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DWP Finalises New Funding Regulations

In 2022, the DWP consulted on its draft Occupational Pension Scheme (Funding and Investment Strategy and Amendment) Regulations. Together with the new Code of Practice on Scheme Funding to be issued by the Pensions Regulator (TPR), these will provide a new funding regime for Defined Benefit (DB) pension schemes. DWP has now published a response describing the outcome of its consultation, together with a revised version of the Regulations, and these are being laid before Parliament.

Summary

- The new funding regime will apply for actuarial valuations with effective dates on or after 22 September 2024.
- There is greater clarity over when the "relevant date" for targeting funding on a low dependency funding basis will fall, albeit that the final details will be set out in TPR's new Funding Code.
- Changes have been made to the Regulations to clarify that they are not intended to unduly restrict schemes' actual investment strategies, and indeed the DWP response states that "even mature schemes can invest in a wide range of assets".

Recap

The central intention of the new Funding Code is to lead schemes to be well funded and cautiously invested by the time they are mature. The rationale is that mature schemes pay out a high proportion of their assets each year as benefit payments, and if they are poorly funded at this stage it is difficult (and risky) to have assets needing to grow against this tide of cash outflows. In the Regulations they use the following related terms: "relevant date" – the (scheme specific) date at which a scheme is deemed to be "significantly mature". Whilst "significantly mature" is yet to be fully defined it will be based on the "duration" of the liabilities. Duration is the weighted average (in years) of the benefit payments due, where the weightings are the present values of the benefit payments, and is sensitive to the discount rate used (typically the "gilt yield"). The term "low dependency" investment allocation describes where the assets shouldn't be expected to diverge from the liabilities to such an extent that further contributions are required by the employer. In other words, there should be low (but not zero) dependence on the employer for future financial support.

What's changed on Scheme Funding?

The "relevant date" is still required to be no later than the date on which a scheme reaches "significant maturity". The Regulations confirm that maturity will be measured as the duration of a scheme's liabilities. A scheme's duration increases or decreases as bond yields fall or rise; for many schemes, their duration

fell by 3 or 4 years over the course of 2022 as gilt yields rose. Left as it was in the previous draft, the "relevant date" would have changed as yields changed, making it very difficult for trustees and employers to target their funding and investment strategies appropriately. This has now been changed; the Regulations now state that the calculation of duration must be based on economic conditions on 31 March 2023, significantly reducing the variability in determining the "relevant date".

The Regulations confirm that a scheme will reach "significant maturity" when it reaches the duration specified by TPR in its new Funding Code. Originally this was intended to be 12 years, but the DWP response confirms that TPR is reassessing and revising this point in the light of the changes in financial conditions over the last 18 months and updated analysis. The revised point will only be known once TPR issues its updated new Funding Code.

There is now explicit confirmation that when determining their "relevant date", schemes which are open to future accrual can make appropriate allowance for the impact this will have on their projected duration; such schemes can be expected to mature much more slowly, so taking this into account is intended to avoid forcing them to de-risk investments unnecessarily.

What's changed on Investment Strategy?

Changes have been made to the Regulations to address perceived inconsistencies between them and TPR's draft new Funding Code. A particular concern was the requirement in the draft Regulations that in a low dependency investment allocation, assets should be invested such that the cashflows from the investments broadly match the payment of benefits from the scheme. This requirement has been removed, and the DWP states that this is so that "schemes are clear that they can invest a reasonable amount in a wide range of assets beyond government and corporate bonds after significant maturity". The Regulations still refer to the assets (relative to the liabilities) needing to be "highly resilient" to short-term adverse changes in market conditions.

Further changes have been made to ensure that the Regulations do not affect trustees' independence to set their investment strategy, after consultation with the employer. It is confirmed that there is not a regulatory requirement to adopt a low dependency investment allocation once a scheme is significantly mature. So the assumption of a low dependency investment allocation is required for funding purposes, but is not a mandatory investment strategy once a scheme is significantly mature.

On how surplus assets are invested, the Regulations have been watered down, to make it clear that they do not apply to any surplus - in other words Trustees retain freedom to invest any surplus as they see fit.

On liquidity, the Regulations have been simplified so that there is no longer a need to include potentially complicated analysis of liquidity needs through time. The Regulations now just require that the investments have "sufficient liquidity to enable a scheme to meet expected cash flow requirements and make a reasonable allowance for unexpected cash flow requirements".

Comment

The changes made to the Regulations are sensible and pragmatic. There were significant concerns that Trustees would be heavily restricted on investment strategy and that it may lead to ever greater 'herding'

towards similar assets. It is encouraging that these concerns have been addressed. Of course, since the 2022 consultation, the Chancellor, in his Mansion House speech, set out proposals to encourage pension schemes to invest in productive finance, and many of the changes to the Regulations are clearly designed not to force schemes to de-risk their investment strategies unnecessarily.

Because schemes are required to target being fully funded on a low dependency funding basis by the time they are significantly mature, as they continue on a prudent funding basis, in most scenarios the assets should outperform the liabilities, generating a surplus. This raises the prospect of trapped surplus, but rather than address that directly, the DWP response rather glibly just refers to the Government's Call for Evidence last year on how investing surpluses can be encouraged and how they can be best utilised.

We now await TPR's updated version of its new Funding Code, including the changes being made to reflect the impact of changes in market conditions, in order to have a complete picture of the new funding regime.

If you would like to discuss any of these matters further, please get in touch with your usual contact at Cartwright.

250 Fowler Avenue
Farnborough Business Park
Farnborough GU14 7JP

Marlborough House
Victoria Road South
Chelmsford CM1 1LN

T: 01252 894883
E: enquiries@cartwright.co.uk
W: pensiontrusts.cartwright.co.uk

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Registered Office: 250 Fowler Avenue, Farnborough Business Park, Farnborough, Hampshire GU14 7JP
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