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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 this consultation.

Executive Summary

- **Concerns around proportionality:** We like many aspects of the Code, but overall we believe that the additional requirements placed on schemes are not proportionate with the benefit the code brings.

  The requirements placed on trustees are significant, and will result in a significant increase in adviser costs for many schemes. Whilst this may be of benefit in some cases, we do not believe they are necessary for a lot of schemes. We appreciate that TPR is unlikely to want to make large changes to the draft code at this stage. As such we have made a number of suggestions that are small but we believe would have a material impact on making the requirements more workable for schemes. In summary:

  - The Code appears to require a considerable amount of covenant work, which may not be proportionate in all cases. We hope the upcoming covenant guidance and consultation on the requirements of the Statement of Strategy ensures that trustees can take a sensible approach to looking at covenant (i.e. being proportionate and focusing on the key areas that underpin strategy in the context of scheme size and funding level).
  - Further, we believe that the Statement of Strategy should only require schemes to

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commission work that adds value to the trustees and will be used by TPR. So, for example, if TPR is not going to use the Reliability Period for schemes that are Fast Track compliant, for example, and the trustees do not believe it is relevant in their employer's circumstances for whatever justifiable reason, then they shouldn't need to produce the Reliability Period figure (so long as they have considered the high level principle of ensuring the covenant can support the risk being taken in the scheme).

  - We suggest that the requirement for immature, Fast Track compliant and small schemes to specify the path of their investment strategy in the Statement of Strategy is removed. Instead these schemes should simply have to confirm that their Technical Provisions allow for de-risking in line with the Funding Code.
  - We support the adoption of a fixed set of market conditions for calculating duration in order to determine significant maturity – this will remove the need for schemes to alter their strategy just because the duration metric has changed with volatile market conditions.
  - Schemes with a duration of 15 or higher (broadly those expected to be more than 2 valuation cycles from their date of significant maturity) should be allowed to use the proxy from Appendix 4 of the Fast Track consultation to generate their expected maturity date.

- **Complexity**: We also believe that the Code is too long and very complex in places – again, unnecessarily so given the benefit in member outcomes it will bring will be limited for many schemes. We strongly suggest that TPR tries to limit complexity where possible, in particular given the need for lay trustees to understand the Code (albeit with help from their advisers).

  Much of the content of the Code appears to be guidance in nature. This creates a long document and considerable ambiguity for readers (even with the clarifying statements in the introduction). We would suggest moving content that is guidance in nature out of the Code and keeping the Code focused on the key requirements and principles.

- **Interaction with regulations:** The Code in several places has taken a helpful and pragmatic view of the draft regulations. However, we have some concerns that TPR's helpful interpretation of the Regulations might not be shared by all, and suggest that the wording in the Regulations is changed to more closely align with TPR's interpretations. This would avoid the potential legal risk schemes may have due to potential different interpretations. For example:
  - In relation to long-term investment strategy, requirements in the regulations that "cash flow from the investments is broadly matched with the payment of pensions" and "the value of the assets relative to the value of the scheme's liabilities is highly resilient to short-term adverse changes in market conditions" appear very restrictive, and risk being interpreted as meaning low risk and low return, resulting in sub-optimal strategies and higher costs for many schemes. The Code clarifications are helpful but there is a risk legal advice encourages trustees to go further based on the regulations (see Q40).
  - A similar comment applies on the new legal requirement that deficits should be recovered "as soon as the employer can reasonably afford" which again risks being interpreted as requiring significant extra costs for sponsors in the short term. The Code wording is again helpful but legal advice could require stronger

interpretation.

- Linked to this point, we note there is reference to concepts such as reasonable covenant leakage when defining reasonable affordability, which blurs the lines between the Funding Code and transactions. TPR has historically considered transactions separately from valuations; changing this approach risks transactions that are detrimental to covenant just being wrapped into a viable journey plan and valuation without mitigation being provided to the scheme in question.

- **Covenant guidance:** – We consider it positive that TPR is giving due consideration in the Code to the fundamental components of covenant. However, we note that the covenant guidance has yet to be published and it is difficult to provide a comprehensive response prior to seeing the practical advice that the guidance will provide.

  We agree that covenant ratings are subjective but believe they serve a valuable purpose of pulling all relevant factors together and providing a benchmark for tracking changes or evaluating transactions. The Code splits covenant into component parts but without sufficient guidance as to how each element should be used or how to draw it all together. This means certain elements (such as period of reliability, which is highly subjective) are over-emphasised, whilst other more qualitative factors may be overlooked. We suggest TPR focus on making sure the covenant guidance helps trustees scope meaningful covenant work (linking to the above point about how to be proportionate in the context of the new regime).

- **Formulaic vs principles based approach:** Whilst we understand TPR's desire for a more rules/numerical based approach, we believe a more principles based approach would be appropriate in a number of areas. This is particularly pertinent for the maximum supportable risk equation (which we consider to be highly problematic – see question 30) and the period of reliability (which is very subjective and yet a key driver of much of the new regime – see question 18).

  A formulaic approach also risks "covenant complacency" if trustees lose sight of the underlying covenant risks through "box-ticking" or a false sense of security linked to meeting Fast Track or Low Dependency parameters. We suggest this is addressed in the covenant guidance.

Detailed Response to specific questions

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

In terms of specific comments on the summary itself:

- The summary does not capture some important nuances that are included later on. For example the setting of the Low Dependency Investment Allocation could be less specific and based on an estimated investment return assumption where a scheme is a long way from significant maturity rather than trying to construct a cashflow matched investment strategy.
- We do not necessarily agree the statement in Paragraph 20 that trustees must obtain the employer's agreement to the funding and investment strategy (noting this is also repeated later in the Code). We understand this comes from para 6 of Schedule 10 to the Pension Schemes Act 2021 which adjusts Section 229 of the Pensions Act 2004. However, we believe there is an exception in relation to the situation where the trustees determine the employer contribution – in this case they will not be required to agree the funding and investment strategy with the employer, just consult. This is because in such situations, Section 229 is modified by paragraph 9(1) of Schedule 2 to the Occupational Pension Schemes (Scheme Funding) Regulations 2005 (SI 2005/3377). If you agree then this should be clarified in the final Code each time the requirement to agree the funding and investment strategy is stated.
- There are specific areas where we would like TPR clarification – ideally set out clearly in the final Code:
    - We think TPR needs to clarify when exactly schemes which are already significantly mature need to comply with the regulations, in particular the need to be 100% funded on a low dependency funding basis. Our understanding is that schemes are only required to move to the new regime as part of their next valuation process after the regulations and Code are in force (potentially 3+ years after once you allow for the valuation process and the scheme to then start taking action) although earlier adoption of key principles would clearly be desirable. However, clarity on this would be most welcome.
    - The description of the location of the journey plan is confusingly described in 174 and 179 (and the corresponding need for employer agreement or consultation). We suggest adding 'high-level' or 'broad' in front of journey plan in 174, and removing 175 (which is in any case repetition). 177 is then presumably 'Within the funding and investment strategy, the high-level journey plan should set out…'

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?

Whilst we broadly agree with the proposed concept, we think the definition may be too restrictive. We are unsure if it applies to individual bonds or aggregate assets. It appears that the former is being proposed based on the document's description of broad bucketing, which may prevent investment in good quality bonds which have callability features attached to them. Even if this test is at an aggregate level, the stability and predictability of a portfolio of high-quality bonds can reduce in a deteriorating credit environment where defaults are expected to tick up.

At a practical level, cash and other floating rate assets may not fall under the definition given the uncertainty and changing nature of interest rates. The definition should allow pension schemes to hold floating rate notes/cash assets in their cashflow matching portfolio. In that sense, we believe that cash clearly has a place in an LDI portfolio, as can longer dated Floating Rate Notes.

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

We broadly agree, as importantly the drafting accepts that schemes may undertake high liability hedging without being strictly cashflow matched. We believe the Regulator should explicitly recognise that most schemes will not be exactly cashflow matched, but instead will be broadly cashflow matched, with an appropriate level of hedging in place and a controlled allocation to growth assets.

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?

Cashflow matching is always approximate given that the liabilities are uncertain. In general, it is not an unreasonable approach. There is space to let advisers exercise judgment in how to assess matching and structure assets.

It may be helpful for the Code to recognise that arriving at a broadly cashflow matched state does not necessarily mean a static and unchanging portfolio. It would also help for this purpose to draw on the theme of proportionality in paragraph 74 and a general appreciation that each scheme will have specific considerations.

We believe the more important focus should be on resilience. Schemes with very high levels of liability hedging alongside very high levels of liquidity could automatically be considered to cashflow matching in the very broad sense of the concept.

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?

There are a significant pitfalls and dangers of prescribing categories of investments into which assets can be grouped, as this could stifle innovation, create uncertainty and inconsistency around assets that straddle categories, and could quickly become out of date. Also, trustees need to have freedom to draw on the full investment opportunity set, which is difficult within an inflexible framework. The issues surrounding assigning assets for a scheme return are perhaps good examples of the challenges.

By not prescribing an asset list also helps to reduce systemic risk in credit markets, where pension schemes dump assets which are not on the list, particularly as the rising gilt yields may mean many pension schemes have reached maturity much earlier than expected and there is no transition period to the new Code.

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

We do not agree.

Given the natural variance in hedging, the 90% minimum might force schemes to target hedging level of 95% or more (to ensure they do not slip below the minimum). This may involve using higher leverage or increased approximation / mismatches exposing schemes to other risks (e.g. being materially over hedged on inflation). In particular, it may be difficult for small schemes to accurately target a 90% hedge given the need for them to use off-the-shelf "average scheme profile" LDI building blocks.

If leverage is further reduced within LDI portfolios then 90% will be a significant limiting factor on the long-term assets schemes are expected to hold, potentially pushing up costs for sponsors.

We do not believe there should be a strict minimum hedging level. Rather than having an explicit target, we believe that a focus on high resilience and liquidity will naturally control the level of risk in portfolios.

We think that the drafting is imprecise and should be amended – to define a hedge one has to define the discount basis as well as whether you are hedging on asset or liability value. Limiting the probability – under the Value at Risk model – of a "more than 4.5%" loss could be more accurate.

We also suggest TPR acknowledge the risk of over hedging (for example, due to not reviewing the LDI design frequently enough).

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)?

Yes. For instance, smaller schemes could not afford the cost of complete flow matching forecasting and their cashflows have the potential to be proportionately more volatile as a result of individual member experience. The approach needs to be pragmatic and sensitive to the scheme's size.

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

A stress test is a reasonable way but we agree trustees should be using a variety of risk metrics rather than solely relying on one method. For example, please see our comments later in Q9 regarding potential limitations of Value-at-Risk and credit portfolios. Clarity over the expectation to use longevity within a stress test would be welcome.

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?

It is not unreasonable, and we note the flexibility to consider high resilience in other ways than suggested by the draft code, as the draft regulations do not specify a certain method. Based on current risk model calibrations, the 4.5% limit implies a reasonably high level of allowance for growth assets, which many schemes will welcome.

It is commonly accepted that most VaR models are better at pricing equity risk rather than credit and so may need further development as the industry moves to more credit-focused long-term strategies.

Schemes should be able to take into account external capital sources and the code should offer more flexibility with contingent assets.

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

Yes, we agree. We believe that schemes should be encouraged to use a range of risk metrics. Also, we think trustees and sponsors should be left to use the most appropriate methods for their circumstances. Standardising stress tests, whilst it would create a more consistent output, may result in larger schemes using simpler less sophisticated risks tests than currently and would add to systemic risks.

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, we agree that this is effectively specified already.

We note that, structurally, liquidity should be considered with low dependency investment allocation risks. Whilst liquidity is a focus for 2023, the reason for needing liquidity may be scheme specific. We also note that the draft code references investment in corporate bonds but does not include a distinction between investment and sub-investment grades in Chapter 3.

As a general comment better cross-referencing in the final Code would be highly desirable. A possible unintended consequence of loose drafting could be schemes holding high-yield debt liabilities with excessive default risk, which would not be the policy intention. However, we recognise that pension schemes will be asked to carry out stress tests which should prevent this risk from materialising.

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 agree – we do not believe stochastic analysis would be proportionate for the majority of schemes.

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. We are comfortable with the descriptions as drafted.

14. Should we provide guidance for any other methodologies?

No, we are comfortable with these as drafted.

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?

We note a general push for evidence based assumptions, or incorporating extra prudence. Although we are generally supportive of this, we have the following comments:

- For smaller schemes in particular we note recent experience may not be statistically relevant and the wording around cash commutation in Appendix 3 would benefit from the

same approach used later '**Where recent, statistically credible information is available then** the proportion commuted should be no higher than recent experience…'.

- Where evidence is not available we have a concern that the draft Code implies the need for prudence in many areas, leading to a disproportionately prudent basis overall.
- We also question how this need for prudence interacts with the need for accurate cashflow analysis in determining the LDIA (eg paragraph 65). In this case there is a focus on understanding accurate assumptions which would tend to mean best estimates rather than prudent assumptions – this seems a little contradictory.

We also have some comments on specific areas of content in those Appendices:

- Pension increases – we agree in general though note that a more prudent approach than described is adopted in some cases - eg when trying to match insurer pricing.
- Cash commutation – we disagree that assumed factors should be no lower than current factors. Commutation factors can go up or down and indeed recently a lot of schemes have reduced them given rises in gilt yields. Where there is a consistent past practice allowing for updated market conditions/valuation assumptions then it would seem reasonable to set the factors as a percentage of the technical provisions liabilities – this can result in factors that are higher or lower than the existing factors. More generally if a reduction in terms is agreed at the time of carrying out the valuation but not yet implemented, it should be possible to reflect this.
- Mortality base tables – Size of pension is not the only proxy for socio-economic class. We suggest this is less prescriptive or given as one example.
- Withdrawal – we note a higher withdrawal assumption can sometimes be more prudent eg where salary increases are capped at a level below expected inflation.
- Age difference – use of "No lower" seems incorrect or is at least unclear – what is prudent depends on the gender divide of the scheme.
- Expenses – no comment other than in the subtitle "where there is a requirement for the employer to pay expenses" we assume this means beyond the Schedule of Contributions and if so should be clarified. Similarly, the later heading should be consistent i.e. '…where there is a requirement **beyond the Schedule of Contributions** for the employer to pay expenses'.
  We also note there is some inconsistency in wording in the Code versus the consultation document – the former says TPR "expects" the low dependency basis to include a reserve for expenses, the latter says a reserve "should" be included which is stronger. We also note there is ambiguity around Fast Track requirements here – we comment on this in our response to the Fast Track and regulatory approach consultation.
- Finally, we think the reference in paragraph 99 to Appendix 3 should actually be to Appendix 4.

In general Appendix 3 (particularly demographic assumptions) could probably be simplified and condensed given the regular repetition of similar principles.

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

On balance we would rather just have one method for all schemes, noting duration is not a particularly difficult calculation for scheme actuaries to carry out.

That being said allowing small schemes to adopt a simplified calculation of duration is not unreasonable assuming it is consistent with the regulations.

One area where a simplified approach could be considered is in the projected significant maturity date. For schemes that are still several valuation cycles from this point, we suggest that the proxy set out in Fast Track for the term to significant maturity should be reasonable rather than requiring a bespoke calculation.

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?

No – option 3 would not solve the volatility issue. Also, this adds complexity to an already complex regime, and so we would be strongly against this approach.

The key issue is that schemes need to be able to plan for the date they need to achieve low dependency and this should not change materially between valuations.

We also dislike option 2 i.e. smoothing over a period. Again this would not solve the key issue (as there could still be a large change in date of significant maturity between subsequent valuation dates) and it would add a large amount of calculation intensity and complexity, for little benefit.

From the options provided, we strongly advocate option 1 i.e., using fixed market conditions to determine duration. This would provide more consistency. We note that if current market conditions were used, a 12 year duration for significant maturity should perhaps be reduced. We also suggest these fixed market conditions are set by TPR, rather than in regulations.

As an aside, if a scheme has a buy-in can you confirm that duration should include all the liabilities. This should be clearer in the Code.

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

We consider it positive that TPR is giving due consideration in the Code to the fundamental components of covenant, including recognition of the way in which covenant evolves over time. However, we note that the covenant guidance has yet to be published and it is difficult to provide a comprehensive response prior to seeing the practical advice that the guidance will provide.

The definitions of visibility, reliability and longevity need to link into the strategic decisions that they drive. In this regard, it seems that only the period of reliability has impact. We have significant concerns about the period of reliability as it is highly subjective (or arbitrarily defined) and yet is a key driver for much of the new regime.

Considering that, our preliminary observations are:

- The period of visibility appears to have no clear role in funding or investment decisions based on the methodology set out in the Code; further clarification would be needed and how this relates to the period of reliability (other otherwise links in);

  The period of reliability is the principal driver for the maximum investment risk as well as influencing recovery plans, expense reserves, and allowance for future accrual and new entrants. However, it is a highly subjective (and potentially volatile) measure and it is quite feasible that there could be material differences amongst independent covenant advisers on the period of reliability. For example one adviser may conclude on a 4 year

period of reliability and another 6 years which would represent a 50% increase in the period of maximum risk for the same covenant. Whilst not explicitly set out in the Code, we understand TPR is considering an approach of using a six year period, subject to trustees justifying a higher or low figure – this is considerably easier but does mean a key driver of much of the new regime is arbitrarily defined. For simplicity, we have used a six year period in a number of our responses where the period of reliability is referenced (but note an arbitrarily defined period of reliability clearly has its disadvantages).

- The period of longevity covers the period beyond the period of reliability until the maximum period the employer is expected to remain in existence. In reality, Trustees and advisers are likely to consider a further subdivision of this i.e. the period up to the relevant date and the period after the relevant date (the period of low dependency). At this point, the focus of covenant should shift from cash generation to covenant longevity.

Our recommendations are:

- Covenant visibility should inform the period of covenant reliability but it does not appear to make sense as a standalone period as it does not drive any strategic decisions based on the Funding Code
- As the period of reliability is a subjective measure, we would recommend the detail on the application of this measure on funding and investment should either form part of the supporting guidance or alternative approaches/the limitations of this approach should be considered in the Code.
- We suggest longevity is included in guidance rather than the Code. Further, we suggest TPR is clearer on how covenant longevity should be taken into account in the journey plan.
- We also suggest TPR is clearer on the distinction between sponsor reliance before and after low dependency (including how TPR's expectations differ in these circumstances).

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 principle of identifying free cash flows after operational costs and before discretionary expenditure to inform decisions about funding and investment. However, we have a number of observations on the proposed approach:

- The Code principally focuses on establishing a figure for free cash flow which is a key driver for the supportable risk that can be run by a scheme and determines recovery plan affordability. However, as with the period of reliability, this metric is subjective and likely to result in different interpretations by different advisers/trustee bodies which could have a significant impact on how much risk is considered supportable. As per the period of reliability, we recommend the detail on the application of this measure on funding and investment should either form part of the supporting guidance or alternative approaches/the limitations of this approach should be considered in the Code;

- The focus on establishing a figure for free cash flow risks losing much of the valuable analysis around risks and uncertainties in the forecasts;

- It is not clear as to whether the guidance will indicate the extent it would be appropriate to add a level of prudence to forecasts to account for these risks/uncertainties;

- Reasonable alternative uses of cash are considered separately from assessing cashflow but are inextricably linked when considering supportable risk and recovery plans; and
- Investment in sustainable growth is considered alongside covenant leakage and discretionary payments to other creditors as reasonable alternative uses, which risks underplaying the essential nature of investment in ensuring the longevity of a sponsor.

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

The Regulations list the matters to be considered in "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". Our observations are:

- We assume the "other factors" referenced in the Regulations are met by the factors outlined in paragraph 144 of the Code, further clarification on this would be helpful;
- The inclusion of the "risk of an employer insolvency event" in paragraph 144 is not consistent with the Regulations which consider it a separate factor. Arguably the risk of an employer insolvency event is also a consequence of the factors listed, rather than a driver;
- We broadly agree with the factors outlined and welcome the inclusion of "other relevant factors" so schemes with unique covenants can reflect their specific circumstances in their assessments. We note that for smaller schemes, considering all these factors may be challenging and their inclusion in the Code could place a lot of pressure on trustees to do more work than would be proportionate;
- The output of the assessment of prospects appears to principally drive the period of reliability. As noted, we believe there are challenges to having such a subjective measure be a principal driver of supportable risk. We welcome further clarity from the upcoming guidance.

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 note that the principle set out at paragraph 148 of the draft code replicates draft regulation 7(2)(b), meaning that it is to that extent a given. However, we also note that DWP did not specifically consult on this part of the draft regulations.

The draft regulation specifies that the contingent asset must be enforceable by the trustees, whereas the wording in the draft code does not. We are aware of some situations where wider group support is formalised by inter-company agreements – e.g. indemnities for contributions – which are nevertheless not enforceable by the trustees. We think that there should be some covenant allowance for direct or indirect group support.

The approach set out works for a number of clear and simple examples but there are many examples of contingent assets that are more bespoke in nature and the benefits more nuanced (contingent assets do not always support DRCs or the covenant throughout the life of a scheme). It would be unfortunate for sponsors to shy away from providing contingent assets on the grounds they do not get credit, even if a contingent asset is objectively covenant enhancing.

Allowing covenant to be factored into journey planning via a principles-based approach will allow flexibility and encourage the use of covenant enhancing contingent assets. The Code and related guidance should focus on how different types of contingent assets can be factored into journey planning, rather than only giving credit for vanilla options.

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

The approach to setting out value is logical.

It appears that the draft regulations and code give considerable credit for security in the assessment of covenant strength, but limited credit for balance sheet strength without security. This distinction risks being unfair. This may also make it harder to argue that transactions that weaken the balance sheet (where there is not security) are detrimental to covenant.

We think it is important that the approaches of TPR (in the code) and the PPF (to certification for levy purposes) should be consistent, insofar as they relate to insolvency, so that trustees are not required to value security arrangements in different ways for different purposes. That said, we do recognise that contingent assets may provide value in situations other than insolvency.

We note that ABCs are not explicitly mentioned in the draft code. There is also no mention of contingent funding arrangements and how these relate to ongoing funding strategies. These are an important part of many schemes' covenants and should be included.

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

We are not convinced by the characterisation of 'look through' guarantees in paragraph 156. The common form of section 75 guarantees provides an unfettered ability to claim against the guarantor in respect of monies owed by the employer (third sentence), but this does not entail a formal look through to the guarantor for affordability purposes (second sentence). Absent an insolvency triggering a s.75 debt, monies owed are determined by the schedule of contributions, which in our experience is usually determined by the affordability of the employer. 'Look through' arrangements as described in the draft code are rare and do not merit the prominence given in this section.

Paragraph 156 potentially places an additional burden on a guarantor beyond what would have been envisaged by the parties when the guarantee was entered into. In our experience, the vast majority of pension scheme guarantees are given by the guarantor solely in order to give comfort that the obligations of the relevant employer will be met. They are not also intended to increase the rates at which the relevant contributions are offered. Just because the guarantor of a solvent sponsor is prepared to stand behind the ultimate s.75 liability of that sponsor, does not mean that the guarantor also agrees that the contribution rates to which that sponsor is exposed should be accelerated to reflect an artificial representation of affordability. In our experience many guarantors would refuse to enter into scheme guarantees that they would otherwise be prepared to give, if it was also a requirement that the guarantee contain a "look through" mechanism.

Further, we consider that there would be practical difficulties in increasing the use of 'look through' guarantees as implied by the draft code. This would potentially create a situation where the directors of the sponsor are expected to sign up to an unaffordable recovery plan, which

would be at odds with their directors' duties (and would render the sponsor cashflow insolvent on the Insolvency Act 1986 s.123(1) cashflow basis). We note also that the sponsor's failure to pay the unaffordable contribution would result in the trustee calling on the guarantee for the unpaid amount; but this would make the guarantor into a fresh creditor of the sponsor for that amount, as a result of the counterindemnity obligation that the sponsor owes at law to a guarantor of its liabilities. This is likely to be a difficult issue for the sponsor's directors.

We broadly agree with the approach regarding other guarantees. However, it is unclear how the valuation of such guarantees is intended to be combined with the affordability of contributions in the maximum risk test set out at paragraphs 185-199 of the draft code.

We think it is important that the approaches of TPR (in the code) and the PPF (to certification for levy purposes) should be consistent, insofar as they relate to insolvency, so that trustees are not required to value guarantees in different ways for different purposes. That said, we do recognise that guarantees may provide value in situations other than insolvency.

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

The list of considerations is all helpful and all areas we would expect to consider. However, there is little guidance on the practical implications of each point – i.e. how does that consideration impact the decisions they should be making? We would hope to see more clarity in the forthcoming guidance.

The draft code does not distinguish between associated and non-associated multi-employer schemes. We suggest that this be added to the list of points to consider at paragraph 162.

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?

Assessing cash flows available for the pension scheme in a not-for-profit sponsor is always challenging as there is always a tension between purpose of the sponsor and the requirement to fund the DB scheme. Qualitative considerations are particularly helpful, as is understanding relatively (scheme vs sponsor) and balance sheet resilience. Asking trustees to focus on a cash flow number could draw focus from these important areas. Further guidance would likely be needed to quantify a cash flow figure.

The considerations for the assessment of cash flow at paragraphs 165 focus on income. We think that consideration should be added regarding the use of funds. It is inherent in their non-commercial nature that not-for-profit organisation target a modest surplus or break-even position, leading to a more stringent need to assess the affordability of pension contributions against potential savings on other costs than in a commercial employer.

The considerations for the assessment of prospects at paragraph 168 are more focused on charities than member organisations, such as trade associations, professional bodies or trade unions, the prospects of which may be derivative on the prospects of a particular sector. We think that this should be expanded.

In our experience, many such organisations have weak cash flow but hold substantial liquid investment assets that provide balance sheet resilience, in a way that is less common in

commercial employers. We think that it should be permissible to make appropriate allowance for this in the covenant assessment of a not-for-profit, whether or not there is a contingent asset.

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?

Yes, this seems broadly reasonable.

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?

This approach would appear to allow schemes to push out their date to start de-risking as the period of covenant reliability (likely) gets extended at each valuation.

We believe it is sensible for schemes to be allowed to invest in this way, though it is worth noting that requiring to fund for de-risking that you do not actually expect to do in practice would be expected to lead to a surplus. This could be a source of frustration and conflict with employers.

It is unclear how options such as an escrow account can be recognized within the TPs to help address this.

Also, if in practice schemes may not need to de-risk until close to significant maturity it would seem disproportionate to be requiring any granularity of journey plan beyond a very high level one given this is likely to be rewritten at each valuation.

Finally, the uncertainty around the reliability period as described in our response to question 18 suggests we may be applying spurious accuracy to a very uncertain starting point.

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

We agree that it is helpful to consider the ability of the employer(s)' covenant to support the level of investment risk being taken by a scheme. We also agree that the funding position in downside scenarios (rather than the absolute amount stress) should be the focus i.e. all else equal better funded schemes would have more latitude within the code to take investment risk for a given level of covenant support.

In our view the process of balancing different risks to form a journey plan should be iterative. For example, this might include testing whether alternative investment strategies can be supported by the covenant. Where all plausible investment strategies are supportable by the covenant, less detailed covenant work may be required.

Stochastic modelling is one helpful measure to measure investment risk, and allows correlation of risks to be taken into account. However, this type of modelling is based on subjective assumptions and different advisers may calculate materially different 1-in-6 downsides. Given that we also have concerns regarding the level of accuracy with which the maximum affordable contribution can be estimated, the "equation" shown in paragraph 197 of the draft code could be unhelpful. Having a less prescriptive principles based approach may therefore be preferable – please see our response to Q30 for more detail.

Simpler downside scenario analysis may also be helpful e.g. for smaller schemes.

Finally, like other areas of the draft code a different approach may be required where employer affordability is constrained. For example, it may be necessary for the 1-in-6 downside to exceed the level which the covenant could support in order to give any realistic prospect of member benefits being paid in full.

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?

We agree that committed DRCs should be deducted when calculating an employer's ability to support funding downside risk. Discretionary contributions should not be deducted when calculating an employer's ability to support funding downsides (nor deducted from the deficit before stress).

Many contribution schedules include contingent contributions e.g. based on employer performance, dividends, funding level. The range of contingent contributions is too wide to set out a prescriptive approach, and it may be appropriate to deduct contingent contributions in some circumstances. There should always be consistency between the adjustment made to the 'before stress' funding position and whether contingent contributions are deducted when calculating an employer's ability to support funding downsides.

Funding downturns are likely to occur concurrently for most DB schemes (albeit to different extents). Whilst deducting committed DRCs by an employer to other schemes makes sense, multiple schemes may be relying on the same affordability in a downturn i.e. there is potential for double counting.

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 our view the "maximum risk equation" should not form part of the Funding Code, but rather be framed as an illustration.

Inclusion in the Funding Code implies it is applicable to all situations. It is a helpful illustration but it becomes increasingly challenging to apply as the level of complexity increases, becoming unworkable in some cases. In many situations we do not believe it to be proportionate.

It is a calculation of maximum risk in the near term for a specific shape of journey plan. This does not consider longer term reliance on covenant or other journey plan shapes (beyond saying lower risk is acceptable). Trustees will therefore have to undertake this calculation as well as the necessary analysis to support their specific strategic decisions.

It is our understanding that the Regulations do not require a one-size-fits-all formulaic approach to factoring covenant into a journey plan; instead this is part of TPR's approach to regulation. It should therefore form part of the Fast Track / Bespoke commentary from TPR. Importantly, this would allow TPR some flexibility in the application of the equation to ensure trustees are not spending valuable resources on a calculation that is not driving their strategic decision-making.

In accordance with the Regulations, the Funding Code should require trustees to justify the risk in the journey plan by reference to the covenant support. It may still be appropriate to require trustees to quantify the key elements (timing: period of maximum risk, period to low dependency, period beyond low-dependency; scheme risk metrics: e.g. VaR; covenant metrics: cash, prospects and contingent assets) but this should be proportionate to the scheme's circumstances.

Below we set out our concerns regarding the maximum risk equation, the implications and some suggested alternative approaches.

Concerns with the maximum risk equation

- **Period of reliability**: There is too much emphasis on period of covenant reliability, because it drives both maximum supportable risk and period over which that can be taken). Unless covenant has a clear cut off (e.g. reliance on a key contract), period of covenant reliance is subjective (or arbitrarily defined as 6 years unless demonstrated otherwise)
- **Contingent assets** are included but it's not entirely clear how they would be factored in. For example, maximum affordable contributions appear to be measured annually but contingent asset support might be a lump sum, and the scenario for claiming on a contingent asset may not be a 1-in-6 downside event
- **Liquid assets** appear to be included as part of the assessment of available cash as set out at paragraphs 298 and 299, but it is unclear whether they are included in the equation. The use of the term 'available cash' at paragraph 192 would imply that liquid assets are included, but references to 'affordability' at paragraph 193 refer only to the covenant section of the code and not to the definition of 'available cash' at paragraph 298. The extent to which liquid assets are expected to be included should therefore be clarified.
- **Each element of the equation is subjective**, for example**:**
    - Maximum affordable contribution is subjective (and even more so, looking to the future); this is increased if forecast information is not readily available (e.g. due to divisional rather than entity reporting)
    - The stochastic 1-in-6 downside calculation is based on subjective assumptions
- **Practical application is challenging beyond a simple example:**
    - Quantifying the maximum affordable contribution and period of reliance for multi-employer schemes further amplifies the subjectivity (e.g. how different employer metrics are combined in a last man standing scheme vs joint and several)
    - Scheme with sponsors with negative cash flows cannot take any risk based on the equation.
    - Sponsors that use all their spare cash flow to contribute to the scheme have nothing left to support investment risk so have to take zero investment risk (whereas a sponsor that holds back some cash flow could take more investment risk despite the scheme being funded more slowly)

Implications of concerns with maximum risk equation

- **Increased costs and loss of focus:** Asking advisers to quantify each element will potentially lead to increased advisory costs and may ultimately distract from holistic journey planning (particularly if this is a costly tick-box exercise that does not actually drive the strategy)
- **Protracted negotiations**: It will be easy to demonstrate compliance where there is a clear margin but it will need to be a fairly large margin if advisers are using prudent versions of all the inputs. Borderline cases will be tougher, and that could lead to protracted negotiations between sponsors and trustees on each element, which may not ultimately feed directly into scheme strategy
- **Cliff-edge for challenged schemes**: Schemes on the borderline between stressed and not stressed will face a cliff-edge (given flexibilities proposed for stressed schemes)
- **Opinion-shopping**: There is a risk of "opinion-shopping" to ensure compliance given the subjective nature of the inputs

- **Mixed messages**: Inconsistent application of the maximum risk equation (e.g. if it is not required for those schemes meeting Fast Track requirements) undermines the message that all schemes need to comply with the Funding Code, and Fast Track is just a regulatory filter
- **Extended reliance on covenant**: the maximum risk equation focuses on near term risk capacity; derisking in the near term could extend reliance on covenant, reducing the security of members' benefits

Alternative approaches

We believe a prescriptive, one-size-fits-all, formulaic approach to factoring covenant into journey planning for the Funding Code has significant challenges, but understand why TPR would find such an approach to regulation helpful. Below we set out suggestions that may help refine the maximum risk equation and would be happy to work with TPR to further refine its approach.

As an example, working within the constraint of using an equation, the following approach may be preferable:

- Change the title of "stress test" to "Stressed TP deficit". Paragraph 202 suggests that this is what the "Stress test" is i.e. TP deficit less present value of committed DRCs plus 1 in 6 VaR. However, other sections (e.g. paragraph 190, the graphic illustration of the equation at paragraph 197 and paragraph 227) appear to refer to the investment stress only. If a formula is retained that includes a "Stress test" then clarifying this point will be important, and our view is that the stressed TP deficit is most logical.
- Flip the equation around to:
    - maximum affordable additional contributions (including contingent contributions) over reliability period > Stressed TP deficit (after committed DRCs)
- Maximum affordable contributions is the sum of the employer's available additional cash over the covenant reliability period. Although this could be calculated as a single year amount multiplied by the reliability period (as appears to be currently envisioned in the equation), in our view it would be appropriate to reflect some element of increased uncertainty over available cash as time progresses, to recognise that 'reliable' is not the same as 'certain'. Methods to do this could range from an allowance for the equation to reflect a variable level of additional cash generation over the reliability period (e.g Yr 1 is £Xm, Yr 2 is £Ym, Yr 3 is £Zm, where X>Y>Z) or by applying an overall discount to the equation that reflects the Trustees' assessment of prospects (i.e. stronger assessment is a lower discount, weaker assessment is a higher discount)
- Typically, the stressed deficit would be calculated first, perhaps with alternative investment strategies. The maximum affordable additional contributions over the reliability period would then be checked to make sure they are likely to be greater than this. Wording clarifying that this is not an exact calculation is crucial given the highly subjective nature of the maximum affordable additional contributions over the reliability period.
- Contingent assets would only be included in maximum affordable additional contributions if they directly provide cash to a scheme in the stressed scenario e.g. an escrow paying out in a funding downside which would trigger in the stressed deficit scenario (during the reliability period) would be included. Assets that only provide security on insolvency e.g. non-look through parent guarantees would not be included (consistent with the principle that there appears to be no weight placed on employer balance sheet strength).
- Where contingent assets are a one-off and do not accumulate annually, they should not be multiplied by the reliability period (as appears to be the case in the proposed equation)

- Liquid assets should be explicitly included in the assessment of available cash for the purposes of the stress test, to the extent that they are expected to persist over the period of reliability. As with contingent assets, where liquid assets do not accumulate annually, they should not be multiplied by the reliability period.
- Default covenant reliability is 6 years but could be higher (perhaps significantly higher) or lower in certain circumstances. An example where the period would be lower is if major contracts are coming to an end in less than 6 years and unlikely to be replaced. An example where covenant reliability may be higher than 6 years is long term rolling licenses that act as barriers to competition such as employers operating in regulated industries.
- The equation is to be disregarded for "weak" employers where DRCs have been set at or close to the maximum affordable for the employer. In this scenario the maximum affordable additional contributions may be close to nil, but that should not imply that investment strategy should be constrained such that the stressed TP deficit needs to be very similar to the unstressed TP deficit. In this scenario, the Trustees will need to consider what actions are in the best interests of members.

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

Yes in principle but see our response to questions 27 and 30.

We also note that sponsors will likely have concerns around over-funding if a scheme is immature since contributions will be assessed assuming de-risking occurs in (say) 6 years once covenant reliability ends – but at the following valuation this period can be pushed out again once reliability is reassessed, so you effectively get a "gain" in the funding position.

Please can you also clarify the "lower for longer" approach described in Paragraph 212 – can this lower level of risk then extend to the point of significant maturity, as this seems to differ to what is implied in paragraph 225 which implies a maximum level of assumed risk is the linear de-risking approach. If this is the case it is not "lower for longer" but "lower until you hit the linear de-risking line", which is effectively just extra prudence.

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

Yes, we agree with this – in practice schemes will have different shapes of journey depending on circumstances, market conditions etc.

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?

We generally agree with the approach and recognise that greater risk may be taken whilst the employer covenant is still to be relied on to underwrite the scheme. We note that many schemes may take less risk in the early years (versus the maximum risk test) resulting in potentially slower de-risking plans after the covenant reliability period ends than implied by the maximum risk test.

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?

We believe the requirements of the Statement of Strategy, as drafted, create an unnecessary burden on many trustee boards. Further, we believe that the Statement of Strategy should only require schemes to commission work that (1) adds value to the trustees to produce; and (2) is

expected to be directly used by TPR in relation to that scheme.

We appreciate the detail of this will be consulted on in due course, but in the absence of this we have included some initial comments below.

Covenant requirements: In our view the implied detail within the following covenant requirement is unnecessary in many cases: **"**We expect trustees to provide cash flow and liquidity information, the covenant visibility and reliability period, covenant prospects with an estimate of the covenant longevity".

We fully agree that considering covenant is an important part of the Code but believe the emphasis should be on confirming that the covenant is more than strong enough to justify the approach and level of risk being taken.

There are a number of ways this could be simplified, for example:

- Requiring trustees to confirm (and evidence in broad terms) that their approach is within the limits of what the employer covenant can justify. (e.g. "Since the available cash flow is over £xm, with visibility of at least y years, the Trustees were comfortable with this approach."); or
- It would be appropriate to ease the requirements (or specific aspects) in certain circumstances, for example:
  - We understand TPR is not going to use the Reliability Period for schemes that are FastTrack compliant. In this case, and if the trustees do not believe it is relevant in their employer's circumstances for whatever justifiable reason, then they shouldn't need to produce the Reliability Period figure provided they have considered the high level principle of ensuring the covenant can support the risk being taken in the scheme over the journey plan.
  - A scheme that has secured a buy-in for all of its liabilities shouldn't need to provide any covenant information to TPR;
  - A scheme not making use of the reliability period (i.e. it is fully de-risked already, is fully funded and has no accrual) shouldn't need to produce the reliability figure; and
  - We encourage TPR to think of ways to make the requirements simpler for small schemes.

For clarity, our suggestion for these schemes is that they would still be required to consider covenant as part of the Code (as indeed they do now) but just not required to calculate all of the specific information requested by TPR. One option would be for the Statement of Strategy to include high level commentary as to how the trustees have approached their journey planning in the context of covenant, and why it is appropriate and proportionate.

Other points:

We note there is potential for significant overlap or duplication with existing documents including the Statement of Funding Principles and Statement of Investment Principles. We would prefer repetition in these documents be avoided.

We do not believe that it should be a requirement to set out the investment strategy journey plan, and investment strategy at significant maturity, for all schemes – in particular for small schemes, Fast Track compliant or immature schemes this feels unnecessary. Requiring a statement confirming a scheme's funding plans allows for them to de-risk their assets in accordance with

TPR's Code should suffice. We appreciate this detail is in the draft Regulations, but we suggest this is changed.

We understand TPR will be consulting on the content of the Statement of Strategy and how this information will be collected. We would encourage you to do this as soon as possible so the industry has more time to get to grips with what is expected. We also think that in due course a template Statement of Strategy may be useful, depending on the content and detail in the consultation.

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 broadly agree, but would like the Code to be very clear that adopting more prudent TPs than implied by the investment strategy/journey plan is allowable. (Paragraph 264 should be more generic ('…more prudent TPs **e.g.** that adopt the low dependency funding basis at a point before the relevant date.')

Also paragraph 263 says that where the valuation effective date falls *before* the relevant date, then in respect of period after relevant date TPs "must be calculated in a way that is consistent with the *low dependency funding basis assumptions*". The term 'must' implies a legal duty but draft regulation 20 (amending current regulation 5) only requires that "by the time the scheme reaches the relevant date, and thereafter, the [TP] assumptions chosen must be consistent with the way in which the trustees or managers intend pensions and other benefits under the scheme will be provided over the long term, as set out in the scheme's funding and investment strategy".

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 assume "future accrual" here includes a sensible allowance for new entrants.

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 find this question hard to answer without sight of further covenant guidance and detail on how schemes can evidence their covenant reliability.

Notably there may be a significant difference between the period of time that a business might be expected to support some level of contributions into a pension scheme, and the period of time over which the trustees can have confidence that the business will be able to continue to support a defined level of contributions to the pension scheme.

Further, this approach may not be appropriate for all schemes, eg multi-employer last-man standing schemes, or industry-wide schemes where the chances of the entire industry disappearing are negligible, albeit to some extent we acknowledge that might be reflected in the trustees' assessment of reliability.

In general terms, however, the concept that trustees should not plan for accrual beyond the period over which they have confidence the sponsor will be in a position to continue to meet such additional obligations appears reasonable, noting that the end of the period of covenant reliability will likely extend with each valuation.

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 the principles based approach.

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

Given the Draft Regulations refer to the Code in the requirement for Trustees to assess cash flows, additional detail is helpful.

Our understanding of the Code is that 'reasonable alternative uses' reflect discretionary cash outflows that trustees may reasonably consider constrain the sponsor's affordability of contributions for the purposes of setting a recovery plan that eliminates the scheme's deficit 'as soon as the employer can reasonably afford'.

The three alternatives identified appear reasonable and would be expected to catch the majority of alternative uses of cash, although the 'discretionary payments' could be extended to capture 'stakeholders' more generally rather than being limited to creditors (this would ensure discretionary payments were captured at the point of declaration, if the recipient were not already a 'creditor').

One element not captured is transformative investment, where an investment made in the business is not merely designed to be sustainable, but rather transformative at a correspondingly higher level of risk. This could be a particularly relevant consideration in the context of investing for ESG purposes.

It is also slightly unclear as to how trustees might address a decision to retain cash, both in circumstances where it remains as a liquid asset and where it offsets borrowing (e.g. repayment of an RCF).

We would also highlight that payments to other DB pension schemes could be discretionary if they exceed agreed recovery plans.

More generally, we would note that whilst the alternatives might be expected to catch the majority of alternative uses, they are not exhaustive (e.g. investment for transformational change) and we are conscious that not all cash flows will fall neatly into such defined categories. As a consequence, even with ongoing payments (but particularly if 'one-offs' are included), considerable judgement will be required in coming to a quantitative answer. A single number will also obscure all the nuances of the underlying cash flows and underlying risks of the sponsor that is gained through qualitative commentary.

Additionally, whilst we are supportive of the trustees taking account of 'alternative uses' of cash in their own deliberations on affordability, we are mindful that in some cases it may be seen as trustees 'overreaching' and seeking to influence how sponsors run their business (particularly if they feel under a legal obligation to do so). For example, a management team deciding to invest in transformational growth for the expected long-term benefit of shareholders might find itself under pressure from the trustees if the consequence was reduced DRCs in the shorter term. This appears contrary to previous commentary from TPR that it is not for trustees to tell management how to operate the sponsor. It could also have material cost implications for trustees.

Finally, guidance on what constitutes a 'discretionary' item would be of assistance; for example, a dividend would typically be considered to be both 'discretionary' and 'leakage' but where such dividends are required to meet wider group commitments under banking facilities, they might instead be treated as a necessary expenditure that reasonably constrains affordability. This

example highlights the challenge of categorising cash flows, emphasising the importance of information flows and judgement.

TPR should be mindful that due to the challenges highlighted above, the requirements may prove to be onerous, and lead to clashes between trustees and employers as trustees look to determine reasonable alternative uses of cash.

See further comments on Q42 and our exec summary.

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 we stated in our response to the consultation on the Regulations, we feel strongly that "reasonable affordability" should not be the only driver for setting a recovery plan and that matters prescribed by regulation 8(2) remain relevant. In our view, it would become the only driver if the proposed amendment to Regulation 8 of the Occupational Pension Schemes (Scheme Funding) Regulations 2005 is made. For example, if the employer can reasonably afford to pay off the deficit in 3 years then under the Regulations that should arguably be the Recovery Plan and consideration of the other matters in regulation 8(2) would seem to be irrelevant. Trustees would then find themselves in a situation where, effectively, they apply no weight to any of the matters in Regulation 8(2) because they are irrelevant once they have applied the reasonable affordability principle.

Our preference would be for "reasonable affordability" to be included in Regulation 8(2) as one of the matters trustees should take into account when determining a recovery plan. If, however, the Regulations remain as drafted, the Regulator should provide a more detailed explanation of how the principle and the matters in Regulation 8(2) interact as this is not clear from the draft Code. Paragraph 305 of the draft Code provides that similar matters to those set out in Regulation 8(2) should be considered when determining whether potential alternative uses for available cash are reasonable. We could see that if reasonable affordability is retained as an overriding principle, the matters in Regulation 8(2) would be relevant factors when considering potential alternative uses for available cash. However, paragraph 305 does not refer to Regulation 8(2) so it is not clear whether this is how the matters in Regulation 8(2) are intended to interact with the overriding principle.

The principles trustees are expected to adopt when considering alternate uses for available cash are not entirely relevant where the sponsor is a not-for-profit organisation (paragraphs 306 to 317). It would be helpful if the Code could provide further guidance for trustees of such schemes on how these principles should be applied.

Finally, we would also question how this principle interacts with the Regulator's statutory objective to minimise any adverse impact on the sustainable growth of an employer.

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

We agree that the trustees' assessment of reliability is one of a number of factors that should be factored into discussions over the length of the recovery plan, noting that the reliability of available cash is a key element of the trustees' assessment of the employer covenant and affordability of contributions.

However, we do not consider that reliability of available cash should be the sole determining factor. In this regard we are mindful that schemes will face a range of circumstances, including constrained affordability, so it is important that trustees are given the flexibility to agree a recovery plan that they consider appropriate for their circumstances. For example, where affordability is constrained, it may be necessary to extend a recovery plan beyond the period of reliability. Similarly, trustees may be comfortable in allowing a longer recovery plan period if adequately supported by contingent assets, such as guarantees or ABC funding structures.

As previously highlighted, it would be helpful to receive more guidance from TPR as to how 'available cash' and 'reliability' might be assessed and crucially, how they might interact.

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?

In answering this question, we have considered the principles set out in the code from paragraph 305 to 320.

In general terms, we agree with the concepts that:

- Para 307 – Where a scheme is poorly funded, DRCs should be prioritised
- Paras 314-317 - Sustainable investment is reasonable where it is expected to benefit the employer covenant during the time frame in which the scheme will rely upon in
- Para 318 – It would appear reasonable to include the guarantor in any affordability assessment, where that guarantor has provided a 'look-through' guarantee covering all scheme obligations (subject to further guidance on 'look-through' guarantees)
- Paras 319-320 - Sponsors should provide sufficient information for trustees to assess affordability, including alternative uses of cash

We believe that following concepts are largely reasonable, but require further consideration:

- Paras 308-309 - Where a scheme is mature, we agree that it would have less time for investment returns to redress changes to the employer covenant and consequently, discretionary uses that reduce liquidity in the short term could be of heightened concern. However, we are also mindful that a less mature scheme would expect to be reliant on the employer covenant for longer (with the employer covenant also underpinning investment risk) and consequently would also be concerned about discretionary payments, albeit perhaps those that would impact the period of reliability and longevity.
- Paras 310-311 – We agree that using available cash for discretionary payments or to effect covenant leakage where it would result in DRCs extending beyond the reliability period could be of concern to trustees. However, we have a few issues with this approach:
    - First, we have a fundamental concern that leakage and discretionary payments are examples of 'corporate events' and should therefore be addressed as transactions (and subject to that guidance) rather than here.
    - Second, the flip side of the concept is that discretionary payments that do not result in DRCs extending beyond the reliability period are by implication, permissible. Taken together with the point raised above, this

risks setting an unhelpful precedent for transactions, which should be considered on their own merits. Notably, many examples of one-off 'leakage' would be expected to have no impact on cash generation, being funded from a sponsor's assets rather than cash flows.

  - Third, the Code does not differentiate between regular cash outflows (e.g. a consistent dividend policy) and material one-offs (e.g. a large one-off dividend). As highlighted above, we consider that the latter typically represents a 'corporate event', and should be considered on its own merits.
  - Finally, as set out in our response to question 39, there may be circumstances where apparent 'discretionary payments' or 'leakage' do not fall neatly into the identified category and are effectively 'necessary', for example the use of dividends to meet creditor obligations further up the group.
  - We would also welcome guidance from TPR as to how a contingent asset might mitigate effectively for leakage in the context of the 'maximum supportable risk' calculation

- Where a sponsor has obligations to multiple pension schemes, we agree that in most circumstances it should seek to treat those schemes fairly, reflecting the specific consequences of those schemes. However, we are conscious that where there are fundamental differences between schemes (e.g. size, funding level, industry schemes) it may be appropriate to treat schemes differently in a way that could look 'unfair'; for example, making a discretionary payment to buy out a small competing scheme.

Additional principles could be added around:

- Transformational growth, even if only to refer to transactions guidance
- Retention of cash

Additionally, we would ask TPR to consider adding commentary that where the employer covenant is particularly strong, there is a general recognition that (with the exception of 'material events' such as one-off dividends, transformational change etc) employers can allocate capital as they see fit without needing to justify all alternative cash flows as a reasonable 'alternative use'. Such an approach would be in line with the concept of proportionality.

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

Yes this seems sensible.

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

Yes broadly, though we note there may be an interaction with the wording around stressed schemes. Such schemes will need to take additional investment risk which may not be supportable as is described in the Code – we presume the intention here would be no investment outperformance allowed in recovery plans but such plans can be as long as is required to repair the deficit. However some clarification here would be helpful.

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

No, we think flexibility is key and worry that more specifics would be analogous to more constraints.

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

We agree that trustees' decisions should "generally be consistent" with the strategies set out in the funding and investment strategy, as this concept provides sufficient flexibility for deviation, which may be appropriate depending on the circumstances of the scheme. For example, we think investment strategies should be allowed to be more risky than that implied by the Technical Provisions provided this risk is supportable. This could be achieved by having the Scheme's actual investment strategy differ from that set out in the funding and investment strategy, or by allowing the Technical Provisions and funding and investment strategy to diverge.

The requirement to agree (save where section 229 has been modified by the Scheme Funding Regulations 2005) the funding and investment strategy with the employer does create confusion over the roles of the trustees and the sponsor. While we agree that the requirement does not alter the fact that trustees have ultimate discretion over how the scheme's assets should be invested, there is concern over what should happen if the trustees and employer cannot agree the funding and investment strategy. The example given in the draft Code suggests that if agreement cannot be reached, the trustees can exercise their investment powers to follow the investment strategy they consider to be appropriate. In these circumstances, the trustees would need to report a failure to agree to the Regulator. It is not clear from the draft Code however, how the Regulator would expect the parties to proceed in these circumstances. We assume the trustees should continue to follow the investment strategy that they consider to be appropriate even though this means there continues to be a failure to agree on the funding and investment strategy. The alternative would be for the trustees to sign the funding and investment strategy on terms they can agree with the employer and then invest in a way that diverges from that strategy, which would place trustees in a very uncomfortable position. We would appreciate it if the final Code provides more clarity on what the Regulator would expect trustees to do in these circumstances.

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

We believe there will be confusion regarding the interaction of the Statement of Strategy with the Statement of Investment Principles and how this will work in practice. We think it would be helpful for the Regulator to confirm:

- The Statement of Strategy cannot override the Statement of Investment Principles and an employer, whilst agreeing and consulting on the content of the Statement of Strategy needs to recognise the supremacy of the Statement of Investment Principles.
- The requirements of Statement of Investment Principles are unchanged – trustees will continue to be required only to consult with their sponsors on, but not seek agreement. And trustees should continue to invest in line with their Statement of Investment Principles.

- There is a reasonable 'get out' clause for trustees if there is failure to agree a Statement of Strategy because it contradicts the Statement of Investment Principles. We would suggest changing the requirements so that it is clear trustees will be deemed to have taken "all reasonable steps" to produce their Statement of Strategy, in these circumstances.

In addition, whilst beyond the scope of the draft funding code, we would suggest instead encouraging the Statement of Investment Principles to include more details on future investments and long-term plans that are intended to be in the Statement of Strategy.

Also see Q 46.

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

Yes – we are supportive of the approach described by TPR in the Code, which seems pragmatic. However, we would prefer that the regulations are changed to make it clearer that this is allowed in law.

We also note there appears to be a cliff edge between employers that are deemed stressed and allowed the flexibility set out in the Funding Code, and those that are on the borderline (i.e. not deemed stressed but failing the maximum supportable risk test). We would expect the covenant guidance to include commentary as to how a stressed scheme is defined and how borderline schemes are treated in the Funding Code (to ensure they do not become stressed schemes).

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?

We are broadly supportive of the approach.

We appreciate the comments around a proportionate integrated approach (e.g. Paragraph 340), which we agree with. We note the rest of this chapter has a lot of detail and many uses of the word "should". Greater clarity would be appreciated here – eg "should if deemed proportionate" may be preferable in many instances where "should" is currently used.

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 believe the guidance in paragraphs 351 to 369 of the draft Code is useful, although we would suggest recognising in paragraph 359 that the recommendation to hold sufficient liquidity to manage a 300 to 400 basis point rise in long-term interest rates is a stop-gap in view of the recent LDI liquidity crisis, and it may well become appropriate to modify these levels as market conditions normalise.

There is also a typo in paragraph 361 where the word "won" should be "own" and paragraph 354 should more reasonably say 'For these schemes, **reflecting retirement plans (where known)** for these few members will be key…'.

In relation to the guidance on assessing liquidity (in paragraphs 370 to 372), we suggest there should be an emphasis on the importance of legal advice in determining not just the standard processes around redemption (etc.) under-investment documents but, importantly, the circumstances in which redemptions can be suspended, gated or deferred and steps such as redemption *in specie*

and in part (with side-pocketing) may be taken. We also suggest mentioning, in this section, the considerations around secondary market sales and employer (or other third-party) loans for liquidity, particularly as these matters have come to the fore in connection with the LDI liquidity crisis.

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

There does not appear to be much detail on security, profitability and quality, even in the sections of the draft Code that are cross-referred to in paragraph 349. We suggest either building out paragraphs 347 to 350 (and potentially including guidance on the implications of other features of paragraphs 4 and 5 of the Occupational Pension Schemes (Investment) Regulations 2005) or trimming them back.

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

No further comments

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

We do not believe there is potential for significant herding and concentration risks regarding growth assets. Even if pension schemes decided to reverse out of current de-risking plans, growth assets used by pension schemes are highly diversified across the globe. It is very difficult to imagine a scenario where the UK DB market has an outsize influence on global growth markets.

We do consider, however, there might be risks of herding within matching assets and note the potential for systematic risks within gilt markets in Q54 (as future difficult sellers of gilts). Schemes may become forced buyers of gilts "at any price". In addition, diversification risks should be considered with long-dated sterling corporate bonds, which tend to be concentrated in a small number of sectors.

There is also a funding risk of herding to Fast Track and as such "levelling down" in funding approaches, driven by sponsors using Fast Track as a negotiation tool to push for a less prudent approach. We comment on this in our response to the Fast Track and regulatory approach consultation.

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.

We note that certain systemic risks are not mentioned in the draft Code: the return of low inflation; the risk that pension schemes want to sell gilts and there be no natural buyer; climate risk and longevity risk. We suggest that these should be addressed in the Code.

Response ends.

Yours faithfully

Chris Ramsey
Chair, DB Committee

Fred Emden
Chief Executive, SPP

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