Punter Southall Pension Solutions

Defined Benefit Policy: The Scheme Funding Team
DWP Consultation Coordinator
4th Floor
Caxton House
Tothill Street
London SW1H 9NA

Sent by email to: private.pensionspublicconsultation@dwp.gov.uk

14 October 2022

Dear Sirs

The draft Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2023

Response to the public consultation on behalf of Punter Southall Pensions Solutions Limited ("PSPS")

PSPS was established in 2019 by Punter Southall Group Limited to create innovative solutions for the occupational defined benefit pension scheme market. Most of its employees are pension specialists with a consultancy background, who collectively possess significant expertise in actuarial, investment and employer covenant matters. PSPS currently offers two solutions, the Stoneport Pension Scheme ("Stoneport") and the Pension Safeguard Solution ("PSS").

Stoneport is a consolidator for smaller schemes with fewer than 1,000 members. It operates on a sectionalised basis currently but will become a centralised scheme once it reaches sufficient scale (around 100 schemes). By bringing schemes together, Stoneport reduces costs for sponsors, improves scheme governance and radically improves the security of members' benefits.

The PSS is a capital backed journey plan solution, which we offer in partnership with the Carlyle Group, providing third party capital to support schemes on their journey to a full buy-out of their liabilities. The PSS improves the security of members' benefits, whilst the capital buffer removes downside risk for the sponsor, without incurring the upfront cost of a full buy-out.

Before turning to the questions posed in the consultation document, we provide below some high-level comments on the draft regulations as a whole. We then address the questions that are of most relevance to PSPS, based on our areas of expertise and the solutions we offer to the market, in the appendix to this letter.

Overview

We consider that the current legislative and regulatory framework for scheme funding has many advantages and believe that it works well. It is long-established and well understood and crucially, affords trustees the flexibility to take account of scheme specific circumstances when setting and reviewing their funding strategy.

The draft regulations will, if enacted as drafted, remove much of that flexibility and create a quasi minimum funding requirement that all schemes have to target, placing additional contribution requirements upon many employers, irrespective of the level of financial support available to their schemes.

The new rules will also place significant restrictions on how schemes invest their assets. This will necessitate a significant (further) shift away from growth assets as schemes approach and reach significant maturity, which seems at odds with stated Government policy.

In our opinion, the proposed restrictions are wholly unnecessary for schemes that provide a high level of benefit security to their members. Benefit security can be derived from many different sources, all of which should be taken into account. For example, the size and strength of the employer, either individually or on a collective basis for a centralised scheme like Stoneport; and the value of any contingent assets, such as secured charges or access to third party capital through a vehicle like the PSS.

Furthermore, we believe that these measures will have a very limited impact (positive) on the security of members' benefits across the industry as a whole.

The proposed changes will also have a significant administrative cost, which we think the impact assessment dramatically understates.

Conclusion

In summary, we have serious reservations about the impact of the draft regulations on schemes and their sponsors and do not understand the rationale for seeking to remove the flexibility that has served the industry so well for more than a decade and a half.

Yours faithfully

Richard Jones FIA

Principal

Appendix

Question 1: Draft regulation 4(1)(b) provides that a scheme reaches significant maturity on the date it reaches the duration of liabilities in years specified by the Pensions Regulator's revised Defined Benefit Funding Code of Practice.

i) Do you think that it would be better for the duration of liabilities at which the scheme reaches significant maturity to be set out in the Regulations rather than the Code of Practice?

We don't believe that the flexibility in the current funding regime should be removed. For this reason, our view is that the duration of liabilities at which the scheme reaches significant maturity should not be specified in the Regulations or the Code of Practice. Instead, it should be left for schemes to determine, as appropriate, based on their particular circumstances.

ii) If you think that the point of significant maturity should be specified in Regulations, do you agree that a duration of 12 years is an appropriate duration at which schemes reach significant maturity?

Notwithstanding the above, we consider 12 years to be too long a duration, particularly when combined with the proposed requirements to de-risk and fund to low dependency, irrespective of the level of support available.

We believe that the investment spiral risk is overstated and moreover, that if steps have been taken to mitigate this risk, it should be possible for schemes to take that into account (see answer to Question 9).

Question 2: Do you think that the definition of low dependency investment allocation provided by draft regulation 5 is appropriate and will it be effective?

We consider the requirement for scheme benefits to be "broadly matched" by cash flow from investments to be too restrictive. Similarly, we believe that requiring scheme funding levels to be "highly resilient" to short-term adverse changes in market conditions to be too onerous and will cause unnecessary de-risking within the pensions market as a whole, which is inconsistent with wider Government policy and aims.

Restricting investment allocations in this manner may lead to sub-optimal outcomes whereby cash that could be used to support and grow the sponsor (and the underlying employer covenant thereby creating more support for the pension scheme) may be diverted to low-risk, low-return investments within the pension scheme. This is at odds with the Pensions Regulator's long stated view that the best support for a pension scheme is the presence of a strong and ongoing employer, a view that is accepted throughout the industry.

Question 3: Do you think that the definition of low dependency funding basis provided by draft regulation 6 is appropriate and will it be effective?

The definition of low dependency funding basis is fine in isolation. It is the requirement to reach that target by significant maturity, irrespective of scheme circumstances, that is unnecessarily prescriptive.

Question 4: i) Do you agree with the way that the strength of employer covenant is defined?

The concept of employer covenant is well understood by the industry. That understanding reflects the current guidance from the Pensions Regulator's *"Assessing and monitoring the employer covenant"* which includes the definition *"The covenant is the extent of the employer's legal obligation and financial ability to support the scheme now and in the future"*. We therefore see no need for the strength of employer covenant to be defined in regulations.

ii) Are the matters which trustees or managers must take into account when assessing it, as provided by draft regulation 7, the right ones?

The underlying factors determining the strength of the employer covenant are specific to each sponsor and scheme. It is therefore not possible to provide a definitive checklist of measures that should be taken into account when assessing covenant strength. Further, enshrining such an approach in Regulations, rather than providing some degree of flexibility in a Code of Practice or Guidance set by the Pensions Regulator is unnecessarily restrictive.

We also note that draft regulation 7(3) fails to recognise that the strength of the employer covenant should be assessed in relation to the size of the scheme, not just the magnitude of any deficit (because even a fully funded scheme can be exposed to significant risks if it is large relative to the size of its sponsor).

Question 5: Does it work in practice to set a minimum requirement for the relevant date to be no later than the end of the scheme year that the scheme is estimated to reach significant maturity?

We foresee some practical and financial difficulties arising from setting the relevant date to be no later than the end of the scheme year that the scheme is estimated to reach significant maturity. In particular, the duration of a scheme's liabilities could change quite considerably due to a point in time event like a bulk transfer, or as a result of changes in market conditions. For example, a rise in long-dated gilt yields of 1% per annum could bring forward the date at which a scheme is expected to reach significant maturity by two years. In such situations, schemes could be forced to sell return-seeking assets quickly and employers may be forced to make substantial additional contributions to their schemes at very short notice.

Question 8: Do you think that these minimum requirements are sensible and will provide additional protection for the accrued pension rights of scheme members?

We expect the minimum requirements to provide additional protection for the accrued pension rights of some scheme members. However, they will provide very limited additional protection for the majority of well-run schemes and this benefit will come at a very significant cost, by reducing flexibility and adding to the compliance burden across the industry.

Question 9: i) Should such limited additional risk at and after significant maturity be permitted, if supported by contingent assets? If so, to what percentage of total liabilities should this be limited?

We are very firmly of the view that some risk taking should be permitted after significant maturity, subject of course, to those risks being supportable. Moreover, we see no reason to place an upper limit on the amount of risk taking, which we believe should be left to the discretion of the trustees, having regard to the type and amount of support available.

We see no need for schemes to operate a low-risk funding and investment strategy from significant maturity if they provide a high level of benefit security. Trustees must be permitted to take into account the support available to the scheme, which in Stoneport means the collective strength of all the employers and in the PSS means the capital buffer upon which the scheme can call. The example limit of five percent of total liabilities seems so low as to make the flexibility it provides close to worthless.

Furthermore, we see no reason to require risk taking to be supported by contingent assets provided by another company within the group or a third party. For example, why would contingent assets pledged by the sponsor not be acceptable, or other forms of support, such as a parent company guarantee?

Question 11: Do you think that the principles in paragraphs 4 and 5 of Schedule 1, requiring funding risks and investment risks to be linked primarily to the strength of the employer covenant, are sensible?

We agree that funding and investment risks should be linked primarily to the strength of the employer covenant and also (as drafted) to the time to significant maturity. However, we consider the requirement for schemes to de-risk as they approach significant maturity implicit in the statement *"more risk can be taken where a scheme is a long way from reaching the relevant date and less risk can be taken where a scheme is near to reaching the relevant date"* to be unnecessarily restrictive.

Question 13: Will the matters and principles set out in Schedule 1 enable the scheme specific funding regime to continue to apply flexibly to the circumstances of different schemes and employers, including those schemes that remain open to new members?

No. For closed schemes in particular, the matters and principles set out in Schedule 1 will remove nearly all the flexibility that currently exists under the scheme specific funding regime once schemes reach significant maturity. Moreover, some flexibility will be lost even sooner if schemes are required to de-risk as they approach significant maturity.

Question 21: Do you consider that the new affordability principle at draft regulation 20(8) should have primacy over the existing matters, if they do remain relevant?

We see no need for the new affordability principle to be introduced into the Regulations. However, if it is to be introduced, we consider that it should not have primacy over the existing matters, as that could lead to money being diverted into schemes that might be better spent investing in the sponsor's business.

Question 22: Will the requirements in draft regulation 20(9) work in practice for all multi-employer pension schemes?

We are not lawyers, but we believe that they will, from a purely practical perspective.