HYMANS # ROBERTSON

Sixty second summary

Long-awaited DB funding & investment legislation aired

The Department for Work and Pensions (DWP) has published an eagerly-anticipated consultation draft of the legislation necessary to implement scheduled reforms to the defined benefit (DB) funding regime.[1] The main outcome would be a statutory requirement for long-term planning, but the revisions would have the side effect of obliging DB trustees to appoint a chairperson, and would also clarify what makes a recovery plan '*appropriate*'. This paves the way for the Pensions Regulator to launch a second consultation into its funding Code of Practice, later in the year.

Recap

The *Pension Schemes Act 2021* contains amendments that would require trustees to prepare and maintain—with the agreement of their sponsor(s)—a '*funding and investment strategy*' (FIS). Regulations are required to bring the provisions into force and to fill in the details of the legal obligation. The Regulator has been working on a new funding Code of Practice in parallel with the legislative developments: its proposed twin-track ('*Fast Track*' versus '*Bespoke*') routes to compliance, and most notably the crucial Fast Track parameters, are *not* part of this DWP consultation exercise.

Getting busy with the FIS-y

Extending and amending the current scheme funding legislation, the draft Regulations look to embed the key principles in law whilst leaving the details of how things should operate in practice for the Regulator to fill in. Trustees and sponsors would need to agree on a FIS within fifteen months of the effective date of the first actuarial valuation obtained after the legislation comes into force (some time in 2023, it is suggested). Thereafter, FIS reviews would be required within fifteen months of each subsequent valuation, or as soon as reasonably practicable after any material changes to the circumstances of either the scheme (for example, affecting its funding or maturity levels) or the employer (for instance, in the strength of its covenant).

The goal of the draft legislation is for trustees to plan on the basis that, by the time their scheme reaches '*significant maturity*', it has sufficient assets, and is invested in such a way, that there should be no need (barring unforeseeable events) for additional employer contributions to provide the benefits then accrued. A scheme becomes increasingly mature as the proportion of benefits that have come into payment increases. The proposed measure of the maturity of a scheme, for the purposes of the new legislation, would be the average time until the payment of benefits, weighted by the discounted payments. The Code of Practice would define what constitutes '*significant maturity*': the consultation document suggests that the Regulator will propose a duration of liabilities of twelve years as the point at which significant maturity is attained. The expected timing of significant maturity would need to be reviewed whenever the FIS is (that is, at least triennially).

The FIS would have to be drafted on the basis that, by the time a scheme reaches significant maturity (specifically, by the end of the scheme year in which that occurs), the cash flows from its investments match (broadly) its benefit payments, and the

[1] <www.gov.uk/government/consultations/draft-occupational-pension-schemes-funding-and-investment-strategy-and-amendment-regulations-2023>.

value of its assets relative to its liabilities is highly resilient to adverse short-term market swings. The strategy would also assume that, by that time, the scheme will be fully funded, on a basis that assumes that no further employer contributions should be necessary to provide the accrued benefits.

The levels of investment and actuarial risks that could be taken by the trustees in accordance with the FIS as the scheme proceeds towards significant maturity would depend on how close it is to that point and, chiefly, on the strength of the employer covenant. The draft Regulations contain rules for assessment of covenant strength upon which the Regulator would issue guidance. The stronger the covenant, and the further the scheme is from significant maturity, the more risk can be borne. The strategy would need to be drafted on the understanding that, by the time the scheme reaches significant maturity, its investments will be liquid enough to match its expected cash flow requirements, and make reasonable allowance for unanticipated demands.

The draft Regulations recognize that, in practice, this '*low dependency*' approach may differ from the trustees' *actual* end goal. They would need to explain, in their FIS, their plan for providing the scheme's benefits in the long term (for example, by allowing the scheme to 'run on', transferring to a consolidator, or buying out with an insurer).

Making a statement

As soon as reasonably practicable after each FIS review, the trustees would need to prepare a written statement of strategy, that (as well as describing the FIS) would assess their performance against the FIS (and any remedial action required to get back on track), the risks faced when implementing it (and what they can do to mitigate them), and what they have learned from the decisions that they have taken along the way. It would also need to set out the current state of play and likely future development of various factors crucial to the scheme's journey plan: scheme maturity, investment and actuarial risks, liquidity, funding level, actuarial assumptions, and employer covenant. The scheme sponsor needs to be consulted about the contents of the statement of strategy, and may make comments for inclusion in it.

Statements of strategy would need to be in a form set by the Regulator, and would be submitted to it alongside actuarial valuations (which would in future have to be sent regardless of whether they disclose a deficit or not). The statement would have to be signed by the chair of the trustees: the legislation would require the appointment of a chair if the scheme does not have one already.

Planning appropriately

When an actuarial valuation shows that a scheme has a funding deficit, the trustees are obliged to prepare or revise a recovery plan that is '*appropriate having regard to the nature and circumstances of the scheme.*' The draft Regulations would amend the rules on the preparation of recovery plans to say that, when determining whether a plan is '*appropriate*', the trustees '*must follow the principle that funding deficits must be recovered as soon as the employer can reasonably afford.*'

What comes next?

Comments about the proposed legislation should be submitted by 17 October 2022. The Regulator intends to take the draft Regulations into account when composing its revised Code of Practice on DB scheme funding, which it expects to consult upon in the autumn; if things go to plan the Code is expected to launch in late 2023 or early 2024. The DWP would be obliged to review the effectiveness of the new provisions at least every five years.

The draft Regulations begin to sketch out the form of the revised funding regime, but do not themselves tell us much that is new. They will, however, allow the Regulator to proceed to the second stage of consultation on its new funding Code, which will confirm how it is all expected to operate in practice—particularly the details of the proposed 'Fast Track' and 'Bespoke' funding approaches. For now, trustees and sponsors will need to press ahead in the knowledge that significant changes are coming down the line: the draft Regulations and the (hopefully) imminent Code consultation will help with those preparations.

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