Broadstone

Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2023

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Executive Summary

We understand that the government is committed to reducing the risk profile of DB schemes. However, forcing schemes to adhere to the same strategy has risks in of itself.

While your ministerial foreword correctly states "*it is important that we get the right balance between ensuring those [defined benefit] pensions are secure for members over the longer term and keeping them affordable for sponsoring employers*" the rigidity and very low risk requirements of the proposed regime would appear to push this too far and move away from the strengths of a flexible scheme specific approach which you explicitly stated you wanted to preserve.

While it is hard to fully judge some of the measures without the accompanying understanding of how the Pensions Regulator might enforce this, or whether there will be any form of transitional arrangements (particularly for those already close to the significant maturity barrier), we are concerned that strong employers with small schemes will face material additional costs as a result of the more stringent requirements. Small schemes also need a proportionate approach as they are more likely to face 'trigger' events and will be see a higher impact on running costs from the additional advice requirements.

There is a danger that prescription of lower risk strategies and funding targets based solely on affordability could hasten the demise of weaker employers, potentially to the detriment of member outcomes by removing reasonable flexibilities available to them within the current regime. Further herding of pension scheme investments into low-risk assets could also cause further disruption to the economy, adding to systemic risk and impacting on the government's wider growth agenda.

A summary of our key points is as follows:

- A rigid definition of significant maturity (or a sharp cliff edge at this point) should be avoided. Events of recent weeks have demonstrated that this could lead to short term and material shifting of the goalposts, undermining the long-term planning that it is intended to support. Greater flexibility in the definition will particularly help smaller schemes who are more likely to experience volatility around a set date without some additional consideration.

- There is not enough understanding and allowance for strong employers able to sponsor their scheme over the long term. Forcing them to a low-risk position will cause additional costs and is likely to hasten their path to buy-out. While in itself this might appear a desirable end-game position, given the limited short-term capacity within that market it would seem preferable not to force the strongest employers further forward in the queue.

- Smaller schemes are disproportionately impacted by additional costs and by hard and fast rules which will not recognise their resources and / or more volatile position (individual member experience is inevitably more likely to have a material impact on figures). Allowing flexibility in strategies (carefully overseen by the Pensions Regulator) will act as a safety valve when regulations might otherwise force actions to the detriment of members' benefit security and employers' sustainability.

- Relying solely on affordability within a recovery plan is not appropriate. We do not want employers to be put under pressure for no good reason other than the regulations are forcing detrimental funding and investment decisions.

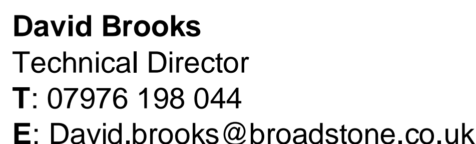
- For small schemes the cost of putting a contingent asset in place could easily outstrip the expected benefit of 5% in growth assets meaning this flexibility would then potentially only benefit larger arrangements. Flexibility should be based on the strength of security provided by the sponsor covenant and contingent assets.

- Requiring agreement of employers to a specific future investment strategy that may be a decade or more away (and almost certain to change) seems an unnecessary inclusion within the Funding and Investment Strategy (FIS). Acknowledging the broad principles of the requirements for a low-risk position at that point (without specifying specific investment classes) could avoid an unnecessary source of potential conflict and cost.

- The purpose of the FIS needs to be clear. We can see that by adding weight to the document it adds credibility and prevents it becoming a tick box exercise. However, on behalf of our clients we question whether the level of detail goes too far in places and in fact leads to unnecessary cost, making this an unwieldy and ultimately flawed exercise in spurious accuracy.

- The extent to which active monitoring of schemes is required to ensure adherence to the regulations is not clear and should be reviewed to avoid disproportionate work that is unnecessary and not in accordance with the aims of the new regulations. In particular we question whether there is value in requiring urgent action in response to positive events.

- The impact assessment is extremely light in detail, but we are convinced that the new regulations will result in a significant increase in employer and scheme costs in relation to the operation of their DB pension schemes and believe this is not yet being properly acknowledged.



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Scheme Maturity

Question 1: Draft regulation 4(1)(b) provides that a scheme reaches significant maturity on the date it reaches the duration of liabilities in years specified by the Pensions Regulator's revised Defined Benefit Funding Code of Practice.

- **i) Do you think that it would be better for the duration of liabilities at which the scheme reaches significant maturity to be set out in the Regulations rather than the Code of Practice?**
- **ii) If you think that the point of significant maturity should be specified in Regulations, do you agree that a duration of 12 years is an appropriate duration at which schemes reach significant maturity?**

We believe that it is not desirable to include a tight definition of Scheme Maturity in regulations.

Duration is a function of many factors including scheme membership, investment strategy and market forces. These can fluctuate for many reasons and also be subject to step-change following scheme activities such as buy-out and bulk transfers (e.g., on scheme mergers). Smaller schemes can also be disproportionately impacted by member movements - for instance by members with large benefits relative to the remaining members.

The Pensions Regulator should be in a position to be more flexible than regulations to define what significant maturity looks like, with potentially some flexibility around the application of this for schemes to make sensible strategic decisions, having taken appropriate advice. In particular, we are keen to avoid the cliff edge of schemes having to comply immediately (especially where the trigger date has moved materially since the last valuation).

As currently drafted, we are concerned that schemes suddenly finding themselves having to comply with hard-coded regulations could be in a difficult position. For example, they could be under pressure to make drastic changes to investment strategy (potentially forced sellers of undervalued assets) in short order and place large and unexpected cash calls on the sponsor as a result. Transitional arrangements would help with the initial 'shock' when the new regulations are introduced but would not fully address this issue.

Als, schemes could see themselves moving in an out of a "significantly mature" position, often due to issues outside of their control. Once you are into the "significantly mature" regime it would appear that you are unable to change strategy should you exit but this does not seem fair or appropriate.

The recent experience in the gilt market (late September 2022) is a good example of where schemes would have seen extreme volatility in their duration and hence their point of significant maturity. How are trustees supposed to operate in a system where they are required to take action when a point of significant maturity is hit? Some may well have crossed the border of significant maturity during this period and then returned to the other side – would they now be held to the rules for mature schemes, or would that be true only if their valuation date happened to fall at an inopportune moment that crystallised that calculation?

At this point it would be helpful to include a comment from one of our clients (considering both the Trustee and Company viewpoint):

"*Overall, whilst we have been progressively de-risking our scheme for many years, it is logical that trustees should be obliged to plan for low dependency. However, whilst the Relevant Date as defined is the obvious point at which to seek low dependency, it is still, in the overall journey plan, an arbitrary point. Its enforcement risks the insolvency of many good companies which would impact badly on UK growth.*

Draft regulation 7(4)(c) sensibly seeks to capture the employer's wider business prospects as part of the assessment of the employer's covenant though the journey to the Relevant Date. Those business prospects may change through the journey plan, but they do not necessarily instantly evaporate once the Relevant Date is reached. We believe that in answer to Question 1 of the Consultation, the duration of liabilities at which the scheme reaches significant maturity should be set out in the Code of Practice. That leaves the Pensions Regulator with greater flexibility to engage constructively with employers, whose schemes fail to reach low dependency at the Relevant Date, but who still have satisfactory business prospects, without the Pensions Regulator in effect being obliged by legislation to enforce insolvency."

Low dependency investment allocation

Question 2: Do you think that the definition of low dependency investment allocation provided by draft regulation 5 is appropriate and will it be effective?

The investment allocation being defined in regulation appears to be too restrictive although critical aspects of the language in the regulations are currently ill defined – "broadly matched" and "highly resilient" are subjective. We assume that the Regulator's code would provide greater clarity here, but it is hard to fully judge the implications without this understanding.

In general, having such hard defined actions in the regulations are undesirable as they are unable to take in account individual circumstances or evolving economic conditions.

In particular, we are concerned about the requirement for cash-flow matching for smaller schemes where member movements (transfers, retirement and deaths) can cause this to fluctuate. The costs for monitoring and rebalancing should not be required if there is adequate overall resilience to adverse changes in market conditions.

Schemes already have an operational requirement to ensure liquidity is in place to match benefit payments and this can be structured following existing Pensions Regulator guidance and regulated investment advice.

Finally, we are concerned that the actions taken at significant maturity do not allow flexibility to attract investment return to meet expenses. If a scheme is in surplus on a low dependency basis, which we believe should not be discouraged, then restricting the entirety of scheme assets (rather than just the amount required to match the scheme's liabilities) seems unnecessarily restrictive. Responsible investment of such surplus funds to help meet adverse experience should be permitted.

Low dependency funding basis

Question 3: Do you think that the definition of low dependency funding basis provided by draft regulation 6 is appropriate and will it be effective?

We believe the required allowance for expenses (which presumably will be clarified by the Pensions Regulator) could be material to the figures quoted and the immediate strain that these new regulations will place on schemes. If they are incorporated, they could represent a significant amount (especially for smaller schemes) and if ignored then you are effectively placing reliance on the sponsor to continue to support these.

In the absence of the accompanying funding code, it is hard to judge such aspects. Similarly, understanding the exact trigger for significant maturity and any transitional requirements to allow schemes adjust to these new funding rules will be important in determining whether the new approach is appropriate and effective.

Strength of the employer covenant

Question 4:

- **i) Do you agree with the way that the strength of employer covenant is defined?**
- **ii) Are the matters which trustees or managers must take into account when assessing it, as provided by draft regulation 7, the right ones?**
- **iii) Does draft regulation 7(4)(c) effectively capture the employer's broader business prospects?**

We are not covenant advisers and recognise the desire to raise the bar in this area but wish to note our concerns that this will increase the burden on smaller schemes to obtain objective numbers on a number of criteria. It is important that such additional costs add value and do not simply underline or reinforce points that are already clearly understood. In particular, for a large, strong employer with a relatively small scheme, detailed and robust quantification of available cash will not be expected to impact on any aspect of the pension scheme's strategy.

We believe that as much as possible should set and defined by The Pensions Regulator to allow the required circumstantial flexibility. A proportionate approach should be encouraged focused on areas that will genuinely influence scheme cashflows and strategy.

Relevant date

Question 5: Does it work in practice to set a minimum requirement for the relevant date to be no later than the end of the scheme year that the scheme is estimated to reach significant maturity?

We agree it makes sense that the next scheme year-end is an adequate proxy for the date of reaching significant maturity rather than requiring anything more accurate. However, there are still practical considerations, particularly if there is any cliff edge in treatment before and after a trigger.

For example, a scheme may be expected to reach maturity close to a year end date in which case the precise calculations (or member experience) could move the date forward or back a year.

We are keen that nothing in the new regulations requires disproportionate additional monitoring and are conscious that small schemes in particular are most likely to see fluctuations in their significant maturity date.

Similarly, we would see little value in requiring schemes to retrospectively determine when they had triggered significant maturity if a valuation (or other required funding calculation) reveals they are already past this date. Given schemes of less than 100 members are not required to undertake annual funding updates, you would not necessarily have this information at each year end.

Question 6: Does your scheme already have a long-term date and how is it calculated?

In general, no. They will have discussed long term funding strategies but would not typically have sought to specify precise trigger dates that might potentially be many years into the future.

We are concerned about spurious accuracy and the work involved in making specific plans for a date that in some cases could be 10-15 years or more in the future. This is too far in the future to not expect these would be subject to change and refinement in response to evolving conditions. Requiring excessive specificity in this area (and debate and argument between the trustees and employers in agreeing this) would appear to be a poor use of time and resource relative to a broader long-term plan.

The long-distance soothsaying does little to address the short-term risks and issues. There should be in the regulations (or our preference guidance) as to how schemes should be approaching the position where they are immature to ensure the resources of the trustees and sponsor are better allocated.

Question 7: Where the funding and investment strategy is being reviewed out of cycle with the actuarial valuation, would it be more helpful to require it to align with the most recent actuarial report?

In general, this would seem pragmatic to avoid unnecessary additional work. However, if a funding and investment strategy review is triggered by a material change in scheme circumstances that the trustees are keen to reflect, it would seem unhelpful to require them to then refer back to the position at an earlier date.

Minimum requirements on and after the relevant date

Question 8: Do you think that these minimum requirements are sensible and will provide additional protection for the accrued pension rights of scheme members?

Yes, we agree they should provide additional security if schemes are able to reach this state. Whether they are sensible will depend on how they are enacted.

The wording as drafted suggests that at the point of significant maturity a scheme should be fully funded and in low-risk investments. Trustees will be worried about being in a position that does not comply with those parameters, for instance, where there remains a recovery plan are they in contravention of the law? What are the repercussions? For a scheme that cannot meet both of these, which takes primacy (restoring to full funding or low investment risk)?

It is important that introduction of these measures does not encourage undue risk taking, either in the run up to the first valuation when these are in force, or if there is a market shock as a scheme approaches significant maturity and they find themselves with an unexpected deficit.

Question 9:

i. **Should such limited additional risk at and after significant maturity be permitted, if supported by contingent assets? If so, to what percentage of total liabilities should this be limited?**
ii. **What additional risks to members' benefits might be posed as a result, and what safeguards should apply to protect members?**

Yes, we consider limited additional risk should be allowed if demonstrable support is in place (either through a strong employer covenant or appropriate contingent assets). We consider 5% is too low a figure and certainly any surplus funds should have greater flexibility.

In our view the contingent asset focus is too simplistic and for example ignores the circumstances where a demonstrably strong employer is in place (a strong employer may well provide more comfort than a weak employer with a contingent asset in place).

For small schemes the cost of putting a contingent asset in place could easily outstrip the expected benefit of 5% in growth assets meaning this flexibility would then potentially only benefit larger arrangements. The amount should be raised and based on the strength of security provided by the sponsor covenant and contingent assets.

This has been reiterated by one of our clients:

"*We agree that limited additional risk at and after the Relevant Date should be permitted, if supported by contingent assets. The limit should be far higher than the 5% envisaged but should depend on the quality of the assets.*"

While permitting investment risk does produce some risks, preventing any meaningful investment risk would also potentially impact on members. Sponsors will be more reluctant to overfund schemes beyond this measure and as a result there will be additional reliance on the sponsor to underwrite any adverse experience (e.g., a sudden improvement in mortality expectations, expenses over and above those anticipated within the valuation), potentially at a point when the covenant is no longer able to do so.

Investment risks on journey plan

Question 10: Do you think that the provisions of paragraph 4 of Schedule 1 will allow appropriate open schemes to continue to invest in growth assets as long as that risk is appropriately supported?

Application of this will probably depend on the precise valuation approach and any guidance or restrictions within the code of practice. We think the same logic should apply to immature schemes, not just to open schemes, with the ability for them to take appropriate levels of risk.

Risk in relation to calculation of liabilities on journey plan

Question 11: Do you think that the principles in paragraphs 4 and 5 of Schedule 1, requiring funding risks and investment risks to be linked primarily to the strength of the employer covenant, are sensible?

Yes, in general. However, we require the detail from the Pensions Regulator.

Liquidity

Question 12: Do you think that the new liquidity principle set out in paragraph 6 of Schedule 1 is a sensible addition to the existing liquidity requirement of regulation 4(3) of the Occupational Pension Schemes (Investment) Regulations 2005?

We agree these are probably sensible, but we question the necessity.

Question 13: Will the matters and principles set out in Schedule 1 enable the scheme specific funding regime to continue to apply flexibly to the circumstances of different schemes and employers, including those schemes that remain open to new members?

It is impossible to judge this fully without understanding how the Pensions Regulator plans to enforce it. We are however very concerned about the lack of flexibility in the system as designed, particularly following the point of significant maturity.

We expect schemes will begin to focus on the matters in Schedule 1 (given their relative regulatory strength) and this could be disproportionate and require spurious detail for an open or immature scheme. At the same time, depending on the Regulator's funding code, the restricted options for a scheme starting to approach the significant maturity point (e.g., within two valuation cycles) could render the 'scheme specific' elements of the remaining funding regime relatively meaningless, with little more than a token impact.

There is no apparent flexibility to allow for any sort of transitional arrangements when the new rules come into force (particularly for schemes who are already 'mature' but may not have historically funded to this level).

Funding and investment strategy – level of detail

Question 14: Is the level of detail required for the funding and investment strategy by draft regulation 12 reasonable and proportionate?

We believe there should be clarity that the requirement for detail increases the closer you are to the relevant date as it is disproportionate to agree in any detail the asset mix/re-balancing that might be applied in 10-15 years' time. We have noted spurious accuracy already and attempting to find agreement across multiple interested parties in something that may never happen does not seem appropriate use of resources as long as the broad principles are fully understood.

We believe it should be acceptable for schemes more than six years (two valuation cycles) from reaching significant maturity to simply confirm that they understand that at the point of significant maturity assets will be required to be invested in line with the low dependency investment allocation as prescribed in regulations and that assets will be transitioned to this point in the run up to the relevant date.

For small schemes, where it is less likely that bespoke/complex investment strategies would be used (and hence relatively standard actuarial assumptions are likely to be adopted in the 'mature state'), this should be sufficient.

Question 15: Do you think the requirement for high level information on expected categories of investments will impact trustees' independence in making investment decisions in the interests of scheme members?

We are concerned about the requirement for the employer to agree and sign a copy of the statement – in particular the potential for a 'failure to agree' to arise simply because of a difference of opinion around longer-term investment strategy.

In the current regime we often find employers are reluctant to make binding longer term commitments and given we know that (even high level) asset allocations are likely to be reviewed and amended in future valuations, we question the value in having this as a potential sticking point for negotiation as long as the high level principles are agreed and understood by all parties.

Determination, review and revision of funding and investment strategy

Question 16: Are the requirements and timescales for determining, reviewing and revising the funding and investment strategy in draft regulation 13 realistic?

The definition of 'material' is clearly critical here, but we are unclear of the level of monitoring that's required, in order to identify potential deviation from the high-level strategy. For smaller schemes, they will not engage in routine monitoring (in some cases they will not formally consider the funding position in between triennial valuations) but are more likely to see volatility in their maturity and potentially their funding level.

We question the value of requiring a review 'as soon as reasonably practicable' if the impact is positive (i.e., an acceleration) and assume that there is no intention that a review would be triggered by a planned funding contribution (although this would represent a material change in asset values).

It is important that the regulations provide sufficient flexibility for aspects such as short-term market spikes (e.g., gilt yield fluctuations over a few days that then settle to previous levels) or foreseeable market events (e.g., profit-related contributions) to be handled in a proportionate manner.

Requirements for revised actuarial calculations (for example, rather than appropriate actuarial advice) as part of any review could generate unwelcome additional costs for a small scheme without necessarily leading to a material change in strategy.

Statement of strategy

Question 17: Are there any other assessments or explanations that trustees should evidence in Part 2 of the statement of strategy?

This should be covered in the consultation on the funding code run by the Pensions Regulator.

Requirements for chair of trustees

Question 18: Do you agree that these are the appropriate requirements for the scheme trustee board when appointing a chair? Are there any other conditions that should be applied?

These appear fine and we would not expect them to be expanded further.

Actuarial valuation and reports

Question 19: We would like to know if you think these requirements will work in practice?

We note again the level of additional work involved in precisely calculating all of these numbers, some of which would appear to have no clear purpose or goal. For example, being required to specify a precise date when the scheme is expected to reach significant maturity, over and above confirming the 'relevant date' (with the implication that significant maturity will be hit within the year running up to this point).

For all schemes this will be a significant increase in valuation costs, and these will be proportionately higher for smaller schemes. Trustees and employers will expect a clear steer from the Pensions Regulator/DWP to ensure that the rationale for these additional figures and additional costs is understood.

Recovery plan

Question 20: Do you consider that the matters prescribed by regulation 8(2) of the Occupational Pension Schemes (Scheme Funding) Regulations 2005 remain relevant for trustees or managers to take account of when determining or revising recovery plans? If so, why and how are they relevant to the setting of appropriate recovery plans?

Question 21: Do you consider that the new affordability principle at draft regulation 20(8) should have primacy over the existing matters, if they do remain relevant?

Yes, we believe the existing rules around a recovery plan remain relevant and that there should be considerations over and above affordability. This can be hard to measure reliably for a struggling employer and a more balanced approach can be important in producing the optimum solution for all parties.

As a further example, a strong employer with an immature scheme should not be required to meet deficits immediately. As we have seen in recent weeks, there can be periods of market volatility and a flexible approach is needed to accommodate cases where a scheme valuation falls at a date of particular market stress. Hard coding the requirement for recovery plans runs the risk of not providing the required flexibility for schemes and their sponsors facing uncertain economic futures.

There also needs to be a transitional allowance. As noted previously, there may be schemes who are at or very close to significant maturity who had previously been anticipating future investment returns supported by the strength of their employer. For these cases, despite having a reasonable investment strategy and recovery plan within the current regulations there will potentially be a new and significant deficit arising.

Multi-employer schemes

Question 22: Will the requirements in draft regulation 20(9) work in practice for all multi-employer pension schemes?

We can see issues, but these may not be different to actions that sectionalised and non-sectionalised schemes navigate now. We note our comments for increased cost and resources would apply here.

Business burdens and regulatory impacts

Question 23: Do you agree with the information presented in the impact assessment for the funding and investment strategy?

Question 24: Do you expect the level of detail required for the funding and investment strategy to increase administrative burdens significantly?

Question 25: Do you agree with information presented in the impact assessment for the statement of strategy, referenced in paragraph 6.1?

We do not believe there is sufficient information in the impact assessment to judge – familiarisation costs would appear to be the tip of the iceberg. We expect that if the regulations are implemented as drafted that all sponsors will see a significant increase in their annual running costs and that an increased burden will be placed on employers in terms of funding DB pension costs in general (given the reduced ability for investment performance to contribute).

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