New approach to funding defined benefit pension schemes

DWP consults on new draft funding regulations

July 2022

Background

The Pension Schemes Act 2021 provided for a framework for a new defined benefit funding regime. In particular, the framework would require defined benefit schemes to have a funding and investment strategy for the purpose of ensuring benefits under the scheme can be paid over the long term. As part of this, trustees will be required to produce:

- A funding and investment strategy; and
- A statement of strategy.

The detail of what this would mean in practice was to be set out in regulations. The DWP has now published a draft of these regulations, on which they are consulting.

Funding and investment strategy

Trustees of defined benefit occupational schemes will be required to have a funding and investment strategy. This needs to set out how pensions and benefits under the scheme can be provided over the long term. This must state:

- The funding level the trustees intend the scheme to have achieved as at specified date (not later than the end of the scheme year in which the actuary estimates the scheme is expected to reach significant maturity (**Relevant Date**)); and
- The investments the trustees intend the scheme to hold at the Relevant Date.

The Relevant Date will be reviewed each time the funding and investment strategy is reviewed to ensure it remains appropriate.

At significant maturity

A key principle that must be followed when determining or revising the funding and investment strategy is that schemes must be in, at least, a state of low dependency on their sponsoring employer by the time they reach significant maturity. This means the scheme should not rely on further employer contributions to provides for accrued liabilities at the point of significant maturity. This will be achieved by:

- scheme assets being invested in low dependency investments. These are investment the cash flow from which will broadly match with the payment of benefits from the scheme. The investments will also be such that the value of the assets of the scheme relative to its liabilities is highly resilient to short-term adverse changes to market conditions; and

- the scheme being fully funded on a low dependency funding basis. This basis is calculated using assumptions that further employer contributions would not be expected to be required to make provision for the accrued benefits under the scheme.

The regulations provide how scheme maturity is to be measured and this will be measured in years using a duration of liabilities measure. The Pension Regulator's forthcoming code of practice will specify the period at which a scheme will reach significant maturity. This will be the latest time a scheme should meet the two conditions above. In its first consultation on this code, the Regulator suggested a scheme would be significantly mature when it reached a duration of liabilities of 12 to 14 years, and it is expected the next consultation will suggest 12 years for this measure.

The regulations also set out further information that must be set out in the strategy.

Between now and significant maturity

The level of risk that can be taken by the trustees in relation to the investments of the scheme and the actuarial assumptions used for calculating the liabilities of the scheme before it reaches the Relevant Date will depend on:

- the strength of the employer covenant (that is the financial ability of the employer to support the scheme). The regulations set out how this is to be determined; and
- how near the scheme is to reaching the Relevant Date.

There were concerns during the passage of the Pension Schemes Act 2021 that the new requirements would force schemes to de-risk. However, the DWP has emphasised that it does not want to see schemes de-risk unnecessarily. The intention of this approach is that where appropriate, schemes on their journey to maturity can invest in riskier investment with potentially higher returns if this risk can be supported and member benefits effectively protected.

Timing

The first funding and investment strategy will need to be determined no later than 15 months after the effective date of the first actuarial valuation of the scheme after the regulations come into force.

The strategy will then need to be reviewed and where necessary revised (broadly) (i) within 15 months after the effective date of each subsequent actuarial valuation; or (ii) as soon as reasonably practicable after any material change in the circumstances of the pension scheme or of the sponsoring employer.

Statement of strategy

The trustees must also prepare a written statement of strategy which will set out the scheme's funding and investment strategy, as well as other supplementary matters.

These supplementary matters include an assessment of whether the funding and investment strategy is being successfully implemented. The trustees should set out the main risks faced by the scheme in implementing the strategy and how the trustees intend to mitigate these. The trustees must also state what steps they will take if the risks identified, materialise. The trustees are also required to provide details relating to asset allocations.

This part of the strategy must be reviewed, and where required revised, as soon as practicable after the review of the funding and investment strategy

The statement must also include other information on the maturity of the scheme, investment risk, liquidity, funding level, technical provisions, risks in relation to the calculation of liabilities and employer covenant.

The statement of strategy will need to be signed off by the chair of trustees. Where a scheme currently does not have a chair, one will need to be appointed. The statement will then need to be submitted to the Pensions Regulator.

Other changes

There are some other changes proposed by the new draft regulations. Most notably:

- The requirement for defined benefit schemes without a chair to now appoint a chair;
- by the time a scheme reaches the Relevant Date, the assumptions used when calculating the scheme's technical provisions will need to be consistent with how the trustees intend the benefits under the scheme to be provided over the long term, as set out in the funding and investment strategy; and
- when trustees are determining if a recovery plan is appropriate, they should follow the principle that the deficit should be recovered as soon as the sponsoring employer can reasonably afford. The DWP is also considering whether this new factor would have primacy over the existing matters trustees should take into account when setting recovery plans.

Next steps

Following the consultation, the DWP will publish the regulations in their final form. The consultation closes on 17 October 2022 and so the final form of the regulations will appear sometime after this.

The Pensions Regulator will also be consulting in due course on a revised Defined Benefit Funding Code of Practice which will support the new legislative requirements. The Regulator was awaiting the draft regulations before it published this and so it is worth keeping an eye out for this in due course.

Comment

The draft regulations do limit the investment risk that scheme's will be able to take once they reach significant maturity. This is one area that the DWP is seeking further views on as to whether additional risk should be permitted where, for example, this can be supported by contingent assets provided by another company. We await to see consultation responses on this point and whether more flexibility is given to mature schemes.

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