Institute and Faculty of Actuaries

March 2023

IFoA response:

Defined Benefit Funding Code and Fast Track consultations

The Institute and Faculty of Actuaries (IFoA) is a royal chartered, not-for-profit, professional body. We represent and regulate over 32,000 actuaries worldwide, and oversee their education at all stages of qualification and development throughout their careers.

The Institute and Faculty of Actuaries (IFoA) is pleased to submit feedback on the Pensions Regulator's defined benefit Funding Code and Fast Track consultations.

Within the actuarial profession we have experts in technical detail, executives in small and large financial institutions, and practitioners working within the financial system itself. Our outlook is rooted in our Royal Charter (dating back to 1884) and in our long history of working with policymakers to effect change. We focus forwards on how we can help individuals and organisations solve financial and risk-related problems in the 21st Century.

If you have any questions on the response, please contact Caolan Ward (caolan.ward@actuaries.org.uk) in the first instance.

The IFoA strongly believes that the scheme specific nature of the current funding regime is a real strength, and we are keen to see this maintained. We are therefore supportive of the flexibility that the Pensions Regulator (TPR) has incorporated into the draft Code, for example in the requirements for low dependency funding and investment targets, as they allow this more scheme specific approach, where justified.

We are also very supportive of the separation of the Code and the Fast Track guidance. However, for the Regulations and Code to be workable and implementable by trustees, there are still a number of issues that need clarification and consistency between the Regulations and the Code. In addition, we believe there are some points that require further consideration in the Regulations themselves as well as in the Code.

In particular, we would like to see amendments to or clarifications on the following, and have also raised these in our response to DWP's recent consultation on the draft Regulations where applicable:

1. The calculation of duration and hence the relevant date
2. Covenant assessment, and the role of covenant and contingent assets after significant maturity
3. Low dependency investment and funding requirements in the Regulations
4. Clarity on requirements for schemes already at/after significant maturity
5. Clarity on the approach for stressed schemes
6. Clarification of the content of parts 1 and 2 of the Statement of Strategy, in particular as regards the description of the journey plan in part 1 versus part 2 and how this impacts the balance of powers between trustees and sponsors.

We know there are some areas where TPR and DWP are continuing to discuss the policy intent (notably the calculation of duration, the definition of low dependency and the requirements for schemes already past their relevant date at the time of implementation), and to this end, it is essential that the final Regulations and Code work together. Ultimately, trustees need to comply with the law, not the Code, so the Code cannot be used to work around gaps and lack of clarity in the law.

The IFoA strongly urges both parties to seek some industry review of both the regulations and the final Code before finalising the new regime, even if that is informal.

We have set out below further details on some of the key areas of the draft Code and have provided detailed responses to the consultation questions in the attached response.

Duration

We agree that a duration calculation to determine significant maturity is the most appropriate approach, as despite some reservations on this method we think alternative approaches would also have drawbacks. However, we are very concerned that the current requirement, which depends on current market yields, leads to a volatile and constantly moving date (as the changes over the last 18 months have shown). This is unworkable for schemes who are trying to plan, monitor and manage their scheme Journey Plan.

We welcome the recognition by TPR and DWP that this is an area that may need to be revised in the final Regulations. Of the alternative options set out in the consultation document, our preference would be for a fixed yield approach with assumptions chosen that would lead to outcomes not dissimilar to adopting a 12 year duration based on the 31 March 2021 conditions we understand TPR previously used in its analysis. We also note that if the approach used is to continue to be based on current yields, then a duration of 12 years for significant maturity is too long, resulting in many, if not most, schemes having a relevant date earlier than currently planned and earlier than the date they currently expect to reach maturity and fund on a low dependency basis.

Clarity of TPR's expectations in fast track guidance

Whilst we strongly support TPR's approach of not trying to define every parameter and assumption in Fast Track and view the flexibility included as helpful, there are some areas there are some areas we have identified where further clarification would be helpful to ensure Scheme Actuaries and trustees understand the policy intent:

1. Clarity regarding the inclusion of expense reserves for the Fast Track tests
2. Clarity on the allowance for commutation in Fast Track. We understand from TPR that the intention was to allow for commutation in Fast Track consistently with the allowance in the Funding Code, but this needs to be clearly articulated in the Fast Track guidance.
3. Treatment of insurance policies (e.g. buy-ins) where the benefits are still in the name of the trustees. We understand from TPR that the intention was to include insured assets (i.e insurance policies) and the associated liabilities in the duration calculation and the investment stress test. Again, this needs to be clearly articulated.

Actuarial confirmation under Fast Track

For Fast Track, where the scheme actuary will need to confirm the tests are met, the code needs to be very clear about exactly what it is the Scheme Actuary is confirming. In principle, the IFoA is supportive of, and can see the merit in, asking Scheme Actuaries to confirm the Fast Track tests are met, and we see no reason why this couldn't be made to work. However, it should also be clear what the confirmation covers, and, importantly, what the Scheme Actuary is not taking responsibility for, by clearly distinguishing between a mechanical role in assessing the three tests, and the separate elements of trustee judgement included in the calculations (for example, the choice of allowance for mortality and commutation).

It should also be made clear that confirmation by the Scheme Actuary that Fast Track tests are met does not mean that the Scheme Actuary necessarily agrees that the choice of Fast Track is appropriate for the scheme or in the interests of scheme members. The IFoA would be keen to work with TPR to agree the terms of the actuarial confirmation, including regarding the format and any necessary caveats that can then be used by Scheme Actuaries. Without these clarifications, there may be a reluctance on the part of Scheme Actuaries to provide the necessary confirmations.

Small schemes

The draft Code and the Fast Track document have various references to *small schemes* and *smaller schemes*, and *schemes with less than 100 members*. We would encourage the use of consistent terminology throughout, along with more guidance on proportionality for smaller schemes (in the general sense, as opposed to 'less than 100 member' schemes).

The Code needs to work proportionately for smaller schemes in order to avoid disproportionate prudence and disproportionate compliance costs, as well as to recognise that smaller schemes may find it more difficult to comply with the low dependency investment allocation requirements, both through lack of access to suitable asset classes and due to lower cashflow predictability, as they are far more subject to idiosyncratic risk through individual member experience.

We have concerns that, as drafted, even the minimum requirements for smaller schemes will be very challenging for trustees and sponsors to meet. Also, a wider range of schemes than just those with less than 100 members should be allowed to use approximate rather than full yield curve approaches where the costs or practicalities of using full yield curves are prohibitive, otherwise it could be detrimental to member outcomes.

We welcome the comments around proportionality throughout the consultation document and in particular around the statement of strategy requirements, but the details of how this will be applied in practice will be key to making this a success.

As an organisation we represent many members who work with small schemes as scheme actuaries and would be happy to share our experience and engage with TPR on how best to make the requirements of the Code work for small schemes.

Expenses

For the Code (as opposed to Fast Track), we believe it would be appropriate to allow trustees some judgement about any reliance on the sponsor to continue paying expenses after the period of covenant reliability (particularly, for example where the trustees believe covenant reliability extends for more than the medium term envisaged by TPR, and where, in practice, the sponsor currently meets most or all expenses and has indicated a willingness to continue to do so). Again, TPR could choose to allow less scope for judgement in Fast Track, and this would help to pin down the actuarial confirmation of the tests being met.

Covenant

We note that determining covenant reliability requires a difficult judgement (by not just the trustees and TPR, but also for experienced covenant advisers). We have concerns about being too prescriptive about this because under the draft Code it becomes a cornerstone for the journey plan and determines maximum risk taking, and so is a key part of the decision-making.

We expect the ECPA will need to input on this, as some of the concepts are new, and the implications in funding terms are even more so. There is a concern that ranges will be provided by covenant advisers, but that TPR will expect the shorter end of the range by default (which could put pressure on covenant advisers to be less prudent and/or leave trustees still having to exercise and justify significant judgement).

There is also some concern about TPR framing covenant reliability as ‘medium term’ and not more than 6 years, which won’t always be appropriate. We see genuine challenges here at both ends of the spectrum – very short reliability and very long.

Clarity of the FIS, and parts 1 and 2 of the SoS

Given the requirement for employer agreement for part 1, it is important to clearly distinguish between contents required for parts 1 and 2. In particular, it is unclear to us in the draft Regulations what level of detail on the journey plan is required in Part 1. A possible interpretation is that the Part 1 requirements are simply for high level principles of the journey plan, i.e. maximum risk and liquidity constraints, with all the detail then to be covered in Part 2. This interpretation is, to us, consistent with the stated policy intention that the current trustee investment powers are not changed by the new regulations. However, as drafted, the regulations themselves are not entirely clear on what the trustees would be expected to document in part 1, unless it is simply a statement that they have complied with the principles set out in the regulations.

However, our reading of the Code is that TPR’s expectation is that more detail on the Journey Plan should be included in Part 1. We have serious concerns about this in terms of the balance of power on investment between sponsors and trustees. In any event, for both the Regulations and the Code to work, in our view there is a need to clarify the journey plan requirements to be included in Part 1 of the Statement.

Statement of Strategy and FIS

We hope there will be a comprehensive and early consultation of the content and format of the SoS, as it is difficult to envisage it, and equally difficult for trustees and sponsors to understand what will be expected of them and plan accordingly. The level of detail, and the ability to provide a qualitative explanation of the FIS, will be key drivers of actions taken now. We hope to see information requirements kept proportionate to the risk and the chances of improving member outcomes.

Investment strategy

We are supportive of the wider range of asset classes set out in the draft Code, which will provide scheme specific flexibility as well as reduce systemic risk of all pension schemes investing in the same assets.

While we recognise that the requirements for schemes to be broadly cashflow matched is set out in the draft Regulations, we note that it may be more difficult for some schemes to implement (e.g. small schemes or schemes with more significant optionality where cashflows are less predictable). For these schemes, it may be appropriate to accept a lower standard of cashflow matching and instead focus on adequate liquidity. We would therefore also be more supportive of a desired range of interest rate and inflation hedging (say 80% - 100%) than a firm minimum of 90%.

We support the use of stress testing when determining the requirement of the low dependency investment allocation to be highly resilient to changes in short-term market conditions, but would propose that this is set as guidance rather than a firm requirement. In particular, we have concerns over the proposed 1-in-6 VaR of 4.5% as a benchmark. While commonly used and a useful metric when considering strategy, the concept of VaR has well-documented flaws, including the sensitivity of results to assumptions and model calibrations. Different schemes may determine very different VaR figures for the same asset allocation depending on their advisors' models and, for example, some models would show a much lower impact on VaR of increasing hedging levels than other models.

Open schemes

As set out in our response to the DWP consultation on the draft Regulations, in our view it is not necessary to require open schemes to fund as if they are closed schemes. However, if this remains the policy intent, we are very supportive of the approach to allow ongoing new entrants and accrual, and the flexibility on the calculation of future service. It is important though that open schemes with strong covenants and longevity should be allowed to assume new entrants and future accrual for some time to come and there is still a question mark over whether the proposals are proportionate for genuinely open schemes.

We also do not fully understand the proposed principle on security of open and closed schemes for past service. As with the current regime, we understand that scheme specific outcomes remain appropriate, which take into account the individual circumstances of the scheme including the current funding, investment strategy and covenant support. We do not believe the proposed additional open scheme "principle" is helpful in these considerations for the trustees of open schemes. We also doubt Fast Track will generally be applicable for schemes which are genuinely not expected to mature in future.

Stressed schemes

We welcome the recognition in the draft Code that there are some schemes that will not be able to comply with the draft Regulations and also continue to manage the scheme in such a way as to be expected to pay full benefits to members in future. The sections in the Code covering stressed schemes are helpful in setting out TPR's expectation that the trustees can (cautiously) take investment risk to improve outcomes. We'd like to be sure that there is a proportionate way of addressing the Code for schemes in this position, and that

TPR will keep the evidence requirements proportionate. We note though, that clarification in the regulations of the DWP policy intent in this regard is also highly desirable, so that the trustees of stressed schemes who follow TPR's suggested approach do not need to be concerned that they are not compliant with the underlying legal requirements.

Funding Code consultation response

Question 1: Are there any areas of the summary you disagree with or would like more/less detail? If yes, what areas and why?

There are some comments that could be misleading:

- The phrase 'end game' (paras 17/18) does not appear in the legislation and may not be the same as the LTO (e.g. the LTO may be to run off the scheme, but the ultimate 'end game' may be to wind up and buy out any remaining benefits once these have become so small it is inefficient to carry on running the scheme.
- There is also a general point for the whole draft Code about keeping the terminology as narrow and consistent as possible.
- It should be made clear that the requirements for sponsor consent mirror those required for Part 3 funding more generally. In particular, where the trustees are currently only required to consult with the employer on funding (because they have sole power for funding under the relevant scheme rules) it should be made clear that consultation only, and not agreement, is required for these schemes for Part 1 of the Statement of Strategy (see para 20).
- It should be clarified in both the Code and the Regulations that the investment strategy and resilience for low dependency is focussed on maintaining at least 100% funding on the low dependency basis. Where a scheme is better funded than that, and chooses to take more risk (for example, to reach full funding on buy-out or to pay discretionary pension increases) then more risky investment strategies should be possible after significant maturity, as long as it continues to be expected that the low dependency funding position will remain above 100%.

Question 2: Do you agree with the principles for defining a matching asset that i) the income and capital payments are stable and predictable; and ii) they provide either fixed cash flows or cash flows linked to inflationary indices? If not, why not and what do you think is a more appropriate definition?

We agree with the broad principle, although we note that some assets (such as infrastructure and property) may be regarded as matching or growth assets or indeed have elements of both. Where appropriate, it should be possible to include these to some extent in the broadly matching category.

Importantly, the draft Code seems to assume that all cashflows are predictable and can be 'broadly matched', when in practice that isn't the case. For example, longevity risks and pension increase caps and floors can't be matched, there is uncertainty over the timing of member options, and investment strategy may be in the member's control (e.g. in underpin schemes).

Question 3: Do you agree with our approach for defining broad cash flow matching? If not, why not and what would you prefer?

The description appears to allow flexibility in determining whether cashflows are broadly cash flow matched (subject to also being highly resilient to short-term adverse changes). This flexibility is welcome but in our view there is a potential for the Regulations to be interpreted significantly less flexibly and for trustees therefore to have some uncertainty over whether their strategy meets the underlying regulatory

requirements. We strongly suggest that the wording in the Regulations themselves is reviewed and brought more into line with the approach suggested in the Code.
It is worth noting that for some schemes it may be more appropriate to focus on sufficient liquidity to meet projected pensions outgo rather than cashflow matching. This may the case for schemes where cashflows are less predictable, e.g. small schemes where cashflows will be more heavily dependent on individual member experience, or schemes with higher optionality in benefit structure. It would be helpful to provide flexibility for this approach in both the Regulations and Code where appropriate.

Question 4: Do you think draft adequately describes the process of assessing cashflow matching? What else would be appropriate to include in the code on this aspect?

Yes, as a general description of the process.

Question 5: Should the code set out a list of the categories of investments into which assets can be grouped for the purposes of the funding and investment strategy? If so, what would you suggest as being appropriate?

No, there are too many types of investments that would not easily fall into a (small) number of categories. Trustees should have the flexibility to describe and group assets in a way that takes into account the specific investments held and best fits their current investment strategy and target.

Question 6: Do you agree that 90% is a reasonable benchmark for the sensitivity of the assets to the interest rate and inflation risk of the liabilities?

We agree that 90% is within the range of reasonable targets, but would prefer TPR to set a wider range (maybe anything from say 80% to 100%). We note that with the recent changes in collateral requirements and, especially for smaller schemes, the challenges around effective LDI implementation, it may be that some schemes can only feasibly be at the lower end of the range. It should also be possible for very well-funded schemes to take a different view, or to regard some of their non-LDI assets as providing an element of interest and inflation protection.

Question 7: Should we, and how would we, make this approach to broad cash flow matching more proportionate to different scheme circumstances (e.g. large vs small)?

The approach described appears to have sufficient flexibility for different scheme circumstances, although noting that small schemes may only have access to pooled funds and find it difficult to invest directly in assets which provide the required cashflow profile. For such schemes, the focus could instead be on sufficiently managing their short and medium term liquidity requirements by holding suitably high quality, stable and liquid assets.

Question 8: Do you agree with our approach that a stress test is the most reasonable way to assess high resilience?

Yes, consistent with the feedback from the first consultation. This is a minimum though and we also agree that further analysis beyond the PPF-style stress test is likely to be appropriate in many cases. For some schemes, specific scenario testing is also likely to be an effective way to measure high resilience and communicate it to trustees, with stochastic modelling also likely to be used by larger schemes. It should also be possible for such schemes to demonstrate compliance with the regulatory principles using this approach instead.

Question 9: Do you agree that setting the limit of a 4.5% maximum stress based on a one year 1-in-6 approach is reasonable? If not, why not and what would you suggest as an alternative?

We are comfortable with the use of a 4.5% VaR as a guidance for the level of risk that may be appropriate for most schemes but do not support this as a limit that is required to be met.

While VaR is a useful and commonly used tool to compare investment strategies, it has well documented flaws as an absolute measure of risk. In particular, it is highly dependent on assumptions and models used and it is likely that schemes will determine quite different VaR measures for the same asset allocation if they use different models.

From a practical perspective, we note that using a 1-in-6 measure is currently not at all common practice, so actuaries and investment consultants are not currently set up to calculate it, and it is not easily understood or interpreted by Trustees. From this perspective, this new measure will cause some additional work and expense for schemes and their professional advisers.

Question 10: Do you agree that we should not set specifications for the stress test but leave this to trustees to justify their approach? If not, what would you suggest as an alternative?

Yes. We believe the Code should remain principles-based where possible, with prescription reserved for Fast Track.

Question 11: Do you agree with our approach for not expecting a detailed assessment of liquidity for the low dependency investment allocation (LDIA) since we have set out detailed expectations in relation to schemes' actual asset portfolios?

Yes, for schemes that are not yet at the point of significant maturity it would be disproportionate to require a detailed assessment of liquidity for the LDIA. Clearly once actually at the LDIA target and post relevant date, detailed liquidity analysis is important (arguably even more so than an assessment of broad cashflow matching).

Question 12: Do you agree with our approach for not expecting a stochastic analysis for each assumption to demonstrate that further employer contributions would not be expected to be required for accrued rights, but rather focussing on them being chosen prudently? If not, what would you suggest as an alternative?

Yes, stochastic analysis is not necessary and for many schemes would be prohibitively costly. We also believe that it should be clarified that it is the overall basis that needs to have an appropriate level of prudence, not each individual assumption. We are concerned that TPR's requirements may lead to trustees unnecessarily layering prudence on prudence. It should be clear that, as currently, it is the overall prudence that is most important.

Question 13: Do you agree that the two approaches we have set out for the discount rate for the low dependency discount rate (LDFB) are the main ones most schemes will adopt? Should we expand or amend these descriptions, if so, how?

Yes, these descriptions are broadly sufficient.

Question 14: Should we provide guidance for any other methodologies?

Yes. The Fast Track guidance allows schemes with less than 100 members to use a single equivalent discount rate, and this provision should be reflected in the code, and potentially widened to include smaller schemes with significantly more than 100 members, especially where it would be disproportionately costly to implement a term dependent approach.

Question 15: Do you agree with the guidance and principles set out in Appendix 3 and 4? Are there any specific assumptions here you would prefer a different approach? If so, which ones, why and how would you prefer we approached it?

As a general comment, these Appendices seem to go beyond the level of detail one might expect in a principles-based code and it appears they are a result of the Code and fast track originally being combined. A comment requiring evidence-based/consistent assumptions with an overall appropriate level of prudence would seem sufficient.

If this detail is to be retained, we have some comments on the specific assumptions:

- Following on from question 14, the code should allow the use of single equivalent inflation-related assumptions for smaller schemes, including those with less than 100 members, consistent with the Fast Track guidance. We also support this extending to "smaller" schemes with more than 100 members.
- On commutation, the requirement to use factors no lower than current factors should be removed. For example, in current conditions, it is quite possible that commutation factors will reduce once post-valuation reviews of factors are conducted, to reflect the significant changes in yields since the previous review. We propose that instead the principle should be that the commutation factors are no lower than expected to apply in practice in the short to medium term.
- On expenses, we believe it would be appropriate to allow trustees some judgement about any reliance on the sponsor to continue paying expenses after the period of covenant reliability (particularly, for example where the trustees believe covenant reliability extends for more than the medium term envisaged by TPR, and where the sponsor in practice currently meets most or all expenses and has indicated a willingness to continue to do so).
- We are also concerned about prudence on prudence in the demographic assumptions for smaller schemes that do not have their own statistically credible experience analysis. As previously noted, the requirement should be for the overall prudence to be sufficient, noting the uncertainties overall in the demographic assumptions, rather than requiring explicit prudence in each assumption.

Question 16: Do you agree that a simplified approach to calculating duration for small schemes is appropriate?

Yes – the option to use a simplified approach would provide additional flexibility, particularly for calculating projected duration values. It isn't entirely clear whether "smaller" in the draft code means less than 100 members or is a more general comment that could apply to small schemes even if they have more than 100 members. Our preference would be for the latter interpretation, aligning more with the wider proportionality comments throughout the draft Code.

Question 17: Do you think setting an earlier point for significant maturity within Fast Track as compared to the code (as described in option 3 in this section of the consultation document) would be helpful for managing the volatility risk of using duration? If yes, where would you set it and why?

We agree with the comments made in the consultation document that it would be helpful to have a measure of significant maturity that is less sensitive to movements in market conditions. Of the options presented, our preference would be option 1.

However, we recognise that this option would not be possible as the Regulations are currently drafted. If no changes were made to the Regulations, we believe that option 3 would be preferable to the current approach to avoid the Fast Track parameters having to be frequently changed (but noting that it doesn't address the volatility issue for those using Bespoke).

If TPR was aiming to use a 12 year duration based on analysis in 2020/21, we believe adopting a 9 year duration would be appropriate to reflect subsequent movement in long term interest rates since then. For option 3, using 9 years in the Code and 11 years for Fast Track parameters would appear reasonable.

Question 18: Do you agree with the definitions for visibility, reliability, and longevity? If not, what would you suggest as an alternative?

We can understand TPR's desire for trustees to consider covenant strength over different periods, with the three definitions broadly reflecting short, medium and long timeframes respectively. From this perspective, the definitions are helpful in framing how trustees can approach their covenant assessment across their journey plan.

It will be important to see TPR's new guidance on covenant. These questions should be revisited at that point. There needs to be flexibility for trustees to undertake a covenant assessment that is scheme and sponsor specific and takes into account the funding position and level of risk.

Visibility

The definition provided is useful primarily as it recognises that most sponsors are likely only to produce short term projections/forecasts (which will in many cases be much shorter than the period over which trustees will be setting journey plans and any recovery plan).

However, other than recognising this point when looking at cash flow estimates for deriving the maximum affordable contributions, the visibility period isn't really referred to in the rest of the Code. It may be helpful to either make this point explicitly in the Code (i.e. that the visibility period of forecasts is only relevant to assessing cashflow) or move this wording into the assessing sponsor cash flow section.

Reliability

This is one of the key measures introduced by the Code (as it drives the shape of the journey plan at the short end and any recovery plan).

The definition is positive as it recognises that sponsors are likely to have affordability beyond the period for which they produce forecasts (i.e. the visibility period).

However, given the importance placed by the Code on the figure put on the period of covenant reliability, we would note the following:

- We note that this is, in most situations, likely to be highly subjective. It appears that trustees who take external covenant advice will need to ask for a value to be provided. We suspect most covenant advisers will struggle to provide a single figure as the assessment is likely to be highly qualitative. Equally, trustees who are carrying out their own assessment may struggle to justify any particular number.
- While we appreciate the flexibility in the drafting of the code, the wording 'medium term' isn't defined (with users inferring from the Fast Track parameters that this is around 6 years).

Instead of determining a number with potentially spurious accuracy, we believe a better approach would be to carry out an assessment of whether the current journey plan / level of risk can be supported, i.e. whether the period of covenant reliability is at least as long as required for the journey plan.

Longevity

The definition appears reasonable and we agree it is helpful for trustees to consider covenant longevity, noting that it will be part of a holistic assessment of the journey plan rather than a figure that has to be calculated with precision.

Question 19: Do you agree with the approach we have set out for assessing the sponsor's cash flow? If not, what would you suggest as an alternative?

We agree with the approach set out, but note that the issue of reliable cashflows can be difficult and highly subjective. As such, we suggest that this should be in the covenant guidance rather than the Code.

Question 20: Do you agree with the approach we have set out for assessing the sponsors prospects? If not, what would you suggest as an alternative?

The approach appears broadly reasonable. We would like to see the points under ESG factors expanded to consider the interaction with the scheme's investment strategy (with a cross reference in the investment and IRM sections).

We also note that there needs to be more clarity that the matters outlined are what is referred to in draft Regulation 7(4)(c) (which we assume is the intention).

Question 21: Do you agree with the principles we have set out for contingent assets, ie that i) it is legally enforceable and ii) it will be sufficient to provide that level of support? If not, what would you suggest as an alternative?

The principles are reasonable and in line with current practice. We note that the examples are relatively straightforward though, and that it should be clear that more complex contingent assets can also have some value and be taken into account.

Question 22: Do you agree with the approach we have set out for valuing security arrangements? If not, what would you suggest as an alternative?

The wording appears reasonable, but we note that care is needed in any conclusions drawn about how this affects the ability of the employer to support the scheme. Funding risk is likely to occur in a different scenario to that in which the security will crystallise, noting that many security arrangements only provide value in an insolvency scenario, and so, while related, there may be no direct impact on covenant reliability.

We suggest TPR considers consistency with PPF valuation principles where appropriate, and also with the contingent asset assessment used for other purposes such as Contribution Notice powers.
We also note that asset backed contributions are not mentioned in the Code, and assume they will be covered in the upcoming covenant guidance.

Question 23: Do you agree with the approach we have set out for valuing guarantees? If not, what would you suggest as an alternative?

Our understanding is that "look through" guarantees are relatively uncommon, and, for example, that the standard form PPF guarantee would not be strong enough. Is the intention for the look through guarantee to be stronger than full section 75 debt on insolvency, i.e. it needs to capture the requirement for the guarantor to meet ongoing contributions and expenses if the sponsor wasn't to pay them? If that is the case, then we think the wording should be made clearer. Also, we would not want employers to be cut off providing

guarantees of lesser value (but which still improve the covenant for the scheme) if the bar is set too high in terms of what can be taken into account for contingent funding.

As previously, we note the need to distinguish in terms of guarantee impact between contingent arrangements which improve ongoing affordability and those which primarily provide support on insolvency. Both should, however, be relevant to the overall covenant assessment and view on the maximum risk which can be taken.

Question 24: Do you agree with the approach we have set out for multi-employer schemes? If not, what would you suggest as an alternative?

It is helpful to explicitly reference these types of scheme in the Funding Code and to provide flexibility for trustees to adopt a proportionate approach reflecting the specifics of their scheme.

We would expect that in situations where there are non-associated sponsors who operate on a "last man standing" basis, this may justify a longer covenant reliability period. If this is the case, it would be helpful to reference this here (or in the earlier wording on setting covenant reliability).

Question 25: Do you agree with the approach we have set out for not-for-profit covenant assessments? If not, what would you suggest as an alternative?

We are concerned that the wording in the draft is picking up only additional negative implications for not-for-profit organisations.

It would be helpful for this section to also acknowledge situations where the non-commercial nature of organisations can be positive, e.g. long-term evidence of public funding of third-sector organisations, organisations (e.g. Housing Associations) which have significant asset bases, lack of natural competition, etc.

We also believe that it would be reasonable to include explicit reference to charities being able to undertake their charitable purpose as being a reasonable use of cashflows when trustees are assessing affordability.

Finally, we note that many charitable organisations depend at least in part on the use of their significant liquid investment holdings, and a key financial decision will be around the balance appropriate for using their investment earnings for their charitable purposes versus using them to support the scheme. For such organisations, cashflow generation is not the primary focus, and it should be possible to take into account balance sheet strength and/or significant tangible assets when assessing the covenant strength of such employers.

Question 26: Do you agree with how we approached how maturity has been factored into the code? If not, what would you suggest as an alternative in particular with reference to the draft regulations?

We are supportive of the concept that, as a general rule, more immature schemes, and those expected to mature more slowly (or indeed, not at all if they are open to new entrants) are able to manage higher investment volatility than more mature schemes, and that this should be taken into account in journey planning. In our view, this is also consistent with the requirements set out in the draft regulations. However, as noted previously, it should be possible for schemes over 100% funded to continue to follow a more risky strategy if they are, for example, aiming to reach buy-out or fund discretionary increases, provided the funding remains resilient when measured relative to 100% of low dependency liabilities.

We also note though that, where short to medium term scheme cashflow and liquidity is well matched and managed, even more mature schemes can afford to take some investment risk, and we support a legislative

framework where this is an option. As noted previously, this will be important for smaller schemes who may not easily be able to hold cashflow matching assets directly.

As we have commented elsewhere, it is very important that the relevant date calculated is appropriate in the first place and, to enable proper Trustee planning, monitoring and governance, it does not move around significantly between valuation dates for reasons other than material changes to the underlying membership.

Question 27: Do you agree with the way in which we have split the journey plan between the period of covenant reliability and after the period of covenant reliability? If not, what would you suggest as an alternative?

We note that covenant reliability is not part of the underlying regulatory framework, and therefore that it should be made clear that assessment of covenant reliability (as separate from the broader concept of covenant strength) is a TPR expectation rather than a legal requirement.

As a theoretical concept, we agree covenant reliability is a helpful consideration. However, we think that for many, if not most, employers, it will be very difficult for either trustees or advisers to come up with a definitive view of the covenant reliability period for their specific situation, and that this will therefore be an area of difficulty for trustees generally. It will also be an area where there is significant scope for material differences in view between the sponsor and trustees when attempting to agree a journey plan. We are also concerned about unintended consequences in this respect – we can see possibilities for some trustees and employers to take either too bullish or indeed too conservative views on covenant reliability, neither of which would be in the best interests of members.

We also note that, other than in very specific circumstances, there is unlikely to be a cliff edge between the period where covenant reliability is good, and where it is not. A more general position may be that it simply becomes more uncertain the longer the period considered. Trustees should be free to shape the journey plan accordingly.

Question 28: Do you agree that trustees should, as a minimum, look at a one year 1-in-6 stress test and assess this against the sponsors ability to support that risk?

We note that, other than for the very specific PPF stress tests, most schemes do not currently consider or monitor 1-in-6 stress events. We also note that the test is relatively simplistic, but that in reality applying it will require significant judgements and assumptions – both in terms of covenant and investment risk. It is therefore unlikely to be straightforward to apply in practice. It will also require new and different analysis compared to that trustees currently undertake. We note various challenges with applying the test in practice:

- For some employers, and for many multi-employer schemes, coming up with a view on cashflow availability and reliability is not straightforward and ranges are more likely.
- Where sponsors of schemes in deficit are already paying deficit contributions that are at the maximum the employer can reasonably afford, it is not clear where and how they would also still have scope to support a further 1–in-6 downside event.

We are obviously supportive of the underlying principle – that employer covenant strength is an important factor in determining the level of risk. We also note that the Regulations themselves focus on a higher level concept of employer strength – and suggest that this is considered in the context of the size of any deficit on a low dependency or solvency basis. We would prefer the Code to include higher level principles, and more than one (mechanistic, but in practice potentially difficult to apply) approach to determining the level of risk which is supportable. These principles could include options for either stochastic or scenario analysis as appropriate to allow trustees to understand and form views on whether the risk being taken is supportable.

We also suggest that the Code could be clearer about using proportionate approaches where the trustees do not wish to run maximum risk, and we encourage TPR to keep information requirements to a minimum in cases where the information is not needed to agree (and regulate) a journey plan.

Question 29: Do you agree that if trustees are relying on the employer to make future payments to the scheme to mitigate these risks, then the trustees should assess the employer's available cash after deducting DRCs to the scheme and other DB schemes the employer sponsors?

As noted above, if employers are already making deficit contributions at the maximum level that is reasonably affordable, then it is not clear to us that there would be much cash available to offset further risk in the short term. This would suggest that the test should be conducted before deducting DRCs, as otherwise it is not meaningful. Indeed, in these situations, it is just as important to consider whether the current Recovery Plan could be extended if required to cover additional deficit contributions as it is to consider whether more cash could be made available in the short term.

Where employers sponsor multiple schemes, current approaches do take into account known commitments to other schemes. It would be highly unusual though, for the schemes to share non-public information with each other on their funding and risks, and we are not sure whether this would be workable in practice.

Question 30: Do you agree that this approach is reasonable for assessing the maximum risk that trustees should take during the period of covenant reliability?

See response to Question 28. We think a more principles based approach will be needed in many situations (and is more consistent with the requirements in the underlying regulations).

Question 31: Do you agree with the considerations we have set out regarding de-risking after the period of covenant reliability?

We are in agreement with the principle that, in deciding on the shape of the derisking journey, trustees should take into account how employer covenant and the ability to support investment risk is expected to develop over time. We note that this may differ materially in different circumstances – where covenant reliability becomes obviously less certain over time, the proposed linear derisking shape makes sense. However, in other cases different approaches may be suitable – for example, for more mature schemes with robust employers, supportability may actually improve as the scheme reduces in size relative to the size of the employer, and therefore there may be arguments for flatter derisking shapes than the assumed maximum linear derisking line proposed.

We agree with the considerations and agree that only the *maximum* risk assumes linear derisking after the covenant reliability period. We also welcome the flexibility to allow different journey plan shapes within the overall maximum level of risk over the period. Our understanding is that the maximum risk is limited in aggregate over the journey plan period and that TPR does not intend to suggest that risk is limited to the maximum at every point up to the relevant date.

Question 32: Do you agree with our approach of not being prescriptive regarding the journey plan shape?

Yes, as noted in Question 31, there should be flexibility to choose a shape that is efficient and appropriate relative to the views on future sponsor covenant.

We do note though that this is not entirely consistent with the regulations, which suggest that the reliance on sponsor covenant should reduce as the period to maturity reduces. Our preference though, would be for more flexibility in the Regulations in this regard.

Question 33: Do you agree with our approach that the maximum risk trustees should assume in their journey plan is a linear de-risking approach where they are taking the maximum risk for the period of covenant reliability?

As noted above, there could be situations where this is not a true reflection of how the covenant may develop in future.

We also note that, once chosen, schemes should be able to maintain their journey plan even when, viewed from a later date, the risk is now above the "maximum supportable" line – a strategy that starts out lower risk, but maintains this until close to the relevant date, would start out below the "maximum line" but at valuations closer to the relevant date, could well be above it. This should be acknowledged and allowed if it has consistently been the chosen approach.

It is also noted that in practice there is likely to be volatility to the funding path and that the Code should be clear that it is not expected that schemes will in practice follow a simple linear path regardless of changes in covenant, funding and market conditions.

Question 34: Do you agree with our explanation of the statement of strategy and are there areas it would be helpful for us to expand on in this section?

In paragraph 47, it would be helpful to clarify that a review of the FIS is one in accordance with the requirement to review and revise if necessary within 15 months of a valuation. We would not expect part 2 of the SoS to have to be reviewed and revised in a situation where the FIS is reviewed informally and not revised.

Paragraph 237 is not completely clear. It may require the trustees to set out 'the way in which' they will reach low dependency, and 'the way in which' they will be fully funded on a low dependency funding basis at their relevant date. However, it might also mean setting out 'that' they will reach low dependency and 'that they will be fully funded on a low dependency funding basis at their relevant date'. Our reading of the draft Regulations is that they do not explicitly require the explanation of the journey plan in part 1 (although the journey plan principles are set out in the regulations under part 1), and similarly paragraph 177 suggests that part 1 includes the shape of the de-risking strategy and a qualitative description of the approach, whereas paragraph 180 is clear that the levels of risk, discount rates and details of assets held *along the journey plan* fall under part 2.

Given the difference between employer agreement and employer consultation, depending on whether an item falls under part 1 or under part 2 as a 'supplementary matter', we would encourage clarity regarding what belongs in each part in both the Regulations and the Code. As noted above, it is very important, as we understand is the DWP policy intention, that the requirements for part 1 do not mean that the balance of powers as regards investment between trustees and sponsors is materially changed. This implies that the Part 1 requirements for the Journey Plan should be very high level and principles based, with the detail left to Part 2.

A further comment relates to proportionality, where we would like to see clear guidance on what proportionality looks like, particularly for smaller and simpler schemes.

Question 35: Do you agree with how we have described the consistency of the TPs with the funding and investment strategy? If not, why not and what would you suggest as an alternative?

No, we do not agree with your description of what is required for the period after the relevant date. The draft Code says that “For the period after the relevant date, the assumptions used in the TPs **must** be the same or stronger than those in the low dependency basis”.

The use of “must” implies that this is a legal requirement under the draft regulations. It is not. The draft regulations actually require that “by the time the scheme reaches the relevant date, and thereafter, the assumptions chosen must be consistent with the way in which the trustees or managers intend pensions and other benefits under the scheme will be provided over the long term, as set out in the scheme’s funding and investment strategy.”

“Consistent” does not mean “the same”. The regulations do not appear to require the same funding assumptions as used for the low dependency target (and would presumably have used different wording if that had been the policy intention). Our view is that the legislative requirement is to reflect in the TP assumptions the underlying investment strategy that the trustees intend to follow after the relevant date, but that this may result in different detailed assumptions (for example, using different levels of prudence) for the technical provisions when compared with the low dependency assumptions.

We agree that, before the relevant date, the assumptions should be consistent with the intended journey plan.

Question 36: Do you agree that open schemes could make an allowance for future accrual – thereby funding at a lower level - without undermining the principle that security should be consistent with that of a closed scheme?

We strongly agree that open schemes should be able to make allowance for future accrual where there is good justification for doing so. For schemes closed to new entrants but open to accrual, this should allow for a sensible journey plan to a more appropriate relevant date than would otherwise be the case. We note though that for schemes open to new entrants, if the accrual allowance is limited to six years or less, this only modestly changes the relevant date, and still requires such schemes to fund as if they will be derisking over time, when in practice this is unlikely to be the actual expected future strategy.

For schemes that remain open to new members, our view is that the default should be that this will remain the case and the trustees’ funding and investment strategy should be focussed on remaining open rather than planning for closure. An assumption of closure should only be made if this has been signalled by the employer or is indicated as necessary by covenant advice.

We are not clear what the principle that security should be consistent with that of a closed scheme means, if it does not mean having a similar level of TPs, and suggest that its inclusion in the Code creates confusion without adding anything helpful to the process or considerations for trustees and members of open schemes. Security for open schemes arises from the fact that, like all other schemes, the level of risk they take needs to be considered in the context of the strength of the employer covenant, and we do not think additional “principles” (which are not in the Regulations) are helpful or necessary in addition to this.

Question 37: Do you agree that this should normally be restricted to the period of covenant reliability? If not, why not and what you suggest as an alternative?

As we noted above, the concept of “covenant reliability” is difficult in any event. We think the key principle for determining how long to allow for future accrual and new entrants should be that the trustees are able to objectively justify why it is reasonable and appropriate (for example, because of strong and continued support for DB accrual from employers, unions and members and where there are good reasons to believe the employer’s business will continue for a long time to come and at least for the period chosen). This is a bit different to the “covenant reliability” period, which focuses on an employer’s ability to meet a particular level

of deficit contributions, and is not the same as consideration of a period for which it could continue to support future accrual and the associated costs.

Question 38: Do you agree with our principles based approach to future service costs? If not, why not and what you suggest as an alternative?

Yes, we agree with a high level principles based approach that gives schemes flexibility in how they set future service contributions. We note that, other than in severe stressed scheme scenarios, it is seldom the role or responsibility of the trustees to consider whether future accrual is appropriate, and therefore paragraphs 281 and 282 of the Code need to be substantially reworded.

Question 39: Do agree with our approach to defining Reasonable Alternative Uses? If not, why not and what you suggest as an alternative?

As a guide for trustees to assess reasonable affordability, the concept of reasonable alternative uses is helpful. However, the draft code sets this out in a formulaic way, which may not be representative of the subjective, and *expert*, covenant analysis that is likely to be required in practice for a large proportion of schemes.

In due course, the guidance in the draft Code on covenant analysis and allowing for covenant strength in the funding and investment strategies will need to be viewed in conjunction with TPR's revised covenant guidance, so it is impossible to give a complete view of the proposals when the guidance has yet to be released. We encourage TPR to pay close attention to the feedback from covenant professionals when considering the final Code and Guidance in due course, to ensure the proposals are workable and balance risk and return in a way that is proportionate to the impact on members' benefits and risks to the PPF.

Given covenant is not specifically allowed for in Fast Track, and given it is less relevant for well-funded schemes with prudent funding and investment strategies, we encourage TPR to provide more guidance on proportionate covenant assessments in the final guidance, to avoid trustees having to undertake and evidence a disproportionate level of analysis.

Question 40: Do you agree with the description in the draft Code of the interaction between the principle that funding deficits must be recovered as soon as the employer can reasonably afford and the matters that must be taken into account in regulation 8(2) of the Occupational Pension Schemes (Scheme Funding) Regulations 2005?

The draft Code doesn't describe the interaction between the 'as soon as reasonably affordable' principle and the matters set out in regulation 8(2). It simply sets out the regulation 8(2) matters (by repeating the legislative requirement) and goes on to set out how the trustees are expected to assess reasonable affordability. The draft Code does not explain how reasonable affordability interacts with the requirements of regulation 8(2) in cases where affordability is not constrained, and nor does it explain how the elements of regulation 8(2) can or should come into consideration where affordability *is* constrained.

Question 41: Do you agree that reliability of employer's available cash should be factored in when determining a scheme's recovery plan length?

The reliability of available cash does not directly determine the recovery plan length. Rather it seems to us that the reliability of available cash is factored into the assessment of reasonable alternative uses, such that it is not reasonable to use cash for alternative uses if that would extend the recovery plan beyond the period of covenant reliability. The outcome appears to be a blunt statement that there can be no covenant leakage/dividends during the recovery plan if the deficit is not projected to be met within the period of covenant reliability. Given the subjective nature of the assessment of the covenant reliability period, we

foresee tensions between trustees, covenant advisers, employers and TPR around this point, and a tendency for covenant advisers to act cautiously when advising on covenant reliability periods.

Question 42: Do you agree with the principles we set out when considering alternative uses of cash? If not, which ones do you not agree with and why? What other principles or examples would it be helpful for us to include?

The principles seem reasonable. However, the interaction between them is less clear and there are various interpretations. For example, we see potential for TPR to interpret the second principle (the more mature, the greater the need for cash in the near term) as not permitting alternative uses, e.g. dividends, after significant maturity for a scheme that is not fully funded at that point (for example, even if there is a legal entitlement to contingent assets held outside the scheme).

Question 43: Do you agree with our approach to post valuation experience? If not, why not and what you suggest as an alternative?

Generally, yes. However, we note that the draft Code only seems to consider recovery plans, whereas we would expect the same considerations to be taken into account for a schedule of contributions where no recovery plan is required.

Question 44: Do you agree with our approach to investment outperformance? If not, why not and what you suggest as an alternative?

Yes, we agree with the proposals.

Question 45: Should we set out more specifics around what we would expect by way of security to protect against the additional risks?

No.

Question 46: Do you agree with our approach that, while trustees' discretion over investment matters is not limited by the funding and investment strategy, we expect investment decisions by trustees should generally be consistent with the strategies set out in the funding and investment strategy? If not, why not and what you suggest as an alternative?

We agree this is reasonable, but the word "generally" is important and we would not agree otherwise. We also note that the Code later refers to "mirroring" the FIS. We would prefer to use the terms "consistent" and "inconsistent" throughout. We note though that the requirement to agree the FIS with the employer places potential constraints on the extent to which this is achievable in practice, and it should be clear that schemes can follow a different strategy where they have a robust rationale for doing so (as TPR itself has acknowledged is the case for stressed schemes).

Question 47: Do you agree with the examples we have given for when trustees' investment strategies may not mirror their FIS? Are there other examples we should consider?

We broadly agree. As we have noted elsewhere in this response, we believe both the Code and Regulations should support some risk taking after the relevant date where the funding position is strong, and the trustees are aiming for a target above the low dependency basis. We also note that it should be clear that there may be situations not specified in the Code where the trustees follow a different strategy, and the requirement from TPR should be that any rationale for doing so is robust and in the interests of scheme members.

Question 48: Do you agree with the expectations regarding trustees with stressed employers? If not, why not and what you suggest as an alternative?

Yes, we agree. The provisions are helpful, although as noted above we would prefer there to be more clarity so that the approach proposed is consistent with the underlying legal requirements, preferably in the Regulations themselves.

Question 49: Do you agree with the principles we have set out regarding risk management? Are there other aspects it would be helpful for us to include?

Yes, broadly, although we might have expected the key risks in paragraph 341 to include governance-related risks. We would also like to see help from TPR on the kinds of dashboards it suggests, particularly for smaller schemes with small or weak employers and/or smaller governance budgets.

Question 50: Do you agree with the principles we have set out regarding liquidity? If not, why not and what you suggest as an alternative?

Yes.

Question 51: Do you agree with how we have approached security, profitability and quality? If not, why not and what you suggest as an alternative?

Yes.

Question 52: Are there other aspects it would be helpful for us to include?

No.

Question 53: Do you agree with the above considerations? If not, please explain.

LDI leverage risk: The draft Code doesn't limit LDI leverage more than current guidance. Fast Track can be met with low levels of leverage, so doesn't specifically encourage high leverage, but it doesn't prevent or discourage it either. So it may be true to suggest that the code doesn't increase or exacerbate LDI leveraging risks, but this is quite a low bar when the systemic risk has been shown to exist. Expectations around risk awareness and LDI governance are positive.

Herding risk to bonds and gilts: TPR will be aware of the continued move towards bonds and gilts, not least caused in preparation for buy-out by many schemes. Whilst the draft Code itself could be argued to be not causing a material increase in allocations gilts and bonds, the requirement to set a long term objective and to have a journey plan that aims to derisk by significant maturity does in our view encourage schemes to move away from growth assets. Some changes to the Code and Regulations to allow continued risk taking (as opposed to re-risking) after significant maturity, for example where a scheme is in surplus, would alleviate the increase in systemic risk.

Timings and gilt issuance: we cannot argue that as DB schemes get smaller, so the aggregate financial risks reduce. The wealth nevertheless does not reduce, and there may be questions about other emerging systemic risks, for example in relation to consolidator vehicles and insurers, as well as risks for savers (see the IFoA's work on the Great Risk Transfer).

Herding to Fast Track: We agree it seems unlikely that Fast Track will materially increase equity allocations, although we do expect some herding towards Fast Track (as indeed does TPR). The risk to

savers of employers levelling down, and the risk that the Code and Regulations further drive the closure of DB schemes, is probably a more material risk.

Question 54: Do you think there are any areas of systemic risk that should be considered further in in light of our draft code? If yes, please explain.

See our comments above.

END OF FUNDING CODE RESPONSE (Fast Track response follows below)

Fast track consultation response

Question 1: Do you agree with how we have positioned Fast Track relative to the code of practice?

We agree that the way that TPR has now positioned Fast Track (as a set of regulatory filters) is helpful and preferable to having Fast Track as part of the Code itself. In addition, the comments TPR has made about both Bespoke and Fast Track approaches being equally valid is also helpful to trustees and sponsors.

TPR has commented that '*some trustees may find Fast Track a useful tool when negotiating with their sponsoring employers*'. This could be read as suggesting that Fast Track is more than a set of regulatory filters and we are not sure that this statement is helpful.

Question 2: Are there any aspects of this [how Fast Track is positioned relative to the code of practice] you think it would be useful for us to clarify further?

We think that it is important that trustees and sponsors understand that Fast Track is not a risk-free option, and that Fast Track may not represent the 'right' level of risk for a pension scheme even if it can comply with the parameters.

Question 3: Do you agree that Fast Track should come with a lower level of burden in terms of the explanations required as part of the trustees' valuation submission?

Yes, we agree that Fast Track should come with a lower level of burden in terms of the explanations required as part of the trustees' valuation submission. However, we would note that complying with Fast Track is unlikely to reduce the costs to schemes of conducting a valuation exercise. In addition, trustees and sponsors of pension schemes that select the Fast Track route to compliance will still be required to draft and submit to TPR a Statement of Strategy. If the intention of the Fast Track route is to reduce the compliance burden on pension schemes, one option available to TPR would be to allow Fast Track compliant schemes to submit a less detailed version of the Statement of Strategy.

Question 4: Do you see any unintended consequences from requiring the scheme actuary to confirm when a submission meets the Fast Track parameters?

We are supportive of giving the scheme actuary the role of confirming in a valuation submission whether the Fast Track tests are met.

However, overall, we think that it is very important that the Fast Track parameters are defined clearly, so that it is clear what the scheme actuary is confirming and what has been left to the trustees to confirm. Such confirmation requires the parameters to be clear (TPR notes in Section 9 of the draft guidance that the matters in the scheme actuary's confirmation should be 'factual' and by inference not subjective or open to interpretation by the Actuary). As currently drafted, we think that the description of the Fast Track parameters and how the scheme actuary should perform the tests in Appendix 1 and Appendix 2 of the draft guidance could be improved.

In particular, the low dependency discount rate must be '*reasonable*' in the context of the expected investment strategy. It should be clear that it is the trustee, not the actuary who decides this. The Scheme Actuary will be confirming that the low dependency discount rate is no higher than the Fast Track minimum, and that the TPs overall satisfy the Fast Track requirements.

Rather than Fast Track referring to Appendix 3 of the draft code, and as noted in our response to question 15 of the code of practice consultation, we think that it would be better to move this detailed appendix from

the code into the Fast Track guidance. This would allow TPR to provide guidance on each assumption required in the Fast Track low dependency funding basis and to keep the Code principles based.

We would be happy to work with TPR to ensure that the Fast Track guidance is sufficiently clear to allow scheme actuaries to provide confirmation that the Fast Track tests are met, and in particular to clarify the assumptions which continue to include an element of subjective judgement and those which are fully specified.

Question 5: Could we make Fast Track more proportionate for schemes in differing circumstances?

The main class of schemes we would highlight are small schemes. TPR's definition of a small scheme is a scheme with less than 100 members. We think that this definition could exclude some schemes that could legitimately be termed 'small'. For example, the PPF defines a small scheme as a scheme with s179 liabilities below £30 million. We believe that TPR should consider adopting a liability based small scheme definition instead of, or in addition to, the current number of members-based definition.

It may also be beneficial to small schemes if the Fast Track valuation assumptions are simplified as much as possible. For example, TPR could allow schemes with less than 100 members and /or £30 million of liabilities to use:

- single equivalent discount rates and inflation assumptions;
- s179 assumptions for all non-financial assumptions;
- projected duration calculated in line with a simple proxy; and
- to complete a significantly simplified proforma Statement of Strategy.

Question 6: Are there other considerations not discussed in the consultation document we should be considering?

As noted in our response to question 2 we think that there are some schemes (for example, those with very weak sponsors) where Fast Track would not be appropriate. It would be helpful if TPR could give examples of the scheme specific situations in which Fast Track would not be an appropriate approach.

Question 7: Do you believe it would be useful to include an additional set of parameters for schemes where the employer has a high insolvency risk? If yes, how should schemes in this category be defined and where should the Fast Track parameters be set?

No. For very weak and stressed schemes, in our view it is likely that a tailored approach would be required in any event. Therefore, linked to our comments in response to Question 6, very weak covenants are one of the areas where we believe TPR could clarify that a scheme specific approach is required and that the Fast Track parameters may not be appropriate.

Question 8: Do you agree with our approach of setting the Fast Track technical provisions test as a percentage of the low dependency funding basis liabilities? If no, explain why and what would you suggest as an alternative?

Yes, although we note that in current conditions the proposed parameters, based on a 12 year significant maturity duration, appear stronger than TPR may have intended based on the 31 March 2021 analysis.

Question 9: Do you agree with the limits we have proposed? If no, explain why and what would you suggest as an alternative?

We believe that it is for TPR to determine the limits and the level of tolerated risk from a regulatory filtering perspective. As noted above, in our view not changing the duration parameter from 12 years despite the very significant changes in yields does mean the limits are significantly stronger than TPR appears to have intended based on the 31 March 2021 analysis, which will mean that rather fewer schemes are able to meet the Fast Track bar.

Question 10: Do you agree that for a Fast Track low dependency funding basis measure, the minimum strength of the discount rate basis should be gilts + 0.5% with no inflation risk premium?

We believe that it is for TPR to determine the minimum strength of the discount rate in the Fast Track low dependency funding basis and the level of tolerated risk from a regulatory perspective. That said, in our view gilts + 0.5% is not unreasonable.

Question 11: Do you agree that our approach to other assumptions in the Fast Track low dependency funding basis (as set out in Appendix 1) is reasonable? If no, which assumptions would you suggest are amended and how?

Two further areas where clarification is required are:

- the Fast Track assumptions need to be clearer on TPR's expectations for the expense reserve.
- we understand that TPR is aware of this issue but for completeness we would note that it should be clarified that the Fast Track low dependency liabilities can include an allowance for members commuting pension for cash.

Question 12: Should we allow more flexibility for smaller schemes in relation to any of the assumptions?

See our response to question 5.

Question 13: Do you agree that the maximum recovery length after significant maturity should be set to three years rather than six? If no, explain why and what you would suggest as an alternative.

We think that it is for TPR to determine the appropriate recovery plan length after significant maturity and the level of tolerated risk from a regulatory perspective. However, we do think that this period should start from 15 months after the valuation date, not from the effective date of the valuation itself. For a scheme post significant maturity, the proposed Fast Track requirements would mean that there would usually be less than two years to meet a deficit at the time the valuation is agreed (assuming this takes 12 to 15 months from the valuation date, which in our experience is not uncommon). This is unrealistic and it is likely very few schemes would be able to comply.

Question 14: Do you agree with our approach of using the valuation date as the starting point for the recovery plan length?

See our response to Question 13. We think the period should start 15 months after the effective date of the valuation (or that the periods should be extended by say a year if the valuation date requirement is retained.

Question 15: Do you agree with our approach to how to allow for post valuation experience in Fast Track recovery plans? If no, explain why and what would you suggest as an alternative?

Yes.

Question 16: Do you agree that annual increases to deficit repair contributions should not be more than CPI? If no, what would you suggest as an alternative?

This is reasonable, although TPR could also consider allowing increases up to RPI. However, it should be clear that this refers to minimum deficit repair contributions to meet the deficit. We assume more can be paid and there can be greater than CPI year on year increases, but only in relation to contributions above DRCs or DRC brought forward. E.g. it should be reasonable to have a bigger step up in year 2, say, if the reason is early payment of year 3's contributions.

Question 17: Do you agree with our approach for the stress test? If no, explain why and what would you suggest as an alternative?

This approach is broadly reasonable.

Question 18: Do you agree with the limits we have proposed? If no, explain why and what would you suggest as an alternative?

Broadly yes, though we think it would be helpful to indicate when there might be more flexibility in these. Perhaps the Regulator could indicate in its annual statement or ensure review of the parameters if conditions are such that the limits could be flexed that year (for example, this might be appropriate just after a downside event has already occurred).

Question 19: Do you agree with how we have allowed for schemes in surplus within the stress test?

Yes – we agree that it should be possible to take more risk where a scheme is in surplus, as noted in our response to the Code consultation.

Question 20: Do you agree it is reasonable to use the Pension Protection Fund Tier 1 asset classes? If no, what do you suggest as an alternative?

We like the simplicity of this approach, although we note there are some limitations to the PPF approach, for example in insufficiently reflecting the duration of the bond portfolio relative to the liabilities, and in not allowing for a stress scenario in which gilt yields increase.

Question 21: Do you agree that smaller schemes should not have to produce cash flows to calculate projected duration?

Yes.

Question 22: Do you agree with the proxy we have proposed for smaller schemes?

Yes.

Question 23: Do you agree with our definition of smaller schemes for this purpose?

As noted previously, we would like to see this widened to include schemes with assets under a certain level (say £30m) and we would like to see consistent use of 'small', 'smaller' and 'less than 100 members'.

Question 24: Do you agree that six years is a reasonable Fast Track parameter for the allowance of extra accrual in open schemes? If no, explain why and what would you suggest as an alternative?

Yes, this is likely to be reasonable for many schemes open to new accrual but not new entrants. It is highly likely that schemes open to new entrants will not choose the Fast Track approach in any event, so it would not be worth defining anything else for these schemes.

Question 25: Do you agree with our approach for new entrants? If no, explain why and what would you suggest as an alternative?

Yes.

Question 26: Do you think having no additional restrictions on future service cost will weaken the Fast Track approach significantly?

No. The actuarial certification of the Schedule of Contributions is already a useful safeguard against any future service approach materially diluting liabilities, as the Scheme Actuary is required to certify that the Technical Provisions are expected to be fully funded at the end of the SoC period, and must allow for the cost of accrual and expected contributions in relation to future service in providing that certification.

Question 27: Which of the options for reviewing our parameters do you prefer?

We prefer option 2 – annual review. There needs to be clarity about the timing and the expectations of schemes who have already completed valuations, or largely completed them. Not all valuations are completed at the 15 month deadline, and many will start work before the effective date.

Question 28: Do you think a different approach to reviewing our parameters is preferred?

No.

Question 29: What further analysis do you think would be helpful to illustrate the potential impacts of any final regulations and code?

Robust analysis of the implementation and ongoing costs for schemes and their advisers. We are not convinced that the “levelling down” assumptions made in the TPR analysis conducted to date are necessarily a good reflection of what may happen in practice, so that the impact of Fast Track may be understated in the analysis conducted to date.

END OF FAST TRACK RESPONSE