LCP INSIGHT CLARITY ADVICE

Missing the target: How over-rigid pension scheme funding proposals could have unwelcome consequences

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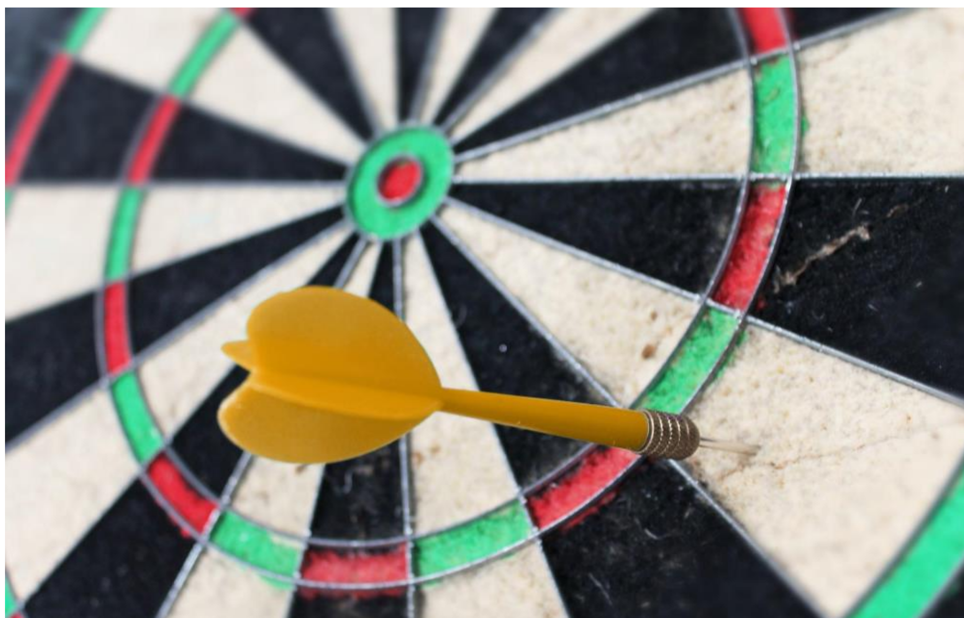

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Note that this paper and our estimated impact assessment were put together prior to the extraordinary movements in gilt markets following 23 September 2022. However, we believe that similar principles and quantums would apply in most market conditions, and the concerns we raise are still very much applicable.

Executive summary

The Department for Work and Pensions is currently consulting on draft regulations which will lay the legal framework for a new DB pensions funding regime, expected to result in the biggest shake up in the management of DB pensions since 2004/05.

We have some major concerns about the unintended consequences that could arise from the way the DWP regulations have been drafted. What is more, we challenge the lack of a meaningful impact assessment from the DWP, with our estimate of the potential impact on pension schemes being in excess of £30bn – a cost that will ultimately be borne by sponsors and pension scheme members.

Note that this paper and our estimated impact assessment were put together prior to the extraordinary movements in gilt markets following 23 September 2022. However, we believe that similar principles and quantums would apply in most market conditions, and the concerns we raise are still very much applicable.

Background

The journey to the new Defined Benefit (DB) funding regime has already been a long running saga, with its roots in a 2017 DWP Green Paper – "Security and Sustainability in Defined Benefit Pension Schemes". The first consultation from the Pensions Regulator (TPR) was launched in March 2020 on the principles underlying the new Code of practice, and was the subject of a previous LCP paper: A Fast Track to problems? Why TPR's new DB funding Code needs to be flexible.

A second consultation from TPR on the specific details and parameters is expected to follow later this year. In the meantime the DWP is consulting on the legal framework that will underpin the Code – the all-important funding & investment regulations, which are the subject of this paper. Within the pensions industry some concerns about the draft regulations have already been raised both publicly and privately.

So what's wrong with the regulations?

It is worth stating upfront that the aims of the new regime are admirable – improving pension funding standards and practices within the universe of UK defined benefit pension schemes.

Our concerns are more with the detail of how DWP is intending to lay the legal framework for this regime, and (in our view) some concerning unintended negative consequences.

It is also worth noting this consultation has been issued against the backdrop of a challenging macro-economic environment for employers and significant improvements in DB scheme funding levels in recent months – making the question of whether we need a new funding regime at this time, and the question of what form this should take, all the more pertinent. Whilst improved funding levels will not improve TPR's ability to enforce when schemes are not behaving as they should – which is a key driver behind the new regime –it does change the context for the new regime nonetheless.

Content of this paper

We set out in this paper our concerns in detail, illustrated where appropriate by case studies based on real life schemes we advise. We also set out some possible alternative approaches in some areas.

In section 1 we summarise and comment on key points from the DWP consultation. In that section we express some particular concerns about the lack of clarity in the regulations and how they will interact with the Code, and the lack of a meaningful impact assessment. We note that whilst further detail will be provided by TPR as part of their Code consultation later this year, the industry is not expected to have sight on that until after the regulations are finalised.

In section 2 we discuss our main concern, that **the regulations risk forcing all schemes into a single one-size-fits all approach**. The current DB funding regime is scheme-specific, meaning schemes fund in different ways and at different rates. This is with good reason – there is wide variation in the circumstances and objectives of the c5,000 DB schemes in the UK, including strength of sponsor covenant (ability to support the scheme), profile of members, and investment strategies linked to the overall objectives.

Under the DWP regulations as drafted, ***all*** DB schemes will have to reach a state of 'low-dependency'. This means that schemes have to plan to reach a funding level where no additional funding is expected to be needed from sponsoring employers, and then to lock-in to that situation by means of a low-risk (and low-return) investment strategy. This goal has to be reached by the time schemes are 'significantly mature', which for a typical scheme means their members have mostly retired.

Whilst this may be suitable for many schemes, it will not be for all. In fact, for a minority of cases this is expected to lead to sponsors being asked to pay unaffordable levels of contributions, which **could lead to significant pressure on businesses and in some cases insolvencies and job losses, and cuts to pension benefits for scheme members**. We highlight this by means of some case studies.

In section 3 we comment on two other key areas where we have concerns with the draft regulations:

1. The requirement for deficits to be recovered "as soon as employers can reasonably afford" – this has been a broad TPR principle for some time, and at first may sound reasonable, but **we are concerned about the impact of putting this into law**. Where a sponsor is making sizeable pension contributions but paying dividends, does this mean that dividends need to cease until the pensions deficit is cleared? Will some sponsors be forced into paying off the DB pensions deficit immediately (or within a very short period) at the expense of investment in their business, or indeed perhaps in lieu of higher contributions to a Defined Contribution scheme for current employees? And how does this interact with TPR's statutory objective to minimise any adverse impact on the sustainable growth of an employer?

2. The treatment of schemes that remain open to new members – the consultation document alongside the draft regulations seemed to indicate DWP think they have come up with a solution that will enable open DB schemes to continue to admit new members. Whilst this may be true in terms of allowing them to continue investing in growth assets, the regulations as drafted appear to force open schemes to fund (ie to agree a cash contributions based on certain actuarial assumptions) as if they will close to new members and then de-risk by some future date. **This could drive up costs for some schemes and perhaps even make otherwise viable schemes unaffordable, forcing them unnecessarily to close.**

Our estimated impact assessment is in the Appendix, with a **total estimated cost of c£30bn**. Whilst there is considerable uncertainty about the detailed costs, and the detail of the Code (once known) could in some areas mitigate the costs, we have been prudent in our estimates based on what we know so far and we currently believe the cost will be at least this order of magnitude, and will fall on both businesses and pension scheme members. We also comment on who we expect will be most interested in responding to the consultation in section 4.

We encourage all Trustee and Company Boards to consider the implications of the DWP proposals for their circumstances, and respond to the consultation as appropriate.

01 A summary of the consultation

In this section we cover the key highlights of the consultation, with some comments on areas of potential concern.

We highlight key points to note including suggested alternative approaches in this format throughout.

The consultation package

On 26 July 2022 the DWP launched its long-awaited consultation on draft funding and investment regulations. These amend and extend the current DB scheme funding regulations, providing the necessary legislative backing to enable TPR to deliver its new approach to scheme funding oversight through an updated Code of practice on which it set out its first thoughts back in March 2020. The regulations (alongside the Code) are intended to also enable TPR to intervene more effectively than currently.

The consultation package comprises the consultation document, draft regulations and an impact assessment – though as we describe later on below, this impact assessment is lacking in important detail.

Our overall viewpoint: These regulations mark a significant milestone in the long and winding road towards a new framework for the funding of DB pension schemes. The world has changed a great deal since initial ideas were first set out and we welcome the fact that consideration has clearly been given to this, as well as concerns raised by the industry. However, the potential material impact on some schemes should not be understated, as we highlight in this paper. And we are still some way from a finished product, with little detail on how the regulations will fit with the Code or the potential impact on UK schemes, sponsors and members.

Reaching "significant maturity"

The new funding regime is to have a focus on what is expected by the time a scheme reaches "significant maturity" as measured by the duration of the scheme's liabilities (ie the average time until the payment of pensions and other benefits, weighted by the discounted payments). The draft regulations require that at this point, or sooner, the scheme follows the principles of low dependency on the employer in relation to both the investment and funding strategies.

The consultation document indicates the Code will likely initially require a low-risk approach to be adopted by the time a scheme reaches a 12-year duration (this could change over time), which is as we expected and is in line with TPR's first funding consultation. This is generally similar to the point at which a scheme's members are expected to become mostly pensioners.

Our viewpoint: Firstly, we note sponsors may be concerned that trustees appear to have control over pace of reaching a low risk state, rather than needing to agree this with them, and we wonder whether this is intentional.

Secondly regarding maturity, in its first consultation on the new regime, TPR set out a number of options to measure maturity, and there was a sense that duration was considered the best, with no perfect option available. Other methods such as a proportion of liabilities relating to pensioners, or proportion of assets paid as benefits were also considered.

*Duration does have drawbacks – notably it is highly sensitive to market conditions, meaning schemes targeting a certain date for their low-risk strategy can easily find that having to be suddenly brought forward by many years if conditions change. For example, for two example schemes we looked at, one relatively immature and one relatively mature, as of late September 2022 they were expected to reach significant maturity a full **nine years** earlier than if the same calculation was done at the start of this year – primarily due to gilts yields rising over the year to date. For the relatively mature scheme, this has meant a journey plan to significant maturity of 10 years shortening to a matter of months. Whilst the movement in yields so far in 2022 might be said to be unprecedented, this illustrates the challenges that could arise from using this measure of maturity. What is more, there is potential to "game the system" here – durations can be changed by (for example) assuming members live longer, or take different options at retirement. TPR could see some manipulation for schemes wanting to stay "on risk" for longer.*

The weaknesses of duration as a measure of maturity should be recognised in TPR's code and regulatory approach – we think it's important there is flexibility in the Code rather than more detailed definitions in the regulations.

Low dependency investment allocation

Once they reach significant maturity, schemes must "broadly match" cashflows from investments with benefit payments and invest such that the value of assets relative to liabilities is "highly resilient" to short-term adverse changes in market conditions. These terms are open to some interpretation but nonetheless this is potentially restrictive for investment allocations for schemes at or close to significant maturity. One of the consultation questions asks if limited additional risk should be permitted, if supported by contingent assets.

Our viewpoint: Many schemes and sponsors already have funding and investment strategies that de-risk as the scheme matures, and the new requirements are likely to have little impact. However, some schemes, particularly those who are already close to significant maturity or with weak covenants, may have to change their strategies significantly if they have been relying on expected future investment returns to fill deficits.

Terms like "broadly cash flow matched" and "highly resilient" are vague terms to be put into law and open to interpretation. Some might argue that a strategy can be designed targeting a return of, say, 1.5% pa or more in excess of gilt yields, and meet these requirements. Others would take a much stronger line, arguing that something closer to a gilt based investment strategy and discount rate is appropriate. The practical financial difference between the two is enormous. Given the importance here – pension schemes need investment returns to be able to pay pensions, and the investment strategy also dictates the funding strategy and hence sponsor contributions – we think some schemes and/or sponsors may end up in the Courts to determine what is compliant and what is not. We question if this is the best use of resources for schemes and their sponsors and an appropriate way for government and TPR to regulate.

We also have concerns that a cash flow matching strategy, whilst right for some schemes, is not optimal for many. What is meant here by cash flow matching is of course the key question – noting that many assets that DB schemes use to hedge their liabilities, eg "Liability Driven Investment" (LDI) assets, do not precisely match cash flows. And we question why the focus should be on short-term volatility when pension schemes have always been long-term investors.

DWP should amend the definitions to ensure that a suitably wide range of low-risk investments can be held at significant maturity.

Low dependency funding basis

The regulations describe this somewhat clumsily, but essentially at significant maturity the actuarial assumptions adopted should be consistent with the low dependency investment allocation. There is interestingly no reference to prudence, which is a key principle in the current DB funding regime.

Our viewpoint: This could allow schemes to fund closer to a "best estimate" basis once they reach a low-risk strategy – this could be appropriate in some cases, and we support this flexibility.

Funding and investment strategy

This strategy needs to be documented and revisited every three years alongside valuations. It must include, amongst other things, a high-level statement of the investments intended to be held at the future "relevant date" – broadly at significant maturity. Under the Pension Schemes Act 2021 this strategy requires sponsor agreement in many cases, so this has the potential to restrict trustees' ability to set investment strategy.

Our viewpoint: Investment strategy has always been (rightly) the remit of the scheme trustees. How the requirement for sponsor agreement works in practice and whether it dilutes a trustee's investment powers is unclear. This has been discussed at length in the industry since the Act became law, but the regulations which were anticipated to provide clarification have not done so.

There remains considerable uncertainty on the interaction of the new regulations with trustee investment powers – many trustees are likely to want to highlight this to DWP.

Journey planning

As expected, schemes with strong covenants or ones that are less mature will be able to take more risk on their journey to significant maturity. However, for the first time, the regulations provide for new rules on measuring the strength of the employer covenant on which we are expecting TPR to build extensive guidance, some of which will form part of their new Code.

Our viewpoint: The industry will need to grapple with new detailed requirements around covenant assessments, which will likely need to be reported to TPR. This will be a big step up for some schemes.

Recovery plans

Where funding deficits emerge along the journey, it is proposed that there will be a new legal requirement that recovery plans must follow the principle that the deficit is recovered "as soon as the employer can reasonably afford". The consultation document asks whether this requirement should be given primacy over existing matters that should be taken account of in setting recovery plans (as set out in the current regulations) – such as asset and liability structure, risk profile, liquidity needs, and member age profile. This could have potentially significant implications for some employers – and is another area we discuss in section 3. There is no mention of specific recovery plan lengths – presumably more will come in the Code.

Our viewpoint: The legal requirement on recovery plans is unclear, with potentially significant implications for sponsor cashflow and perhaps even dividend policies. We discuss this area of concern further in section 3.

Sponsors in particular should carefully consider the implications of this new legal requirement, and consider responding to DWP.

Statement of Strategy

The regulations also cover the reporting of the new requirements in detail, including more detail on the requirements introduced by the Pension Schemes Act 2021 for all schemes to regularly prepare a "statement of strategy" to report progress to TPR; to appoint a Chair of Trustees to sign off the statement of strategy if they currently do not have one; and provide details of what must be included in that statement of strategy.

Our viewpoint: Most of this seems sensible but there is the potential for it to be onerous for smaller schemes.

DWP and TPR should ensure a proportionate approach that is not overly onerous for smaller schemes.

Lack of clarity, lack of impact assessment

A key concern that runs through all areas of this paper is the lack of information and detail that the industry is being given at this stage. In particular:

- The lack of clarity of how the regulations will fit with the Code – the Code is expected to be consulted on later this year, but by that time the DWP consultation will have ended, with no obvious opportunity for the industry to provide further comments.

- The lack of a meaningful impact assessment – DWP says that the impact of the new regime can only be assessed once TPR's revised Code has been published. But TPR is expecting to publish its Code for consultation after the regulations consultation has closed – meaning there will be no official data on the impact of DWP's measures in their own right, which we think are likely to be significant.

Our viewpoint: Given the regulations and the Code are two pieces of the same jigsaw, it seems inappropriate to consult with the industry on the shape of one without knowing the shape of the other, and how (or indeed whether) they will fit appropriately together.

Regarding the impact assessment, we believe these new rules are likely to impose a significant burden on a number of employers, with consequential knock-on impacts for jobs, and there are likely to be negative impacts for member benefits from schemes too. We have done some calculations based on what is already known (or strongly hinted at) and believe the cost could run into tens of billions of pounds for schemes, sponsors, the PPF and members – see the Appendix for our estimated impact assessment.

DWP should recognise the cost of their proposals, and should "keep listening" even once their consultation closes, so that any additional concerns the industry has about the regulations once they get sight of the Code can be addressed.

What isn't covered

Whilst the regulations are extensive, it is interesting to note what isn't covered in them.

There is no mention in the draft regulations or the consultation document of the "fast-track" or "bespoke" approaches that TPR put forward in its March 2020 consultation. Our understanding is that these concepts still exist, but we will need to await the Code for the detail and to see to what extent they have evolved.

Similarly, there is little mention of schemes that remain open to new members and how the duration calculation for significant maturity will work here, though as a minimum, for such schemes the "relevant date"

will of course be pushed out at each new valuation and revisiting of the funding and investment strategy. And there is reassurance in the consultation document that the intention is not to restrict such open schemes from investing in growth assets as appropriate.

There are no transitional provisions, with the full force of the new requirements coming into play at each scheme's first actuarial valuation following the commencement of the regulations.

Our viewpoint: Despite the reassurances in the consultation document, we are concerned about the funding implications for schemes that remain open to new members (the requirement to contribute cash based on an assumption of future closure) and again cover this in section 3.

The lack of transitional protections could be challenging for a number of schemes, especially those that have already reached or are close to reaching significant maturity. DWP may feel that the transitional period is already underway and that the broad strokes of the new regime have been known for some time.

Given the scale of the impact as we set out in the Appendix, we think some explicit transitional provisions will be needed to avoid significant impacts for many schemes, sponsors and members.

Timescales

Finally a note on when the new regime is expected to come into force. It's fair to say things have not gone to plan so far, with significant delays since TPR's first consultation on the new regime in March 2020.

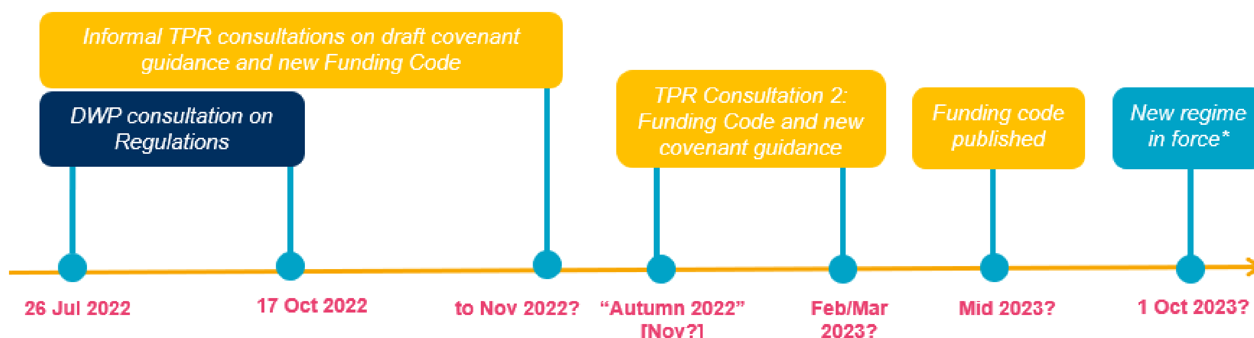
DWP's consultation runs to 17 October 2022, and DWP will then take a little time to finalise the regulations.

We think it likely that TPR cannot start its consultation on the replacement Code until the regulation consultation is closed (and perhaps until they are finalised – this is not yet clear). Consultation on the Code was previously scheduled for this "Autumn", and there are indications that this may mean November, although this could slip if the industry expresses serious concerns about the regulations.

Looking further ahead, we are aware there is an ambition to bring the new regime into force for valuation effective dates from 1 October 2023 – but this could slip to the end of 2023 and possibly into 2024.

Our current best estimate is that at the earliest the new regime will be effective for valuation dates from 1 October 2023 onwards.

The timeline below sets out our best guess of when developments will happen, but this is still uncertain.



*When comes into force will be for valuations with effective dates falling on or after this date.

02 Our main concern with the consultation

We think the new regulations risk forcing all schemes into a single one-size fits all approach which will not be right for all, and leading to potentially severe outcomes in some cases, including insolvencies, job losses and pension scheme members not getting their full benefits. We therefore believe extra flexibility should be allowed, especially where this is demonstrably in members' interests.

As we have stated, under the regulations, all DB schemes will have to reach a state of 'low-dependency'. This means that schemes have to plan to reach a funding level where no additional funding is expected to be needed from the employer under reasonably foreseeable circumstances, and then to lock-in to that situation by means of a low-risk (and low-return) investment strategy. This goal has to be reached by the time they are 'significantly mature', which for a typical scheme means their members have mostly retired.

Our analysis suggests that approaching 10% of UK schemes could already be regarded under the rules as 'significantly mature' and would have to move to a low-risk investment strategy immediately (if not already there). But projections we have run indicate that within a decade, around half of schemes are expected to be regarded as 'significantly mature'.

There will be a measure of flexibility as to how schemes get to a state of low-dependency. In particular, prior to being significantly mature, and subject to having a strong enough employer to support them, schemes will be able to invest more freely. However, under the proposed regulations, every scheme will be expected – by law – to reach a very similar low risk end destination by the time it is mature, and there will be very little flexibility for schemes after that time.

The problem with this is that it is a 'one-size-fits-all' solution which does not reflect the diversity of the DB pensions world and will be unsuitable in a number of cases.

Most importantly, some schemes have a relatively 'weak' employer who may not have the resources to top up scheme funding to the required level in time; full funding could have been achieved (without materially adverse impacts on the employer) if the scheme was able to take an appropriate level of investment risk over a sustained period, but this option is now expected to be closed off by the new cut-off date for 'low dependency'. If the new rules are implemented, in some cases the resultant deficit will be such that the sponsoring employer will not be able to afford the required contributions, and therefore would be at risk of insolvency. In this situation it is likely that the members would not receive full benefits – for example the pension scheme could end up in the Pension Protection Fund (PPF) – the lifeboat for schemes that are underfunded and can no longer be supported by their employers, where benefits are significantly lower.

Our analysis suggests that up to 5% of schemes (c200 schemes and employers in the country, including some charities) could currently be in this position. This means that, if the regulations are implemented without amendment, trustees of those schemes will face a very challenging choice: either break the law by maintaining their current investment and funding risk in the scheme, or comply with the new law and likely

force the sponsoring employer into unsustainable financial difficulties, likely leading to restructuring requirements, job losses, some insolvencies and cuts to pension benefits for members.

In particular, the directors of such employers would promptly find themselves in a situation where they cannot confirm the ongoing viability of the business, and would need to look at restructuring.

The impacts here are potentially significant – our estimated impact assessment in the Appendix shows a potential £5bn impact for affected members, and £2.5bn hit to PPF finances – though it is worth stating this is in the context of the PPF reporting it is in exceptionally rude health and is considering levy cuts.

There will also potentially be thousands of redundancies, costs in terms of restructuring fees measured potentially in the hundreds of millions of pounds, and losses to society from employers, including some charities, that are forced to close down.

What is of most concern is that in many of these cases the restructuring costs, the loss of jobs, and the losses to members and the PPF are expected to be avoidable under the current funding regime. This is because currently such schemes are able to target higher returns by taking more investment risk than would be allowed under the new regulations, so are still very likely to eventually be able to pay all pensions in full. It is the new regulations which would prohibit this approach and lead to expected worse member outcomes.

We highlight two such schemes in the (anonymised) case studies on the following pages – these are both based on actual LCP clients, and we anticipate there are many more schemes in similar situations throughout the country.

Negative consequences for TPR?

In addition to the impacts for stakeholders described above and illustrated in the case studies below, we believe there are also negative consequences of this proposed regulatory approach for TPR itself.

To see this, consider that for the c200 schemes mentioned above, in the new regime, TPR would seemingly have two options:

- Rigidly enforce the law, in which case this will likely lead to insolvencies, job losses, member benefit cuts in some situations, and likely severe criticism for TPR for not showing flexibility.
- Turn a blind eye to such schemes continuing to invest in a way that is riskier than the law requires, because that is the only way to avoid said insolvencies, and the best chance of members receiving full benefits. But in this situation, it seems inevitable that despite being afforded much needed flexibility, some of those schemes will still run into trouble and that there will be at least a few insolvencies – indeed these schemes are sponsored by some of the weakest employers in the DB universe. In this case, TPR will likely come under severe criticism for NOT having used its powers earlier.

It is therefore a Catch-22 situation for TPR.

A related potential issue is that of regulatory "precedence". By this we mean that if TPR choses to not use its powers for one scheme – for example not requiring them to take additional de-risking steps because it is not affordable for the scheme or sponsor in that situation – then there is a risk that other schemes argue they should also be allowed to take a similarly flexible approach. And in this situation TPR could find it difficult to challenge those other schemes given the precedent that has been set.

Case study 1: £100m scheme sponsored by research company employing c500 people

Background

The scheme is sponsored by a company that is the main trading entity of a not-for-profit group, that provides industry-wide research for a sector that is important to the UK's economy.

The company historically made profits that were sufficient for significant deficit contribution payments to be paid into the scheme. However, the business has recently faced significant challenges due to the pressures of Brexit and the pandemic – severely restricting the company's ability to pay pension deficit contributions.

With the pressures of Brexit and the pandemic having now eased, a new Company board in place, and the business having stabilised somewhat, there is the prospect of increased future profitability in due course.

The scheme has a significant deficit (70% funded, with a c£30m deficit) on a technical provisions basis and has a similarly material shortfall on the PPF basis. The scheme's duration is currently 16 years, and it is projected to become significantly mature in the early 2030s.

Given the employer is not-for-profit, there is no covenant leakage to speak of. As the business is fundamentally a people business, it has limited physical assets, so no real prospect of meaningful recovery on insolvency. This also means there are no meaningful contingent assets the trustees can obtain.

The scheme investment strategy targets a return of gilt yields plus 2.5% pa (in perpetuity). This level of risk is higher than we expect the new law to allow, but is necessary (and optimal) in the circumstances.

The trustees and company recently agreed a revised recovery plan that is 21 years' long, with meaningful contributions restarting in 2024, by which time it is expected that profits will have recovered somewhat. The funding plan is predicated on continuing to take a measured level of investment risk over this entire period - the plan makes allowance for a prudent estimate of the target returns at around gilts plus 1.5% pa. The resultant level of contributions is currently expected to be the maximum the company can reasonably afford.

To further protect the scheme, contingent contribution mechanisms have also been agreed that ensure that the scheme will receive extra contributions if the company sells one of the faster-growing subsets of its business or profitability / cash flow is higher than expected.

The current position is therefore that, as long as the targeted reasonably prudent estimated returns are achieved, along with the improved profitability and contributions under the agreed recovery plan, the company and scheme can continue with members expected to receive all their benefits and the business remaining viable and profitable, with some growth opportunities. It is recognised that if, in the long term, the targeted investment returns are not achieved, or the Company growth does is not sufficient for it to meet its committed contributions, then the situation is not sustainable, but modelling suggests that the chances of not achieving the anticipated returns in the long-term is a low likelihood and the current strategy is optimal. Furthermore, relying on investment returns is deemed to be less risky than relying more heavily on the company's ability to pay contributions.

Expected impact of the new regulations

If the new regulations require all schemes to be fully funded on a low-risk basis with a de-risked investment strategy by the time they are significantly mature, the scheme would need to de-risk quicker than is expected under its current long-term journey plan. In turn, this could lead to a much higher deficit, and recovery plan contributions would need to materially increase.

As the Company is already paying the maximum amount reasonably possible into the scheme, further increases in contributions would push the Company into immediate financial difficulties – most likely with the scheme then falling into the PPF and members seeing benefits reduced. This would also be expected to result in a significant number of redundancies from a business that is otherwise viable.

The new law would increase the current risk of failure from "modest" to "close to inevitable".

Case study 2: £500m scheme sponsored by UK manufacturing company employing 5,000 people

Background

The sponsor is a UK manufacturing and logistics company employing over 5,000 people generating revenues over £500m pa.

There are two main DB schemes, totalling around £500m of assets. These schemes are under-funded on technical provisions – recovery plans are in place into the 2030s, with the sponsor paying 2/3rds of free cashflow into the schemes (and with the remainder spent on business investment, ie no covenant leakage through dividends). Shorter recovery plans would not be reasonably affordable.

The schemes are already mature, with one scheme already being "significantly mature" (12 year duration) as expected to be defined by TPR, and the other expected to reach "significant maturity" by 2027.

The trustees have established investment strategies targeting around 5-6% pa (equivalent to gilts+2-3% pa) over the recovery plan period, with a strong focus on capital preservation and ensuring ongoing cashflows are met. These strategies target healthy returns, but in a risk-controlled way and the schemes have continued to meet these targets for some years now, through differing volatile economic environments.

The trustees are planning to target transitioning towards a lower-risk, predominantly bond-based strategy expected to deliver 3-4% (around gilts +1%) pa once fully funded. This is currently expected to be in more than a decade, when the schemes are expected to have durations of less than 10 years.

Under the current investment and funding plans, the schemes are on track, and the sponsor remains viable. Whilst material risks remain (both on performance of scheme assets, but also performance of the sponsoring employer), these are being closely managed and everyone (trustees and company) is comfortable that they are working through a viable plan.

Expected impact of the new regulations

Under the new draft Regulations, the schemes would be forced into far lower-returning investment strategies, and far sooner than planned. This would appear to leave two options to comply with the law:

Seek a further c£250m+ of contributions – this can be expected to lead to the sponsoring employer having to A) cut business investment to zero, damaging sustainable growth and weakening the covenant in the longer term; B) close / sell divisions, again weakening the covenant in the longer term; or C) go through a major restructure, potentially even winding up the company (making 5,000+ people unemployed) and passing the schemes to the PPF; or

For the scheme that isn't already significantly mature, invest in very risky strategies now (targeting c15% pa returns over the coming 5 year period to significant maturity) in order to try and generate enough returns to then be able to materially reduce risk once significantly mature (whilst hopefully still retaining an affordable deficit).

Neither of these options feel sensible or practical, given the schemes and company have existing viable plans as set out above.

Again, the new regulations are clearly going to lead to worse outcomes for all parties for schemes in such situations.

So what is the alternative?

This is of course the £1 million (or potentially £2 trillion) question, and is not an easy one to answer – but no-one ever said that regulating over 5,000 DB schemes would be easy. Our thoughts are below.

Modelling we have previously done (as part of our paper: A Fast Track to problems? Why TPR's new DB funding Code needs to be flexible) shows the best outcome (for any and all stakeholders) is not always de-risked investments, a higher funding target and shorter recovery plans, especially for schemes with weaker covenants. It is important to consider the interaction between the scheme and the sponsor in an integrated way, as we have shown in the case studies above.

We recognise that most schemes, especially smaller ones, would not want to pay large amounts of fees to consultants for complicated modelling in order to justify their valuation approach. But we would urge DWP and TPR to consider this type of analysis and thinking in designing the new Code and the legal framework that underpins it.

TPR has previously consulted on a "twin-track" funding regime:

- a fast-track route for those who wish to avoid regulatory scrutiny – under which schemes would have to pass a series of tests
- a bespoke route for schemes unable or not wanting to satisfy all fast track parameters – where schemes evidence why their approach is right for their circumstances

Our proposal is as follows:

Rather than requiring ALL schemes by law to be low-risk and cash flow matched by the time they reach significant maturity, in our view this should be required only for a fast track route, and bespoke schemes should be allowed to follow a more principles-based approach.

For example, principles like these taken from TPR's first consultation document where it describes its aims for Fast Track:

- *a position of 'tolerated' risk for different scheme-specific factors such as maturity and employer covenant*
- *a justifiable, prudent position that most stakeholders would recognise as within the range of reasonable outcomes*

The trustees and company could then sign off that they have met the principles for their Bespoke valuation – rather than adopting a potentially inappropriate approach in terms of prudence, contributions and risk, which will lead in some cases to worse outcomes.

03 *Our other key concerns*

Whilst we see the risk of the 'one-size-fits-all' approach and potential insolvencies and schemes forced into the PPF as the key issue, there are a number of other concerns we have with the consultation proposals. We set out our two other key concerns below – these are also likely to be high priorities for some trustees or sponsors responding to the consultation.

1. The requirement for deficits to be recovered "as soon as employers can reasonably afford"

Whilst fair treatment for pension schemes has been a TPR principle for some time, including a focus on what sponsors can afford, this will be the first time this principle appears as law.

This wording may at first sound reasonable, after all should sponsors not be safeguarding member benefits if they can afford to do so?

However, we have many questions and concerns around what this means in practice, including:

- Where a sponsor is already making sizeable pension contributions but also paying dividends, does this new law mean dividends need to cease until the pension deficit is cleared?
- Will sponsors who can in practice afford to do so be forced into paying off the DB pensions deficit immediately (or within a very short period)? Could some sponsors even be required to borrow money to do so where they can do this reasonably?
- How does this requirement interact with TPR's statutory objective to minimise any adverse impact on the sustainable growth of an employer? Who decides what is reasonable in this context?
- This new requirement is actually described as a principle that trustees must follow – does this make trustees the arbiters of what employers can reasonably afford? How does this work in practice? What if the employers, or TPR, disagree?
- What does this mean in practice for "shared cost" pension schemes? These are schemes where deficit contributions are often funded over many years, and split between employers and employees, even though the employer could in fact afford to pay off a deficit quicker. Will members need to also pay off their share of the deficit as quickly as the employer can afford to do so?
- Taking a step back, is a further shift towards greater protection for DB pension schemes appropriate in the current climate, with potentially negative consequences for future business investment, employment and spending on Defined Contribution (DC) schemes?

This new legal requirement will be a key point of interest for sponsors of DB schemes and we expect many to reply to the consultation. This is yet another area where some clarity of what this means in practice would be helpful, but as noted, the industry is being asked to comment on the draft regulations without sight of the Code. And of course even if we had the Code – this is another area where ultimately it would be for courts to

decide what is "reasonably affordable", because there is no legal hook in the law for TPR to define what is "reasonable" in this context.

What is clear is that this proposal seems to represent a shift in the legal balance of risks to be taken by different company stakeholders, strengthening the position of pensions relative to shareholders and other creditors. Particularly at a time of economic uncertainty and potential recession, and the need to promote economic growth, some may question whether a shift towards greater protection for pensions (and less for other stakeholders) is appropriate. However, ultimately this is a political decision, and the proposals will clearly strengthen the hand of some trustees in a way that will benefit some schemes and members.

As is set out in the Appendix, we think the impact here could be an additional £5bn of contributions required from sponsors. Crucially this is not just paying money sooner than they otherwise would have, it is additional costs – because if a longer recovery plan were still allowed, then in most cases some recovery plan payments would prove to not be needed as the scheme's investment returns are expected to beat the prudent assumptions required for funding valuations.

Sponsors in particular should carefully consider the implications of this new legal requirement and consider responding to DWP.

2. The treatment of open schemes that continue to admit new members

During the passage of the Pension Schemes Act 2021 through Parliament, concerns were expressed by many that there is no proposed special treatment of schemes that are open to new members and, in turn, this could lead to many open schemes being forced to close. Parliament was assured by the (then) Pensions Minister that this was not the intention and that the regulations and Code would ensure this was not the case.

The consultation document issued alongside the draft regulations seems to indicate DWP think they have come up with a solution that will enable such open DB schemes to stay open.

In one sense this is true – as long as the strength of the employer's covenant to the scheme is judged to be sufficient to support the risk, the draft regulations certainly allow schemes to continue investing in growth assets until they reach significant maturity. As such schemes are not expected to ever reach significant maturity, they can continue to keep their investments appropriately "on risk".

However, our reading of the draft regulations is that the regulations continue to force open schemes to adopt a funding basis which assumes that at some point in the future they will close to new members and therefore be required to de-risk. The way actuarial valuations work means that, in order to comply with the law, open schemes will need to assess their funding position based on this assumption, and the resultant deficit will then need to be addressed as soon as the employer can reasonably afford to do so. This means that much higher contributions will need to be paid into some open schemes than is currently the case, and that these higher contributions are likely to prove to be unnecessary in due course. In turn, faced with these higher cash costs, in our view some employers will no doubt decide it is appropriate to close the (otherwise viable) scheme to new members. The impact here then falls on the members whose pension benefits will be moved to a (likely much less generous) alternative. As set out in the Appendix we believe this could amount to £1.5bn of lost value to members over 10 years, just for schemes that are open to new members.

We recommend schemes that are open to new members consider the implications of these regulations and respond to the consultation.

04 Who should be responding to the consultation?

We believe the more responses to the consultation the better, and we are sure DWP (and TPR) would agree. The more voices are heard, the more they can gauge what the industry thinks, and the more they can adapt their approach to avoid unintended consequences.

In this paper we have covered a number of concerns with some of the proposals in the consultation and some potential solutions. We hope you consider which you might raise when responding to the consultation.

In our view there are some types of schemes (and sponsoring employers) who should particularly consider responding:

Schemes where the sponsor is weak

In this paper we have noted the risk that the requirement for all schemes to adopt a low risk investment and funding strategy will not be achievable for all schemes – especially those where the sponsor covenant is weak. Here the requirements under the new regulations could even lead to insolvency. For schemes in this position we think an integrated approach including analysis of the covenant risk should be taken to find the best solution, which would not seem to be in line with the current regulations as drafted.

Already significantly mature schemes

Mature schemes might find that they are amongst those most affected by the draft regulations, indeed many may already be at significant maturity and hence at risk of having to make wholesale changes to their approach in the very short term in order to comply.

Sponsors of schemes in deficit, who are concerned about impact on cashflow and other stakeholders

As discussed in the previous section, we expect many sponsors in this situation will wish to respond, making clear the potential impacts of the draft regulations on their other stakeholders (including shareholders) and questioning how the new requirements will work in practice and whether the proposals are reasonable.

Schemes that are open to new members

We recommend trustees and sponsors of open schemes consider the potential implications of the proposed draft regulations and whether they wish to feed back their views.

Appendix: LCP estimated impact assessment

As we covered earlier in our paper, DWP has stated that the impact of the new regime can only be assessed once TPR's funding code has been published. Whilst this is technically true, we have done some estimated calculations based on what is already known (or strongly hinted at) and believe the cost will run into billions of pounds for schemes, sponsors, the PPF and members – see below.

There are a number of impacts and each is difficult to measure, but based on what we already know we can estimate the order of magnitude of each impact, and they are all significant. Note that these estimates were made prior to the extraordinary movements in gilt markets following 23 September 2022. However, we believe that similar principles and quantums would apply in most market conditions.

The nature of the impact costs varies. Some are initial one-off costs, other costs can only easily be assessed as present values, and others are annual costs. In the case of the annual costs, we have multiplied by 10 to give a single capitalised cost. Some of the costs are frictional, one-off costs, seemingly with no added value to society. Others are cash costs, but do have the benefit of making pension benefits more secure, albeit typically by only a small amount and for a short time period. In our impact assessment, we haven't estimated the *benefit* of making pension schemes more secure, which could offset some of the costs below.

In assessing the impact, we of course need to make assumptions about what TPR will set out in its draft Code later this year. We have assumed that schemes are required to invest and have a funding basis in line with a "gilts + 0.5% pa" level by the time they reach significant maturity, which is defined as when they reach 12 years duration. These figures seem likely based on what has been published so far – though there may prove to be a little more flexibility on target investment returns once we see the Code.

Impact 1: cost of designing, agreeing and documenting the new funding and investment strategy, including the Statement of Strategy, for all schemes

This is broadly the cost that DWP estimated in their impact assessment as c£1.7m – £3.9m.

We don't think the DWP figure is realistic as it principally relates only to trustees familiarising themselves with the new requirements.

There is much more work needed here – many will need to take formal professional advice (including in many cases more covenant advice to support any Bespoke approach), and there will be time spent negotiating and agreeing with employers, as well as documenting what has been agreed. Employers also often have their own advisors, and will wish to seek their own advice and negotiate.

If we suppose that trustee, employer and respective advisor time amounts to £20,000 per scheme initially, and £10,000 additional costs per subsequent valuation (which do not seem unreasonable – some schemes will spend much more than this), then across the DB universe of c5,000 schemes that is an upfront cost of £100m plus £50m every three years thereafter. Capitalising the ongoing cost we believe the impact here

could easily be a total cost of around **£250m**. In some cases, this cost will be paid for from scheme assets and hence reduce member security.

Impact 2: requiring more schemes to derisk sooner

As we explain in our paper, under the new regime, all schemes must now de-risk investments and target a low-risk approach by significant maturity. It is of course true to say that most schemes would have done this anyway, though perhaps not quite as quickly or to the same extent as the draft Regulations require. Some other schemes would have continued on with a higher level of supportable risk.

Typical schemes

If we assume 25% of DB pension scheme investments (c£400bn[1]) would have continued on with returns that were on average 0.5% pa higher for a further 5 years, then the cost of this additional de-risking is 2.5% of £400bn, or **£10bn**.

This is in effect a cost to employers, in order to make DB pensions (for a proportion of already reasonably secure schemes) a little more secure. Put another way, this amount represents c0.6% of member benefits, which would be at risk of corporate insolvencies for a slightly longer period without the new regulations.

We also note that such de-risking (mostly into gilts or similar investments) means that schemes will be less likely to invest in areas that can be expected to have knock on benefits for the economy – such as to support the build back better initiatives, transition to the net zero economy, or other illiquid assets like infrastructure projects. This is in effect also a further cost which we haven't attempted to quantify – but we expect UK Treasury would consider it potentially significant.

We note however that DWP has specifically consulted on whether continued (supportable) risk for schemes should be permitted once a scheme has reached significant maturity. If additional risk were permitted, much of this cost could fall away.

Schemes that are most at risk

There is also the particular challenge for poorly funded schemes with weaker sponsors, as we have described in section 2 of our paper. This is because the required de-risking would put additional burdens on the sponsors which will in some cases be unaffordable and threaten the future of the scheme and business.

As we described, we think there are c200 schemes in this category. A little over £1.5trn of DB assets divided amongst 5,000 schemes is an average scheme size of £300m, though of course this is skewed by the very largest schemes. If we assume these affected schemes average £100m in size, that gives their total assets around £20bn. We might then assume PPF deficits of c£2.5bn (though some may have small surpluses), and buyout deficits of c£7.5bn – these are typical to the relative proportions we would see with clients in this space.

The impact of the draft regulations would then include:

- The cost of considering the future of each business once the pension scheme becomes unaffordable because of de-risking, leading to 200 businesses taking various actions:
    - Redundancies – likely measured in **10,000s of jobs**

[1] As at Q1 2022 total DB assets stood at around £2.0 trillion. However, allowing for market movements since then and in an effort to ensure we are coming up with a conservative impact assessment, we assume current asset values are closer to £1.6 trillion.

  - Restructuring fees from professionals, leading to the business being restructured and sold on where possible, and pension schemes being compromised / going into the PPF – likely cost **£200m** (based on an average of £1m a case, albeit this will vary considerably dependent on the size of the business and the nature of the restructuring and can run into many millions in complex cases)
  - Some such employers are charities and will need to close down, others are businesses that cannot be restructured and will become insolvent. These will be permanent losses to society – if we suppose there are 20 such cases each with current turnover of £10m pa – the cost will be £200m pa or **c£2bn** when capitalised.

- The cost to the PPF and therefore levy payers (DB schemes) – this would be the PPF deficits in the relevant schemes, so our **£2.5bn** figure from earlier.

- The cost to pension scheme members in terms of lost benefits from entering the PPF - the cost here is effectively the difference between the buyout deficit and the PPF deficit – so **c£5bn.**

Impact 3: paying off deficits faster

As we described in section 3, there will be a new legal requirement to pay down deficits as soon as employers can reasonably afford.

A key reason why sponsors like to pay down deficits over a longer period – typically 5 to 7 years – is because on average scheme investment returns are likely to beat the prudent funding assumptions and so in reality not all anticipated payments are expected to turn out to be needed. On the other hand, promptly eliminating any deficit in a pension scheme against the prudent funding measure is necessarily expected to lead to higher future pension surpluses and hence wasted corporate capital.

Being required to fund schemes sooner will impact on corporate cashflows, but in itself this isn't strictly a cost for strong schemes and companies – it will just mean less cash needs to be paid in later, and most companies can restructure balance sheets to achieve this. But, as described above, currently it is likely that a proportion of future expected contributions won't end up needing to be paid. And the new law will make this less likely.

The level of deficit contributions to DB schemes has been c£20bn pa for some years (estimates vary), but this is expected to reduce over the coming 5 years. It seems reasonable to assume that half of schemes would save 1 year of contributions currently by delaying repayments, and this option will be removed – resulting in an additional cost of **£10bn** to sponsors. These additional cash costs will act to improve the security of member benefits a little (they represent c0.6% of member benefits, which would otherwise be at risk of corporate insolvencies for a slightly longer period).

Impact 4: schemes that are open to new members

According to the 2021 Purple Book there were 560 schemes still open to new members at 31 March 2021. Allowing for some reduction since, let us assume there are currently c500 schemes open to new members.

As we explained in section 3, whilst we believe the draft regulations allow these schemes to continue to invest in growth assets, we think there are increased funding costs from what is proposed, and this could lead to more closures.

This is another area where it is particularly hard to estimate the impact, but let's assume 10% of those schemes close as a result, by way of illustration (which we do not think is unrealistic).

The 2021 Purple Book showed 657,000 active members in these open schemes – so we might assume 50,000 members in our schemes that are forced to close (a little less than 10%).

There are a number of ways of assessing the cost to members, but a simple illustration would be that if replaced with DC benefits, the loss of value is likely to be at least 10% of payroll, and based on an assumed £30,000 pa average salary this gives a cost of 10% x 50,000 x £30,000 pa = £150m pa.

And the capitalised value of this over 10 years is **£1.5bn.** Note that whilst this amount represents a loss to members it is a saving to employers.

Summary of LCP estimated impact assessment

Area	LCP impact estimate	Comments on any further possible costs and /or benefits
Cost of designing, agreeing and documenting the new funding and investment strategy, including the Statement of Strategy	**£250m**	Schemes have a more robust long term plan agreed with the employer
Requiring more schemes to de-risk sooner	**£10bn** across "typical" schemes Plus, for "at risk" schemes: • **10,000s of jobs** • Restructuring costs of **£200m** • Cost to society of businesses closing down **£2bn** • **£2.5bn cost to the PPF** • **£5bn cost to members**	• Would make DB pensions a little more secure in "typical" schemes • Schemes less likely to invest in areas with knock on economic benefits – eg "build back better", transition to the net zero economy • Much of the cost for "typical" schemes could fall away if Regulations allow additional risk at and after significant maturity if supportable
Paying off deficits faster	**£10bn cost to sponsors**	These additional cash costs will act to improve the security of member benefits a little
Open schemes	**£1.5bn cost to members** of schemes that are open to new members	Note that these amounts represent a saving to employers.
TOTAL	**c£30bn**	

LCP INSIGHT CLARITY ADVICE

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