We are at the dawning of a new era for pension scheme funding and investment strategies

Let the XPS FIS Companion be your go-to handbook for getting to grips with the key elements of the new requirements and the actions you should be taking.

The Pensions Regulator (TPR) has long been stressing its expectation for all schemes to plan for the long term but the new funding regulations go a step further, making it a legal requirement. For a defined benefit (DB) pension scheme's first triennial valuation on or after 22 September 2024, the scheme's trustees and employer must agree a plan for ensuring that the scheme's benefits will be provided for over the long term. This requirement is set out in the Pension Schemes Act 2021 and DWP's Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2024. Associated guidance has been provided through TPR's 2024 defined benefit funding code of practice.

This will, for the majority of pension schemes, give rise to extra steps in the valuation process, including material preparatory work, and in most cases require earlier and greater collaboration between trustees, sponsoring employers and advisers.

Our six-part 'FIS Companion' series will help trustee boards and employers approach their first valuation under the new funding regime in a logical, practical order, while highlighting the key considerations for both.

1 Setting a long-term strategy

Your scheme **must set a long-term strategy** that is agreed between the trustees and employer and that targets a state of low dependency on the employer within a certain timeframe.

View full document here

2 The covenant assessment

Set out in law for the first time, **formal consideration of employer covenant** is now a requirement. There are new covenant concepts for you to consider and measure.

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3 Scheme investments under the new regime

You are required to **agree a low dependency investment allocation (LDIA)** and target investing in it within a certain timeframe.

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4 The funding valuation and journey plan

By significant maturity, your scheme's **technical provisions (funding) basis** must be at least as strong as the low dependency basis. More risk can be taken by less mature schemes and those with stronger covenants

Coming soon July 2025

5 Fast Track versus Bespoke

Many schemes will want to **assess their valuation against the Fast Track parameters.** We explore the conditions that must be met and the pros and cons of both a Fast Track and Bespoke valuation submission.

Coming soon July 2025

6 Key questions and challenges

To round off the series **we address some of the common questions** that have arisen as we have discussed the new requirements.

Coming soon August 2025

1 Setting a long term strategy: Introduction

Your scheme must set a long-term strategy that is agreed between the trustees and employer and that targets a state of low dependency on the employer within a certain timeframe.

Your long-term plan for the scheme, low dependency position, technical provisions and funding requirements, the journey plan including current and future investment allocations and reliance on covenant will all form part of your funding and investment strategy.

Achieving in principle agreement between the trustee and employer at outset will make the valuation process more efficient meaning a smoother process towards ensuring compliance with the new funding requirements.

What do the regulations and guidance say?

Regulatory requirements:

- **Long-term objective:** The way in which the trustees of the scheme intend pensions and other benefits under the scheme will be provided over the long term.
- **Low dependency test:** The funding and investment strategy must aim to achieve low dependency on the employer by significant maturity (at the latest), which means intending to be fully funded on a 'low dependency funding basis' and having an objective of a 'low dependency asset allocation' such that further employer contributions would not be expected to be required.
- **Relevant date:** Target for reaching low dependency. It must be on or before significant maturity (which for most schemes is when the duration reaches ten years).
- **Consultation and agreement:** For most schemes, the employer must agree the headline long-term strategy and be consulted on regarding some of the finer detail.
- **Written record:** The strategy must be recorded in the statement of strategy which is submitted to TPR, meaning TPR's requirements for it are legally binding.

Code guidance:

The funding code helpfully reinforces key components of the regulations, noting that for the purposes of determining 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 the relevant date

c. the investments they intend to hold at the relevant date

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

The funding code also provides practical guidance on how trustees might comply with the regulatory requirements.

- **Low dependency funding basis:** The funding code sets out guidance rather than prescription on how it expects this to be set . Assumptions should be chosen prudently and the risk in the basis should be understood sufficiently so that trustees can be confident they can pass the 'low dependency test'.
- **Low dependency investment allocation:** The code provides guidance on the types of analysis it expects trustees to carry out and evidence, to prove adherence to the legal requirements of the low dependency investment allocation. It notes that TPR generally expects a minimum hedging target of 90%, and resilience testing to be carried out. The code also provides clarity that the investment allocation is a target and should not interfere with trustees' existing investment duties (and powers).

In this first part of your FIS Companion, we explore the common long-term objective options and delve into the detail of the guidance around setting the low dependency funding basis.

Setting a long term strategy: Common options for pension schemes

What's new...

Trustees must set a strategy for ensuring that benefits under the scheme can be provided over the over the long term. The first part of this is the long-term objective.

The regulations and code do not constrain schemes to any particular long-term objective. The most suitable long-term objective for your scheme will ultimately come down to trustee and employer preferences and, possibly, negotiations. Scheme circumstances and individual preferences evolve over time, as can the pros and cons of the options themselves, and therefore the long-term objective must be kept under review. We explore the most common options below.

Long-term objective	In a nutshell	Most suitable for
Run-on	A scheme runs on over the long term, perhaps with a specific aim to generate surplus. Members and the employer may be able to share any surplus generated. Can include future accrual of benefits for members. All risks remain within the scheme. Option remains open to settle liabilities at a later date.	Open schemes, larger schemes and those with stronger covenants. Employers that wish to maintain contact with and continue to support members. Immature schemes who can reassess their options when more mature. All schemes should consider if run-on is suitable - remember there is no insurer premium to pay with this option.
Buy-in	Primarily an investment decision, an insurance policy is purchased and held as an asset of the scheme. Removes many risks, such as inflation, longevity and investment risk for members covered under the policy. Option to move to buyout at a future date.	Employers who want similar risk reduction that buyout brings but do not want to commit to buyout or wish to maintain contact with members. Well-funded schemes, approaching or past the point of significant maturity.
Buyout	Premium paid to a regulated insurance company to secure all members' benefits and associated risks. The employer and trustees are discharged from their responsibilities to the scheme and the scheme can be wound-up.	Well-funded schemes, approaching or past the point of significant maturity. Many other pension schemes, regardless of their current funding position, whose trustees have buyout as their preferred ultimate goal.
Superfund / consolidator	A regulated pension scheme that another scheme can transfer into. The superfund provider will run the scheme and may later consider securing the benefits with an insurance company. The employer and trustees are discharged from their responsibilities once transferred to the superfund.	Those who meet the following 'Gateway criteria': - Buyout unlikely to be affordable within five years, and in transferring to a superfund, the likelihood that members receive full benefits is increased. - Scheme must be sufficiently well funded to qualify (typically 90% to 95% funded on buyout).

Setting a long-term strategy: Low dependency funding basis

What's new...

The funding and investment strategy must include the intention of having low dependency on the employer by significant maturity.

Low dependency means, that once fully funded on a 'low dependency funding basis' and invested in a 'low dependency asset allocation', further employer contributions would not be expected to be required. This is the 'low dependency test'.

The code provides details on how TPR believes the low dependency funding basis should be set, with the key principle being that assumptions are chosen prudently. It also reaffirms that trustees should ensure the low dependency test is met under most reasonably foreseeable circumstances.

The code provides detailed guidance on many of the assumptions to consider when setting your low dependency funding basis and a summary of these is set out below.

Assumption	TPR guidance on the low dependency funding basis.
Discount rate	Two main approaches are considered in detail: a risk-free rate plus a margin and a discount rate directly linked to a scheme's investments.
Expense reserves	Where there is no requirement under the scheme rules for the employer to pay expenses, TPR expects a reserve for all non-investment related expenses incurred on and after the relevant date to be included. This reserve should be consistent with the scheme's long-term objective. For schemes where there is a requirement under the rules for the employer to pay expenses, there is strong encouragement for trustees of those schemes to consider including an expense reserve.
Inflation	Consistent with approach taken for discount rate. There should be no inflation risk premium and if such an adjustment is made, TPR may ask for justification.
Mortality	All schemes to consider a mortality study to tailor standard tables. If not carried out, uncertainty must be reflected with increased prudence.
Cash commutation	Proportion commuted should be prudent and commutation factors should not be lower than the current or agreed future rates.
Other assumptions	Draw on scheme experience where statistically credible analysis of recent experience is available.

We expect trustees to take a proportionate approach in setting their low dependency funding basis..... we expect more careful analysis in determining the assumptions to meet the low dependency test as a scheme approaches its relevant date.

The Pensions Regulator, Defined benefit funding code of practice

Setting a long-term strategy: Statement of strategy

What's new...

Trustees and employers are required to record the agreed long-term funding and investment strategy in the statement of strategy and submit it to TPR within the usual 15-month deadline for submission of an actuarial valuation.

It is helpful to know where this all ultimately leads in terms of what trustees are obliged to submit under the statement of strategy. The statement of strategy replaces the valuation submission of the previous funding regime. It is a much bigger beast than the old valuation submission, weighing in at somewhere between 84 and 265 questions to answer depending on a scheme's circumstances.

The key question regarding the long-term strategy that you must answer in the statement of strategy is the following somewhat open and broad question that asks for a free text narrative answer.

What is the way the trustees intend benefits to be provided over the long-term?

TPR's guidance: A description of the way the trustees intend to provide benefits over the long term (known as the long-term objective). In describing the long-term objective, we would usually expect trustees to include a summary of the desired funding target within the description.

This is a question from the part of the statement of strategy that must be agreed between the trustees and the employer, so it is imperative that setting the strategy is a collaborative undertaking. If the considerations in your XPS FIS Companion are reflected on, answering this question should be straightforward!

Related questions that must be answered in the statement of strategy concern the funding level on low dependency, details of the low dependency basis and the low dependency investment allocation, and an estimate of when the scheme is expected to reach significant maturity.

> Trustees should not underestimate the support they may need to complete the statement of strategy. Having a clear understanding of the requirements from the start means it is more likely that you cover them all through your valuation discussions. This will lead to a much smoother experience when completing the valuation and the statement of strategy.

Pauline McConville
Senior Consultant
e pauline.mcconville@xpsgroup.com

Setting a long-term strategy: Potential pitfalls

Why this is a problem	Solution
Potential pitfall: Confusing the requirement to define how you intend the scheme to provide benefits over the long term with the minimum low dependency requirement.	
Rather that itself being an approach for providing benefits over the long term, low dependency is a minimum requirement - it is a funding target with a specified timeframe. The trustee and employer must agree the long-term objective for the scheme and set out how this complies with the low dependency funding target. For example, a scheme with run-on as its long-term objective will also need to target being at least fully funded on a low dependency basis by the relevant date. Another example might be a scheme that ultimately intends to secure the benefits with a third-party insurer. This scheme may have buyout as its long-term objective for providing benefits, but this does not mean an intention or commitment to be fully funded on buyout by the relevant date. The trustee and employer can agree on a low dependency target they do intend to reach by the relevant date and then seek to bridge the gap from low dependency to the insurance cost later through, for example, investment outperformance. If trustees and employers do not agree both elements it may lead to anomalies such as trying to agree a second funding objective recorded outside the new framework and then challenges in describing the strategy in the statement of strategy.	Trustees and employers should agree the long-term objective and agree a separate low dependency funding target. There may be challenges in this - for example not wanting to commit to a long-term objective of buyout due to potential accounting impacts. The solution to this challenge could come in how the long-term objective is described. For example, describing the objective as run-on with the potential to transfer benefits to a third party if affordable at a future date. It is important to understand that low dependency is the only funding target that comes with a specified time-frame under the regulations. Ensuring the distinction between the two can also help with understanding how to allow for benefits such as underpins and discretionary benefits. For example, a long-term objective of run-on may incorporate the intention to pay discretionary benefits only where future surplus generation allows. The associated low dependency funding basis would not necessarily fund for for discretionary benefits To eliminate any concerns, trustees and employers should work with their advisors to make sure that the agreed long-term objective is expressed appropriately in the statement of strategy alongside the low dependency funding target, both as part of the overall funding and investment strategy.

Setting a long-term strategy: Potential pitfalls

Why this is a problem	Solution
Potential pitfall: The trustee and employer don't have a common broad objective for the scheme	
The trustee and employer must agree the scheme's long-term objective. For some schemes this will be challenging, particularly if there has been a gap between trustee and corporate ambitions for the scheme in the past.	Trustees and employers should come together to discuss and explain their objectives for the scheme, ideally prior to the valuation date. The goal is to agree a strategy that both are comfortable with, so concessions may be needed by one or both parties to find a middle ground to agree upon. Subsequent work carried out for the valuation will then be reflective of an agreed joint goal avoiding surprises and rework further down the line.
Potential pitfall: No preparatory work is undertaken before the valuation date	
Despite the valuation being a more involved process with additional steps, the 15-month deadline still applies.	Trustee should prepare for the valuation several months before the valuation date, engaging with the employer and advisers to ensure the key elements of each valuation step can be given sufficient thought.
Potential pitfall: Advisers aren't aligned to the trustee and company's joint objectives	
The long-term objective is a key element of the new funding regime. If inappropriate advice is given, then the suitability of this long-term objective will be in question.	Trustees and employers need to understand how the advice given to them by their advisers is relevant to their objectives and, where necessary, challenge them accordingly.
Potential pitfall: The valuation process isn't co-ordinated effectively	
A poorly co-ordinated valuation process will result in an inefficient, protracted process with higher adviser fees than necessary.	Trustee should ensure that broad timescales, and process, are agreed between all parties. Oversight during the process is recommended.

Engaging early on when setting strategy will be key to an effective valuation process this time around. We're encouraging obtaining in principle agreement on strategy with your employer, ideally well in advance of your valuation date where time permits. Don't forget that the strategy includes elements of actuarial, investment and covenant, so it is productive to get all parties together to discuss this topic.

Heidi Webster
Senior Consultant
e heidi.webster@xpsgroup.com

Setting a long-term strategy: Next steps

Checklist for trustees

Prepare for your first valuation under the new funding regime

- ✓ Download your FIS Companion.
- ✓ **Get up to speed with the new requirements. Training on the regulations and funding code is advised for all trustees.**
- ✓ **Review the statement of strategy templates to get to grips with the extent of the information TPR is asking for, and to determine where the gaps are compared to your previous valuation.**
- ✓ **Include the employer early on in long-term strategy conversations to support agreement and avoid any surprises further down the line.**
- ✓ **Draw up an action plan ahead of your first valuation under the new funding regime. Work backwards to set out a timetable of actions, which might mean starting work well ahead of the valuation date.**
- ✓ **Consider your scheme's governance framework. The new requirements on trustee boards emphasise the importance of ensuring your scheme has suitable governance which facilitates strong and informed decision-making and risk management. This will be key when setting strategy but also managing the journey to achieving your scheme's objective.**

Talk to your advisers

- ✓ **Your strategic adviser (which may be your covenant, investment or actuarial adviser) will help you consider the range of strategy path options available to you, taking account of changes to the rules around use of surplus, and determine how this aligns with a low dependency target.**
- ✓ **Engage a covenant adviser, perhaps for the first time, to carry out the formal assessment of covenant that is now required. This will be discussed in more detail in Part 2 of your XPS FIS Companion.**
- ✓ **Understand the range of options that could be considered a low dependency investment allocation and how this ties into your long-term strategy path. These will be discussed in detail in Part 3 of your FIS Companion.**
- ✓ **Consider what legal advice you may need to ensure compliance with the new funding requirements.**

Setting a long term strategy: Next steps

Checklist for employers

Prepare for your first valuation under the new funding regime

- ✓ Download your FIS Companion.
- ✓ **Get up to speed with the new requirements. Training on the regulations and funding code is advised for all relevant employer representatives.**
- ✓ **Perform a 'Health Check' on long-term funding assumptions, investment strategy and covenant to help you understand how your scheme's current position compares to the new regime.**
- ✓ **Proactively engage with your trustees as early as possible to set the future strategy and ensure outcomes are aligned with your corporate objectives.**

Discuss strategy with your advisers

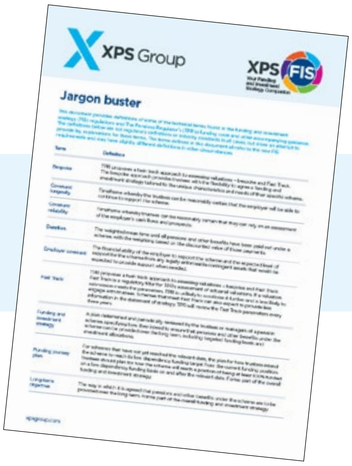
- ✓ **Involve your corporate pensions adviser from the start to make sure that any long-term strategy discussions are mindful of your broader corporate objectives. This should include understanding the pros and cons of different long-term strategy options.**
- ✓ **Consider whether independent covenant advice is required to allow you to successfully present your covenant and cash position to the trustees. Part 2 of your XPS FIS Companion will cover the new covenant requirements in detail.**
- ✓ **Determine the level of investment risk the business is comfortable supporting now and as your scheme matures, including the downside risk you can fund. Part 3 of your XPS FIS Companion will cover the new investment requirements in detail.**
- ✓ **Consider what legal advice you may need to ensure compliance with the new funding requirements.**

About us

XPS Group is a leading UK consulting and administration business specialising in the pensions and insurance sectors. A FTSE 250 company, XPS combines expertise and insight with advanced technology and analytics to address the needs of over 1,400 pension schemes and their sponsoring employers on an ongoing and project basis. We undertake pensions administration for over one million members and provide advisory services to schemes and corporate sponsors in respect of schemes of all sizes, including 83 with assets over £1bn. We also provide wider ranging support to insurance companies in the life and bulk annuities sector.

Jargon Buster

This jargon buster is designed to accompany this companion.
It provides definitions of technical terms. Click here



Find out more

To discuss any of the issues covered in this edition, please get in touch with Heidi Webster, Pauline McConville or George Sullivan. Alternatively, please speak to your usual XPS contact.

Heidi Webster
Senior Consultant
e heidi.webster@xpsgroup.com

Pauline McConville
Senior Consultant
e pauline.mcconville@xpsgroup.com

George Sullivan
Consultant
e george.sullivan@xpsgroup.com

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