EXPLANATORY MEMORANDUM TO

THE OCCUPATIONAL PENSION SCHEMES (FUNDING AND INVESTMENT STRATEGY AND AMENDMENT) REGULATIONS 2024

2024 No. 462

1. Introduction

1.1 This explanatory memorandum has been prepared by the Department for Work and Pensions and is laid before Parliament by Command of His Majesty.

1.2 This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Purpose of the instrument

2.1 This instrument introduces new measures to the occupational pensions defined benefit (DB) scheme funding regime that will support trustees and sponsoring employers to plan and manage their DB scheme funding over the long-term. Most DB pension schemes are well managed but good practice is not universal. The changes we are making will support scheme trustees and employers to manage risks effectively with the aim of protecting the security of benefits for members. The Regulations will enable the Pensions Regulator to intervene more effectively to protect members' benefits when needed.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 The draft Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2024 were laid on 29th January 2024 and were withdrawn and re-laid on 26th February 2024. The changes made when the Regulations were re-laid are both in Regulation 20 and are amendments to the Occupational Pension Schemes (Scheme Funding) Regulations 2005 (S.I. 2005/3377).[1]

3.2 Regulation 20(3)(d) of the 2024 Regulations is expanded to insert a new paragraph (10) in regulation 7 (actuarial valuations and reports) of the 2005 Regulations. This clarifies that the Part 4 amendments to the 2005 Regulations that relate to actuarial valuations and reports only take effect where the effective date of the actuarial valuation is on or after 22nd September 2024.

3.3 Regulation 20(4)(c) of the 2024 Regulations is replaced by a provision that inserts new paragraphs (7A) and (7B) into regulation 8 (recovery plan) of the 2005 Regulations. This is so that the amendments in Part 4 of the Regulations which relate to the recovery plan only take effect where the effective date of the valuation to which the recovery plan relates is on or after 22nd September 2024.

3.4 The reason for these changes is to give sponsoring employers, scheme trustees and managers the same amount of time to prepare for the new requirements in the recovery plan as they are being given to implement the Funding and Investment Strategy.

[1] https://www.legislation.gov.uk/uksi/2005/3377/contents

4. Extent and Territorial Application

4.1 The extent of this instrument (that is, the jurisdiction(s) which the instrument forms part of the law of) is England and Wales and Scotland.

4.2 The territorial application of this instrument (that is, where the instrument produces a practical effect) is England and Wales and Scotland.

5. European Convention on Human Rights

5.1 The Parliamentary Under Secretary of State for Pensions, Paul Maynard MP, has made the following statement regarding Human Rights:

"In my view the provisions of the Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2024 are compatible with the Convention rights."

6. Legislative Context

6.1 The legislative requirements for funding occupational pension schemes, are provided by Part 3 of the Pensions Act 2004[2] and the Occupational Pension Schemes (Scheme Funding) Regulations 2005 (S.I. 2005/3377).[3] This legislation excludes money purchase schemes, known as defined contribution pension schemes, along with collective money purchase schemes. It therefore applies only to defined benefit pension schemes, although these are not defined in law. This legislation also excludes most public sector schemes which are mostly unfunded.

6.2 Section 123 of the Pension Schemes Act 2021[4] introduces Schedule 10 which provides: at Part 1, amendments to the scheme funding requirements in Part 3 of the Pensions Act 2004; and at Part 2, minor and consequential amendments.

6.3 These amendments added the following provisions to Part 3 of the Pensions Act 2004:

- Section 221A requires trustees or managers of defined benefit (DB) pension schemes to have a funding and investment strategy for ensuring that pensions and other scheme benefits can be provided over the long term.
- Section 221B requires trustees or managers to prepare a statement of strategy that sets out: 1) their funding and investment strategy; and 2) supplementary matters. The statement of strategy must be signed by the chair of the trustee board and where the trustee board does not have a chair, it must appoint one.
- Sub-section 222(2A) requires the schemes liabilities, known as 'technical provisions', to be calculated in a way that is consistent with the scheme's funding and investment strategy.
- Sub-section 224(7A) requires trustees or managers to send a copy of their actuarial valuation to The Pensions Regulator, together with such other information as may be prescribed.
- Sub-section 226(3A) provides a regulation making power to prescribe the matters that should be considered or the principles to be followed in determining whether a recovery plan is appropriate having regard to the nature and circumstances of the scheme.

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[2] https://www.legislation.gov.uk/ukpga/2004/35/contents
[3] https://www.legislation.gov.uk/uksi/2005/3377/contents
[4] https://www.legislation.gov.uk/ukpga/2021/1/contents

- Amendments to section 229 add the funding and investment strategy to the matters requiring the agreement of the employer.
- Amendments to section 231 extend The Pensions Regulator's powers to include the new funding and investment strategy.

6.4 This instrument provides further requirements for the new funding and investment strategy and statement of strategy, along with amendments to the Occupational Pension Schemes (Scheme Funding) Regulations 2005 (S.I. 2005/3377).

7. Policy background

What is being done and why?

7.1 When the original 2005 scheme funding regime was implemented, more DB schemes were open. The legislation was framed in terms of schemes operating in a steady state - there were no requirements to consider the effects of increasing maturity, nor to plan for end game strategies. The regime was extremely scheme specific and flexible - this was one of its strengths, but also one of its weaknesses. While most schemes were operating effectively, some were not, and The Pensions Regulator found it difficult to impose standards to protect members and the Pension Protection Fund, as the requirements lacked sufficient clarity for enforcement, ultimately in the courts. This was brought into sharp focus by several high-profile insolvencies of companies with underfunded Defined Benefit (DB) pension schemes which caused widespread concern and threatened to undermine confidence in the funding regime. While the Government's 2018 White Paper, Protecting Defined Benefit Pension Schemes,[5] concluded there were no systemic problems with the funding regime, it did recommend that the system could be improved for members, trustees and employers by introducing greater clarity on scheme funding principles. Rather than eliminate risk from the system, the changes aim to support trustees in planning for the long-term and managing risk effectively – balancing the protection of member benefits with the sustainability of the employer. Greater clarity of what is required of them aims to provide trustees with the tools to make more informed decisions and allows The Pensions Regulator to take more effective and efficient action in the minority of cases where flexibilities are misused.

Explanations

<u>*What did any law do before the changes to be made by this instrument?*</u>

7.2 DB pension schemes provide a predetermined level of pension benefits which are usually based on the scheme member's final or career average salary and length of employment. Employers are required to fund the pension benefits promised by their DB schemes, above any amount provided through employee contributions.

7.3 The 'statutory funding objective' requires DB schemes to have sufficient and appropriate assets to cover their accrued liabilities which are known as technical provisions. The scheme actuary estimates the value of the liabilities using assumptions determined by the trustees and agreed with the employer where appropriate. Those assumptions must be chosen prudently to allow for a margin for adverse deviation.

7.4 At least every three years, a valuation must be completed and where there is a funding deficit, an appropriate recovery plan must be put in place. The purpose of a valuation

[5] https://www.gov.uk/government/publications/protecting-defined-benefit-pension-schemes

is to assess whether a scheme has sufficient assets to meets its technical provisions. Scheme trustees or managers must prepare a schedule of contributions setting out the rates and due dates of contributions the employer must pay to the scheme, again with the agreement of the employer.

7.5 Trustees must also prepare a statement of funding principles setting out their policy for meeting the statutory funding objective which must include the actuarial assumptions used to estimate the scheme's liabilities and the details in any recovery plan. The employer must be consulted on the statement of funding principles.

7.6 The Pensions Regulator has a number of powers to intervene where trustees or managers fail to comply with their legal obligations in relation to scheme funding, for example if the trustees and employer cannot reach agreement. The Pension Regulator's powers include imposing a schedule of contributions, or giving directions as to how the technical provisions are to be calculated, or what the recovery plan should be.

Why is it being changed?

7.7 Most DB schemes are closed and are therefore maturing with declining numbers of active members and declining contributions along with increasing numbers of pensioner members to whom pension benefits must be paid. Generally, fully funded maturing schemes need to sell assets to pay pension benefits and it is important that they are properly funded to ensure that pension benefits can be paid.

7.8 Increased interest rates in recent years have helped many schemes to improve their funding positions and most now have a funding surplus. However, this could change, and it is important that appropriate funding levels are maintained. Severely underfunded schemes are a risk to scheme members, the Pension Protection Fund and its levy payers.

What will it now do?

Funding and investment strategy

7.9 Trustees or managers of Defined Benefit (DB) schemes will be required to regularly prepare a funding and investment strategy (alongside each actuarial valuation) with the aim of ensuring that pensions and other scheme benefits can be provided over the long term. The strategy must specify the funding level, defined as the ratio of assets to liabilities, and the investments that trustees or managers intend the scheme to have at a 'relevant date'. The funding and investment strategy must set out a 'journey plan' to that funding level.

7.10 The funding and investment strategy must set out 'the way scheme benefits will be provided over the longer term'. The 2018 White Paper called this 'the long-term objective' which could be to either: (i) run-on with low dependency on the employer; (ii) buy out with an insurer; or (iii) enter a consolidator, such as a superfund.

7.11 At and after the relevant date, as a minimum, schemes must be fully funded on a low dependency funding basis. Low dependency on the employer means that no further contributions are expected, under reasonably foreseeable circumstances, to meet the scheme's liabilities. The funding level at the relevant date and on the journey plan to that date must be calculated on a low dependency funding basis.

7.12 The investment information set out in the funding and investment strategy will be the proportion of scheme assets that the trustees or managers intend to allocate to

different categories of investments on the relevant date, but actual investment allocation may diverge from this. However, if the trustees or managers do not think that the Funding and Investment Strategy is being successfully implemented, they will need to explain how they intend to remedy the position, as set out in paragraph 7.16 below.

7.13 Before the relevant date, funding risks taken by a scheme must be supportable by the employer. This is because the employer must address any funding shortfall where such risks materialise. Subject to the employer covenant, less mature schemes can take higher levels of risk because if those risks materialise there is more time to address any funding shortfall this causes.

7.14 The first funding and investment strategy must be determined alongside the first actuarial valuation with an effective date on or after 22 September 2024. Subsequently, it must be reviewed and, if necessary revised, alongside each actuarial valuation and in the same timescales; and following any material change in the circumstances of the scheme or employer.

7.15 At each valuation, the scheme actuary will estimate when the scheme is expected to reach significant maturity and where the scheme is open to new members and future accrual of benefits the date of significant maturity will move further into the future. Schemes which have sufficient new members, will not move closer to significant maturity and a very few may become less mature.

Statement of strategy

7.16 Trustees or managers will be required to send a written statement of strategy to The Pensions Regulator (TPR) setting out their funding and investment strategy and the following supplementary matters.

a) the extent to which, in the opinion of the trustees or managers, the funding and investment strategy is being successfully implemented and, where it is not, the steps they propose to take to remedy the position (including details as to timing);
b) the main risks faced by the scheme in implementing the funding and investment strategy and how the trustees or managers intend to mitigate or manage them;
c) reflections of the trustees or managers on any significant decisions taken by them in the past that are relevant to the funding and investment strategy (including any lessons learned that have affected other decisions or may do so in the future);
d) other matters prescribed by this instrument include: a summary of the actuarial valuation and where appropriate the recovery plan along with information about scheme maturity, investment risk, liquidity and the strength of the employer covenant i.e., the financial ability of the employer to support its legal obligations towards the scheme, together with any support from contingent assets.

7.17 The Pensions Regulator (TPR) has discretion as to the level of detail required for the information at paragraph 7.16(d) above. This is to ensure that explanations and supporting evidence are only provided where needed which will avoid unnecessary administrative burden.

Amendments to the Occupational Pension Schemes (Scheme Funding) Regulations 2005

7.18 Part 4 of this instrument provides for various related amendments to the Occupational Pension Schemes (Scheme Funding) Regulations 2005 including:

1) Amending regulation 7 (actuarial valuations and reports) to require actuarial valuations to include the actuary's estimate of:
    a) the maturity of the scheme as at the effective date of the valuation
    b) the maturity of the scheme as at the relevant date
    c) the date on which the scheme is expected to (or, if applicable, did) reach significant maturity; and
    d) the funding level of the scheme as at the effective date of the valuation, calculated in accordance with the requirements of regulation 9(2) of these Regulations.
2) Amending Regulation 8 (recovery plans) –
    - trustees or managers, in determining whether a recovery plan is appropriate must follow the principle that funding deficits must be recovered as soon as the employer can reasonably afford.
    - trustees or managers to take account of the "impact of the recovery plan on the sustainable growth of the employer."
3) The amendments to regulation 7 take effect where the effective date of the actuarial valuation is on or after 22nd September 2024 and the amendments to regulation 8 take effect where the effective date of the actuarial valuation to which the recovery plan relates is on or after 22nd September 2024.

8. European Union Withdrawal and Future Relationship

8.1 This instrument does not relate to withdrawal from the European Union / trigger the statement requirements under the European Union (Withdrawal) Act.

9. Consolidation

9.1 This instrument provides amendments to Regulation 7 and Regulation 8 of the Occupational Pension Schemes (Scheme Funding) Regulations 2024. It also makes amendments to regulation 2 and Schedule 2. No Keeling Schedule has been prepared.

10. Consultation outcome

10.1 A consultation on the draft Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2023 ran from 26 July 2022 to 17 October 2022. We received 92 responses which included representatives of occupational pension schemes, employers, legal and consultancy firms, trade unions and individuals. DWP met with a wide range of stakeholders to discuss the policy and draft Regulations and to better understand the concerns raised.

10.2 The Government's response to the consultation can be found here: DWP launches consultation on DB funding rules - GOV.UK (www.gov.uk)

10.3 Many stakeholders were supportive of the overarching objectives of the draft Regulations but there were also common areas of concern:

Flexibility and stability in long-term planning

10.4 Respondents thought the draft Regulations should provide a stable framework for long-term planning, but greater scope for schemes and sponsoring employers to fund and invest flexibly within that framework. They considered that the measure of scheme maturity created too much uncertainty as its sensitivity to market conditions

would mean schemes' long-term plans could be disrupted by changes in economic conditions.

10.5 They suggested that the definition of low dependency investment allocation and how this interacts with investment decisions would limit the types of assets schemes can invest in and would not apply flexibly to the specific circumstances of each individual scheme.

10.6 There were concerns that if employer contributions were to increase, because of the new affordability principle in the amendments to the Occupational Pension Schemes (Scheme Funding) Regulations 2005, some schemes might become overfunded and that trapped surpluses could arise as a result.

Risk aversion

10.7 Respondents thought the draft Regulations would introduce a new scheme funding regime that would be too risk averse, which could increase the cost of providing DB pensions to the detriment of sponsoring employers' businesses. They considered that schemes should be able to take some additional risk at and after significant maturity.

10.8 There were suggestions that the new affordability principle would eliminate any risk-taking in the recovery of scheme deficits. Respondents contended that it would require employers to release too much of their available capital into their pension schemes too quickly and would not allow for appropriate other uses of the employer's cash alongside contributions to the scheme and may limit their ability to allow for investment returns to contribute towards deficit recovery. This would then have an adverse impact on investment in the sustainable growth of employers' businesses.

Open schemes

10.9 Respondents were concerned that the draft Regulations did not fully reflect the circumstances of open schemes. They suggested the draft Regulations would prevent trustees of open schemes from taking account of new entrants and future accrual when managing their scheme funding, which could lead to these schemes planning to de-risk sooner than necessary and increased technical provisions.

Administrative burden

10.10 There were concerns that the new regime would result in a disproportionate governance burden for small schemes, due to the amount of information trustees would have to provide to TPR within the draft statement of strategy.

Alternative scheme designs

10.11 Some respondents were concerned that the Regulations would only work for 'traditional' DB schemes and not for cash balance schemes that sit alongside Collective Defined Contribution Schemes.

Revisions to the Regulations following the consultation deliver the following outcomes:

10.12 We have made clearer the flexibilities that were intended within the draft Regulations. For example, the Regulations do not constrain actual investments and even mature schemes can invest in a wide range of assets.

10.13 We have provided assurance that the impact on the sustainable growth of the employer is a matter to consider when determining an appropriate recovery plan.

10.14 We have made it explicit that open schemes can take account of new entrants and future accrual when determining when the scheme will reach significant maturity.

10.15 We have provided a partial exemption for schemes that have cash balance sections which operate alongside Collective Defined Contribution (CDC) pension sections from the requirement to adopt the 'relevant date' within the Regulations because we wish to facilitate the creation and implementation of CDC schemes and these schemes provide only part of the total benefits.

10.16 To make planning and implementation easier and to avoid unnecessary administrative burden, we have given The Pensions Regulator the flexibility to ask for less detailed information in some cases, depending on the circumstances of the scheme.

11. Guidance

11.1 The Pensions Regulator has consulted on a draft revised defined benefit (DB) funding code of practice[6] and regulatory approach and will shortly consult further on the statement of strategy and what information will need to be included within it. After this instrument is made, The Pension Regulator's DB Funding Code will be finalised and laid before Parliament. It is expected to come into force from 22 September 2024.

12. Impact

12.1 The impact on business, charities or voluntary bodies is that all those with DB pension schemes will be impacted, as all schemes and trustees will need to familiarise themselves with and implement the regulations.

12.2 Initial implementation costs, including familiarisation, will total around £36.8 million in the first year. Schemes would then face ongoing costs of £5.4 million per annum, excluding costs associated with changes in deficit repair contribution (DRC) payments. Implementation and ongoing costs to scheme sponsors will vary significantly between schemes, as those who do not already have a long-term objective for securing member benefits, or one that is only aspirational, will be more greatly affected in their implementation of the new requirements.

12.3 Although dependent on scheme behaviour, some scheme sponsors may need to increase, or decrease, their deficit repair contribution (DRC) payments as a result of assumptions used for the calculation of technical provisions and asset allocations. The impact assessment estimated 1,200 schemes are expected to pay more DRCs, with their payments increasing by around £7.1 billion over the 10-year period. However, there will also be a greater number of schemes who after moving their assumptions in line with the regulations may see their deficits decrease and could lower their DRCs. We estimate around 1,400 schemes may expect to pay less in DRCs, with their payments decreasing by around £7.4 billion over the 10-year period. This results in a net saving to businesses, however whether individual businesses will face an increase or decrease in costs is dependent on how far their current funding target and recovery plans are, relative to the new framework.

12.4 There is no, or no significant, impact on the public sector.

12.5 A full Impact Assessment was undertaken and is submitted with this memorandum and published alongside the Explanatory Memorandum on the legislation.gov.uk

[6] https://www.thepensionsregulator.gov.uk/en/document-library/consultations/draft-defined-benefit-funding-code-of-practice-and-regulatory-approach-consultation

website. Any changes in DRCs will be dependent on the future funding position of schemes and the last 12 months have seen a noticeable improvement in DB scheme funding levels. As a result, any DRC changes may now have further improved.

13. Regulating small business

13.1 The legislation applies to activities that are undertaken by small businesses. Analysis shows only around 10% of members saving into a DB scheme work in a small or micro business. Closed schemes appear to follow a similar trend, therefore the impact on small businesses is likely to be low given few have DB schemes.

13.2 However, to be consistent with the Pensions Dashboard Impact Assessment 2027[8], we defined Small and Micro businesses as DB schemes having fewer than 1,000 members. This is around 80% of all DB schemes. Initial implementation costs for Small and Micro businesses, including familiarisation, will total around £30.9 million, with ongoing costs estimated to be £4.3 million per annum (excluding costs associated with changes to DRC payments). Analysis suggests that small schemes, defined here as having less than £100m in liabilities, may need to increase their DRCs. This amounts to a total cost of around £313 million over the ten years (not discounted). It is important to note that this may vary across schemes and not necessarily all smaller schemes will be supported by a small/micro business.

14. Monitoring & review

14.1 The Department for Work and Pensions will informally monitor these regulations to make sure that they operate as intended. This will involve engagement with the Pensions Regulator and representative industry groups.

14.2 Regulation 3 provides for the statutory review clause required by Part 2 (section 28 and 30) of the Small Business, Enterprise and Employment Act 2015. The first report under this regulation must be published before the end of the period of five years beginning with the day on which these Regulations come into force. Subsequent reports under this regulation must be published at intervals not exceeding five years.

15. Contact

15.1 Nicola Lloyd at the Department for Work and Pensions, email: Nicola.lloyd@dwp.gov.uk can be contacted with any queries regarding the instrument.

15.2 Samantha Hainsworth, Deputy Director for Defined Benefit Policy, at the Department for Work and Pensions can confirm that this Explanatory Memorandum meets the required standard.

15.3 Paul Maynard MP, Parliamentary Under Secretary of State for Pensions at the Department for Work and Pensions can confirm that this Explanatory Memorandum meets the required standard.

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[7] https://www.legislation.gov.uk/ukia/2022/81

[8] Pensions Dashboards Impact Assessment - Impact Assessment (legislation.gov.uk)