XPS Pensions Group

XPS Insights
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First piece of the defined benefit (DB) strategy jigsaw is in place

What you **need to know**

- The final draft of the funding and investment strategy regulations was laid before Parliament on 29 January 2024. It comes into force on 6 April 2024 and will apply to valuations with effective dates on or after 22 September 2024.
- This is the first piece of the jigsaw on new rules on setting a formal funding and investment strategy. In the coming months we expect the final revised DB funding code, guidance on the form of the statement of strategy, and updated covenant guidance. The final regulations are more aligned with Government policy on investing in productive finance, and a consultation on DB surplus rules expected this winter will also impact some strategies.
- Compared to the draft, some significant changes are introduced. The most fundamental are expected to result in:
  - More flexibility in setting the investment strategy when schemes are mature.
  - More certainty on when schemes are considered to be mature, and the time in which schemes must transition to the strategy required at maturity. Open schemes can reflect the fact that they are open in working this out.
  - More options on the categories of contingent assets permitted, and flexibility on managing surplus.
  - A greater need to fully reflect current and future covenant prospects.
  - Potentially, more balance in assessing the affordability of contributions, reflecting the employer's sustainable growth.
- A key question remains on whether the changes to how investment strategy is captured in the statement of strategy removes concerns that trustees' investment power is impacted by the primary new rules in the Pension Schemes Act 2021.

Actions you can take

- **Review the key changes** to understand how this may impact your scheme's strategy options.
- **Identify** when you will first need to comply with the regulations.
- **Be mindful of the various documents and consultations** that we are waiting for, and how this might impact on the timing and content of your decision making.
- **Plan now for how you will assess your employer covenant** in line with the new regulations.

The key changes from the previous draft regulations

Item	Change or development
Low dependency investment strategy	The requirement to 'broadly match' assets and liabilities has been removed. Surplus assets do not need to follow a low dependency strategy.
Significant maturity	Clarity is provided on how duration will be calculated for working out when a scheme is mature to prevent this moving with market conditions.
Open schemes	In calculating significant maturity, a reasonable allowance (reflecting covenant) may be made for new entrants and future accrual.
Covenant	New requirements to consider the future ability of the employer to support a scheme. Contingent assets confirmed to be wider than just guarantees.
Recovery plans	While recovering deficits as soon as is affordable remains the prime requirement, trustees must also consider the impact on the sustainable growth of the employer.
Statement of strategy	Changes to where investment strategy and risk are covered is intended to ensure it is clear that trustees have the power to determine investment strategy.

The finer detail: Final funding and investment strategy regulations

Where do the regulations fit	The Pension Schemes Act 2021 requires schemes to have a long-term funding and investment strategy recorded in a statement of strategy. The final regulations provide the detail on what is legally required. A funding code of practice (TPR's interpretation of how trustees can comply) is needed for the regulations to take effect. To be operational, detail on the form of the statement of strategy and how to submit this is needed. We also expect TPR to update its covenant guidance.
Expected timing	The regulations come into force on 6 April 2024 and will apply to valuations with effective dates on or after 22 September 2024. Schemes will have 15 months from their first effective date to determine and submit their funding and investment strategy. We expect to see TPR's final code of practice over the summer, along with guidance on covenant and the statement of strategy, ahead of the effective date of the regulations.
Implications for low dependency strategies	Schemes are required to have a low dependency funding and investment strategy when significantly mature. The requirement for this to mean that future employer contributions are unlikely to be needed, when fully funded, remains. However, there is now more flexibility on the low dependency investment strategy which only requires that the value of the assets relative to the value of the scheme's liabilities is highly resilient to short-term adverse changes in market conditions, so that further employer contributions are not expected to be required. The requirement for investments to broadly cashflow match benefits has been removed. These requirements will not apply to any surplus assets.
Covenant	The regulations now explicitly include the matters to be considered in assessing the financial ability of the employer to support the scheme, including the timescales over which the trustees can be reasonably certain of continued support. This was previously delegated to the code of practice. Changes now also make it clear that contingent assets can be wider than guarantees.
Significant maturity	A scheme must aim to achieve a low dependency strategy when significantly mature, with this determined by reference to duration. Changes now fix the calculation date of measuring duration, to give more certainty and prevent timescales moving around due to market volatility. TPR must specify the relevant duration in its code and we expect this will be set to give more time than the previously proposed duration of 12 years. Open schemes can include new entrants and future accrual in calculating maturity, subject to this being reasonable, reflecting employer covenant.
Cash funding	The regulations still require that any deficit must be met as soon as the employer can reasonably afford. However, there is now also a requirement for trustees to consider the impact of the recovery plan on the sustainable growth of the employer.
Statement of strategy	The regulations set out requirements for what must be included in the statement of strategy. This is divided into the headline strategy and supplementary matters. The former must be agreed with the employer and the latter consulted on. Managing investment risk (both when mature and along the journey plan) has been moved to the supplementary matters. This aims to help make it clear that trustees retain the power to set investment strategy. However, investment strategy is still intrinsically a part of the overall headline strategy, so we expect collaboration to still be key.

For further information, please get in touch with **Pauline McConville** or speak to your usual XPS Pensions contact.

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