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60-second summary

Plink, plink, FIS: funding & investment remedies administered

The Department for Work and Pensions (DWP) has announced the outcome of proposed reforms to the defined benefit (DB) funding rules, addressing concerns that the new regime will be unduly restrictive. Final Regulations have been laid before Parliament, with the expectation that they will come into force on 6 April 2024, and apply to valuations with effective dates from 22 September onwards.

Funding & investment strategies

As a reminder, the reforms will mean that trustees are expected to formulate a 'funding and investment strategy' (FIS), whereby their scheme will be fully funded, with low dependency on additional employer contributions, high resilience to market volatility, and sufficient liquidity to meet its cash-flow requirements, by the time that it reaches 'significant maturity'. These fundamentals of the new regime are still to be found in the re-drafted FIS Regulations. However, the DWP has made several changes to the details in response to consultation feedback, making it clearer that there is continued scope for scheme-specific flexibility and appropriate risk-taking. It paves the way for a revised Code of Practice from the Pensions Regulator (TPR) to give detailed guidance on how schemes can comply with the legislative requirements.

Maturity

The initial draft legislation raised concern that the 'duration of liabilities' method prescribed for determining scheme maturity would prove to be overly sensitive to market events. The DWP does not want to oblige trustees to make needless strategy revisions, so now the economic assumptions for the maturity calculation must be based on conditions on 31 March 2023. The duration of liabilities at which a scheme is taken to reach 'significant maturity' will be established in TPR's Code (the draft proposed that it be set at twelve years, but it will be reassessed in light of market conditions). Schemes that have already passed the point of significant maturity by the time they produce their FIS will base it around the effective date of the associated actuarial valuation.

The final Regulations explicitly permit trustees of open schemes to make allowances for the admission of new members and for future accrual, provided that their assumptions are appropriate to the strength of the employer covenant. This could mean that a scheme is not expected to mature significantly in the foreseeable future. The Government hopes that this will allow the trustees to invest more in growth assets for the long-term.

Low dependency investment allocation

There was also concern that the requirement for the FIS to assume a 'low-dependency investment allocation' (LDIA), once a scheme has reached significant maturity, would inappropriately constrain trustees' investment discretion. The DWP has, in response: amended the LDIA definition to remove reference to cash flow from assets being broadly matched with benefit payments; downshifted the LDIA from a 'principle' (which must be followed) to an 'objective' (that must be taken into account); and phrased the objective so that it applies only to assets backing the minimum funding level, and not any surplus. Again, it hopes that this will allow trustees to hold growth-seeking assets for longer. The consultation response says that whilst TPR will generally expect trustees to invest in ways consistent with the FIS, '*there may be good reasons for some divergence.*'

Employer covenant

The initial draft Regulations were notable for explicitly requiring, for the first time, that regard is had to 'the strength of employer covenant'. The DWP has tweaked the phrase's definition to position the strength of the employer covenant in relation to the sponsor's legal obligations to the scheme, to require that wider consideration is given to factors affecting the employer's future capacity to support the scheme, and to remove any implication that contingent assets are limited to guarantees.

Journey planning

The Regulations establish principles about the level of risk that trustees can take in the assumptions underlying their 'journey plan' toward significant maturity. The DWP has focused the journey plan on funding matters, removing proposed principles about investment risk so that it is no longer an element of the FIS for which employer agreement must be obtained.

When formulating their FIS, trustees will be required (amongst other things) to follow the principle of investing to provide sufficient liquidity to meet expected cash-flow requirements and make reasonable allowance for *un*expected needs. The DWP has removed requirements to anticipate liquidity needs over the entire journey plan, and after the point of significant maturity, in answer to concern about the costs of planning for liquidity too far into the future.

Statement of strategy

Trustees will be required to prepare and maintain a 'statement of strategy' that describes their FIS, evaluates the progress toward and risks to implementation, and reflects upon their decision-making. The DWP has revised the information and level of detail to be provided with the intention of making the statement less onerous. It has given TPR discretion to set the level of detail appropriately, and reduced the number of supplementary matters that must be covered. Whilst the statement will now need to incorporate a summary of the associated actuarial valuation, trustees will no longer need to supply that information alongside recovery plans submitted to TPR. Copies of statements will generally need to be sent to TPR as soon as practical after they are prepared or revised.

Recovery plans

One of the more controversial aspects of the initial draft Regulations was the requirement for trustees to eliminate funding deficits as quickly as the employer can reasonably afford. Although that principle has long formed part of TPR's calculus, many commentators were concerned about the implications of enshrining it in legislation ahead of other considerations. Although the DWP has retained the principle that deficits should be recovered as quickly as is affordable, it has now tempered the effect somewhat by requiring that trustees consider the impact of the recovery plan on the sponsor's sustainable growth.

Other news

The DWP published an updated Impact Assessment with its consultation response. It estimates that around 1,200 schemes will pay additional deficit recovery contributions (DRCs), totalling approximately £7.1bn over the next 10 years, though this analysis pre-dates recent market moves. The total initial costs of implementing the new requirements are estimated at around £36.8 million, with additional ongoing costs of about £5.4 million each year.

The Pensions Regulator is reconsidering the parameters for its 'Fast Track' compliance route, in light of consultation responses and changes in market conditions, and will publish details alongside the finalized Code of Practice. We understand that the plan is for the Code to be laid before Parliament in late May or early June 2024, in order for it to be in force for September.

It's good to see that the DWP has listened to the industry in so many areas, with revisions addressing some of the biggest concerns. After numerous delays, the wheels finally seem to be in motion for a 2024 launch of the revamped regime. However, trustees will need to wait for TPR's Code of Practice to understand precisely how it will operate in practice.

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