NEW STATUTORY FUNDING REQUIREMENTS PUT FOCUS ON END GAME FOR DB SCHEMES

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Legal Briefings

The Pension Schemes Act 2021 finally received Royal Assent on 11 February 2021. The Act contains some significant new funding requirements for defined benefit (DB) occupational pension schemes which mean that trustees and sponsors will soon be required to set a legally binding long-term objective for their scheme. In future, this objective will drive the sponsor's funding obligations to its scheme.

This is the most significant change to the statutory funding regime for DB schemes since the new regime was introduced at the end of 2005 and, generally speaking, it is likely to mean that DB sponsors will be under pressure to pay more money into their scheme's more quickly.

KEY TAKEAWAYS

- Trustees of DB schemes will soon be required to agree legally binding long-term funding and investment targets for their scheme with the scheme's sponsor(s).
- In most cases, a scheme's short-term funding target (set at each three yearly valuation) will need to increase over time to ensure these targets are met.
- The Regulator is due to issue a new Code of Practice on DB funding for consultation later this year.

NEW STATUTORY DB FUNDING REQUIREMENTS

FUNDING AND INVESTMENT STRATEGY

The new requirements contained in the Pension Schemes Act will require trustees to determine and keep under review a strategy for ensuring that pension benefits under their scheme can be provided in the long term.

This will be known as a scheme's **"funding and investment strategy".**

The strategy must specify:

- the funding level that the trustees intend the scheme to have achieved as at the "relevant date" (the meaning of which is to be set out in regulations), and
- the investments that the trustees intend the scheme to hold on that date.

Generally speaking, trustees will be required to agree this strategy with their scheme's sponsoring employer(s).

The Act does not specify the date by which these targets need to be met, as this will be set out in implementing regulations which are due to be published for consultation shortly. However, the Regulator has previously indicated that it expects schemes to hit their long-term target by the time they are "significantly mature", which it considers to be when they reach peak cash flow, and we would expect any future regulations to reflect this.

Significantly, once a scheme's funding and investment strategy has been set, a scheme's technical provisions (or liabilities), which drive the level of the deficit repair contributions that need to be paid, must be calculated in a way that is consistent with this strategy.

It is not clear from the legislation precisely what this means. However, in its new funding Code, the Pensions Regulator is expected to say, essentially, that (all other things being equal) it expects a scheme's technical provisions to increase over time to ensure that a scheme's long-term funding target is met. The provisions contained in the Act would appear to give statutory effect to this requirement. This marks a significant shift in the statutory funding regime and, depending on the circumstances, could lead to a significant increase in deficit repair contributions for some sponsors.

IMPLEMENTATION STATEMENT

As soon as reasonably practical after determining or revising their scheme's funding and investment strategy, trustees will also be required to produce a written statement which must set out, among other things:

- the extent to which, in the opinion of the trustees, the funding and investment strategy is being successfully implemented, and where it is not, the steps they propose to take to remedy the position (including timings),
- the main risks faced by the scheme in implementing the funding and investment strategy and how the trustees intend to mitigate these, and
- reflections of the trustees on any significant decisions taken by them in the past that are relevant to the funding and investment strategy (including any lessons learnt).

Trustees will be required to consult with their scheme's employer when preparing or revising this statement but they will not be required to agree the contents of the statement with them.

If schemes fail to put in place a funding and investment strategy the Regulator will be able to exercise its powers under section 231 of the Pensions Act 2004. This will include a new power for the Regulator to impose its own long-term funding and investment strategy on a scheme.

NEW FUNDING CODE OF PRACTICE

In March 2020, the Regulator launched the first stage of its two-part consultation on a revised Code of Practice on funding DB schemes. The consultation asked for views on a number of proposals including:

- TPR's proposed regulatory approach (twin track routes to demonstrating compliance: Fast-Track and Bespoke)
- the principles that should underpin all valuations in the revised framework, and
- ideas on how these principles could be applied in practice to provide clearer guidelines.

In summary, under the Fast-Track approach a scheme can expect limited regulatory intervention provided the scheme meets prescribed metrics laid down by the Regulator. The metrics cover matters such as:

- recovery plan length,
- discount rates,
- investment risk, and
- the shape of a scheme's journey plan.

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For further information on the first consultation, see our blog post.

In its recent interim response, the Regulator indicated that there was general support for its proposed principles and regulatory approach. However, the following concerns were highlighted:

- the risks associated with the Fast-Track guidelines (such as the increase in cost of DB pension provision)
- the proposed Fast-Track guidelines for open schemes
- the potential loss of flexibility for schemes by benchmarking the Bespoke route against the Fast-Track parameters
- the risk of increased evidential burden for schemes choosing the Bespoke route
- the risk that the Bespoke route may be perceived as "second-best", and
- the reliance on covenant being watered down and what a greater trustee focus on covenant visibility would mean for schemes' ability to rely on covenant beyond the medium term.

The Regulator has said it is considering the consultation responses (which contain over 6,000 comments) and that it will develop its Fast-Track guidelines, taking account of the economic conditions, including the impact of Covid-19 on sponsors and schemes during 2020 and beyond as well as the unknown impact of Brexit.

WHEN WILL THESE NEW REQUIREMENTS COME INTO FORCE?

The revised Code of Practice will be published for consultation after the DWP's consultation on draft regulations has been published (which is expected to be in the first part of this year). This is to ensure the Code is consistent with the new legislation. The Regulator anticipates, therefore, that it will be in a position to publish the second consultation in the second half of 2021.

It is unclear when the new statutory requirements will come into force, but the Regulator has indicated that schemes will not be required to comply with the new funding Code until Spring 2022 at the earliest. However, trustees and sponsors that are going through a valuation process this year should have regard to it.

COMMENT

The new statutory funding requirements will fundamentally change the way the scheme funding process works. Going forwards, trustees and sponsors will need to agree a legally-binding long-term objective for their scheme and work backwards to put in place a funding plan enabling this target to be achieved. Rather than simply going through the normal three-yearly valuation cycle, there will be much more focus from the Regulator on ensuring that schemes are on track to hit their long-term objective.

The Regulator's interim response to the first consultation on its new funding Code suggests that it recognises the concerns that have been raised and the challenges facing many schemes and sponsors as a result of the current economic environment. However, we must wait for the second part of its consultation to see how far the Regulator will modify its proposed approach to address those concerns and to mitigate the impact on struggling DB sponsors. We should discover the answer to this during the course of this year.

To keep up to date with our views on the Act and our upcoming podcast series detailing the various provisions, subscribe to our Pensions blog.

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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