MACFARLANES

RESPONSE TO THE PUBLIC CONSULTATION BY THE DEPARTMENT FOR WORK & PENSIONS ON THE DRAFT OCCUPATIONAL PENSION SCHEMES (FUNDING AND INVESTMENT STRATEGY AND AMENDMENT) REGULATIONS 2023

October 2022

Dear Sirs,

We are responding to the public consultation on the draft Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2023 (the "**Draft Regulations**") commenced in July 2022.

Macfarlanes LLP advises trustees of occupational pension schemes, employers sponsoring such schemes, and their shareholders, lenders and other counterparties.

We advise both in relation to larger schemes (assets in excess of £2bn) and smaller schemes (assets below £100m).

While many groups with defined benefit pension schemes are focused on winding up any defined benefit pension schemes and transferring the pension liabilities to the insurance sector as soon as possible, others are aiming to continue operating and supporting their schemes as originally intended, so as to provide good benefits at a cost that is lower than the cost of annuity policies, using a prudent but more diverse investment strategies.

Our key concerns with the Draft Regulations is that:

- They override the discretionary powers of trustees and the statutory and contractual rights of employers and guarantors from a point in time based solely on duration of liabilities, disregarding all other risks and risk mitigations;
- They give trustees the power to unilaterally adopt an ultra-prudent low risk valuation and investment basis at any time without the consent of the employer by unilaterally bringing forward the "relevant date". This is a material change depriving employers of the ability to manage their own liabilities and cashflows and at odds with the employer consent provisions in relation to the funding and investment strategy provided in the Act;
- They compel all schemes to disinvest from return seeking assets and adopt a cash flow matching and asset liability matching strategy on a broadly similar timeframe (as defined benefit schemes may have similar duration of liabilities) which may have negative market impacts both for the schemes competing for limited assets (and the businesses of their employers and guarantors that have to fund the inflated cost) and for the wider economy that might otherwise access investment from such schemes;
- Whereas the Act (and sections 221A and 221B inserted in the Pensions Act 2004 in particular) avoided mandating the funding and investment strategy, requiring the trustees to take ownership of their strategy and account for their decisions, the Draft Regulations restrict the risks and the risk mitigants they can consider;

- They may exceed the powers provided in the Act, notably by appearing to impose a mandatory funding basis and asset strategy and a requirement to be fully funded on a prescribed basis (the “minimum requirement”) where the Act only provides for the Secretary of State to set “principles” for trustees to follow;
- The low risk funding and investment strategies, while expensive, are built on expected cashflows, as actual cashflows are unknown, and therefore will not meet their own core objective of ensuring that further contributions from the employer will not be needed.

Yours faithfully,

Camilla Barry

Macfarlanes LLP

Responses to specific 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 think it would be better for the trustees to determine and revise the “relevant date” having regard to the duration of liabilities and other circumstances of the scheme, including the strength of the employer covenant and any contingent assets, on a scheme specific basis and having regard to guidance in a Code of Practice.

Policy comments

We note:

- The Act provides that the trustees have to set a funding and investment strategy by reference to the “relevant date” which is to be determined in accordance with regulations and, from that relevant date, the trustees must invest the assets on a low dependency investment allocation and use a low dependency funding basis and align their technical provisions to this.
- The Draft Regulations provide that:
    - the “relevant date” is a date chosen unilaterally by the trustees that is no later than the date of “significant maturity”;
    - the date of “significant maturity” is the date the scheme reaches a duration of liabilities in years specified by the Regulator in a Code (and the consultation suggests this might be 12 years);
    - the date when the scheme reaches “significant maturity”, as the prescribed or Code-based duration of liabilities, is determined by the scheme actuary at an actuarial valuation as the weighted mean duration of the liabilities on a low dependency funding basis.

The question is therefore whether the Secretary of State or the Regulator should determine, in terms of duration of liabilities, the latest date for all schemes to switch to low dependency funding and full cashflow matching and asset liability matching and require employers to fund the resulting shortfalls.

We do not think a “one-size-fits-all” rule based on one factor only, the duration of liabilities, mandating schemes to switch to a prescribed low dependency funding basis is either necessary, prudent or appropriate. We do not think this is something that either the Regulator or the Secretary of State should prescribe.

This is a material statutory intervention with the contractual arrangements of private sector schemes which needs strong justification, recognising not only the benefit to scheme members and the Pension Protection Fund but also the impact on employers and their other stakeholders, including employees.

This will impose material contribution obligations on employers and lock-in to low returns.

The weighted mean duration of liabilities itself will be volatile, being notably impacted by interest rates, inflation expectations and other market factors. So one volatile factor will be driving asset allocations and deficit contributions in disregard of other factors and circumstances and will be herding defined benefit schemes to buy into similar assets at the same time.

There are many other ways to provide for determination of the "relevant date" by the trustees that would meet the requirements of the Act and would also take account of a wider range of relevant matters and might avoid the unnecessary market concentration risks likely to result from these provisions.

This approach appears contrary to the stated legislative intention to avoid a "*one-size-fits-all*" and to keep "*the strengths of a flexible scheme specific approach and risks increasing market concentration risks unnecessarily and forcing schemes to undertake inappropriate de-risking of their investment approaches*". It may have adverse economic consequences.

Legality comments

We further note that the Regulator is a statutory body empowered to issue codes pursuant to and in accordance with sections 90 to 91 of the Pensions Act 2004. Specifically, the Regulator can only issue codes *"(a) containing practical guidance in relation to the exercise of functions under relevant pensions legislation, and (b) regarding the standards of conduct and practice expected from those who exercise such functions".* This would not seem to encompass fixing the long-stop date for the trustee's determination of the relevant date for targeting full funding on a low dependency basis. The Pension Schemes Act 2021 does not appear to have extended the Regulator's code issuing powers.

As such, in a Code, the Regulator could only issue guidance and standards of conduct if the regulations provided for the trustees or some other person to determine the threshold for "significant maturity" for their scheme on a scheme specific basis. The Regulator could then give them guidance on how to make that determination under a Code duly issued under the Pensions Act 2004. The regulations could require the trustees to use a weighted mean duration of liabilities basis as provided in the Draft Regulations and also to take certain other factors into account.

(Incidentally, the definition of "Code" in the Draft Regulations ought to refer to sections 90 to 91 of the Pensions Act 2004 or any other provisions (if any) empowering the Regulator to issue a 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 per our response to question 1, we do not think that the point of "*significant maturity*" should be defined in regulations as a "*one-size-fits-all*" based solely on duration of liabilities and disregarding scheme circumstances. This appears to be contrary to the stated intent of the legislation.

We cannot comment on whether 12 years' duration of liabilities is the ideal latest point at which to de-risk but it seems highly unlikely that it could be right in all cases and all circumstances.

Key reasons are:

- The duration of liabilities is itself volatile;
- The approach disregards the scope for liability changes and other tail risks and other mitigants to tail risks;
- It appears inconsistent with the stated intention of the legislation.

We note that:

- the weighted mean duration of liabilities as defined using low dependency funding assumptions for calculating the liabilities will be sensitive to market movements, particularly in respect of interest rates and inflation expectations; so a scheme that is at 14 years' duration of liabilities on one date may move to being at 11 years' duration of liabilities at another date following a change in interest rates (and vice versa);
- tail risks for mature schemes are not limited to investment spirals and there may therefore be other more appropriate and cost effective risk mitigants.

Contingent assets (escrows, guarantees, secured contingent contributions, tailored insurance products, etc.) may be better tools for covering tail risks, including mortality as well as investment risks. Such options may avoid over-funding and trapped surpluses[1] (unnecessary transfers from the real economy to low risk investments) and allowing a diversity of approaches may avoid the market concentration risks that could arise from a policy requiring all defined benefit schemes to move in step to the same cashflow matching and asset liability matching assets (since defined benefit schemes relate mainly to one generation and closed to accrual in the 2000's, they can be expected to have similar duration of liabilities).

For example: a scheme with a material and robust contingent asset of independent value covering say, 110% of the sum of section 75 deficit of the scheme and the estimated value at risk on the basis of the scheme's chosen funding and investment basis, could reasonably maintain an investment and funding strategy designed to achieve full funding on a buy-out basis in a reasonable time-scale and with limited employer contributions. Requiring it to abandon such a strategy in the event of it reaching a duration of liabilities of 12 years at a valuation could be *"inappropriate de-risking*" and would lose "*the strengths of a flexible scheme specific approach*" (contrary to the stated intent of the legislation).

It may also be contrary to established principles of case law to the effect that a power to require *"appropriate*" contributions *"would not entitle the trustees to demand a contribution for the purpose of building up a surplus*" (*Pinsent Curtis v Capital Cranfield* [2005] 4 All ER 449).

There will be unforeseen risks in tying investment and funding requirements to a single factor of scheme risk without reference to other risks and risk mitigants.

Setting the point of significant maturity at a duration of liabilities of 12 years does not appear to meet the legislative intent as summarised in the consultation document, including getting *"the right balance between ensuring [defined benefit] pensions are secure for members over the longer term and keeping them affordable for sponsoring employers".*

Proposal:

Our view is that the point of significant maturity ought to be determined and periodically reviewed by the trustees having regard to the circumstances of the scheme and not solely by reference to the duration of the liabilities. This would be more consistent with the stated policy intent of ensuring the defined benefits scheme funding regime remains "*scheme specific*" and applies *"flexibility to the particular circumstances of individual schemes and their sponsoring employers*" and avoiding a *"one-size-fits-all*".

The Regulator or the regulations could provide for a standard measure of significant maturity as part of a fast track approach but permitting a scheme specific and more principles based alternative to be set by the trustees on a bespoke basis.

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?

The definition in draft regulation 5 is confusing and unclear.

We assume "appropriate and effective" are to be considered by reference to current law and the stated policy intent including:

- "*increasing the likelihood that pension schemes can meet their objective of funding the pension benefits promised to their members*";
- achieving *"a state of low dependency"* when schemes are "*significantly mature*" but allowing for schemes to plan to deliver benefits in different ways,
- getting "*the right balance between ensuring [defined benefit] pensions are secure for members over the longer term and keeping them affordable for sponsoring employers*".

Having regard to the above, the definition of "*low dependency investment allocation*" seems surprisingly prescriptive and may not allow trustees and employers to do what is best and most efficient for their scheme in the circumstances. It is a very material restriction of trustee investment discretion and employer funding options.

As such, it may not be appropriate or effective.

We note:

Market concentration risks - It may not be appropriate and effective to mandate by legislation that all schemes adopt the same investment strategy at significant maturity, bearing in mind that many schemes may reach significant maturity at the same time, as this could create market risk concentration and excessive demand for the assets required to comply.

Inappropriate restriction of trustee investment discretion - It may also not be appropriate for the Secretary of State to effectively impose a limited investment strategy when determination of investment strategy is a trustee discretion either under scheme rules or pursuant to currently applicable legislation (under the Pensions Act 1995, trustees have discretion to invest as if they are absolutely entitled to assets subject to limitations in legislation and the scheme's rules). It is not clear that the Act intended to provide for such a severe restriction of the trustee's investment discretion by the Secretary of State. The Act is expressed in terms of trustee determinations taking account of prescribed matters and principles.

Effectiveness of asset-liability matching - High resilience in the asset-liability ratio to short term adverse changes in market conditions may not sufficiently ensure that further employer contributions are not required in the long term.

Effectiveness of cashflow matching to expected payments - We note that cashflow matching should be expressed to be by reference to the *expected* payment of pensions and other benefits under the scheme (as actual payments will not be knowable), noting however that such actual cashflows will *not* match expected cashflows, particularly for smaller schemes, and therefore cashflow matching will not of itself eliminate the need for further employer contributions.

Departure from existing regulation - The matching requirements may also conflict with the requirements the Occupational Pension Schemes (Investment) Regulations 2005. These provisions derive from EU law.

Interaction of provisions - The relationship between the cashflow matching requirement, the asset liability matching requirement and the objective of not expecting further employer contributions is not clear and also may not be appropriate and effective:

- The first two appear to be mandatory conditions.
- It is not clear how any tension between them is to be addressed.
- It is not clear whether the objective adds anything or whether trustees who comply with the cash flow matching and asset liability matching requirements will automatically be deemed to have met the objective.

It might be more appropriate for the objective (of ensuring that further employer contributions are not expected) to be preeminent and for (i) cashflow matching and (ii) asset liability matching so as to achieve short term resilience to market movement, to be non-exclusive means of achieving that objective. This would allow more effective options to be used if available.

For instance, a material contingent asset (e.g. security over a suitable asset or an escrow fund) could me more effective at reducing the likelihood of further contributions being required than cashflow and asset liability matching which are strategies that (i) work best for the largest schemes (where experience may be closer to mean expectations), (ii) may be costly to implement, (iii) do not allow for discretionary benefits and (iv) do not accommodate member choices.

Proposal:

We'd suggest that the legislation should provide for the trustees to invest their assets so as to target an objective of not requiring further employer contributions, using cashflow matching and asset liability matching to achieve high resilience to short term market movements <u>*or such other strategies*</u>

as the trustees consider will achieve that objective, having regard to the circumstances of the scheme, market conditions and any contingent assets and insurance policies they may have.

A statutory low dependency investment allocation could provide a fast track basis provided trustees had the option of using a bespoke or scheme specific basis.

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?

We assume again that "appropriate" and "effective" should be considered by reference to current law and stated policy intent.

The definition in draft regulation 6 is confusing and unclear.

We think the provision means that an actuarial valuation on a low dependency basis is one that uses actuarial assumptions that would result in a low expectation of employer contributions being required to provide for accrued rights to pensions and other benefits, if the scheme were fully funded on the basis of those actuarial assumptions and invested in accordance with a low dependency investment allocation.

We think the provision is otherwise appropriate and effective, provided that trustees are not required to take such approach where it is unnecessary, e.g. because they are satisfied that there is a high expectation that any further employer contributions that might be required will be met (whether because of the relative strength of the employer covenant, the existence of security or some other contingent asset or otherwise).

Proposal:

Trustees should have flexibility not to adopt a low dependency funding basis from the relevant date if they are otherwise satisfied that there is a high expectation that any employer contributions that might be required will be met. Alternatively, they should have flexibility to determine the relevant date as a date that is later than 12 years' duration of liabilities.

The low dependency funding basis could provide a fast track option provided the trustees had the option to choose an alternative under a bespoke or scheme specific funding and investment strategy.

Strength of the employer covenant

Question 4:

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

The concept of "support" is not particularly clear.

A contingent asset may be an asset of the scheme and there should not be double-counting.

Proposal:

We think an assessment of the employer covenant should be an assessment of:

(i) the employer's current and, so far as reasonably foreseeable, future financial ability to:

a) meet its legal obligations to make payments to the scheme from time to time (including in the event of termination of the scheme or an employer insolvency and having regard to the likelihood of such termination or insolvency); and

b) assume further legal obligations to make payments to the scheme in respect of any reasonably expected future increase in the difference between the value of the assets of the scheme and the value of its liabilities; and

(ii) the likelihood of the employer suffering an insolvency event.

Its ability to assume further obligations is relevant to its ability to absorb risks in the funding and investment strategy of the scheme. The exposure to insolvency risk is relevant because the employer’s insolvency is disruptive to any long term funding and investment strategy as it would force an early termination of the scheme and curtail the scheme’s ability to achieve the required investment returns to be able to pay benefits over time.

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

The references to a Code that is not available make it difficult to answer this question.

The provision appears to limit the assessment to (i) employer cashflows, (ii) likelihood of insolvency event and (iii) other factors affecting the performance or development of the employer’s business.

While the last category is wide, there seems to be no reason not to have a non-exhaustive list.

As a linked point, it is unclear what material change in relation to the employer of the scheme (other than a material change in the strength of the employer covenant) would trigger a review of the funding and investment strategy under Draft Regulation 13(3).

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

It is not clear why regulation 7(4) is framed in terms of an exhaustive list rather than a non-exhaustive list. This creates the risk that the provisions do not capture all matters that would be relevant to an assessment of the employer covenant (bearing in mind this is expected to cover every type of business: stand-alone businesses, parent companies, trading subsidiaries, service companies, charities, regulated industries, partnerships etc.).

It is not clear why other factors are limited to those likely to affect the performance or development of the employer’s business rather than all factors likely to affect the employer’s ability to meet its legal obligations to the scheme or assume further legal obligations to fund the scheme if required, which would seem to be the objective of an employer covenant assessment.

Proposal:

Use a non-exhaustive definition including all matters relevant to the “strength of the employer covenant” as defined.

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?

We think the provisions will work in practice in the sense of being capable of operation.

We do not think they will work in practice in the sense of achieving the stated intent of the legislation in getting "*the right balance".*

The drafting is quite convoluted. The effect of the provisions appears to be that:

- the trustees must set and from time to time revise the "relevant date" for the purposes of setting their funding and investment strategy under section 221A of the Pensions Act 2004; and
- the "relevant date" must be no later than the end of the scheme year after the date on which the duration of liabilities is expected to be or became [12 years], according to the actuary's current or latest actuarial valuation (as specified).

We note the duration of liabilities is a variable period (and will be sensitive to market factors as well as membership movements) and therefore it is appropriate that there is scope both for the actuary to reassess at each valuation the date when the duration of liabilities falls or is expected to fall to [12 years]. We note the actuary's assessment sets the latest date the trustees can adopt as the relevant date for their funding and investment strategy (i.e. to switch to a low dependency funding basis and asset allocation).

The actuary determines at each valuation (see reg 9(3) and (5)(b)) when the scheme will reach a duration of liabilities of [12 years]. There is no provision for the actuary to review the duration of liabilities between valuations. We think this is reasonable given the data required to determine the duration of liabilities will only be available at valuations and will work in practice.

We note:

- The trustees can select any date as the "relevant date" so long as it is not later than the end of the scheme year in which the actuary determines that the scheme has or will reach a duration of liabilities of [12 years]. This may be a date in the past. The trustees are not limited in choosing an earlier date.
- The trustees may at any time review and revise that date and must review and revise it when reviewing the funding and investment strategy if necessary or appropriate "taking account of" the provisions of reg 8 (reg 8(1) and (4)).

"*Taking account of*" the contents of reg 8 seems only to require the trustees to ensure the "relevant date" is a date that is not later than the end of the scheme year in which the scheme has or is expected to reach a duration of liabilities of [12 years] (according to the current or latest actuarial valuation). This does not give any indication of other factors the trustees should "take account of" as might have been expected but we do not think that means the provisions cannot "work in practice".

However, the fact that the trustees can bring forward the date for switching to a low dependency funding basis and asset allocation without the consent of the employer is a material risk for

employers that may not "*work in practice"* in the wider sense of *"getting the right balance between ensuring that pension benefits can be paid over the longer term and keeping them affordable for sponsoring employers*". It causes defined benefit schemes to be an even more uncontrolled and hazardous risk for employers and their contractors and investors. It overrides the balance in pensions legislation which otherwise requires employer consent for changes in funding strategy.

Proposal:

We think the balance would be restored and the provisions would be more likely to work better in practice to achieve the stated legislative aims if, consistently with current funding legislation and with the other provisions of the Act in respect of the funding and investment strategy, determination of the "relevant date" required the consent of the employer. This could be added as a section 229(1)(zb) of Pensions Act 2004.

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

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?

No.

The actuarial report would not normally require provision of the updated data that would be required for a reassessment of the duration of the liabilities.

If there are reasons for reviewing the funding and investment strategy out of cycle, those reasons may also warrant an out of cycle actuarial valuation. Reasons for revising the duration of liabilities between cycles are likely to be linked to a material change in the scheme liabilities such as a change in law (e.g. a change to minimum retirement age), a material change in membership such as a pensioner buy-out, a material transfer value exercise or a scheme merger or demerger or market movements affecting the duration of liabilities (e.g. an increase in interest rates).

These matters if likely to be sufficient to warrant an out of cycle change in funding and investment strategy and reassessment of the duration of liabilities are likely to also warrant an out of cycle actuarial 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?

The minimum requirement as provided for in Schedule 1 paragraph 3 of the Draft Regulations is not a principle (the Act provides that regulations may provide requirements for the trustees <u>to follow principles</u> when determining or revising their funding and investment strategy).

To paraphrase: it provides that, in funding and setting their funding and investment strategy, the trustees must follow a principle that the scheme is subject to a requirement to be fully funded on a low dependency basis from the "relevant date".

In effect, the minimum requirement is not a principle but a requirement to be fully funded on a particular basis. More accurately, the provision either:

- Purports to impose a requirement to be fully funded on the prescribed low dependency basis which has not been provided for in the Act; or
- Requires the trustees to follow a principle based on a fictitious requirement to be fully funded on the prescribed low dependency basis.

As drafted, the Draft Regulations could be interpreted as purporting to deprive the trustees of the powers to set their funding and investment strategy as granted to them by the Act (and to deprive the employer of its right to agree or not). It may arguably exceed the powers granted to the Secretary of State by the Act.

It is also not clear whether the provision will be breached if the scheme is not fully funded on the prescribed basis after the relevant date, exposing the trustees to fines under section 10 of the Pensions Act 1995. This would seem unreasonable and we assume a court would seek an alternative interpretation.

We do not think this is "sensible" because it does not appear consistent with the stated legislative intent or the provisions of the Act.

Even if valid, combined with other provisions such as the trustees' unilateral power to set an early relevant date, it is a material transfer of power and increase in financial risk for employers, limiting their ability to manage their pension liabilities alongside other commitments and business risks. It is likely to have unnecessary adverse economic consequences for employers with defined benefit schemes.

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?

Yes.

"Significant maturity" as defined - in years of weighted mean duration of liabilities - is not the only measure of risk for a mature scheme. Contingent assets can cover the tail risks of mature schemes and may be a more appropriate means of covering such risks than a low dependency funding basis and low dependency asset allocation (see example in response to question 1).

We see no reason why contingent assets should be provided by another company or entity other than the employer. The point is whether the contingent assets or employer covenant are sufficient.

We see no reason for a percentage cap. 5 per cent would be meaningless for a small scheme (or a scheme that is materially bought out). The variability in tail risks is likely to be far more than 5% of the assumed value of the liabilities.

The Act anticipates a principles-based approach, not arbitrary limits and conditions.

The issue is whether the contingent asset adequately covers the value at risk over a prudent estimate of the expected duration of the liabilities bearing in mind that smaller populations may deviate more from the mean.

The trustees should have a strategy for ensuring the pensions and other benefits under the scheme can be provided over the long term and the regulations should set principles which they are required to follow.

Principles could include requiring the trustees to:

- consider whether the employer covenant, together with contingent assets, are likely to adequately cover the value at risk over the expected duration of the liabilities;
- in doing so, to:
    - use a low dependency funding basis to determine the value of the liabilities;
    - use the trustees' actual funding and investment strategy;
    - consider whether the factors that might affect any contingent assets correlate with the asset liability risks of the scheme;
    - take account of potential for changes in inflation and mortality expectations (including from member options and market factors).

(These are just examples of principles that it might be sensible and appropriate to prescribe.)

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

The additional risks depend on the additional risks taken and the contingent assets used as mitigants but would be expected to include:

- the contingent assets not being a good hedge for the scheme risks or not providing sufficient cover for the remaining volatility in the asset-liability matching or the variability in cashflows or not being available or sufficient to cover the liabilities when they arise;
- the additional risks deviating from expectations more than expected and the deviation exceeding the headroom in the value of the contingent assets.

Safeguards should be provided for in the principles and the principles should require safeguards to be appropriate to the risks.

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?

Yes. However, this begs the question as to what it means for an open scheme to be *"appropriately supported*". If the "support" requires employers to commit funding or security that might otherwise be used to support their businesses, then defined benefit accrual may have to cease.

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?

Not if the implication is to disregard other security available to the scheme, e.g. pursuant to contingent assets.

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?

Yes.

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?

No.

The principle in paragraph 3 of Schedule 1 (*Minimum requirement*) is not a principle and does not allow scheme specific funding to apply flexibly to different schemes and employers. See our response to question 8.

Instead:

- it allows trustees to impose a low dependency funding basis and low dependency investment allocation unilaterally at any time irrespective of the maturity of the scheme and the strength of the covenant contrary to the principles of scheme specific funding by setting an early “relevant date”; and
- it requires them to adopt the low dependency funding basis and low dependency investment allocation from the date of “significant maturity” irrespective of whether this is needed to meet the aims of the funding and investment strategy, i.e. to “*ensure the pensions and other benefits can be paid over the long term*”.

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?

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?

The categories can be high level but should not be limited.

More importantly, it is the withdrawal of their discretion over asset allocation from the "relevant date" by the imposition of a narrow and prescriptive low dependency investment allocation that causes concern. This may prevent the trustees exercising their discretion in the best interests of members by restricting their investment discretion forcing them to buy assets that are already oversold. (See comments in response to questions 1 and 2.)

Trustees must retain the right to revise their investment strategy at any time, for proper purposes and subject to proper advice and following consultation with the employer, and should not be bound by their own funding and investment strategy or by legislation imposing a low dependency investment allocation.

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?

Yes.

Statement of strategy

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

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?

Yes.

Actuarial valuations and reports

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

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?

Yes.

These are the correct matters for trustees to consider in setting appropriate recovery plans on the basis that the purpose is to ensure the pensions and other benefits can be paid as they fall due. We see no reason for change.

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.

It disregards the interests of other stakeholders of the employer including current employees and other counterparties (and charitable objects in the case of charities) and disregards the importance of enabling employers to invest in their business for the long term or pursue their other purposes.

The overriding principle should be ensuring the pensions and other benefits can be paid as they fall due, not to accelerate funding unnecessarily.

Draft regulation 20(8) fails to maintain the balance between ensuring defined benefit pensions are *"secure for the members over the long term and keeping them affordable for sponsoring employers*" because it prioritises funding on a low dependency basis irrespective of whether this is necessary in all the circumstances. It should not have primacy over other considerations.

Multi-employer schemes

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

Business burdens and regulatory impacts

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

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

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

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