First Briefing, August 2022
Draft funding and investment strategy regulations

The Department for Work and Pensions (DWP) has published draft regulations on scheme funding and investment. These build on the framework set in the Pension Schemes Act 2021.

The proposals set out the principles that maturing schemes should manage risks carefully, reduce reliance on the sponsoring employer, and invest in a *low dependency* manner once they have reached *significant maturity*. For each scheme, the way this is done will be set out as part of its *funding and investment strategy*.

The DWP is keen to emphasise, however, that no inappropriate de-risking will be required for schemes open to future accrual or new members.

Much of the practical detail is still to come in the second draft of The Pensions Regulator's (TPR) revised funding code, now expected in autumn 2022. As things stand, the new regulations will apply to valuations with dates from September 2023 onwards.

The DWP's consultation on the draft regulations closes on 17 October 2022.

Background

The draft Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2023 were published on 26 July 2022. Once finalised, they will expand on the funding provisions in the Pension Schemes Act 2021.

Funding and investment strategy

The Pension Schemes Act 2021 requires that trustees of Defined Benefit (DB) schemes have a funding and investment strategy. The draft regulations now specify the key principle that trustees will have to follow in determining or revising the funding and investment strategy. Schemes should be in a state of low dependency on their sponsoring employer by the time they are significantly mature.

It is recognised, however, that not all schemes will have achieved 100% funding on a low dependency basis when they reach significant maturity. Trustees will need to specify in their funding and investment strategy the funding level they expect to have achieved at that point, together with the high-level investment allocation they expect to hold at that time.

The strategy also needs to set out how the trustees expect to settle the scheme's obligation to pay member benefits – by buying out benefits with an insurer, transferring the scheme to a pensions consolidator, or running on with low dependency but still with theoretical support from the sponsor.

The strategy will need to be reviewed as part of each three-yearly actuarial valuation, and in-between valuations if there are material changes to the scheme or employer's circumstances.

Scheme maturity / relevant date

The regulations propose that scheme maturity is measured by the weighted average time of expected future pension payments, weighted by the discounted value of those payments. This is referred to as the duration of the liabilities.

A mature scheme with a high proportion of pensioner members will have a shorter time horizon before most of the benefits are paid, less time to address any shortfall in the assets, and a shorter duration.

The regulations leave it to TPR to determine when a scheme has reached significant maturity, but the DWP now expects that the second draft will specify 12 years for all cases. The Scheme Actuary will need to estimate when significant maturity is expected to be reached at each valuation – and update that estimate whenever the strategy is separately reviewed.

The regulations rely on the definition of a relevant date for each scheme.

The trustees must set the relevant date to be no later than the end of the scheme year in which significant maturity is expected to be reached. The relevant date will change in line with the actuary's estimate of when significant maturity is achieved.

Low dependency

The DWP suggests that low dependency means *under reasonably foreseeable circumstances the scheme is not expected to need further employer contributions*.

The DWP avoids the term 'self-sufficiency' because the employer remains legally responsible for providing additional funds in the event of unexpected and materially different circumstances, no matter how small the remaining risks.

Low dependency means that the scheme's investments would need to be matched to its liabilities to pay pensions, both in terms of:

- Anticipating the scheme's expected cash flow requirements, and
- Asset and liability values moving together in reaction to short-term adverse changes in market conditions.

For there to be no further need for employer contributions, the scheme would also need to be fully funded on a basis that reflects the returns expected from such low-risk investments.

Employer covenant

The draft regulations on employer covenant do not add significantly to what TPR has been promoting through its covenant guidance for a number of years:

- The level of funding and investment risk that a scheme can take is primarily dependent on the strength of the employer covenant
- Covenant strength can take into account both the ability to pay employer contributions and the availability of legally enforceable contingent assets
- Covenant strength needs to be assessed relative to the size of any scheme deficit. The regulations make it clear that for this comparison, the deficit must be measured on a buy-out basis (i.e. the cost of purchasing annuities for all members).

The regulations will require the trustees to explicitly cover their assessment of the strength of the employer covenant in the statement of strategy, including the evidence on which they based this assessment.

The journey plan to significant maturity

Again, the draft regulations set out, on a statutory basis, existing principles of integrated risk management covered in TPR's guidance.

Supportable investment risk can be taken as a scheme moves along its journey plan to significant maturity. The level of risk is proportionate to the strength of the employer covenant and can be greater the further a scheme is from reaching significant maturity.

The same approach applies in determining actuarial assumptions for calculating liabilities. The stronger the covenant, and the less mature the scheme, the more acceptable it is to use less prudent technical provisions assumptions than those used for the low-dependency calculations.

Once a scheme has reached significant maturity

The principle that trustees are expected to follow is that a scheme should be fully funded on a low dependency basis, with a low dependency investment allocation. Note that this is just a principle. In practice, schemes may not be able to achieve 100% funding in time or may have already reached significant maturity without having de-risked their investment allocation. Trustees would then need to set out in their statement of strategy what remedial action they intend to take to bring their scheme in line with the low dependency principle.

The consultation seeks feedback on whether schemes may still take a modest amount of investment risk, backed by contingent assets. The consultation suggests up to 5% of the liabilities, although it is not clear whether this means:

- Up to 5% of the assets could be invested in additional growth assets, or
- A larger proportion could be invested for growth, such that the additional downside risk taken is limited to 5% of liabilities in most circumstances (on a Value at Risk, or VaR, measure).

Open schemes

Guy Opperman (Parliamentary Under Secretary of State at the DWP) was at pains to say that the regulations have the flexibility to apply to open schemes. Open schemes are likely to be much further off significant maturity and to be maturing relatively slowly. The DWP asserts that the principles in the draft regulations will allow open schemes to take more investment risk and use assumptions for funding that reflect the expected long-term returns

from doing so. Also, future accrual and new entrants may result in the scheme's relevant date being pushed back as younger members' benefits are payable further into the future.

The statement of strategy

The draft regulations require trustees to prepare a written statement of strategy setting out the scheme's funding and investment strategy itself (part 1) and supplementary matters (part 2). The statement of strategy is essentially a regular progress update from the trustees to TPR on the scheme's journey to low dependency. Part 2 will need to be reviewed whenever the funding and investment strategy (part 1) is revised – typically as part of each valuation.

The statement of strategy will need to include an assessment of whether the funding and investment strategy is being successfully implemented, or any remedial action the trustees intend to take to get the strategy back on course. Also, the key risks and mitigations for implementing the strategy and reflections on any key decisions and lessons learned.

More detail on the contents of part 2 is included in the table on the final page of this briefing.

The DB chair of trustees

The statement of strategy must be signed by the chair of the trustee board. This, in turn, will require schemes now operating without a formal chair to appoint one. There are some restrictions on who can be appointed to be chair, but these will not apply to existing chairs, and, in any case, are unlikely to be restrictive for the sorts of trustee boards we see in practice.

Issues for employers

There are some issues for employers to note on the requirements of the draft regulations.

The sponsoring employer will need to explicitly agree the scheme's funding and investment strategy. This includes what the scheme's high level investment allocation will be, which is critical to the pace of de-risking on the journey plan to low dependency, and therefore how much of any deficit is recouped through investment return and how much is left to the employer to contribute. This is a potentially significant development as the current regime only requires trustees to consult with employers on the scheme's investment strategy.

Trustees will be required to provide evidence in support of their assessment of employer covenant strength – this may lead to additional demands on employers to provide more detailed information and to do so more frequently.

The employer must be consulted on the contents of the trustees' statement of strategy. They will have the right to add their comments, but no veto power on the trustees' commentary that will be read by TPR.

Finally, any material changes to the employer's circumstances will be more likely to trigger a review of the funding and investment strategy than is currently the case. Trustees may feel less able to wait for the next actuarial valuation to consider potential changes to their assessment of covenant strength and actuarial assumptions.

TPR consultation on revised funding code

TPR has been saying for some time that they will wait to see the DWP's revised funding regulations before publishing the second draft of their revised funding code. The last indication was that this would be in autumn 2022. It remains to be seen whether they will now wait for the DWP's consultation to be completed and the draft regulations to be finalised. This might delay the second draft of the revised funding code into early 2023.

It won't be until this further consultation that we get TPR's decision on significant maturity and matters such as:

- Recovery plan lengths
- Fast track valuation parameters
- How bespoke valuation submissions will be assessed.

Next steps

Even though the funding code is still at the consultation stage, trustees should discuss with their advisers and understand the extent their current approach to funding and investment strategy might need to change to comply with the principles of the draft regulations.

Employers will also want to understand the impact of these regulations and should take advice. A key area is the asset allocation at the point the scheme reaches significant maturity given it requires sponsor agreement.

If there are strong views on some areas of the consultation, trustees and employers might wish to respond to the consultation.

For further information, please contact your usual First Actuarial consultant.

Contents (for schemes that have not yet reached significant maturity) of part 2 of the statement of strategy

*** matters on which the trustees must set out the evidence on which their explanations are based**

Risk management	The main risks faced by the scheme in implementing the funding and investment strategy and how the trustees or managers intend to mitigate or manage them. This includes what actions the trustees intend to take if the risks materialise.
Maturity	The actuary's estimate of the maturity of the scheme as at the effective date of the actuarial valuation. How the maturity of the scheme is expected to change over time*.
Investment Risk	The current level of investment risk and the level of risk trustees intend to take as the scheme moves along its journey plan to significant maturity*. How the above approach complies with the principles in the regulations in relation to covenant strength, and how close the scheme is to significant maturity*. How the trustees intend to reach a low dependency asset allocation by the point of significant maturity*.
Liquidity	How the investments enable the scheme to meet expected cash flow requirements and make reasonable allowance for unexpected cash flow requirements*.
Funding level	The low dependency funding level at the effective date of the valuation, the assumptions used to calculate this funding level, and how these assumptions differ from those used in calculating technical provisions in that valuation.
Technical provisions	The discount rate(s) and other assumptions used in calculating technical provisions in the relevant actuarial valuation. How the trustees expect these discount rates to change over the course of the journey plan to low dependency*.
Risk in relation to calculation of liabilities	How the level of risk taken in determining the actuarial assumptions complies with the principles in the regulations in relation to covenant strength and how close the scheme is to significant maturity*.
Employer covenant	An assessment of the strength of the employer covenant, how long it is reasonable to rely on this assessment, and any changes since the last statement of strategy*.
General	The extent to which the funding and investment strategy is or remains appropriate*. Confirmation that the trustees or managers have consulted the employer in the preparation or revision of part 2 of the statement of strategy, with any comments that the employer has asked to be included in relation to the scheme.