XPS Group

XPS FIS
Your Funding and Investment Strategy Companion

Part 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.

Investment considerations are a crucial part of the new funding and investment strategy regulations. Trustees and sponsoring employers are required to agree an LDIA and how they intend to transition from the current investment strategy to the LDIA over a certain timeframe – this is known as the investment journey plan.

The LDIA and journey plan set out a notional long-term investment strategy that the trustees and sponsoring employers agree that they intend to target. Trustees retain the power to invest in different ways if they believe it is in the best interests of members. Notwithstanding this point, the LDIA and investment journey plan have very important and real-world implications for scheme funding, and it is important that they are given due consideration.

What do the regulations and guidance say?

Regulatory requirements:

- **Funding and investment strategy:** As part of this, trustees must determine the investments they intend to hold at the relevant date, which is no later than significant maturity.
- **Minimum requirement:** Trustees need to set an objective that, on and after the relevant date, the assets supporting at least a fully funded low dependency position are invested in accordance with a low dependency investment allocation. This objective does not apply to surplus assets.
- **High resilience:** Under the LDIA the value of the assets relative to the value of the scheme's liabilities (assessed on a low dependency funding basis) must be *'highly resilient to short-term adverse changes in market conditions so that further employer contributions are not expected to be required'.* High resilience is not defined in the regulations.
- **Liquidity:** Scheme investments must have sufficient liquidity to enable the scheme to meet expected cash flow requirements and make a reasonable allowance for unexpected cash flow requirements.

Code guidance:

- The code makes it clear that both the investment strategy used to support a scheme's current funding assumptions and the LDIA are intended to be 'notional' investment allocations
- Targeting the LDIA therefore, does not interfere with trustees' duty to invest in the best interests of members nor does it interfere with their investment powers. TPR notes that it expects most schemes' actual investment allocation will be the same or similar to schemes' notional investment allocations but understand that they may differ in some circumstances.
- TPR expects schemes' LDIAs to target at least 90% hedging on interest rates and inflation (on the low dependency funding basis), gives some steer on testing 'high resilience' and sets out requirements for the liquidity of the LDIA.

In this third part of your FIS Companion, we focus on the LDIA and how adherence to regulatory requirements can be achieved alongside adopting an LDIA appropriate for your scheme. The fourth part will cover the investment journey plan in more detail.

Our six-part 'FIS Companion' series will help trustees 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	2 The covenant assessment	4 The funding valuation and journey plan	5 Fast Track versus Bespoke	6 Key questions and challenges
View full document here	View full document here	Coming soon July 2025	Coming soon July 2025	Coming soon August 2025

Scheme investments under the new regime: LDIA

What's new...

Trustees must set a funding and investment strategy and as part of this determine the investments they intend to hold at the 'relevant date' which is no later than significant maturity.

The regulations require trustees to specify the proportion of assets that they intend to allocate to different categories of investments on the relevant date. The long-term objective, which in most cases must have been agreed between the trustee and the employer, should be taken into account when considering an appropriate LDIA for the scheme. Long-term objectives are discussed in detail in Part 1 of your XPS FIS Companion

The regulations and the code provide trustees with sufficient flexibility to set an LDIA that is consistent with their long-term objective with TPR recognising that there is no 'one size fits all' approach. We explore the key factors below which trustees should consider when setting their LDIA.

Factor	Commentary	Questions for trustees
Long-term objective	The LDIA should reflect the trustees' long-term objectives. For example, schemes looking to buy out may wish to target an LDIA comprised of liquid assets that are easy to disinvest when required. They may also, to the extent possible, choose assets which complement the way insurers price pensions. However, thought also needs to be given to whether the LDIA is expected to generate sufficient returns to achieve buy out without further support from the employer. On the other hand, schemes whose long-term objective is run-on may wish to invest in a greater proportion of growth assets and exploit their longer time horizons by investing in less liquid assets.	Does the scheme's proposed LDIA reflect its long-term objective? If not, what changes could be made to address this?
Proportionality	TPR expects schemes to take a proportionate approach when setting the LDIA. It expects a greater focus on the granularity of the investment allocation and risks as a scheme approaches its relevant date.	How can you determine the right level of detail / depth of analysis?
Surplus assets	TPR acknowledges that after the relevant date, any surplus assets (when measured against the low dependency funding basis) do not need to be included in the LDIA. They will, however, give schemes the option to record how surplus assets are invested in the statement of strategy. TPR also notes that schemes with a material surplus may be able to invest all assets, not just the surplus, in a manner different from the LDIA. This could help very well funded schemes target higher risk adjusted returns, for example if they are looking to run on to target distributing surplus.	

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Scheme investments under the new regime: High resilience

What's new...

Under the LDIA the value of the assets relative to the value of the scheme's liabilities (assessed on a low dependency funding basis) must be highly resilient to short-term adverse changes in market conditions.

The regulations do not define 'highly resilient', leaving it to trustees and their advisers to interpret what this means. The code does give a steer though, with TPR suggesting that trustees consider whether, following adverse changes in market conditions, the LDIA will allow the scheme to return to full funding on low dependency in a reasonable timeframe.

When carrying out this 'test' to demonstrate high resilience, trustees are expected to assume that their scheme is fully funded on the low dependency funding basis. Then, looking at the change in funding level from a subsequent stressed or downside scenario, trustees need to satisfy themselves that the scheme can recover back to full funding within a reasonable timeframe with low dependency on the employer (i.e. assuming no employer contributions or limited contributions if the stress applied is much stronger than the example in the code).

Detailed guidance on how high resilience can be demonstrated is not provided but the code gives an example. This involves applying a 1-in-6 likelihood one year stress, with high resilience being achieved if full funding is expected to be restored within 6 years. We explore this 'bounce-back' test in more detail on the next page.

One observation of a bounce-back test is that it tends to favour higher returning (and hence higher risk) investment strategies. This is not necessarily consistent with the general consensus on what would be suitable for the low dependency investment strategy.

TPR's guidance on high resilience favours higher risk and return investment strategies than would historically have been thought to be suitable for schemes fully funded on low dependency. Trustees need to consider the level of risk in their LDIA to ensure their investment strategy is suitably robust

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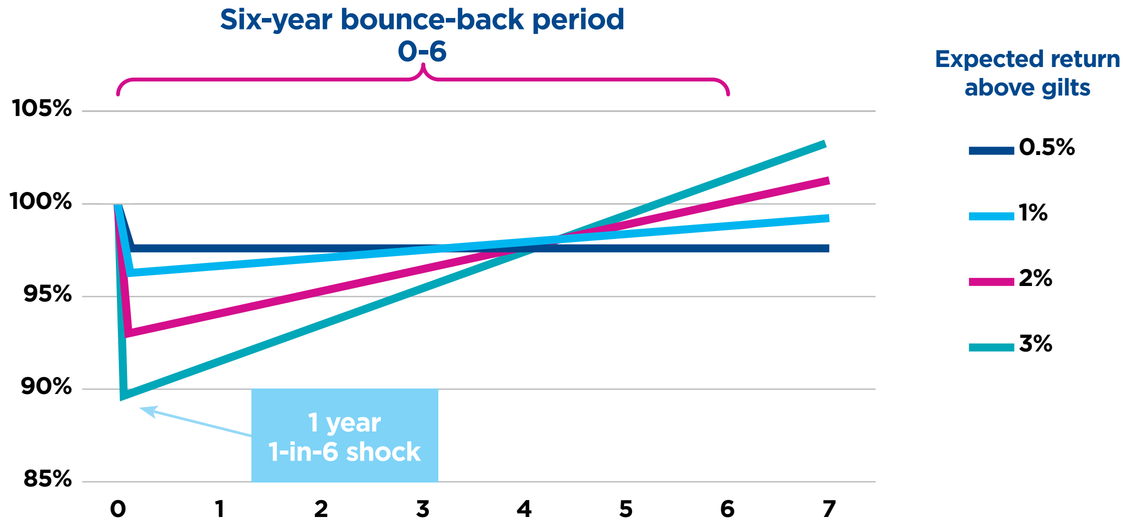
3 Scheme investments under the new regime: High resilience

Illustration of TPR’s bounce-back test with varying levels of investment return target (underlying gilts + 0.5% low dependency basis)



The chart above shows the impact of a short-term adverse change in market conditions and subsequent “bounce-back” for investment strategies targeting a range of investment returns from gilts + 0.5% p.a. to gilts +3.0% p.a. The higher risk and return investment strategies suffer more than the lower risk and return strategies during the initial “shock” but their higher expected returns mean they recover quicker than the lower returning strategies, and recover in less than 6 years. So, higher risk and return investment strategies pass the bounce-back test whereas low risk and return strategies, more typical of low dependency, do not.

Following the code rigidly would suggest that an LDIA targeting an investment return of gilts + 1.5% p.a. or higher is acceptable. However, our view is that, in many cases, such high risk and return invest strategies are not consistent with the concept of low dependency. To ensure that excessively risky investment strategies are not adopted for the LDIA, we suggest that a test of downside risk is carried out in addition to the bounce-back test to demonstrate high resilience.

The other concern with the bounce-back test is that investment strategies dominated by government or corporate bonds, which are typical of the investment strategies long adopted by schemes targeting a low dependency state, would not be expected to pass the bounce-back test. This is because such investment strategies may not be able to demonstrate that they could generate sufficient investment returns to ‘bounce-back’ within 6 years. Although part of this is due to current market conditions that may change in the future, it highlights an issue that must be considered by trustees and their advisers.

Trustees wishing to take relatively low levels of investment risk in their LDIA may want to adopt a low dependency discount rate that is consistent with the assets underlying the LDIA. In simple terms, this would result in the liabilities moving more in line with the assets following a ‘stress event’. The ‘stress-event’ modelled can also be structured to be more true-to-life as to the expected impact on the assets underlying the LDIA.

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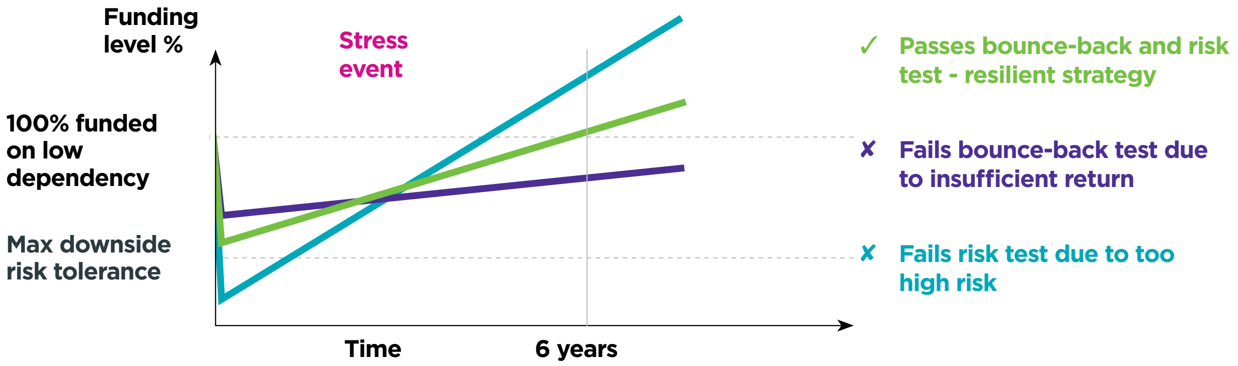
Scheme investments under the new regime: High resilience

More effective test of high resilience



As shown in the chart above, testing downside risk in addition to the bounce-back test will render some of the higher risk investment strategies unsuitable as an LDIA.

However, there are several options available to trustees to address the issue that lower risk investment strategies, (such as those invested significantly in government and corporate bonds or assets with similar characteristics) fail the bounce back test. We explore two options below.

Approach one: Structure of low dependency discount rate	Approach two: A greater emphasis on credit-based assets
For the low dependency discount rate, TPR expects trustees to use one of two main approaches (or a combination of both); a risk-free rate plus a margin, or a discount rate directly linked to a scheme's investments. In the latter approach, schemes whose LDIAs include an allocation to lower risk assets such as corporate bonds may include the return on corporate bond yields in the definition of the low dependency discount rate. This would result in the value placed on the low dependency liabilities falling more in line with the expected movement in the LDIA in a 'stress event', and a lesser net reduction in the funding level. This allows lower returning strategies to bounce-back in a suitable timeframe.	A more realistic approach can alternatively be taken in the high resilience test itself by allowing for enhanced returns on some of the lower risk assets making up the LDIA, following the downside events. Corporate bonds, for example, exhibit this behaviour in the real world and so such an approach may be appropriate. In a stress event the price of credit assets like corporate bonds might fall because companies are deemed more likely to fail and default on their debt. However, if the stress event does not result in insolvency, the debts will ultimately be paid in full and the assets will recover, resulting in increased returns soon after a downside event.

Approach one has the advantage that it seems sensible for a pension scheme's liabilities to be measured based on the yields available on its the assets and so might be a more durable approach over the long run. However, it does involve a fundamental change in the approach to valuing the scheme's liabilities. Approach two may therefore be easier to adopt in practice. It should also be more helpful in allowing low risk investment strategies with material allocations to corporate bonds pass the bounce back test.

3 Scheme investments under the new regime: Liquidity and liability hedging

What's new...

Scheme investments must have sufficient liquidity to enable the scheme to meet expected cash flow requirements and make reasonable allowance for unexpected cash flow requirements. The code also specifies a minimum level of interest rate and inflation hedging.

Factor	Commentary	Questions for trustees
Interest rate and inflation hedging	The LDIA should target a minimum interest rate and inflation hedge of 90% of the low dependency liabilities. While the code states that trustees should consider their scheme's hedge against the shape of its liabilities (as well as the absolute amount of hedging), TPR expects the depth of analysis to be proportionate to the size of the scheme and the time to the relevant date.	Is your hedge target sufficient?
Liquidity	Trustees must consider whether a potential LDIA provides appropriate liquidity to meet expected and unexpected payments like pensions, transfer payments and collateral calls. The code also says that trustees should undertake cashflow forecasts over at least 3 to 6 months. Smaller schemes should consider cashflow issues around the impact of retirement plans for members with larger benefits. More immature schemes may have greater scope to invest in illiquid assets. However more mature schemes can also invest in illiquid assets as these can help generate cashflows to match benefit payments. Consideration also needs to be given to retaining liquid assets to meet cash calls from liability hedging and other derivative based assets.	Will the scheme have sufficient liquidity to meet all expenses and payments to members?

3 Scheme investments under the new regime: Next Steps

Checklist for trustees

Engage with the employer

✓ Trustees and employers should work closely to ensure sufficient time is given to each of the additional requirements introduced under the funding and investment strategy regulations. Investment considerations should feed into wider discussions regarding long-term objectives.

Determine your proposed LDIA

✓ Trustees should ensure their chosen LDIA aligns with their long-term objective.

Is the proposed LDIA highly resilient?

✓ Take advice on a suitable test of high-resiliency. This may include the LDIA passing both a "bounce-back" test and a test that the low dependency funding level would not fall by more than the trustee's maximum tolerance in response to short-term adverse changes in market conditions.

Does the proposed LDIA meet the other requirements of the code?

✓ Does the proposed LDIA hedge at least 90% of the interest rate and inflation risk relative to the low dependency liabilities? Is the LDIA suitably liquid to be able to meet known and unknown future cashflow requirements?

Scheme investments under the new regime: Next Steps

Checklist for employers

Determine your objectives

✓ How would you like the trustees to provide the scheme's benefits over the long-term? Do you want to buy out or would you prefer to run the scheme on? What are your views on the scheme's current investment strategy – are you comfortable maintaining the current level of investment risk / return for as long as possible or would you prefer to incorporate some immediate de-risking?

Determine your investment risk and return preferences

✓ How much investment return would you like the trustees to target? How much investment risk can you tolerate? Consider your preferences both now and how they might change in the future

Engage with the trustees

✓ Trustees and employers should work closely to ensure sufficient time is given to each of the additional requirements introduced under the funding and investment strategy regulations

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 86 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 Adam Rouledge, Pauline McConville or Tom Fallon. Alternatively, please speak to your usual XPS contact.

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