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The Pensions Regulator
Defined benefit funding code of practice

Response from The Pensions Management Institute

Pensions Management Institute
Moving pensions forward

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Response from the Pensions Management Institute to TPR's consultation on its defined benefit funding code of practice

Introduction

PMI is the professional body which supports and develops those who work in the pensions industry. PMI offers a range of qualifications designed to meet the requirements of those who manage workplace pension schemes or who provide professional services to them. Our members (currently some 6,000) include pensions managers, lawyers, actuaries, consultants, administrators and others. Their experience is therefore wide ranging and has contributed to the thinking expressed in this response. Due to the wide range of professional disciplines represented, our members represent a cross-section of the pensions industry as a whole.

PMI is focused on supporting its members to enable them to perform their jobs to the highest professional standards, and thereby benefit members of retirement benefit arrangements for which they are responsible.

Executive summary

Following detailed consultation with relevant stakeholders, in its white paper 'Protecting Defined Benefit Pension Schemes', the government concluded that 'the system is currently working well for the majority of Defined Benefit schemes, trustees and sponsoring employers'. Further, the government set out its intentions in relation to its approach for the future of the DB system: '…we are clarifying the rules and expectations…but not otherwise making fundamental changes to the existing system.'

PMI notes that in some areas TPR's proposals appear to represent a material departure from the existing system, in terms of both expectations and governance burden. TPR should consider whether this is consistent with the mandate and policy intentions outlined above, and whether this is a proportionate way of identifying and addressing 'those few [trustees and sponsoring employers] whose irresponsible decisions impact on their pension scheme.'

In responding to this consultation, and consistent with the policy intention above, our overriding objective is for TPR to ensure that where schemes are currently deemed to be compliant with the existing funding regime, their status is not altered as a consequence of the changes proposed. This includes such schemes not being forced to amend their existing approach, nor having to commission and supply onerous additional advice, in order to demonstrate compliance. In response to many of the consultation questions you will therefore see our support for the option that represents the smallest departure from the status quo.

Whilst not forming part of this consultation, TPR will be aware that the additional criminal powers proposed in the Pension Schemes Bill sparked widespread concern and criticism from across the pensions industry. Viewed in combination with TPR's proposals, we expect that trustees, sponsors and advisors (many of whom are represented amongst our membership) would welcome reassurance from TPR that behaviour and actions currently deemed compliant with the existing regime would not cease to be viewed as such under a revised regime.

Finally, PMI also notes in response to certain consultation questions that sufficient information is not available to enable full consideration and conclusions to be drawn in relation to the proposed changes - in particular, definitive proposals on the Fast Track criteria, how these are expected to be updated over time, and sufficient detail on the process and specifics of the Bespoke compliance route. Whilst we understand TPR's two-stage consultation approach, we suggest that the industry is provided with the opportunity to scrutinise and comment on this missing information before such stage as TPR presents a draft code.

Chapter 3: Proposed regulatory approach

1. Twin-track compliance

Do you think twin-track compliance is a good way of introducing objectivity into a scheme-specific regime? What are your views on the proposals set out above? If you disagree, what do you propose instead?

TPR's proposals do introduce objectivity, via the prescribed Fast Track criteria. We can understand why a more prescriptive set of funding requirements might be appealing for some schemes - for example, some smaller schemes and those whose existing funding framework is either already Fast Track compliant or could be made so without significant disruption. It is our expectation, however, that only a relatively small proportion of the DB scheme universe (by membership number or liability) would fall into this category - a recent survey of our membership found that roughly two-thirds expected to follow the Bespoke compliance route.

There is limited detail on the Bespoke compliance route in the consultation documentation, but it would suggest for most schemes a more onerous process than is the case under today's regime. TPR may view this as proportionate to achieving its aims, although as noted in our Executive Summary to the consultation, the government concluded in its white paper 'Protecting Defined Benefit Pension Schemes' that the present framework is largely fit for purpose, which might call into question the need (or mandate) for such a comprehensive overhaul.

As explored in our responses to subsequent questions, we highlight some areas for TPR to consider in relation to the practical implementation of its proposals. For example, the recent market volatility and funding level falls resulting from COVID-19 are a timely reminder of the perils of setting inflexible Fast Track parameters (e.g. maximum technical provisions recovery plan lengths). TPR should consider whether and how it intends to update its Fast Track parameters periodically in response to prevailing market conditions, or accept that at times of market stress many more schemes would be forced into Bespoke compliance (and ensure that it has sufficient resources to deal with this). We have noted reports that TPR has already acknowledged the need for changes to the Fast Track parameters it is currently consulting on, and await the further detail on this point which is expected in a second consultation.

Chapter 4: Employer covenant

2. Insolvency risk and reliance on covenant

Do you think the risk of member benefit reductions on insolvency is an acceptable part of the existing regime and that trustees should be able to place some reliance (whether implicit or explicit) on the employer covenant? To what extent do you think this should be the case? Do you think this risk is well understood by scheme members?

Whilst the risk of member benefit reductions on insolvency is clearly undesirable (and probably not well understood by some members), we believe that it would be unaffordable for the majority of sponsors to fund schemes immediately to such a level that no reliance is placed on the employer covenant.

3. Integration covenant into funding

a. Do you think it is better to keep the Fast Track route simpler by only factoring covenant into Bespoke (TPs and/or RP)?
b. If you think covenant should only feature in Bespoke, how do you think it should be done?

c. If we were to integrate covenant into Fast Track guidelines, do you prefer option 1, 2 or 3 or some other approach for reflecting the employer in scheme valuations, and why? If another approach is appropriate, what do you think this should be?

Option 1 (the closest to the current regime) would appear to be most consistent with government's assessment that the current framework is largely fit for purpose.

4. Covenant assessment

a. Should a holistic approach to assessing employer covenant be retained (but with further guidance to assist trustees), or should we seek to define a more prescribed, formulaic approach?

b. If the former (holistic approach), what amendments/clarifications to our existing guidance on covenant do you consider may be necessary? Do you agree with the ones suggested above? Is the structure and content of our existing employer covenant guidance helpful and accessible to trustees? If not, what would make it better?

c. If the latter (formulaic approach), what do you think of the proposed RACF approach? How would you propose that covenant could be explicitly defined in a clear, consistent and measurable manner? What other metric(s) may be appropriate?

d. Alternatively, would it be appropriate to require employer covenant to be assessed in a prescribed (formulaic) way for Fast Track purposes, and only allow for a more holistic approach under the Bespoke framework?

The holistic approach (the closest to the current regime) would appear to be most consistent with government's assessment that the current framework is largely fit for purpose.

Aside from it being a more material departure from the current framework, we believe that it would be challenging to sensibly capture the wide array of different businesses and sources of covenant strength into a single formulaic approach (RACF or otherwise).

5. Reliance on indirect covenant

Do you think that the strength of the wider commercial group should be factored into the sponsoring employer's assessment? If so, how, and to what degree?

Retaining the ability to factor in the strength of the wider commercial group (as at present) would appear to be most consistent with government's assessment that the current framework is largely fit for purpose.

6. Covenant grades

a. Should we use a greater range of covenant grades to set guidelines in the code and assess schemes and, if so, what would be an appropriate number of grades?

b. Would there be sufficiently different characteristics between a greater number of grades, such that a set of trustees could reasonably and reliably assess covenant strength without requiring professional advice?

We consider the current range of covenant grades to be appropriate.

Chapter 5: General principles

7. Low dependency LTO

Should all DB schemes have a low level of dependency on the employer by the time they are significantly mature? If not, what do you think would be an appropriate expectation to ensure trustees manage the run-off phase for their scheme effectively and efficiently?

We believe that TPR's proposals meet the new requirements in the Pension Schemes Bill. Some may view the proposals as going beyond these requirements, which may be seen as inappropriate (for example, where a sponsor has significant covenant strength/visibility beyond the LTO timescale).

8. Timing of the LTO

What factors should influence the timing of reaching the LTO? Do you think that the timing should be linked to maturity?

Maturity has the advantage of being an objective metric to define the LTO timescale, which could be applied consistently across the DB universe. This metric effectively removes any consideration of sponsor covenant, however, which may not be appropriate. As described above, for schemes that are already close to (or at) the point of being 'significantly mature', sponsor covenant may still be strong and future visibility good. TPR might wish to consider whether it is appropriate to introduce a mechanism to consider rolling covenant visibility as a component of the LTO timescale.

TPR might also wish to consider whether any transitional protections should be put in place for already mature schemes who are not yet fully funded on the LTO.

9. High resilience to risk at the LTO

Do you think that the investment portfolio should be highly resilient to risk when schemes reach their LTO? If not, what do you suggest?

See our answer to Q8 in relation to covenant visibility – some may view an element of investment risk as appropriate, if sponsor covenant permits.

10. Risk-taking for immature schemes

Is it reasonable for less mature schemes, which would have more time to reach low dependency funding, to assume and take relatively more investment risk than a mature scheme?

Yes.

11. Journey planning

What are your views of the rationale above for the journey plan? Do you think there is there a better way for trustees to evidence that their TPs have been set consistently with the LTO?

The proposals are consistent with the legislative requirement introduced by the Pension Schemes Bill.

12. Relevance of investment for funding

Do you agree that the actual investments and investment strategy are a relevant factor for scheme funding?

Yes.

13. Broad consistency between investment and funding strategy

a. Should the investment strategy be broadly consistent with the level of current and future investment risk assumed in the funding strategy? If not, why not?

b. If it is not broadly consistent, for instance where trustees want to take additional investment risk (than that assumed in the TPs), should trustees have to demonstrate that the investment risk taken can be managed appropriately? If not, why not and what would you suggest?

Yes, although we note that trustees and sponsors may still consider it appropriate to target an appropriate degree of investment out-performance as a component of recovering any shortfall.

14. Liquidity and quality at maturity

Do you think that security, quality, and liquidity become more important as a scheme becomes significantly mature? In particular, do you think that the scheme's asset allocation at significant maturity should have a high level of liquidity and a high average credit quality?

Yes.

15. Covenant visibility

a. Do you think it is prudent for reliance on employer covenant to be reduced beyond the period over which there is reasonable visibility? If not, why not?

Yes.

b. How much visibility do you think most trustees can have over the employer covenant? In the absence of evidence to the contrary, do you think it is reasonable for most schemes to assume there is reduced visibility beyond 3-5 years?

This answer could vary enormously depending on the individual scheme and sponsor.

16. Use of additional support

Should additional support, such as contingent assets and guarantees, be allowed in scheme's funding arrangements provided they are sufficient for the risk being supported, appropriately valued, legally enforceable and realisable at their necessary valued when required?

Yes.

17. Appropriateness of RPs and affordability as a key factor

a. Should employer affordability be the key factor to determine the appropriateness of a RP? If not, what should it be?

Employer affordability is certainly a key factor, but we believe there are others, such as sponsor covenant (which may not be the same thing as affordability – see below).

b. Is it reasonable to require schemes with a stronger employer covenant (and a resulting reduction in prudence in the assumed TPs and size of deficits) to have a commensurately shorter RP?

We are not sure that it is necessarily the case that a strong employer covenant always equals affordability to recover a deficit over a shorter period. For example, sponsor strength could reside in fixed assets such property or other longer-term sources e.g. contracts or licences.

18. Open schemes, past service

Should past service have the same level of security, irrespective of whether the scheme is open or closed?

No. It should be possible for open schemes with longer investment time horizons to be able to take different (higher) levels of risk.

19. Open schemes, future accruals

Do you think it would be good practice for trustees to ensure that the provision of future accruals does not compromise the security of accrued benefits?

Yes, although typically it is the case that decisions about future accrual rest with the sponsor, not the trustees. If trustees (and hence sponsors) are forced to fund future accruals in such a way that adds material cost increases, we would expect to see an increasing number of schemes being closed to future accrual. TPR should consider whether this is its intention. Further, TPR should consider that there are a number of schemes where due to legal or other protections, future accrual cannot be ceased, and therefore where additional cost increases could have other consequences.

Chapter 6: Other issues

20. Other issues

Do you agree with our assessment of the issues above and do you have any further comments?

It is difficult to comment on aspects of this section without further detail on the Bespoke compliance process, and how TPR intends to ensure suitability for all schemes/sponsors.

In relation to trapped surplus, TPR appears to assume that all schemes will look to settle liabilities and wind-up. If instead the intention is to run the scheme off over time, then assuming experience is in line with expectations, an LTO surplus will emerge over time, which cannot be accessed or utilised by the sponsor (i.e. it is effectively trapped until the last member dies).

Chapter 8: Setting the long-term objective (LTO)

21. Fast Track low dependency discount rate

What are your views on our proposal that the appropriate low dependency funding basis for Fast Track should be with a discount rate somewhere in the range of Gilts +0.5% to Gilts +0.25%? Where in the range do you think it should be and why? If you disagree, what do you think would be a more appropriate basis and why (please provide evidence)?

We do not comment on what an appropriate low dependency discount rate should be, save to note that one might reasonably expect this to depend on the size of the scheme (and therefore how predictable membership experience is expected to be, on average).

We also note that many schemes will already have discount rates within (or below) the proposed range. TPR should consider the risk that its proposals lead to a weakening of LTO targets (and hence member security) for these schemes.

22. Options for defining other assumptions for Fast Track low dependency funding basis

Which of these options should be used to set assumptions for low dependency funding under Fast Track? Are there any other options we should consider? Are there any other pros and cons we should consider?

Option 1 (the closest to the current regime) would appear to be most consistent with government's assessment that the current framework is largely fit for purpose.

Relative to Option 2, other than RPI/CPI inflation we are not sure that there are many other non-scheme-specific assumptions that TPR could specify. We do not believe that mortality is an assumption that TPR could specify whilst maintaining a scheme- specific funding approach.

We do not believe that TPR has the mandate to implement Option 3, which would arguably remove the scheme-specific nature of the funding regime, and has echoes of the failed MFR framework.

23. Defining assumptions for Fast Track low dependency funding basis

a. What are the most significant assumptions (other than discount rates) for the calculation of the Fast Track low dependency liabilities?

b. If we were to specify some or all of the assumptions to calculate the level of Fast Track low dependency liabilities, which assumptions should we specify and how should we do this? Do you have views on the suggested benchmarking factors in the table above?

c. If we determined mortality assumptions, how could we balance the scheme- specific nature of mortality with the desire to ensure a level of consistency in the assumptions used by different schemes?

Please see our answer to Q22.

24. Low dependency basis – verification that other assumptions meet the best estimate principles

a. Which of these options do you prefer to verify that other assumptions used for low dependency liabilities under Fast Track meet the 'best estimate' principle and why? Are there any other pros and cons we should consider? Are there any other options we should consider?

b. If we decided to require schemes to provide additional information about their assumptions, what information should we require schemes to provide compared to the current requirements?

Option 1 (the closest to the current regime) would appear to be most consistent with government's assessment that the current framework is largely fit for purpose.

25. Other assumptions for Fast Track low dependency basis – prudence

a. If we specified certain assumptions, should we aim for those to be best estimate or to be chosen prudently?

b. Given the uncertainty around assumptions such as future improvements in mortality should we: i) define these assumptions in Fast Track and ii) set the assumptions prudently?

We consider it more consistent with TPR's stated aim (to increase transparency) to incorporate prudence via the discount rate, with all other assumptions intended to be set as a best estimate.

26. Low dependency liabilities – reserve for future ongoing expenses

a. Should the low dependency liabilities carry an expenses reserve? If so, should this only be a requirement for schemes that self-fund their expenses?

b. To what extent should we define the reserve for future expenses under Fast Track? Should we just provide guidance on how to calculate an appropriate reserve? As part of that, what level of ongoing expenses is it reasonable to allow the employer to pay directly without any reserve?

c. If we defined guidelines on expenses for Fast Track, how should we reflect the proportionally different level of expenses incurred by schemes of different sizes? Could we adopt a sliding scale of percentages of liabilities based on the size of the scheme or a fixed element and proportionate element of expenses?

It would appear to be consistent for schemes not to rely on the sponsor to meet expenses under a low-dependency scenario. Trustees and sponsors would appear to be better-placed to determine a reasonable expense reserve than TPR.

27. Definitions of maturity

a. Should maturity be defined as duration for the purpose of prescribing significant maturity under Fast Track? If not, which measure would you favour and why? Note that whatever measure we use, it needs to be applicable not only to the time at which we would expect a scheme to reach significant maturity but also at all earlier times in the scheme's life.

b. Whichever method is used to determine maturity, we need to use actuarial assumptions to make the calculation. Should we require that the Fast Track low dependency assumptions are used for this purpose? What other assumptions could be used?

We believe that duration is an appropriate measure of maturity for this purpose. Fast Track low-dependency assumptions could be appropriate for this purpose (although TPR should consider whether this would create additional calculation costs for schemes who might not otherwise have undertaken calculations on this basis).
Alternatives could include the Solvency Estimate, technical provisions or CETV bases.

28. Defining the timing point for significant maturity

What are your views on our proposal to set significant maturity (used to define the timeframe for reaching the LTO) for Fast Track to be in the range of a scheme duration of 14 to 12 years (or equivalent on a different maturity measure)? If you disagree, what would be a more appropriate timeframe and why? Please provide evidence.

We do not comment on what an appropriate duration might be for this purpose.

We do, however, note that scheme duration can be sensitive to the assumptions used. For example, if gilt yields were to rise, schemes' LTO horizons would shorten. TPR should consider whether and how it intends to allow for this (for example, by reviewing this range over time).

29. Points or ranges for low dependency funding basis and timing point

Do you think our proposal to set a particular level for the low dependency funding basis and/or a range for the significant maturity timing associated with the LTO would be helpful to schemes to manage volatility and allow some smoothing? If not, what would you suggest?

In practice we would expect many schemes to adopt levels at the upper ends, even if ranges were quoted initially. We therefore expect this to have limited impact to help schemes manage volatility over time.

Chapter 9: Technical Provisions (TPs)

30. Journey plan shape for Fast Track TPs

a. Which shape of journey plan is most appropriate to define for calculating the Fast Track TPs and why? Does this vary depending on the circumstances of the scheme?

b. Are there any other journey plan shapes we should consider?

c. What unintended consequences might arise from adopting the linear de-risking or horizon method journey plans for Fast Track?

The appropriate journey plan shape will vary depending on the circumstances of the scheme, in particular the investment strategy and any de-risking plans already in place. This is likely to differ enormously depending on the size and sophistication of schemes' existing strategies.

31. Key factors for Fast Track TPs

Should other scheme-specific factors other than covenant and maturity be considered to define the journey plan and TPs in Fast Track?

No.

32. Extent of reliance on covenant in Fast Track TPs

a. Should we define a maximum period of acceptable full covenant reliance for Fast Track TPs? For example, a general guideline of five years? Or should covenant reliance be assumed to decline in the much shorter term (or immediately)?

b. What level of covenant support should subsequently be assumed? Should there be an assumption of a single covenant grade reduction (eg CG1 to CG2), a reduction to assumed returns in line with a weak covenant, or something else?

c. Over what period should any reduction in reliance take place? Should this be immediate (eg a reduction to a lower covenant reliance in the sixth year) or more gradual (eg over the subsequent five years)?

d. Does the need for a covenant visibility overlay depend on the approach taken for the journey plan to low dependency? For example, is this a more relevant consideration where the horizon journey plan shape is used?

Please see our response to Q15b in relation to potential covenant visibility. Given that schemes will be undertaking valuations at least every three years (potentially sooner depending on out-of-cycle valuation powers), this naturally gives trustees the opportunity to reconsider the covenant (and if appropriate, update the TPs to reflect the new covenant grade). Introducing arbitrary future covenant deterioration could lead to volatility in the TPs over time and make it more difficult to set an appropriate funding and investment strategy.

33. How Fast Track TPs should be expressed

Which option do you think is preferable for defining TPs/journey plans under Fast Track and why? What are the practical issues associated with each option? If you disagree with these options, what would you suggest and why?

Specifying maximum single-equivalent discount rates would be closest to the current regime (and hence most consistent with government's assessment that the current framework is largely fit for purpose).

34. Method to derive Fast Track TPs

a. Do you prefer a particular approach? If so, why? Is there another approach that would be suitable?

c. Do you have ideas as how to best approach each option?

d. How do trustees incorporate considerations about covenant strength into their TP assumptions/discount rates?

e. If a stochastic approach is adopted, what would you consider to be an appropriate confidence level against which to mark the results?

f. Do you have any data or modelling results which you think would provide useful evidence for the baseline TPs or covenant overlay? Please provide full details of methodology/data limitations.

The data driven approach would appear to be most consistent with government's assessment that the current framework is largely fit for purpose. The other two approaches would appear to introduce additional complexity and cost.

Chapter 10: Investments

35. Which reference point from which to measure investment risk in Fast Track

a. Would a measure of the liabilities be an appropriate position to measure investment risk from? If not, why not?

b. Do you prefer a liability measure on the low dependency basis (Gilts +0.5% to +0.25%) or a Gilts flat basis? Why? Are there any other liability measures that would be suitable?

c. Would a liability reference portfolio approach (as a proxy for liabilities) for smaller schemes be more proportionate and practical? If so, how should a small scheme be defined for this purpose (number of members, assets or liabilities)? What would be an appropriate threshold?

d. Would a reference portfolio consisting of gilts and inflation-linked gilts with a duration similar to the liabilities be appropriate as a proxy for the liabilities for smaller schemes? If not, how would you go about constructing a reference portfolio as a reference point from which to measure risk for smaller schemes?

We agree that a measure of the liabilities is an appropriate position to measure investment risk from. In order to minimise the additional complexity and cost of additional calculations, we consider that it would be most appropriate for this to be calculated based on an existing measure, e.g. LTO basis.

A liability reference portfolio approach would appear to add additional complexity and optionality to the funding framework. We would expect that smaller schemes would still have the capacity to calculate the liability measure described above.

36. Methodology to measure investment risk in Fast Track

a. Would a simple stress test to measure investment risk in Fast Track be the most preferable option? If not, why not? Are there other measures of investment risk that are more suitable, taking account of the desire for a relatively simple and objective measure?

b. Do you agree with the proposed principles for an appropriate pensions stress test, namely a fall in growth assets and a fall in interest rates? If not, what do you suggest?

c. What are your views on which stress test we should use? Do you think the PPF stress test (Bespoke and simple approach) would be a good starting point?

d. Which of the ways to measure the impact of the stress would you prefer and why? Is there an alternative method not listed that would work better? If so, please describe it.

A simple test would appear to be most consistent with government's assessment that the current framework is largely fit for purpose, and we agree with the proposed principles. For the same reason, we consider that use of the existing PPF stress test to be the most appropriate, to reduce the additional governance/calculation burden on schemes. We have no views on how to present the impact of the stress, provided that it is applied consistently across all schemes.

TPR should consider the risk that a consequence of this proposal is to either limit the practical investment universe available to schemes; and/or to promote 'herding' in particular asset classes, lowering the overall diversification of DB pension schemes universe (and therefore ultimately placing higher risk on the PPF).

TPR should also ensure that any investment stress test is suitable for the Liability Driven Investment, Cashflow Driven Investment, Diversified Growth and Hedge Fund strategies that are currently employed by a large number of schemes.

37. Approach to defining maximum levels of investment risk for schemes of different maturities in Fast Track

a. What are your views on the proposed methodology for setting maximum thresholds for investment risk for significantly mature schemes in Fast Track? If you disagree, what would you suggest?

b. In relation to acceptable portfolios and consistency with discount rates, is it reasonable to use a best estimate return premium for growth assets over long-term gilts in the range of 3-5% pa?

c. Should the allowance for prudence be higher for an investment portfolio with a higher level of risk?

d. What are your views on the considerations we have set out to determine investment limits for immature schemes (journey plan shape, downside risk and covenant)? In particular, should the maximum level of investment risk for immature schemes vary by covenant under Fast Track?

As previously stated, we expect relatively few schemes to follow a Fast Track compliance route. However, defining maximum levels of risk will still have a knock- on effect on Bespoke compliance (where the intention appears to be to judge schemes by reference to the Fast Track criteria).

We believe that TPR should consider the extent to which schemes are already compliant with its proposals on maximum levels of investment risk. To the extent that TPR's proposals in this area cause any material number of schemes to fail Fast Track without amending their investment strategy, then we would consider the proposals to be inconsistent with the government's conclusions that the current framework is broadly fit for purpose. We have not carried out any analysis on this question, but would encourage TPR to do so (and publish the results).

If schemes are forced to de-risk their investment strategies as a result of these proposals, then this will result in increases in contribution requirements for sponsors, which are likely to be unwelcome.

38. Defining guidelines for liquidity and quality of the investment portfolio in Fast Track

a. Do you think we should define some guidelines around liquidity and quality in Fast Track?

b. If so, what are your views on the options outlined above? Are there other approaches you favour?

c. What limits would you set on the above criteria and why?

d. How would the above change for a more immature plan?

Trustees are already obliged to consider these points (and to report their approach via the Statement of Investment Principles). In the absence of any evidence that the status quo is not working, we cannot see a strong argument for TPR to impose additional regulation/guidelines/criteria.

Chapter 11: Recovery Plan (RP)

39. Fast Track guidelines on RP length

a. What are your views on the principles set out above in relation to RP length under Fast Track? In particular, do you have views on what may be appropriate RP length thresholds for different covenant strengths? Is it helpful to frame these in terms of the typical multiple of valuation cycles (ie three years)?

b. Do you consider it would be more appropriate to have a single maximum guidance RP length and to expect trustees (under the Bespoke framework) to justify any plans that are longer than this?

c. Do you think Fast Track RP lengths should be shorter for schemes nearing and/or at significant maturity? If so, to what extent?

The principle of setting guidelines on reasonable RP lengths is consistent with the current approach, and is therefore unobjectionable. In terms of specifying what an appropriate length(s) should be, we do not comment on this, save to note that given the government's assessment that the current regime is largely fit for purpose, it would seem reasonable to ensure that the guidelines do not force the majority of schemes to have to change their current plans. This should include making adjustments to reasonable RP lengths if TPRs other proposals result in an increase in technical provisions deficits, and if the ability to allow for asset out-performance in the RP period is removed.

We do not see any advantage in framing periods in terms of multiples of 3 years.

40. Fast Track guidelines on RP structure

Should the extent of back-end loading be limited to increases which are in line with inflation (in the absence of appropriate additional support such as a contingent asset being provided)? Or should there be more flexibility subject to a significant proportion of DRCs being committed in the early years of the plan? If inflation-linked increases are acceptable, what measure of inflation do you consider would be an appropriate benchmark?

We would suggest schemes and sponsors are able to retain as much flexibility as they have currently to agree an appropriate RP structure.

41. Fast Track guidelines on investment outperformance

Should investment outperformance not be allowed in Fast Track RPs? What do you think the impacts may be?

We note that allowing for investment outperformance in RPs is currently widespread practice (at least in part due to previous support by TPR). TPR should consider whether, in view of the government's assessment that the current regime is largely fit for purpose, there is evidence to support making a fundamental change to the status quo. The impact of prohibiting this practice under Fast Track will be to force a large number of schemes into the Bespoke compliance route. TPR should consider whether this is intended, and whether it has sufficient resources to cope with this.

42. Fast Track guidelines on future RPs

In what circumstances should/could outstanding RP payments be re-spread at subsequent valuations? In particular:

a. If a scheme's funding deficit has reduced (at least) in line with the expectations at the previous valuation, would it be appropriate to maintain the same end date? Or would it be pragmatic to re-spread the remaining deficit over a renewed period?

b. If a scheme's funding deficit is higher than expected, what guidelines should apply for the appropriate length of the new RP?

c. Would the idea of 're-spreading' be more acceptable where a scheme has a long period before it becomes significantly mature?

Evidence over recent years has been that, on average, schemes have been re- spreading outstanding RP payment to an extent (i.e. average RP lengths have not been falling materially over time – and certainly not by one year per year).

This may be viewed as appropriate, to the extent that future covenant visibility is a rolling window – and so as time passes, the same RP length may continue to be supportable (a point that is independent of scheme maturity).

The other reason for the experience above is likely to be that RP lengths are used as an important "release valve" for negative valuation experience. Continued falls in gilt yields over the past decade have led to higher technical provisions for most schemes. With schemes generally unwilling to re-risk their investment strategies, and with insufficient additional sponsor contributions available in some cases to wholly fund the adverse experience, RP extensions are the logical consequence.

In this context, we note the recent market volatility and funding level falls resulting from COVID-19 means that many schemes will find themselves in a position where existing RPs are no longer expected to be achieved, and extensions beyond TPR's proposed RP lengths (which were set prior to COVID-19) are required. TPR should consider whether it intends to update its Fast Track parameters periodically in response to prevailing market conditions, or accept that at times of market stress many more schemes would be forced into Bespoke compliance (and ensure that (a) it has sufficient resources to deal with this and (b) Bespoke compliance is sufficiently flexible to respond to such market experience).

43. Equitability

What are your views on the concept of 'equitability' in respect of how a scheme is treated compared with other stakeholders? Should any requirements be qualitative (in line with the commentary above) or should trustees also be expected to consider a specific metric? If so, what might be an appropriate measure of equitability (for example, comparing the ratio of DRCs to dividends, or the size of scheme deficit to the 'stake' of other stakeholders) and how could this reflect a scheme's superior creditor status over shareholders?

We believe that the concept of equitability is already well understood by trustees and sponsors. This is already an area that would be routinely considered by a covenant assessment, and therefore feed into the funding arrangements of a particular scheme/sponsor.

When shareholders invest in sponsoring companies they enhance covenant (via improved balance sheet and enabling sponsors to undertake capital expenditure and target growth). Shareholders do so in the expectation of a certain level of return on their investment. In the absence of this expectation, capital markets may cease to function efficiently for such sponsors, ultimately risking damaging covenant. In the "deficits vs dividends" narrative, this point is often overlooked (as indeed it is by TPR

in the sentence 'For the avoidance of doubt, we do not automatically recognise dividends as essential business cost…'). Further, pension schemes (via their equity assets) are also often the beneficiaries of such distributions.

That said, it is likely that there are some limited examples of sponsors who wilfully and recklessly favour other stakeholders before their pension scheme to such an extent that it seriously endangers the likelihood of members receiving their benefits in full. In such circumstances it is entirely proper for TPR to use its range of powers to encourage or enforce appropriate contributions to the scheme. However, we believe that such cases are likely to be in the minority, aligned with the government's conclusion that the current regime is largely fit for purpose.

We suggest TPR considers whether its proposals are a proportionate way to address these situations. If so, given the enormous range of different business models, structures and relative statuses of schemes, TPR would need to carefully consider how any requirements are specified, to ensure that they are widely and consistently applicable.

Chapter 12: Open schemes

44. Treating past service and future service liabilities separately in Fast Track
What are your views on our proposed approach to outlining code guidelines for open schemes. Should any other approach to calculating future service liabilities be considered?

We support the intention to make the guidance appropriate for both open and closed schemes.

45. Fast Track LTO for open schemes
Should the LTO (low dependency at significant maturity) for an open scheme be the same for a closed scheme? If not, how should they differ?

Yes.

46. Fast Track TPs for open schemes
What option do you favour and why? Are there other options we should consider?

An open and closed scheme with the same duration should be treated equitably at a point in time. Over time, however, the closed scheme will mature more quickly (and hence its TPs would become closer to the LTO), whereas the open scheme will mature more slowly (or not at all) and therefore retain flexibility to take different (higher) levels of risk (and hence higher TPs), consistent with its longer investment time horizon.

47. Fast Track guidelines for calculating future service costs

a. Which options do you favour and why? Are there any other options for calculating future service costs which should be considered, for example pre-and post-retirement discount rates?

b. If Option C (best estimate) were adopted, how should the best estimate return assumption be determined? Are there any options other than those described above that we should consider?

c. Would our preferred approach (Option B) make it difficult for scheme actuaries to certify schedules of contributions?

Option D (no requirements on future service cost calculations) is most consistent with the current regime, which was considered to be largely fit for purpose, and does not seek to place additional restrictions onto trustees & sponsors.

48. Funding future service using past service surplus
Do you think that this approach to funding future service using past service surplus is reasonable? If not, why not? What else would you suggest?

Yes.

Chapter 13: Bespoke framework key features

49. Criteria for assessing Bespoke arrangements

What are your views on the criteria we propose to use to assess Bespoke arrangements? If you disagree, what would you change and why? What else should we consider?

The criteria themselves appear to be reasonable. However, there are several key aspects of their practical application which are omitted from the consultation, as detailed below:

1) Confirmation of the final Fast Track criteria

This will enable schemes to accurately determine whether they are likely to be forced to follow Bespoke compliance, and how 'far away' from Fast Track criteria they are likely to be.

2) The level of acceptable deviation from Fast Track criteria

As previously noted, there may be a large number of schemes who cannot comply with Fast Track, but whose funding and IRM plans are in line with legislation and currently considered to be entirely appropriate. It would be helpful for TPR to set out exactly how such schemes would be treated under Bespoke.

3) Process

TPR should provide much more detail on the whole Bespoke compliance process, including detailed examples of what constitutes the 'robust evidence' that TPR would require.

Our overriding rationale in relation to these questions (and the introduction and application of Bespoke more generally) derives from the government's conclusion that the current regime is largely fit for purpose. Therefore, we consider that schemes currently deemed to be compliant with all relevant funding legislation, regulations and guidance, should not suddenly be considered non-compliant unless either they make material changes to their current approach, or have to incur material time, cost and effort in justifying their approach.

We suggest that TPR considers and consults fully on the Bespoke compliance option prior to its implementation, to allow sufficient opportunity for the industry to scrutinise and provide comments.

50. Bespoke examples

a. Do you have any comments on the assessments we have made in the examples above?

b. Could you provide other examples (relevant to your own scheme experience or that of schemes you advise) of arrangements which you think will follow the Bespoke route? Why do you think these arrangements would be compliant?

c. In example 2 (LTO–CDI strategy), could it be appropriate, in your view, to be able to use a higher discount rate/lower value of TPs (low dependency basis) than in Fast Track? If so, in what circumstances and by how much?

The examples given do appear to have been chosen due to their simplicity and obvious and explicable rationale for Fast Track deviation. It is our expectation that for the majority of schemes forced to follow the Bespoke compliance route, their

circumstances will not be as clear cut. We suggest that TPR presents boundary cases and examples of schemes that are compliant with the current funding regime, but who would not meet Fast Track as proposed (because, for example, they currently allow for investment out-performance in their recovery plan, or have a recovery plan that is longer than the lengths specified). Such examples should also set out the detailed 'robust evidence' that TPR would expect schemes to provide to evidence their current position.

51. Stressed schemes

a. Assuming that affordability is genuinely constrained, are very long RPs ‘appropriate’ and therefore compliant with the Act?

b. Alternatively, should we make an exception to the principles and allow the trustees of stressed schemes to take unsupported investment risk, or more risk investment risk than other CG4 schemes (schemes with weak employers)? What checks and balances should we put in place in addition to those mentioned above (equitable treatment, risk management)?

c. For schemes with unviable RPs, should an exception be made for them in terms of the level of acceptable investment risk?

d. Are you aware of situations other than stressed schemes where the trustees and employer would have difficulties meeting the Bespoke compliance principles?

Yes, we consider that longer RPs are an appropriate "release valve" for such schemes, and that this is preferable to such schemes taking additional investment risk. For the few schemes/sponsors where a viable RP does not exist, it may be appropriate to consider the RAA regime.

We would also make an observation in relation to a refusal to grant parent company guarantees from group companies with no legal obligation to a scheme. If the trustees have done everything in their power to obtain such a guarantee, the existence of a potential guarantor who refuses to provide additional security should not result in a scheme being considered any less compliant (compared to an otherwise identical scheme without such group structure).

Part (d) of the question is not possible to answer without more detail being provided on the Bespoke compliance boundary cases (see our response to Q50).

Chapter 14: Additional support

52. Trustees' assessment of additional support in Bespoke arrangements
Do you have any views on the framework we set out for trustees to assess the appropriateness of additional support in Bespoke arrangements? If you disagree, what do you suggest?

We believe that the framework is reasonable, however we would expect that the majority of trustee boards would require expert advice in order to make the assessment envisaged. Given that TPR appears to be placing much more emphasis on additional support as a pre-requisite to obtaining Bespoke compliance in many of the examples given, it is presumably expecting far more schemes to seek to put this in place, and should consider whether it is comfortable with the burden of additional advisory cost this will entail.

53. Accessing additional support
When do you think trustees should be able to access the additional support? Does it depend on the Bespoke arrangement and the type of risk that it supports?

Trustees should be able to access the additional support for as long as it is being used to support a weaker funding agreement than would otherwise be the case if reliant on the sponsor alone.

54. Assessing the value of additional support
Should trustees be required to assess the stressed value of any contingent asset? What other guidance do you think we should set out on the recoverable value of contingent asset support?

Yes, it is important for trustees to understand the value of the additional support. Please see comments to Q52 above in relation to the additional financial burden this will create.

55. Independent valuation
Should trustees always be expected to seek an independent valuation of continent assets, or should it depend on asset value and/or type? If this should be based on value thresholds, how should these be defined? How frequently should we expect trustees to seek an independent valuation? Should trustees be expected to regularly monitor contingent asset value in the intervening period?

We do not consider a unilateral requirement for independent valuation to be appropriate. For example, in some cases, where a small scheme is being supported by a guarantee from a materially larger company, it will be clear that the additional support is more than sufficient in all scenarios.

56. Guarantees

a. Should we treat guarantee support differently to asset backed support?

b. Should trustees rely on guarantee support to change the covenant grade assessment or do you think in these circumstances the supporting entity should become a statutory employer instead?

The framework proposed is flexible enough to cover all aspects of additional security. We believe that the provision a guarantee is (and should be kept) separate to the status of statutory employer.

57. Other mitigations

Can you think of any other types of arrangements which can help trustees mitigate risks?

No.

58. Reporting information on additional support

Is there any reason why it would be unreasonable to expect trustees to undertake the analysis and provide the information outlined above? Is there additional information that should also be provided to us?

TPR should consider whether it is comfortable with the additional cost associated with providing the information listed, and the implications this may have on the security of members' benefits.