03/2023

XPS Express for Employers

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The new funding and investment regime – key implications

At a glance

New requirements for defined benefit (DB) schemes to have long-term funding and investment strategies are expected to come into force from 1 October 2023

The Department for Work and Pensions published draft regulations last year and The Pensions Regulator (TPR) is consulting on its code of practice on how trustees and employers should comply with these regulations

By the time they are significantly mature, schemes will need to be fully funded on a low dependency basis and follow a low dependency investment strategy

TPR proposes that a scheme will reach significant maturity when it has a duration of 12 years. A lot of schemes are already close to this point

Reliability of the employer covenant is essential to the amount of risk that can be taken. There is also a new requirement for deficits to be cleared as quickly as can be reasonably afforded

It is imperative that employers engage with trustees on covenant and funding affordability

Key requirements for employers

Area	Requirement	Action
Strategy	Agree the long-term objective for your scheme.	Understand the contribution requirements of different objectives.
Covenant	Engage on key areas of covenant assessment: • Cash; • Prospects; and • Contingent assets.	Be ready to share robust cashflow projections and views on longer-term prospects.
Investment	Agree a low dependency investment allocation (and plan to de-risk over time).	Understand volatility of potential investment strategies and implications for cash contributions.
Funding	Pay off deficits as soon as can be reasonably afforded.	If applicable, demonstrate other uses of cash are reasonable (e.g. dividends).

Key issues for employers in the consultation

Issue	Commentary
No transition period	The draft code does not include any transitional arrangements for schemes that are already close to significant maturity. This could lead to significant demands for higher cash contributions for some schemes.
Affordability and dividends	The draft code guides trustees to look at free cash flow before dividends are paid. TPR expects trustees to ask for dividends to be reduced if recovery plan lengths are viewed as too long. Employers may need to justify that their dividend policy is sustainable.

Actions employers can take

1. **Understand how the draft code will affect your business and whether you should respond to the consultation (deadline is 24 March).**
2. **Identify the first actuarial valuation that will need to comply with the new regime, and how long it will be until your scheme is significantly mature.**
3. **Consider how you will present your employer covenant and affordability of cash contributions in light of the approach taken by TPR.**
4. **Review your long-term strategy given the above.**

Higher gilt yields mean there is less time to act

The new regime uses duration as a measure of a scheme's maturity. A shorter duration means schemes will be closer to being significantly mature, meaning:

- Schemes will have to de-risk sooner, so will lose out on investment returns from holding growth assets; and
- There is pressure for employers to fund any deficits more quickly.

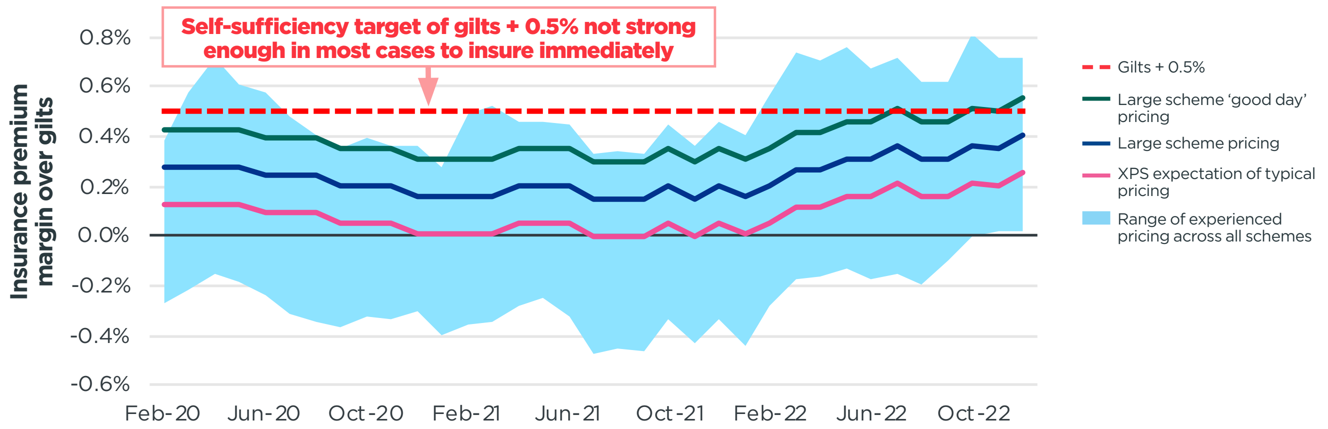
Over 2022, we saw a significant rise in yields which has led to durations falling materially. It is critical to understand your current duration and how much time you have until your scheme reaches significant maturity.

Source: Refinitiv

Long-term targets will now directly impact cash contributions

Under the new funding regime, all schemes will now be required to have a long-term funding target. As your scheme matures, your technical provisions need to be consistent with this target, which will drive contributions from the employer.

Employers should take care in agreeing this long-term funding target as an overly prudent target risks over-funding, while an overly optimistic target risks having insufficient assets to insurer liabilities. The chart below shows typical insurance costs over the past three years. Whilst insurer pricing has been improving over the past year, in all but a few instances a scheme that is fully funded at gilts +0.5% (a typical self-sufficiency target) when it first reaches significant maturity would not be able to insure its liabilities. This means a strategy will be needed to bridge the gap to the cost of insuring benefits.



Source: XPS Pensions Group

For further information, please get in touch with Jim Heal or Mark Witkin or speak to your usual XPS Pensions contact.

t 01483 330 119

e jim.heal@xpsgroup.com

t 0203 836 7157

e mark.witkin@xpsgroup.com

@xpsgroup

xpspensionsgroup

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