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The draft Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2023

Consultation response from the Employer Covenant Practitioners Association

The Employer Covenant Practitioners Association (ECPA) welcomes the opportunity to respond to the Department for Work & Pensions' (DWP) consultation document, *The draft Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2023, July 2022* (the Regulations and Consultation respectively).

As an organisation of employer covenant practitioners, we have focused on the questions that are either directly or indirectly referencing employer covenant. This response should be seen as a collective response from senior industry practitioners and not as a response from any of the ECPA's member organisations specifically.

Our view is that we support the intention of the draft Regulations which will help improve understanding and management of key risks in relation to scheme funding, investment and covenant.

However, we consider overall that the draft Regulations are too prescriptive on matters that need to be clearly set out in the Code of Practice (the Code). Furthermore, some principles within the Regulations should be revised to help avoid unintended consequences for pension schemes. In some instances, these consequences could affect wider financial markets and the UK economy more broadly. In particular, we consider that the Regulations as currently drafted could:

- Encourage a narrow view of covenant, leading to more limited covenant discussions and less effective action being undertaken to understand and mitigate covenant risks within a scheme's funding and investment strategy.

- Over-focus on short term cash demands from sponsoring employers as opposed to longer term employer and scheme resilience.

- Drive a narrow view which does not give sufficient flexibility with respect to scheme specific issues, for example open schemes.

In addition, we note that despite recent guidance from TPR around the necessity to continue covenant review and monitoring as a scheme continues its journey past full funding on a technical provision basis, the Regulations are not clear on this point.

Finally, we note that it is difficult to respond fully to the questions raised in the Consultation without seeing the detailed Code and covenant guidance - noting the references and balance between statutory regulations and a 'comply or explain' Code of Practice.

Question 1: Draft regulation 4(1)(b) provides that a scheme reaches significant maturity on the date it reaches the duration of liabilities in years specified by the Pensions Regulator's revised Defined Benefit Funding Code of Practice.

i) Do you think that it would be better for the duration of liabilities at which the scheme reaches significant maturity to be set out in the Regulations rather than the Code of Practice?

ii) If you think that the point of significant maturity should be specified in Regulations, do you agree that a duration of 12 years is an appropriate duration at which schemes reach significant maturity?

Throughout the consultation, there are many references to the upcoming Code from the Pensions Regulator. Given that the Code has not yet been published, it is challenging to conclude on the appropriateness of matters specific to this consultation. In relation to Q1(i), absent the wider context that is likely to be apparent within the Code, for example whether the details surrounding the calculation of duration, or the duration itself, is to be subject to change influenced by external factors, we are not able to provide a considered response to this question.

These details, and the interaction of the Regulations with the Code, are particularly important in relation to schemes that remain open to new members and where the scheme is not expected to mature in the foreseeable future (if at all). Based on the wording within the draft Regulations, it does not appear to be possible to make allowance for future new entrants into a pension scheme. All schemes will, therefore, need to put in place a funding and investment strategy based on an assumption that their scheme will mature over time -even open schemes which are not actually expected to mature for the foreseeable future.

The consultation document states that open schemes can avoid unnecessary de-risking of the investment strategy by reconsidering the position at each valuation - if a scheme has not matured, then the de-risking of the investment strategy can be deferred. However, simply assuming that the investment strategy will be de-risked in future – even if this ultimately does not happen in practice – has an immediate and very substantial impact on Technical Provisions. This is because the assumption that the investment strategy will be de-risked over time will need to be reflected in the discount rates used to calculate Technical Provisions. This will reduce discount rates for non-maturing schemes, increasing Technical Provisions. Such a significant step change in the contribution requirement risks making an open scheme unaffordable, demanding cash from sponsoring employers as they would then be required to de-risk the scheme's investment strategy as the now maturing scheme matures, whilst also making contributions to their employees' alternative pension offering. Such an otherwise inefficient use of cash could weaken the employer covenant of the DB scheme and put the security of members' benefits at risk.

That said, for many closed schemes, and in particular for smaller schemes that choose not to take the benefit of professional advice and adopt a scheme-specific approach, the presence of a defined 'significant maturity' date is welcome.

However, in relation to Q1(ii), for more complex situations where Trustees have the benefit of good quality professional advisers and where investment and funding strategy is considered in a truly bespoke efficient manner, including taking proper account of the strength of employer covenant, we consider that the numerical value of duration is given too much prominence in the draft Regulations. Whilst this appears to strengthen the regulatory framework, it does not appear to add to the overall security of members' benefits as nothing within the scheme changes on that date. The security of members' benefits before and after that date will continue to remain reliant on the strength of the employer covenant supporting the scheme.

Question 2: Do you think that the definition of low dependency investment allocation provided by draft regulation 5 is appropriate and will it be effective?

For many closed schemes, and in particular for smaller schemes that choose not to take the benefit of professional advice and adopt a scheme-specific approach, the definition of a 'low dependency' investment allocation is welcome and could be effective. However, for more complex situations, where Trustees have the benefit of good quality professional advisers and where investment and funding strategy is considered in a truly bespoke efficient manner, including taking proper account of the strength of employer covenant, such definition could prove inefficient.

From an employer perspective, any compulsion to act in a way which causes inefficient cash usage could by definition lead to a weakening of that employer: compelling it to use its cash to fund a scheme, as opposed to invest in its business, may weaken the employer's ability to fund the scheme over the longer term. As 'low dependency' is not 'no dependency', the scheme's members continue to rely on the employer maintaining viability until all the liabilities are bought out, are fully paid-out or are taken over by a consolidator. Low dependency is not and should not be viewed as an 'endgame'. In this context, a requirement that schemes invest in assets with cash flows that broadly match the expected liability cash flows is overly prescriptive when schemes may wish to retain a very liquid investment portfolio in order to seek opportunities to buyout (which is an endgame). To achieve buyout from a cash flow matched position is likely to demand additional cash. From a wider perspective, under a truly scheme-specific regime, the requirement to invest in such a narrow asset allocation could itself give rise to inefficient cash demands being placed on the sponsoring employer, particularly where the employer itself provides a greater level of member security than a 'low dependency' asset allocation, even on a fully funded basis. Schemes should not be prevented from taking these approaches, under a truly flexible, scheme specific funding regime.

Question 3: Do you think that the definition of low dependency funding basis provided by draft regulation 6 is appropriate and will it be effective?

For many closed schemes, and in particular for smaller schemes that choose not to take the benefit of professional advice and adopt a scheme-specific approach, the definition of 'low dependency' funding basis is welcome and could be effective. However, for more complex situations, where Trustees have the benefit of good quality professional advisers and where investment and funding strategy is considered in a truly bespoke efficient manner, including taking proper account of the strength of employer covenant, such definition could prove inefficient.

The draft Regulations do not mention any transitional arrangements for schemes that are already at, or near, a position of significant maturity. For some of these schemes, a sudden and sharp shift to a position of being required to be fully funded on a low dependency basis, could lead to a material increase in employer contributions and member contributions, which could ultimately threaten the security of member benefits. The lack of flexibility in both timescales and investment strategy means it is unclear how compliance is possible if the employer cannot afford to resolve the deficit in very short order (or immediately if the scheme is already at significant maturity). At an extreme, an employer could be forced to make a decision to either (a) break the law or (b) conclude that it is unable to pay its debts as they fall due, causing an otherwise unnecessary insolvency to the detriment of members, employers, employees (many of whom may not be scheme members), the Pension Protection Fund and the economy / society in general. Such an unnecessary and unwelcome 'breach of law' outcome may also give rise to real difficulties for scheme auditors and trustees in finalising scheme accounts.

Even where an employer could afford to achieve the proposed fully funded on a low dependency position, from an employer perspective, any compulsion to act in a way which causes inefficient cash usage could by definition lead to a weakening of that employer: compelling it to use its cash to fund a scheme, as opposed to invest in its business, may weaken the employer's ability to fund the scheme over the longer term. As 'low dependency' is not 'no dependency', the scheme's members continue to rely on the employer maintaining viability until all the liabilities are bought out, are fully paid-out or are taken over by a consolidator. Low dependency is not and should not be viewed as an end game. In this context, a requirement that schemes invest in assets with cash flows that broadly match the expected liability cash flows is overly prescriptive when schemes may wish to retain a very liquid investment portfolio in order to seek opportunities to buyout (which is an end game). To achieve buyout from a cash flow matched position is likely to demand additional cash. To demand that a scheme is 'fully funded' on this basis, by a somewhat arbitrary date (see Q 1 response) may give rise to further inefficient cash demands being placed on the employer. From a wider perspective, under a truly scheme-specific regime, the requirement to invest in such a narrow asset allocation could itself give rise to inefficient cash demands being placed on the sponsoring employer, particularly where the employer itself provides a greater level of member security than a 'low dependency' asset allocation, even on a fully funded basis. Schemes should not be prevented from taking these approaches, under a truly flexible, scheme specific funding regime.

Strength of the employer covenant

Question 4: i) Do you agree with the way that the strength of employer covenant is defined? ii) Are the matters which trustees or managers must take into account when assessing it, as provided by draft regulation 7, the right ones? iii) Does draft regulation 7(4)(c) effectively capture the employer's broader business prospects?

i) Do you agree with the way that the strength of employer covenant is defined?

Whilst we welcome the fact that a definition of the *'strength of the employer covenant'* is being enshrined in regulations/legislation for the first time, it is imperative that any such definition captures all relevant matters.

TPR's Code of Practice 3 – Funding Defined Benefits ('CoP3') defined 'employer covenant' as:

> *'the extent of the employer's legal obligation and financial ability to support the scheme now and in the future'.*

In our document 'Principles for covenant assessment in scheme valuations', the ECPA explained that the definition of employer covenant in CoP3 could be further distilled into:

> *'an employer's ability to put cash (or other assets that can be converted into cash) into a pension scheme when needed.'*

The draft Regulations seek, in part, to weave these two definitions together which is welcome, particularly recognising specifically the contingent asset support that may be available to augment the employer covenant strength. We agree that any such contingent asset support should only have value to the employer covenant if it is legally enforceable and sufficient to provide that support when needed.

However, we have concerns that the definition as drafted omits certain fundamental strands to the employer covenant concept.

For example, the omission of the wording 'legal obligation' and limiting the definition to 'financial ability' does not distinguish the specific primary obligations a statutory employer may have legally to a scheme; and those of non-statutory employers which are laid out in the trust deed and rules and any ancillary legal documentation.

Secondly the omission of 'now and in the future' fails to recognise:

- the potential for that legal obligation or financial ability to change over time; and more importantly

- the fundamental significance of the forward-looking position (in terms of covenant horizon and corporate longevity) to the strength of the employer covenant.

Not only is the forward-looking position arguably far more important to assessing the strength of the employer covenant than an understanding of what has happened historically or is happening now (and particularly even more so with the ever-increasing ESG agenda), but the omission of the wording fails to recognise that ongoing covenant support requires an ongoing employer.

We would, therefore, suggest that these issues are recognised in the definition, for example by extending 7(2)(a) as follows:

> *'The strength of the employer covenant means:*
>
> *<u>(a)</u> <u>the extent of the legal obligation and financial ability of the employer in relation to the scheme to support the scheme now and in the future</u>.*
>
> *<u>(b)</u> <u>[ ]</u>'*

In suggesting this, we assume this and/or s7(2)(b) cover from an interpretational perspective:

- any legal obligation provided by the employer or other party by way of contingent asset support.

- any relevant amendment to a scheme's trust deed and rules from time to time.
- any change in the employer(s) from time to time.

We suggest that the definition does not seek to be prescriptive about the length of time over which the covenant assessment should be considered, given the case specific dynamic nature of covenant assessment and an appropriate time horizon for any particular circumstance. Please see the January 2021 ECPA paper '*Time horizons and the employer covenant: the importance of evaluating sponsor longevity as part of a dynamic analysis'.*

ii) Are the matters which trustees or managers must take into account when assessing it, as provided by draft regulation 7, the right ones?

The draft regulations set out that:

- the strength of the employer covenant is assessed in relation to the deficit or surplus on both low dependency and solvency bases, with the weight afforded to each dependent on the likelihood of an event happening which would lead to a s75 debt being triggered.; and
- the matters which trustees and managers must take into account when assessing the strength of the employer covenant as being:
    - the cash flow of the employer, as set out in a Code
    - the likelihood of an insolvency event, within the meaning of section 121 of the Pensions Act 2004; and
    - other factors which are likely to affect the performance or development of the employer's business, as set out in a Code

Given the aim of the proposed Regulation is to have a funding and investment strategy designed to see schemes de-risk and move to a low dependency state, we see no area of concern in assessing covenant in relation to the funding bases set out, save for noting that, in particular, those employers which sponsor schemes which remain open and/or are immature will likely have (as an unintended consequence) to make increased deficit contributions given the impact on technical provisions which could be viewed as an inefficient usage of the employer's cash balances.

As regards the matters to be taken into account, we note that the Ministerial foreword focuses on the fact that 'best practice is not universal'. ECPA is concerned that any attempt to 'shoe-horn' factors or matters into the Regulation (as opposed to providing some latitude within a Code) will inevitably mean that these matters/issues are too narrow; and that merely focusing on the issues set out in the Regulation (by way of compliance) will drive covenant standards down, not up.

Whilst we agree that the factors/matters noted are important, given the need for cash to be put into a scheme and for an employer to remain solvent to provide ongoing support, we would point to other matters which could be included such as: robustness of an employer balance sheet, underlying trading performance, debt maturity profile and/or security net, capital investment strategies, inter-dependencies and relationships between employer and its corporate group, resilience (or otherwise) to macroeconomic factors, ESG, business competitive dynamics or recessionary factors. There will be others depending on the nature of the circumstances.

In our view, it would therefore be counter-productive and potentially dangerous to set out in the Regulations a set of matters/factors which are both too narrow and assume a 'one box fits all' approach. Covenant is not a 'one box fits all' concept; it is specific to the circumstances of the relevant employer(s), stakeholders and the scheme.

We would therefore suggest that, in light of the forthcoming second consultation on the DB Funding Code and associated covenant guidance, any reference to matters or factors to be taken into account in assessing the strength of the employer covenant is left to a Code. This will provide scope for those assessing the strength of the employer covenant to be case specific and not stymie the progress which has been made in driving best practice and higher covenant standards generally.

iii) Does draft regulation 7(4)(c) effectively capture the employer's broader business prospects?

Draft regulation 7(4)c states that *'other factors which are likely to affect the performance or development of the employer's business, as set out in a Code'*.

The public consultation sets out certain examples, but draft regulation 7(4)c does not list those examples. We are, therefore, not sure how this question can be answered at this time.

We welcome the fact that these factors will be incorporated into a code, as opposed to there being too narrow a focus if enshrined into regulation (as noted in our response to 4(ii) above). This will allow a degree of latitude in shaping any assessment of the strength of the employer covenant to be specific to the circumstances, not a 'one box fits all' approach.

Question 5: Does it work in practice to set a minimum requirement for the relevant date to be no later than the end of the scheme year that the scheme is estimated to reach significant maturity?

Not answered

Question 6: Does your scheme already have a long-term date and how is it calculated?

Not answered

Question 7: Where the funding and investment strategy is being reviewed out of cycle with the actuarial valuation, would it be more helpful to require it to align with the most recent actuarial report?

Not answered

Question 8: Do you think that these minimum requirements are sensible and will provide additional protection for the accrued pension rights of scheme members?

For many closed schemes, and in particular for smaller schemes that choose not to take the benefit of professional advice and adopt a scheme-specific approach, these minimum requirements are welcome and could be effective. There should however be a transition period, to allow schemes that are perfectly well managed but not yet 'compliant' with this new approach, to become compliant over a reasonable period of time. This would minimise the risk that employers may need to use cash, perhaps significant cash, in an otherwise inefficient manner (see below). However, for more complex situations, where Trustees have the benefit of good quality professional advisers and where investment and funding strategy is considered in a truly bespoke efficient manner, including taking proper account of the strength of employer covenant, such minimum requirements could prove inefficient.

The draft Regulations do not mention any transitional arrangements for schemes that are already at, or near, a position of significant maturity. For some of these schemes, a sudden and sharp shift to a position of being required to be fully funded on a low dependency basis, could lead to a material increase in employer contributions and member contributions, which could ultimately threaten the security of member benefits. The lack of flexibility in both timescales and investment strategy, means it is unclear how compliance is possible, if the employer cannot afford to resolve the deficit in very short order (or immediately if the scheme is already at significant maturity). At an extreme, an employer could be forced to make a decision to either (a) break the law or (b) conclude that it is unable to pay its debts as they fall due, causing an otherwise unnecessary insolvency to the detriment of members, employers, employees (many of whom may not be scheme members), the Pension Protection Fund and the economy / society in general. Such an unnecessary and unwelcome 'breach of law' outcome may also give rise to real difficulties for scheme auditors and trustees in finalising scheme accounts. At a minimum, this could lead to increased audit costs for schemes. At the more extreme end, this could lead to a failure to complete scheme accounts potentially leading to other breaches of regulations, fines, and negative reputational consequences.

From an employer covenant perspective, any compulsion to act in a way which causes an inefficient use of cash by a sponsoring employer by definition leads to a weakening of that employer i.e. it is using its cash in an inefficient manner. As 'low dependency' is not 'no dependency', the members continue to rely on the employer maintaining viability until all the liabilities are bought-out, are fully paid-out or are taken over by a consolidator. Low dependency is not and should not be viewed as an end game.

In this context, these minimum requirements are overly prescriptive when schemes may wish to retain a very liquid investment portfolio in order to seek opportunities to buyout (which is an end game). To achieve buyout from a cash flow matched position is likely to demand additional cash. To demand that a scheme is 'fully funded' on this basis, by a somewhat arbitrary date (see Q 1 response) may give rise to further inefficient cash demands being placed on the employer. From a wider perspective, under a truly scheme-specific regime, the requirement to invest in such a narrow asset allocation could itself give rise to inefficient cash demands being placed on the sponsoring employer, particularly where the employer itself provides a greater level of member security than a 'low dependency' asset allocation, even on a fully funded basis. Schemes should not be prevented from taking these approaches, under a truly flexible, scheme specific funding regime

Question 9: i) Should such limited additional risk at and after significant maturity be permitted, if supported by contingent assets? If so, to what percentage of total liabilities should this be limited? Ii) What additional risks to members' benefits might be posed as a result, and what safeguards should apply to protect members?

If additional risk taken after significant maturity is supported by good quality contingent assets, then we see no reason to limit or cap this, provided appropriate safeguards are in place.

The Consultation describes the importance of identifying risk and ensuring that it is supportable by the employer covenant. We consider this to be a sound principle and believe this should remain an underlying principle at significant maturity if backed by good quality contingent assets. Placing a cap on the level of risk that can be taken feels arbitrary and unnecessary.

There could be good reasons for trustees and employers to want to continue to take some level of investment risk at significant maturity – for some schemes reaching significant maturity will be a point along a journey to buyout rather than an end goal, and it may therefore be desirable (and in members' best interests) to permit some investment risk to seek to bridge the path to buyout. Once a scheme reaches full funding on a low dependency basis, it is still reliant on the employer covenant and may have to wind-up in the event of employer insolvency. It is therefore often in members' best interests to reach buyout as quickly as possible. In our view the Regulations need to permit schemes to bridge the gap between low dependency and buyout through potential investment returns rather than a pure reliance on employer cash. Preventing schemes from doing this could lead to fewer schemes reaching buyout (as the employer refuses to fund it purely with cash) and more instances of members' benefits not being paid in full.

In terms of safeguards, we consider that contingent assets at significant maturity would need to be high quality, e.g. cash in escrow, and include appropriate legally binding triggers requiring a flow of funds into the scheme, for example based on funding level.

It should be noted that some schemes are likely to have contractual, good quality Asset Backed Contribution arrangements which extend beyond significant maturity. Ignoring these is likely to result in some form of inefficient use of cash, either for the employer or for the ABC provider.

Question 10: Do you think that the provisions of paragraph 4 of Schedule 1 will allow appropriate open schemes to continue to invest in growth assets as long as that risk is appropriately supported?

No. The Consultation states that open schemes can avoid unnecessary de-risking of the investment strategy by reconsidering the position at each valuation - if a scheme has not matured, then the de-risking of the investment strategy can be deferred. However, simply assuming that the investment strategy will be de-risked in future – even if this ultimately does not happen in practice – has an immediate and very substantial impact on Technical Provisions. This is because the assumption that the investment strategy will be de-risked over time will need to be reflected in the discount rates used to calculate Technical Provisions. This will reduce discount rates for non-maturing schemes, increasing Technical Provisions. Such a significant step change in the contribution requirement risks making an open scheme unaffordable, demanding cash from sponsoring employers as they would then be required to de-risk the scheme's investment strategy as the now maturing scheme matures, whilst also making contributions to their employees' alternative pension offering. Such an otherwise inefficient use of cash could weaken the employer covenant of the DB scheme and puts the security of members' benefits at risk.

Risk in relation to calculation of liabilities on journey plan

Question 11: Do you think that the principles in paragraphs 4 and 5 of Schedule 1, requiring funding risks and investment risks to be linked primarily to the strength of the employer covenant, are sensible?

We agree that employer covenant strength should be a key driver for funding and investment strategy.

A key concern is the level of prescription that the Regulations and Code may place on schemes. In our view, the Consultation highlights a sound principle that risk should be identified and should be supportable by the employer covenant. We would be concerned if the Code introduced narrowly defined levels of permissible investment risk on the path to low dependency, as it is important to maintain the current scheme specific approach to investment and funding strategy. A collateral impact could be that the use of a more on-risk investment strategy to seek to achieve full funding (and pay members' benefits) will potentially be a breach of the law: trustees whose schemes benefit from weaker covenants may find it impossible to meet the expectation of full funding by low-dependency, because neither DRCs nor investment returns are available. This could put trustees / employers in the invidious position of breaching the Regulations or declaring that the scheme is insolvent. It is unclear what the consequences of a breach in these circumstances would be.

In our view there could be instances where the maturity of a scheme may not need to be directly linked to the investment strategy. For example, for very small DB schemes where the covenant strength is very strong (annual cash flow is many multiples of the s75 debt), a high % downside investment risk could remain supportable until significant maturity – and could be desirable for the trustees and the employer (and the members) as all parties seek to reach full funding on a solvency basis.
In our view maintaining flexibility and a true scheme specific approach is critical in ensuring good member outcomes.

Question 12: Do you think that the new liquidity principle set out in paragraph 6 of Schedule 1 is a sensible addition to the existing liquidity requirement of regulation 4(3) of the Occupational Pension Schemes (Investment) Regulations 2005?

Not Answered

Question 13: Will the matters and principles set out in Schedule 1 enable the scheme specific funding regime to continue to apply flexibly to the circumstances of different schemes and employers, including those schemes that remain open to new members?

Not answered

Question 14: Is the level of detail required for the funding and investment strategy by draft regulation 12 reasonable and proportionate?

Not Answered

Question 15: Do you think the requirement for high level information on expected categories of investments will impact trustees' independence in making investment decisions in the interests of scheme members?

Not Answered

Question 16: Are the requirements and timescales for determining, reviewing and revising the funding and investment strategy in draft regulation 13 realistic?

Not answered

Question 17: Are there any other assessments or explanations that trustees should evidence in Part 2 of the statement of strategy?

In relation to the employer covenant aspects of Schedule 2 (at nos. 14-16) we agree with the unrestrictive description of 'An assessment of the strength of the employer covenant'. This appears to allow the Trustee the scope to note all relevant matters that should be taken into account. At 15, the requirement to state 'How long it is reasonable to rely on this assessment' is vague. It would be worthwhile to require trustees to note specifically matters that are taken into account when assessing the longevity of covenant strength, and to opine on whether these give confidence in the employer's ongoing ability to support the scheme for the duration of the scheme, or to note how regularly such a longevity assessment is to be carried out or reviewed. However, given the complexity involved in considering covenant longevity concepts, it would be misguided to require trustee to define a timescale i.e. 3 years or 5 years, other than perhaps in the weakest covenant situations.

Finally, we question whether Trustees should state in their statement of strategy whether they have taken independent covenant advice or not.

Question 18: Do you agree that these are the appropriate requirements for the scheme trustee board when appointing a chair? Are there any other conditions that should be applied?

Not answered

Question 19: We would like to know if you think these requirements will work in practice?

Not answered

Recovery plan

Question 20: Do you consider that the matters prescribed by regulation 8(2) of the Occupational Pension Schemes (Scheme Funding) Regulations 2005 remain relevant for trustees or managers to take account of when determining or revising recovery plans? If so, why and how are they relevant to the setting of appropriate recovery plans?

To the extent that we believe that the proposed affordability principle in its current format is undesirable and would have unintended consequences (see answer to Q21 below), we believe that the additional scheme related matters such as those currently outlined in regulation 8(2) remain of relevance to trustees when determining an appropriate recovery plan.

Specifically, we note:

a) The asset and liability structure of the scheme is relevant to the extent that investment returns and outperformance can form part of a suitable recovery plan for some schemes.
b) The risk profile including Value at Risk is relevant as it helps trustees understand the likelihood of not reaching a targeted funding level over the proposed time period and the appropriate balance between investment risk and employer contributions.
c) The liquidity requirements of a scheme will also help determine the amount and timing of contributions, to the extent these are needed to ensure appropriate scheme liquidity rather than rely on investment returns which may be volatile.
d) The age profile of members helps trustees understand the point of significant maturity and thereby inform appropriate recovery plan length.
e) To the extent the recommendations of a person are required under a scheme's trust deed and rules, this requirement must remain relevant to determining an appropriate recovery plan.

We also believe that affordability is the key consideration when determining an appropriate recovery plan. However, we have some concerns over the proposed drafting of the new affordability principle (see Q21 below). We believe there are also other factors trustees may wish to take into account, such as a scheme's ongoing journey plan and the preferences/objectives of the employer.

Question 21: Do you consider that the new affordability principle at draft regulation 20(8) should have primacy over the existing matters, if they do remain relevant?

Whilst in general we are supportive of steps taken to improve the security of members' benefits, we do not believe that the Regulations should be restrictive and require a 'one-size fits all' approach. The principle of repaying a deficit as soon as an employer can 'reasonably afford' has been part of the Regulator's approach to covenant since its early inception. However, this was removed from TPR's Code of Practice on Funding in 2014 and TPR has been subject to an objective to 'minimising the impact on sustainable growth of an employer', and trustees and employers have been able to take advantage of flexibilities to fit a scheme's specific circumstances. We believe the inclusion of similar wording in the Regulations without the context of the wider guidance would restrict flexibility and limit the scheme specific nature of the funding regime.

For example, the new affordability principle states that trustees 'must follow the principle that funding deficits must be recovered as soon as the employer can reasonably afford'. Our interpretation of this statement is that for very strong covenants the Regulations would require any deficits to be recovered immediately (upon signing of the recovery plan), which is contrary to current practice where many strong employers would seek to spread contributions over a reasonably short period for which there remained a very high confidence of receipt. We believe that requiring immediacy of contributions in this scenario would result in a very significant short-term deviation of funds from capital investment programmes, thereby having a potentially material impact on the longer-term sustainability of the sponsor and more widely UK economic growth. Where the covenant can underwrite the risk of spreading these contributions it is not immediately clear that there is any significant value to a scheme of requiring this immediacy of repayment, whereas the broader economic consequences could be significant. Furthermore, the requirement could disincentivise employers from agreeing to a more prudent funding target if they were compelled to pay contributions over a short time period.

It is also worth noting that the Pensions Regulator's 2021 Annual Funding Statement states that the 'best support for a pension scheme is a strong employer' and we believe there is a risk that the proposed wording regarding affordability may undermine this principle.

More generally the Regulations do not, and should not in our view, include a view of how to determine affordability and what is reasonable. Whilst we expect the Regulator's forthcoming Code to outline their expectations in this regard, these do not override the Regulations and we have concerns that the interpretation of this wording could differ significantly between key stakeholders, and this would be especially problematic if affordability was given primacy over all other matters.

Finally, we note that for some schemes the primacy of affordability of contributions by 'the employer' does not fully take into account broader affordability considerations such as for:

- shared-cost schemes (i.e. where members also contribute in an agreed proportion); and
- Non-associated multi-employer (NAME) schemes where there are many employers with varying levels of affordability.

The ECPA's preferred approach would be for the Regulations to include affordability of contributions as one of a number of matters for consideration in setting the recovery plan, with recommendations for assessing reasonableness, affordability and the balance of each of the relevant factors to be set out in the Code and/or guidance to ensure appropriate flexibility for trustees and employers alike.

Question 22: Will the requirements in draft regulation 20(9) work in practice for all multi-employer pension schemes?

Where individual sections of a multi-employer scheme are in effect stand-alone schemes with individual employer covenant characteristics, we see no alternative to the extension of provisions to each individual section.

Question 23: Do you agree with the information presented in the impact assessment for the funding and investment strategy?

We believe that the costs of the funding changes are understated within the impact assessment and make the following comments:

- Whereas the impact assessment states that there will be no additional costs to members, this is not true for shared cost schemes, or for schemes open to accrual where a change in investment or funding strategy is brought about by these changes.
- Whilst the impact assessment notes that IAS19 deficits may not change, as the changes will increase short-to-medium term cash costs to some sponsors this could have adverse balance sheet and credit rating impacts for these companies – and impact the broader UK economy.
- As noted above, the draft Regulations do not mention any transitional arrangements for schemes that are already at, or near, a position of significant maturity. For some of these schemes, a sudden and sharp shift to a position of being required to be fully funded on a low dependency basis, could lead to a material increase in employer contributions and member

contributions, which could ultimately threaten the security of member benefits. The lack of flexibility in both timescales and investment strategy, means it is unclear how compliance is possible, if the employer cannot afford to resolve the deficit in very short order (or immediately if the scheme is already at significant maturity). At an extreme, an employer could be forced with a decision to either (a) break the law or (b) conclude that it is unable to pay its debts as they fall due, causing an otherwise unnecessary insolvency to the detriment of members, employers, employees (many of whom may not be scheme members), the Pension Protection Fund and the economy / society in general. Such an unnecessary and unwelcome 'breach of law' outcome may give rise to real difficulties for scheme auditors and trustees in finalising scheme accounts. At a minimum, this could lead to increased audit costs for schemes. At the more extreme end, this could lead to a failure to complete scheme accounts leading to other breaches of regulations, fines, and negative reputational consequences.

Question 24: Do you expect the level of detail required for the funding and investment strategy to increase administrative burdens significantly?

Not answered

Question 25: Do you agree with information presented in the impact assessment for the statement of strategy, referenced in paragraph 6.1?

Not Answered

About the Employer Covenant Practitioners Association (ECPA)

The ECPA's member firms can be found on the Association's website at https://ecpa.org.uk/members/ . Collectively the ECPA provides a forum where specialist employer covenant professionals:

- Discuss technical, legal and regulatory issues relevant to providing financial advice to clients – trustees or sponsoring employers – on matters connected with the employer covenant.
- Participate in discussion around relevant matters such as the Pensions Regulator and Pension Protection Fund and, where appropriate, to promote the views of the ECPA with those bodies.
- Act as a vehicle for raising the standards of, and promoting, the employer covenant financial advisory industry generally amongst the pensions community, including trade bodies, professional groups and potential clients - scheme Trustees or sponsoring employers.
- At the heart of our work is the preservation of value for scheme members, supporting the ongoing viability of sponsors and schemes, and ensuring their ability to deliver members benefits in full through appropriate funding arrangements and adherence to good quality, effective, coherent regulation.

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