ASSOCIATION OF CONSULTING ACTUARIES

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23 March 2023

db.consultation@tpr.gov.uk

DB funding code team
The Pensions Regulatory
Napier House, Trafalgar Place
Brighton
BN1 4DW

Dear Sirs

Consultation by the Pensions Regulator on Fast Track and our Regulatory Approach

I am writing on behalf of the Association of Consulting Actuaries in response to the above consultation.

We are broadly happy with the approach to Fast Track, and keen to ensure that the requirements are sufficiently clear. Although we have some comments on the details below, we would encourage the Regulator to press on towards their implementation.

We support separating Fast Track from the code, however it would be helpful to provide some guidance on circumstances in which adopting Fast Track compliance would not be a suitable approach for a scheme.

Our responses to your specific questions are set out in the appendix to this letter.

We hope that you find the contents of this letter of assistance. We would be happy to discuss them further if that is helpful. In that event, please contact me on 01372 733763 or at peter.williams@aon.com.

Yours faithfully

Peter Williams
Chairman, Pension Schemes Committee
On behalf of the Association of Consulting Actuaries Limited

APPENDIX

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

Yes.

We strongly support Fast Track being separated from the code of practice and not being used as a benchmark to assess schemes which do not adopt Fast Track compliance.

In section 3 you suggest that trustees might use Fast Track as a negotiation tool. This comment should be removed, given Fast Track is no longer a benchmark.

2. Are there any aspects of this you think it would be useful for us to clarify further?

It would be helpful to provide more information on scenarios in which it would not be appropriate for trustees to use Fast Track compliance.

We note that the code of practice envisages trustees carry out a reasonably detailed assessment of the sponsor's covenant, but that Fast Track compliance makes no allowance for differences in strength of covenant. It would be helpful to expand on the circumstances in which the trustees' assessment of covenant should lead them to conclude that adopting Fast Track compliance is not appropriate.

In addition to consideration of scenarios in which the sponsor has a particularly poor covenant, it would be helpful for the Regulator to comment on scenarios in which schemes who are already targeting lower risk strategies or longer-term plans might come under pressure, perhaps from the scheme sponsor, to 'level down' to Fast Track, and what steps the Regulator thinks trustees should take in these circumstances.

In addition, it would be helpful for the Regulator to outline the process it will follow in reviewing the Fast Track parameters.

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?

Any additional burden for schemes choosing bespoke compliance with the code of practice should be kept to a minimum.

We agree with your comment in paragraph 7, that the complexity of risks being taken (rather than whether a scheme is adopting Fast Track or bespoke) should determine the level of evidence and explanation required. We are pleased to note, in paragraph 8, that the statement of strategy could provide sufficient evidence for trustees to expect minimal scrutiny and engagement with the Regulator.

We envisage that many schemes will be adopting plans that are broadly and perhaps significantly stronger than the requirements of Fast Track overall, while potentially not satisfying every element of Fast Track. Other trustees may simply not want to meet the additional costs of checking their approach against the various Fast Track parameters (which might or might not all be satisfied).

Schemes can legitimately choose not to spend additional time and resources to assess how their chosen approach stacks up against the Fast Track parameters, and the additional regulatory burden for such schemes should be kept to a minimum.

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

It is very difficult to comment properly without knowing exactly what the scheme actuary will be asked to certify, and the precise wording that will be used.

The comments in paragraph 45 of the consultation and paragraphs 46 and 64-67of Appendix 1 are helpful in explaining the scheme actuary's role.

The actuary should only have to formally confirm whether the scheme meets the Fast Track requirements in situations where the Trustees have explicitly decided to adopt this regulatory approach, as confirming whether or not a scheme meets the Fast Track parameters requires additional work.

It will need to be made clear that the scheme actuary is not giving any opinion on whether it is appropriate for the trustees to adopt Fast Track in their specific circumstances and is simply commenting on whether the scheme meets the Fast Track tests set out by the Regulator. Paragraph 66 of Appendix 1 is helpful but could be extended to clarify this point.

There may also be circumstances in which the trustees have agreed to adopt assumptions which are not those which the scheme actuary would have chosen if they had the responsibility for setting the basis (although the assumptions may still be considered to be within a reasonable range). In any event, since not every assumption is specified for FastTrack (an approach which we fully support) it will need to be made clear that the confirmation is based on assumptions set by the trustees. Another scenario might be where the assumptions adopted by the trustees result in Fast Track being passed but in the actuary's opinion, the investments held do not justify adopting a 'gilts+0.5%' basis. Again, it would need to be clear that the actuary is simply applying the Fast Track tests and not applying judgement on whether these tests are appropriate in the specific circumstances.

We suggest that TPR and the Actuarial Profession agree a form of confirmation that will meet TPR's needs, while also being sufficiently clear on the extent of the confirmation being taken on by the Scheme Actuary so as to make it straightforward for them to sign it when appropriate.

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

The suggested amendments for small schemes, as summarised in paragraph 50, seem reasonable.

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

No.

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.

As we note in our response to question 2 above, the Regulator needs to set out clearly the circumstances in which it would not be appropriate to adopt the proposed Fast Track parameters and employers with a high insolvency risk is likely to be one example to include. The comments in paragraph 96 indicate that this is such an example but the fact that Fast Track is unlikely to be appropriate in these circumstances should be stated prominently.

In terms of an alternative approach for such schemes, as the purpose of Fast Track is to act as a regulatory filter, and we might expect the Regulator to be interested in schemes with a high insolvency risk unless they are particularly well funded, one approach might be for the Regulator to filter such schemes based on the use of a low dependency funding basis, irrespective of their current maturity. Arguably this is consistent with the draft code, if we interpret schemes as having high insolvency risk as having minimal covenant longevity/reliability/visibility. However, we note that in paragraph 96 of the Fast Track consultation you suggest that requiring such schemes to fund to this level to pass Fast Track compliance would be "disproportionate" as "only a small proportion of these employers will actually go insolvent in the short term". This will need to be the Regulator's call – do you want such schemes to pass through the Regulatory filter or be flagged for further Regulatory consideration?

Our preference is clear guidance for trustees on when adopting Fast Track is not appropriate. A further issue that would be associated with a two-category Fast Track (with tougher Fast Track requirements for high insolvency risk schemes) is that in applying the Fast Track tests the scheme actuary would potentially be drawn into considerations of whether the scheme had a "high insolvency risk" sponsor or not. The Regulator would need to explain very clearly how a scheme sponsor would be determined to fall into this category.

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. On balance we expect that this approach will require less additional calculations (i.e. calculations carried out purely for the purpose of testing compliance with Fast Track) compared to some others and on that basis believe it is a reasonable approach to adopt.

We disagree that interpolation should be used for durations of non-integer values (which will be most cases) and suggest that using duration rounded up to the nearest whole year would be more appropriate with ensuring the test is straightforward to understand and apply.

We note the potential for inconsistency between the low dependency basis being used to calculate the duration (i.e. the scheme's own low dependency basis) and the low dependency basis being used in calculation of the minimum technical provisions (i.e. relative to the scheme's own low dependency basis OR the fast track minimum low dependency basis). We suggest these are aligned, so the scheme can base the test on the duration as calculated on the Fast Track minimum low dependency basis where this is consistent with the approach taken for the calculation of the minimum technical provisions relative to low dependency.

As set out in our response to the Code consultation, in our view using a duration of 12 in current market conditions produces a relevant date which is too early. This has a knock-on effect on the proposed Fast Track parameters, where in current conditions the minimum Technical Provisions levels are higher than expected. We anticipate that if the duration is changed to say 9 or 10 years (or a different approach used) then more schemes would currently be able to comply with the Fast Track parameters.

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

The rationale of transitioning between gilts+2% to gilts+0.5% seems a reasonable method of generating the limits proposed for Fast Track.

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?

This seems reasonable.

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?

We understand that the intention is to allow schemes to assume members commute pension for cash under Fast Track, even if this reduces the projected liabilities (as the reference to "other options" in table 5, refers to the "other options" in the code of practice, which does not include commutation). We agree that commutation should be allowable under Fast Track and this should be made clear in the final documentation.

On reserving for future Expenses, our understanding is that the requirements of the code (which "expect" a reserve for future expenses in most circumstances) mean that the Fast Track low dependency funding basis should include an allowance for expenses in the same circumstances as set out in the code. This should be stated explicitly in the final Fast Track documentation.

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

The suggested amendments for smaller schemes seem reasonable. As we have noted above, we agree that cash commutation should be allowable for all schemes.

We would question whether there should be an expectation of an expense reserve. This could increase the risk of a trapped surplus emerging for smaller schemes where the required expense reserve may be proportionally more material.

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.

Given the draft Code's principle of encouraging shorter recovery plans with greater maturity, the approach of having a shorter recovery length after significant maturity appears reasonable. This does lead a cliff-edge for those looking to adopt Fast Track, with a halving of the recovery period for a scheme just after the point of significant maturity. However, given that in these situations' schemes would be able to submit their valuation under bespoke and would expect limited intervention if this was the only one of the Fast Track parameters that wasn't met, the adoption of some form of tapering would appear to be a complication that doesn't outweigh the simple approach being proposed.

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

No, if the 6 and 3 year periods are adopted. Given the 12-15 months typically required to complete valuations, if the period is measured from the valuation date it would be more reasonable for the timescales to be a 7 year period (and 4 year post significant maturity) to more accurately reflect the period of two valuation cycles.

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?

We believe that it is important that Fast Track allows for option of including post valuation experience. The proposed approach appears reasonable.

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?

We agree that it can be helpful to allow for some flexibility to adopt increasing recovery plan contributions. Recognising that Bespoke will allow greater flexibility if required for any scheme specific situation, it seems reasonable to put a limit on the level of back-end loading under Fast Track. As such, CPI increases would appear like a simple and sensible limit, although in our view RPI would also be a reasonable approach.

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

We agree that it is necessary to have a standardisation and simplicity for the stress tests however we think that it may be useful to observe what is done Solvency II. In particular, this is in respect of the interest rate exposure where under the PPF stress tests holding gilts looks like it will always be a positive stress. As last year has shown, interest rates can be a significant risk with bonds falling significantly (and in some cases more than equities). Under the current approach a scheme with significant bond and equity exposure would have looked low risk last year, which would not have turned out to be the case.

We think it may be useful to consider an approach like SII where interest rates are shocked up and down and the worst of each of these is taken as the risk factor.

We also understand that there is a need for simplicity however we do think it would be worth considering if the granularity of asset classes should be wider. A potential risk that can occur with relatively simple asset classes is that you can get some unintended consequences for how asset classes are allocated. For example, short duration gilts get a very positive score in this despite the fact that the stress factor is based on long duration gilts. This could lead to schemes holding gilts within a Growth allocation for diversification purposes when the true level of diversification is significantly lower.

We do not wish to go through each asset class assumption given these are taken from the PPF but we would note that the 4% loss in property given the moves this year seems relatively low. This may also be a good example of the twinning of this with the systemic risk as part of the reason for the fall in property prices is that many UK DB pension schemes invested in UK property and when they needed to resize portfolios it led to systematic selling across the whole complex.

If the PPF-based approach is adopted, schemes that use a bespoke PPF stress test should also be able to use this approach for Fast Track purposes.

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

The limits in terms of the levels seem reasonable (particularly when considering the analysis done on the current universe), however our main point would be in ensuring there is some flexibility around these. For example we would not want short term market movements to require pension schemes to make changes that are not beneficial to their members because they felt constrained by the requirements of Fast Track.

In particular we note that if trustees felt like the limits were hard and fast they may target a relatively wide buffer to give room which is not something that would be beneficial.

We also think it would be useful for the Regulator to indicate annually if they feel that it is a year where stresses have been higher than anticipated. If this is not the case, then you can create issues as after a stress event has occurred trustees may still feel they need to stay within all the limits even though the stress event that was anticipated has already occurred. We presume that this is something that could be covered under the review that is envisaged in section 14 of the consultation.

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

An objective of schemes in surplus should be to ensure they can still pay all the benefits as they fall due. In that respect trustees need to ensure that having a surplus does not mean that they justify taking unwarranted risks (although some risk might well be warranted – for example to reach buy-out).

As we understand the tests, a scheme in a strong surplus (unless they have a risky asset strategy) would come out with effectively 1 – Fast Track TP Parameter/Fast Track TP Parameter which is appropriate. If they have an excessively risky asset strategy however this will show up with a stressed funding level below 100% which is an appropriate outcome.

One comment we would make is that if a scheme is using some of their surplus to meet the cost of future accrual this may not be reflected in this and could make the tests less stringent given a proportion of the assets are already pledged against future liabilities.

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?

Although there is simplicity in this approach, we would advocate for a specific set of assumptions derived for this purpose. We have noted some issues we have with the PPF Tier 1 shocks and asset classes in response to Question 17. At the very least we would advocate for breaking out the duration of the bonds to allow schemes more granularity.

Given the desire for simplicity (which we agree with) a simple adjustment may be to say that gilts for LDI purposes are in the long-dated bucket and those for other purposes are short dated (using Tier 2 PPF categories).

If we could go further though we believe splitting the durations out would also be beneficial to ensure that schemes do not look as though they are running less or more risk than they actually are. For example. as we understand it at the moment a short dated scheme with 100% liability hedge would categorise their bonds as long dated which may not be the case (if the bonds match their duration) and could lead to them looking very low risk as bonds all receive a positive stress.

We would also suggest considering if asset shocks could consider a rate rise and a rate falling environment as SII does. At the current time the stresses effectively assume that rates will fall in a stressed scenario, unfortunately this is not what occurred in 2022. At the current time, schemes could effectively be running long duration (over hedged) and use that to offset other risks such as equity risk in the stress test. The issue is that this would have looked low risk but in 2022 it could have opened up a much wider gap in the funding level than the risk metrics allowed for.

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

Yes.

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

Yes.

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

We suggest the definition be broadened to include all schemes with either fewer than 100 members or with assets less than a certain amount e.g. £20m. Average member liability can vary widely among schemes. Including an asset-based threshold as well would better reflect the comment in the consultation document that the additional costs of compliance will be significantly larger for smaller schemes when considered as a percentage of scheme liabilities.

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 we believe a six year allowance for future accrual is reasonable for Fast Track, although it may in practice limit the number of open schemes (especially those open to new entrants) who choose the Fast Track approach.

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

Yes we are comfortable with the proposed approach of limiting allowance for new entrants to be based on the average level over the preceding three years for Fast Track.

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

We do not believe there need to be additional restrictions on future service cost applied for Fast Track. We note that this is effectively already addressed by the existing 2006 requirements for the Scheme Actuary to certify that Technical Provisions are expected to be fully funded by the end of the Schedule of Contributions period. This certification directly takes into account the level of future service contributions being paid, and is a confirmation that they can be supported while still meeting the trustee's funding target.

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

We would prefer option 2 – an annual review. For individual schemes either an annual or triennial review approach means a change is possible from one triennial valuation to the next. Annual reviews are likely to result in smaller step changes from year to year, and give schemes more notice of changes that might impact them in future.

The timing of the announcement will be the most important issue for schemes. The announcement will need to be timed so that it does not disrupt valuations. With this in mind, announcing the parameters well in advance of the end of the year, to apply to valuations with effective dates from the upcoming 31 December onwards, would be preferable. Providing sufficient notice is key.

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

No.

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

In our view, the analysis already done potentially understates the overall impact of Fast Track, given the relatively high amount of "levelling down" assumed in the projections. In our view many employers and trustees who currently fund on a stronger basis than that assumed for Fast Track may well choose to continue their current approach.

In our response to the DWP on the draft regulations we expressed concern over the lack of a proper impact assessment, given that the draft regulations appeared to be potentially impose significantly higher contributions on employers.

The draft code of practice has included helpful interpretations on key aspects of the draft legislation, which indicates that there is considerably more flexibility than we had feared. We therefore have less concerns over the potential impact on contributions. Indeed, as many schemes have already been encouraged to take significant steps towards long term planning in advance of the legislation coming into force, if the comparison is with the current position the main impact may be some 'levelling down', in addition to the additional costs associated with compliance and documentation.

The impact on open schemes may be the most significant impact – but this is hard to predict with certainty.

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