By email only: db.consultation@tpr.gov.uk

DB Funding Code Team
Regulatory Policy Advice and Analysis Directorate
The Pensions Regulator
Napier House
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23 March 2023

Dear DB Funding Code Team

SPP RESPONSE TO Draft defined benefit (DB) funding code of practice and regulatory approach consultation.

We welcome the opportunity to respond to the consultation on the Fast Track parameters.

Detailed Response

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

   Yes. We welcome the separation of the draft funding code and the Fast Track parameters consultation.

   We note that the Draft Regulations and Code put covenant at the heart of journey planning whereas Fast Track does not have any covenant parameters. We understand TPR's rationale for a simplified set of parameters for filtering schemes. However, we strongly encourage TPR to make It very clear that covenant is still an important consideration for FastTrack compliant schemes.

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

   We suggest you clarify that for the asset stress test the strategic asset allocation used is the allocation in the Statement of Strategy, not the current one. I.e. whether this allows you to change your strategy post valuation date and have this feed into the test.

   We suggest that you provide examples of situations where Fast Track on its own is good enough to meet the code and other examples of situations where you would require

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additional information.

We suggest that TPR clarifies more clearly in the final version that the code is paramount – and that compliance with Fast Track does not necessarily mean compliance with the code. For example, we understand in some cases (eg weak covenant) TPR would expect trustees to adopt more prudent assumptions than those needed to meet Fast Track minimum compliance.

It would be useful if you provide examples of what appropriate evidence could look like for Bespoke submissions and outline the process trustees should follow in these cases.

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

Yes.

We would also note that the initial evidence that TPR requires for bespoke submissions should be reasonable and limited to what TPR would require to assess the funding and investment strategy and valuation for the majority of schemes. Additional information could then be requested for those schemes where it believes further evidence is required.

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

Until we see the wording of the confirmation this question is difficult to answer. The risk of unintended negative consequences increases the more any confirmation requires judgement rather than being mechanical based on factual tests. We are particularly concerned that there may be elements of judgement in assigning certain pension scheme assets to particular asset buckets defined by TPR – if this is the case then we strongly believe scheme actuaries should not be the ones making this judgement. We urge TPR to make the guidance on assigning assets to particular buckets as clear as possible.

More generally, we suggest TPR works with the IFoA to agree the wording of the confirmation.

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

We would prefer to have one method/approach rather than different approaches for schemes in differing circumstances, which we fear could lead to additional complexity and/or ambiguity.

In addition, for those schemes that intend to follow a bespoke submission route, we do not consider that there should be a requirement for these schemes to undertake work to assess where they sit against the Fast Track parameters. We would also expect that the Scheme Actuary confirmation is only required for those schemes that intend to use the Fast Track route (i.e. for bespoke schemes the Scheme Actuary would not be required to confirm which if any of the tests were met). Schemes going for the bespoke route could still choose to provide information relating to Fast Track tests, for instance where schemes meet the tests relating to technical provisions and investments but not the recovery plan.

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

Given market movements, 12 year duration for significant maturity is significantly closer in

time than it previously was, which is a cause for concern for many schemes. We understand that TPR is considering this further.

Related to the above, the duration calculation and the market conditions used are critical. Stability would be very useful to trustees and employers for planning purposes. To put another way, if duration is not stable, more frequent re-planning will be needed leading to extra costs.

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, we suggest that you keep Fast Track straightforward so that stakeholders can more easily understand it, and it is more straightforward for the scheme actuary to certify compliance.

   We would also reiterate that TPR should make clear that the code is paramount and schemes may be subject to additional scrutiny even if they meet Fast Track requirements.

   High insolvency risk should be used as an example of where additional information (and scrutiny from TPR) is expected even where Fast Track is met. However, we do not think additional requirements should be part of Fast Track.

   We would also highlight that high insolvency risk is just one extreme example where Fast Track may not be appropriate for all schemes. There are others as well (e.g. concerns over longevity of covenant).

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, subject to the comments below.

   We suggest that you make it very clear that the trustees' own low dependency basis must be at least as strong as the Fast Track Low Dependency basis. This is somewhat ambiguous in the current wording and is arguably a fourth test, where to date TPR has described Fast Track as requiring three tests.

   Again, you should reiterate that the Code is paramount and schemes may need to go beyond Fast Track in some circumstances (i.e. where the investment strategy does not support a G+0.5% discount rate). Again, examples would be useful.

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

   Yes, subject to the comments below.

   We suggest that you make it very clear at what point an expense reserve is needed and how it must be allowed for (eg as a percentage of post significant maturity cash flows).

   On a similar note we also suggest you make it clear whether commutation can be allowed for – we understand from TPR discussions that it can, but this is not clear in the Fast Track documentation at present – currently it clearly states that "Other options" can only be allowed for where they increase the value of liabilities.

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?**

    Yes. We would like TPR to make clear that use of a gilt yield curve other than the Bank of England curve is permitted, again this is ambiguous currently. There are practical reasons why the approach should not be limited to Band of England curves. Several consultancies do not use Bank of England curves given they can produce flawed results.

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?**

    Yes, subject to the comments below:

    CPI as RPI less 0.8% pre 2030 is more prudent than many consider to be best estimate. We suggest the gap could be (up to) 1%. Similarly a small gap could be permitted post 2030 to allow for a long term expected difference between CPIH and CPI. There are good reasons to use best estimate assumptions on inflation assumptions – for example , a best estimate approach provides most accurate hedging.

    We would also note that a wider gap is appropriate when inflation is high. This is a good example of an assumption that might need a review if markets change.

    As per our response to question 9, we would also like more clarity and detail on commutation, and expenses.

    We also question why for the Fast Track low dependency funding basis test, the requirement is at an assumption by assumption level with every assumption needing to be at least as strong as under Fast Track. We think this should be an aggregate check as per the Technical Provisions test, otherwise the overall assumptions may be unnecessarily prudent, which is unhelpful for liability matching purposes and may lead to additional work and fees.

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

    No. our preference is to keep it (Fast Track) the same for all schemes. Again this risks extra complexity for little benefit.

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

    We suggest a period of 4 years (3 years plus 12 month allowance for completing a valuation). We note that, in practice, a period of 3 years from the effective date could mean a 21 month period or perhaps less where negotiations exceed “normal” valuation timescales.

    Please can you clarify what the Fast Track recovery plan limit is for schemes close to, but before, significant maturity. i.e. are these schemes limited to 3 years after significant maturity, or can these recovery plans run for 6 years even if this is longer.

    In addition we note that the consultation document is not always consistent as to whether the maximum recovery plan length is dependent on whether the scheme is past its

relevant date or the date of significant maturity. While there are several references to significant maturity, in the 'length of recovery plan' section of appendix 1, the reference is to relevant date.

As an aside, we note that typically recovery plan length / period would be closely linked to covenant factors. Noting that covenant does not form part of Fast Track, recovery plan structure and period is an example of where trustees should be encouraged to consider covenant factors even if they meet the Fast Track parameters.

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

Yes, subject to the comments below:

We note that this practice is not common under current regulations but we agree that it ensures consistency between schemes.

Pre significant maturity, we suggest a period of 7 years if using valuation date as start point (i.e. 2 valuation cycles plus allowance for 1 year to agree the valuation). Post significant maturity, we suggest a period of 4 years.

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

Yes, we are pleased that this has been included.

We suggest that you clarify any need to retest (i.e. would a scheme actuary need to re-certify the Fast Track check at a post valuation date, or just certify once and if so at which date).

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?

At a high level, we think it is reasonable subject to the points below:

- Does this include a period of grace from the valuation date whilst an existing recovery plan is continuing? i.e. DRCs could be £1m in the year after the valuation date but then step up in year 2 after a new valuation agreement has been reached.
- Clarity is needed over irregular patterns. E.g. A pattern of £10m then £1m then £2m ought to be ok, but it's not clear that it is.
- Clarity on how CPI is defined (i.e. In the SoC does it have to be CPI or the CPI inflation assumption? If the assumption at what date?)
- The option to use a fixed percentage would be useful (eg 3% pa) as some employers will prefer known steady increases.

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

For the most part, subject to the comments below.

Whilst we note the use of the PPF Tier 1 Stress test, the liability stress of (inflation – 0.11%) does not seem intuitive compared to the high inflationary nature of pension schemes. VaR models, which will be used by trustees to consider high resilience, are likely

to imply a materially different stress for inflation.

Given the move to more credit dominant investment strategies it is surprising that there are no more credit based asset buckets. There is only one for non IG bonds, compared to three for equities. Diversified credit, emerging market debt, high yield bonds and private debt are examples of asset classes that you would expect to be used by pension schemes. Is the Regulator happy that these are all mapped to one single 'sub-investment grade bond' asset class?

We were surprised that the Fast Track consultation was silent on how leveraged LDI funds should be mapped. We assume that a 'negative cash approach' should be used, but it would be helpful if guidance on the this could be confirmed.

Some indication on the frequency of updates to the proposed stress test would be appreciated. Outside of Fast Track, we would expect consultants to update their risk models on a very frequent basis.

We are supportive of the proposal that schemes would get credit for being in surplus (e.g. more scope to invest in riskier assets).

There are also several points related to insured assets:

- Please provide clarity and example on how insured assets (even when not included in the accounts) should be treated. Our view is that the liabilities will include those covered by insured assets so annuities should be included in the assets for consistency.
- Please provide clarity on whether the duration calculation includes the buy-in.
- We would also note the impact of potential mismatches on annuities and assumed 70% inflation linkage of liabilities. For example, a scheme that has a 100% matching strategy could have a stress caused by the scheme being more or less inflation linked than 70%. If it is practical to do so, we would prefer the same stress is used for the assets and liabilities for annuities.

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

Whilst we note that Fast Track seems to permit a material holding in traditional growth assets, 1.9% is significantly lower than the 4.5% in the draft code. This may result in many schemes being compliant with the code but failing Fast Track on investment risk grounds.

We note the legal requirement to be highly resilient. Our view is that resilience does not mean funding should never fall, but it is about the ability to bounce back. The 1.9% test appears closer to avoiding short-term losses rather than accepting some level of volatility implied by the Code.

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

Yes.

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?

Yes.

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

    Yes, provided there is flexibility to use a cashflow based approach.

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?**

    Yes, subject to the comments below

    The threshold of 100 members should only include DB members. We are aware of situations where a hybrid scheme has a small DB section with fewer than 100 members but inclusion of the DC only members would exceed the threshold.

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.

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

    Yes, subject to the comments below.

    We recognise other approaches are reasonable and available through the bespoke route.

    We note that at the current time, the three year look back period is potentially abnormal (i.e. includes Covid period) which may lead to more schemes wishing to use bespoke.

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

    No. We note that the flexibility will be useful, especially for shared cost schemes, and SoC certification is sufficient to support adequacy of contributions.

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

    Option 1, noting the following:

    Option 1 provides more stability and would give more notice of changes, whereas option 2 could be more difficult, especially for employers.

    We would also note that any changes mid valuation should be avoided as these could be very difficult/costly to manage – hence the relevant parameters should be either those in force at the valuation date, or be published shortly after the date they are effective from.

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

    No, noting points under response to Q 27

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

We suggest that you consider repeating the analysis of which schemes will meet Fast Track based on more up-to-date market conditions. This will help both TPR and trustees/employers/advisors understand potential impact. Regarding this analysis, we think that the likelihood of schemes "levelling down" is lower than TPR makes allowance for. We also note that even if such "levelling down" takes place, it will be of little comfort to the sponsors of those schemes required to "level up" for whom there is still a large expected cost from Fast Track – we suggest TPR acknowledges this in the impact analysis.

Response ends

Yours faithfully

Chris Ramsey
Chair, DB Committee

Fred Emden
Chief Executive, SPP

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