PENSIONS AND
LIFETIME SAVINGS
ASSOCIATION

THE DRAFT OCCUPATIONAL PENSION SCHEMES (FUNDING AND INVESTMENT STRATEGY AND AMENDMENT) REGULATIONS 2023: PLSA RESPONSE

18 OCTOBER 2022

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ABOUT US

The Pensions and Lifetime Savings Association is the voice of workplace pensions and savings. We represent pension schemes that together provide a retirement income to more than 30 million savers in the UK and invest more than £1.3 trillion in the UK and abroad. Our members also include asset managers, consultants, law firms, fintechs, and others who play an influential role in people's financial futures. We aim to help everyone achieve a better income in retirement.

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EXECUTIVE SUMMARY

- We welcome the publication of these regulations, and opportunity to comment. A framework to require a long-term target for maturing schemes is important, and we recognise the engagement that has already taken place with the industry in forming these proposals.
- We are, however, concerned that this framework risks forcing all schemes into a standardised approach, which does not reflect the wide variety of DB schemes, and could be detrimental to schemes, employers, and members. This would also be contrary to commitments set out during discussions of the Pension Schemes Act.
- One of the key questions asked is whether a low dependency investment strategy at the point of maturity is an appropriate target for all schemes and should be set in regulation. We firmly believe this should not be the case.
- We would urge instead that majority of the detail is covered in TPR's code of practice, to enable more bespoke approaches and also to ensure sufficient flexibility to adapt to macro-events.
- We have particular concerns about the proposals for open DB schemes, as set out here, and would urge the DWP to further reflect on how their circumstances and differing needs can be accommodated. We believe that the proposals, though seeking to 'exclude' open schemes from certain obligations, will actually result in further costs to them.
- The consultation does not appear to fully consider the potential knock-on wider consequences of requiring funding on a low dependency basis, including the new requirement to recover deficits as soon as an employer can reasonably afford – both are a departure from current requirements, which does not appear to be acknowledged in the impact assessment.
- We believe it is vital that a transition plan is put in place, for those schemes already at the point of significant maturity, or approaching it. Without it, we risk those schemes having to sell off growth assets quickly or unnecessarily, which may result in further market distortion.
- The regulations appear to introduce an employer veto over investment strategy in some circumstances. We do not agree this is consistent with fiduciary duty, and believe the current wording – which requires schemes to engage with employers – must be retained.
- We also feel that the regulations and the code need to be considered together – there remains too much unclear to be able to comment in a meaningful way. The plans for fast track and bespoke process, for example, are not referred to here. We don't think it's appropriate that the draft Code of Practice and expected Covenant Guidance will only become available after this consultation closes and regulations settled.
- The lack of meaningful impact assessment a concern – some in the industry are estimating additional costs of around £30bn to schemes and employers as a result of these proposals. It's certainly the case that, if applied across the board there could be substantial costs associated with the proposed changes which does not appear to be addressed at all in the consultation document.
- We consider that elements of the regulations may not be proportionate or value additive for small and medium sized schemes – the Statement of Strategy requirements, for example - may require information that schemes won't readily have, and is expensive to source. How regulators will use this information to fulfil their functions in a meaningful way is also unclear.

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- Though timeframes are not covered here, we would note concern that the timelines to finalise regulations, meaningfully consult on the funding code and consider the responses in full and address any technical, legal or policy issues are short. At this stage they would not appear to give the industry, schemes and employers sufficient time ahead of implementation in late 2023.
- Finally, we would note that the proposals lack a clear and measurable objective, particularly given the proposals aimed at introducing a long-term funding target. Whilst the Impact Assessment sets out that this intervention is necessary to maximise the probability of members receiving their pension in full, we do not agree that the proposals are wholly proportionate, given the low risk of members not receiving their pension.

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QUESTIONS

Scheme Maturity

Question 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?

We agree that this is a matter for guidance, not regulations. TPR will be in a position to respond more quickly to scheme circumstances and market conditions than if these matters are entrenched in regulations. The volatility experienced in recent weeks, for example, would have had a substantial impact on a scheme's expected date of maturity, if the new code had already been in place. Had that been the case, we believe that a duration set out in regulations would have caused significant additional challenges, given its sensitivity to market conditions. For example, hypothetically, a scheme could have expected to be some years away from significant maturity might find itself reaching the target far sooner than planned. Given the impact this would have on the sponsor and the scheme investment strategy – a matter that would be set out in legislation, and so by no means optional – we believe that these proposals would make forward planning extremely challenging, and therefore are potentially unworkable.

This question also refers to the proposals for open schemes. The PLSA has significant concerns that the proposed method of dealing with open schemes – by effectively allowing them to move the date of maturity so that it is never reached – is not practical, and could cause detriment. We note concerns raised by a number of open schemes that having a maturity requirement set out in this manner will impact their discount rate, and therefore their liabilities, and could increase their costs.

We would therefore ask that, as well with making this a guidance matter, the plans on open schemes are revisited entirely.

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 note that plans for TPR to consult on a Code of Practice later this year. Given our answer above, we believe this point should be considered in that consultation, rather than the draft regulations.

Nonetheless, we have reservations about duration being an appropriate method for determining significant maturity, for the reasons set out above.

Low dependency investment allocation

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

Firstly, we would like to note our concerns about the definition, and the assumption that this ought to be the desired target for all schemes. We believe there is potential for this definition to have a significantly detriment impact on schemes, and that a far more flexible approach should be adopted. In particular, we are concerned that the definition appears not to take non-investment risks – such as longevity - in to account. A low dependency investment allocation, broadly matched to the payment of pensions, with no growth assets, risks the possibility of shortfall, or of trustees having to target a funding level of in excess 100%, in order to meet the expectations of the regulations. We do not agree that investment should be limited to simply the payment of pensions, even at the point of significant maturity, and therefore this is not an appropriate target to be set out in legislation.

In terms of the drafting, we do not believe imprecise terms such as ‘broadly matched’ are appropriate for regulations. This is likely to cause some confusion, and possibly even result in court activity in order to obtain a reassurance of what is meant. The phrase is substantially stronger than the existing language setting out expectations on trustees in this regard, and we fear could significantly alter investment decision making as a result. In engagement with members we heard concerns that this would effectively push schemes that have reached - or are approaching - maturity, towards a narrower number of asset classes, which may not have suitable capacity as the DB sector matures. This may also result in herding, which could distort markets or result in systemic risks.

We would also note this approach is not compatible with the Government support for the sector to investment in asset types, such as illquids, to aid UK growth. Whilst we are strongly of the view that trustees should retain full fiduciary duty decision making authority, having conflicting regulatory or policy measures is not conducive to aiding decision making or encouraging scheme investment.

Overall, therefore, we ask that there is greater flexibility in the wording of regulations, in order to take into account of the full range of factors schemes need to consider in meeting funding targets. Events of recent weeks have further emphasised the complexities in defining a ‘low risk’ portfolio, and we therefore firmly believe that it is a not a matter for legislation. We believe this should be a matter for the Code of Practice, and that the Code should also avoid seeking to infringe trustees’ fiduciary duties.

Finally, we note that despite the aggregate position of schemes being in surplus, there is no specific reference to surplus in the relevant sections. We would not agree that it should be a requirement for surplus to be invested in a way that is consistent with cashflow.

Low dependency funding basis

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

Again, we have concerns about whether low dependency, as set out in the regulations, is an appropriate target, and have concerns that the full costs of such a strategy does not appear to have been fully considered.

In engaging with our members, it's clear that many schemes have a strong track record of providing flexibility to scheme sponsors on this point, which has been in the interests of both scheme members and employers. We are concerned that these regulations would effectively put an end to such arrangements and force all schemes – irrespective of individual circumstance – into a 'one size fits all' arrangements. It's unclear to us why a 'catch-all' approach is appropriate or necessary to address a problem with a small number of schemes, which should instead receive more targeted action from the regulator.

Finally, in terms of drafting, we note again that some of the language used in this section appears unusually broad for regulations, and risks leaving trustees and their advisors being unclear on how to interpret them. We also note that the language used in the consultation document, which describes 'reasonable, foreseeable circumstances', does not appear to match that in the draft regulation.

Strength of the employer covenant

Question 4:

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

We believe this section is broadly correct.

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

Again, we broadly agree. We understand that TPR is planning more detailed covenant guidance, and welcome further details in that.

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

This is unclear without sight of the draft code, which we believe is the correct location to set out these considerations.

Relevant date

Question 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?

Generally yes, but the requirements need to take into account market volatility, and it's unclear to us at the moment how this would be achieved.

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We do however have concerns that neither the draft regulations nor the consultation paper provide any details of whether a transition period will be allowed for those schemes that are close to, or passed, the relevant date. The date may also become an arbitrary cliff-edge if schemes are in the midst of certain activities e.g carrying out a bulk transfer. The change in expectations could have a significant impact for those in this predicament, particularly if they were in a satisfactory position in regulatory terms under the existing regime, but would not be under the new one.

This has become particularly demonstrated during the volatility experienced in recent weeks. As highlighted above, volatility not only can significantly alter a scheme's anticipated date of maturity substantially, but it would therefore also seem, under the plans, to require schemes to become forced or more rapid sellers of certain assets. We are nervous that this could result in further market distortion at some points, and that it will drive schemes that are still considered to be some way off maturity to minimise holding growth assets in their portfolios, in order to avoid this situation. This may have a particularly limiting effect on investment in illiquids.

Finally, whilst the broad thrust of the requirements are reasonable for closed DB schemes we believe they are completely disproportionate for open schemes and need reconsideration to suit their needs.

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

N/A

Question 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?

The regulations should enable flexibility on this point.

Minimum requirements on and after the relevant date

Question 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 earlier answers, we do not believe that a 'low dependency' target, as defined, is an appropriate target for all schemes, and therefore do not agree these measures should be set out in legislation.

Again, we would also reiterate our earlier concerns about the lack of transitional arrangements, particularly for those schemes already significantly mature when, and if, the regulations come into effect.

Question 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?

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

We agree the use of appropriate contingent assets should enable greater risk within investment strategies.

Investment risks on journey plan

Question 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?

We agree this is appropriate for closed schemes, but do not agree this is appropriate for open schemes, for the reasons set out above. We believe there should be a specific exemption from the requirement create a journey plan for open schemes that are not close to maturity.

Risk in relation to calculation of liabilities on journey plan

Question 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?

No – feedback from our membership has noted concerns that the current wording does not appear to link funding and investment risk primarily to the strength of employer covenant. The wording suggests that would be a secondary, rather than a primary, concern, and that mature schemes would not be able to take funding and investment risks (or only minimal risks) irrespective of the strength of the covenant. We would agree that some risk should be allowable for significantly mature schemes, if the covenant is deemed strong, and that the wording should allow for this.

Liquidity

Question 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?

Though we don't have anything in particular we wish to highlight here, we believe it would be sensible for this to be further reviewed in light of recent events.

Question 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?

As set out previously, we believe the regulations are far too inflexible, and that the current level of detail is not appropriate for legislation – much of this detail needs to be set out in TPR guidance.

We believe that overly prescriptive regulations risk having a significant and negative impact on the running of schemes and their engagement with sponsoring employers.

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Again, to reiterate, we have serious concerns about the consequences of applying these regulations to open schemes, in their current form.

Funding and investment strategy – level of detail

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

The level of detail expected is fair.

Question 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?

We have significant concerns about the proposals in this regard.

The requirements, as drafted, appear to introduce a new requirement that investment strategy is 'agreed with employers'. This is a significant departure from existing practice, and one which we fear fundamentally undermines fiduciary duty.

Constructive relationships between employers and schemes are important, and on the whole will benefit scheme members – however, we do not agree that employers should effectively, as the regulations imply, have a veto over investment strategies. The passage of the Pensions Act prompted debate over how this issue would be handled, and we are disappointed that the regulations have not addressed these points and provided further clarity, other than to appear to reiterate that employers should have the opportunity to 'agree' investment strategy.

In terms of the level of detail, we would prefer that trustees should be required to set a target return and risk budget, rather than an asset allocation, which will already be set out in a statement of investment principles, and is likely to change, at times, according to market conditions.

Determination, review and revision of funding and investment strategy

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

We believe they set realistic expectations.

Statement of strategy

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

Overall, we believe this approach is largely sensible.

However, we have concerns that trustees might not have access to the full information required on the sponsoring company as set out in Schedule 2, and so their ability to meet this obligation may be limited to the information provided to support the covenant assessment. Trustees may find themselves dependent on wider sector outlooks in order to publish this information.

We would also note our concerns about the cost of providing this information, particularly for smaller schemes that are already overwhelmed by existing reporting requirements. We would recommend that the requirements set out in this section are re-assessed, in order to establish whether trustees are likely to have access to this information, and whether it is proportionate to require them to obtain and publish it, as well as how any information will be utilised in practice by regulators or members.

Requirements for chair of trustees

Question 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 are reasonable.

Actuarial valuations and reports

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

We have nothing further to add to this section.

Recovery plan

Question 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?

We would agree.

Question 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?

We are concerned that this new principle is a significant departure from current expectations, and risks leaving trustees with a number of unanswered questions in relation to the specific expectations on them.

At the moment, the existing code of practice enables trustees to take a holistic view of the issue, and to take into account the long-term growth of the sponsoring employer, while still protecting member benefits. This has appeared to be successful and workable, and has minimised schemes seeking protection from the PPF. It is also in keeping with TPR's statutory objective to minimise adverse impacts on the growth of sponsoring employers.

This new requirement suggests a statutory obligation for trustees to require the sponsor to choose between investment in the business and making contributions. It does not make clear how trustees should approach, for example, required investment to grow the business and protects jobs, payment of dividends, and whether contributions into the DB pension should take priority over any increases to DC scheme savers within the same organisation.

We recognise that the is an existing general expectation that deficits should be a priority for sponsoring employers. However, we do not agree that it makes sense to embed it into law in this manner.

The impact of this requirement could be substantial for employers – we note some consultancies quoting figures of around £30 billion overall. Although we have not sought to calculate this cost, we are concerned that the impact on sponsoring employers does not seem to have been fully assessed in the consultation document – and an impact assessment is not readily available given the lack of information on the TPR Code of Practice.

We would therefore suggest that a full assessment is done on the cost of this new requirement, and that consideration is given to the specific impact on trustees and schemes as a result.

Multi-employer schemes

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

We don't have any concerns to raise on this at this stage.

Business burdens and regulatory impacts

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

We share the concerns expressed by many others about the lack of a meaningful impact assessment. The consultation effectively states that the true costs of the proposals will not be known until the draft Code of Practice is available to trustees, which will not happen until after this consultation closes. Given concerns raised about the potential impact of some of the proposals on DB schemes and sponsoring employers, we do not agree this is an appropriate manner in which to consult.

We note there a number of new expectations set out in the consultation that introduce significant changes to current expectations – for example affordability being given primacy, and the new low dependency target - which could potentially have a huge impact on both schemes and sponsoring employers. This does not appear to be acknowledged, suggesting that full consideration has not been given to the impact of these regulations.

We believe schemes and employers should be in a position to see the 'whole picture' when being asked to comment on the regulations, but there is clearly a great deal of information not included in this document, which is vital to our understanding to how the regulations would work in practice. For example, TPR has previously consulted on a system that allows both fast-track and bespoke systems. However, as the regulations don't refer to that, we have to assume that all requirements would apply to all schemes equally. This leads us to have concerns about the appropriateness of forcing all DB schemes into the same investment strategy, and about the proportionality of the requirements.

We believe that the regulations should not be passed without a full impact assessment first being carried out.

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

We have some concerns about the information within the Statement of Strategy and the likely burden this will have on schemes, as set out in Question 17.

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

We have nothing further to add.

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