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DWP consults on scheme funding requirements

The DWP has published a consultation seeking views on draft regulations that set out the detail of the new requirements in the Pension Schemes Act 2021, for defined benefit (DB) pension schemes to have a funding and investment strategy and submit a statement of strategy to The Pensions Regulator.

The consultation also invites comments on proposals to amend the existing scheme funding regulations and provides details of the new requirement for DB schemes to appoint a chair of trustees where they do not already have one.

The consultation closes on 17 October 2022.

Background

The Pension Schemes Act 2021 is a major piece of legislation, covering a number of different policy areas. Many of the provisions have either already been brought into effect or have at least already been through a period of consultation.

The last big issue to be consulted on from this Act is the detailed requirements on how DB pension schemes will be expected to strengthen their funding framework. It is currently unknown exactly when the regulations are expected to take effect. The only clue we have is that the draft regulations are dated 2023.

Now that this consultation has been published, the Regulator can release its long-awaited revised funding code of practice, which will support these new requirements. The Regulator plans to consult on the revised code later this year, although it is not currently expected to come into force until September 2023.

Funding and investment strategy

The Act requires trustees of DB schemes to adopt and maintain a funding and investment strategy. The draft regulations (the regulations) provide that a key principle the trustees must follow when determining or revising their scheme's strategy is a requirement for schemes to be in, at least, a state of low dependency on their sponsoring employer by the time they are significantly mature. This would require scheme assets to be invested in a low dependency investment allocation and for schemes to be fully funded on a low dependency funding basis. There is a recognition, however, that schemes will go about meeting this standard in different ways.

Trustees will be required to implement their first funding and investment strategy no later than 15 months after the effective date of the first actuarial valuation of the scheme after the regulations come into force. Thereafter, they will have 15 months after subsequent valuations to review and put in place subsequent strategies. Should there be a material change in circumstances of the pension scheme or sponsoring employer, a new strategy must be confirmed as soon as reasonably practicable. There are shorter time limits if the Regulator has given directions in relation to a scheme.

Scheme maturity

Maturity is a measure of how far a scheme is through its lifetime. A scheme which has a high proportion of active or deferred members, will probably be immature, whilst a scheme which has a high proportion of pensioner members is likely to be more mature.

The regulations provide enough flexibility to allow the characteristics of an open scheme to be considered in the projection of scheme maturity. For open schemes that are not maturing, the "relevant date" (set by the trustees each time the strategy is reviewed, which cannot be later than the end of the scheme year in which the scheme is expected to (or did) reach significant maturity as advised by the Scheme Actuary) can move into the future following subsequent review, in which case no investment de-risking is required as a result of the scheme moving closer to that date. The extent to which any de-risking does take place for such schemes will depend on the circumstances of the scheme, including the support available from the employer.

The duration of liabilities is to be used as the measure of scheme maturity for the purposes of the funding and investment strategy. A scheme will reach significant maturity on the date it reaches the duration of liabilities in years to be specified by the Regulator in the forthcoming code of practice (currently expected to be set at 12 years). A scheme is required to be invested in a low dependency way by the end of the year in which significant maturity is met. Scheme funding should be consistent with this investment strategy, so should be targeting full funding on at least a low dependency funding basis by the same date.

Low dependency

A scheme has low dependency on its employer when it has sufficient assets invested in a low dependency investment strategy to provide for accrued pension rights and is not expected to need further employer contributions. Such a scheme may still receive contributions from the employer for further accrual of future pension rights for any active members.

Low dependency is not self-sufficiency, because there may be unexpected circumstances which are materially different from those assumed which require the employer to provide additional funds.

A low dependency investment allocation, means that:

- the assets of the scheme are invested in such a way that the cash flow from the investments is broadly matched with the payment of pensions and other benefits under the scheme; and
- the assets of the scheme are invested in such a way that the value of the assets relative to the value of the scheme's liabilities is highly resilient to short-term adverse changes in market conditions.

Employer covenant

The strength of employer covenant is defined as the financial ability of the employer to support the scheme together with the level of support that can be provided by any contingent assets, to the extent that these contingent assets are legally enforceable by the trustees and sufficient to provide that support at the time it might be needed. The strength of the employer covenant is a relevant factor for trustees' decisions in determining the appropriate funding and investment risks to take and has over time become a key feature of the scheme funding regime.

Accordingly, the regulations provide that in determining or revising the funding and investment strategy, the principles the trustees or managers of a scheme must follow relating to the level of investment risk and the level of funding risk that can be taken by a scheme as it moves along its journey plan, are that the level of risk is dependent, primarily, on the strength of the employer covenant.

The regulations require the strength of the employer covenant to be assessed in relation to the size of any scheme funding deficit (or surplus). For example, even a successful and profitable employer might not provide a strong employer covenant if the pension scheme funding deficit is disproportionally large. Conversely, an employer with limited income might provide a strong covenant if the pension scheme deficit is very small or the scheme is very well funded with surplus assets.

Investment and liability risks

Both the investment risk that trustees can take, and the actuarial assumptions that trustees can adopt to determine liabilities, as a scheme moves along its journey plan (the period from the current date to the relevant date), are dependent on:

- the strength of the employer covenant. (More risk can be taken where the covenant is strong); and
- how close the scheme is to reaching the relevant date.

Liquidity

Trustees must ensure they invest the assets in such a way that there is sufficient liquidity to enable the scheme to meet expected cash flow requirements and make reasonable allowance for unexpected cash flow requirements, both as the scheme moves along its journey plan and on and after the relevant date.

Statement of strategy

Trustees are required by the Act, in consultation with the sponsoring employer, to prepare a written statement of strategy setting out the scheme's funding and investment strategy. This statement must be signed off by the chair of trustees and if there is not currently a chair, one must be appointed.

All actuarial valuations, whether or not a scheme is in deficit, will have to be sent to the Regulator and the statement of strategy must accompany it.

Within this statement of strategy trustees are required to provide an assessment of whether the funding and investment strategy is being successfully implemented, or any remedial action they intend to take, to get the strategy back on course. Trustees are also required to set out the key risks and mitigations for implementation and their reflections on any key decisions and lessons learned.

The statement must include:

- The actuary's estimate of the maturity of the scheme as at the effective date of the actuarial valuation and (for a scheme that has not reached its relevant date) how the scheme's maturity is expected to change over time.
- An explanation about the level of risk the trustees intend the scheme to take in relation to the investment of assets now and (for a scheme that has not reached its relevant date) over the course of the journey plan.
- Details about complying with the principle relating to liquidity of assets, and how the trustees expect to meet cash flow requirements.
- The actuary's estimate of the scheme's funding level as set out in the actuarial valuation. For a scheme which has reached the relevant date, the assumptions used in that estimate must be set out. For schemes before the relevant date, trustees should confirm the assumptions used in specifying the funding level they intend the scheme to have achieved at the relevant date and explain how these differ from those used in the technical provisions.
- The discount rate used, and any other assumptions used in calculating the scheme's technical provisions, and how the discount rate is expected to change over time.
- An assessment of the strength of the employer covenant.

Comment

The strengthening of requirements on trustees around DB funding and the detail needed for the statement of strategy will be daunting for many smaller schemes, which will likely need to commission additional advice (at additional cost) in order to fulfil the new disclosure of information requirements.

The 15-month deadline to "revise" an investment strategy following a valuation seems unrealistically tight. If negotiations on funding assumptions and contributions are not concluded until the 15 months is nearly up, then there will be no time for the detailed investment modelling required to update strategy to reflect updated liabilities and (most importantly) final contributions – while an iterative process between funding and investment strategy sounds like a great idea in theory, the difficulties (and costs) involved in revising investments as funding strategy changes through a negotiation process should not be overlooked.

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