Department for Work & Pensions	Impact Assessment (Bill introduction)

Title of measure		Clearer funding standards for Defined Benefit occupational pension schemes – funding and investment strategy
Lead Department/Agency		DWP
Planned coming into force /implementation date		TBC
Origin (Domestic/EU/Regulator)		Domestic
Policy lead		Mo Muqtadir
Lead analyst		Tom Mouland/Eleanor King
Departmental Assessment		Self-certified
Total Net Present Social Value (in 2016/17 prices) (over 10year period): £-1.3m	**Equivalent Annual Net Direct Cost to Business (EANDCB- in 2016/17 prices)(over 10 year period: £0.2m**	**Business Impact Status:** Non-Qualifying Regulatory Provision

Summary - Intervention and impacts

Policy Background – Issue – Rationale for Intervention – Intended Effects

To address poor decision-making[1], we will set out more clearly the funding standards all Defined Benefit (DB) schemes will be required to meet, and the Pensions Regulator (TPR) will support trustees and sponsor employers through a revised DB Funding Code. To make sure that trustee boards take a more strategic and long term view, we will require all 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.

This impact assessment deals with the primary legislation needed to achieve the above. There will be subsequent secondary legislation which will, for example, prescribe factors to consider in establishing a long term funding and investment strategy.

Brief description of viable policy options considered (including alternatives to regulation)
We considered the following options:

Option 0: Do nothing
Leaving the system as it is would not deliver improvements to the scheme funding system. Funding standards would lack clarity, which would continue to lead to poor decision making, and TPR would continue to find them difficult to enforce. Although many schemes have a long-term strategy in place, evidence[2] suggests that a sizeable minority do not. As a result, members of these schemes would be at

[1] The Department's White Paper 'Protecting Defined Benefit Pension Schemes' identified that DB scheme funding outcomes are affected by poor decision making, short term thinking and a lack of accountability. https://www.gov.uk/government/publications/protecting-defined-benefit-pension-schemes
[2] Defined benefit trust-based pension schemes research summary report- Link and Global Pension Risk Survey 2017- Link

risk of poorer retirement outcomes because of poor decision making outside the scope of existing TPR powers.

Option 1: Making the DB Funding Code enforceable

Making DB Funding Code[3] enforceable would not resolve the problem of lack of clarity; giving statutory force to something that was already unclear would not achieve our aim of targeting poor decision making . In addition, TPR has already taken steps to support trustees' voluntary application of the Code, and this has not been enough to suggest that making it enforceable would be effective. We therefore determined to tackle the root cause by using primary and secondary legislation to deliver clearer funding standards, which will be reflected in a clearer Code in due course.

Option 2 (preferred option): Amend primary legislation to:

- give TPR stronger scheme funding powers to take action against trustees that do not comply with this new obligation;
- introduce a new regulation making power, to be used alongside existing regulation making powers to support clearer funding standards by clarifying "appropriateness" in secondary legislation;
- require trustee boards to explain their funding strategy in a new Statement that is to be submitted to TPR. The impact of this measure will be assessed once the content of the Statement is determined through secondary legislation (see IA on Chair/Statement[4]).

Preferred option: Summary of assessment of impact on business and other main affected groups

Impacts will be determined by the factors to be set in secondary legislation, and the long-term destination that is set by the trustee board. A Business Impact Assessment will be completed by TPR following their consultation to accompany the revised DB Funding Code (TPR call this a Business Impact Target). At this stage, we give a high-level assessment of possible business and other impacts.

We anticipate there to be minor familiarisation and implementation gross cost to business, partially offset by savings associated with improved clarity of the requirements. There are also expected savings as a result of a better funding position. The new requirement for trustees to set a long-term funding and investment strategy is not expected to have a significant impact on schemes and their sponsors who already have an existing obligation to meet their pension liabilities/promise. There may be some, relatively minor, implications on scheme servicing and associated costs.

Departmental Policy signoff (SCS): Joanne Gibson	Date: 12/03/2019
Economist signoff (senior analyst): Joy Thompson	Date: 14/03/2019
Better Regulation Unit signoff: Prabhavati Mistry	Date: 12/03/2019

Additional detail – policy, analysis, and impacts

Setting long-term strategy - costs and benefits to businesses

1. Background information – scheme liabilities; and scheme running strategies and objectives

Defined Benefit (DB) pension schemes pay a fixed amount of pension income to their members based on an employee's salary and years of contribution. Risks – including longevity risk and investment return risk - are born by the scheme and its sponsor (employer), not the member. A scheme's funding position is evaluated annually as required by legislation and submitted to TPR at least every three years.

A scheme's funding position is the difference between the assets the scheme holds and its liabilities (i.e. how much it is expected to have to pay out to its members). DB liability (and hence funding position)

[3] Code of Practice 03- Funding Defined Benefits Link
[4] See annex X for the IA on Chair/Statement.

estimates inherently carry an element of uncertainty as, for example, it is impossible to estimate future longevity or investment returns with certainty. There are a range of DB scheme liability measures, each designed and used for a specific purpose. They differ in the way the assumptions needed to assess scheme liabilities (like future investment returns) are made. The most relevant measures for the purposes of this impact assessment are the Statutory Funding Objective and the International Accounting Standard Nineteen (IAS19):

- Statutory Funding Objective (SFO): This is a 'going concern' assessment of whether the fund will have sufficient assets to meet its liabilities. This is the measure used by TPR to assess if a deficit repair plan (RP) is needed. The precise method of measurement and assumptions made varies from scheme to scheme according to the circumstances, but it is always prudent to some degree.
- IAS19 (also known as 'the accounting measure'). This valuation method is used when companies report their annual accounts. The methodology is set on a common basis to facilitate international comparisons.

More details of all four widely used valuation methods is set out in the Department's green paper 'Security and sustainability in Defined Benefit pensions' and in TPR's 'Understanding DB pension scheme funding' factsheet[5].

It is important to highlight that scheme liabilities are a product of the number of current and future members, the level of pension promised to them based on their contributions, their longevity (and other characteristics like family status), and future investment returns. However, liability estimates vary depending on valuation method used because most of these components are not known with certainty at present time and assumptions have to be made.

DB schemes may have different strategies and objectives regarding how they are run in longer-term (more detail and discussion can be found in the White Paper). Examples of an acceptable long-term strategy could be to:

- Run-on with employer support (for open schemes);
- Reach self-sufficiency with low-risk investment strategy and run-off with minimal call on the sponsor employer;
- Buy-out by a set time; or
- Enter a consolidator vehicle within an agreed timeframe.

The existing good funding practice, facilitated by TPR, already encourages schemes to have a long-term objective in place. However, it is not mandatory.

2. The baseline / counterfactual

Most DB schemes already have a long-term strategy in place. For example, according to TPR's DB Research 2018[6], 76% of trustees and 79% of employers responded that schemes closed to future accrual had in place a journey plan or long-term target; which leaves nearly a quarter that did not have an explicit long term-target. Surveys from pensions consultancies also tend to suggest that most schemes already have a long-term strategy. For example, according to Aon's Survey[7], which interviewed 185 schemes, only 5% to 10% (depending on size band) did not have a long-term plan (but note that Aon's clients may not represent the industry average).

Based on this evidence, we assume that 80% of DB schemes already have a long-term strategy in place (approximate midpoint between the 76% TPR research and 90-95% Aon Survey). As this is a point in time estimate, we also assume that there is a constant proportion in the counterfactual over time. This assumption is based on signals suggesting that although the proportions of schemes with different objectives have been changing over recent years, the proportion reporting no or unknown objectives stayed broadly similar (e.g. 6% according to Aon's survey 2015, and 8% according to Aon's survey 2017).

[5] Understanding DB pension scheme funding- Link
[6] Defined benefit trust-based pension schemes research summary report- page 5. Link
[7] Global Pension Risk Survey 2017- Link page 6.

However, as pointed out by TPR and referenced in the Department's White Paper, *schemes may well have a long-term plan but for some the plan may be largely aspirational and does not drive funding and Deficit Repair Contribution (DRC) commitment.* This means that some schemes may have a largely aspirational plan and will 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 (LTD) here.

3. Business impacts

The proposed option will require schemes to set a long-term destination, but it is for individual schemes to choose what is best for them (trustees to set it in line with the specific characteristics of the scheme such as its maturity[8], whether it is open or closed to future accrual and the financial strength of the employer). A regulation making power will allow for the factors to be considered by trustees when setting a suitable destination to be prescribed in secondary legislation.

3.1 Familiarisation and implementation costs.

There are 5,524 DB schemes in total. As set out above, we assume 80% already have a long-term objective in place. That means the remaining 1,105 schemes[9] will be directly affected by the requirement. As some schemes may have a largely aspirational plan, which does not drive scheme management and funding decisions, we make an assumption about the number of schemes with a funding and investment strategy that does not drive scheme management decisions. The percentage of schemes with a LTO that is only aspirational could be anywhere between 0% and 100%. In the absence of any certain information, we assume that half of those that already have an LTO have it as an aspiration – i.e. 2,210[10] schemes. Sensitivity analysis around this assumption is conducted below in section 3.1.1.

The exact requirements and guidance that will be available are not known at this stage. TPR will undertake an initial consultation[11] on making its Defined Benefit Funding Code of Practice clearer, focusing on how 'prudence' and 'appropriateness' can be defined to better balance employer commitments with risks to members and the Pension Protection Fund (PPF). The consultation will also consider what parameters are needed for meeting the SFO; and setting the technical provisions in the context of the scheme's funding and investment strategy (for example through a Code and guidance), as well as how trustees can best assess the SFO's robustness against external risks. This consultation will inform future changes to secondary legislation and lead to a revised DB Funding Code.

At this stage, before the consultation and exact requirements and guidance are agreed, we cannot estimate familiarisation and implementation (and other) costs with any certainty. As set out above, a full assessment will be provided for the secondary legislation stage and/or in TPR's Business Impact Target. For now, we give a broad illustration of potential and broad scale of impact only.

For the purposes of giving an illustration of familiarisation costs we assume the following:

- It will take half a day (4 hours) for a trustee to read through and 'absorb' the changes.
- Just one trustee from those schemes that already have a funding and investment strategy will need to familiarise (sharing the information with other trustees of the scheme is then assumed to be negligible).
- All trustees from those schemes that have none or just an aspirational LTO will have to familiarise;

There are 3.2 trustees per DB scheme[12], on average. Assuming an average hourly wage of a trustee of £28.50 per hour[13] and applying the figures and assumptions above gives an illustrative cost estimate for familiarisation at the secondary stage of £1.5 million[14].

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[8] Maturity level is the proportion of all scheme members that are current pensioners; the higher the proportion the more mature the scheme is said to be.
[9] = 5,524*0.20 = 1,105
[10] = ((5,524-1,105) x 0.5) = 2,210
[11] Sections 90 and 91 Pensions Act 2004
[12] Trustee Landscape Quantitative Research 2015- Estimate based on Figure 3.2.3 Number of trustees by scheme size. Link, page 14.
[13] The median hourly wage for a corporate manager or director is £22.44 in the Annual Survey of Hours and Earnings 2017 revised, Table 2.5. This is uplifted by 27% for overheads from the archived Green Book. Link
[14] Calculation: (1,105+2,210) x 3.2 x4 x £28.50 + (2,210) x 1 x 4 x £28.50 = £1,460,926

Those that do not already have a long-term destination or set their statutory funding objective with a long-term destination in mind will need to do this. This may involve trustee negotiations with their sponsoring business, as well as seeking advice from scheme actuaries and / or external consultants. Associated costs are expected to vary on a scheme-by-scheme basis – from negligible for those that already have a clear strategy and just need to formalise it, to potentially material for those that are currently applying a short-term approach to scheme management (focused only on the next triennial review). At this stage, we cannot quantify the funding and investment strategy setting costs due to scheme specific nature and significant uncertainties involved. TPR will consult before any changes to the DB Funding Code are made, and will produce a Business Impact Target. As mentioned in the Department's White Paper, TPR's initial view based on their experience is that *the governance costs of setting a long-term objective will be relatively low for those already adopting good practice and applying the principles set out in the DB funding code*[15].

3.1.1 Familiarisation/Implementation Cost- Sensitivity Analysis

We have arbitrarily assumed that 50% of the schemes with an LTO have it as an aspiration rather than firm commitment. If all schemes with an LTO were to have this as an aspiration rather than firm commitment, all 5,524 schemes would have to go through the full familiarisation process with all trustees reading through and transposing the requirements. In this worst-case scenario, the total familiarisation cost to businesses would be approximately £2 million[16]. However, if all schemes with an LTO currently have it as a firm commitment, then only schemes who do not have an LTO currently would have to complete the full familiarisation process. As discussed above we assume 20% of schemes do not have an LTO currently, and therefore only 1,105 schemes would have to go through the full familiarisation process. This would result in total familiarisation costs of £0.9m[17].

3.2 Ongoing costs and benefits.

As set out above, having a long term funding and investment strategy in place will not alter the schemes' underlying pension liabilities. However, it may have some implications on scheme servicing and associated costs. Broadly speaking, clearer funding requirements, including LTD, may have the following implications on some schemes:

1) Scheme liability estimates and associated contributions.

Any estimates of scheme liabilities and hence net funding position inherently carry a degree of uncertainty (irrespective of the long-term destination that is chosen). Those schemes that are currently targeting artificially low pension scheme liabilities and / or inconsistently with their long-term objective may need to revise their approach as a result of the proposed changes. In some cases, the change in the valuation may lead to a higher estimated deficit (of the scheme). The higher estimated deficit may in turn lead to higher DRCs required by TPR. This does not change the real (underlying) pension liability; but it alters the way the scheme is being serviced. In essence, in this situation, some contributions into the scheme are brought forward, but the overall funding requirement over the scheme's lifetime is not altered. However, applying time-discounting (as required by the HMT's Green Book) to cash flows means there may be some cost to business from contributions brought forward even if the overall scheme's lifetime gross servicing cost remains unaffected.

However, in some cases the scheme funding (and hence business cost) impact may be the opposite. Current lack of clarity in funding requirements and the scheme's long-term objective means there is a risk that in some cases schemes may be applying overly cautious assumptions for the purposes of their valuations leading to artificially inflated deficit estimates and associated costs. The requirement to have a specific long term funding and investment strategy and clearer funding standards more generally may lead to some savings for those schemes.

The extent of these impacts and the net position is highly uncertain. Throughout our engagement with TPR and the pensions industry, we have heard different views. Some views suggested that in some cases there

[15] Protecting Defined Benefit Pension Schemes (White Paper- March 2018) Link, page 57.
[16] = 4*3.2*28.50*5524 = 2,015,070
[17]= (4*3.2*28.50*1,105) + (4*3.2*28.50*4,419) = 906,782

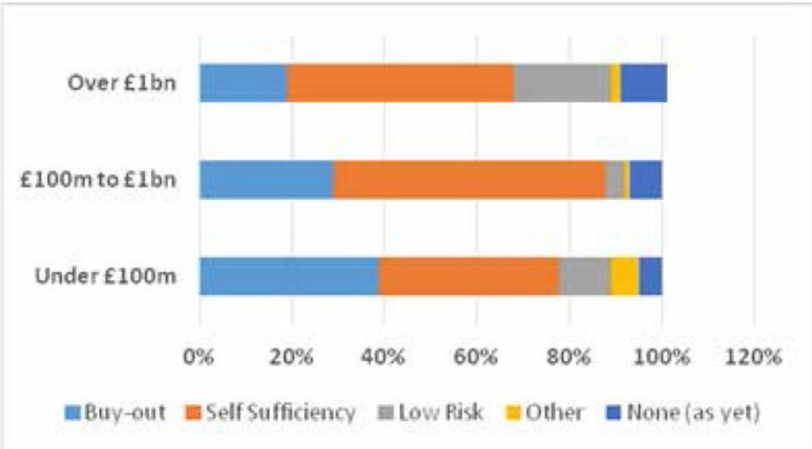
is likely to have been insufficient prudency in the assessments of scheme funding position (which would imply a cost to business as a result of this legislation). On the other hand, we have heard some views, explicitly or implicitly, that in some cases there may be excessive prudency (for example, a publication by First Actuarial[18] says that *there is plenty of prudency already in the system)*. Due to this complexity and because at this stage the exact requirements are not known we do not quantify these impacts.

In any case, clearer requirements are expected to reduce the amount of time and resources schemes need to invest in understanding what is required from them.

2) A change in the scheme's chosen investment strategy.

The proposed option will not require schemes to set a particular objective. It will only require schemes to have an objective, but it is for individual schemes to choose what is best for them. Existing evidence shows that many schemes are already considering different objectives depending on their scheme specific circumstances – see figure 1 below.

Figure 1. Distributions of long-term objectives by scheme sizes.



Source: Aon, Global Pensions Risk Survey 2017[19]

Once the requirement to set a long term funding and investment strategy is implemented, some schemes may need to revise their funding and investment strategies in order to achieve this destination. We expect that they will only choose a particular objective if, on balance, it is better than their second best alternative.

In the baseline, there is an option for schemes to not have an objective at all. Those schemes without an objective are implicitly taking one of the possible paths but this is not expressed explicitly and therefore not accounted for in scheme running decisions. After the proposed changes are implemented, when a long term funding and investment strategy is mandatory, those schemes will have to take account of their end goal in their scheme running decisions. On this basis, we expect a long term funding and investment strategy to lead to a better considered and fit for purpose funding and investment strategy which could potentially result in efficiency savings to the scheme. This would in turn benefit members as they are more likely to receive their benefits in full. We do not quantify this impact given the lack of evidence and level of uncertainty.

3.3 Indirect impact – potential company balance sheet and credit rating impacts.

As set out above, there may be some schemes that will see an increase in their estimated DB pension liability as a result of the proposed requirement for a long-term destination, together with proposals to define more clearly key terms such as "prudence" and "appropriateness" in secondary legislation. However, when it comes to company balance sheets, the overarching DB liability measurement standard is IAS19 – which is based on a standardised set of assumptions for schemes. We anticipate

[18] First Actuarial Report- Link
[19] Aon Global Pension Risk Survey 2017- UK survey findings. Link page 6.

that this should not affect the IAS19 based deficits since it is based on standardised assumptions that are not likely to be affected by the changes.

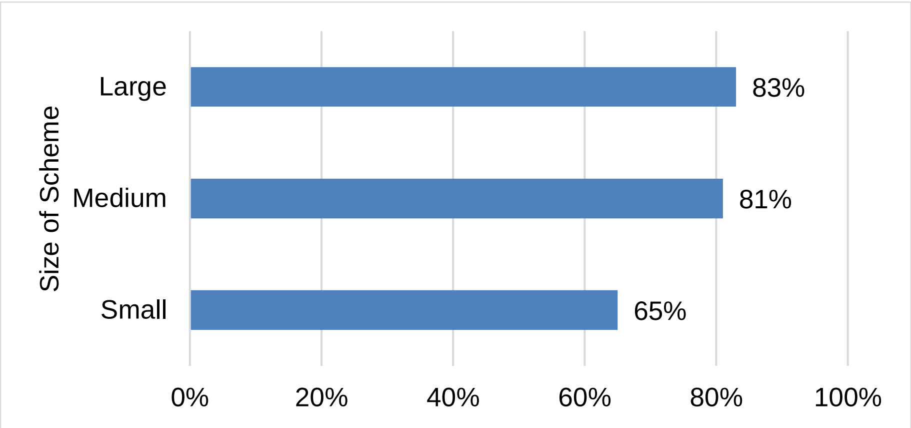
4. Costs and benefits to scheme members

There will be no costs to members as there will be no need for them to familiarise with the changes or implement them. The requirement is aimed and designed to improve scheme governance and decisions making, which in turn is intended to make scheme running more efficient, economically viable, and secure. Better scheme governance is anticipated to improve the security of members' pensions – i.e. to increase the likelihood of members ending up getting their pensions paid in full. It is not deemed proportionate to monetise this benefit.

5. Small and Micro Business Assessment (SaMBA)

The costs to business fall on funded (private sector) DB pension schemes. As shown in the figure below, small and micro schemes are less likely to be compliant and as a result, are more likely to incur costs because of the proposed changes. In the case of DB schemes, these costs will be passed on to their sponsoring employers. Therefore, businesses that sponsor small schemes are more likely to incur a cost because of the proposed change. As such, it is possible that small and micro businesses that sponsor small DB pension schemes may be affected.

Figure 2: Proportion of trustees that reported having an aim for journey plan, by scheme size[20].



Source: TPR Defined benefit trust-based pension schemes research summary report.

It is important to note that DB schemes are predominately of medium or large sizes. As shown in the table below, 36% of DB schemes have less than 100 members and are therefore considered to be small. The proposed changes are expected to have a disproportionate impact on small schemes, however, these schemes make up a smaller proportion of DB schemes in total.

Table 1: Estimated numbers of DB schemes split by size of scheme[21].

Size of Schemes (The number of members)	Estimated 2018 Universe
2-99	1,985
100-999	2,411
1,000-4,999	759
5,000-9,999	171
10,000+	198
All	**5,524**

[20] Defined benefit trust-based pension schemes research summary report- page 24. Link
Small: 12-99 Members, Mid-sized: 100-999 Members and Large: 1000+ Members
[21] The Purple Book 2018- Link , page 12.

However, assessing the impact of the proposed changes here on this group is difficult. As it is not necessarily the case that small and micro pension schemes correspond to small and micro businesses. For example, large firms may run a DB scheme with only a few members. Similarly, small employers may enter their staff into a large DB scheme (as it is possible for a DB scheme to be sponsored by more than one employer). As this legislation will affect schemes depending on their compliance with the requirements in the baseline and small schemes are less compliant it is likely that employers that sponsor small schemes are likely to be disproportionately affected. There is currently no robust evidence to link pension scheme size to employer size and so it is difficult to accurately assess the impact on small and micro businesses.

There is information in the Annual Survey of Hours and Earnings (ASHE) data set on the size of DB sponsoring employers with active members. This will only include those who are contributing to a DB pension so will exclude members who are in schemes closed for future accrual but it helps to provide an indication of the size of DB sponsoring employers. The table below shows the proportion of private sector and not for profit active DB members by employer size.

Table 2: Proportion of active DB members, by employer size[22]

Size of Employers	**Proportion of DB members[23]**
0	0%
1-9	2%
10-49	10%
50-99	4%
100-499	14%
500-999	9%
1000+	61%
All sizes	**100%**

This information above provides evidence that the majority (88%) of active DB members are employed at businesses with more than 50 employees. However, there is no information on the business sizes where there are no longer active members and this doesn't provide information about the size of the scheme that the members are in. But it does provide an indication that the majority of DB sponsoring employers are medium or large employers.

6. Monitoring and Evaluation

We will work with TPR and the industry in order to understand and review the post implementation impact.

[22] Source: DWP estimates derived from ONS Annual Survey of Hours and Earnings (GB)
[23] Figures are rounded to the nearest 1%.

Table 3: Estimated Direct Cost to Business

	Scheme Volumes	Cost[24]	How often?	Assumptions
Familiarisation (Central Estimate)	5,524	1,460,000	One-off	All trustees[25] have to familiarise. Hourly wage of a trustee is £28.50. For those without an LTO or only an aspirational LTO it will take four hours to familiarise and transpose the regulations. Approximately 80% of schemes have an LTO. Arbitrarily assumed that 50% of those with an LTO have it as an explicit target. Those with an LTO as an explicit target only take 1 hour to familiarise.
Familiarisation (Lower Estimate)	5,524	910,000	One-off	All trustees have to familiarise. Hourly wage of a trustee is £28.50. For those without an LTO or only an aspirational LTO it will take four hours to familiarise and transpose the regulations. Approximately 80% of schemes have an LTO. Arbitrarily assumed all those with an LTO have it set as an explicit target. Those with an LTO as an explicit target only take 1 hour to familiarise.
Familiarisation (Upper Estimate)	5,524	2,020,000	One-off	All trustees have to familiarise. Hourly wage of a trustee is £28.50. For those without an LTO or only an aspirational LTO it will take four hours to familiarise and transpose the regulations. Approximately 80% of schemes have an LTO. Arbitrarily assumed that none of the schemes with an LTO have it as an explicit target. All have to do full four hours of familiarisation.

[24] Costs all rounded to the nearest 10,000.
[25] Used the average number of trustees (3.2) for this.