

Proposed draft changes to the Occupational Pension Schemes (Investment) Regulations 2005 (with related changes to primary legislation)

1 Introduction

- 1.1 This paper accompanies proposed draft amendments to the Occupational Pension Schemes (Investment) Regulations 2005, as amended (the **2005 Regulations**) which clarify issues relating to fiduciary duty and relevant investment factors. A change is also proposed to primary legislation (the Pensions Act 1995 by way of an amendment in the Pension Schemes Bill 2025) to enable and support the proposed amendments to the 2005 Regulations. The Pension Schemes Bill amendment would also require corresponding rules to be made for workplace personal pension schemes and the local government pension scheme.
- 1.2 The policy rationale for the proposed changes will be outlined separately. The purpose of this paper to outline how the proposed legal drafting works.
- 1.3 References to a “Regulation” are to a provision of the 2005 Regulations unless otherwise stated.

2 Structure

- 2.1 By section 36(1) of the Pensions Act 1995, nearly all occupational pension schemes have a statutory duty to invest in accordance with regulations.¹
- 2.2 Pursuant to this section, Regulation 4 of the 2005 Regulations lists a number of mandatory factors which in-scope pension schemes must follow when investing – see Regulation 4(1). These include, for example:
 - 2.2.1 The assets must be invested in the best interests of members and beneficiaries and, in the case of a potential conflict of interest, in the sole interest of members and beneficiaries – Regulation 4(2) or Regulation 4A in relation to a DC default arrangement.
 - 2.2.2 The powers of investment, or the discretion, must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole – Regulation 4(3).
 - 2.2.3 The assets of the scheme must consist predominantly of investments admitted to trading on regulated markets – Regulation 4(5).
 - 2.2.4 The assets of the scheme must be properly diversified – Regulation 4(7).
- 2.3 The proposed draft legislation adds further provisions to Regulation 4, either specifically or by defining existing concepts that are not currently defined within the 2005 Regulations.
- 2.4 In effect, the draft legislation adds new “relevant factors” for schemes to adopt within investment decisions, at varying levels of legal compulsion. The result would be that in-scope schemes would, as appropriate, take the new factors into account as factors alongside the existing provisions when

¹ Occupational pension schemes with fewer than 100 members are exempt and there is a partial disapplication for schemes being wound up – see Regulations 7 and 9 of the Occupational Pension Schemes (Investment) Regulations 2005.

carrying out investment and stewardship or engagement activities in line with their duty under section 36(1) of the Pensions Act 1995. Some schemes may already be addressing one or more of the new relevant factors as a result of considering them based on an understanding of the current law and commentary. In these cases, the substance of the scheme's position is not changed: the new language simply puts existing practice onto a legislative footing for the future.

- 2.5 However, the new factors are only mandatory where they are financially material. In other situations (and in all cases where the factor is member views), they are permissive.
- 2.6 The draft legislation does not specify particular actions or decisions that must flow from considering the new factors alongside the existing ones under Regulation 4. It is left for schemes, following a proper decision-making process, to decide their own course of action provided it complies with the law.
- 2.7 The proposal envisages that the above changes would be delivered through secondary legislation which amends the 2005 Regulations.
- 2.8 There is an accompanying draft clause for primary legislation that would, if enacted, (i) require the Government to make the amending regulations within one year of the primary legislation receiving Royal Assent and (ii) allow the Government to issue statutory guidance to support schemes with their compliance with the investment regulations. Statutory guidance is expected to have an important role to play in assisting schemes with implementing the Regulations.

3 Defined terms

Regulation 1 – new defined terms added

- 3.1 Paragraphs (a) and (b) of the draft introduce two key defined terms into the list of definitions in Regulation 1: “appropriate time horizon”; and “system-level considerations”. These definitions are outlined below.
- 3.2 Later in the draft, in the changes to Regulation 2, paragraph (b) makes a minor consequential drafting change to delete the definition of “appropriate time horizon” from within Regulation 2(4), because that term is replaced by the new definition of appropriate time horizon in Regulation 1 mentioned above.

4 Appropriate time horizon

- 4.1 Save for member views, all of the new factors operate by reference to the “appropriate time horizon”. This is newly defined as what the trustees consider to be the expected remainder of the lifetimes of members and beneficiaries of the trust scheme while benefits that are or were attributable to the trust scheme will be payable.
- 4.2 This concept has been included in response to feedback on earlier drafts of the proposed amendments, which indicated that it would be important and useful to make it clear that when taking investment decisions, trustees are able to consider relevant issues by reference to periods up to and including the very long-term. Consistent with the purpose of the trust, the appropriate time horizon is limited, in effect, to the expected duration of benefit payments to beneficiaries.
- 4.3 The language is not intended to be prescriptive about how each scheme determines the length of the appropriate time horizon, or to require detailed analysis on this point, though it is expected that trustees would give this question proper consideration in line with their decision-making duties under general law. Some trustees may choose to take professional advice. Statutory guidance issued

under the proposed enabling provision in the primary legislation could be provided on this point if helpful.

- 4.4 It is important to note the definition of appropriate time horizon does not mean that trustees have duties to act beyond the term of their trust (e.g. after winding up) or to prolong the life of the trust. It simply prescribes a long-term time horizon (the future) to which trustees should have regard when carrying out investment activities in the present. Thus, for example, where a DB scheme is contemplating transfer to another provider or securing DB liabilities with insurance and then winding up in the nearer-term, trustees should, at the time of selecting a receiving provider, consider how long-term issues over the appropriate time horizon and after transfer to the provider would influence their choice of, and engagement with, a provider. But it does not require the trustees to continue managing issues after the transfer has been completed and/or their trust has wound up. In other words, trustees are always acting at a point-in-time (the present) by making asset allocation or investment strategy decisions or carrying out stewardship or engagement, and the effect of “appropriate time horizon” is that they should have regard to the long-term “appropriate time horizon” (the future) when deciding how to act in the present.

5 Optional factors

Regulation 1 – new paragraph (2A) inserted

General notes

- 5.1 This paragraph introduces optional factors that trustees of a trust scheme may take into account, amongst other matters, when they are considering what is in the best interests of members and beneficiaries for the purposes of investment, under Regulation 4(2) (or 4A). This aspect of the draft is an interpretive provision concerning the term “best interests”, which is already used within the 2005 Regulations without being defined. So, because Regulation 1 covers matters of interpretation, the language is added as a new Regulation 1(2A).
- 5.2 The list of optional factors within the draft is permissive and non-exhaustive, so it neither requires trustees to take account of the listed matters nor prevents them from taking into account other factors relevant to members’ best interests in relation to investments.
- 5.3 The listed optional factors reflect key matters which are capable of being relevant to the pension scheme’s purpose of delivering benefits which provide financial outcomes for members in retirement. The drafting permits trustees to take such factors into account. It does not require trustees to apply any additional tests or criteria before taking account of a particular issue. The inclusion of these criteria in a permissive manner means that where trustees wish to take them into account but are unable to establish direct financial materiality at proportionate cost, the trustees are not required to go on to carry out the much-discussed two-stage test for non-financial factors. Rather, where trustees follow a proper decision-making process in line with the general law, this would be sufficient.
- 5.4 Three of the four optional factors are considered by reference to the appropriate time horizon, discussed at 4 above.

Optional factor (1) – system-level considerations

- 5.5 System-level considerations are given a specific definition in Regulation 1. They are, over the appropriate time horizon, risks and opportunities relevant to the scheme that:
- 5.5.1 cannot be fully managed through diversification alone; and

- 5.5.2 arise from circumstances at the level of one or more economic sectors, financial markets or economies, including but not limited to those relating to environmental or social matters.
- 5.6 The definition requires system-level considerations to be relevant to the scheme. This means relevant to the scheme's proper legal purpose of providing beneficiaries with the benefits they are entitled to. The reference to circumstances at the level of one or more economic sectors, financial markets or economies is intended to ensure that the definition captures such issues from the perspective of their macro financial or economic implications, broadly understood.
- 5.7 Relevance has been selected as the appropriate general legal threshold for system-level considerations because this is the fundamental legal criterion around which trustee decision-making is based in law. For completeness, some schemes may already be addressing some system-level considerations having received legal advice about the concept of "financially material factors" as developed by the Law Commission in 2014 and considered in subsequent legal commentary, for example in relation to some sustainability issues. Where system-level considerations are financially material, further provision applies under the regulations – see 6 below.
- 5.8 Thus, it remains for trustees to decide which system-level considerations are legally relevant to their scheme (as outlined above), and to prioritise among them. Statutory guidance could elaborate upon this.
- 5.9 Some system-level considerations may be sources of investment opportunity as well as risk, and this is captured within the definition (though arguably opportunities are a natural consequence of management of risk).
- 5.10 A common theme for identifying system-level considerations is that they cannot be fully managed by schemes diversifying investments to move towards or away from them. As noted below (see 6.3), diversification may provide a partial response in practice, but the legislation contains flexibility to allow other steps to be taken.
- 5.11 This definition is deliberately broad because existing system-level considerations can evolve over time, new considerations may emerge, or current ones may recede. The definition acknowledges that environmental or social matters may be system level considerations.
- 5.12 System-level considerations should be considered by reference to the appropriate time horizon. The appropriate time horizon is discussed in 4 above.

Optional factor (2) - external impacts

- 5.13 The second optional factor is the reasonably foreseeable impacts over the appropriate time horizon of the assets or organisations in which the trust scheme invests upon financial systems, the economy, the community and the environment over the appropriate time horizon.
- 5.14 This complements system-level considerations by providing a permissive basis for trustees who wish to do so to take account of the impact of the scheme (through the assets in which it invests) upon wider forces in the real world that affect members' and beneficiaries' broader best interests in receipt of their benefits over the appropriate time horizon.
- 5.15 Reasonable foreseeability is included as a legal check so that such potential impacts must not be taken into account if they are irrational, but neither is there a risk of trustees being in breach of this provision for failing to take account of something that could not reasonably have been foreseen. Statutory guidance would expand further on how to approach this from a scheme perspective,

recognising that individual asset- or entity-level assessment may often be unlikely in practice, and that narrative approaches may be more practical and accessible than data, at least in the short-term.

- 5.16 Where external impacts are financially material, further provision applies under the regulations – see 6 below.

Optional factor (3) – impacts for beneficiaries

- 5.17 The third optional factor is the reasonably foreseeable impacts over the appropriate time horizon of assets or organisations in which the trust scheme invests upon members' and beneficiaries' standards of living; and health and social and economic well-being, in each case as determined by the trustees. It is acknowledged that some schemes may already consider beneficiary standards of living as a financially material factor: this approach remains permissible under the proposed drafting.
- 5.18 It is expressly for the trustees (subjectively) to form a view on members' and beneficiaries' standards of living or their health and social and economic well-being. Beneficiaries may have diverse interests and be affected by different issues in different ways, whereas the trustee thought process here aims at reaching an overall assessment for the generality of members and beneficiaries.
- 5.19 Similarly to the second optional factor, this provision enables but does not require schemes to consider reasonably foreseeable impacts of their investment activities upon members' broader best interests in receipt of their benefits. The provision is flexibly drawn and, again, it is envisaged that it would be supported by statutory guidance covering practice and the role of narrative judgment.
- 5.20 For example, the provision could enable trustees who wish to do so to consider, based on either narrative or quantitative information, whether a strategy for asset allocation or stewardship could help mitigate, directly or indirectly, risks to the purchasing power of the generality of benefits in payment from structural themes such as long-term underinvestment across the economy (through reasonably foreseeable real-world impacts of those structural themes such as sustained high inflation, disruption to food supplies or lack of access to housing or effective healthcare).
- 5.21 Where these issues are financially material, further provision applies under the regulations – see 6 below.

Optional factor (4) - views

- 5.22 The fourth optional factor is the views of the members and beneficiaries (including but not limited to their views in relation to the social or environmental impacts of the assets or organisations in which the trust scheme invests). This factor is always optional: the further requirements outlined in 6 below do not apply to it..
- 5.23 Statutory guidance may emphasise that this could be particularly relevant to money purchase and CDC benefits where beneficiaries have a more direct stake in how pension accounts are invested, and may be less applicable or less widely adopted for DB benefits.
- 5.24 The provision is largely self-explanatory, and it is permissive because it is recognised that not all schemes will be equipped to undertake an exercise in this area. Rather the provision is designed to assist schemes with the appetite and resources to take member views into account by providing an express legal provision that allows this to be done. Currently there is significant debate about the extent to which member views may be taken into account by trustees when investing. As noted above, the regulations deliberately do not replicate the widely discussed two-stage test for non-financial factors as a precondition for taking member views into account.

- 5.25 The provision is deliberately left flexible as to how member views may be obtained, and as to questions such as what level of consensus may need to be apparent among beneficiaries. It would be important for schemes to be clear with members about the potential financial implications when seeking their views. And, for example, if a higher risk to financial outcomes is expected if member views are taken into account, it would be logical to expect a higher level of member support for the view. Statutory guidance could indicate how schemes, in practice, may seek member views and take them into account in decision-making. This may include placing some previous influential commentary in this area (such as that produced by the Law Commission) onto a statutory guidance footing.

6 Mandatory factors: financial materiality

Regulation 4 – new paragraphs (3A) and (8A) inserted; and Regulation 2 – paragraph (3) amended

General notes

- 6.1 The draft language makes amendments to Regulation 4. Paragraph (a) of these amendments inserts a new Regulation 4(3A) stating that the powers of investment, or the discretion, must be exercised in a manner that considers and manages the first three optional factors above where they are financially material. In other words, where trustees establish that one or more of these three optional factors is financially material, it ceases to be optional and the trustees have a duty to use their powers in order to consider and manage it as a financially material issue. At its core the provision exists as a positive prompt to schemes to think about and act upon broader issues over the appropriate time horizon in relation to their investments where financially material.
- 6.2 This is a new mandatory consideration under the 2005 Regulations, with the same status as the other mandatory considerations already listed in Regulation 4.
- 6.3 For schemes that already treat system-level considerations and other relevant issues such as effects upon members' standards of living as financially material factors and act accordingly, the substance of their position is not changed by the new language (or to put it another way, they would already be complying with the regulations as amended). The draft legislation puts the approach on a legislative footing and provides a strong signal that schemes should likewise engage with the relevant issues and consider financial materiality.
- 6.4 Supplementing the above, paragraph (b) of the draft amendments to Regulation 4 inserts a new Regulation 4(8A). This provision aims to make it clear that the reference to the use of the investment power or discretion to consider and manage one or more of financially material factors encompasses the carrying out of stewardship or engagement activities (within the meaning of Regulation 2(3)(c)) in addition to allocation, investment or disinvestment decisions in exercise of the investment power. This is because whilst asset allocation decisions may provide a partial response to some system level considerations, it is anticipated that stewardship and engagement will be important tools for the management of system-level considerations, which by definition cannot be fully managed by diversification of the portfolio. Regulation 2(3)(c) is not exhaustive as to the types of stewardship or engagement activities that may be carried out, and this could include public policy engagement or collaboration among schemes and industry bodies to liaise with Government. It may be appropriate to flag this point in statutory guidance.

Requirement to consider and manage

- 6.5 The draft legislation envisages that in-scope schemes will actively engage with the specified factors where they are financially material, through a requirement for trustees to exercise the investment power in a manner that "considers and manages" them.

- 6.6 The word “considers” conveys that schemes must actively think about the issues, for example in discussion with advisers.
- 6.7 The word “manages” does not mean that financially material issues must be “addressed”, “resolved” or “removed” altogether. Rather, “manages” connotes taking some effective step(s) or making a careful decision about an issue. Schemes are already familiar with the general concept of managing (but not removing) risks in diverse areas of scheme activity. Examples include climate risk management for schemes that are subject to duties under the Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021, as amended; and risk identification, evaluation and controls on various issues including cybersecurity, administration and service providers as part of the effective system of governance and internal controls under section 249A of the Pensions Act 2004 and the Pensions Regulator’s General Code of Practice.
- 6.8 The draft legislation therefore envisages that schemes will take positive action, through their investment decisions including stewardship and engagement, in relation to the specified factors they have identified as financially material. The draft legislation does not prescribe in detail what steps should be or when they should be taken. This is similar to the position for the existing mandatory factors in the Regulations such as the requirements for liquidity and diversification. It would be for each scheme to decide the steps it should take. It is envisaged that statutory guidance should provide practical examples and indications of a proportionate approach.

SIP

- 6.9 Amendments to Regulation 2(3), which sets out the required content for a scheme’s Statement of Investment Principles, will require in-scope schemes to include the specified factors, where they are financially material, within their existing statement of their policy on financially material considerations in the SIP.

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