HOUSE OF COMMONS LIBRARY

BRIEFING PAPER

Number CBP-4877, 2 July 2020

Defined benefit pension scheme funding regime

By Djuna Thurley

Inside:

1. Introduction
2. *Pensions Act 2004*
3. *Pensions Act 2014*
4. *Pension Schemes Bill 2019-21*
5. Impact of the COVID 19 outbreak

Contents

Summary **3**

1. Introduction **5**
1.1 Valuations 5
1.2 How funding is measured 5
1.3 How well-funded are schemes 6

2. *Pensions Act 2004* **8**
2.1 The previous regime 8
2.2 Introduction of scheme-specific funding 10
2.3 Code of Practice 12

3. *Pensions Act 2014* **14**
3.1 Revised Code of Practice 15
3.2 Changes to the regulatory approach 16
3.3 Proposal for discount rate smoothing 17

4. *Pension Schemes Bill 2019-21* **18**
4.1 Work and Pensions Committee Report 18
4.2 White Paper – February 2018 22
4.3 The Bill 24
Debate 26
4.4 Consultation on the Code of Practice 27

5. Impact of the COVID 19 outbreak **31**

Contributing Authors: Djuna Thurley (policy) and Rod McInnes (statistics)

Summary

The current funding regime for defined benefit (DB) pension schemes (which provide pension benefits based on salary and length of service) was introduced under the *Pensions Act 2004* (part 3). The legislation followed a number of high-profile cases in which a DB scheme wound up under-funded on the insolvency of the employer. These events had made it very evident that the previous regime, although intended to ensure that schemes had sufficient assets to protect pensions - did not guarantee the same for younger members. The result was that many found themselves expecting pensions far short of what had been promised.

The funding regime introduced in the 2004 Act requires trustees to:

- Draw up a statement of funding principles (i.e. a written statement of the policy for meeting the statutory funding objective, which is that the scheme has 'sufficient and appropriate assets' to meet its liabilities);
- Obtain a full actuarial valuation of their scheme at least every three years; and
- Where the scheme is in deficit, prepare a recovery plan setting out the steps that will be taken to meet the funding objective over what timeframe.

The aim is not to "eliminate all risk to members' benefits" but rather to "strike a reasonable balance" between the demands on the employer and the security of member benefits, recognising that "a strong, sustainable employer is the best protection for a DB scheme" (Cm 9412, Executive Summary).

The regime is regulated by the Pensions Regulator TPR. To assist trustees, it issued a Code of Practice (Feb 2006). It issued a statement on its regulatory approach in May 2006. This explained, for example, that a trigger for it to intervene was if a scheme had a 'recovery plan' of longer than 10 years.

There have since been two major reforms to the scheme funding requirements. The first followed the introduction in *Pensions Act 2014* of an objective for TPR - to minimise any adverse impact on the sustainable growth of an employer when regulating scheme funding. The context was concern about the costs of funding deficits for some employers. TPR issued new guidance, explaining that it would take a more risk-based approach, engaging more fully with fewer schemes that posed a greater risk. It would move away from specific triggers for intervention to a wider suite of risk factors.

In its December 2016 report on DB pensions, the Work and Pensions Committee made recommendations aimed at "reducing the risk of another scheme collapsing in the manner of BHS". A major concern for the Committee had been the length of the recovery plan to repair the funding deficit (23 years) and the time it had taken the Pensions Regulator (TPR) to intervene.

In its February 2017 Green Paper, Security and sustainability in Defined Benefit Pension Schemes, the Government said that while most schemes had a funding deficit, these were not generally 'unaffordable' for employers. However, there were some employers on whom the deficits were having a significant impact and for whom the level of contributions might become unsustainable. It asked for views on reform options, such as providing greater clarity over the requirements for scheme funding – perhaps with a comply or explain regime.

The White Paper published in February 2018 said there was no systemic problem in the regulatory and legislative framework governing DB schemes. However, DB scheme funding outcomes were affected by poor decision making, short-term thinking and a lack of accountability. The Government would clarify key terms in regulations. A revised Code of Practice from The Pensions Regulator, would clarify the new funding standards and help trustees and sponsoring employers to understand the requirements. Legislation would require DB scheme trustees to appoint a Chair, who would report on key funding decisions. (Cm 9591, March 2018).

Provision for this is in clause 123 of the *Pension Schemes Bill [HL] 2019/21.* In March 2020, TPR launched a consultation on a revised code of practice for DB scheme funding, to implement measures in the Bill. The proposal is for a twin-track approach, allowing trustees to choose either: a 'fast track' approach, if they could demonstrate that their valuation met the guidelines, or a 'bespoke' approach.

At Report Stage, the House of Lords voted to accept an Opposition amendment which would require a different approach to the regulation of scheme funding for open and closed schemes (HL Deb 30 June 2020 c679).

TPR published guidance for trustees on DB scheme funding and investment decisions during the COVID outbreak on 27 March 2020. It said that trustees should be open to requests to reduce or suspend deficit reduction contributions provided certain conditions were satisfied (i.e., it could be justified, there was a plan to catch up with deferred payments and to mitigate any detriment to the scheme, and the scheme was being treated fairly compared with other stakeholders). TPR would take a pragmatic approach to regulation.

In an update issued on 16 June 2020, TPR reported that around 10% of schemes had agreed a temporary suspension or reduction of DRCs (contributions to repair scheme deficits). However, others were in the process of discussing requests to suspend or reduce contributions, and extensions could be needed, as some employers continued to experience significant trading and liquidity pressures. TPR expected trustees to exercise due diligence in response to requests. It would expect trustees, wherever possible, to comply with their reporting requirements (for example, in relation to missed contributions) from 1 July 2020. It would "continue to regulate pragmatically and sympathetically."

Other relevant briefing papers are: CBP 4368 The Pensions Regulator: powers to protect pension benefits (July 2020) and CBP 8219 Defined benefit pension schemes white paper (July 2018).

1. Introduction

This briefing paper looks at the funding position of defined benefit (DB) pension schemes i.e. schemes that promise to pay a pension linked to salary and length of service.[1]

Private sector DB pension schemes operate on a funded basis which means that contributions are paid into a fund, which is invested. The assets are held under trust (so overseen by a board of Trustees). The fund is then used to pay pension benefits as they fall due.

1.1 Valuations

Because schemes need to have sufficient assets to pay pension benefits as they fall due, they need to be valued periodically – at least every three years. Guidance to trustees from the Pensions Regulator (TPR) explains:

> Your defined benefit (DB) scheme is subject to the statutory funding objective, which means it needs to have appropriate assets to cover its accrued liabilities (known as 'technical provisions'). You must prepare and maintain a statement of funding principles setting out your policy for meeting the statutory funding objective and a schedule of contributions covering payments due to the scheme.
>
> You need to commission actuarial valuations periodically (at least every three years) to check your scheme meets the statutory funding objective. If the scheme doesn't meet the objective, you need to put in place a recovery plan.

This is provided for in the *Pensions Act 2004*, s143 and the *Occupational Pension Scheme (Scheme Funding) Regulations 2005 (SI 2005/3377)*.

1.2 How funding is measured

As the Government's 2017 DB Green Paper explained, there are four main approaches to measuring the funding status of schemes:

- the Statutory Funding Objective used by trustees as part of the scheme specific funding regime to value pension liabilities (often known as Technical Provisions);
- the Solvency measure – known as full buy-out – an actuarial estimate based on the cost of securing full scheme benefits with an insurer;
- FRS 17/102 (and IAS19) – used to calculate and present the pension liabilities in company accounts; and
- the Pension Protection Fund's Section 179 basis (a subset of the solvency measure) is the estimated cost of securing PPF

[1] The other main type of scheme - defined contribution (DC) – pays out a sum or sums based on the value at retirement of the member's fund (which will depend on factors including the contributions made to it, investment returns and any charges).

> compensation levels rather than the full scheme benefits with an insurer.[2]

A scheme's assets are usually measured at market value. Liabilities are measured by "discounting" the promised future payments.[3] This allows for the fact that assets held to meet future liabilities will be invested and earn returns over the intervening period." The main differences between the different standards listed above lie in the way that *liabilities* are valued. From an economic perspective, the differences reflect the different degrees of certainty required in the payment of pensions.[4]

1.3 How well-funded are schemes

The Government's February 2017 Green Paper said that while most defined benefit pensions schemes were in deficit, they were not generally 'unaffordable' for employers:

> Whilst almost all DB schemes currently have a funding deficit, our modelling suggests that these deficits are likely to shrink for the majority of schemes if employers continue to pay into schemes at current/ promised levels.
>
> The available evidence does not appear to support the view that these pensions are generally 'unaffordable' for employers. While DB pensions are more expensive than they were when they were originally set up, many employers could clear their pension deficit if required. There is also little evidence that scheme funding deficits are driving companies to insolvency, and it seems clear that the majority of employers should be able to continue to fund their schemes and manage the risk their schemes are running. The single biggest risk to the members of these schemes is the collapse of the sponsoring employer.
>
> However, there are some employers who are finding that their pension scheme deficit is having a significant impact and where the level of Deficit Repair Contributions may become unsustainable.[5]

The PPF and Pensions Regulator conduct regular risk-monitoring of the DB pension landscape. The PPF's annual The Purple Book provides the most comprehensive overview of the aggregate balance sheet of the UK's private-sector DB pension schemes. Its dataset covers 5,422 schemes, with 10.1 million DB scheme members (42 per cent of whom are pensioner members, 47 per cent are deferred members, and 11 per cent are active members).[6]

The liabilities of these schemes are presented on two bases:

---

2 DWP, Security and Sustainability in Defined Benefit Pension Schemes, Cm 9412, February 2017, p39. For more detail, see paras 148-55

3 "Paying off Pension Fund Deficits. Impact on company behaviour, share prices and the macro-economy", A report by Pricewaterhouse Coopers LLP, November 2005, para 1.4

4 The Pensions Regulator, 'How the Pensions Regulator will regulate the funding of defined benefits, Consultation document', October 2005, para 1.3.2-4; "Paying off Pension Fund Deficits. Impact on company behaviour, share prices and the macro-economy", A report by PWC LLP, November 2005, para 3.3.3

5 DWP, Security and Sustainability in Defined Benefit Pension Schemes, Cm 9412, February 2017, p5

6 Purple Book 2019, Executive Summary

- **Section 179 basis**: this is an estimate of the amount needed to pay PPF levels of compensation to scheme members rather than full benefits. This is the key risk measure for the PPF as this is the liability that the lifeboat fund takes on in the event of scheme failure.
- **Full buy-out**: this is the most expensive valuation and reflects the amount that would need to be paid to an insurance firm to take on the liability of paying full benefits to members in the form of annuity contracts. The buy-out deficit is usually much bigger than other estimates as it includes the extra amount needed to cover the insurer's risk-related capital reserve requirements and profit margin.

The 2019 Purple Book explains that scheme funding improved in the year to the end of March 2019:

> Universe scheme funding improved in the year to 31 March 2019. The net funding position on a section 179 (s179) basis as shown in the PPF 7800 index improved to a deficit of £12.7 billion compared to a deficit of £70.5 billion the year before, while the aggregate funding ratio increased to 99.2 per cent from 95.7 per cent. The increase in the aggregate funding ratio is the result of
>
> On an estimated full buy-out basis, the net funding position improved to a deficit of £475.6 billion from a deficit of £584.0 billion the year before, with the funding ratio improving from 72.9 per cent to 77.3 per cent.[7]

The PPF provides monthly updates of the funding status of those schemes eligible for it.

[7] Ibid

2. *Pensions Act 2004*

The current regulatory framework was introduced under the *Pensions Act 2004,* following concerns about the adequacy of the regulatory framework after a number of high-profile schemes wound up underfunded on the insolvency of the employer.[8]

These events had made it very evident that the old regime – the Minimum Funding Requirement (MFR) – although intended to ensure that schemes had sufficient assets in the event of wind-up to protect pensions - did not guarantee the same for younger members.[9] The result was that many found themselves expecting pensions far short of what had been promised.

2.1 The previous regime

Prior to 1997, there were no legislative requirements about the level of assets an on-going scheme needed to hold - this was decided in accordance with the rules of their scheme.[10] The *Pensions Act 1995* aimed, in part, to respond to public concerns about the perceived lack of safeguards to protect occupational pensions in the light of the Maxwell scandal. The then Government established the Pension Law Review Committee, under Professor Roy Goode. This recommended a minimum solvency requirement to secure the pension rights of members.[11]

For more on the background, see

Library Briefing Paper Minimum Funding Requirement (CBP 1215, Oct 2008).

The Minimum Funding Requirement (MFR) was introduced by the *Pensions Act 1995* and came into force from 6 April 1997 (sections 56-61). It was a funding standard applying to private sector, funded, defined benefit pension schemes.[12] It was intended to ensure that schemes had sufficient assets to fully protect pensions already in payment and to give younger members a "cash amount which, if placed in a personal pension, would allow them a reasonable expectation - but not a guarantee - of achieving, at retirement, benefits equivalent to those lost."[13]

The MFR was subject to criticism from early on. The Government announced a review of the MFR in 1999, explaining that this was due to concern that "the valuation method is not as robust as originally expected under changing economic conditions and that it should be re-

8 See Library Briefing Paper RP 04/18 Pensions Bill (February 2004)
9 DWP, "Response to the Report by the Parliamentary Ombudsman, "Trusting in the pensions promise", June 2006, p9, para 11
10 DWP, Response to the Report of the Parliamentary Ombudsman, 'Trusting in the Pensions Promise', June 2006, para 10
11 Pension Law Reform. The report of the pension law review committee', Cm 2342-I, September 1993, p 249
12 Section 56, *Pensions Act 1995;* OPRA, 'A guide to the Minimum Funding Requirement', May 1999, p3
13 Parliamentary Ombudsman's Report 'Trusting in the Pensions Promise: Government bodies and the security of final salary occupational pensions', HC 984 2005/06, para 5.53; DWP, 'Response to the Report by the Parliamentary Ombudsman, 'Trusting in the Pensions Promise', June 2006, para 10-11

examined."[14] This led to the publication of a DSS consultation document in September 2000, seeking views on amending the MFR to deal with perceived problems and alternatives to the funding test, such as prudential supervision by a regulator, compulsory insurance and a central discontinuance fund.[15]

Paul Myners in a review of *Institutional Investment in the UK* undertaken for HM Treasury and published in March 2001 concluded that it was "distorting investment patterns without providing effective protection for members of defined benefit pension schemes." [16] He recommended that it should be replaced by a "scheme specific long-term approach based on transparency and disclosure, under which pension funds would report publicly on the current financial state of the fund and on future funding plans."[17]

At the same time, the Government announced that it would legislate to replace the MFR "with a long term scheme-specific funding standard, with additional protective measures, including a statutory duty of care for the scheme actuary, stricter rules on voluntary wind-up and extension of compensation for fraud."[18] A DWP/HM Treasury document, '*Security for Occupational Pensions: The Government's proposals*', set out key elements of its proposals. These included:

- a long-term scheme-specific funding standard;
- a strong regime of transparency and disclosure;
- a recovery plan for returning the scheme to full funding;
- a statutory duty of care towards scheme members on the scheme actuary.[19]

In September 2001, it published proposals for reform of the MFR[20]

In 2002, DWP confirmed its view that the MRF was insufficiently flexible and had led schemes to focus too much on the short-term:

> The MFR has not worked as intended, and from the outset has given rise to a number of concerns. It has proved to be inflexible and unable fully to reflect the specific circumstances of individual schemes. The need to satisfy the MFR test has also led some scheme to focus too much attention on the impact of short-term market conditions instead of an appropriate strategy for meeting their specific pension commitments.[21]

---

14 DSS Press Release, 'Timms announces review of Minimum Funding Requirement', 3 March 1999
15 DSS, 'Security for Occupational Pensions – a consultation document', September 2000
16 HM Treasury, Institutional investment in the UK: a review, March 2001, para 8.62
17 Ibid
18 HM Treasury, 'Budget 2001', HC 279, March 2001, p 48
19 HM Treasury and DSS, 'Security for occupational pensions. The Government's proposals', March 2001
20 HM Treasury and DWP, 'Minimum funding requirement: the next stage of reform', September 2001
21 DWP, Simplicity, security and choice: technical paper, December 2002, p12, para 3

2.2 Introduction of scheme-specific funding

The Labour Government gave an overview of its proposals in a 2002 Green paper.[22] The key elements of its new scheme-specific funding requirements were announced in a White Paper the following year:

> 6. The key elements of the scheme-specific funding requirements will be that:
>
> ● scheme trustees will be required to draw up a Statement of Funding Principles;
>
> ● trustees will be required to obtain a full actuarial valuation of their scheme at least every three years;
>
> ● following the valuation, the trustees will be required to put a Schedule of Contributions in place, setting out how much the employer and employee will pay into the scheme;
>
> ● where trustees and employers cannot reach agreement on issues fundamental to the funding of the scheme, the trustees will be given, as a last resort, powers to freeze or wind up the scheme;
>
> ● trustees will be required to send regularly updated information to scheme members each year, containing key information about the funding position of their scheme, in line with the likely requirement of the EU Occupational Pensions Directive; and
>
> ● the scheme actuary's duty of care towards scheme members will be clarified.
>
> 7. These proposals require employers, trustees and the scheme actuary to work together to develop an appropriate funding strategy for their scheme. Providing scheme members with funding information about their scheme will raise their awareness and understanding of the funding proposals of their scheme and increase accountability. We estimate that there will be savings of around £100 million a year arising from the impact of the removal of the MFR on schemes' investment strategies.[23]

Key elements of the new regime

The key elements of the scheme-specific funding regime introduced by the *Pensions Act 2004* are that:

> The scheme specific funding (SSF) regime requires the majority of DB schemes to complete an actuarial valuation at least every 3 years. Annual update reports are carried out in the intervening years.
>
> The actuarial valuation establishes how much the scheme's assets are worth and how much the scheme needs in order to pay pensions as they fall due (the 'technical provisions' or 'funding target'). The valuation reflects a particular point in time and assumes that the scheme will continue in the future.
>
> The SSF regime requires a scheme to be funded (have assets) to at least cover its technical provisions. If the trustees find the scheme

---

22 DWP ; Simplicity, security and choice: Working and saving for retirement, December 2002, Cm 5677, chapter 4, para 33. Further details were set out in 'Simplicity, security and choice: technical paper', December 2002, p12-16

23 DWP, 'Simplicity, security and choice: working and saving for retirement: action on occupational pensions', June 2003, Cm 5835, An Annex to the White paper explained how the £100 million saving figure was reached.

> to be in deficit, they must draw up a plan to address that funding gap. This is a recovery plan.
>
> For most schemes, trustees must reach an agreement with the employer on the assumptions and method used to calculate the scheme's technical provisions, as well as the terms of the recovery plan.
>
> Once agreed, the recovery plan can stay in place until the next valuation. However, if there are any significant changes to the situation of the employer during that time, the trustees may consider bringing forward the valuation and making changes to the recovery plan.
>
> The trustees of a scheme have 15 months from the valuation date to complete a statement of funding principles, a schedule of contributions and, if there is a deficit, they must submit this recovery plan to us and a summary of the valuation.[24]`

The legislation is in Part 3 of the 2004 Act*:*

- Section 221 set out the scope of the provisions. The intention was that they would "broadly apply to those schemes to which the Minimum Funding Requirement currently applies, subject to the scope of the provisions of the requirement of the European Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision (the IORP Directive).[25]
- Section 222 provided for the **statutory funding objective.** A schemes is required to have "sufficient and appropriate assets to cover their technical provisions" i.e. the amount required, on actuarial calculation, to provide for its liabilities.[26]
- Under section 223, trustees or pension scheme managers must prepare, periodically review and if necessary revise a **statement of funding principles:** "a written statement of the trustees' policy for ensuring that the statutory funding objective is met." The statement must record "the methods and assumptions to be used in determining the scheme's technical provisions" and the "period over which a failure to meet the statutory funding objective would be rectified and the manner in which it would be rectified.[27]
- Under section 224, trustees must obtain **actuarial valuations** once a year (or every three years, if they obtain actuarial reports for intervening years).[28] Section 225 requires the actuary to certify the calculation of the scheme's technical provisions when carrying out an actuarial valuation. The valuation must be made available to the employer within seven days of its receipt by the trustees.[29]
- Section 226 requires to trustees to prepare a **recovery plan** where it appears from an actuarial valuation that the statutory funding objective is not met. This must set out the steps to be taken to meet the statutory funding objective and the timeframe

---

[24] TPR, A quick guide to...scheme specific funding, valuation and recovery plans, November 2011; TPR, How the Pensions Regulator will regulate the funding of defined benefits. Consultation document. October 2005, para 2.1.1
[25] *Pensions Act 2004.* Explanatory Notes, para 794
[26] Ibid, para 795-6
[27] Ibid para 799-802
[28] Ibid, para 803
[29] Ibid, para 811

over which this is to be achieved. The recovery plan must be appropriate to the nature and circumstances of the scheme and any prescribed requirements. A copy of this plan must be sent to the Pensions Regulator[30]

- Section 227 provides that the trustees must prepare, periodically review and, if necessary, revise, a **schedule of contributions**: a statement setting out contributions payable by both the employer and active members of the scheme. An actuary must certify that it is consistent with the statement of funding principles. Where the funding objective is not met, the actuary must certify that it is sufficient to enable the funding objective to be met at the end of the period in the recovery plan determined by the trustees.[31] Where a payment is not made on time, this must be reported to the Pensions Regulator and the scheme members.[32]
- The employer must generally agree to the statement of funding principles, the recovery plan and the schedule of contributions.[33]
- Civil penalties may apply for failing to take reasonable steps to comply with certain of the requirements.

Details are provided for by *The Occupational Pension Schemes (Scheme Funding) Regulations 2005 (SI 2005 No. 3377).* The provisions took effect from 22 September 2005.

2.3 Code of Practice

The Pensions Regulator (TPR) is responsible for regulating scheme funding in accordance with its statutory objectives (i.e; initially, to protect the benefits of pension scheme members and reduce the risk of situations which may lead to calls on the Pension Protection Fund).[34]

In October 2005, it said it would take a risk-based approach, focusing on the schemes that posed the greatest risk to members' benefits. It also aimed to take an approach that was proportionate "to the ability of the employer to fund a realistic recovery plan."[35]

TPR's Code of Practice 03 Funding defined benefits, published in February 2006, was intended to assist trustees with the requirements.

In May 2006, TPR published a statement on its approach to regulation. It had developed "triggers" to identify schemes for further investigation. These related separately to "technical provisions" (i.e. the assumptions set for estimating the scheme's liabilities) to recovery plans (i.e. the plan for repairing any deficit in the scheme). A scheme might trigger further investigation, for example, if a recovery plan was longer than ten years, appeared to be significantly back-end loaded or was based on inappropriate assumptions, for example regarding investment returns.[36]

[30] Ibid, para 814-18
[31] Ibid, para 820-28
[32] Ibid, para 829
[33] *Pensions Act 2004,* 229
[34] Ibid, s5
[35] 'TPR sets out approach to scheme funding requirements', PN05-31, 31 Oct 2005
[36] How the Pensions Regulator will regulate the funding of defined benefits', September 2008.First published May 2006, para 3.3 and 3.14-6

Once a scheme triggered, TPR would decide whether to intervene, either informally or by using its statutory powers. It might do so if it became aware that the trustees had failed to complete, or make effective progress towards meeting, the requirements of Part 3 of the 2004 Act by the 15-month statutory deadline. This might happen if the trustees were unable to reach agreement with the employer on any of the following matters:

- method and assumptions for the calculation of the technical provisions;
- content of the statement of funding principles;
- content of a recovery plan; and/or
- content of the schedule of contributions.

TPR would use its powers only where it considered that the same (or an equally good) outcome cannot be achieved by informal means.[37] Where agreement could not be reached, it might:

- require a skilled person's report, for example from the actuary in respect of calculations of technical provisions using one or more methods and sets of assumptions notified by the regulator;
- modify the future accrual of benefits;
- issue a direction as to how the technical provisions are to be calculated, indicating the method and assumptions to be used;
- direct how a recovery plan is to be drawn up, including its length;
- impose a schedule of contributions;
- issue a freezing order whilst consideration is given to ordering a scheme wind-up; or
- order a scheme wind-up.[38]

In February 2008, TPR considered introducing a separate trigger based on mortality assumptions but decided only to look at these where the scheme had been flagged up by one of the other triggers.[39]

For more on TPR's statutory powers, see

Library Briefing Paper The Pensions Regulator – powers to protect pension benefits (CBP 4368).

[37] Ibid, para 8.1
[38] Ibid, para 8.5
[39] TPR press release, 'Regulator sets out intentions on longevity'. 18 February 2008, TPR press release, 'Regulator publishes response to longevity consultation', 23 September 2008

3. *Pensions Act 2014*

In the Autumn Statement of 2012, the Coalition Government said it would consult on a new statutory objective for TPR - to consider the long-term affordability of deficit recovery plans:

> 1.137 The Government is determined to ensure that defined benefit pensions regulation does not act as a brake on investment and growth. The Department for Work and Pensions (DWP) will consult on providing the Pensions Regulator with a new statutory objective to consider the long-term affordability of deficit recovery plans to sponsoring employers. The Government also recognises that volatility in measures of pension scheme deficits can make it hard for companies to manage their investment plans and attract external funding. DWP will also consult on whether to allow companies undergoing valuation in 2013 or later to smooth asset and liability values.[40]

The background to this, as explained by TPR, was an evolution in its understanding and approach, a changing pensions landscape, and pressures on DB scheme funding and sponsoring employers:

> We now have had the benefit of eight years of regulating DB funding and our approach has evolved as we better understand the nature of risks within the DB landscape and how to address them. There have also been significant shifts in the DB landscape with increased scheme closure and maturity. Some DB schemes continue to be underfunded with their employers failing and leading to claims on the Pension Protection Fund (PPF).
>
> Difficult economic conditions (for example, low interest rates and volatile markets) as well as continuing increases in longevity in recent years have also challenged schemes' funding positions and have put pressure on their employers.[41]

In January 2013, the Government consulted on the need for a new objective for TPR "to consider the long-term affordability of deficit recovery plans to sponsoring employers."[42] In Budget 2013, it said it would proceed with this:

> 1.155 Across the entire regulatory system, the Government is taking action to shift the balance of regulation in favour of private sector investment and growth. This is particularly important for the regulation of defined benefit (DB) pensions as recent economic conditions have put companies sponsoring DB schemes under significant financial pressure. The Government will provide the Pensions Regulator (TPR) with a new objective to support scheme funding arrangements that are compatible with sustainable growth for the sponsoring employer and fully consistent with the 2004 funding legislation. The precise wording of this new objective will be set out in legislation that the Department for Work and Pensions (DWP) will publish later in spring 2013. Implementation of the new objective will be subject to review after 6 months and TPR will revise its Code of Practice to reflect their forthcoming new objective as soon as possible in

40 HM Treasury, Autumn Statement 2012, Cm 8480, 5 Dec 2012, para 1.137

41 TPR, Regulating defined benefit pension schemes', December 2013; For an international perspective, see 'Can pension funds and life insurance companies keep their promises?', in OECD, Business and finance outlook 2015

42 DWP, Pensions and Growth. A call for evidence, January 2013

> 2013. The Government is also consulting on a new growth duty for non-economic regulators and is attracted, subject to the results of that consultation, to applying such a new duty to TPR.[43]

In its response to the consultation, it said that just over half (51%) of the 89 respondents to the consultation favoured a new objective for TPR. However, there were different views on what this should be, with the business community arguing for the impact on sponsoring employers ability to invest and grow to be taken into account and the Pension and Lifetime Savings Association and trade unions arguing for a focus on promoting good pension provision and prolonging the longevity of schemes. The introduction of the new objective was opposed by scheme members and trustees, who argued that a reasonable balance between member protection and the employer's ability to prosper was already being struck and that any change would tip the balance of power in funding negotiations too far towards the employer, weakening the position of trustees to negotiate on behalf of the scheme.[44]

The new objective was legislated for in the *Pensions Act 2014*, s48.

For the debates in Parliament, see

Pensions Bill 2013/14 – House of Commons stages (CBP 6643, November 2013) and Pensions Bill 2013/14 – House of Lords stages (CBP 6846, March 2014).

3.1 Revised Code of Practice

A new version of CoP 03 was published in June 2014, reflecting the new objective given to TPR under the 2014 Act. It recognised that "a strong, ongoing employer alongside an appropriate funding plan is the best support for a well-governed scheme" and therefore stressed the importance of trustees having a good understanding of the employer's position and plans.[45] It explained that there were flexibilities in the legislation, for example, in setting the investment strategy, the assumptions used when measuring scheme funding, and an appropriate recovery plan.[46] Where a scheme does not meet its statutory funding objective, an appropriate recovery plan should be put in place, only one aspect of which is its length. The level of risk trustees accept should depend on the overall funding and security arrangements agreed:

> 141. A recovery plan should be appropriate. Its structure is fundamental. Length is only one aspect of its structure. When setting the plan structure trustees should recognise that the time taken for the scheme to meet its technical provisions represents a period over which the trustees and employer may have agreed to accept a risk level higher than that of the technical provisions. The level of risk accepted should depend on the overall funding and security arrangements agreed.
>
> 142. Although affordability of deficit repair contributions is a factor to consider, this does not mean that an employer should be expected to pay deficit repair contributions at a particular level simply because it would be able to afford to contribute at that level or because it has been paying them at that level. Instead, trustees can use the flexibilities available in recovery plans to ensure that they are appropriately tailored to both scheme and

---

43 HM Treasury, Budget 2013, HC 1033, March 2013
44 DWP, Pensions and Growth. Government response to the call for evidence, May 2013
45 TPR website, Code 03: funding defined benefits (viewed April 2020)
46 TPR, CoP 03 – Funding defined benefits, June 2014, para s 48 and126

> employer circumstances. They should recognise, for example, that a longer recovery plan period may be appropriate where technical provisions reflect a particularly low risk approach. Conversely, the impact on scheme risk of adopting weaker technical provisions may result in the need for a proportionately shorter recovery plan period.[47]

3.2 Changes to the regulatory approach

In a consultation in changes to its regulatory approach, TPR said it would make risk management its guiding principle and move away from specific triggers for intervention:

> Our case work experience and landscape analysis shows that some schemes do not have a sound risk awareness culture and fail to understand the interaction between key scheme risks (covenant, investment and funding) and the impact they may have on achieving their objectives. Therefore, we want to make risk management a guiding principle of the revised code as it is key to schemes achieving good funding outcomes.
>
> • We want to align our overall approach to assessing risks posed by schemes to focus on the same risk areas – covenant, investment and funding – which we expect trustees to understand and mitigate as part of their integrated approach to risk management.
>
> • We have moved away from our old triggers focused on specific aspects of technical provisions and recovery plans and we want to adopt a broad suite of risk indicators which will allow us to have a more rounded view of risks and scheme characteristics.[48]

It would be more targeted in its interventions, engaging more fully with fewer schemes that posed a greater risk:

> At the outset of the specific funding regime we opened a significant number of cases (around 600 in 2006). In recent years, we have evolved our risk assessment so that we now aim to investigate fewer, but more complex, cases more efficiently than under our previous strategy. In line with the regulatory approach we are proposing in this consultation, we anticipate to be investigating significantly fewer schemes (around 200) with valuation dates between September 2012 and September 2013. The risk-based approach outlined in the proposed funding policy will mean that we are more likely to engage directly with larger schemes because overall, they represent the greatest risks to our objectives. It is important that we reach out to small schemes as well and we will focus on education as the most effective and proportionate way of regulating the whole DB landscape.[49]

The data and modelling capabilities it had built up would enable it to be more proactive in identifying trends in the landscape and specific scheme risks and issues, without waiting for reports to be made.[50]

---

47 Ibid
48 TPR, Regulating defined benefit schemes consultation, December 2013
49 Ibid
50 Ibid

3.3 Proposal for discount rate smoothing

Another proposal considered over this period, but not taken forward, was whether pension schemes should be able to incorporate an anticipated improvement in economic circumstances in the assumptions (for example regarding the discount rate) used in scheme valuations. [51] DWP asked for views in its January 2013 call for evidence.[52] TPR said it did not think discount rate 'smoothing' (i.e. averaging asset prices and discount rates over a longer period of time, instead of using current market spot rates) was consistent with the legislative requirements.[53] It warned that adjusting discount rates risked "simply picking the answer you want and ignoring the reality of the situation."[54] In Budget 2013, the Government said the call for evidence and not revealed a strong case for changing legislation to permit smoothing, so it would not pursue this measure.[55] In February 2017, it said again that it did not see the case for change in this area:

> It is not clear that in general discount rates being used are overly pessimistic, and that there is not strong evidence to demonstrate a systemic issue with the current flexibilities available.[56]

It would explore whether more could be done to encourage optimal investment strategies.[57]

The discount rate

The discount rate is a figure used to convert future cash flows into a single figure in today's terms. It is a way of working out how much would need to be invested today to pay a promised level of benefits in future.

See HM Treasury, December 2010, Box 1A

[51] PLSA, DB Funding – a call for action, October 2012; CBI chief calls for urgent action to prevent pension costs harming UK growth prospects, July 2012
[52] DWP, Pensions and Growth. A call for evidence, January 2013
[53] TPR, Annual defined benefit funding statement 2012, para 18
[54] 'NAPF 2012: TPR rejects NAPF calls for discount rate smoothing', Professional Pensions, 17 Oct 2012
[55] HM Treasury, Budget 2013, chapter 1, para 1.156; DWP, Pensions and Growth – a call for evidence, January 2013
[56] DWP, Security and sustainability in defined benefit pension schemes, Cm 9412, February 2017, Executive summary
[57] Ibid

4. *Pension Schemes Bill 2019-21*

Provisions in the *Pension Schemes Bill 2019-20*, which aim to achieve greater clarity and accountability in scheme funding decisions, were proceeded by a Green and White Paper and a report by the Work and Pensions Select Committee.

4.1 Work and Pensions Committee Report

In its 2016 report on Defined Benefit pension schemes, the Work and Pensions Committee made a series of recommendations aimed at "reducing the risk of another scheme collapsing in the manner of BHS". A major concern for the Committee had been the length of the recovery plan for the BHS scheme and the time it had taken for TPR to intervene:

> 48. There were warning signs to TPR about the nature of the BHS pension schemes. The deficit recovery plan agreed after the 2009 valuation was 12.5 years long, with employer contributions concentrated towards the end of the period, and TPR was concerned about optimistic assumptions. Under our proposals, TPR may have intervened more actively, requiring concessions from Sir Philip Green, bringing forward the 2012 valuation and monitoring the scheme more closely. It certainly would have taken action during the two years from the start of a valuation that ended with a 23-year recovery plan borne of a refusal on the part of Sir Philip to negotiate the necessary contributions.[58]

The Committee recommended more frequent valuations for risker schemes, a shorter period for reporting the outcomes of valuations, and recovery periods longer than ten years only in exceptional cases:

> 8. The Pensions Regulator (TPR) has a substantial suite of powers. It is, however, reluctant to use some of them. This is particularly true of interventions before a scheme is in severe stress which could nip potential problems in the bud. Furthermore, we get the impression that it can be somewhat aloof in dealing with trustees when it is well placed to provide timely, informal guidance. We welcome TPR's announcement of a review of its regulatory approach and will follow its progress with interest. (Paragraph 57)
>
> 9. TPR has a scheme-specific approach to regulation, but this does not extend to the frequency of scheme valuations. *We recommend that the Pensions Regulator should adopt a risk-based approach to scheme valuations. Riskier schemes should provide them more frequently, while low risk schemes should not be required to report as regularly.* (Paragraph 62)
>
> 10. Fifteen months is a long period for any negotiation. It is certainly far too long for a regulator to be kept in the dark. If a scheme valuation and recovery plan takes more than nine months to agree then TPR's intervention in the scheme may well be warranted anyway. **We recommend that the statutory timescale for the submission of valuations and recovery plans be reduced to nine months. In instances where TPR has concerns about the sustainability of a scheme or the progress of recovery plan, it may be appropriate for it to intervene sooner to request information—for example, the**

[58] Work and Pensions Committee, Defined Benefit Pension Schemes, December 2016, para 148

> **valuation on which basis negotiations are ongoing. Similarly, TPR should encourage trustees to keep it updated on the progress of discussions and offer support where necessary. (Paragraph 67)**
>
> **11. TPR needs to be tougher on deficit recovery plans. It should not be shy or slow in imposing a contribution schedule when a sponsor is not taking its responsibilities seriously. Recovery plans of more than ten years should be exceptional. Particular attention should also be paid to any plan which concentrates employer contributions in the distant future. As a general rule, the onus should be on sponsors to demonstrate that a recovery plan is reasonable in their specific circumstances. (Paragraph 74)**[59]

It also recommended increasing TPR's powers to require an employer to make contributions to a scheme – for example, by giving it power to "add punitive fines to Contribution Notices and Financial Support Directions."[60]

Government response - DB Green Paper

In its February 2017 Green Paper, the Department for Work and Pensions said the available evidence did not appear to support the view that DB schemes were generally 'unaffordable' for employers. However, there were some for whom the level of deficit repair contributions might become unsustainable:

> While DB pensions are more expensive than they were when they were originally set up, many employers could clear their pension deficit if required. There is also little evidence that scheme funding deficits are driving companies to insolvency, and it seems clear that the majority of employers should be able to continue to fund their schemes and manage the risk their schemes are running. The single biggest risk to the members of these schemes is the collapse of the sponsoring employer. However, there are some employers who are finding that their pension scheme deficit is having a significant impact and where the level of Deficit Repair Contributions may become unsustainable.[61]

Respondents took different views on the appropriate level of member protection. While some felt members were over-protected and employers over-burdened, others thought that "additional protection was needed to further reduce the risk of employers walking away from their pension promises." Nearly all agreed that there was "no need to change the fundamentals of the overall regime for DB pensions." However, some proposals for reform were considered.[62]

---

59 Work and Pensions Committee, Defined Benefit Pension Schemes, December 2016
60 Ibid, conclusions and recommendations, para 21; TPR's powers are discussed in a separate Library Briefing Paper CBP 4368
61 DWP, Security and sustainability in defined benefit pension schemes, Cm 9412, February 2017, Executive Summary
62 DWP, Security and sustainability in defined benefit pension schemes, Cm 9412, February 2017, para 139

More frequent valuations for risky schemes

DWP said the Work and Pensions Committee's recommendation that more frequent valuations be required for risky schemes might be counter-productive:

> 178. We should be clearer about what the problem is that we are trying to solve. If it is to ensure that schemes have the right ongoing monitoring processes in place rather than overly focussing on the triennial valuation, and the Regulator has access to the information they need to undertake their functions, then changes to the valuation cycle may not be the best solution to this problem. In fact, requiring a struggling employer with an underfunded scheme to undertake more frequent valuations might be completely counter-productive if it racks up cost on a disproportionate basis. Another option might be to introduce risk-based reporting and monitoring requirements which may offer some reduced burden to lower risk schemes, with a proportionate monitoring regime for higher risk schemes.[63]

A different approach for stressed employers

The Green Paper went on to discuss the question of whether the current balance of the regime between the protection of members and the demands on sponsors needed to change. It acknowledged that deficits had "stubbornly persistent for some years despite very substantial payments by employers":

> 200. Since the financial crisis in 2008, deficits of UK DB schemes have increased significantly. The aggregate deficit of schemes in the PPF 7800 index (which estimates the ability of schemes to secure PPF compensation levels on a buy-out basis) was £196.5 billion at the end of January 2017 compared to a small aggregate surplus in early 2008. However, the aggregate deficit reached a peak of over £400 billion earlier in 2016, which demonstrates the volatility of the measure. The deterioration of the aggregate funding position since 2008 is largely the result of depressed bond yields driving down the expectations of returns from investments which trustees use to set discount rates to calculate the liabilities. Whilst scheme assets have increased in value over this period, this has been more than offset by the corresponding increase in liabilities.
>
> 201. Up to a point the increase in deficits is a natural consequence of the way the system is designed to work. The existence of the flexibilities in the UK DB funding regime is one reason why schemes have been able to operate in deficit. Today, around 90-95% of schemes are in deficit on a Technical Provisions basis. On average Recovery Plans are around eight years long, which is only marginally shorter than the average length when the current regime was introduced around 10 years ago. However, this is despite the volatility seen in market conditions and the historically low yield environment.[64]

Increasing employer contributions was one way to improve the funding position of a scheme. However, it could also be in the interests of scheme members for the employer to invest in the business.[65]

---

[63] Ibid
[64] Ibid
[65] Ibid para 203-4

Although the Government thought most employers could manage their contributions and that some could potentially afford higher levels, there might be a case for a tailored approach.[66] There might be a case for requiring employers with significant resources and severely underfunded schemes to make faster progress:

> 212. One way to achieve this might be to tighten up the scheme funding regime for employers where there is significant affordability. One option, for example, would be to limit extensions to recovery plans, or to set hard limits on the lengths of recovery plans in certain circumstances. It could be argued that the employer should not be able to push back the date for dealing with the deficit or have a long recovery plan while they have significant resources available.
>
> 213. Another approach which has been suggested is to set interim funding targets for severely under-funded schemes, and, until they are met, require the employer to stay closely in touch with the Regulator and explain on a regular basis what action is being taken to repair the deficit. One way of focussing these requirements for consultation would be to only apply them to schemes which were not funded to PPF level, because if their employers were to go insolvent this would have negative repercussions for the DB universe as a whole, rather than just for the scheme's members.[67]

There might also be a case for allowing reduced contributions for stressed schemes and sponsors, but there was a risk of moral hazard:

> 223. If stressed employers are to be allowed additional flexibilities, the key questions then are how a struggling or stressed employer is to be defined and in what circumstances would it appropriate to target such easements. Wherever such lines are drawn there will be significant issues which would need to be resolved – for instance there is the possibility of moral hazard, where sponsors could seek to reduce their DB liabilities and take advantage of safety valves, by manipulating circumstances to ensure they meet the criteria.[68]

Options to make it easier for a struggling business could include allowing them to more easily separate from their pension scheme or renegotiate scheme benefits, for example, indexation arrangements.[69]

Triggers for investigation

The Green Paper commented that the removal of the 10-year recovery period as a trigger for investigating schemes had contributed to a significant divergence in practice, making it challenging for trustees, scheme sponsors and TPR. Options included setting out the requirements more clearly:

> 299. The absence of any clear boundaries or any legislative definition of what is 'prudent' or 'appropriate', has contributed to a significant divergence of approach across schemes which has

---

[66] Ibid, para 206-9

[67] Ibid

[68] Ibid

[69] See Library Briefing Paper CBP 4877 The Pensions Regulator – powers to protect pension benefits (October 2019); CBP 8219 The Defined Benefit Pension Schemes White Paper (July 2018)

> been highlighted by the published data from the Regulator regarding valuations and recovery plans. […]
>
> 301. Some have said that not only is this this lack of clarity challenging for trustees and their sponsors, but it also makes it particularly challenging for the Regulator to use its powers to enforce a more appropriate approach. A number of commentators, including the Regulator, have argued that the efficiency and effectiveness of the Regulator and the level of protection for members and the PPF could be enhanced if improvements were made in this area to allow more effective use of the Regulator's scheme funding powers. The recent Work and Pensions Select Committee Report into DB schemes also suggested that the Regulator should set out more clearly how trustees should use information from the sponsor when setting funding and recovery plans, but also that the Regulator should be tougher on recovery plans.
>
> 302. Options might include:
>
> a) setting out requirements explicitly in legislation, or
>
> b) giving the Regulator the power to set binding standards in this area, or asking the Regulator to set out its expectations in the form of detailed codes or guidance – which, to be effective may need to be supported by a legally enforceable "comply or explain" regime requiring trustees and sponsors to explain why they have not complied with the code.[70]

4.2 White Paper – February 2018

The White Paper published in February 2018 said there was no systemic problem in the regulatory and legislative framework governing DB schemes:

> Despite a few recent high-profile cases, our findings, and most consultation responses, suggest that there is no systemic problem in the regulatory and legislative framework that governs them. This framework is designed to respond flexibly to ever-changing conditions, and to provide employers and trustees with a wide range of options in how they manage their pension liability. However, there are examples of sponsoring employers misusing this flexibility and sometimes benefitting at the expense of pension scheme members. When wrongdoing against the pension scheme takes place, the impact on individual members can be significant.[71]

However, DB scheme funding outcomes are affected by poor decision making, short term thinking and a lack of accountability. It said that to clarify scheme funding principles, the Government would:

> 1. Strengthen the Regulator's ability to enforce Defined Benefit scheme funding standards, through a revised Code, focussing on:
>
>   a) How *prudence* is demonstrated when assessing scheme liabilities;
>
>   b) What factors are *appropriate* when considering recovery plans; and

---

70 Ibid, para 302

71 DWP, Protecting Defined Benefit Pension Schemes, Cm 9591, March 2018, Executive Summary

c) Ensuring a long-term view is considered when setting the statutory funding objective.

2. Require the trustees of Defined Benefit pension schemes to appoint a Chair and for that Chair to report to the Regulator in the form of a Chair's Statement, submitted with the scheme's triennial valuation.[72]

Responses

The Pensions Regulator argued that the current funding regime had for the most part demonstrated its resilience, but it had learnt from experience that it needed to be bolder in testing the scope of our scheme funding powers. It welcomed the White Paper proposals:

> 13. The DB funding regime has been placed under significant pressure during the past decade because of the persistent low interest rates and other factors. We believe that, for the most part, it has demonstrated its resilience and that most schemes will be able to meet their promises to members. However, regulating DB funding involves complex judgments. There have been times where the balance between schemes and employers was not always right over the past decade and, as a regulator, we have learned from this. A key lesson is that we need to be bolder in testing the scope of our scheme funding powers (section 231 of the *Pensions Act 2004)*. We asked the Government for improvements to existing legislation to make s231 a more practical and effective regulatory tool, and we welcome the White Paper's proposals for change.[73]

Some industry representatives were cautious about change, arguing that the existing system worked well. Royal London warned against returning to too prescriptive an approach:

> 3. "Prudent" and "appropriate" were intentionally left undefined in the original legislation since the prescribed definitions within the MFR legislation were found to be impractical as conditions changed, and adjustment of the legislation was very difficult. Regulators need to avoid repeating past mistakes.
>
> 4. Instead of trying to define these terms, the Committee should consider if there are alternative ways in which trustees and sponsors can be provided with information that will enable them to successfully steer the future of their schemes for the benefit of their members. The use of a one-dimensional balance sheet liability value ignores the long-term nature of a pension scheme.[74]

The ACA warned against destabilising a system that was "by-and-large working well."[75]

The PPF argued that the revised Funding Code of Practice should consider how best to address specific issues:

> 5. *Lack of progress in closing deficits* - Recovery plan lengths are broadly unchanged over the last 6 years (two triennial valuation cycles) and are still on average around 8 years in

72 DWP, Protecting Defined Benefit Pension Schemes, Cm 9591, March 2018
73 Written evidence from the Pensions Regulator (BPW0025) May 2018
74 Written evidence from Royal London Consulting Actuaries (BPW0007) May 2018
75 Written evidence from ACA (BPW0020) May 2018

> length. […] the lack of progress is striking especially in the context of findings set out in the White Paper that for FTSE350 companies paying DRCs and dividends, the ratio of DRCs to dividend payments has declined from around 10 per cent in 2011 to around 7 per cent in 2017 (primarily due to a significant increase in dividends without a similar increase in contributions).
>
> 6. *The prevalence of long recovery plans* – Around one in five schemes (around 1,050) have a recovery plan length that is longer than 10 years. We know from experience that even the strongest sponsors can deteriorate rapidly. The consequence of which can leave members and our levy payers exposed. Almost 400 schemes with employers in our strongest levy bands (levy bands 1 and 2) have a recovery plan of more than 10 years. We believe it is important the new Code introduces clear boundaries for recovery plan lengths, ensures strong sponsors close deficits within reasonable timeframes, and offers less leeway to take greater risk on account of employer strength or to "back-end load" recovery plans.
>
> 7. *The strength of Technical Provisions (TPs) relative to s.179* – Currently almost 3 in 5 schemes (around 3,100) are targeting a level of funding which wouldn't allow them to buy out PPF levels of benefits in the event of employer insolvency. […] there may be merit in ensuring trustees understand and monitor their PPF funding position (as a key indicator of the position of their scheme in an insolvency scenario) and for this to inform their approach to scheme funding.[76]

On the other hand, trade unions and groups representing scheme members argued that more needed to be done to keep schemes open.

The TUC described the White Paper as a "missed opportunity" to devise a plan to keep DB pension schemes open. It called for an inquiry on whether current assumptions were appropriate and whether "alternatives could be more appropriate for managing pension provision for current members and future generations."[77]

This concern was shared by UNISON who thought many valuation assumptions were unnecessarily over-prudent. It had commissioned independent actuarial advice that showed "not only are changes often unnecessary but closing to new members and bringing in a DC scheme with an inadequate employer contribution represents bad value for money both for the employer and members."

The AEA Technology Pensions Campaign also wanted a change in focus – onto how to reverse scheme closures.[78]

4.3 The Bill

The *Pension Schemes Bill [HL] 2019/21* was published in the House of Lords on 7 January 2020. Clause 123 would implement the measures proposed in the White Paper to deliver clearer more enforceable scheme

[76] Written evidence from PPF (BPW009), May 2018
[77] Written evidence from TUC (BPW0019) May 2018
[78] Written evidence from AEAT Pensions Campaign (BPW0016) May 2018

funding standards.[79] The Government explains that to address poor decision-making, it will set out more clearly the funding standards all DB schemes should meet. TPR will support trustees and employers through a revised Code of Practice. To make sure that trustee boards take a more strategic and long-term view, it will require trustee boards to:

> • Determine the long-term funding and investment strategy for their scheme underpinned by a funding strategy for reaching this destination;
>
> • Be clear about the strategy of the scheme to reflect the long-term nature of pensions;
>
> • Encourage accountability through explaining their funding strategy, their consideration of risk management and how they are complying with clearer funding standards. This will be via a Statement submitted to TPR at least every three years, complementing the actuarial scheme funding valuation.
>
> These measures are designed to improve scheme funding across all DB schemes and in the context of a maturing DB landscape where most schemes are closed.[80]

Clause 123 would introduce amend the *Pensions Act 2004,* to require trustees and managers:

> • Under new section 221A, to **determine a funding and investment strategy** for the scheme to ensure pensions and other benefits can be paid over the long term. The strategy must refer to the assets and liabilities in the scheme at key milestones.
>
> • Under new section 221B, to have a **written statement setting out that strategy and information** about it, including trustees' assessment of whether they are on track to deliver the strategy, how they intend to mitigate key risks and their reflection on past decisions. This statement of strategy is to be submitted to the Regulator with other relevant information. The statement must be signed by a chair of trustees on behalf of the trustee board.[81]

It would also enable the Government to make clear what is an appropriate recovery plan and strengthen TPR's scheme funding powers:

> 1.428 The measures also amend the statutory funding objective, so it takes into account the scheme's funding and investment strategy. In addition, they ensure that Government can make clear in legislation what is an appropriate recovery plan when the trustees are not on track to deliver the strategy.
>
> 1.429 Further, the measures strengthen the Regulator's scheme funding powers so that it can take action when trustees and managers fail to comply with their new duties, in particular in respect of their duty to determine a suitable funding and investment strategy.[82]

The intention is to help improve trustee and sponsoring employer behaviours and decision-making, and support TPR with its enforcement

---

79 Pension Schemes Bill [HL] 2019-20 – Explanatory Notes, para 595
80 Impact Assessment – Annex H
81 DWP, Pension Schemes Bill – delegated powers memorandum, January 2020, p109
82 DWP, Pension Schemes Bill – delegated powers memorandum, January 2020, p109

action where there is concern that the scheme's long-term funding and investment strategy is not suitable or cannot be achieved.[83]

The Government estimates that 80% of DB schemes already have a long-term strategy in place. However, for some this may be "largely aspirational", rather than driving funding and Deficit Repair Contribution (DRC) commitment. Such schemes would "still be required to change their existing Long-Term Objective (LTO) to reflect the proposed changes of introducing a long-term funding and investment strategy."[84]

Debate

Dividend payments

In Committee stage debate, Crossbench Peer, Lord Vaux, proposed that the making of dividend payments should be a 'notifiable event' to TPR, in certain circumstances (such as where the scheme was in deficit and depending on the rate of deficit repair contribution).[85]

Baroness Steadman-Scott responded that the Government believed it was taking a proportionate approach. She said that provided a suitable recovery plan was in place and the company had the resources, "it should be able to choose what it does with the remainder of the distributable reserves—it is rightly subject to business priorities."[86]

Labour Peer Baroness Drake objected that the recovery plan was based on assumptions about the strength of the employer covenant, which could be impacted by a huge dividend payment.[87]

Open DB schemes

At Report Stage on 30 June, the House of Lords voted to accept an Opposition amendment that would require different approaches to the regulation of scheme funding for open and closed DB schemes. This was on the basis that "the liquidity profile of an open and active scheme that is receiving regular, significant cash contributions is very different from a closed scheme."[88]

Baroness Bowles explained that a "low-risk liquid investment strategy is more appropriate for closed schemes where the loss in asset values would impair a model that relies on asset consumption as it moves to its end date." The same did not apply to open schemes, where a pipeline of new and younger members meant assets did not need to be liquid and a far longer investment horizon was possible.[89]

She argued that open schemes were under threat because TPR's Code (see section 4.4 below) suggested "treating accrued benefits the same in open and closed schemes of the same maturity, which fails to recognise the difference in the models." The effect would be to

[83] Ibid, para 1.430
[84] *Pension Schemes Bill 2019-21* – Impact Assessment – Annex F
[85] HL Deb 26 February 2020, c129GC
[86] Ibid c138GC
[87] Ibid c143GC
[88] HL Deb 30 June 2020 c679
[89] Ibid

"require huge increases in contributions and, at an instant, put schemes in deficit."[90]

Former Pensions Minister Baroness Altmann supported the amendment. She said the funding code appeared to be at odds with the Government's stated objective as set out in the 2018 White Paper (for a scheme funding regime which "enables the best deal for members, supports the economy and does not place extra burdens on business.") TPR's funding code seemed to want to "drive DB schemes on a path to so-called de-risking, aiming for a particular date of maturity." She said this was "simply inappropriate for an open scheme."[91]

Responding, Earl Howe said the amendment was not needed. The factors listed were all "important factors to take into account when developing secondary legislation for defined benefit pension scheme funding." It was the Government's aim that the scheme funding measures in the Bill should not change existing flexibilities but, rather, "seek to make best practice universal and ensure that all schemes are planning for the long term."

Baroness Bowles responded that:

> We are, in fact, in a rather strange situation where the Minister is in agreement with the policy; it is in government policy, but yet there is a significant danger from what the Pensions Regulator has actually said. That is the sole reason why there needs to be something on the face of the Bill that confirms what is government policy.[92]

Her amendment was accepted on division by 263 votes to 227.[93]

4.4 Consultation on the Code of Practice

TPR published its consultation on the Code of Practice on 3 March 2020, to run until September 2020. The context was that:

> With most DB schemes closed to new members and / or future accruals, we can expect them to be significantly mature in 15 to 20 years' time, with the majority of their members retired. These schemes will be more vulnerable to risks associated with poor funding levels and shorter investment horizons. Therefore, trustees should aim to reduce their scheme's reliance on the sponsoring employer as they mature. We want to be confident our expectations are effective and appropriate for trustees and in turn the savers in these schemes.[94]

TPR proposed a twin-track approach:

> **Fast Track**
>
> • We set straightforward quantitative compliance guidelines for trustees to assess whether we would consider their valuation compliant with the legislation.

---

90 Ibid
91 Ibid c681
92 Ibid c687
93 Ibid
94 Major consultation on clearer DB funding standards launched by TPR, v3 March 2020

• If all aspects are satisfied, trustees can expect minimum regulatory involvement on DB funding.

Bespoke

• This option provides trustees and employers with more flexibility to account for scheme and employer-specific circumstances.

• Decisions in this route will need to be fully articulated and evidenced, and may mean higher regulatory involvement.

It also set out the principles which should apply:

Compliance and evidence

• We expect trustees and employers to be able to understand their scheme-specific funding and investment risks and objectively evidence how these risks have been assessed as remote or minimal or can otherwise be properly managed (i.e; supported and/or mitigated). Robust evidence should be provided when risks are genuinely unsupportable.

• When demonstrating how risks are managed, trustees should be able to compare the risks they have taken to a tolerated risk position and then demonstrate the mitigation and/or support available.

Long-term objective (LTO)

• By the time they are significantly mature, we expect schemes to have a low level of dependency on the employer and be invested with high resilience to risk.

Journey plans and technical provisions (TP)

• We expect trustees to develop a journey plan to achieve their LTO.

• We expect trustees to plan for investment risk to decrease as their scheme matures and reaches low dependency.

• TPs should have a clear and explicit link to the LTO, and over time, should converge to the LTO as evidenced by the journey plan.

Scheme investments

• The actual investment strategy and asset allocation over time should be broadly aligned with the scheme's funding strategy (TPs and RP).

• Trustees must ensure their investment strategy has sufficient security, sufficient quality, and can satisfy liquidity requirements based on expected cash flows as well as a reasonable allowance for unexpected cash flows.

• We expect the asset allocation at significant maturity to have high resilience to risk, a high level of liquidity and a high average credit quality

Reliance on the employer covenant

• Schemes with stronger employer covenants can take more risk and assume higher returns.

• However, trustees should assume a reducing level of reliance on the covenant over time, depending on its visibility. Reliance on additional support

• Schemes can account for additional support when carrying out their valuations provided that it:

– provides sufficient support for the risk(s) being run

– is appropriately valued, and

– is legally enforceable and realisable at its necessary value when required.

Appropriate recovery plan (RP)

• TP deficits should be recovered as soon as affordability allows, while minimising any adverse impact on the sustainable growth of the employer

Open schemes

• Members' accrued benefits in open schemes should have the same level of security as members' accrued benefits in closed schemes.[95]

It anticipated that this would "introduce greater clarity for trustees and employers, so they can understand whether and why we may have concerns about their funding arrangements and what can be done to lessen those concerns."[96]

TPR did not expect its new proposed approach to be "too onerous for most schemes to implement" as it took forward features of its recent guidance (integrated risk management and the importance of long-term planning). However, it appreciated that "there could be significant impact for some schemes, particularly those that have been running excessive and unjustifiable levels of risk."[97]

Supporting analysis by the Government Actuary's Department suggested it would be feasible to set the parameters of the Long Term Funding Objective at "what would appear an affordable level for most schemes, with a high probability of proceeding to full buy-out of member benefits without resorting to sponsor support." However, the range of possible outcomes remained relatively wide and "in some scenarios of market conditions considered, support would be required from the sponsor or the Pension Protection Fund (PPF)."[98]

Members of House of Lords expressed concern that the Funding Code seemed to require the same approach for open and closed schemes of the same maturity. It voted to accept an Opposition amendment requiring them to be treated differently (see above).

Comment

Lane, Clarke Peacock said it was set to be "the biggest revolution to the requirements for scheme funding and investment for 15 years." Its implications were likely to include:

- higher contributions payable by sponsors;
- earlier de-risking of investments;
- increased interest in transfers to insurance companies and consolidators;

[95] Ibid, p5-6
[96] TPR, Quick Guide to our defined benefit funding code consultation, March 2020
[97] Ibid
[98] GAD, Modelling the long-term funding objective, Feb 2020

- regulatory pressure to close some schemes to future accrual, where still open.[99]

The Pension and Lifetime Savings Association explains that the revised CoP is intended to address concerns about the "need for greater transparency and accountability around the risks being taken on behalf of members and employers." The aim is to "provide clearer funding standards as well as provisions to ensure that trustees and employers have the right information, tools, commitment and incentives to make consistently good decisions, to protect schemes' long-term sustainability and members' outcomes."[100]

[99] LCP, Our viewpoint – Pension Schemes Bill, March 2020
[100] PLSA, DB Funding Code consultation, March 2020

5. Impact of the COVID 19 outbreak

On 27 March, TPR issued guidance for employers on DB scheme funding in the context of the COVID 19 outbreak. While it could not waive trustees' statutory obligations, it would not take regulatory action in respect of late reporting or a failure to make contributions for a period of three months. It would be "pragmatic" in scenarios where trustees were being asked to agree to reductions or suspensions in payments to reduce scheme deficits, provided certain conditions were met (i.e., it could be justified, there was a plan to catch up with deferred payments and to mitigate any detriment caused to the scheme, and the scheme was being treated fairly compared with other stakeholders). TPR would review the position at the end of June.[101]

For more detail, see

Library Briefing Paper Pensions: automatic enrolment – current issues (CBP 6417, April 2020).

In an update issued on 16 June 2020, TPR reported that only a small proportion of employers had so far asked to suspend or reduce contributions (deficit repair contributions (DRCs) or future service payments). Around 10% of schemes had agreed a temporary suspension or reduction of DRCs.

However, it understood that more trustees and employers were in the process of discussing possible requests to suspend or reduce contributions, and extensions could be needed in the near future, as some employers continued to experience significant trading and liquidity pressures.[102]

TPR expected trustees to exercise due diligence in response to requests:

> DRC suspensions or reductions may continue to remain appropriate. However, in view of the improved visibility of employers' financial situations, we do not expect trustees to unquestioningly extend their original suspension arrangements on a three-month rolling basis based on limited information and for this to become the new normal. Instead, we now expect that most trustees will be able to undertake due diligence on the employer's financial position before agreeing a new suspension or reduction.[103]

It would expect trustees, wherever possible, to comply with their reporting requirements from 1 July 2020. For example, where DRCs have been suspended, trustees need to submit a revised recovery plan or report of missed contributions. TPR would "continue to regulate pragmatically and sympathetically."[104]

---

[101] TPR, DB scheme funding: COVID-19 guidance for employers, 27 March 2020 [archived webpage]; DWP's response to the Coronavirus outbreak, Work and Pensions Select Committee, HC178, 22 June 2020, para 273
[102] TPR, DB scheme funding and investment – COVID19 guidance for trustees, Update:16 June 2020
[103] Ibid
[104] Ibid

Comment

The Pensions and Lifetime Savings Association welcomed this support for employers and savers in respect of long-term financial wellbeing, during the crisis.[105]

In a report published on 22 June, the Work and Pensions Select Committee said it supported the more lenient approach being taken by TPR during the pandemic. However, the Committee urged it to remain "alert to the risk of unscrupulous employers not in financial difficulty seeking to take advantage." In particular, it should keep a close eye on the small number of employers who might seek to pay dividends to shareholders and bonuses to senior executives at a time when they are reducing contributions to their pension scheme.[106]

---

[105] PLSA comments on TPR pension guidance for employers, 9 April 2020; TPR, Automatic enrolment and pension contributions. COVID 19 guidance for employers, 9 April 2020

[106] DWP's response to the Coronavirus outbreak, Work and Pensions Select Committee, HC178, 22 June 2020, para 277-8

BRIEFING PAPER

Number CBP-4877, 2 July 2020

The House of Commons Library research service provides MPs and their staff with the impartial briefing and evidence base they need to do their work in scrutinising Government, proposing legislation, and supporting constituents.

As well as providing MPs with a confidential service we publish open briefing papers, which are available on the Parliament website.

Every effort is made to ensure that the information contained in these publically available research briefings is correct at the time of publication. Readers should be aware however that briefings are not necessarily updated or otherwise amended to reflect subsequent changes.

If you have any comments on our briefings please email papers@parliament.uk. Authors are available to discuss the content of this briefing only with Members and their staff.

If you have any general questions about the work of the House of Commons you can email hcinfo@parliament.uk.

Disclaimer - This information is provided to Members of Parliament in support of their parliamentary duties. It is a general briefing only and should not be relied on as a substitute for specific advice. The House of Commons or the author(s) shall not be liable for any errors or omissions, or for any loss or damage of any kind arising from its use, and may remove, vary or amend any information at any time without prior notice.

The House of Commons accepts no responsibility for any references or links to, or the content of, information maintained by third parties. This information is provided subject to the conditions of the Open Parliament Licence.