HERBERT SMITH FREEHILLS

UK GOVERNMENT HERDS DEFINED BENEFIT PENSION SCHEMES TOWARDS LOW-DEPENDENCY FUTURE

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Legal Briefings

The new legislation will push schemes towards low-risk funding and investment strategies

After a significant delay, the UK Government has finally published its **consultation** on draft regulations that will underpin the new long-term funding and investment requirements for UK defined benefit (**DB**) occupational pension schemes contained in the Pension Schemes Act 2021.

These new requirements are designed to drive DB schemes towards a "low dependency" funding level by the time they are "significantly mature". This means, from that point on, it would "not be expected that any further employer contributions will be required to make provision for accrued rights and other benefits under a scheme."

Based on the current drafting, the regulations will also codify the principles, that:

- investment risks should be reduced where a scheme has a weak employer covenant; and
- funding deficits must be recovered as soon as a scheme's employer(s) can reasonably afford.

For most schemes, trustees will be required to agree their scheme's low dependency funding level and investment strategy with their scheme's employer(s) and, at each statutory valuation, they will need to set their scheme's technical provisions at a level designed to ensure this funding target is met by the time the scheme is significantly mature. However, the draft regulations do not make clear what trustees should do where their scheme is unlikely or unable to reach that target.

BACKGROUND

The Pension Schemes Act 2021, which received Royal Assent in February 2021, contains new funding and investment requirements for DB schemes. Once introduced, they will mean that:

- Trustees of DB schemes will be required to agree legally binding long-term funding and investment targets for their scheme with their scheme's sponsoring employer(s).
- A scheme's short-term funding target (or technical provisions), which are set as part of each statutory valuation, will need to increase over time to ensure this long-term funding target is met by the time the scheme is significantly mature.

Following the current consultation, the Pensions Regulator is due to consult on the contents of its new DB funding Code of Practice which will support the implementation of these new requirements.

LONG-TERM FUNDING AND INVESTMENT STRATEGY

The Pension Schemes Act 2021 is due to extend the statutory funding requirements contained in the Pensions Act 2004. Once these changes come into force, trustees of DB schemes will be required (under new section 221A Pensions Act 2004) to "determine, and from time to time review and if necessary revise, a strategy for ensuring that pensions and other benefits under the scheme can be provided over the long term."

Among other things, this strategy must specify:

- the funding level the trustees intend their scheme to have achieved by the time the scheme is significantly mature; and
- the investments the trustees intend their scheme to hold on that date.

The target funding level and investment strategy will both need to be set on a "low dependency" basis. This means by the time the scheme reaches significant maturity it would "not be expected that any further employer contributions will be required to make provision for accrued rights and other benefits under [the] scheme".

According to the draft regulations, a scheme will be deemed to reach "significant maturity" on "the date it reaches the duration of liabilities in years specified by the Regulator in [its new DB funding Code]". In its consultation paper, the DWP indicates that the Pensions Regulator may propose that this will be when a scheme reaches a duration of liabilities of 12 years.

Duration of liabilities is one of several different methods that can be used to measure the maturity of a DB scheme. It is the mean term of the liabilities weighted by the value of the scheme's future cash flows. It is measured in years and can be calculated directly using the scheme's cash flows. Mature schemes have a shorter liability tail and, hence, a shorter duration while immature schemes have a longer duration.

Trustees will be required to set their first funding and investment strategy as part of their first statutory valuation process after the regulations come into force. They will need to review and, where necessary, revise this in various circumstances, including:

- as part of any subsequent statutory valuation process; or
- after any material change in the circumstances of their scheme or employer (such as a material change in the funding position of their scheme or its maturity or a material change in the strength of the employer covenant).

In relation to most schemes, trustees will be required to agree their scheme's low dependency funding level and investment strategy with their scheme's employer(s). This is the case, even though trustees are only required to consult with their scheme's employer(s) in relation to their scheme's ongoing investment strategy.

STATEMENT OF STRATEGY

Trustees will be required to prepare, and from time-to-time revise, a written statement of their long-term funding and investment strategy. Where a scheme has not yet reached significant maturity, this will need to contain, among other things, commentary on:

- The maturity of the scheme at the effective date of the valuation and how this is expected to change over time.

- The level of investment risk the trustees intend to take as the scheme moves along its journey plan.

- How the actuarial assumptions used to calculate the scheme's technical provisions in the current valuation differ from those used to set the scheme's low dependency funding target.

- The trustees' assessment of the strength of the employer covenant and how long it is reasonable for them to rely upon this assessment.

The statement will also need to identify the main risks faced by the scheme in implementing the funding and investment strategy, how the trustees intend to mitigate or manage these and what action they will take should any of these risks materialise.

A copy of this statement will need to be submitted to the Pensions Regulator as part of a scheme's statutory valuation process.

SETTING TECHNICAL PROVISIONS AND RECOVERY PLANS

The Pension Schemes Act 2021 will also amend section 222 Pensions Act 2004 to provide that a "scheme's technical provisions shall be calculated in a way that is consistent with the scheme's funding and investment strategy, as set out in the scheme's statement of strategy."

This means, over time, the level at which a scheme's technical provisions are set will need to converge with the scheme's low dependency funding target. For some schemes this will have the effect of increasing the size of the scheme's deficit on a statutory basis which may in turn increase the amount of the deficit repair contributions that the scheme sponsor(s) will need to pay.

Significantly, on this latter point, the draft regulations contain a provision which will put the principle that a scheme's statutory funding deficit should be cleared "as soon as the employer can reasonably afford" onto a statutory footing. The government is also seeking views on whether this principle should take primacy over all other factors when setting a recovery plan. This would mark a significant departure from the current approach in which affordability is one of several factors for trustees to consider when agreeing a recovery plan with their scheme's employer(s).

COMMENT

These proposed changes mark the most significant change to the UK's statutory funding regime for DB schemes since the current funding regime was introduced back in 2005. They are designed to ensure that as many schemes as possible reach a low dependency funding level over the next 10 to 15 years. However, the draft regulations also raise some important points of principle:

- Why should a scheme not be able to rely (to some extent) on ongoing employer contributions once it has reached significant maturity, particularly where the employer covenant is strong?

- What will happen to schemes that do not, or cannot, reach a low dependency funding level by this point (as the draft regulations do not seem to cater for this)?

- Is it right that a scheme with a weak employer covenant that is in deficit is required to invest on a low-risk basis, which risks locking in the deficit and a future cut to members' benefits?

We expect these issues, along with many others, will be raised by stakeholders in their responses to the consultation which closes on 17 October 2022.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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