ASSOCIATION OF CONSULTING ACTUARIES

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db.consultation@tpr.gov.uk

DB funding Code team
The Pensions Regulator
Napier House, Trafalgar Place
Brighton
BN1 4DW

Dear Sirs

The New Funding Code of Practice

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

We strongly support the principles set out in the draft Code of practice. 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 of practice.

Our most significant concern is the disconnect between the relatively prescriptive wording used in the draft DWP Regulations and the greater degree of flexibility signalled in the draft Code of practice, in particular in how the low dependency funding and investment targets are described. As a minimum, it would be reassuring to have written DWP confirmation that the Code is in line with the policy intent. Our preference would be for the final regulations to be refined to more closely reflect the flexibilities set out in the Code. Trustees and sponsors need to be certain that following the approach outlined in the Code will ensure compliance with the legislation. [See Q3, Q8 and Q39]

We have a strong preference for a less volatile measure of significant maturity, to help schemes plan ahead with certainty on when they must reach low dependency. We would support a fixed basis for the calculation of duration. We also note that in current conditions, using the approach outlined in the draft regulations and Code with a duration no less than 12 produces a target date for low dependency that is too early for many schemes. In addition, as set out in our response to the draft regulations, we would prefer schemes to be able to set a relevant date within a wider range of the projected date of significant maturity. [See Q17]

The Code should make it clear that trustees can have a longer-term target beyond achieving low dependency by their relevant date – such as to achieve a funding level sufficient for buy-out (which may not have a fixed target date). [See Q1]

For schemes which are 'genuinely open' and therefore not moving at pace towards significant maturity, the requirements impose an obligation to set and fund for a journey plan that is not expected to materialise in practice. This places a significant amount of additional work, and potentially cost, for minimal (if any) benefit – although we recognise this is a legislative point, we reiterate the call we made in our response to the draft regulations, for a carve-out for such schemes. In a recent ACA survey of two-thirds of respondents who indicated the issue was applicable, thought the proposed new regime would have a negative impact on schemes open to future accrual. [See Q36]

We also have concerns about the use of subjective covenant measures such as the free cashflow of the sponsor and the period of reliability to define maximum risk, as the interpretation of these measures could vary significantly by assessor leading to a wide variety of outcomes. They may also be overly simplistic when considering large multi-national groups. As a result, we believe that these matters may be best considered in guidance rather than the Code with flexibility to consider alternative approaches to assessing the covenant's ability to support risk, where appropriate. We also have some concerns that perceived limitations on the value that can be placed on contingent assets may deter some forms of covenant support altogether.

The proposals increase the prospect of 'trapped surplus' under some scheme rules. It would be perverse to require higher employer contributions which lead to trapped surpluses, which may then not be refundable or refundable after a tax charge. As there seems no intention for the Regulations to change the rights to surpluses under individual scheme rules, the funding regime must instead be sufficiently flexible to consider of the likelihood of 'trapped surpluses' when agreeing journey plans, low dependency asset allocations, employer contributions and use of contingent assets.

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

An additional point to raise, which does not fall naturally under any of your questions, is that the Code does not mention cash balance or hybrid schemes (either those with "DB plus DC" benefits or those providing the higher of DB and DC benefits), and how the Code should be interpreted for these schemes. For cash balance schemes in particular, further consideration is needed of the appropriate duration to be used for determining significant maturity.

Other than the comment in Appendix 3, there is also no mention of discretionary pension increases (which could range from aspirational through to a funded established practice) and how these should be allowed for under the new regime.

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

The funding regime

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

In the description of the legislative requirements, we do not think it is helpful to use informal terms such as 'end game'. Many schemes may envisage an ultimate 'end game' of buy-out, without wanting to set this as "the funding level the trustees or managers intend the scheme to have achieved as at the relevant date" as described in s221A of PA04. We suggest that this section, describing the legislation, should refer to the actual terms used in the legislation and make it clear that although schemes need to plan for low dependency on the employer by the relevant date, there might well be a further funding objective beyond low dependency.

Paragraph 20 states that the funding and investment strategy must be agreed with the employer. This should be amended to clarify that it needs to be agreed with the employer only where the trustees and the employer already need to formally agree a valuation under Part 3 – for example, this is not the case where scheme rules give the trustees the power to set the contribution rate unilaterally.

There are several references to the 'low dependency asset allocation' in the draft Code, which should reference the 'low dependency investment allocation'.

Low dependency investment allocation

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?

To an extent, and we recognise the need for simplicity, though "contractual cashflow" or similar may be a better description here.

Trustees should understand the principle behind the definition of a matching asset, albeit recent volatility in both realised inflation and future inflation expectations has highlighted that inflation-linked cashflow matching assets such as index-linked gilts have income and capital payments that are neither stable nor predictable, in nominal terms at least. Furthermore, there are very few/no truly "matching assets" other than a buy-in – index-linked gilts, for example, do not match pension payments (which may be linked to CPI, and capped, say).

The definition also raises questions regarding whether floating-rate instruments and/or non-Sterling assets would meet the criteria of a "matching asset".

Finally the defined split between "growth" and "matching" assets is fairly simplistic – some assets (such a various forms of property and infrastructure) can perform both roles.

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

This is an area in which the proposed legislative requirement for "cash flows from investments to be broadly matched with the payments from pensions and other benefits" appears more onerous than the flexible interpretation set out in the draft Code. "Broadly" would suggest more extensive matching than suggested in the Code – perhaps more consistent with the legislations requiring "appropriate" matching.

Paragraphs 61-64 are clear around the principles behind cashflow matching (notwithstanding the above comments) and the types of assets that should be held to achieve this, highlighting that there is a degree of flexibility around this, whilst trustees need not look to perfectly match what are unknown liabilities (paragraph 66). We agree with this approach.

Paragraph 67 is somewhat unclear as to what is being suggested and the circumstances under which this might apply - for example why might a scheme "plan to put in place alternative hedging strategies" instead of simply having such a strategy in place already, and what do "alternative hedging strategies" refer to? More widely, an important point here is that there will still need to be sufficient assets available for realisation (likely from the growth portfolio) to meet any additional cashflow needs.

That said, we would encourage an approach, as summarised in paragraph 70, of looking to broadly match expected cashflows as far as is able/practical to do so, specific to a scheme's individual circumstances (e.g. adjust the strategy as necessary if buy-out is on the horizon) with the LDI portfolio being seen as a "completion" portfolio to manage overall interest rate and inflation exposures – though the wording in paragraph 70 and surrounding paragraphs does not specify why a scheme might only carry out "some" cashflow matching.

Paragraphs 68 and 69 are clear on the uncertainties around interest rates and inflation, and hence the need to take this into account when looking to hedge exposures. More widely, scheme cashflows themselves are uncertain (as hinted at in paragraph 65) owing to transfers, commutation, early/late retirements, mortality etc. At the same time expected asset cashflows can vary over time (particularly within "evergreen" pooled funds). Hence any such cashflow matching strategy should be revisited regularly (at minimum every 3 years).

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, the draft broadly captures the main principles behind cashflow matching, and schemes ultimately putting themselves in a position to meet benefits as they fall due, without being a forced seller of assets. As suggested above, we feel the draft could further highlight the level of uncertainty over liability (and asset) cashflows, and hence the need to set a strategy accordingly, and regularly review.

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?

All assets are different, offering unique characteristics and therefore lying on a spectrum (be this from “low risk” to “high risk”, or “pure matching” to “no matching”, say). As such, any definition of “matching” and “growth” is somewhat arbitrary. As highlighted above, some assets can perform dual roles – for example certain property or infrastructure assets expected to provide both a return in excess of liabilities, and stable cashflows – as such one scheme’s matching asset may be another scheme’s growth asset. Meanwhile other assets such as gilts (and related derivatives) may accurately match mark-to-market liability valuation risk, whilst not provide a sufficient level of cashflow to meet benefit payments. Therefore it is the balance at total portfolio level that is important.

That said, we recognise that defining a broad split can serve a purpose for governance and/or operational reasons, and thus in allowing trustees to better define and set an appropriate cashflow-focused investment strategy.

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?

Setting a specific threshold of 90% seems too prescriptive for the Code itself, particularly in light of recent LDI developments. In our recent ACA survey, 44% of respondents that expressed a view thought that the new regime was likely to increase systemic risk.

If setting a minimum hedge ratio, the basis for the liability should be clearly defined. Assuming the calculation is carried out on a low-dependency basis with best estimate experience assumptions, a minimum of 90% may be too high for some schemes, for a couple of reasons:

> a) Schemes will need to maintain a higher level of collateral headroom following the gilt crisis of 2022, as such, there is a natural tension between level of hedging and level of collateral for schemes with leveraged gilt exposure. A hedge ratio slightly below 90% (e.g. 80%) may be more efficient from a perspective of maintaining adequate collateral, whilst running an investment strategy expected to deliver a sufficient level of income (and provide a sufficient long-term return), with only a modest impact on “mark to market” investment risk.
>
> b) the “right” hedge ratio for managing risk on a low dependency basis may not be the “right” hedge ratio for managing risk for a scheme looking to buyout in the short-to-medium term

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

The requirement to develop a scheme-specific low dependency investment allocation (LDIA) would be quite onerous on smaller schemes, in the manner set out in the draft Code. We suggest that the Code could make clear that simple adoption of the example “satisfactory” LDIA set out in the Code could suffice for smaller schemes.

We would caution against even the most sophisticated schemes looking to very accurately match year-on-year liability cashflows, given the number of assumptions underlying both the asset and liability cashflows, and knowledge that liabilities can vary considerably from one valuation to the next, dependent on member experience, options, and assumptions. From a practical perspective, the existence of member options may be a valid reason for not cashflow matching closely.

Where the approach to cashflow matching may differ more meaningfully is for schemes with differing strategic objectives, particularly those aiming for long-term run-off versus those targeting medium-term buyout. Small schemes in this camp may not be able to carry out detailed modelling on cashflow matching – some simple quant tests may be appropriate for such schemes.

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

Yes, except for smaller schemes.

However, this is another area in which the proposed legislative requirement, in this case that the asset value relative to the liability value be "highly resilient to short-term adverse changes in market conditions", appears more onerous than the interpretation set out in the draft Code. We would suggest that the legislation should follow the proposals in the Code more closely – perhaps referencing simply "resilient" rather than "highly resilient".

Any such stress test should make suitable assumptions regarding the certainty of underlying cashflows – for example the possibility of credit defaults which would impact income received from corporate bonds. Any such test should ideally capture resilience from the perspective of being able to maintain the prevailing investment strategy at times of market stress.

The application of the stress tests as outlined by the Code is also likely to be onerous for many smaller schemes. Since the Code recognises that a proportionate approach is expected, we consider that it should be possible and adequate for trustees of smaller schemes, for example, to be able to explain "high resilience" in the statement of strategy in a manner which does not necessarily require the reporting of numerical stress tests. Also, a significant proportion of the liabilities can be concentrated in a handful of lives in some smaller schemes meaning that the value of stress-testing assets can be lost when weighed against the potential impact of varying demographic experience.

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?

A stress based around VaR95 would be the natural choice (with a revised maximum stress limit), given its ubiquity across the pension scheme industry as a measure of risk, and the fact that most trustees do not currently consider or monitor 1 in 6 stresses.

If looking at 1-in-6 year risk (presumably analogous to tracking error), the limit of 4.5% seems like a reasonable one, allowing for reasonable variation between different models used for carrying out such analysis (though, as noted in question 8, it is questionable whether it meets the "highly resilient" bar set by the draft regulations). Schemes following a broad cashflow matching approach in line with the guidance included in the draft Code should sit comfortably within this limit.

The above said, small schemes may not have the means and/or resources to carry out such a test, whilst there is a danger of some schemes "gaming" the calculation.

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.

Trustees will use a range of models for carrying out the stress test, each with different underlying assumptions and parameters. Being overly prescriptive for the stress test is likely to be unduly restrictive and reduce competition and innovation amongst providers.

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, whilst we believe it is critical to carry out a suitable assessment of liquidity based upon actual holdings, there is little merit in carrying out such a calculation on a hypothetical portfolio.

Low dependency funding basis

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 – we support the proposed approach, avoiding further prescription.

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, we agree these are the main approaches and the descriptions in the draft Code are adequate.

The Code should include an expectation that the trustees obtain advice from their scheme actuary when considering their low dependency funding basis. Our reading is that (perhaps surprisingly) the legislation does not require actuarial advice on setting the assumptions for this basis.

14. Should we provide guidance for any other methodologies?

We do not think this is necessary.

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?

On appendices 3 and 4 in general, we question whether the level of detail is appropriate for a principles-based Code. While the comments might generally be reasonable we think the overarching requirement for prudence is sufficient for the Code and that these two appendices should be removed.

We note that paragraph 94 of the consultation document might be read as suggesting that appendix 3 is only guidance and not "part of the Code". This seems a preferable approach, but it is not clear that is the case from the draft Code. Paragraph 98 states that appendix 3 sets out how the Regulator "expects" trustees to approach the assumptions, which is a word used elsewhere to signify a requirement of the Code as opposed to legislation (as per paragraph 12 of the Code). Appendix 3 also refers to expectations. We would support Appendix 3 being clearly labelled as guidance rather than part of the Code.

On Inflation-related pension increases, another recognised method that should be included is "hard capping", where a yield curve is used, with the inflation in each year capped at the relevant maximum (or floored at the minimum) as appropriate.

On cash commutation, the "no lower than current factors" comment is too prescriptive in the context of rising interest rates. Factor reviews are often carried out after the valuation has been concluded, and where yields have risen substantially, it is quite possible that commutation factors will reduce once the review has been implemented. It would therefore be helpful to clarify that allowance can be made for lower commutation factors in some circumstances (for example, where the factors are expected to reduce at the next review) although better would be to remove the restriction and require that the rates are no lower than expected to apply in the medium term.

The requirements for mortality assumptions should mirror the relevant regulations, that is, they should be "based on prudent principles" rather than "chosen prudently".

The references to use of available information (for example, in the context of proportion married assumptions) should include some reference to whether carrying out an analysis of the available information would be proportionate.

On expenses, the reference to appendix 3 in paragraph 99 should be to appendix 4.

Generally, we would support a less prescriptive wording on the expectation for expense reserving, allowing trustees to make appropriate allowance for future expenses, accommodating circumstances where (for example) the employer provides administrative services to the trustees. We comment on the details below.

We are also concerned that, particularly for smaller schemes, there is an element of loading prudence on prudence where the schemes are expected to set every demographic assumption with a prudent margin or based on PPF assumptions when faced with a lack of scheme specific data. The principle, as currently, should be that overall the assumptions are sufficiently prudent, taking into account the experience and data on which they are based.

On appendix 4, we would suggest that any legally binding obligation for future expenses to be met by an employer should be treated in the same way as such an obligation set out in the scheme rules. In addition, if there is an obligation to meet certain expenses (rather than "the full costs") then an appropriate adjustment to the expenses reserve should be allowed. (The draft Code and the consultation document seem inconsistent on this point – the draft Code refers to "a requirement for the employer to pay expenses" while the consultation document suggest the exemption only applies where there is a requirement for "the employer to cover the full cost".)

In addition, the wording in appendix 4 should enable the expense reserve to be reduced to reflect funds held in escrow to meet future expenses. This flexibility is essential to avoid trapped surpluses.

The Code should make it clear that, where there is a longer-term objective to buy-out at some future date (which is not the low dependency target at the relevant date) and wind-up, then the expense reserve need only cover expenses up to the anticipated date of winding up.

In addition, the references to allowing for expenses on or after the relevant date should also say "or, if later, the valuation date", to reflect schemes which are already significantly mature.

We note that the expense requirements are particularly onerous for small schemes. In practice, a buy-out target might be lower than a low dependency target with a full expense allowance for such schemes.

Relevant date and significant maturity

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

Yes – this could be helpful in some circumstances.

It is not clear what is meant by “small schemes” or “smaller schemes” (which is the wording used in paragraph 113 of the draft Code) in this context. This could be interpreted as schemes with ‘less than 100 members’, as referenced elsewhere in the Code in the context of Own Risk Assessment, but we suspect the intention is a wider scope – in which case it would be helpful to clarify which schemes can use the simplified approach.

More generally, we noted in our response to the draft regulations that duration relates to ‘liabilities’ which is not defined, and that this makes it unclear how duration would be impacted by a ‘buy-in’ which matches part of a scheme’s liabilities with annuity contracts. Our reading is that a scheme actuary can choose to include or exclude such liabilities, consistent with Regulation 3(4) of the OPS (Scheme Funding) Regulations 2005. It is not clear to us whether – in principle - such secured liabilities should be included or excluded, as there are arguments for and against. However, the decision could have a very large impact on the resulting duration, and therefore on how close the scheme is to significant maturity and the required strength of its technical provisions. If this issue is not addressed in the final regulations, you may wish to take a position within the Code by setting an expectation for the approach to be adopted in these circumstances.

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 have a strong preference for a less volatile measure of significant maturity, to help schemes plan ahead with some certainty on when they must reach low dependency, and to manage and monitor their journey plan appropriately on an ongoing basis. We would support a fixed basis for the calculation of duration similar to option 1. The key issue is that cashflows are met in the short to medium term.

In addition, as set out in our response to the draft regulations, we would prefer schemes to be able to set a relevant date within a wider range of the projected date of significant maturity. It should be possible to retain a stable target date unless the liability profile actually changes.

If the current structure is retained – the benchmark should now be 9 or at most 10 years, rather than 12 – reflecting changes in yields since the original proposals were put forward in 2020.

Setting differing durations within the Code and fast track, assuming both were still based on a market related basis, would not solve the problems associated with volatility caused by market movements – except to the extent that a scheme previously targeting fast track could ‘fall back’ on a more flexible requirements in the Code following adverse market movements.

From a regulatory perspective, this would presumably be problematic as large numbers of schemes might move from fast track to bespoke compliance at the same time. However, from an individual scheme’s perspective, this would provide some additional flexibility in comparison with the proposed approach currently set out in the draft Code and fast track proposals.

Assessing the strength of the employer covenant

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

The Code defines three periods of covenant outlook, and whilst we support this focus we note:

- The period of visibility has limited impact on a scheme's funding and investment decisions and therefore does not appear to be a valuable definition beyond educating the period of reliability.
- The interpretation of the definitions is subjective and there could be significant variability between assessors which could give rise to significant differences in views on supportable risk.
- Supporting commentary from TPR indicates that your view is that the period of reliability should generally be no longer than 6 years unless there are reasons to support an alternative view. If this is TPR's view then this should be outlined in the Code.
- The period of longevity is likely to be challenging to define, and we would consider it more appropriate to consider whether there is any reason that the covenant will not continue to support the scheme until the relevant date (and potentially beyond).
- There is limited focus on the role of covenant beyond the relevant date, and we note that, in particular where schemes have chosen a relevant date which is tangibly ahead of the period of significant maturity, they may continue to rely on the covenant in some form well beyond the relevant date.

19. Do you agree with the approach we have set out for assessing the sponsors cash flow? If not, what would you suggest as an alternative?

We agree with the overall principles outlined in the Code of assessing the sponsor's free cash flows however we again note that this measure may be subjective and could have a significant impact on the scheme's level of supportable risk. We suggest these matters may be best dealt with as part of the guidance rather than requirements under the Code.

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?

We agree in principle with the factors outlined in the Code with regard to assessing the sponsor's prospects. However, we believe there should be greater clarity that the matters outlined relate to those indicated in Paragraph 7(4) of the Regulations i.e. for "assessing financial ability of the employer in relation to the scheme to support the scheme" to include cash flow, likelihood of an insolvency event, and "other factors… as set out in a Code".

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?

We recognise that contingent assets form an important component of many schemes covenant support and broadly support the approach laid out by TPR. However, in the absence of the wider covenant guidance, we are concerned that the inclusion of the straightforward examples included in the Code may result in more complex contingent assets, that do not fit these categories, to be given limited credit - or more concerning, to not be offered at all, despite offering often valuable additional covenant support.

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

We recognise the rationale for considering the value of security arrangements in the circumstances in which they will be called, however we do not agree that this directly correlates to the ability of the sponsor to support a funding deficit as indicated in proposed calculation for maximum risk. 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.

We also believe there is an inconsistency in giving only indirect credit to a sponsor's balance sheet, in terms of the resilience of the sponsor, with the concept of material detriment and TPR's contribution notice powers which calculate the impact of the event on the outcome to the scheme in an insolvency scenario. We believe TPR should also seek consistency with PPF valuation principles where appropriate.

Finally, we note that Asset-backed Contributions (ABCs) are not mentioned in the Code and would expect this to be covered in the upcoming guidance.

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

Our experience is that "look through" guarantees are reasonably uncommon in the current pension universe, and we question whether the focus on the characteristics of a "look through" guarantees may put corporates off providing additional valuable contingent support. This is especially relevant as many schemes funding levels improve and recovery plans are becoming a smaller part of journey plans.

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

We do not have any concerns about the considerations outlined with regard to multi-employer schemes, however we note the Code does not differentiate between associated and non-associated multi-employer schemes and we believe this is an important consideration for trustees that should be reflected in the Code.

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?

In our experience, the economic viability of not-for profit organisations is dependent on the balance of its income and its use of funds. We view the Code as focusing principally on income generation, with limited appreciation of the use of funds, and in particular the balance of the use of funds for charitable purposes and contributions to a scheme.

We also note that many such organisations hold significant liquid investments which underpin their operations. It is not clear how these would be reflected where the investments are not directly charged to the scheme, noting that for many not-for-profit organisations the scheme may be the principal creditor.

Journey planning

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?

As mentioned in response to Question 17, we have a strong preference for a less volatile measure of significant maturity, to help schemes plan ahead with some certainty. Using current yields and a duration of 12 years currently produces a relevant date before the point most schemes would currently consider themselves "significantly mature" and earlier than current journey plans assume for reaching low dependency.

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?

The distinction between the two periods makes some sense, although we note that in practice there may not be two distinct periods, but rather just a widening degree of uncertainty over covenant reliability as the period increases.

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?

In principle, it is sensible to use a stress test and assess this against the sponsor's ability to support the risk. However, depending on the nature of the sponsor and their covenant, this can be done significantly more simply for some schemes than for others.

When translating the 1-in-6 stress test to an increase in resultant contributions, the Code is unclear on the following:

- Is the covenant also stressed in this scenario, and if so, how and to what extent?
- Which parameters of a recovery plan calculation (other than asset outperformance, which is explicitly mentioned) are permissible to be incorporated e.g., inflation-linked contributions and whether the inflation assumption can be consistent with the stress.
- Whether the parameters of the recovery plan (other than asset outperformance which is explicitly covered) are permissible to vary e.g., if your current recovery plan *does not* make any allowance for asset-outperformance or inflation-linked contributions, is it permissible when considering the recovery plan that would be in place following a 1-in-6 stress?
- Is there any ability to allow for unusual shapes (e.g., back-end loading) of contributions following a stress to better fit with the shape of affordability in each year for the sponsor over the period of reliability?
- What (if any) management actions, by the sponsor and/or trustees, are permissible to allow for? For example, could it be agreed that following an adverse stress, the sponsor would put in place alternative security to justify a more back-end loaded contribution pattern to better match their affordability profile?

It should be recognised that there is a circularity in the definition of the Maximum Risk Test. In order to carry out the test, one needs to define a Technical Provisions basis to then stress alongside the assets and ascertain the resultant contributions. If these contributions are tested against affordability for the sponsor and found to be unaffordable, there will need to be an iterative loop to (for example) de-risk the asset allocation, which in turn may then require a strengthening of the Technical Provisions and potentially reducing the asset outperformance, and so change the Maximum Risk Test (or potentially increase the risk in the assets, weaken the TP basis, and reduce the contributions – depends on the position of the scheme). We suspect in most cases this will not be a major issue. But for those schemes on the edge of sponsor affordability, this may become a complex, onerous and circular exercise.

We also note that it is not clear where the funding for an additional 1 in 6 stress event will come from where an employer is already paying deficit contributions which are the maximum that they can reasonably afford.

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?

At one level, we think it is sensible to deduct other DRCs when thinking about this stress. Ideally, trustees should also consider a broad estimate of similar stress events on the other schemes with the same sponsor but we note that in practice this is unlikely to be realistic or proportionate. For employers already paying contributions at or close to the maximum affordable level, then it is not clear this stress test will add much additional insight and should instead consider what level of extension might be required to the current recovery plan.

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

In concept, we think this is a reasonable approach. However, there could be significant complexities in determining the Maximum Risk Test and affordability. As well as difficulties in assessing cashflow for complex businesses, there is, for example, the complexity in assessing a realistic recovery plan following a stress event. The recovery plan is a negotiated agreement which often takes a long time to resolve between trustee and sponsor – what would be the impact on the sponsor's affordability and reasonable asset return assumptions (for outperformance in the recovery plan) following a stress?

The trustees may also have reasons (for example, because of the existence of other contractual or regulatory support for the employer or scheme) to believe the scheme can take more risk than suggested by the stress test, and these circumstance should be recognised.

Our preference would be for the Code to be less prescriptive in how to assess affordability and maximum risk levels.

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

We agree that the considerations are appropriate in terms of the level of de-risking to be assumed in the journey plan beyond the period of covenant reliability.

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

We would suggest the Code is actually quite prescriptive regarding the Journey Plan shape as it sets assumed linear de-risking beyond the period of covenant reliability as a minimum.

Trying to compare aggregate risk levels under the linear and horizon ("lower-for-longer") de-risking patterns is technically difficult and introducing the horizon as an option is more complicated (especially given the Fast Track parameters will push most people towards linear in practice as the starting point).

In addition, a lower for longer strategy may be below the "maximum" line at outset, but above it at later dates – how will this be reflected in TPR's approach?

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?

Yes, this seems reasonable.

Statement of strategy

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?

This section of the Code provides little information beyond that which is already set out in the draft regulations. It is clear from those draft regulations that the statement of strategy will be a lengthy document covering many aspects of long-term planning and progress towards the target. It is less clear what level of detail might be envisaged on each of the various aspects.

It would be very helpful to have significantly more information on what the Regulator envisages well in advance of the implementation date for the new regime, particularly as the draft regulations state that the Regulator will set out the form of the statement of strategy. We note in particular that these issues will need to be considered and agreed with the employer as a first step in the valuation process for each scheme, schemes will need to know what is required well before the new regime is implemented.

As part of this, it would be helpful to include specific comment on the appropriate content of a statement of strategy for a scheme which is in relatively poor financial health (both in terms of funding and level of sponsor support). Such cases are discussed in paragraphs 330-335 in relation to the appropriate current investment strategy, but it is less clear what target should be set for the investment strategy after the relevant date. Should the FIS include a low dependency target that is very unlikely to be achieved (perhaps with further information in part 2 of the Statement on the difficulties in reaching this target) or a higher risk target, that is more realistic?

It will be helpful to have further information on this as soon as possible to help scheme plan for the new regime.

It would also be helpful if the comments on the statement of strategy in the Code differentiated clearly between those comments which are merely re-stating the requirements of legislation (which, as drafted, appears to cover the majority of the text) and additional regulatory expectations under the Code. For example:

- The legislation (s221B(2)(a) of PA04) requires comment on the extent to which the FIS is being successfully implemented and, "where it is not, the steps [the trustees] propose to take to remedy the position";
- The Code (para 241) states that the trustees should explain "the actions they will take to ensure they achieve their long term objective, should the scheme's journey plan not progress as expected"

The drafting in the Code seems much more onerous than the legislation, requiring details of actions that will be taken should the journey plan not progress as expected (which could potentially require consideration of a huge range of future possibilities, and seems extremely disproportionate) rather than simply requiring actions in response to events that have already taken place.

Perhaps the section could be restructured so that restatement of the legislation is separated from expectations of the Code.

Technical provisions

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?

We note that paragraph 261 introduces the term "actuarially consistent" when referring to consistency. We note that this term does not feature in the underpinning legislation and therefore would not expect to see it introduced in the Code.

We also note that paragraph 262 suggests the basis must be "the same or stronger". This is an incorrect reflection of the legislation and is inconsistent with the comparable description in paragraph 263 for the period following the relevant date, of "calculated in a way which is consistent with".

On paragraph 271 we believe there is justification to use different demographic assumptions for TPs compared to low dependency, particularly for a relatively immature scheme, for example. We would therefore prefer this wording was updated to suggest that trustees consider whether or not it is appropriate to have consistent assumptions between the TPs and low dependency funding basis.

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?

Yes, we believe it is appropriate for open schemes to be permitted to include an assumption relating to future accrual and new entrants.

For schemes which are 'genuinely open' and therefore not moving towards significant maturity, the requirements impose a higher funding target and a significant amount of additional work for minimal (if any) benefit – although we recognise this is a legislative point, we reiterate the call we made in our response to the draft regulations, for a carve-out for such schemes.

In a recent ACA survey of two-thirds of respondents who indicated the issue was applicable, thought the proposed new regime would have a negative impact on schemes open to future accrual.

We refer below to how the position might be improved within the constraints of the draft regulations. However, this is an overly technical solution within a restrictive framework, with minimal benefit. We would much prefer a carve out – perhaps where duration is above a certain threshold or where the scheme has not matured over the last 3 or 6 years, and there is good reason to suggest it will not mature in the medium term.

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?

We expect that linking this allowance with the covenant reliability periods is likely to be appropriate in some cases. However, in other cases where there are strong reasons to suggest it will be the case, assuming future service continues for the period of covenant longevity might be more appropriate (effectively allowing future service to be assumed to continue for a much longer period, where there is no reason to believe that it will cease after 6 years or so).

We believe this should remain at the discretion of the trustees – for example, we would suggest that paragraphs 277 and 278 be amended to refer to any expectation of closure and the period of longevity rather than the period of reliability.

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

Yes, we agree with the principles-based approach.

Recovery plans

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

This is another area in which the proposed legislative requirement appears more onerous than the flexible interpretation set out in the draft Code. The draft legislation lists only one matter that trustees must take into account when determining if a recovery plan is appropriate – that deficits "must be recovered as soon as the employer can reasonably afford". Rather than relying on the Code to provide an interpretation of "reasonably afford" which then introduces several further matters (in paragraph 303) we would prefer the draft legislation to list those matters along with affordability.

Notwithstanding this point, we are comfortable with the approach set out in the draft Code.

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?

As noted in our response to question 39, the description in the draft Code appears more flexible than in proposed legislative requirements. The wording in the draft Code is reasonable, but it would be helpful if the legislative requirements were more clearly aligned to this position.

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

Yes. Given the prominence placed on the reliability of cashflows within the draft Code, it makes sense to refer to this period when considering recovery plan length. The clarifications on situations where recovery plan lengths may be greater than the reliability period (paragraph 317) are helpful for trustees who find themselves in these situations.

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?

We do not agree with the comments in paragraph 309 regarding DRCs for significantly mature schemes – in particular, that DRCs need to be prioritised over covenant leakage. This could be read as suggesting that (normal course of events) dividends should not be paid until a deficit has been made good. We assume this is a drafting error in the draft Code, as it does not appear to be consistent with the allowance for recovery periods of up to three years in Fast Track for significantly mature schemes. In our view, making good the deficit over the period of covenant reliability should not result in restrictions on dividends for significantly mature schemes.

It would also be helpful to have more comment on how you expect schemes in distress to manage this part of the process.

One-third of respondents to our recent ACA survey envisaged the new regime leading to new constraints on sponsor businesses relating to, for example, dividends, other covenant leakage or business investment plans.

Otherwise, the principles appear reasonable and are consistent with the approach being adopted across the draft Code.

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

We believe that it is appropriate to allow for the option of allowing for post-valuation experience. The wording in the draft Code is reasonable, although we would suggest removing the bullet that says trustees should "be prudent" in allowing for post valuation experience. This could be read as only enabling trustees to allow for post valuation experience if it results in a higher recovery plan contributions. If the trustees have set suitably prudent Technical Provisions and have allowed for asset and liability experience consistently, there should be no need for additional prudence to be added.

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

Yes.

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

It may be appropriate to specifically require trustees to consider the position at the next valuation if returns assuming no investment outperformance were achieved and whether their covenant, including any third-party support, would be able to afford the resulting increase in DRCs (assuming all else was equal).

Investment and risk management considerations

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?

This appears broadly suitable to us, although we note that there is something of a contradiction in simultaneously asserting there is no limitation on the trustees' discretion over investment matters and also suggesting they need to comply with a funding and investment strategy which needs to be agreed (in most cases) with the employer. A key point we would make is that the regulations need to be flexible enough that if an unexpected event occurs that is incompatible with the current strategy then trustees can act in the best interests of members and deviate from the strategy. When this occurs however we would expect these decisions to be minuted and if the deviation from the strategy is longer term then the scheme's documentation should be updated.

The gilts crisis is a good example of when well run schemes encountered an unexpected event and took action outside of their normal expectations but ultimately in the best long term interests of members.

Also, trustees should more generally be able to deviate from the strategy in the FIS where they have robust reasons to do so, and/or where in their view it is in members' interests to do so.

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?

These are reasonable examples. Whilst it is certainly beneficial to provide examples for trustees we do not believe it is possible to list all the possible scenarios. We would not want trustees and advisors to feel constrained because their situation is not on the example list. Instead we believe it is better to set out the principles you would expect stakeholders to follow in these circumstances.

Paragraph 56 of the Code of Practice (and the related later comments in paragraphs 321-326) is helpful in addressing concerns that the new regulations potentially introduce a change to the balance of power over setting investment strategy once a scheme is significantly mature. In particular, the confirmation that trustees are not required to invest in accordance with the funding and investment strategy and acknowledging that there may be good reasons not to do so, is a welcome clarification. We note however that the comments in paragraph 41 of the accompanying consultation document do not appear to be consistent with the draft Code – they emphasise an expectation of broad consistency. The final Code should reflect the draft wording in the Code and not the commentary in the consultation document.

In addition, the draft Code does not address the issue of what trustees – particularly trustees of schemes at or near significant maturity - should do if they cannot reach agreement with the employer on the investment strategy to be set out in the 'funding and investment strategy'. Is it acceptable to agree a 'funding and investment strategy' that the trustees do not intend to implement, in order to progress the valuation? In particular, would the Regulator prefer to have an early warning of schemes which are not able to agree a funding and investment strategy with their employer, given this is effectively the first step in a lengthy valuation process and notification after the 15-month deadline has passed might mean the scheme is well behind in its valuation project?

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

We broadly agree with the expectations and note that there is no easy answer, particularly for those schemes with significant covenant issues. We agree with the Code in that it acknowledges schemes with weaker covenants may need to take more investment risk than would appear to be supported by the covenant as this does offer the opportunity to generate sufficient returns to pay all the benefits.

The schemes that we can see as having the greatest issue are those who are close to significant maturity when this legislation comes in, are underfunded and have weak covenants. We do feel that for schemes like these it would be beneficial to provide some further guidance around the expectations of tPR. In particular this would be more efficient being done now rather than on a scheme by scheme basis as these schemes come through the regulatory review process.

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, we agree with the high level principles, given that further guidance is to be provided elsewhere.

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

We agree that trustees need to pay significant regard to liquidity within their portfolio and should understand the level of liquidity in both normal market conditions and a stressed event. The consultation notes this with respect to property funds but the lack of liquidity can extend across all asset classes, for example investment grade credit can see prices fall and liquidity weaken in a stressed scenario. Asset managers should be able to provide trustees with analysis on the true underlying liquidity of assets to help with this analysis.

The other point we would note here which relates to systemic risk is that trustees and advisors should be cognisant of liquidity risks created by other investors in the same assets. For example if a scheme is invested in a pooled fund with only UK DB pension schemes it is more likely this fund will have limited liquidity in the event of a shock to the UK DB system. More global funds with a wider investor base may not be as well designed for the UK pension scheme market but they may be better placed to offer liquidity in a wide range of circumstances.

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

The approach to security, profitability and quality is relatively high level and we believe gives trustees sufficient guidance without constraining them in their approach. Ultimately (as noted in the section on systemic risk) if this was to be too prescriptive then it could create systematic issues for the UK DB Pension scheme industry.

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

Some additional information on how trustees close to (or at) significant maturity should weigh up the competing risks and communicate with members if they are underfunded and/or have a weak covenant. It is good that the Code acknowledges these schemes will have an issue however in our experience as advisors there is never an easy answer and in many cases it would be very helpful to understand some more detail around the expectations of tPR.

Systemic risk considerations

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

We absolutely agree that systemic risk considerations need to be accounted for when considering these regulations. Our preference is that the Code is flexible enough that trustees can adopt a wide range of investment strategies which will limit the systemic risk to the UK DB pension scheme ecosystem. The more prescriptive the Code is the more likely you are to end up with very similar risk profiles across all pension schemes.

Although the UK pension scheme system may not be that consolidated, one of the benefits of this is that it creates diversification of risk profiles across the system.

We note in our response to question 6 that setting a specific threshold of 90% for hedging on interested rate and inflation risk seems too prescriptive for the Code itself, particularly in light of recent LDI developments, and that 44% of respondents that expressed a view thought that the new regime was likely to increase systemic risk, in our recent survey.

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.

There are a number of areas that we believe should be considered further:

- Herding due to stress scenarios: The stress scenarios that have been set out for a variety of asset classes (taken from the PPF) could lead to herding into specific assets as they look the most "efficient" on the stress scenarios.
    - In particular investment grade credit in the stresses looks relatively attractive, however the UK IG market is relatively small and if a large number of schemes increase their allocations significantly this could put pressure on the efficient functioning of the market.
    - In addition a risk event in that particular market could also cause problems across the UK DB industry.
    - We also note that the gilts in the stress scenarios look very attractive as they are effectively assumed to make money in a risk event.
    - We would caution this could lead schemes to take on too much duration risk as the model assumes they will be very diversifying – 2022 was a good example of when this was not the case.
- Actuarial Assumptions: Not unreasonably there is a reasonable amount of consistency across DB Pension schemes for assumptions like longevity – i.e. you may expect a general consensus to be reached.
    - If however these assumptions turn out to be imprudent then this could lead to a systematic under reserving across the UK pension scheme industry.
    - Note that this is the type of risk that, unlike the LDI risk, is likely to evolve slowly over time and therefore may not be noticed immediately.
- Deficit Recovery Contributions: There is a risk that although the regulations are flexible that schemes will herd together in investment strategy and if this general strategy comes under pressure from investment performance the level of contributions required from corporates across UK PLC could be synchronised.
    - Although this has always been a risk, by setting such factors as the point of significant maturity it could be greater now.
    - For example in 2008 schemes took a variety of approaches to fixing deficits, including longer recovery plans, higher expected return on assets and higher growth allocations – these levers may not be available as easily going forward and may require schemes to push the additional contributions more readily.
    - This could then lead to greater requirements for cash contributions from UK companies at the same time.

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