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Dear Scheme Funding Team

SPP RESPONSE TO DWP CONSULTATION ON THE DRAFT OCCUPATIONAL PENSION SCHEMES (FUNDING AND INVESTMENT STRATEGY AND AMENDMENT) REGULATIONS 2023

We welcome the opportunity to respond to this consultation. We also thank DWP for engaging with the SPP on this matter and in particular for our conversation on 9 September where we were able to ask a number of clarification questions and discuss the draft Regulations with DWP. Where appropriate we have taken on board those discussions in drafting our response.

Overall comments

We support the aims of the new funding regime to protect the security of member benefits. However, we do have significant concerns with some aspects of the proposals, and the unintended consequences of the draft Regulations.

The DWP is rightly concerned that a minority of schemes are pushing the flexibilities in the existing regime too far. However, we worry that the draft regulations are unnecessarily restrictive, and in trying to weed out the bad behaviour of a minority, they will make matters worse for many other schemes and their members.

Recent market movements including seismic shifts in gilt yields have shown the importance of a funding regime that is flexible, and we are concerned these regulations are a shift away from this and will have negative unintended consequences for many schemes and sponsors. On a related

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point, there is a risk that the direction of travel within the draft regulations is to force schemes to consider risk and mitigation in a very narrow fashion. And, as the past few weeks have demonstrated relating to LDI, this can create its own systemic risks.

More generally we note that we are being asked to comment on the Regulations without sight of the Code itself or of a detailed impact assessment, which makes it extremely difficult to understand how what has been proposed will work in practice and what the implications for schemes and sponsors will be. In particular:

- The Code and regulations are two sides of the same coin, and hence there is a need for the industry to be able to comment on them both simultaneously. However, we understand we will not get sight of a draft Code until after this consultation on the regulations has closed. We therefore urge DWP to remain open to feedback on the regulations even once this consultation has closed.
- As currently drafted, we believe the regulations will restrict TPR's ability to offer flexibility, including for schemes in situations where this would result in better member outcomes. Specifically, schemes must be able to pursue a "bespoke" route after significant maturity where they can justify differences to the "fast track" criteria.
- The impact assessment does not address the costs to schemes, sponsors and members from what is being proposed. Whilst we accept some of the impact is hard to assess without the detail in the Code, we believe as currently drafted the impact of these regulations in of themselves will be very significant for the industry. Indeed, this is further reason why DWP must remain open to comments even after this consultation has closed.

Our key concerns in terms of the specific wording of the draft regulations themselves include:

- The draft regulations require all schemes, by law, to invest and fund in a low risk way by significant maturity. Whilst this will be the right approach for many schemes, for others, it is likely to lead to sub-optimal outcomes and potentially in some cases member benefit cuts.

  Some schemes will be able to demonstrate that a higher-risk investment strategy is supportable after significant maturity, either because they have a very strong covenant relative to the size of the scheme, have a form of security (whether that be from the sponsor or a third party), or just by virtue of having a large surplus. We believe that these schemes should be offered significantly more investment freedom than envisaged in the regulations in order to avoid inefficient use of capital. Whilst there are some easements discussed in the consultation for schemes with contingent assets, we do not believe these are sufficient.

  There will be other schemes where affordability is significantly constrained, and forcing a de-risking path on them would put significant pressure on the sponsor to find contributions that may well be unaffordable, potentially endangering members' benefits (and the viability of the sponsor) more than running additional investment risk would have done.

- In relation to long-term investment strategy, requirements that "*cash flow from the investments is broadly matched with the payment of pensions*" and "*the value of the assets relative to the value of the scheme's liabilities is highly resilient to short-term adverse changes in market conditions*" are very restrictive, and many will interpret this to mean low risk and low return resulting in sub-optimal strategies and higher costs for many

schemes. We note that typical liability-driven investment does not cash flow match in this way, and the restrictions seem likely to stifle innovation in the industry (for example, the use of external capital to support a higher return-seeking strategy).

We are also concerned there could be wider economic impacts of the law being restrictive on investment strategy in this way – for example on gilt and corporate bond pricing. We note that any investment in assets (such as illiquid assets) which could support the government's growth agenda would seem difficult to marry with the regulations as currently drafted as the liquidity requirements seem to take no account of alternative sources of capital or liquidity.

- The use of duration to measure maturity has significant drawbacks and these have been magnified by recent events in gilt markets. We are aware of some schemes for whom their date of significant maturity as measured by a 12 year duration is now more than eight years sooner that it was based on market conditions at the start of this year. This clearly makes planning an investment strategy very difficult for schemes, and we also note that if no updates are made to the planned figure of 12 years, then a much larger proportion of schemes will find themselves already significantly mature and with a requirement to change their approach overnight once the regulations come into force.

- The new legal requirement that deficits should be recovered *"as soon as the employer can reasonably afford*" represents a shift in legal footing and will result in significant extra costs for sponsors in the short term. Whilst we understand that this is not DWP's intention, nonetheless we believe this will be the impact.

- We welcome the comments in the Consultation Document on open schemes. However, we have some concerns that the requirements will drive up funding costs in many cases and could lead to further scheme closures. Again, we understand this is contrary to the intention.

- As drafted we believe the requirement for the employer to agree to the "*funding and investment strategy*" does represent a significant shift in the balance of powers and does fetter trustee investment decision-making powers. Once again we understand this is not the intention, and, consequently, we think there needs to be further clarification or amendment here.

- Some schemes will not be able to meet the regulations as drafted, for example, because affordability is constrained. The regulations are silent on the consequences of this.

In summary, we are concerned that the proposals are unnecessarily restrictive, and will result in sub-optimal strategies for many pension schemes leading to higher costs for employers. This seems counter to the Government's wider agenda to reduce red tape and stimulate growth in the economy.

Our responses to the detailed questions set out further detail on these and other areas.

We hope this feedback is useful for DWP and we would be happy to clarify any of our answers if they are unclear, and would welcome the opportunity to discuss any of the points raised further with DWP if you would find that helpful.

RESPONSES TO DETAILED 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?

Our strong preference is that the details of when a scheme reaches significant maturity are set out in the Code of Practice and not in the Regulations, as measures may need to be updated, and market conditions could change over time, demanding some degree of flexibility in this area.

Recent market movements and in particular rises in gilt yields have shown how volatile duration is as a measure. We are aware of some schemes where the date by which they would be "significantly mature" based on a 12-year duration (i.e. the figure mentioned in the Consultation Document) is now more than eight years earlier than it was at the start of this year – purely because of movements in gilt yields. Such movements make it extremely difficult to plan a robust investment strategy.

We therefore think that The Pensions Regulator (TPR) needs as much flexibility as possible to change the measure of maturity, as well as the value chosen for significant maturity. We would also encourage TPR to consider a measure that is independent (or less sensitive to) changes in market conditions.

We also note that if duration is chosen and no updates are made to the planned figure of 12 years, then a much larger proportion of schemes will find themselves already significantly mature and with a requirement to change their approach overnight once the regulations come into force.

It is therefore essential there is scope to update this measure as market conditions change over time, and hence, it should be left to the Code of Practice to enable it to be updated by TPR over time, and not prescribed in law.

We also note that it may be possible for a scheme to enter, leave and re-enter the state of significant maturity as measured by duration (it is not necessarily a one-off event). Thus, we believe that Regulations need to be flexible enough to allow schemes to benefit again from the additional flexibility if they exit the significantly mature state. It is also important that there are no materially different rules or reporting requirements for schemes crossing this threshold that would place a disproportionate administrative/expense burden on a small scheme that happens to drift in and out of this state. For instance, a scheme with fewer scheme members will be more sensitive to individual member movements.

Lastly, we note there is no clarity on how the calculation of significant maturity will work for schemes with buy-ins – in particular whether duration should exclude any members covered by a buy-in. This will make a huge difference to schemes and could result in unhelpful restrictions on the investment strategies for the balance of the assets. The industry will need clarity here, hence this is another area where it is unhelpful that we are having to comment on regulations without having sight of the Code.

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?

As above we strongly believe this should be in the Code, not in the Regulations.

We also note that if DWP and TPR considered 12 years to be an appropriate duration when this consultation opened, then this is likely to now need revisiting in light of large recent increases in gilt yields. Many more schemes are likely to find themselves already significantly mature using this measure compared with the start of the consultation period. We believe this needs a re-think.

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?

We have significant concerns about the definition of a low dependency investment allocation.

Firstly, we note that the concept of a low dependency investment allocation is not fully defined, as it requires the interpretation of words that have no definition within the draft regulations. In particular, the impact will very much depend on a user's interpretation of two key phrases: "broadly matched" and "highly resilient".

Whilst we note TPR may provide further guidance on these terms, we would prefer for the draft regulations to be clearer in order to avoid the Courts having to decide what such phrases mean. We comment further on each below.

We also have concerns around the phrasing of the objective that "further employer contributions are not expected to be required" and how this could interact with vehicles such as Asset-Backed Contribution vehicles or third-party capital structures. We presume that since future contributions from these structures would usually sit on a scheme's balance sheet they could count towards this objective, and the intention is not that such structures would not be permitted at significant maturity (or that a scheme would need to be fully funded without making allowance for these structures). However further clarification here would be welcome.

Broadly matched

At one extreme, a very flexible interpretation of broadly matched could be just for schemes to ensure that they have sufficient liquid assets to drawdown on to meet pension payments. However, we feel most users will interpret this as forcing schemes to construct some form of cashflow matching strategy.

Notwithstanding the approximations within such strategies and the uncertain nature of liabilities, pushing schemes down a strict cashflow matching regime could significantly limit the range of assets in which trustees invest, and therefore the affordability of mature DB schemes.

We feel that the cashflow matching part is unnecessary given the existing liquidity requirements put on trustees and any protection offered by the second part "highly resilient".
There are also potential investment issues with the two main building blocks for cashflow matching: the gilt market (with not enough long-dated and index-linked issuance) and the UK investment grade corporate bond (narrow range of issuers).

It is unclear what TPR's expectations are concerning how this will be enforced. By way of analogy, the response to HMT's Call for Evidence on Solvency II included extensive criticism of the eligibility criteria for matching adjustment assets for insurers. Based on that experience, we warn that the requirements proposed by DWP could evolve in a similarly restrictive way, which may be an unintended consequence of proposed regulations.

Highly resilient

One flexible interpretation of resilience would still permit schemes to invest in growth assets. A typically dictionary definition refers to resilience being the ability to recover from losses rather than having to avoid them. Such an approach would help schemes to build up buffers to help absorb any future funding shocks, in particular in relation to the uncertain liabilities.

The threshold for meeting the resilient standard is unclear, but we believe most users will interpret the phrase as meaning low risk and low return assets. This is compounded by the use of the word “highly” and the phrase “short term” and the description in the consultation document “it is not expected to rely on further employer contributions to provide for accrued liabilities even where investments do not perform as well as expected or lose value relative to the value of the liabilities”. Again this could prove overly restrictive on schemes’ investment strategies and a further drag on costs.

All in all, we think that the proposed definition is not appropriate or effective in practice. In our view, a low dependency investment allocation defined more in terms of having a high degree of hedging with a scheme’s liabilities coupled with sufficient liquidity (as is already a requirement of schemes) would be a better alternative to the proposed draft.

The events of recent weeks on the LDI market will mean fundamental changes going forward. At a high level, schemes will have to choose between lower returns or lower hedging. This will mean meeting the “highly resilient” test, which most will interpret as to involve very high amounts of liability hedging, is now more expensive and capital intensive than it was at the time the draft regulations were conceived. This highlights the importance of flexibility in the new regime to not only reflect the unique circumstances of trustees and sponsors but also the dynamic nature of the investment environment.

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?

This definition could be clearer. However, our understanding is that the requirement is for the funding basis to be consistent with the investment strategy, and on that basis, we are comfortable it is appropriate.

We noted there was no reference to prudence. In that context, we presume that some clarification will come in the Code, but noting that the Code will be guidance rather than law.

Whilst not directly linking to the definition of a low dependency funding basis, we note that transitional arrangements would be important if schemes suddenly had to fund on such a basis.

Strength of the employer covenant

Question 4:

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

TPR original code of practice 3: Funding defined benefits defined covenant as "*the extent of the employer's legal obligation and financial ability to support the scheme now and in the future*."

The proposed wording of the Regulations adopts only one element ("financial ability to support the scheme") of this original definition which has been widely adopted to date.

The *legal obligation* and the need for support to be provided *now and into the future* are both important factors and it is unclear why these have not been included.

Legal obligation covers those schemes with multi employers with different levels of obligation.

Support for the future should be framed in terms of the longevity of the employer and the longevity of the scheme.

The draft regulations introduce *contingent assets* as part of the definition. These can form an important element of employer covenant and should therefore be included. However, as contingent assets can be in many different forms and do not always support Deficit Recovery Contributions or the covenant throughout the life of the Scheme, we suggest the definition be flexed to take into account contingent assets, "as appropriate". This gives trustees flexibility in the weight they might apply to a guarantee for covenant purposes. We also note that as drafted, Regulation 7(2)(b)(ii) would make it difficult for trustees to take into account contingent assets where the value can fluctuate (e.g., security over the property) as it will be hard for them to determine that the asset "will be sufficient to provide the support" at some future date. We believe our suggested amendment would deal with this issue as well.

More flexibility should be allowed for stronger employers. A requirement for them to fully fund a scheme on a very low-risk basis would be a significant shift and potentially excessive from a risk perspective.

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

7(3) and 7(5) required the covenant to be assessed by reference to the size of the scheme deficit either on a low dependency basis or buy out basis rather than the ongoing deficit.

<u>Size of deficit</u>: By referring only to the size of the deficit, the regulations miss the potential importance of the scale of the scheme. While the Scheme is on its journey to a low dependency, low-risk investment status, it will retain exposure to volatility which will be driven in part by the relative size of the scheme's assets and liabilities. Even at low dependency, there may be some residual volatility.

<u>Low dependency vs. buy out</u>: the choice of which measure is based on the likelihood of insolvency. This would appear too prescriptive. The likelihood of insolvency is extremely difficult to predict over anything other than a relatively short time frame and almost impossible to assess over the likely long duration of the scheme. There is a danger that PPF D&B failure or ratings agency assessment become a determinant of the weighting. It could also lead to extensive arguments between trustees and employers over which measure is appropriate.

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

Regarding each factor:

a) “Cash flow” - cash flow is a key factor when assessing covenant but the definition will be key and this will only be revealed in the Code. Ultimately it will be the cash flow available from the sponsor to finance its obligation to the scheme that is the key determinant;

b) “The likelihood of an insolvency event” – as referred to above this is very difficult to assess, particularly over the likely long term duration of a scheme. Key to the covenant is the longevity of the employer compared to the longevity of the obligation to the scheme which is linked to the employer’s prospects.

c) “Other factors likely to affect the performance or development of the employer’s business, as set out in the code” - There are certainly other factors that will need to be taken into account and so this clause is an important inclusion, especially for large employers and multinational organisations with complex arrangements. The consultation lists various factors which are all valid if included in the Code but does not reference employer access to capital or other sources of external support which can be important elements. The term performance and development may be too prescriptive. Historically, TPR have referred to prospects (the term used in Q4(iii) itself) and we do not see why this term would not be appropriate for the Regulations.

More generally, we note that the current code of practice encourages trustees to act proportionately in carrying out their functions given their scheme’s size, complexity and level of risk. The draft regulations do not appear to provide such flexibility which is particularly relevant for small schemes with a very strong covenant. Reference in question 4(ii) is to factors that the trustees **must** take into account. This implies the removal of flexibility.

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?

Yes, we think this is fine, subject to the other comments in our response – in particular in our summary and question 8.

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

The SPP does not represent any single scheme.

However, we note that not all schemes will currently have a target long-term date, even if they have a broad long-term plan, and some of those that do may not specify the date with precision.

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?

Yes potentially, but we believe this needs to be more flexible.

There are some benefits here in that actuarial reports are typically aligned with dates for producing annual accounts, and as a result, it may be easier to collect the required information.

However, trustees should be able to receive an ad hoc update from their scheme actuary as to the date the scheme will reach significant maturity and refer to this within their strategy. Otherwise,

they may revise their funding and investment strategy due to identifying a change in circumstance, yet be required to refer to an inconsistent and out-of-date figure from their last actuarial valuation (or annual update). It should therefore be a calculation 'no older than that undertaken for the purposes of the last valuation'.

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?

We think these requirements go too far.

As noted in our summary, the draft regulations require all schemes, by law, to invest and fund in a low risk way by significant maturity. Whilst this will be the right approach for some schemes, for others we do not believe it would lead to the best outcome. In that sense, we think that a one-size-fits-all approach could depart from the principles underpinning the proposed regulations (e.g., paragraph 1.4, Consultation Document), and, in practice, prevent schemes to take more risks when they are affordable and reasonable under the scheme´s conditions – or even where they are expected to result in better outcomes for members.

For instance, some schemes will be able to demonstrate that a higher risk investment strategy is supportable at and after significant maturity, either because they have a very strong covenant relative to the size of the scheme, have a form of security (whether that be from the sponsor or a third party) or just by virtue of having a large surplus. We believe these schemes should be offered significantly more investment freedom than envisaged in the draft regulations. Although some easements are discussed for schemes with contingent assets, we believe they are insufficient.

Also, there will be other schemes where affordability is significantly constrained, and the scheme is currently adopting an investment strategy that is more risky than allowed under the draft regulations, but where in most circumstances benefits are expected to be paid in full. Forcing a de-risking path would result in rising costs and put significant pressure on the sponsors to find contributions that may well be unaffordable. This may result in a greater risk to members' benefits than running additional investment risk would have done.

Further we note:

- Restriction b) should refer to only the assets of the scheme required to cover 100% of the liabilities. A scheme with a surplus should be allowed more freedom to invest the additional assets, to assist with covering unforeseen expenses, and other contingencies or to help achieve a lower risk goal (e.g. buy-out).
- Another potential unintended consequence of this definition could be to stifle innovation – for example, Capital Backed Journey Plans.
- It is currently unclear what the consequences are of failing to meet these requirements, even if temporarily.

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?

We do believe additional risk after significant maturity should be permitted where supportable.

This proposal would allow greater flexibility to take account of the specific needs of individual schemes, which would be consistent with allowing schemes to adopt a bespoke approach rather than a one-size-fits-all (which we understand remains the policy/ regulatory intention of DWP and TPR).

We do not believe there needs to be a focus on contingent assets here, but that covenant could also be used to evidence that risk is supported. The existence of a contingent asset does not necessarily imply a strong covenant. It does not seem right that scheme sponsored by a weak employer with a contingent asset (which is potentially of little value) should be allowed to take additional risk, but a scheme sponsored by a strong employer with no contingent assets would not.

We assume that it is not intended that the definition of "contingent assets" (reg 7(7)) should be limited to "guarantees", as this could produce anomalous results. For instance, items such as an escrow account where specific funding is available to underwrite risk in light of negative experience could be much more applicable and valuable than a simple parental guarantee. We would therefore welcome a clarification that the definition includes, but is not limited to, guarantees.

We also do not believe the level of additional risk allowed should be capped, and linking to a specific percentage of total liabilities seems arbitrary. The level of the additional risk should be based on the demonstrable strength of the covenant (allowing for other contractual support such as a contingent assets) – i.e. the greater the strength the greater additional risk allowed -. Taking an extreme example, if a scheme has an escrow account with enough assets to cover 10 times the size of the scheme, say, why couldn't that scheme invest 100% in equities post significant maturity?

Again, we feel that the level of surplus should be taken into account – i.e. if a scheme is 120% funded, then the asset level above 100% of liabilities should have more freedom. This is particularly relevant for schemes that target paying discretionary increases.

More generally, additional risk could make sense within the context of a trustee's wider investment strategy – e.g. to facilitate diversification.

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

We believe that if the risk is supported by covenant and/or contingent assets, then the additional risks are very limited.

In some cases, such risks may even be reduced, noting that allowing more investment risk can reduce covenant risk as it means less strain on the employer.

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?

At a high-level yes, but there are some complications for open schemes.

Schemes that are open to new members may not reach significant maturity, and therefore the principles are clear in that investment risk can be taken provided this is supported by the employer covenant.

However, there are other consequences for open schemes, particularly in relation to funding.

In particular:

- The draft regulations still require open schemes to identify a future date at which they will be significantly mature. That date will be pushed out every three years provided schemes stay open, so there should not be a requirement for them to start de-risking their investment strategy unless they do start to mature.
- However, the draft regulations also require the funding basis to be set in line with the investment strategy, hence requiring the discount rate for open schemes to reflect that at some point in the future, they expect to be low-risk. This reduces the long-term discount rate, pushing up costs for open schemes (perhaps significantly in some cases). This could lead to further closures of open schemes.
- This impact would be mitigated to some extent if the calculation of when an open scheme reaches significant maturity could make allowance for some future accrual and new entrants. This is not clear from the draft regulations but we understand could be set out in the Code. However, this would merely limit this impact, not remove it.
- We also note that pushing out the date that significant maturity is reached every three years will lead to some unusual consequences. For instance, it will effectively lead to a "staying open gain" at each valuation as the long-term discount rate can also be pushed out three years.

We also note that the requirement to set a journey plan for your investment strategy should not be made unnecessarily onerous for a scheme that is not expecting to mature.

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?

We agree in principle that investment risk and actuarial assumptions that apply as a scheme progresses along its journey path should reflect the strength of the employer covenant.

However we believe it is important that risk 'is no greater than can be supported by covenant' rather than simply 'in line with covenant'. We do not believe there should be a requirement for a direct link where covenant defines investment risk, and investment risk defines funding basis. For example, the current regulations allow:

- A scheme with a strong employer to invest in a risky manner yet set a stronger funding basis (i.e. covenant = investment risk > funding basis);
- A scheme with a strong employer to invest in a low risk manner, in which case the funding basis is set accordingly with low risk assumptions (ie covenant > investment risk = funding basis).

The actual wording of the draft regulations does appear to offer some flexibility (more risk for a

stronger covenant/far from maturity, less risk for a weaker covenant/close to relevant date). However, there may be instances where trustees may wish to adopt a higher degree of prudence in their investments and or set a more prudent long term funding target than the covenant might imply. The regulations as drafted make this harder to agree with an employer.

In addition, where a scheme has a strong covenant and a guarantee of access to funding, it may be appropriate to run investment risk for longer even as funding towards low dependency improves. For example, a scheme's ultimate objective could be buyout which may be stronger than low dependency, and schemes should be allowed to take some investment risk to bridge any gap to buyout.

A consequence of the proposed regulations is likely to be an overall reduction in the flexibility in the scheme funding regime. The proposed regulations and the imposition of a time limit to reach a low dependency target will leave some schemes in a position where they cannot bring all the covenant, investment and actuarial factors together into a viable/compliant solution. It is not clear what happens in such cases, and further clarification is needed to conduct a complete assessment of new regulations.

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?

We consider that the new liquidity principle set out in paragraph 6 of Schedule 1 would represent a significant shift from the current requirement for trustees to exercise their powers of investment (or discretion) "in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole."

The explicit requirement for "assets of the scheme" to be "in investments with sufficient liquidity to enable the scheme to meet expected cash flow requirements and make reasonable allowance for unexpected cash flow requirements" on or after the relevant date, may have unintended and counter-productive consequences for the ability of such schemes to retain (and/or make) allocations in illiquid investments over the longer term.

As noted previously, where schemes can continue to rely on other sources of support (e.g. from their sponsor and/or a third party), we believe these schemes should be offered significantly more investment freedom than envisaged in the regulations, including in relation to investment in illiquid assets.

Currently, trustees may be able to rely on other sources of liquidity in order to ensure that they can meet expected and unexpected cashflow requirements, whilst retaining allocations to long-term capital which may be redeemed over a longer period. For instance, they may enter into contractual arrangements with their sponsor (and/or other entities in the sponsor's group, or other third parties) to provide *ad hoc,* additional short-term liquidity support for cashflow needs (such as for the payment of benefits, cash top-ups for collateral pools), and thereby avoid the need to disinvest from illiquid assets in an untimely way.

This can be particularly helpful for schemes targeting run-off (i.e. those intending to retain holdings over longer term periods), but it can also facilitate de-risking trades (e.g. allowing schemes to respond quickly to favourable pricing or insurer capacity, whilst still retaining

sufficient liquidity for any interim periods between paying substantial upfront premiums and realising the value of illiquid investments).

If trustees are required to ensure that sufficient liquidity is derived solely from scheme investments (disregarding any other source of support) this could force schemes to disinvest from current holdings and inhibit future allocation to illiquid investments. A narrow focus on the liquidity of scheme investments could also constrain schemes from diversifying their portfolios, and giving due weight to other factors (such as the security, quality and profitability of their portfolios). This could, in turn, affect the costs associated with matured defined benefit schemes.

This proposal appears to run counter to other Government proposals to encourage other types of pensions schemes to invest in illiquid assets, and thereby support growth, the transition to a green economy and levelling-up agendas (e.g. the DWP's consultation on "Facilitating investment in illiquid assets").

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?

Please see our comments in Question 10 for our thoughts on open schemes and our response to Questions 5 and 8 for some wider concerns.

More generally, we believe flexibility is key: the new regime must allow schemes to have appropriate, scheme-specific solutions as the current regime does. However, Schedule 1, as drafted, will significantly reduce this flexibility.

It also needs to be practical and not overly prescriptive. For example, for schemes that aren't maturing or are a long way from significant maturity it may be impractical (and unnecessary) to require the sponsor to consider and approve the details of a potential investment allocation once in the mature state. One way to address this would be to disapply the requirement to agree a funding and investment strategy for schemes that have a duration of liabilities of more than "x" number of years – though noting our previous comments on the drawbacks of duration as a measure.

Flexibility should also permit schemes to go beyond the base requirements (or err on the side of caution) if they wish to do so (e.g. to save costs).

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?

As set out in our response to Question 15 below, we are deeply concerned about the requirement for the employer to agree the funding and investment strategy and in particular agree the future investment allocation. We believe, as written, this will fetter the trustee's decision-making power in relation to investments by requiring the asset allocation at significant maturity to be agreed upon. If this is not the intention, further clarification is needed.

For relatively immature schemes, we worry that in some cases the employer will simply be reluctant to commit their support (at this stage) to a theoretical strategy that would not be implemented for many years. Given the potential for this strategy to change in future reviews, we question if the level of detail is necessary. In particular, few schemes specify asset allocation years

in advance; instead they focus on a target return and level of risk.

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?

As things are currently drafted, many trustees will believe the introduction of the Statement of Strategy and the requirement to agree with the company over Part 1, will fetter the trustee decision making power in relation to investments. If this is not the intention then further clarification is needed.

Whilst some trustees may welcome more involvement from the sponsor, the introduction of the Statement of Strategy could create difficult dynamics unless further clarity is provided. We note that paragraph 3.40 of the Consultation Document says that employers "*need to agree the funding and investment strategy*", but then says that "*trustees will continue to be responsible for investing funds on behalf of scheme members and <u>employer agreement is not required for</u> all other <u>investment decisions</u>".* We think further clarification is needed – an employer's veto over the investment allocation at significant maturity (which is in the funding & investment strategy) will clearly fetter trustee decision making power on or after significant maturity. Furthermore, it is hard to see how such a veto would not strongly influence investment strategy decisions on the journey as well.

It is currently unclear how any conflict between the employers and the trustees regarding the investment categories to be included in the funding and investment strategy would be resolved – e.g. would trustees be able to veto any wording proposed by the employer where they consider this would conflict with the statement of investment principles, or could failure to agree result in a breach of the obligation to prepare a FIS under section 221A?

Moreover, it is not clear what the position would be if trustees are subsequently advised to invest in a way that means the investments they hold are in different proportion or categories of investment to those set out in the Funding and Investment strategy. The trustees would have the power to make the investment but they would not be acting in accordance with the Funding and Investment strategy and so this could lead to challenge by the employer and/or it could refuse to agree to amend the Funding and Investment strategy.

Currently, the Trustees and Sponsor agree the valuation assumptions, which in effect sets boundaries on the investment strategy through the discount rates used. However, the actual investment allocation is a matter for the Trustees to decide with Sponsor consultation. We strongly suggest maintaining this framework.

<u>Interaction with the Statement of Investment Principles</u>

We also query how the interaction of the Statement of Strategy and the Statement of Investment Principles will work in practice, and if there is a need for both. However, if both are to remain then we would suggest updating the draft regulations so that it is made clear that:

- The Statement of Strategy cannot contradict the Statement of Investment Principles and a company, whilst agreeing and consulting on the content of the Statement of Strategy needs to recognise the supremacy of the Statement of Investment Principles.

> The requirements of Statement of Investment Principles are unchanged – trustees will continue to be required only to consult with their sponsors on, but not seek agreement. And trustees should continue to invest in line with their Statement of Investment Principles.

> There is a reasonable 'get out' clause for trustees if there is failure to agree a Statement of Strategy because it contradicts the Statement of Investment Principles. We would suggest changing the requirements so that it is clear trustees will be deemed to have taken "all reasonable steps" to produce their Statement of Strategy, in these circumstances.

In addition, whilst beyond the scope of the draft regulations, we would suggest encouraging the Statement of Investment Principles to include more details on future investments and long-term plans that are intended to be in the Statement of Strategy.

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 think more time may be needed in the first cycle of these valuations.

We feel that Regulation 13 (2) e) is too restrictive. For example, it is unclear why a review would be urgently required if there was an improvement in circumstances. It may also be that a material change in covenant would not (for a mature scheme) influence the funding and investment strategy.

Any review of strategy (even if no changes then needed) would appear (based on other aspects of the draft regs – e.g. 16) to necessitate various additional calculations and other work that would impose an additional cost. This may be disproportionate depending on timing relative to an existing valuation date or relative to the nature of the change being considered, and more flexibility should be permitted to take a proportionate approach.

It is unclear to what extent 13 (2) e) could be seen as introducing a requirement for all schemes to actively monitor funding levels on a daily/weekly basis to ensure they respond as soon as reasonably practicable to any material change. Again, this may be disproportionate (particularly for smaller schemes).

Regarding 13(2) c), we note that valuation negotiations can sometimes exceed the 15 month deadline so it may not be possible to document the funding and investment strategy until after the valuation is completed. What the consequences would be for missing this deadline are key, noting that schemes would technically be in breach of the law.

Statement of strategy

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

In order to enable TPR to receive a full picture of the strategy we suggest it should also include:

- The extent to which the covenant assessment has taken into account contingent assets
- A heading for recovery plan covering:

- Expected employer contributions
- The extent of any contingent employer contributions; and
- The extent of reliance on asset outperformance to remove the scheme deficit

That being said, our understanding is that the information in Part 2 of the statement is predominantly for the benefit of TPR, given it includes covenant information and thus presumably would not (and should not) be made publicly available.

It is therefore unclear why this would be set out in Regulations rather than within TPR's Code. TPR's needs regularly evolve in terms of information required in scheme returns and reporting requirements in this area may similarly need to adapt. It therefore may not be helpful to TPR if this is overly prescriptive, potentially restraining TPR's drafting powers.

More generally this would appear to involve a lot of work and it is unclear what updates would be required if undertaking an interim review between actuarial valuations.

We also note that some schemes may target higher levels (e.g. buyout in x years) yet it may not be in their interests to disclose this (as they may then be judged against an otherwise flexible/aspirational target). In particular, our strong opinion is that schemes should be able to state they are targeting buy-out without setting their long-term funding target to be at a buy-out level.

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?

It seems reasonable to require the appointment of a Chair. We have a preference for no further conditions applying to this (to give maximum flexibility on the choice of Chair). Regulation 17(d) can be deleted as this is referring to NEST and so is not relevant for Regulations that only apply to defined benefit schemes.

Actuarial valuations and reports

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

Yes, but there are costs involved, which would put additional pressure on small schemes. Also, some of these measures may be of limited value (and relevance) for an immature (or open) scheme.

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 feel strongly that "reasonable affordability" should not be the only driver for setting a recovery plan and that matters prescribed by regulation 8(2) remain relevant. In our view, it would become the only driver if the proposed amendment to Regulation 8 of the Occupational Pension Schemes (Scheme Funding) Regulations 2005 is made. Our preference would be for

"reasonable affordability" to be included in Regulation 8(2) as one of the matters trustees should take into account when determining a recovery plan.

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?

No.

We feel strongly that "reasonable affordability" should not be the only driver, and broader issues should be allowed to be taken into account.

As currently drafted, we have a concern that the new affordability principle will have a significant impact on sponsors, though we understand from our conversations with you that this is not the intention. Furthermore as currently drafted, we would question how this interacts with TPR's statutory objective to minimise any adverse impact on the sustainable growth of an employer – either way in our view it is difficult to align the reasonable affordability principle with this objective.

For example, for very large companies sponsoring small schemes, we understand DWP´s intention is not that they would need to pay the full deficit off straight away, or that companies would need to cease paying dividends until the pension scheme deficit is met. However, we think this is how many will interpret this new requirement as drafted and hence clarification is needed. In particular we note that payment of regular dividends is of particular importance to some sponsors and helps to ensure they can raise capital for future covenant-enhancing projects.

Taking a step back, we also note that longer recovery plans are often put in place to reduce overfunding risk. The last few weeks have shown that considerable uncertainty remains in pension scheme funding, but on average given the requirements for prudence in technical provisions it is expected that scheme funding will improve over time, and ultimately recovery plan payments towards the end of recovery plans may not be needed. A requirement for sponsors to pay in more cash sooner will increase overfunding risk. Ultimately this is a political decision but we note this will reduce potential for investment in growth, and DC contributions at the expense of further security for some DB members.

There are also particular concerns here with shared cost arrangements. Would the sponsor having to pay off the deficit much more quickly also mean employee costs went up significantly in the short term?

This is a particular area where an impact assessment on sponsors of UK DB schemes is needed before a decision can be made.

We also note that this new requirement is described as a principle that trustees must follow. We are unsure how this will work in practice, given that trustees are not the arbiters of what employers can reasonably afford, and the employer in many cases might disagree with the trustees (as might TPR).

Multi-employer schemes

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

We consider that they should work in practice.

Business burdens and regulatory impacts

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

In terms of the impacts that are calculated, we do not have significant comments.

Our much greater concern is the impacts that are not calculated. The impact assessment that was published ignored key aspects such as the immediate contributory burden placed on employers, and potential negative impact on members and the PPF as set out in our responses above.

Another area that should be considered is the macroeconomic impact of a potentially large, forced movement into bonds. This may be particularly significant in terms of transitional arrangements.

Please see our comments in the Executive Summary on this topic – including in relation to the lack of detail on how the regulations will interact with the Code.

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

This depends on what is meant by “significantly”. It will likely have a material impact, and in many cases (eg small schemes) could be disproportionate.

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

As per our response to Q23.

Yours faithfully

Jon Forsyth & Chris Ramsey
DB Committee, SPP

Fred Emden
Chief Executive, SPP

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