Department for Work & Pensions

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House of Lords

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Dear Lord Palmer of Childs Hill, Baroness Drake, Lord Davies of Brixton, and Baroness Sherlock

Thank you for your contributions to the debate on the Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2024 on 26 March 2024. I committed to writing to you in response to points raised that I was unable to address in my closing speech.

Lord Palmer asked if the Regulations would help set out the long-term objectives and about mature schemes with fewer contributing members. One of the core principles of the new funding regime is that it requires schemes to set out their plans for ensuring that benefits are paid over the long term, and the Regulations play a critical part in giving effect to that vision.

The Pension Schemes Act 2021 together with the Regulations will require trustees and employers to determine and regularly review their long-term funding objectives and this will support them to plan and manage their scheme funding over the long term.

The new regime is designed to operate effectively for the full range of DB schemes at all points in their lifecycle. Schemes with few or no contributing members will be maturing, and the risks to such schemes should be effectively controlled by requiring them to be funded to a level so that they are unlikely to have to make future calls on the sponsoring employer by the time they are significantly mature.

Those schemes which are not closed will still be able to take account of new entrants and new accrual when determining when the scheme will reach significant maturity. Open schemes which have a good flow of new members, and are not maturing like a closed scheme, will not need to take steps to de-risk their investments in the same manner as a closed scheme. This strikes an appropriate balance, and will keep members hard earned pensions safe, while allowing such schemes to thrive in the future.

Lord Palmer also asked whether we could rely on the duty of trustees to protect the interests of the beneficiaries, especially when the schemes are, in effect, stationary and being wound up and these considerations where funds are being hived off to insurance companies?

Pension scheme trustees have fiduciary duties which require them to act in the interests of all the members. This will continue to be the case under the new funding regime.

The Regulations are aimed at ensuring that maturing DB pension schemes are sufficiently well funded to provide members with their promised benefits over the long term, and to protect the Pension Protection Fund (PPF). This applies whatever the long-term end game for the scheme might be, which could be: (i) to buy out on the insurance market, (ii) to enter a consolidation vehicle, or (iii) to run on with the support of the employer and the returns from investments.

Where a scheme is closed and maturing and reaches a sufficiently high level of funding, there are a range of options available to trustees and scheme sponsors. Every scheme's situation and rules will be different, but when deciding whether to secure members' benefits on the insurance market, trustees will take account of range issues, including what would happen if the sponsor covenant were to weaken, or if the employer were to become insolvent. They will be aware that the economic fortunes of large and seemingly robust companies can, and do change quickly, and without the protection of insurance there is always some risk to members' benefits, even if the scheme is fully funded.

It is for the trustees of a scheme to decide what is in the best interests of their members, but some trustees will rightly see it as being in members' best interests to secure benefits on the insurance market. In contrast to the DB arrangements where members of a failed scheme are protected by PPF compensation, members whose scheme is transferred to an insurance company are protected by the guarantee of full benefits from the Financial Services Compensation Scheme, although this has never been called upon, as insurers are required to be robustly capitalised.

Lord Palmer also raised the point, in respect of actuarial valuations, about schemes keeping funds in reserve.

The scheme funding regime is designed to find an appropriate balance between member security and employer affordability. To help control costs, it has never required employers to fund their schemes to the point where there is no risk at all to scheme benefits. But neither have schemes been required to be funded on a simple 'best estimate' basis, as this would put many members' benefits at risk. That is why the previous arrangements required liabilities to be calculated

prudently such that the scheme has a buffer to deal with potential adverse experience.

The new regime provides clearer funding standards, with clear metrics, to define a better and more explicit balance between member security and employer affordability. It makes it clear that where some schemes are taking too much risk and putting members' benefits at risk, their funding needs to be stronger. But many schemes are already managing their risks effectively and some are investing more prudently than is potentially required by the new arrangements. These schemes will not be required to strengthen their funding. In fact, The Pensions Regulator (TPR) fast track analysis suggests that around 70-75% of schemes have potential capacity for more productive investments.

Baroness Drake asked about instances where a scheme has reached significant maturity and whether retaining the requirement that assets be invested in such a way that cash flow from the investments broadly matches the payment of pensions would be appropriate.

Government recognised that there were some concerns that the draft Regulations we consulted on could be interpreted as driving all schemes to fully matched assets at significant maturity. It was never our intention to require full matching, but rather that schemes should mitigate the risk of needing to disinvest from volatile investments at inopportune moments, potentially crystallising losses and leading to a downward asset spiral, thereby requiring further calls on the sponsor after significant maturity.

The Regulations laid before Parliament achieve this by requiring schemes' funding levels to be highly resilient to short-term market volatility, for the purposes of the funding and investment strategy. This would maintain robust protection, while allowing trustees to invest in a manner proportionate to their scheme's individual circumstances, including their size and governance arrangements.

Lord Davies asked if the Regulator's approach to scheme funding is driven by the objective to protect the PPF and whether this objective is redundant.

The Pension Protection Fund's Strategy Review, published in September 2022, recognised that the funding levels have improved. The PPF board indicated that it may, in the coming years, be able to reduce the pace with which it accumulates reserves, and reduce the levy it collects, without risking its ability to pay its members their benefits. However, it continues to face a number of risks, including changes to economic circumstances which may even impact on established, robust businesses.

These risks, which include future claims for compensation and increased longevity, mean that it will continue to be necessary for the PPF to hold

significant reserves. It therefore continues to be necessary for TPR to have an objective to protect the PPF.

Furthermore, in its approach to scheme funding, TPR focuses on its objective to protect members' benefits, while always aiming to strike the right balance between this and its objective to minimise any adverse impact on the sustainable growth of an employer. Protecting members' benefits by way of appropriate scheme funding aligns with its objective of reducing the risk of calls on the PPF, which can arise in cases of employer insolvency.

Baroness Sherlock asked why the department had not taken the opportunity to redraft the Explanatory Memorandum when relaying the Statutory Instrument.

The House will be aware that I greatly value the work undertaken by the Secondary Legislation Scrutiny Committee.

My Department provided a detailed response to the Secondary Legislation Scrutiny Committee’s questions, which was published in Appendix 1 of the Committee's 13th Report. The Committee agreed DWP had presented a very robust argument in support of the Regulations and how the new regime would work.

At the time we judged that this was a sufficient explanation of the points raised and the changes made to the Explanatory Memorandum were explicitly linked to the new statutory instrument. That being said, I respect the view of the House and will take this back to my department to consider for future SIs.

Baroness Sherlock also asked about the TPR’s discretion on the level of detail, including how the Department will monitor whether TPR is delivering to the required standard and whether Government would be able to increase the powers in the future.

TPR is a risk-based regulator and has widely consulted on a twin track approach to meeting the requirements of the Regulations. This involves a lighter touch and less burdensome regime for schemes that meet certain parameters in their approach to funding and investment and greater scrutiny for other – often larger schemes, which take a more sophisticated approach to funding and investment. For the latter schemes, the Regulator will need more information in order to ensure that the regulatory requirements are being met. Government believes that the discretion afforded to TPR by these Regulations is critical.

My Department closely monitors the funding levels and trends in the DB landscape and works closely with both TPR and the Pensions Protection Fund to monitor the way in which the regulatory regimes are operating, and whether any further changes, including any changes to the powers of the Regulator, may be needed.

Baroness Sherlock asked, in relation to Regulation 16, about occupational schemes where the appointment of the chair was solely the discretion of the employer and whether this carries any implications for the requirements placed on chairs appointed in that way.

I can confirm that these Regulations will also apply to those situations where the decision to appoint the trustee board chair rests with the employer. The chair of the trustees, whether they have been appointed by the employer, will remain responsible for signing the statement of strategy and therefore provide accountability for the scheme's Funding and Investment Strategy.

I hope this letter provides some clarity on questions raised throughout the debate. I will place a copy of this letter in the Library.

My best wishes
James Younger

VISCOUNT YOUNGER OF LECKIE
PARLIAMENTARY UNDER SECRETARY OF STATE
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