TECHNICAL SUPPLEMENT

For pensions trustees and their advisers

Pensions Management Institute

DB Scheme funding in a shifting landscape

Sackers

Introduction

As the story is sometimes told, defined benefit (DB) pensions are the past and defined contribution is the future. Nevertheless, DB schemes still form a large part of the UK pensions market. According to the PPF's 2023 Purple Book, private-sector DB schemes hold around £1.4 trillion in assets. By contrast, based on ONS figures, private-sector DC schemes currently have around £232 billion under management.

As outlined in the Chancellor's "Mansion House proposals", the Government now sees DB assets as potentially playing a crucial role in its productive finance agenda. But a DB pension scheme is not in the business of making profit nor, indeed, is its purpose to invest for the benefit of the wider economy. Its primary purpose is to pay members' promised benefits as and when they fall due.

Against this backdrop, new requirements are on their way under the Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2024 (the "FIS Regulations"), which will require DB trustees to look beyond their scheme's "technical provisions" ("TPs") and agree a strategy for ensuring that pensions and other benefits can be provided over the long term.

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How did we get here?

It has taken a long time for the FIS Regulations to come to fruition. The Government's 2017 Green Paper on the "Security and Sustainability" of DB pension schemes officially set the ball rolling. It was followed just over a year later by the White Paper on "Protecting Defined Benefit Pension Schemes" (March 2018), with the Government promising to "implement a new package of measures to optimise scheme funding", including supporting trustees and employers "to make the best long-term decisions for schemes, by providing greater clarity on what constitutes good practice and encouraging greater accountability".

A great deal has happened in the intervening years since, shifting considerably the original economic backdrop to the FIS Regulations. This includes the global pandemic, Brexit, the war in Ukraine, the now-infamous September 2022 "mini budget" and, of course, the Government's new productive finance ambitions.

At the time of the White Paper, only 20% of DB schemes were fully funded on a TPs basis. By contrast, according to the Pensions Regulator's ("TPR's") latest annual funding statement, over 75% of schemes in "Tranche 19" have an expected surplus on a TPs basis, and around 50% have a surplus on a buy-out basis.

Perhaps unsurprisingly, the final FIS Regulations have had to adapt to better align with current Government policy and to reflect the current economic environment, whilst preserving the ultimate goal of providing long-term protection for members.

Planning for the long-term

The new funding and investment strategy ("FIS") requirements will apply to all valuations with effective dates after 21 September 2024.

When they come to consider their first FIS, trustees must decide their scheme's long-term objective, and a journey plan for how they will reach that objective by significant maturity. The minimum requirement is that the scheme must be in a state of low dependency on the employer by significant maturity and must be fully funded on a low dependency funding basis.

In order to plan for the long-term, trustees need to know how far into the future to plan for. One of the first challenges for trustees, therefore, is to determine how mature their scheme is and how far from significant maturity it might still be. What is meant by significant maturity? Put very simply, it is the point after which the scheme is paying out such a significant proportion of benefits each year that, if the scheme is not in a healthy funding position, it runs the risk of falling into an "investment death spiral" from which it might never recover.

Long-term planning in the FIS Regulations is by reference to the date of significant maturity. Strictly speaking, it is by reference to the "relevant date" (which could be at or before significant maturity) but, for simplicity, let's assume they are the same. Significant maturity puts a stake in the ground by reference to which all the other requirements are determined.

Planning for the long-term (cont)

There were some concerns raised about the volatility of the significant maturity calculation in the first draft of the FIS Regulations, but DWP has addressed these in the final version. Reduced volatility should help schemes to have more of a fixed idea of their date of significant maturity, which should provide trustees with greater stability when planning their strategy.

As soon as reasonably practicable after determining or revising the scheme's FIS, the trustees will then have to prepare a "statement of strategy", capturing this and further detail. Part 1 of the statement is the FIS and Part 2 will cover certain supplementary issues. Employer agreement to the FIS "as set out in the scheme's statement" must be obtained, and trustees will also have to consult sponsoring employers on supplementary matters to be addressed in "Part 2" of that statement.

Given the aggregate improvement in scheme funding, and the vast majority of well-run schemes already having a long-term objective, there have been suggestions that the FIS Regulations are not needed. In response to TPR's recent consultation on the statement's contents, we also expressed concerns about the extra workload and costs burden involved in collating the information that is likely to be required. However, there are still trustee boards, particularly of some smaller schemes, who have not yet turned their attention to the long-term sustainability of their scheme. These regulations will be helpful in requiring them to look beyond the short term.

Investment issues

Changing Government priorities over the last few years are reflected in some of the changes made between the draft and final FIS Regulations, particularly in relation to investments. As the Pensions Minister acknowledged in the consultation response on the FIS Regulations, "we have made changes to make the regulations explicitly more accommodating of appropriate risk taking where it is supportable".

One such change involves loosening the definition of "low dependency investment allocation" ("LDIA") by removing the requirement that the assets must be broadly cash-flow matched. In addition, there is no longer a need for assets to be invested in accordance with the LDIA post-significant maturity.

This been downgraded to an objective (the "Investment Objective") to be taken into account, and only applies to the assets that support the low dependency liabilities. This seems more in tune with the Government's current focus, as there might be circumstances when actual investments can reasonably diverge from the LDIA. Where a scheme is over 100% funded, the policy permits additional risk taking in relation to the investments, with a nudge that such assets could be used for productive finance.

Investment issues (cont)

In terms of member security, however, protection is still provided by the requirement for the LDIA to be highly resilient to short-term adverse changes in market movements, such that further employer contributions are not expected to be required.

But who is it who chooses this investment strategy? One issue that understandably caused consternation in the industry was whether the first draft of the FIS Regulations had shifted the balance of powers on investments (whether intentionally or not), potentially giving employers more of a say. Explaining this in a little more detail, the LDIA primarily relates to the period after significant maturity, although it also needs to be factored in when determining the low dependency funding basis. These new long-term investment considerations are in addition to trustees' existing powers of investment under the Pensions Act 1995 and scheme rules.

A key principle under s. 35(5) of the Pensions Act 1995 is that investment powers cannot be framed so as to require employer consent. But the initial draft of the FIS Regulations suggested that employers would be given an effective veto over trustees' long-term investment decisions, particularly after significant maturity. The root of this problem derives from the primary legislation. It states the FIS must set out "the investments the trustees…intend the scheme to hold on the relevant date". The issue arises from the requirement for the FIS *as a whole* to be agreed with the employer. If the primary legislation had only required the *funding* elements of the FIS to be agreed, this would not have threatened to shift the balance of powers.

Investment issues (cont)

The final draft of the FIS Regulations has generally put these concerns to bed by making a distinction between the funding journey plan, which forms part of the FIS, and the investment journey plan, which now largely sits outside of the FIS. To that end, the level of investment risk as the scheme moves along its journey plan, and how the scheme is meeting the Investment Objective, now sits in Part 2 of the statement of strategy. As it is no longer directly part of the FIS, crucially the trustees do not need to agree the investment journey plan with the employer and only need to consult on it. As the DWP said in its consultation response, it "has listened to concerns raised about the impact the draft Regulations could have had on trustees' independence in making investment decisions", making clear it was not its intention for the balance of powers to change.

This artificial separation of the funding and investment aspects addresses perhaps the most concerning element of the original draft FIS Regulations. Reassuringly, trustees have retained control over investment powers, with the final position striking the right balance between member security and the varying circumstances of schemes, including the different ways they might invest. The requirement for high resilience to short-term adverse market movements also guards against some of the issues that have been seen in the public sector where investment in illiquid assets has caused problems, particularly among local authorities (some of whom have had to declare themselves bankrupt).

Are we nearly there yet?

With the imminent introduction of the FIS to accompany triennial valuations, and with the renewed focus on the way in which schemes invest assets, there is a lot for trustees to digest.

The FIS Regulations are a good example of the tension between high-level policy intent and the amount of time it can take to put it into place. The current environment is very different from the one in which the new funding requirements were first conceived. The FIS Regulations will give trustees a framework for putting their scheme in a position to protect member benefits over the longer term. Schemes in a healthy long-term position can then build on that if they wish to consider investing in productive finance or other illiquid assets.

At the same time, the new environment potentially presents a wider range of end-game options than might have been envisaged back in 2017. With the Government considering ways in which to facilitate the use of DB surpluses, some schemes are already examining the opportunities presented by running on and taking advantage of these surpluses in future, which could be shared between both members and employers.

It is fair to say that the final FIS Regulations are far from problem-free. In some areas, they give the impression of being rushed, whilst they are silent on other areas it would have been helpful to tackle. For example, the risk of trapped surplus after significant maturity or how the assessment of covenant / supportable risk should be addressed for certain kinds of multi-employer schemes. But the main issues from the original draft have, at least, been cleared up.

Next stop is TPR's DB funding code and some further covenant guidance, the last major pieces in the jigsaw that will finally complete the funding picture for DB schemes, although the looming general election (and a potential change of government) casts further uncertainty on when these might see the light of day.

Contact

For more information on managing defined benefit (DB) pension schemes, and how we can help your pension scheme visit www.sackers.com/db-schemes-managing-risk or call +44 20 7329 6699

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