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Defined benefit pension scheme funding: the new regime is afoot

On 29 January 2024, the Government published – and laid before Parliament – the long-awaited Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2024 (the ***FIS Regulations***). These will put into law two major sets of changes to the legal regime governing the funding and investment of defined benefit (***DB***) pension schemes, as enabled by the Pension Schemes Act 2021 (the ***Act***). The first of these is the requirement for each DB scheme to have a funding and investment strategy (***FIS***). The other imposes additional conditions on trustees when adopting a recovery plan, which sets out how a DB scheme's deficit should be remedied; most importantly, a guiding principle that the deficit be funded by the employer as soon as it can reasonably afford.

Since the Act paved the way for these changes, there have been extensive debates as to how the Government should use the new powers, and some uncertainty as to what form the requirements would take. The Government opened a consultation on the first draft of the FIS Regulations in July 2022. This closed in October 2022, having received over 90 responses, from trustees, professional advisors, trade unions, individuals and employers raising many important points and concerns. The uncertainty was increased by the Mansion House reforms announced by the Chancellor in July 2023. With their focus on encouraging more growth-orientated investment by both DB and defined contribution pension schemes, they seemed to call into question key policy elements of the new regime, especially the apparent drive towards investment risk reduction by DB schemes. Now, with the publication of the FIS Regulations, the Government's position on the key unresolved issues is finally being made clear.

In parallel, the Pensions Regulator (***TPR***) has since 2020 been preparing its proposed new Defined Benefit Funding Code of Practice (the ***Code***), which will set out how it intends to exercise its regulatory functions in relation to scheme funding. TPR consulted in early 2020 on the principles that should inform its regulatory approach. The draft Code itself (discussed here) was released in December 2022, in a further consultation process ending in March 2023. We are still waiting for confirmation of when the new Code will be finalised and released by TPR. This will need to happen in good time for trustees and employers to start planning how to meet the requirements, as many will carry out their next scheme valuations under the new regime.

What is the funding and investment strategy?

Over the past decade, a practice has emerged and become widely adopted of putting in place "journey plans" for DB schemes, setting a long-term funding target and a timetable in which this target is expected to be met. Often these journey plans were simply adopted by scheme trustees, though it has become increasingly common for employers to negotiate and agree them as part of a valuation process.

The Act and the FIS Regulations, in essence, standardise and make mandatory this practice of journey plans, building it into the legal regime and subjecting them to a common set of rules, with a requirement to formalise the FIS in a new statutory document: the statement of strategy. But these changes do not just add a new component to the existing set of requirements relating to funding: the FIS requirements will have a profound influence on the entire valuation and funding process. For each scheme, it will play a key role in driving the way that the employer covenant is assessed and taken into account, the outcome of the actuarial valuation and the funding measures that are put in place, and it will also have a significant influence on the scheme's investment strategy.

The Act provides for the statement of strategy to be divided into Part 1 and Part 2. The FIS must be set out in Part 1, and Part 2 contains "**supplementary matters**" (see below). For the majority of schemes, the statement of strategy – and therefore the FIS itself – must be agreed by the scheme's trustee and employer. However, for a scheme where a trustee has unilateral

power over the choice of valuation assumptions and the setting of employer contributions, the trustee will be required only to consult with the employer on the FIS and the content of the statement of strategy.

As with other key documents, such as the statement of funding principles and statement of investment principles, the statement of strategy and the FIS must be periodically reviewed and where appropriate revised. A FIS may evolve and be adjusted to reflect the experience of the scheme and wider economic conditions.

Role of the funding and investment strategy

The Act requires that the FIS specifies the funding level that the trustee intends to achieve by the scheme's **relevant date** (see below), and the investments that the scheme is expected to hold at that time. There is no overarching requirement to adhere to the FIS once it has been set, but the Act does require that in an actuarial valuation, a scheme's technical provisions be calculated consistently with the FIS. Therefore, the FIS will, to a considerable extent, do much to shape the outcome of scheme valuations, as the flexibility to choose the actuarial assumptions will be constrained and guided by the content of the FIS.

The FIS Regulations set out certain key principles relating to the content of the FIS, and therefore indirectly how a scheme's valuation and funding should be addressed.

Significant maturity and the relevant date

The central principle is that the FIS must set a funding level that the scheme is targeting when it reaches **significant maturity**. The FIS Regulations say that a scheme will reach significant maturity at the date when it reaches the duration of liabilities in years, or such other date as specified by TPR in the new Code.

This will determine the **relevant date** for a scheme, another critical concept. In practice, this date will determine the length of the **journey plan** – the period over which full funding on a low dependency funding basis, as set out in the FIS, is to be achieved. Broadly speaking, the FIS Regulations say that it is a date, estimated by the scheme actuary, on which the scheme will reach significant maturity, or no later than the end of the scheme year in which that date would occur. In this new framework, the concept of a journey plan is also given a legal definition, which broadly speaking is a scheme's planned progress in accordance with its FIS as it moves towards its relevant date.

The relevant date is not fixed once and for all – it should (as with the FIS as a whole) be periodically reviewed and revised where appropriate. The relevant date will likely vary considerably between different schemes, but it has been noted in industry commentary that for many closed schemes, the relevant date could be in a range of five to 15 years away.

In the consultations on the draft FIS Regulations and on the Code, it was proposed that a scheme would reach significant maturity when the duration of its liabilities is 12 years. Apparently in response to feedback that a 12-year duration for all schemes may not be appropriate, the FIS Regulations now say that TPR may specify different durations of liabilities, or different dates, for different types of scheme.

The duration of liabilities broadly means the weighted mean time until benefits under the scheme are paid, weighted by discounted payments. Importantly, the economic assumptions used when calculating duration must be chosen by references to circumstances on a fixed date: 31 March 2023. This is in response to feedback that the sensitivity of duration to market conditions (shown when rises in gilt yields in September 2022 caused the maturity date to move rapidly) would otherwise cause volatility, with schemes potentially needing to reset their journey plans as market conditions change. The change to the FIS Regulations means that progress towards significant maturity should only reflect demographic changes.

In the consultation process, legal concerns were also raised as to whether the draft FIS Regulations could validly delegate to TPR the role of defining significant maturity, given that the Act itself did not provide for TPR to have such a power and there are public law constraints on ministers sub-delegating the power to make subordinate legislation. Notwithstanding these concerns, the Government clearly believes that this arrangement is legally permissible. In its response to the consultation, it says that most respondents to the consultation were in favour of having duration set in the Code as this would allow TPR the flexibility to change it more easily in the future.

Much of the feedback focused on the potential impact of these requirements on the significant minority of DB schemes that are open to further accrual and, especially, to new joiners. The concern was that such schemes would be forced to de-risk much earlier than would otherwise be the case, driving up funding costs and potentially curtailing further accrual of benefits. The Government says that it does not intend to discourage the continued operation of open schemes; however, it does not accept the proposition that the trustees of open schemes can assume significant maturity will never be reached. Instead, new language has been added to the FIS Regulations allowing trustees, when determining the future maturity of the scheme, to take into account whether new members may be admitted and therefore the future accrual of benefits.

However, they must use reasonable assumptions when doing so and base these on an assessment of the employer covenant (see below), as this will be relevant to how long a scheme continues to be open. If an open scheme is supported by a weak employer covenant, it will not necessarily be reasonable to assume that significant maturity will be materially deferred when compared to closed schemes.

A more fundamental concern, raised in relation to closed schemes as well as open schemes, is the lack of flexibility for schemes in relation to their approach to funding once significant maturity is reached. Once the relevant date is reached, the regime is highly prescriptive and amounts to the imposition of mandatory funding standards, however broadly expressed they may be. However, this is clearly the policy intention behind the FIS Regulations.

The target funding level – low dependency funding basis

The FIS must set a funding level, that the scheme is intended to reach at the relevant date, under which the scheme liabilities are calculated on a **low dependency funding basis**. This means calculating the liabilities:

- on the assumption that further employer contributions would not be expected to be required for the scheme to meet its obligations; and
- on the presumption that the scheme's assets are also invested in accordance with a **low dependency investment allocation**: in other words, a strategy under which the value of the assets relative to the value of the scheme's liabilities would be highly resilient to short-term adverse changes in market conditions, so that further employer contributions are not expected to be required.

At first glance, the low dependency funding basis resembles the concept of "self-sufficiency" that has been widely used for many years as a way of describing a secure funding target. But whereas there has been considerable diversity in market practice in saying what self-sufficiency means, the low dependency funding basis is defined in a more tightly prescriptive way, though one still allowing different judgements to be made by trustees and employers as to how to achieve it.

An important change to the definition of low dependency investment allocation when compared to the consultation draft is that there is no longer a requirement to invest scheme assets in a way that matches cash flow from investments with the payment of benefits. Concerns were raised that this would restrict too greatly the types of assets that schemes could invest in once they reach their relevant date (such that trustees would be constrained to invest mainly in bonds and liability-driven investment structures). The Government has confirmed that schemes should be able to invest a reasonable amount in a wide range of assets beyond government and corporate bonds after significant maturity is reached. This change clearly reflects the Mansion House agenda, as the Government now says that its intention is to allow schemes to "continue to invest an appropriate proportion of funds in growth assets… including productive finance".

The legal status of the low dependency investment allocation is not straightforward. In the consultation process, some concerns were raised that it would limit the discretion that trustees have over scheme investments under sections 34 and 35 of the Pensions Act 1995 as well as imposing an overriding requirement to have a low dependency investment allocation in place by the relevant date. The Government has confirmed that this is not the intention, and that there is no free-standing requirement to invest in accordance with this approach. Instead, the low dependency investment allocation should simply be an "objective" that trustees take into account when setting the FIS, which in itself has no binding force on how scheme assets are to be invested. The Government also says that the clearer funding standards demonstrate the potential for many schemes to "make their assets work harder", showing it believes that the new regime is compatible with seeking better investment returns.

However, the fact that such an allocation is an objective of the FIS will give it considerable weight. It is likely that many trustees will take steps to align their investment strategies over time with the FIS objective and only invest in a divergent manner when they have compelling reasons to do so. For funding purposes, by the time of the relevant date a scheme's technical provisions will need to reflect the low dependency investment allocation, as the low dependency funding basis will assume that this is how the scheme assets are invested even if the actual investments are different at that time. Before then, if higher investment risk is assumed over the course of the journey plan and this is reflected in the scheme's technical provisions, as discussed below, the FIS Regulations require that trustees justify this by reference to the strength of the employer covenant.

Role of the employer covenant

The FIS Regulations set out a list of matters which trustees must consider when determining or revising a FIS. Of central importance is the strength of the **employer covenant**. Trustees must follow the principle that when determining the actuarial assumptions used to calculate scheme liabilities as the scheme moves along its journey plan, the level of risk they take depends (partly) on the strength of the employer covenant.

The concept of the employer covenant has been central to the funding of DB schemes since both the current funding regime and the so-called moral hazard powers of TPR were introduced in 2005. It has been covered in the current Code and in other TPR guidance, but the FIS Regulations mark the first time that it has been defined in law. In summary, the strength of the employer covenant is defined as the financial ability of the employer, in relation to its legal obligations to the scheme, to support the scheme, as well as the expected level of support from any contingent assets which the trustee reasonably expects to be legally enforceable (and of value at the time it would be called upon).

As a basic concept, this approach to the employer covenant is broadly consistent with normal industry practice. However, the FIS Regulations say that the strength of the covenant must be assessed not in relation to the technical provisions basis currently in use, but the scheme deficit both on the low dependency funding basis in the FIS and the estimated buyout basis, i.e. the most conservative funding bases.

The regulations are also highly prescriptive as to what matters should be taken into account in assessing covenant, including cash flow, expected future cash flow, the performance, future development and resilience of the employer's business and the likelihood of insolvency. In particular, trustees must also consider the length of time they can reasonably expect their assessment of the covenant to remain reliable, and the length of time they can be "reasonably certain" that the employer will be able to continue supporting the scheme. This sets a high standard for relying in the employer covenant. Taken together, these requirements may well pressure trustees and their covenant advisers to take very cautious approaches to covenant assessment, with great care in setting what they consider to be appropriate risk horizons.

A concern raised in the consultation was that the draft FIS Regulations were too stringent and required trustees to have near-certainty as to the ability of an employer to support the scheme or the value of a contingent asset such as a guarantee. In the final FIS Regulations, the drafting has been changed so that the tests address (for example) the "expected" ability of the employer to support the scheme. This will allow trustees to make informed judgements rather than requiring an unrealistic degree of certainty.

Recovery plans – driven by affordability

What is likely to be one of the more consequential changes made by the FIS Regulations relates to recovery plans, which are the timetables for addressing scheme deficits on a technical provisions basis, primarily through employer deficit repair contributions. Legislation already says that recovery plans must be appropriate having regard to the circumstances of the scheme, with the current scheme funding regulations setting out factual matters that trustees need to take into account. But the FIS Regulations add a new requirement for trustees in determining whether a recovery plan is appropriate, which is to follow the principle that funding deficits must be remedied "as soon as the employer can reasonably afford". However, trustees are also required to take into account the impact of the recovery plan on the employer's sustainable growth.

The concept of "affordability" has long been part of TPR guidance and regulatory practice in relation to recovery plans, but this is the first time that that it has been enshrined in law. Concerns were raised in the consultation process that setting deficit contributions by reference to affordability would force trustees to discount the needs of employers. It was also noted that this could lead to confusion as it would conflict with TPR's statutory objective in section 5 of the Pensions Act 2004, when exercising its powers in relation to scheme funding, to minimise any adverse impact on the sustainable growth of an employer. This objective was introduced to allow TPR to strike a reasonable balance between the needs of employers' businesses and the requirements to fund scheme deficits. Ensuring that trustees must have regard to the same factor will allow them to also balance those objectives, informed by their assessment of the employer covenant.

Is the regime still "scheme specific"?

When the current funding regime was introduced in 2005, its central design principle was that it would be scheme specific – with actuarial assumptions, deficit recovery plans and employer contributions determined by trustees, either with the agreement of the employer or in consultation with it, in light of the circumstances of the scheme and its employer. This contrasted with the previous, highly prescriptive, minimum funding requirement regime. The flexibility of the regime is widely believed to be a great strength.

Some of the changes from the draft FIS Regulations do increase flexibility to some extent (for example, being clearer that actual scheme investments are not constrained, not requiring a low dependency asset allocation necessarily to match benefit payment cash flows, allowing the sustainable growth of employers' businesses to be considered, and allowing open schemes to take account of new entrants and future accrual). But fundamentally, the changes made by the Act and the FIS Regulations do mark a departure from the scheme specific principle in important ways, moving the funding regime in a more prescriptive direction, both in relation to and the basis on which a recovery plan is to be set and the central principle of the FIS that low dependency is to be reached by the time of significant maturity. As the funding regime was reassessed following the political fallout from certain high-profile corporate insolvencies with large scheme deficits, this shift was probably inevitable. But many stakeholders have questioned whether the regime will remain truly scheme specific – the Government notes that the majority of respondents to the consultation said the principles governing the FIS cannot be applied flexibly to the circumstances of different schemes and employers.

Balanced against this is the fact the prescriptive elements of the new regime do allow considerable scope for trustee judgement (and employer input) based on the circumstances of the scheme – for example, in determining when significant maturity will be reached, in assessing what risk can be assumed over the course of the journey plan by reference to the strength of the employer covenant, and in deciding what low dependency asset allocation would be an appropriate objective. In this sense, the new regime could be described as one that introduces greater prescription but where this can operate in a scheme specific manner.

What powers will TPR have?

The Government has said its introduction of greater prescription and clear principles governing long-term funding standards is partly designed to enable TPR to intervene more effectively to protect members' benefits when needed. Consequently, the Act provides TPR with some potentially significant powers to intervene:

- If trustees have failed to comply with any of the legal requirements relating to the making of a FIS and its content, TPR's Determinations Panel may give a direction requiring the trustees to revise the FIS. This is a wide power and given the level of detail in the FIS Regulations relating to the FIS, TPR may be readily able to justify intervention when it sees fit.
- TPR may also exercise this power if the trustee and the employer have failed to agree the FIS and the statement of strategy within 15 months after the effective date of the actuarial valuation, i.e., the existing statutory deadline for agreeing funding matters will also apply to the FIS.
- Similarly, TPR's Determinations Panel already has a power to impose a new schedule of contributions specifying what the employer must pay to the scheme where TPR can show that trustees have failed to comply with the requirements governing the preparation of a recovery plan. The basis on which TPR can use this power may well be significantly expanded by the introduction of the affordability principle.

It remains to be seen how TPR will supervise the new regime and how interventionist it will be. Many stakeholders who value the flexibility of the current regime were encouraged by the overall tone of the draft Code, which gave more emphasis to the continuation of the regime's scheme specific nature than TPR's earlier consultation materials.

What next?

The FIS Regulations will come into force in April 2024 and will start to apply to DB schemes whose actuarial valuations have an effective date on or after 22 September 2024. Trustees will need to have the FIS signed off by the deadline for finalising their actuarial valuations and other statutory funding documents, which is 15 months after the effective date of the valuation.

While the FIS Regulations may not fundamentally change the outcome for many mature schemes (as many are already pursuing de-risking or run-off, and do not have an appetite to move to long-term return-seeking investment), a significant minority will be more impacted, such as those seeking long-term investment growth or which are open to accrual or new joiners. The trustees and employers of all schemes will need to see what tools and flexibilities they can use in the new regime to potentially accommodate their objectives within it.

While the FIS Regulations do not amount to a change of course from the policy behind the consultation draft of the FIS Regulations, the changes and clarifications that have been made to them on points of detail clearly reflect the influence of the Mansion House and Autumn Statement agenda. But until TPR publishes its finalised Code and hopefully clarifies further its approach to regulation and supervision, the picture of the funding regime remains incomplete.

If you would like to discuss any issues relating to the new scheme funding regime, or the DB pensions "endgame" more generally, please contact your usual Freshfields contact or any of the contacts in this briefing.

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