Funding and Investment Regulations

Progress report

February 2024

Introduction

A review of the defined benefit funding and investment regulatory regime has had a few false starts and some unexpected challenges to navigate since it started with a Green Paper back in 2017 but we now have the final draft of the regulations.

Whilst there have been some easements and refinements of the original consultation draft in response to feedback, much of the core messaging and direction of travel remains. In particular, schemes will need to document plans for when they will become 'significantly mature' and measure their funding on a 'low dependency' basis.

Subject to parliamentary approval, the new regulations will technically come into force in April. However, we will be dependent on the Regulator's new funding code in order to implement this for valuations from 22 September 2024, as planned, and many crucial details remain to be seen.

What do the regulations do?

The regulations set out the requirements for trustees when setting their funding and investment strategy and prescribe some of the new governance and reporting requirements that accompany the revised approach.

Key points:

- These regulations will apply to actuarial valuations from 22 September 2024 onwards.
- Schemes with funding deficits will have a new 'primary' requirement in agreeing contributions – deficits must be paid off as soon as the employer can reasonably afford.

- Schemes will face additional obligations in terms of the calculations required as part of a valuation and will need to agree a two part 'Statement of Strategy', to be signed off by the Chair of the trustees.
- As well as being reviewed at each valuation, this must be reviewed following any material changes for the scheme (in terms of funding, membership or employer covenant), and revisions submitted promptly to the Regulator.
- The Statement of Strategy will include a 'funding and investment strategy' expected to be consistent with having a low reliance on additional employer contributions once they reach significant maturity.

  Significant Maturity – is to be determined for each scheme based on its profile (calculated based on the duration of the Scheme's liabilities). The Regulator will now be responsible for setting the duration cut off point (which may differ for different types of schemes) and the assessment will use economic assumptions at 31 March 2023 to reduce volatility in this date from one assessment to the next.

  Low Dependency – a new actuarial basis to consider as part of the actuarial valuation, consistent with a 'low dependency investment allocation' (a low risk approach that hedges likely liability movements).
- Trustees will need to set out their investment allocation and how this will develop as the scheme moves towards significant maturity.
- The employer covenant of the scheme sponsor will have to be assessed taking into account current and future expected cash flows, performance and future resilience. Trustees need to assess how long it can be reasonably ascertained that the employer will be able to continue to support the scheme. See below for how this could impact sponsors.
- The consultation is at pains to emphasise that the new regulations do not constrain the trustees' ability to set their investment strategy (there were concerns in the draft that employers were being given additional powers here).
- It also emphasises, repeatedly, that the new regulations are (in the DWP's view) consistent with the government's productive finance agenda (related new guidance on investments has recently been issued by the Regulator). Schemes will have flexibility to take investment risk (particularly with any surplus) but must report on a low dependency position.

Broadstone comment

A step forward (and in the same direction)

We are pleased that progress has been made on this long running project. Some important changes have been incorporated that make the new regime less onerous, consistent with our feedback on the draft regulations. There has not been any major shift in direction though, despite the seemingly contrary government push for investment in productive finance, and there are expected (but limited) concessions to open schemes.

Cost implications

The new regulations still introduce a lot of extra work, but with much of the critical detail yet to be confirmed including some key elements now left to the Regulator. We therefore eagerly await the revised Funding Code and are keen to see whether the Regulator will embrace the flexibility they are being given to allow less onerous reporting where appropriate (e.g. a proportionate approach for smaller schemes). We recognise this will be critical to many of our clients and how they ultimately perceive this new approach.

In terms of changing behaviour and outcomes, for the (now large number of) well-run and well-funded schemes this is largely about additional planning, documentation and reporting. However, the consultation response still suggests that all schemes will have <u>average</u> additional costs of more than £10,000 for their next valuation cycle. We think this could be a very conservative estimate (depending on what follows from the Regulator) and continue to question how much benefit many of these schemes will derive whilst incurring such costs, even at this size. This is particularly true at the smaller end of the market where more useful scheme projects may be deferred or cancelled as a result.

Impact on sponsors/contributions

Additionally, approximately 20% of schemes are expected to have to pay higher deficit reduction contributions under the new regime (albeit based on historic pre-Truss analysis). These will include the cases where the Regulator is keen to enforce stronger funding solutions (a key driver for these new regulations originally) but is also likely to include strong employers who are caught by the new affordability requirement.

New regulations promote 'risk off' – despite the rhetoric

Finally, one of the most notable elements of the consultation response was the messaging in the foreword by Minister for Pensions, Paul Maynard MP. In it, he comments "we've learned that it is easy to inadvertently drive reckless prudence and inappropriate risk aversion" and that the new regulations provide "clear scope for schemes to take more investment risk". However, once you get into the detail, it is hard to see which schemes are likely to do so.

Whilst the regime is less draconian than the original draft, it still encourages more prudence than the current regime, even before the Regulator's 'fast track' approval regime is overlaid. The consultation response still includes references to only accommodating 'appropriate risk taking where it is supportable', and 'even seemingly very robust employers can and do become weaker'. This suggests that, spin aside, the main objective has always been making schemes more financially secure.

Actions needed

Schemes with actuarial valuations later this year (most likely 30 September or 31 December year ends) or Q1 2025 should now be on watch for the revised Funding Code from the Pensions Regulator, where we will learn a lot more about the detail of the work that will be required. It will be worth building some additional trustee training and strategic discussions into your plans and budgets for this year to understand the new requirements.

For sponsors and trustees of other schemes, whilst you should be mindful of the direction of travel and may want to start on some of the wider strategic thinking, we expect many will choose to adopt a waiting brief and learn from the experiences of those in the first tranche.

We will of course keep you updated with future developments in the regulations. Should you wish to discuss the implications of the regulations for your scheme please contact the authors below or your usual Broadstone contact.

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Find out more

For more information on how Broadstone can help you, please contact your Broadstone consultant or use the details below.

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