A new defined benefit funding regime

Updated draft Regulations published

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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. Back in July 2022, the DWP consulted on draft funding regulations (**Initial Regulations**) which set out much of the detail of the new finding regime. Our briefing at that time set out further detail on this first draft.

During that consultation, the industry highlighted a number of concerns that it had with the Initial Regulations, not least of all over a perceived requirement for schemes to be over cautious in their investment decisions. There was also no real provision for open schemes.

The government has now published its response to the consultation replies, together with the revised draft Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2024 (**Revised Regulations**). The industry will be pleased to hear that a number of the concerns raised in the consultation responses have been taken on board and reflected in the Revised Regulations. Unsurprisingly, given the government's keenness to promote the diversification of investments by pension funds, a reason for a number of these changes is to avoid:

"*inadvertently driv[ing] reckless prudence and inappropriate risk aversion*".

The Regulations will come into force on 6 April 2024 and will apply to valuations with effective dates on and after 22 September 2024. Set out below are some of the key changes in the Revised Regulations from the Initial Regulations.

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. What this requires in practice has been expanded in the Revised Regulations to include:

- a journey plan of the funding level the trustees intend the scheme to have along the path to the **Relevant Date** (the Relevant Date is a date not later than the end of the scheme year in which the actuary estimates the scheme is expected to reach **significant maturity**);
- the discount rate and other assumptions used in calculating the scheme's technical provisions;
- how the trustees expect the discount rate to change over time; and
- the proportion of the assets of the scheme allocated to different categories of investment.

A. By the Relevant Date

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 the Relevant Date; that is that further employer contributions would not be expected to be required to meet the scheme's liabilities on the basis of certain assumptions.

There was concern that the requirements in the Initial Regulations could impact the trustees' independence when choosing scheme investments. The Revised Regulations now provide that the funding and investment strategy does not create a regulatory requirement to invest in the way set out in the strategy on and after the Relevant Date. However, it is a regulatory requirement that on and after the Relevant Date the scheme must be fully funded on a low dependency funding basis. Having said this, the government has made clear that the Pensions Regulator (**Regulator**) will expect the trustees' investments to, in practice, usually be consistent with the funding and investment strategy. There may, however, be good reason for some divergence and therefore whilst trustees and employers may agree the funding and investment strategy, it will be for the trustees alone to decide on the actual investments made.

Significant maturity

The Initial Regulations provided that scheme maturity would be measured in years using a duration of liabilities measure. Many in the industry were concerned that this measure would cause uncertainty since it is sensitive to market conditions. As a result, the Revised Regulations now provide that when determining this, the economic assumptions used will be based on the economic conditions on 31 March 2023.

The Regulator's forthcoming code of practice will specify the period at which a scheme will reach significant maturity. The Revised Regulations have been amended to allow the Regulator to set a different date of significant maturity for cash balance schemes.

There was concern with the Initial Regulations over the impact the regulations would have on open schemes, in particular that they would be required to de-risk unnecessarily. As a result, in the Revised Regulations, open schemes may make reasonable allowances for new entrants and future accrual in some scheme maturity calculations. This will be subject to the trustees' assessment of the employer's ability to support the scheme. This approach will allow some open schemes to fund on the basis that it will not begin to mature soon.

Low dependency investment allocation

Whilst mature schemes will need to have a low dependency on the sponsoring employer, there was concern in the Initial Regulations that the way this was formulated would mean that the ability for trustees to invest in higher growth assets would be excessively restricted for these schemes. As a result, amendments have been made in the Revised Regulations to remove the original requirements that assets had to be invested in a way that the cashflow from the investments broadly matched the payment of benefits. The intention is to allow schemes to invest a reasonable amount in a wide range of assets after significant maturity.

B. From now to the Relevant Date – the journey plan

The journey plan sets out the scheme's planned progress in accordance with its funding and investment strategy as it moves to the Relevant Date. This starts with the effective date of the valuation to which the fundings and investment strategy relates and ends on the Relevant Date.

The level of risk that can be taken by the trustees in determining 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; and
- how near the scheme is to reaching the Relevant Date.

The Revised Regulations have been amended to make clear that employer covenant means the employer's financial ability in relation to its legal obligation to support the scheme.

Whilst the technical provisions must be consistent with the journey plan and the low dependency funding basis as at the Relevant Date, it has been made clear that trustees retain primacy over investment decisions and employers do not need to agree them.

Statement of strategy

Trustees must also prepare a written statement of strategy which will set out (i) the scheme's funding and investment strategy; and (ii) other supplementary matters, including how well the funding and investment strategy is being implemented and an assessment of the employer covenant.

In the Revied Regulations, the level of details and supplementary matters that schemes need to provide has been amended in order to reduce the administrative burden. In particular, the Regulator has been given discretion allowing it to take a scheme specific approach. Some schemes may therefore be asked for less detail or not be asked to provide a certain item at all. Trustees must consult with the employer in respect of the supplementary part of the statement of strategy.

The statement of strategy must be sent to the Regulator as soon as reasonably practical after it has been prepared or revised.

Recovery plan

The Revised Regulations now require the impact of the recovery plan on an employer's sustainable growth to be taken into account when preparing or revising a recovery plan. The

requirements in the Initial Regulations for trustees to follow the principle that the deficit should be recovered as soon as the sponsoring employer can reasonably afford when preparing a recovery plan, has been retained.

Comment

It seems the government has taken on board a number of the industry's concerns in drafting the Revised Regulations. There is a clear emphasis that investment decisions remain with the trustees and the trustees alone, and that schemes should not be required to unnecessarily de-risk. The full picture of the new regime cannot, however, be fully understood without sight of the Regulator's final code of practice on this new funding regime. It is hoped the industry will not have to wait too much longer before this is published.

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