SLAUGHTER AND MAY/

CLIENT BRIEFING

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FINAL REGULATIONS ON FUNDING AND INVESTMENT STRATEGIES - WHAT NEXT?

QUICK LINKS

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DWP has published its response to consultation on the draft funding regulations that were issued for consultation in July 2022 along with the final version of the regulations. The regulations are now going through the parliamentary approval process and due to come into force on 6 April 2024. It is anticipated that the revised elements of the funding legislation in the Pensions Act 2004 will come into force on the same date.

For the most part, the broad principles underpinning the new funding regime remain the same, but there are a number of significant changes in the final regulations.

This briefing sets out an overview of what the new funding regime will require and some of the key changes that have been made in the final regulations. We also look at what trustees and sponsors should do next.

OVERVIEW OF NEW FUNDING REGIME

The Pension Schemes Act 2021 amends the Pensions Act 2004 to require trustees to have a funding and investment strategy (**FIS**) which specifies:

- the funding level the scheme should have achieved at a particular date; and
- the investments the scheme should have at that date.

Where the trustees only need to consult the employer on a valuation, they will similarly only need to consult the employer about the FIS. Otherwise, employer consent will be needed, as for the valuation.

There will need to be a formal statement (in a template form to be provided by the Pensions Regulator) setting out the FIS, together with additional details required by legislation.

WHAT DO THE REGULATIONS REQUIRE?

The regulations require the FIS to set out a journey plan showing how the scheme will be fully funded at the point it reaches the "*relevant date*" (see below). The strategy for reaching full funding should assume that the assets are invested in a "*low dependency investment allocation*". The level of risk that the trustees can take along the journey plan depends on the strength of the employer covenant and the length of time to the relevant date.

Key points to note from the new regulations include:

- **Meaning of 'relevant date':** The relevant date for these purposes is defined in the regulations as a date chosen by the trustees which is not later than the end of the scheme year in which the scheme will reach 'significant maturity'.

  A scheme reaches '**significant maturity**' when the duration of its liabilities is the number of years specified by the Pensions Regulator in a code of practice and determined in accordance with a formula. There was concern that the date could fluctuate because of market volatility affecting the assumptions used in the formula. As a result, the regulations provide that the economic assumptions must be based on conditions as at 31 March 2023. The regulations also allow the Regulator to specify different dates for different types of scheme. In determining the date of significant maturity, trustees can take into account whether the scheme is open to new members or future accrual, providing that their assumptions are 'reasonable' and take into account the covenant strength of the employer.

There was some concern about how the FIS would work in a scheme which had already reached its relevant date and the regulations address this by providing that for such schemes, the relevant date will be the effective date of the valuation to which the FIS relates.

- **Low dependency investment allocation:** The definition of 'low dependency investment allocation' no longer requires assets to be broadly cash flow matched to liabilities as the draft July 2022 regulations did. It is now defined as meaning only that the assets of the scheme are invested in a way that is highly resilient to short term adverse changes in market conditions so that further employer contributions are not expected to be required.
- **Trustee investment powers:** The Government says that the new regulations "*will not change trustees' duties in respect of investment decisions*" and "*it is for trustees alone to decide on the actual investments made*". However, the consultation response says that the Pensions Regulator will expect that investment strategies will "*usually be broadly consistent*" with the FIS, as the rationale behind the FIS "*should also underpin trustees' actual investment decisions*" but "*this does not mean they should always be identical as there may be good reasons for some divergence.*" We await the final code of practice to see what the Regulator's views on this are.
- **Surplus:** When determining the FIS, the regulations say that trustees must take into account "*an objective*" that, from the relevant date, the assets required for the scheme to be fully funded should be invested in accordance with a low dependency investment allocation. This is intended to make it clear that the low dependency (and low risk) investment allocation does not apply to any surplus at the relevant date. Schemes are intended to be allowed more flexibility in relation to the way surplus assets are invested.
- **Employer covenant:** The regulations have been amended to make it clear that the employer covenant is "*the financial ability of the employer, in relation to its legal obligations to the scheme, to support the scheme*".

  The draft regulations provided that the Regulator's code of practice would set out factors that the trustees should consider when assessing employer covenant, and the draft code had considerable detail on how they should do this, including the period for which the covenant could be considered to be reliable. The regulations no longer provide for factors to be set out in a code of practice and instead say that trustees should consider "*how long [they]… can be reasonably certain that the employer will be able to continue to support the scheme*" and that the other matters that they have taken into account in assessing the covenant will remain accurate. It will be critical to see how covenant advisers approach these new requirements and how they will opine on 'reasonable certainty'. This is central to how much risk can be taken in the journey plan.
- **Liquidity:** Trustees will not be required to assess liquidity as a scheme moves along its journey plan, only to ensure that they can meet their expected cash flow requirements and have made reasonable allowance for unexpected requirements.
- **Statement:** The strategy and how well it is performing will need to be set out in a formal statement, along with additional information. That information now includes assumptions in relation to future accrual for open schemes. There are also tweaks to the investment information which will need to be provided: the statement will need to set out the level of risk in relation to "*intended*" investments, which presumably reflects the fact that actual investments may be different.

  The Pensions Regulator will be given a discretion as to the level of detail that needs to be included in statements to, according to the consultation response, allow it to take *"a scheme specific approach to requesting information."*
- **Timing:** The first time trustees will need to have a FIS and a statement in place is 15 months from the effective date of the first valuation obtained on or after 22 September 2024.
- **Recovery plan:** Trustees will need to "*follow the principle*" that funding deficits must be recovered as soon as the sponsoring employer "*can reasonably afford*". This is intended to have primacy over the other issues that trustees

are required to consider when setting the recovery plan which will be amended to include "*the impact of the recovery plan on the sustainable growth of the employer*".

CODE OF PRACTICE

The Pensions Regulator is due to issue a revised funding code of practice, we think in Q2, having issued a fairly lengthy draft for consultation in December 2022. As the regulations have moved on quite considerably in some respects it seems likely that the final version of the code will also do so. Changes may include:

- less on assessing covenant strength as the Regulator no longer has a statutory remit to include covenant assessment criteria in the code, and the response to consultation says that "*it is important to maintain the primacy of the Regulations*";
- deletion of the provisions on cash flow matching;
- a new definition of significant maturity (currently defined as having an expected duration of liabilities of 12 years) and possibly different definitions for different types of schemes; and
- greater clarity for open schemes.

The Regulator is also likely to reissue its guidance on its proposed "fast track" funding route which is a more prescriptive approach to the new regime that will result in minimal engagement by the Regulator. It is also expected to issue draft covenant guidance and a template setting out the form which the strategy statement should take.

WHAT NEXT?

Sponsors and trustees should keep an eye out for the regulations coming into force along with the final version of the code of practice, fast track guidance, draft covenant guidance and template strategy statement.

Assuming the regulations remain in their current form (which is likely), trustees should also:

- identify the date by which they will need to have their first FIS and statement in place;
- determine whether they need sponsor consent to their FIS or to consult only;
- talk to the sponsor about their time scale for preparing the first FIS and statement and how they propose to involve the sponsor;
- engage with their scheme actuary to determine when the scheme is likely to reach significant maturity and begin to consider what their journey plan should look like; and
- talk to their covenant advisers and discuss whether the new requirements are likely to pose any problems.

Where the new regime may have the effect of accelerating existing funding plans, sponsors will need to consider affordability. Early engagement with trustees will be key.

If you would like to know more, we will be hosting a 1 hour webinar from 8.30 a.m. on Friday 2 February with Dan Schaffer, Debbie Webb from WTW and Katie Lightstone from PwC which will provide a joined-up legal, actuarial and covenant analysis of the new regulations. If you can't join live, the event will be recorded and a link shared afterwards. If you would like to sign up and haven't received an invitation, please get in touch with your usual Slaughter and May contact.

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