14th October 2022
Ms Fiona Frobisher
Head of DB Pensions Policy Division
Department for Work and Pensions
Caxton House
Tothill Street
London
SW1H 9NA

Dear Fiona,

I am writing on behalf of the CBI in response to the Department's open consultation on the new DB funding regime. In our high-level response we reaffirm our support for the intent behind the new regime that all DB schemes have a long-term funding and investment strategy. We however urge changes to the proposed regulatory framework to ensure a truly scheme-specific approach, as intended, is put in place. We also call for delays to the new Code's effective date of one-valuation cycle for schemes nearing maturity and 6-months for all others.

The CBI is the UK's leading employers' organisation, representing some 190,000 businesses that together employ around a third of private sector employees. This submission reflects the views of corporate employers, pension schemes and advisors from across the CBI's membership.

Changes to the DB funding system must retain a scheme-specific approach

Previous high-profile corporate failures made clear the need for a revised DB funding regime that both ensures savings are better protected and businesses can safeguard schemes through their own sustainable growth. The Regulations as drafted, however, risk the latter, and are a disproportionate response to the issues in DB pension funding that have been exposed.

Regulatory over-prescription on scheme maturity and trustees' duties when drafting recovery plans removes scheme-specific flexibility and will result in excessive overfunding and de-risking, at the cost of productive investment, for the majority of well-funded schemes and sponsor employers. This poses a threat to schemes' and savers' interests. Financially strong employers are, after all, not only schemes' best guarantee of member benefits, but also underpin a growing economy with rising real-wages and living standards.

The proposals' implications also stand in contrast to the measures outlined in the Growth Plan to support business investment and will undermine the government's ambitions to see more pensions capital devoted to return-seeking assets. We are very concerned by estimates suggesting that approx. £200bn of liabilities will be added to sponsor balance sheets because of the new regime, as proposed, over the next 10-15 years[1].

[1] Mercer, 2022, online article: https://www.uk.mercer.com/newsroom/proposed-dwp-regulations-on-db-scheme-funding-will-accelerate-pension-liability-buy-outs-and-the-demise-of-db-schemes.html

DWP should instead ensure that:

- The long-term-objective (LTO) point at ‘significant maturity’ is determined within TPR’s twin-track enforcement regime, not regulation. This will allow schemes assessed through the more closely scrutinised Bespoke route flexibility to adapt their funding and investment strategy to changing circumstances and ensure much of the mass overfunding and de-risking expected because of the new regime is avoided.
- Schemes with strong sponsor covenants can continue to take supported investment risk at maturity. This will mean sponsors with safe, maturing schemes can continue to invest in growth assets and all their employees’ future.
- The ‘affordability principle’ that requires trustees to close deficits ‘as soon as the sponsoring employer can reasonably afford’ is not introduced into law as proposed. Removing this principle will further help ensure excessive overfunding that undermines growth is avoided.
- The new Code’s effective date is delayed by a full valuation cycle for schemes approaching maturity if these amendments are not made. This will help mitigate the impact of the dramatic funding and investment changes these schemes will need to implement because of the proposed new regime.
- The effective date for all other schemes is delayed by 6-months. This will give the pensions sector sufficient time to understand what the new regime entails and ensure their compliance with the law.

These points are elaborated on further below.

De-risking and overfunding will result from regulatory over-prescription that threatens business investment and member benefits

The new regime is right to require trustees to focus on how they plan for the payment of benefits over the long-term, with TPR research showing that there are still schemes without a defined LTO and journey plan to achieve it[2]. This is a threat to both the pensions sector and businesses’ wider reputation, and one that the government is justified in seeking to address.

However, by strictly defining what constitutes maturity for all schemes (by a duration of liabilities measure) in legislation the regulations do not allow schemes flexibility to implement a funding and investment strategy that best suits their investment and growth objectives for member returns.

For instance, when schemes are impacted by unforeseen events such as the current shock to asset values, they will be unable to extend their LTO at maturity in line with a revised strategy. The LTO point will be predicated solely on the duration of their current liabilities as defined by the regulations. Instead, the only levers available to trustees will be to make more extreme revisions to either their funding requirements or their scheme’s investment portfolio than they otherwise would. In these cases, sponsor funding will need to be diverted from growth enhancing investments, even though an extended LTO could have achieved this aim at far less cost. Trustees could also find they need to take on more dangerous levels of investment risk to make up shortfalls in time for an approaching maturity target.

Strictly defining maturing (and the corresponding LTO) by a duration of liabilities measure will also increase schemes’ vulnerability to already volatile market movements, as schemes’ liabilities are themselves discounted by gilt yields. The recent increase in UK gilt yields would, for example, lead to maturity being brought forward for most schemes. Were the regulations to come into force now, schemes would be making even more sizable adjustments to their asset holdings or sponsor

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[2] IFF Research prepared for TPR, 2018
https://webarchive.nationalarchives.gov.uk/ukgwa/20191028123143mp_/https:/www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-research-summary-report-2018.ashx

funding demands to compensate to meet their low-dependency requirement. We have heard anecdotal evidence that schemes which prior to October would have had a maturity date as defined by the proposed regulations in the mid-2030s would now be defined as 'significantly mature' in 2024.

LTOs should be determined by TPR enforcement, which is better placed to implement a scheme-specific approach…

How a scheme's LTO point at maturity is determined should be at TPR's discretion. This would allow schemes undergoing more regulatory scrutiny under the Bespoke route greater flexibility to amend their LTO, if necessary, in line with their scheme-specific position. It would also allow the Regulator to revise their approach to what constitutes an appropriate maturity target in response to what can be incredibly fast-moving market developments – this would be significantly harder to achieve responsively and at pace via secondary legislation.

The Bespoke route is ultimately intended to ensure regulatory resources are targeted to schemes with a funding position or investment strategy that warrant additional enforcement oversight. Restricting schemes' ability to extend LTO at maturity to those assessed via the Bespoke route could achieve the aim of enabling flexibility that supports sponsors' growth and protecting members' benefits.

…and schemes with strong covenants should be able to continue to take supported investment risk at maturity

The proposed regulations further pose unnecessary rigidity by requiring all schemes to be in a state of 'low dependency' on their sponsor at maturity. In practice this requires schemes to be self-sufficient which, in effect, means that all schemes cease taking any risk through investment in growth assets at that point. The proposed regulations should be amended so that schemes with strong sponsor covenants can continue to take supported investment risk at maturity.

We understand many schemes are currently planning to run-on beyond maturity with an investment strategy that allows a degree of investment risk, underpinned by a strong covenant that guarantees payment of benefits in the event that assets underperform. These schemes would have to change this strategy if they were to eliminate dependency on their sponsor at maturity, as required by the proposed definitions of 'low-dependency' investment allocation and funding, neither of which consider covenant strength.

Schemes undertaking this approach are not doing so with the intent of exposing members to unnecessary risk. Benefits are supported by the strength of the employers' covenant, which ensures schemes remain simultaneously able to support themselves while their sponsors make growth investments. This enables scheme covenants to remain strong, and sponsor funding can be invested for the benefit of all employees, investors, and the wider economy.

Introducing the 'affordability principle' into regulation will also add to overfunding and undermine sponsor growth

Introducing the 'affordability principle' into legislation will also lead to an approach to deficits that precipitates overfunding as deficit reduction will have to be prioritised above all else. The principle in law would require that deficits are closed 'as soon as the sponsoring employer can reasonably afford', without appropriate definition of what 'reasonably afford' means. The effect of making deficit reduction 'as soon as possible' the primary compliance concern for schemes will be excessive caution in interpretation, as trustees will rightly be concerned about meeting their obligations. This will likely add to pressure on sponsor's available cash reserves and divert funds from other business investments.

The affordability principle, already in guidance within TPR's current compliance regime, should continue to be considered alongside other factors like the strength of their sponsor's covenant, whether the scheme is being treated equitably relative to other stakeholders and the potential benefit to the scheme of any employer plans to invest in its sustainable growth. These are relevant to whether a deficit should be closed immediately, as are factors such risk profile and scheme asset and liability structure already set out in legislation and required in recovery plans.

A more cautious approach to deficits is not in itself a concern. However, pushing *all* schemes to take a more cautious approach to deficits is not a proportionate regulatory response to the justified concerns about DB funding. As the government acknowledges, most schemes are well run, plan for the future and manage their risks effectively[3].

Under these proposals, sponsors with available liquidity would be required to close a deficit their covenant guarantees at a time when they could more effectively invest for the benefit of all employees and savers, including younger generations more typically receiving a separate DC pension.

This comes at a time when the labour and skills shortages UK employers face is limiting growth, and businesses are increasing their workforce investment to compete to attract and retain staff. 75% of UK employers have faced labour shortages in the last 12 months, 46% of which have been unable to meet output demand as a result. In response, 55% of firms say they are investing in training and upskilling current employees, 56% are investing in base pay and 40% are investing in technology and automation despite high inflation meaning most employers (59%), and the highest since we started asking the question in 2016, seeing labour costs as a threat to competitiveness.[4]

Beyond sponsors and schemes, the market-wide implications of the proposals will have real economy effects that must be accounted for by DWP

It is regrettable that the government's impact assessment of the proposed regulatory framework does not fully account for the wider implications on sponsors or the DB pensions asset market. Especially at a time when the economic backdrop has deteriorated significantly, with high inflation, rising interest rates and a weaker growth outlook leading firms to expect the volume of output to fall by 17% over the next three months and exacerbated cash pressures[5].

Pension consultants LCP have conducted their own impact assessment of the proposals. They estimate that as many as 5% of schemes are already in a position where sponsors would be forced into an unsustainable financial position so that they can immediately meet the low-dependency position at maturity these proposals would require[6]. Similar predictions note that the proposals would require the vast majority of DB pension schemes in the UK to divest of return-seeking assets by 2040 and cause an acceleration of DB scheme closure[7].

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[3] DWP, The draft Occupational Pensions Schemes Regulations 2023 Consultation, 2022, available at: https://www.gov.uk/government/consultations/draft-occupational-pension-schemes-funding-and-investment-strategy-and-amendment-regulations-2023/consultation-document-the-draft-occupational-pension-schemes-funding-and-investment-strategy-and-amendment-regulations-2023#chapter-1--background
[4] CBI, Employment Trends Survey, October 2022, available at: https://www.cbi.org.uk/media-centre/articles/three-quarters-of-uk-companies-hit-by-labour-shortages-in-last-12-months-cbipertemps/
[5] CBI, Industrial Trends Survey, September 2022, available at: https://www.cbi.org.uk/media-centre/articles/manufacturers-expect-a-sharp-fall-in-output-in-next-three-months-cbiaccenture-industrial-trends-survey/
[6] LCP, 2022, online article: https://www.lcp.uk.com/media-centre/2022/08/new-pension-scheme-funding-rules-risk-forcing-employers-into-one-size-fits-all-straitjacket/
[7] Mercer, 2022, online article: https://www.uk.mercer.com/newsroom/proposed-dwp-regulations-on-db-scheme-funding-will-accelerate-pension-liability-buy-outs-and-the-demise-of-db-schemes.html

Further, the pace of market change because of the new requirements on schemes could be significant. The proposed regime will have the effect of bringing forward the point of low-dependency for schemes already approaching their maturity target. At the same time, whilst recent gilt yield movements have improved DB funding positions, those same increases will have already sizably reduced the time horizon to low dependency for those schemes approaching maturity (as the duration of liabilities measure for maturity moves inversely to rising gilt yields). Near to 10% of UK schemes could already be regarded as defined in the Regulations as 'significantly mature' and 50% will become so over the next decade[8].

As the new regime embeds, scheme de-risking could add to already volatile market conditions. Our advisory members approximate that near to £500 billion of the £2.5 trillion of UK DB pension assets[9] would need to transition into bonds as a result of the proposed regime. Given that the total size of the UK bond market is just under £2 trillion, significant asset price distortion over the short-medium term appear highly likely.

These risks, combined with current financial volatility, mean a delay may be needed

In the event that the government goes ahead with these regulatory proposals that we think weaken a scheme-specific funding approach, it must ensure maturing schemes do not move collectively to sell return seeking assets or make unsustainable calls for sponsor support at a time of existing economic uncertainty.

For maturing schemes, which could, for simplicity, be defined by an 18-year duration of liabilities measure (that being the 12 years of liability definition of maturity proposed, plus an additional 6 years to account for those schemes approaching maturity), we suggest a delay to the effective date of the new regime of one full valuation cycle. This period could be used to smooth funding and asset portfolio adjustments, and the corresponding demands on sponsors and asset price distortion expected.

Further, due to previous timetable slippages, the pensions sector is likely to only have clarity of how the new regime will work approximately 6-months before its effective date at the end of September 2023. Final Regulations are not expected now until Q1 2023, and TPR's final Code - following consultation - will now likely follow in Q2.

Particularly given that schemes and sponsors are now so focused on navigating short term risks, this is insufficient time for the pensions industry to fully get to grips with the new regime's implications. The detailed changes to requirements on assessment of covenant strength alone will be a sizable change that will take time for trustees (and advisors) to develop a shared and consistent understanding of to inform funding decisions. We therefore suggest that the incoming regime's effective date is also delayed by 6-months for all schemes.

A new regime that both better protects savers and safeguards growth is possible, but changes must be made

We remain confident that with measured amendments to the proposed Regulations, as outlined above, they can underpin a better regime for DB funding that both supports growth and better protects savers.

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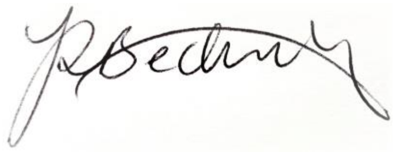
[8] LCP, 2022, online article: https://www.lcp.uk.com/media-centre/2022/08/new-pension-scheme-funding-rules-risk-forcing-employers-into-one-size-fits-all-straitjacket/

[9] ONS, Funded Occupational Pension Schemes in the UK July-Sept 2021, available at: https://www.ons.gov.uk/economy/investmentspensionsandtrusts/bulletins/fundedoccupationalpensionschemesintheuk/july2021toseptember2021

The CBI is keen to continue to engage with DWP and TPR on the new regime as it develops. We would like to reaffirm our continued offer to facilitate discussion between the government and our members on the proposals and would also like to thank you and your department for your constructive engagement thus far.

Yours sincerely,



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