ASSOCIATION OF CONSULTING ACTUARIES

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Defined Benefit Policy: The Scheme Funding Team
DWP Consultation Coordinator
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Dear Sirs

Draft OPS (Funding and Investment Strategy and Amendment) Regulations 2023

I am writing on behalf of the Association of Consulting Actuaries in response to the above consultation.

We strongly support the overall objective, that the trustees of maturing schemes should consider a long-term target, covering both investment and funding level, and establish a plan to move towards this target as the scheme becomes more mature – and that this should all be agreed with the employer.

However, as currently drafted, our view is that the regulations would have a very detrimental impact on the scheme specific funding regime. We have significant concerns that the proposed legislation is insufficiently flexible and reduces the 'scheme specific' element of the current funding regime – replacing it with an industry standard approach, only permitting limited variation in how schemes plan their journeys and set their ultimate destination. Based on these regulations, it would not be possible for the 'bespoke' option outlined the Pension Regulator's 2020 consultation on a revised Code of Practice to be as flexible as we had hoped and all schemes will be required to adopt fairly similar plans.

This standardisation also has potential unintended consequences, such as increasing systemic risks in future by encouraging all DB schemes to invest in very similar ways.

The financial market developments over the last few weeks also bring these systemic risks into sharp focus. In particular, we believe the opportunity should now be taken to reflect on these dynamics to ensure that investment decisions schemes are encouraged to make as they mature do not contribute to an increase in systemic risks when viewed across the whole industry.

In addition, the costs that would flow from this reduction in flexibility have not been properly considered, making it difficult to assess the full financial consequences for employers.

Before turning to long term strategy, we note that the regulations contain a very significant 'stand-alone' change to the provisions for recovery plans, setting a primary principle that deficits should be recovered as soon as the employer can reasonably afford. Although we agree reasonable affordability is a factor that should be taken into account when setting contributions, we do not agree that it should be given primacy over other factors by writing this into legislation. This is a significant change from the current Code of Practice requirements, which will potentially impose large additional costs on employers even if there were no other changes – and may also have unintended consequences for corporate borrowing. The financial impact would be exacerbated if such contributions were required even where somewhat modest expected returns were likely to clear a prudently assessed deficit. This could also increase the risk of trapped surplus. (See Q21 and Q23).

The objective behind introducing a long-term funding target is not clearly stated. The impact assessment suggests that "government intervention is necessary to ensure that schemes are making investment decisions in a way which results in the highest probability of member receiving their pensions in full". This is an extremely high benchmark and is not justified by the preceding rationale (see Q23) which confirms the 2018 White Paper findings that the scheme funding system "is working well for the majority of Defined Benefit schemes".

There are strong employers with mature schemes, which are heading towards significant maturity (or already at that stage), that would run on quite comfortably under the existing regime (supported by the existing sponsor covenant), perhaps buying-out the remaining benefits in full in 10 or 15 years when that becomes affordable. At the extreme, such employers would be forced to de-risk the scheme and pay significant extra contributions – that could otherwise be invested in their businesses - to hit a much higher funding target that would actually not improve member outcomes. Even where the much higher contributions might be deemed "reasonably affordable" at the time they are set, the inefficient allocation of capital would still leave employers more exposed in the event of an economic downturn (or inflationary price shock). In extremis, this higher risk of insolvency could ultimately mean members receive reduced benefits. More generally, the new regime might limit the prospect of discretionary increases being awarded to pensioners, to offset high levels of inflation or where existing scheme provisions do not have automatic increases (e.g. for pre-April 1997 service). These are examples of how the proposed regime would be worse for employers and members.

In our view, the proposals are likely to lead to additional costs for many employers, which may be significant. The impact assessment does not consider the level of additional employer contributions that will flow from both the requirement to fund on a low dependency basis with a low dependency asset allocation (that will lead to a significant reduction in flexibility) or the proposed requirement for deficits to be recovered as soon as the employer can reasonably afford. Indeed, it suggests that a detailed assessment will not even form part of the consultation on the Code of Practice but will follow this consultation (with the precise timing not stated). Clearly it is difficult to make decisions – for example about how low dependency should be defined - without knowing the costs involved.

Of course, the higher contributions flowing from the proposed requirements for recovery plans and low dependency targets will tie up capital that could be invested elsewhere in the economy, detracting from efforts to boost growth.

On the details of the long-term strategy -

- A well governed, mature, pension scheme will want to set a journey plan with a clear end date for reaching low dependency that does not change significantly, simply because of changes in gilt yields (see Q1 and Q5).
- On low dependency asset allocation, the Regulations will unnecessarily restrict flexibility, investment efficiency and innovation. The higher-level principle of 'employer contributions not being expected' should be sufficient for the regulations (see Q2).
- We support significantly mature schemes being able to invest in appropriate levels of growth assets, where this is justified by the strength of the employer covenant and/or contingent assets and where short to medium term liquidity requirements are properly managed. The legislation should be flexible enough to allow this, maintaining an important element of scheme specific funding (see Q9).
- As drafted, it is not clear what the requirements are when a scheme reaches significant maturity and whether there will be any transitional arrangements for schemes that are significantly mature when the new regime is implemented. The Regulations should allow flexibility for significantly mature schemes to recover deficits (whether resulting from the implementation of the new regime or emerging in future) over a reasonable period (see Q5).
- There should be a carve-out for open schemes. Where a scheme is not maturing or is not expected to reach significant maturity in the foreseeable future, these new governance requirements are in our view disproportionate. As a minimum, there should be more flexibility for schemes which are not expected to mature (due to ongoing accrual and material levels of new entrants) in how their funding and investment strategy is determined. (see Q5, 10 and 13).
- Finally, a significant point that has not been addressed is how the requirement for the funding and investment strategy to be agreed with the scheme's employer will apply when a scheme is significant mature – this would appear to introduce an employer veto over high level investment strategy for significantly mature schemes and, unless changes are made to Schedule 1, prior to significant maturity (see Q13 and Q15).

Our responses to your specific questions are set out in the appendix to this letter.

We hope that you find the contents of this letter of assistance. We would be happy to discuss them further if that is helpful. In that event, please contact me on 01372 733763 or at peter.williams@aon.com.

Yours faithfully

Peter Williams
Chairman, Pension Schemes Committee
On behalf of the Association of Consulting Actuaries Limited

APPENDIX

1. Draft regulation 4(1)(b) provides that a scheme reaches significant maturity on the date it reaches the duration of liabilities in years specified by the Pensions Regulator's revised Defined Benefit Funding Code of Practice.

i) Do you think that it would be better for the duration of liabilities at which the scheme reaches significant maturity to be set out in the Regulations rather than the Code of Practice?

No – A well governed, mature, pension scheme will want to set a journey plan with a clear end date for reaching maturity that does not change significantly, simply because of changes in gilt yields.

The threshold should not be set in the Regulations as it will be important for the figure to be flexible, so that it can be updated reasonably swiftly, to reflect significant changes in financial conditions.

Including the threshold in the Code of Practice will make it easier to change and, indeed, it would be preferable if the Pensions Regulator could vary the figure quickly where necessary – perhaps via its annual funding statement.

We would also suggest that flexibility should be built into the regulations, for example by permitting the scheme to target a date within a wider range of the projected significant maturity date (see Q5).

As an example, when long term gilt yields increase significantly this will reduce the duration of scheme liabilities and bring schemes closer to, or even beyond, the threshold – potentially triggering significant changes to asset allocations across the industry - despite there being no actual change to scheme maturities in reality – for example, as measured by cashflow projections. The regime must be capable of flexibility so that the duration-based assessment of maturity can be changed appropriately in these circumstances.

While we accept that duration is a reasonable proxy for relative maturity based on prevailing gilt yields at a particular time, the Regulator must have the flexibility to change this significant maturity threshold based on this measure quickly, in response to changing financial conditions. This fact that durations have fallen significantly over 2022, is a good example.

On a point of detail, the fact that duration relates to 'liabilities', which is not defined, makes it unclear how duration would be impacted by a 'buy-in' which matches part of a scheme's liabilities with annuity contracts. Our reading is that a scheme actuary can choose to include or exclude such liabilities, consistent with Regulation 3(4) of the OPS (Scheme Funding) Regulations 2005. It is not clear to us whether – in principle - such secured liabilities should be included or excluded, as there are arguments for and against. However, the decision could have a very large impact on the resulting duration, and therefore on how close the scheme is to significant maturity and the required strength of its technical provisions. This may be an issue on which you wish to take a policy position, rather than potentially leaving it open for different scheme actuaries to adopt differing positions – with very different outcomes - on otherwise similar schemes.

In addition, it is not clear that liabilities arising from future service can be taken into account when measuring duration. We think this should be confirmed explicitly.

ii) If you think that the point of significant maturity should be specified in Regulations, do you agree that a duration of 12 years is an appropriate duration at which schemes reach significant maturity?

We strongly support the duration threshold being set by the Pensions Regulator, however, on the question of whether 12 would be an appropriate benchmark under current conditions should be reviewed – a lower figure may now be appropriate.

This is another area in which there is a need for flexibility. If a figure is 'set in stone' then schemes will jump forwards and backwards on their journey plan as long-term interest rates change. The Regulator will need to set principles and keep the threshold under review as financial conditions change – it may be more appropriate to set the threshold in its annual funding statement rather than in the Code of Practice (although the principles could be set out there).

We would also suggest that flexibility should be built into the regulations, for example by permitting the scheme to target a date within a wider range of the projected significant maturity date (see Q5).

2. Do you think that the definition of low dependency investment allocation provided by draft regulation 5 is appropriate and will it be effective?

As set out in our covering letter, we have concerns over whether low dependency, as defined, is an appropriate target, especially given the costs to employers have not been assessed.

As noted in our response to question 9, more diverse investment strategies should be allowed where these are supported by appropriate contingent assets and/or the employer covenant.

In principle, we think the focus should be on employer contributions not being expected to be required, taking into account the level of surplus and/or contingent assets, rather than requiring the assets and liabilities to be broadly matched. The Regulations go in to too much detail – which will unnecessarily restrict flexibility and innovation (for example, if there are appropriate contingent assets, such as a surety bond guaranteeing that no employer contributions would be needed, why should the scheme assets need to be matched with the liabilities?). We think the higher-level principle of employer contributions not being expected should be sufficient for the regulations.

The low dependency target as drafted requires a scheme to invest in broadly cashflow matched assets, and for movements in assets versus liabilities to be "highly resilient" to changes in market conditions. These requirements apply regardless of the current funding position of the scheme, the strength of the employer covenant or the existence of high-quality contingent assets outside the scheme. This has a number of potentially significant consequences:

- These requirements will strongly disincentivise schemes from investing in any assets such as infrastructure, whose value will not be "highly resilient" to changes in liability values when market conditions change
- There are a narrow range of assets which meet the requirements above, and schemes will therefore not be able to diversify and invest in economically efficient ways. This herding

behaviour also introduces systemic risk, as indeed seen in recent days, even with the greater range of flexibility currently permitted,

- The “highly resilient” requirements apply regardless of funding level. So a scheme say 120% funded on low dependency still has to follow these principles. However, some schemes, particularly those where low levels of guaranteed pension increases apply, may choose to deliberately over fund and take a bit more risk in order to provide discretionary inflation linked pension increases. As drafted, their ability to do and provide such discretionary increases is significantly limited. This is particularly undesirable at a time of high inflation.
- As currently drafted, the investment requirements for pension schemes who are significantly mature are significantly more restricted and inflexible than those that apply to insurers. This means that for many schemes it will be cheaper to buy-out than to run off. Is this the government’s intention?
- Related to this, insurers have flexibility because they have capital reserves backing any risk taken in their investments. The analogous position for pension schemes would be that they can continue to take appropriately managed risk after reaching significant maturity if this is being underwritten outside the scheme, for example through high quality contingent asset arrangements. For many employers such a route to providing benefits could well be more cost effective than what is proposed in the current regulations. It is also likely to result in as good, if not, better outcomes for members. We therefore strongly believe that this should remain an option for schemes.

Matching the assets and liabilities could lead to a lack of diversification as it pushes schemes towards both certain asset classes such as gilts and high-grade corporate bonds and also certain maturities and sectors. It would also discourage investment in longer term assets such as infrastructure. If this was to happen across the whole pension scheme sector it may lead to each individual scheme looking low risk but create a concentration risk in the sector. There is also not really a need to match assets and liabilities to the extent defined, if the level of volatility and likelihood of needing contributions is low and that would be a better way of expressing the requirements than requiring explicitly matched assets and liabilities.

In addition to this, the focus on resilience to short term adverse changes could put too much onus on short term risks and trustees may not spend enough time on longer term risks. For example, longevity and long-term covenant uncertainty (and even climate change). A more restrictive and inefficient approach to investment strategy for mature schemes is likely to be sub-optimal in building up further reserves to meet these risks or indeed facilitate achieving full insurance settlement for those schemes that ultimately want to target full buy-out.

We comment on the detailed drafting below.

Although we understand the broad thrust of the draft requirement the language is rather different than we might typically expect to see in legislation. For example:

Regulation 5(1) requires that Regulation of 5(2) must be “satisfied in a way that complies with an objective that further employer contributions are not expected to be required…”. This could be expanded upon in the Code of Practice.

Regulation 5(2)(a) does not acknowledge that anticipated cashflows in respect of both the assets and, particularly, the liabilities will be based on significant assumptions.

Regulation 5(2)(b) should perhaps refer to the funding level remaining at or above 100% being highly resilient to short-term adverse changes in market conditions.

3. Do you think that the definition of low dependency funding basis provided by draft regulation 6 is appropriate and will it be effective?

As set out in the executive summary, we have concerns over whether low dependency, as defined, is an appropriate target, especially given the lack of flexibility and that the costs to employers have not been assessed.

The Pension Regulator's 2020 consultation included a discussion on the appropriate allowance for expenses in a long-term funding target (see paragraphs 256 and 257 and Question 26 of TPR's consultation), suggesting that no allowance might be needed in some scenarios. Although expenses are not mentioned explicitly in these draft regulations, or the latest consultation, our reading of the draft regulations is that they would need to include allowance for all future expenses within the long-term funding target, given there will need to be an expectation that no further contributions will be payable by the employer. This does not appear to be consistent with the previous consultation and we are not sure if this is a deliberate change.

We suggest that future expenses should be carved out in the regulations, so that they can be dealt with separately and in detail in the Code of Practice. We also note that there can be tax advantages associated with employers meeting expenses rather than the scheme. The Regulations should not require an approach to expenses that is less tax-efficient than existing practice.

We comment on the detailed drafting below.

There is a discrepancy between the consultation document – which refers to contributions not being required "under reasonable, foreseeable circumstances" and the draft regulations, which do not use this wording. We strongly support not including the wording from the consultation document in the final regulations – both in relation to the low dependency funding basis and the low dependency investment allocation.

Regulation 6(2) requires that further employer contributions would "not be expected to be required". As for Regulation 5, this could be expanded upon in the Code of Practice.

4. i) Do you agree with the way that the strength of employer covenant is defined?

We note that the definition places no value on non-legally binding covenants, such as large groups where only one subsidiary is the scheme sponsor. We would support flexibility to place some reliance on wider support.

In addition, the draft regulations focus on cashflows and would understate the true level of support from a sponsor that has a very strong balance sheet but more limited cashflows (perhaps in the short term).

We note that the undefined term "level of risk" – seems to be key (in particular, in applying the newly defined "strength of the employer covenant" to setting investment strategy and TP strength, in paras 4 and 5 of schedule 1).

ii) Are the matters which trustees or managers must take into account when assessing it, as provided by draft regulation 7, the right ones?

These seem reasonable.

iii) Does draft regulation 7(4)(c) effectively capture the employer's broader business prospects?

It is difficult to comment fully without the draft Code.

5. Does it work in practice to set a minimum requirement for the relevant date to be no later than the end of the scheme year that the scheme is estimated to reach significant maturity?

As discussed in our response to question 1, the new regime will need to be able to cope with volatility in markets which could impact the calculation of duration. A well governed, mature, pension scheme will want to set a journey plan with a clear date for reaching low dependency that does not change significantly simply because of changes in gilt yields. We request that more flexibility is included withing the regulations, for example by permitting the scheme to target a low dependency date within a wider range of the projected date of significant maturity.

We also have some concerns over how the regime will work as schemes move towards and reach significant maturity, as set out below.

The regulations appear to be drafted with only schemes that are some way off reaching significant maturity in mind. Things are less clear when the relevant date is close or has already passed. There appears to be a significant gap in the legislation, setting out how the new regime will operate when a scheme has reached significant maturity. There don't appear to be any transitional provisions for schemes that are already significant mature when the new legislation comes into force. As a result, it is not clear what the consequences are:

- if a scheme passes the relevant date and is not yet fully funded on a low dependency basis;
- if a scheme is significantly mature and cannot afford the contributions necessary to fund the scheme on a low dependency basis with a low dependency asset allocation – or if the recovery period is 50+ years?
- if a scheme is approaching the relevant date and the scheme sponsor cannot afford the contributions necessary to achieve low dependency funding, with low-dependency investment allocation, by this date; or
- if a scheme is fully funded on reaching significant maturity but, despite achieving this low dependency state, falls into deficit in future.

There are strong employers with mature schemes that would run on quite comfortably under the existing regime, perhaps buying-out the remaining benefits in full in 10 or 15 years when that becomes affordable. At the extreme, such employers would be forced – as their schemes are significantly mature – to immediately de-risk and pay significant contributions to hit a much higher low-dependency funding target, that would actually not improve member outcomes. Even though the much higher contributions are deemed "reasonably affordable" at the time they are set, the inefficient allocation of capital would leave employers more exposed in the event of an economic downturn – or inflationary price shocks. Ultimately this could result in higher insolvency risks where members are also likely to receive reduced benefits. More generally, the new regime might limit the prospect of discretionary increases being awarded to pensions, to offset high levels of inflation or where the scheme provisions don't provide for automatic pension increases (e.g. on pre-April 1997 service). **There are examples of how the proposed regime would be worse for employers and members.**

In addition, there may be events such as large transfer payments, deaths, bulk transfers or transfer exercises which, particularly for smaller schemes, could have a significant impact on duration, perhaps making the scheme 'significantly mature' unexpectedly. There needs to be some flexibility within the regime to cope with such developments.

The Regulations should allow flexibility for schemes that are already significantly mature (or are close to becoming significantly mature) to recover deficits resulting from the more stringent new requirements over a reasonable period. In addition, the Regulations should allow flexibility for any deficits that might emerge in significantly mature schemes in future, where experience falls below expectations, to be recovered over a reasonable period.

It is also unclear what will happen when the new requirement for 'low dependency' results in a level of employer contribution that is unaffordable, even over a very long recovery period. It should be possible for the investment strategy to be adjusted in these circumstances, so that an affordable level of contributions is achievable, provided the risks to members' benefits are not excessive. If this is not done, some schemes, particularly those with weaker sponsors and who are not very well funded, may find that there is no funding and investment solution available to them that would meet the legal requirements set out in the regulations.

Schemes that are not expected to mature due to future accrual and material new entrants will not become significantly mature in the foreseeable future and should be exempt from the requirement to set a journey plan that assumes a low dependency strategy at a future date (see question 10).

6. Does your scheme already have a long-term date and how is it calculated?

ACA members advise a large number of schemes that adopt a variety of approaches.

7. Where the funding and investment strategy is being reviewed out of cycle with the actuarial valuation, would it be more helpful to require it to align with the most recent actuarial report?

There may be circumstances in which alignment with the most recent actuarial report would be preferable. We suggest that the legislation should allow for either approach to be adopted.

8. Do you think that these minimum requirements are sensible and will provide additional protection for the accrued pension rights of scheme members?

As set out in the covering letter, we have concerns over whether low dependency, as defined, is an appropriate target, especially given the lack of flexibility and that the costs to employers have not been assessed.

In addition, as noted under question 5, there don't appear to be any transitional arrangements, nor are the consequences spelt out if a scheme is not yet fully funded on a low dependency basis, or falls below this level, once it is significantly mature.

9. i) Should such limited additional risk at and after significant maturity be permitted, if supported by contingent assets? If so, to what percentage of total liabilities should this be limited?

Yes – additional risk at and after significant maturity should be permitted if supported by contingent assets. Provided the risks are adequately supported, we do not see why there should be a prescribed limit. The Code of Practice would need to provide further information on how the required support would need to be assessed.

In our view additional risk could also be supported by the employer covenant, even when a scheme is significantly mature, and the regulations should not prohibit this. Again, provided the risk is adequately supported, we do not see why there should be a prescribed limit. This would maintain an important element of scheme specific funding.

Growth assets may lead to surpluses developing, and such surpluses would provide an additional margin of protection in excess of the low dependency funding target. This raises the prospect of 'trapped surplus' under some scheme rules. It would be perverse to require higher employer contributions which lead to trapped surpluses, which may then not be refundable or refundable after a tax charge. As there seems no intention for these Regulations to change the rights to surpluses under individual scheme rules, the Regulations must instead be sufficiently flexible to consider of the likelihood of 'trapped surpluses' when agreeing journey plans, low dependency asset allocations and employer contributions.

ii) What additional risks to members' benefits might be posed as a result, and what safeguards should apply to protect members?

We support the suggestion in the consultation document that more risk taking should be permitted for significantly mature schemes, where this can be supported.

We would support a higher threshold than 5% - indeed, it is not clear that there needs to be any cap given the requirements for such investments to be appropriately supported. Imposing a specific threshold may also lead to practical difficulties.

The consultation document suggest that additional risks should only be supported by contingent assets – in our view the employer covenant should also be taken into account in assessing whether the additional risks are supportable.

If the risks are adequately supported, the risks to members' benefits should be minimal.

As a minimum, it should also be made clear that surplus can be invested more flexibly.

10. Do you think that the provisions of paragraph 4 of Schedule 1 will allow appropriate open schemes to continue to invest in growth assets as long as that risk is appropriately supported?

Yes – but the proposals would require such schemes to fund as if they were closed, potentially imposing significant costs on their sponsors (and in some cases in service members), It will also impose unnecessary additional governance costs on open schemes.

In our view, open schemes which are not likely to become significantly mature in the foreseeable future (based on the level of new entrants over recent years) should be exempt from the requirement to create a journey plan to a low dependency target, since they are not expected to reach this position at any point in the foreseeable future. The Scheme Actuary could consider this issue and confirm whether this applies in the s224 valuation report.

As a minimum, such schemes should not be required to set technical provisions consistently with a journey plan to low dependency as defined in the regulations. As acknowledged in the consultation document, such schemes do not expect to de-risk in future, and provided the employer covenant and level of new entrants supports this, neither should they be required to fund as if this is the case. Requiring such funding will place significant strains on open schemes – potentially causing some of the few continuing high quality DB schemes to close to the detriment of current and future employees.

11. Do you think that the principles in paragraphs 4 and 5 of Schedule 1, requiring funding risks and investment risks to be linked primarily to the strength of the employer covenant, are sensible?

We do not agree that, as drafted, the primary link is to employer covenant. Our reading is that if a scheme is significantly mature (or close to this threshold) then it cannot take funding and investment risks (or can only take minimal such risks) – irrespective of the strength of the employer covenant.

The employer covenant seems to be a secondary consideration, which becomes less important as a scheme moves towards significant maturity and is not relevant at all once a scheme is significantly mature.

As noted in our response to question 9, we would support some flexibility to allow for growth and other return-seeking assets once schemes are significantly mature – both in the investment allocation and calculation of liabilities to the extent supported by the employer covenant.

12. Do you think that the new liquidity principle set out in paragraph 6 of Schedule 1 is a sensible addition to the existing liquidity requirement of regulation 4(3) of the Occupational Pension Schemes (Investment) Regulations 2005?

This seems reasonable once a scheme has reached significant maturity. It seems less relevant before this point when cashflow requirements could also be met by employer and employee contributions. We suggest therefore that paragraph 6(2) of schedule 1 be amended to refer to cashflows net of employer and employee contributions.

13. Will the matters and principles set out in Schedule 1 enable the scheme specific funding regime to continue to apply flexibly to the circumstances of different schemes and employers, including those schemes that remain open to new members?

The new regime will clearly be significantly less flexible than the current regime and significantly less flexible for those schemes currently approaching significant maturity, for whom very large additional costs may be imposed.

As noted in our response to questions 5 there remain significant gaps which make this question difficult to answer in full. In addition, the Code of Practice will fill in some of the details.

As noted in the covering letter, given the 2018 findings that the current DB scheme funding system was working well for the majority of schemes, and the fact that the objectives of the change in approach have not been clearly set out, it is not clear whether the reduction in flexibility is justified or reasonable to scheme sponsors.

In addition, we note that all the matters in Schedule 1 need to be agreed with the employer. We have noted our concerns with this requirement at significant maturity (see Q15), but recognise that this is a requirement of the primary legislation. However, we think that the matters in Schedule 1 4(1) go even further than this, and effectively require agreement with the employer on levels of risk throughout the journey plan, including current levels of risk as well as those at significant maturity. These should be moved to part 2 to avoid the concerns we express in Q15 extending to the period prior to significant maturity.

We think more flexibility is needed for open schemes (see question 5 and question 10 above).

14. Is the level of detail required for the funding and investment strategy by draft regulation 12 reasonable and proportionate?

This seems broadly reasonable, although we note it will impose a significant governance burden on schemes and we question whether the requirement to quote the expected maturity at the relevant date is necessary (and justifies additional calculation costs), given the other requirements - to calculate when the scheme is expected to become significantly mature and to set the relevant date within a short period of this date.

15. Do you think the requirement for high level information on expected categories of investments will impact trustees' independence in making investment decisions in the interests of scheme members?

Yes, this is a potential risk. A significant point that has not been addressed is how the requirement to agree with the employer the funding and investment strategy – including the investments intended to be held at the relevant date or dates (under the amendment in paragraph 6 of Schedule 10 to the Pension Schemes Act 2021) applies in combination with the general flexibility for trustees to set a scheme's investment strategy and the Statement of Investment Principles without requiring employer agreement.

In particular, once a scheme has reached its relevant date, and should presumably therefore be following the investment strategy outlined in the 'funding and investment strategy', which must be agreed with the employer, what happens if the employer wants the scheme to follow a different investment strategy to that proposed by the trustees. Clarification is required on this important balance of power point. As drafted, the legislation would appear to introduce an employer veto over high level investment strategy for significantly mature schemes.

Indeed, unless the changes we outline in our response to Question 13 are made, this potential employer veto concern would extend to the entire journey plan.

In our view, it is not immediately clear how the issue can be addressed for significantly mature schemes in these regulations, as the issue relates to the Pension Schemes Act 2021 requirement. However, perhaps the Regulator could make it clear in the Code of Practice that trustees – particularly where a scheme is significantly mature or close to being significantly mature - should not agree to a funding and investment strategy if they are not comfortable with the impact that this would have on their current investments (over which they would continue to exercise unilateral discretion).

In addition, many schemes no longer focus on an asset allocation but instead define their strategy in terms of expected levels of return and permissible levels of downside risk. This is particularly the case where fiduciary management is used. The regulations should be flexible enough for schemes to choose to set investment strategy in this way rather than by reference to specific asset allocations.

16. Are the requirements and timescales for determining, reviewing and revising the funding and investment strategy in draft regulation 13 realistic?

This seems reasonable.

We note that, in practice, the funding and investment strategy will need to be reviewed, updated and agreed with the employer before the actuarial valuation report is signed off, as the valuation report will need to be based on the current funding and investment strategy. This presents some practical challenges where the funding and investment strategy includes information to be set out in the valuation report (such as the expected maturity of the scheme at the relevant date, under regulation 12(b)), but these are surmountable.

17. Are there any other assessments or explanations that trustees should evidence in Part 2 of the statement of strategy?

Not that we can think of at the current time. Given the content of the statement, it is important that this document is not added to the list of those disclosable to members on request.

18. Do you agree that these are the appropriate requirements for the scheme trustee board when appointing a chair? Are there any other conditions that should be applied?

The requirements seem reasonable.

You mention consistency with what is currently expected when appointing a chair of a DC scheme. The drafting appears to be identical, but this means that your proposed regulation 17(d) links in effect to the Nest scheme which surely is not relevant for DB schemes?

19. We would like to know if you think these requirements will work in practice?

As noted in our response to Question 16, there are some practical challenges regarding the timings of the funding and investment strategy and the valuation report being finalised, but these should be surmountable.

Our comment on question 16, about the calculation of maturity at the relevant date, also applies to the valuation report requirements under Regulation 20(4).

20. Do you consider that the matters prescribed by regulation 8(2) of the Occupational Pension Schemes (Scheme Funding) Regulations 2005 remain relevant for trustees or managers to take account of when determining or revising recovery plans? If so, why and how are they relevant to the setting of appropriate recovery plans?

The factors set out in regulation 8(2) remain reasonable. For example:

- The asset and liability profile of the scheme may mean that the assets are expected to generate a return in excess of the discount rate which is expected to remove, or help to remove, the deficit over the recovery period. This is a very common feature of recovery plans.
- The risk profile is clearly relevant as trustees should consider the risks associated with a given plan.
- Liquidity requirements may be relevant for severely underfunded schemes – to ensure the scheme has sufficient funds to pay benefits as they fall due.
- The age profile of members could be relevant for very mature schemes – to ensure the scheme has sufficient funds to pay pensions

There are other considerations that should be added, such as:

- Reasonable affordability – whether the employer can reasonably afford a proposed level of contributions will clearly be a practical constraint.
- The impact of the proposed level of contributions on the sustainable growth of the employer – this would reflect the Pension Regulator's statutory objective, to minimise any adverse impact on the sustainable growth of an employer.

21. Do you consider that the new affordability principle at draft regulation 20(8) should have primacy over the existing matters, if they do remain relevant?

No.

The addition of the proposed new requirement as a primary principle – that funding deficits must be recovered as soon as the employer can reasonably afford – is a significant change to the current funding regime which is quite separate from the funding and investment strategy changes.

We agree that what an employer can reasonably afford should be a factor to be taken into account, but giving this primacy, and adding the words "as soon as", would fundamentally change the scheme funding landscape in a way that we do not consider appropriate or helpful.

The current requirements are set out in paragraph 142 of the Code of Practice and are significantly less onerous:

> *142. Although affordability of deficit repair contributions is a factor to consider, this does not mean that an employer should be expected to pay deficit repair contributions at a particular level simply because it would be able to afford to contribute at that level or because it has been paying them at that level. Instead, trustees can use the flexibilities available in recovery plans to ensure that they are appropriately tailored to both scheme and employer circumstances.*

To some extent, the impact will depend on how the term "reasonably" can be interpreted:

- At one extreme, 'reasonable' might be interpreted as requiring any employer with sufficient means to make good any deficit with a lump sum payment.
- Alternatively, 'reasonable' might be considered in the context of alternative uses of the monies within the business – perhaps to boost sustainable growth.
- Going further, perhaps 'reasonable' could even be viewed more widely, in the context of asset returns which might be expected to return the scheme to full funding without the need for employer contributions, over a number of months or years.

All of these approaches are common under the existing regime but it is not clear that anything other than the first interpretation would satisfy the draft legislation. Clearly, introducing a definition without a proper consultation could introduce further problems. This may be an issue which can be clarified via the Code of Practice.

In seems likely that the proposed drafting would result in a significant change from the current position, where trustees can take into account plans for sustainable growth and additional returns expected to be achieved on scheme assets over the recovery period – this change would represent a significant additional financial burden on employers – and may also have unintended consequences for corporate borrowing.

The change may also increase the risk of trapped surpluses – particularly if no allowance can be made for expected returns when setting contributions. We comment on the implications of trapped surplus under question 9.

We note that the financial consequences of this significant stand-alone change are not considered in the impact assessment.

22. Will the requirements in draft regulations 20(9) work in practice for all multi-employer pension schemes?

The changes seem appropriate.

23. Do you agree with the information presented in the impact assessment for the funding and investment strategy?

While we appreciate the difficulties involved in estimating the costs involved, in our view the current impact assessment is not fit for purpose.

The main impact of the proposals would appear to be on the additional contributions required of employers as a result of:

- Meeting any deficit "as soon as the employer can reasonably afford"
- The significant reduction in flexibility, resulting from the requirement to become fully funded on a very narrowly defined low dependency basis by the time the scheme is significantly mature (again, very narrowly defined)
- A potential significant step change in how open schemes (that is, schemes who are not expected to mature) are funded – while there are not many such schemes a small number are very large and the costs will be material.

The first of these changes is not addressed at all (as far as we can see) in the impact assessment. As noted in our response to Question 21, this in itself will have a significant financial impact on employers. The financial impact would be exacerbated if such contributions were required even where expected returns were likely to clear the deficit.

On the second issue, you correctly note that some of the details will need to be confirmed in the Pension Regulator's Code of Practice. However, the draft regulations would make significant changes in isolation. They would 'set in stone' the low dependency end destination and the Regulator has already provided a good idea of the deadline for significant maturity by which schemes must arrive at this point. In itself, requiring low dependency as narrowly defined by the time a scheme is significantly mature will impose significant additional costs on employers (irrespective of the details to be set by the Pensions Regulator, on exactly how low dependency can be interpreted within the legislative definition and on the journey plans that will be allowed to get there).

Against this background we have significant concerns over the timescales for delivering appropriate impact assessments, so that decisions can be reached with the benefit of full information. In particular, the Impact Assessment notes that the anticipated update – including the impact on deficit repair contributions - "will be completed by TPR following their consultation".

Clearly the decision to lock into legislation a requirement for a 'low dependency' target and 'low dependency' investment allocation for significantly mature schemes, set so that no further employer contributions are expected, may impose significant additional costs – this decision should not be finalised without assessing those costs.

We also note that the description of the policy background in the impact assessment includes a significant jump in the logical progression of the argument for 'low dependency'. You note that the 2018 White Paper confirmed that the scheme funding system is working well for the majority of DB pension schemes, but that some were taking a short-term view and severely underfunded schemes presented a risk to the PPF and members. From this accurate description, one might conclude that there should be minimal change for the majority of schemes. It is not clear therefore how you arrive at the conclusion that "government intervention is necessary to ensure that schemes are making investment decisions in a way which results in the highest probability of members receiving their pensions in full". Clearly "the highest probability" could only be achieved at significant additional cost, and these costs have not been assessed.

We also note that the impact assessment that is in place includes a baseline comparison of most schemes already having an LTO. In practice this is because the outline of the new legislative requirements has been known for some time and schemes have been encouraged by the Regulator to move towards these new requirements before they are set out in legislation. Also, while schemes may have such an LTO, for many this will not be "hard coded" into the technical provisions. So using this assumption for the impact assessment will understate the true impact of the legislation.

24. Do you expect the level of detail required for the funding and investment strategy to increase administrative burdens significantly?

There will certainly be additional administrative costs but, whilst material, these are likely to be small in comparison with the additional employer contributions that would be required as a result of the draft legislation being passed.

Even for well governed schemes with robust journey plans in place the requirements will pose a significant additional governance and operational burden, especially as the rigid new requirements will mean that existing plans will need to be reformulated and adjusted to meet the very specific new requirements - and, if the current definition of significant maturity is applied – will also need to be reviewed and adjusted very regularly when gilt yields change and hence the expected date at which they reach significant maturity changes.

25. Do you agree with information presented in the impact assessment for the statement of strategy, referenced in paragraph 6.1?

Again, this appears to be a secondary issue in comparison with the additional employer contributions that could be required as a result of this new legislation.

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