Agree a low dependency investment allocation 3. Agree the relevant date for low dependency target	1. Assessment of the main risks and covenant strength 2. How the current strategy compares to the low term strategy 3. Progression of the duration and timeframe to significant maturity
Agree	**Consult**

The graphic sets out the high-level content, noting that part 1 needs to be agreed with the sponsor whilst part 2 only requires consultation.

The statement is a statement of intent, so future versions will include comments explaining any deviations and any comments from the sponsor.

What is interesting is how this interacts with the existing investment requirements. The new strategy regime does not change any of the existing investment rules as set out in the Pensions Act 1995 or the accompanying investment regulations.

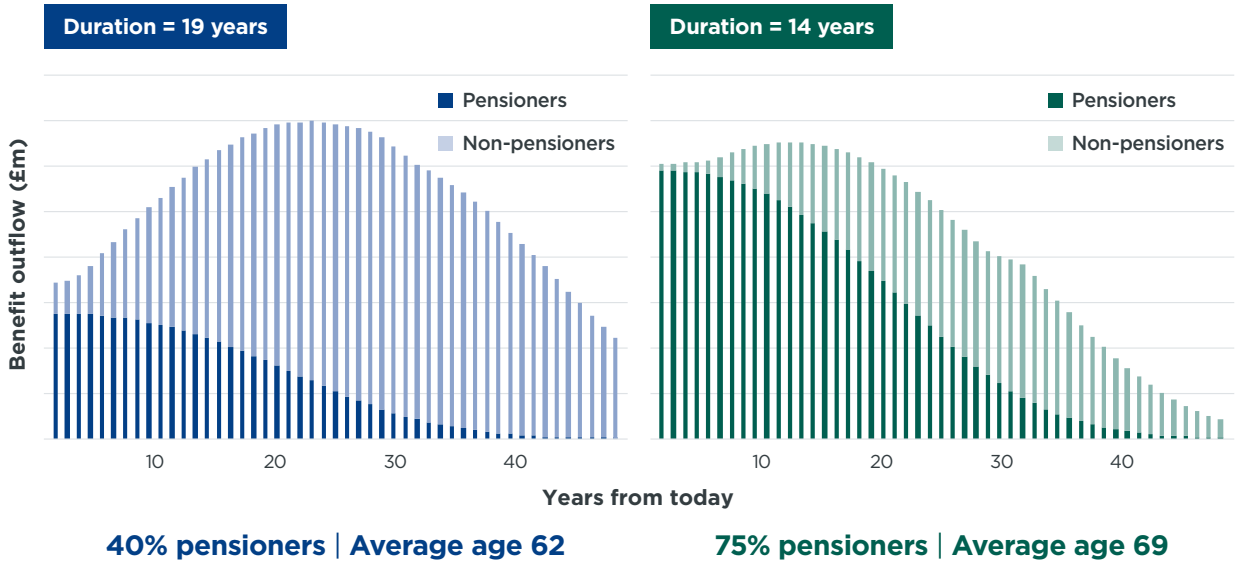
Trustees retain the power to set investment strategy as they only need to consult with sponsors regarding changes in strategy.

The new strategy regime does not change any of the existing investment rules and trustees retain the power to set the investment strategy. The introduction of a statement of strategy, which will sit alongside a scheme's statement of investment principles, may complicate this dynamic for many schemes, despite the assurances from The Pensions Regulator.

Significant maturity and duration – a more detailed look

Under the new strategy regime, duration will become a very important concept as it will define the point a scheme is significantly mature (i.e. the point in time at which they should be targeting a status of low dependency). The draft regulations empower the Regulator to set out the precise requirements in its code (one example of where the code is effectively a legal statement). This is currently set as 12 years.

Duration can be thought of as the time in the future when half the actuarial cashflows will be paid out. The cashflows will be weighted by the discount rates used in the low dependency funding basis.



Source: XPS Investment

Most schemes will not yet have a duration as low as 12 years. A good rule of thumb is that in the normal course of events the duration of a scheme's liabilities falls by one year for every three years that passes. A scheme with duration of 15 years today will have around 9 years until they hit significant maturity (all other things being equal). That said duration can change rapidly as a result of changes in yields.

Duration is calculated using discounted values and is therefore affected by the discount rate. Given the significant rises in gilts yields we have seen durations fall materially over the last 12 months. Higher gilt yields make longer term cashflows less valuable and therefore makes the near term cashflows more prominent in the calculation of duration. As a result, many schemes have seen their duration fall by 3 years or more over 2022, maturing much faster than the typical 9 years as indicated by our real-world rule of thumb.

Having a journey plan end point that can move around so significantly is not helpful for pension scheme planning. Recent falls also bring into question the lack of any proposed transitional arrangements, which are missing in the draft regulations. It is not clear what schemes should be doing if they already find themselves at 12 years duration. The Regulator has commented that 12 years should be considered the backstop and a way to manage the uncertainty is to potentially aim for low dependency before 12 years duration is reached.

A good rule of thumb is that a scheme's duration falls by one year for every three years that passes.

Investment action plan

A new strategy regime is set to bring about significant changes to the funding and investment plans for defined benefit schemes. We propose that schemes should:

1	**Start now** – Given the reduced timescales resulting from decreased scheme durations, we strongly encourage trustees and sponsors to consider this new strategy regime now. Trustees and sponsors don't need to wait for the final versions and will benefit from having a strategy that satisfies the new regulations in advance.
2	**Understand your scheme's duration and timescales** – How far is your scheme from being significantly mature? Schemes are probably nearer to this than they think.
3	**Review your current long-term investment plan** – Is it consistent with the requirements of a low dependency investment allocation? There may be more options and flexibility with the end portfolio than previously expected.
4	**Consider covenant** – Is there sufficient visibility of sponsor strength to determine the level of risk to be taken along the journey?
5	**Engage with the sponsor** – The new strategy regime means trustees and sponsors will need to work even more closely in the future.

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