Sackers

DWP publishes revised DB funding regulations

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Introduction

The first document in the new funding regime jigsaw has now been issued in final form. Designed to implement new requirements set out in the PSA21 for DB schemes to have a funding and investment strategy ("the F&I Strategy"), and to submit a written statement of that strategy ("the Statement") to TPR, the revised regulations ("the Regulations") have been published by the DWP, alongside the response to its 2022 consultation.

Key points

- The Government believes the Regulations, in particular the "clearer funding standards", should provide a platform for its Mansion House proposals, as taken forward in the Autumn Statement, as they allow for investment in productive finance, more flexible use of surplus and are compatible with an expanded role for the PPF.
- DB schemes will be required to have an F&I Strategy aimed at achieving "low dependency" on their sponsoring employer by the time they are "significantly mature".
- The Regulations have been revised in light of feedback (accommodating the "richness of the responses"), to embed more flexibility into the requirements and to accommodate "appropriate risk taking" where it is "supportable", which the industry will welcome.
- Trustees will be required to produce their first F&I Strategy no later than 15 months after the effective date of the first actuarial valuation **on or after 22 September 2024**.
- The Regulations specify what must be covered in the Statement but with TPR having "discretion as to the level of detail" to be provided.
- Further detail on the new requirements will be set out in TPR's revised DB funding code of practice ("the Code"), which is expected later in the year, so this also needs to be on all DB schemes' radars.

Background

The PSA21 sets the scene for a new requirement for DB schemes to have an F&I Strategy, including the funding level which the trustees "intend the scheme to have achieved", and the investments they intend to hold, on the relevant date(s) (see below).

In 2022 the DWP consulted on draft regulations, which set out the matters the trustees must take into account, and the principles they must follow, in determining or revising their scheme's F&I Strategy. The regulations also addressed the level of detail to be provided.

Next came TPR's second consultation on its Code. The Code is designed to partner with the Regulations, providing practical guidance on how trustees can comply with scheme funding requirements.

After the consultations, there was a great deal of push back and queries from the industry, as well as a WPC Select Committee inquiry, the LDI crisis and the introduction of the Government's "productive finance" agenda in the Mansion House reforms, so the DWP has revisited the drafting of the Regulations in light of these developments.

Changes to the Regulations

The DWP says it has "improved" the Regulations, acknowledging that, whilst its aim was to make the funding standards "clearer", it is easy to "inadvertently drive reckless prudence and inappropriate risk aversion". As such, the Regulations have been revised with the aim of striking a "fair and lasting balance between security for members and affordability for sponsoring employers as the economic context evolves".

The changes are intended to address **five** broad areas of concern:

- **flexibility and stability in long-term planning** – the DWP has "sought to explicitly anchor the flexibilities described in the draft Code in these Regulations to put the matter beyond doubt" and make clearer the flexibilities that were originally intended
- **risk aversion** – they provide assurance that the investment in the sustainable growth of sponsoring employers' businesses is a matter to consider alongside the affordability principle
- **open schemes** – it is now explicit that open schemes can take account of new entrants and future accrual when determining when the scheme will reach significant maturity
- **administrative burden** – long-term planning and implementation is made easier and "unnecessary administrative burden" is avoided by giving TPR, for example, the flexibility to ask for less detailed information in some cases, depending on the circumstances of the scheme
- **alternative scheme design** – ensuring that the Regulations work for cash balance schemes, as well as more "traditional" DB schemes.

Trustees' independence in making investment decisions

Concerns had been raised about the impact the draft Regulations could have had on trustees' independence in making investment decisions. It was always the intention that the Regulations should not change the power of trustees in relation to investments and the Regulations have been redrafted to try to reflect this.

Application to scheme surplus

The Regulations have also been amended to make clear that the objective to invest in line with the low dependency investment allocation (see below) does not apply to surplus funding. This is intended to give trustees more flexibility into how they can invest surplus and is in keeping with the Government's other work on the use of surpluses.

F&I Strategy

The Regulations describe the matters the trustees must take into account, and the principles they must follow, in determining or revising their scheme's F&I Strategy.

As was the case with the draft Regulations, the key principle underpinning the F&I Strategy will be a requirement for schemes, as a minimum, to be "in a state of low dependency on their sponsoring employer by the time they are significantly mature". Unsurprisingly, the principles trustees will need to follow to achieve this hone in on the level of investment and funding risk (both dependent, primarily, on the strength of the employer covenant), as well as liquidity.

Process

The overall process is broadly unchanged from the draft Regulations, with the DWP envisaging that trustees will:

- determine the date of "significant maturity" on actuarial advice
- then pinpoint a relevant date, and
- finally, determine a "low dependency asset allocation" they intend the scheme to have achieved by that date, and a "low dependency funding basis" consistent with that asset allocation.

That "low dependency funding basis" will also be used by the actuary to estimate the scheme's funding level as at the effective date of the relevant actuarial valuation. The key concepts are summarised below.

Scheme maturity

Maturity is a measure of how far a scheme is through its lifetime. The Regulations provide for maturity to be measured in years using a "duration of liabilities" measure. This measure is the "weighted mean time until the payment of pensions and other benefits under the scheme, weighted by the discounted payments".

In response to concerns that the duration of liabilities measure is particularly sensitive to market conditions (eg the steep rise in gilt yields at the end of September 2022 caused the proposed significant maturity date to move rapidly by a number of years), the Regulations have been revised to prescribe a fixed date, of 31 March 2023, on which economic assumptions used to calculate maturity must be based.

Significant maturity

To provide more flexibility for it to be adjusted in response to market conditions, the duration at which a scheme reaches "significant maturity" will be set out in TPR's Code and the revised Regulations make clear that TPR can set a different date of "significant maturity" for different types of scheme (eg cash balance).

At each valuation, the scheme actuary will be required to estimate the date on which the scheme will reach significant maturity using the methodology and metrics set out in the Regulations and the Code.

Relevant date

Where schemes have not reached significant maturity, the relevant date must not be later than the end of the scheme year in which the scheme is expected to reach significant maturity, as set out in the actuarial valuation to which the F&I Strategy relates. Each time the F&I Strategy is reviewed, the trustees will be required to review and, if necessary or appropriate, revise the relevant date.

For schemes that are already past the point of significant maturity, the relevant date for these schemes will be the effective date of the valuation to which the F&I Strategy relates.

Low dependency

Following concerns that the original formulation of "low dependency investment allocation" could be interpreted in a way that was "excessively restrictive", the Regulations have been revised, with the intention of clarifying that schemes can invest a "reasonable amount" in a "wide range of assets" (ie not just government and corporate bonds) after significant maturity.

Broadly, a scheme has low dependency on its employer when its assets are invested in such a way that the value of assets relative to the value of the liabilities is "highly resilient" to short-term adverse changes in market conditions, so that further employer contributions are not expected to be required.

No changes have been made to the "low dependency funding basis".

Timing

The first F&I Strategy must be produced no later than 15 months after the effective date of a scheme's first actuarial valuation on or after 22 September 2024. It must then be reviewed, and if applicable revised:

- within 15 months of the effective date of each subsequent valuation, and
- as soon as reasonably practicable after any material change in the circumstances of the pension scheme or its employer.

The Statement

The Statement is intended to facilitate better trustee engagement, and better understanding and accountability between trustees and TPR.

Part one of the Statement is the F&I Strategy itself.

Part two must then:

- provide an assessment of whether the F&I Strategy is being successfully implemented, including any remedial action the trustees intend to take to get the strategy back on course and details as to timing
- set out the key risks and mitigations for implementation, and the trustees' reflections on any key decisions and lessons learned.

Other details to be covered by the Statement include:

- a summary of the information contained in the actuarial valuation (and recovery plan, if relevant) to which the F&I Strategy relates (this is a new requirement, included with the aim of enabling TPR to remove similar questions from the scheme return to minimise duplication)
- 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 of the level of investment risk the trustees intend the scheme to take now and, for a scheme that has not reached its relevant date, over the course of its journey to significant maturity (known as "the journey plan")
- an assessment of the strength of the employer covenant
- an explanation of how the F&I Strategy remains appropriate
- confirmation that the sponsoring employer has been consulted when preparing or revising Part two, as well as any comments which it has asked to be included.

Changes have been made to the level of detail and the supplementary matters schemes need to provide within the Statement, with a view both to practicality and reducing administrative burden. For example, TPR will have power to exercise discretion as to the level of detail required, ie it may ask for less detail, or not ask for an item of information at all.

Part two of the Statement must be reviewed and, if necessary, revised as soon as practicable after any review of the F&I Strategy, whether or not the strategy itself is revised.

The Statement must be submitted to TPR "as soon as reasonably practicable" after it has been prepared or revised (rather than being submitted along with the scheme's actuarial valuation, as was proposed in the original draft Regulations). The submission process will be set out in TPR's Code.

The chair of trustees

The Statement must be signed off by the chair of trustees and, where the trustee board does not have a chair, they must appoint one. In either case, the chair must meet certain basic requirements.

Next steps

The expectation is that the Regulations will come into force on 6 April 2024 and will apply to valuations with effective dates on and after 22 September 2024. This extra time is intended to give the pensions industry "sufficient time to prepare" before the requirements take effect.

TPR's updated Code, which will give schemes more practical guidance on how to comply with the new requirements, is expected later in the year.

Also awaited is the revised covenant guidance so, for now, the funding puzzle remains incomplete.

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