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BRIEFING NOTE

Response to DWP consultation on draft funding and investment regulations

As consultation closes, the draft funding and investment regulations are drawing widespread criticism for being too prescriptive and lacking important scheme-specific flexibility. Herding all schemes towards the same strategies carries large scale systemic risk that has not been properly considered.
Read on for our quick guide to the proposed legislation and discussion of the main concerns.

The draft regulations sacrifice scheme-specific flexibility

In July, the Department for Work and Pensions (DWP) published its eagerly anticipated consultation on the defined benefit (DB) funding legislation. These regulations pave the way for the Pensions Regulator (TPR) to launch a second consultation on its Code of Practice later this year.

Under the draft regulations, schemes must achieve 'low dependency' on their sponsoring employer by the time of 'significant maturity'. Though that reflects how many schemes have been operating for some time, as drafted, the regulations are surprisingly restrictive compared to what had been put forward in TPR's 2020 consultation on DB funding.

The government's 2018 findings[1] showed that the current regime was working well for the majority of schemes. Therefore, the industry had been anticipating that the new funding regime would continue to be flexible enough to take account of the circumstances of individual schemes whilst enabling TPR to regulate the minority more firmly.

TPR's 2020 consultation proposed a twin-track approach with 'Fast Track' and 'Bespoke' routes to compliance. However, as drafted, it is not easy to point to this 'Bespoke' flexibility in the regulations beyond some limited variation in the shape of the journey plan before significant maturity.

With no further employer deficit contributions to be expected under reasonably foreseeable circumstances, there is little scope for a scheme to be able to rely on ongoing employer support once it has reached significant maturity. Even if the strength of the covenant would support it.

Narrow target investment strategies will constrain innovation and supercharge systemic risks

Many schemes already have funding and investment strategies that de-risk as the scheme matures. However, requiring a low dependency investment allocation to 'broadly match' cashflows and be 'highly resilient' to short-term market volatility, feels unhelpfully restrictive. It will inevitably push more schemes towards the same investment strategies.

Herding into assets can push up the cost of those assets and exacerbate systemic risks. We have seen the systemic consequences of pension schemes being regulated into buying gilts in recent months.

[1] DWP White Paper on Protecting Defined Benefit Pension Schemes

Beware the unintended consequences!

Within the proposals there are examples where the narrowness raises issues.

For those with weaker covenants, the effect of being forced to de-risk too quickly, could be to 'lock-in' a deficit with the sponsoring employer being asked for unaffordable pension contributions. This might actually lead to schemes having to depend on sponsors for longer.

Similarly, schemes already at, or close to, significant maturity when the new regime is implemented could be forced to immediately de-risk and pay substantial contributions to hit a higher low-dependency funding target.

It is not clear what will happen to schemes that cannot reach a low dependency funding level by significant maturity, nor whether there will be any transitional arrangements.

The difficulty with duration

Though the exact definition of significant maturity will be left to TPR's code, the draft legislation would tightly define the measurement as a specified duration of liabilities.

Recent events have shown duration is highly sensitive to the level of gilt yields in the market (for an averagely mature scheme, the date of significant maturity could have moved 4 or 5 years forward over this year). That poses a concern given most schemes will want to set a journey plan with a clear date for reaching maturity.

To address this, it would be helpful to see scope to define 'significant maturity' with reference to the underlying principles (e.g., linking to benefit outgo or membership) that would be more resilient to market conditions, or even as a range that is acceptable. TPR could then have the flexibility to set and review any prescribed point for Fast Track in response to changing financial conditions.

Detail belongs in TPR's Code

Overall, a better outcome would be for the regulations to remain more flexible and coherent with the current scheme-specific funding regime.

TPR should be empowered to regulate through the Fast Track and Bespoke model which it has been warming the pensions industry to for the last two years. This would also make it easier for the industry and regulators to keep pace with the ever-changing financial and political climate.

Proposals will lead to additional costs for employers

It is a glaring omission that the impact assessment does not consider the impact on employer contributions. Particularly when this, risks jeopardising economic growth.

The most significant impact will be for those schemes that are not yet on the path to achieving low dependency funding at significant maturity. Particularly those already at or close to significantly mature at implementation. Forcing employers to remove deficits 'as soon as the employer can reasonably afford' would also have an impact if this does not balance employer sustainability.

Governance will be more onerous for open and small schemes

There will be work – at least initially – for trustees and their advisers to map out their future strategy in the depth required and develop a 'statement of strategy'.

For a truly open scheme which is not maturing, the new governance requirements feel, in our view, disproportionate. It seems unnecessary to map out a journey to significant maturity that the scheme does not expect to take. Ultimately anything that makes it more costly to run open schemes risks benefit redesigns and scheme closures.

For small schemes, without the same resources as their larger counterparts, compliance is likely to be more onerous and disproportionately expensive. This might push more small schemes towards consolidation.

What happens next

There is a lot more detail to come.

The consultation on the draft regulations closed on 17 October 2022 and the latest statements from TPR suggest the second consultation into its funding Code of Practice is due by the end of the year.

The new regime won't apply to valuations until October 2023 at the earliest.

Proposals at a glance:

Low dependency funding and investment strategy

By the time a scheme reaches 'significant maturity', it should have sufficient assets to be fully funded on a low-dependency funding basis. Assets should 'broadly match' cashflows and be 'highly resilient' to short-term market volatility. There should be no expectation (barring unforeseeable events) for additional employer contributions to provide the benefits accrued.

Significant maturity

Broadly around the time, the majority of scheme members have retired, and the scheme is materially cashflow negative. Currently expected to be defined as the point a scheme has a duration of 12 years or less though specifics will be left for TPR's Code.

Journey plan

On route to significant maturity, schemes will need to have a covenant and maturity linked journey plan to reduce risk. Schemes with stronger covenants (including enforceable contingent assets) can take more risk and assume higher investment returns but trustees are still expected to reduce reliance on the covenant over time.

Employer covenant

For the first time, employer covenant is defined in legislation. In considering employer covenant, trustees will have to assess the likelihood of employer insolvency, the employer's cash flow and how other factors may affect the business.

Recovery plans

Should be as short as employer affordability allows.

Statement of strategy

Consulting with the employer, trustees will need to appoint a chair and produce a 'statement of strategy' as part of the valuation process describing the strategic approach and implementation.

Open schemes

Schemes which remain open to new members will be maturing much more slowly (or indeed not at all). Whilst they should be able to invest in riskier assets, where there are potentially higher returns, over the longer term, the requirements appear to remain for such schemes to set a journey plan to low dependency.

'Fast track' and 'Bespoke' compliance

TPR's proposed twin-track compliance approach from its first consultation doesn't feature in the principles-based legislation.

- Fast Track – a streamlined compliance approach where TPR prescribes an appropriate scheme funding approach. Passing the tests should lead to limited TPR scrutiny.
- Bespoke – a more flexible scheme-specific compliance approach, but the onus is on trustees to explain and evidence how risk is supported.

However, more is expected to come on that in TPR's follow-up consultation including the specific Fast Track parameters.

The draft regulations begin to sketch out the form of the revised funding regime, but there is a lot more to come. It is important that DWP and TPR take the time to digest the industry feedback and get the detail right. How the regulations and Code operate together will be key. For now, trustees and sponsors will need to press ahead in the knowledge that changes are coming down the line: the draft regulations and the (hopefully) imminent Code consultation should help with those preparations.

You can read our full consultation response here.

Please contact your usual Hymans Robertson consultant if you would like any further information or to understand the position of your scheme before making any decisions

Laura McLaren
Partner and Actuary
0141 566 7914
laura.mclaren@hymans.co.uk

Patrick Bloomfield
Partner and Senior Actuary
0207 082 6111
patrick.bloomfield@hymans.co.uk

Stephen Jasinski
Investment Consultant
0131 656 5134
stephen.jasinski@hymans.co.uk

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