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Practitioners Association
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Department of Work and Pensions
Caxton House
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Dear All

ECPA response to Public consultation on the draft Regulations regarding *"Surplus Flexibilities for Defined Benefit Pension Schemes"* ("the Consultation")

Comments from the Employer Covenant Practitioners Association ("the ECPA").

The ECPA welcomes the opportunity to respond to the Consultation. As an organisation representing the employer covenant industry, we have chosen not to respond to the individual Consultation questions but wish to draw attention to the importance of the role of employer covenant when trustees and sponsors make decisions on surplus release, and recommend it is explicitly reflected in the final Regulations.

Our key recommendation is that the final Regulations should expressly require trustees to consider the employer covenant before agreeing to any surplus release, with confirmation of that consideration reflected in the subsequent notification requirements to the relevant regulatory body / bodies.

Draft Regulations

The draft Regulations understandably include requirements on actuarial certifications and notifications. However, we are concerned that the draft Regulations do not explicitly reference employer covenant, given it is a key determinant of member security and a central component of the statutory scheme funding framework.

Whilst covenant is implicitly recognised in the Regulations through the use of a low dependency funding threshold, low dependency does not mean there is no dependency on the covenant and the use of this threshold should not be interpreted as removing the relevance of covenant from trustee decision-making. Even where a scheme is fully funded on a low dependency basis and is expected to remain so over the certification period, members still remain exposed to the risk that adverse experience cannot be supported if the employer covenant is already, or becomes, inadequate (e.g. weakens), or if it fails. Indeed, if the employer were to fail, a loss to members may be crystallised in a scenario where a scheme has insufficient assets to secure full benefits and no remaining employer support is available.

We note that the initial statement issued by The Pensions Regulator ("TPR") on the new surplus flexibilities placed significant emphasis on covenant considerations. In particular, TPR highlighted that trustees should consider the current strength of the sponsoring employer covenant, future covenant prospects, covenant longevity, the appropriateness of any contingent asset support and the balance between covenant support, funding margins and investment risk when determining whether surplus should be released. TPR also explicitly recognised that covenant strength may affect the amount of surplus that can prudently be distributed and whether additional protections should be negotiated.

The ECPA strongly supports this approach and, given its importance, recommends that considering the covenant aspects of a surplus payment is a requirement set out in legislation rather than being a matter which is only featured in regulatory guidance.

We therefore recommend that the final Regulations require trustees to consider employer covenant before agreeing to surplus release. This would make clear that the actuarial assessment is a minimum gateway, rather than a complete assessment of whether a release of surplus is appropriate in the circumstances of a particular scheme.

This would also address an apparent inconsistency in the proposed framework. Trustees are already required to consider covenant as part of integrated assessments on risk for the purpose of the statutory funding regime, irrespective of a scheme's funding position (albeit recognising that this should be "proportionate"). It would be anomalous and inconsistent if covenant were expressly relevant when setting the long-term funding approach, but not when deciding whether assets can safely be released from the scheme.

Suggested addition to the draft Regulations / Other recommendation

Taking account of comments above, the ECPA suggests the following wording to be added to Part 2 Section 9 of the draft Regulations:

- *A payment under section 37(1)(a) of the 1995 Act may not be made unless the trustees are reasonably certain that, following a proportionate assessment of the employer covenant including any contingent assets pledged in favour of the scheme, the payment will not put members at undue risk of suffering shortfalls to their full benefits.*

In addition, we recommend that the Department for Work & Pensions ("DWP") and TPR should be explicit in their communications that, under trustees' fiduciary duties, covenant should form a fundamental part of considering the question of member security when trustees are considering a release of surplus.

Notification requirements

We suggest that confirmation of trustees having considered the covenant should be reflected in the associated notification requirements. For example, trustees could be required to confirm that they have considered the employer covenant in relation to their proposed release of surplus, the potential impact on member security and whether any additional protections were deemed appropriate.

Concluding remarks

There is a risk that an overly mechanistic interpretation of funding thresholds could be taken to imply that covenant becomes materially less relevant in a surplus environment. In our view, the opposite is true. As schemes increasingly consider run-on, surplus generation and surplus distribution, the covenant remains an important source of support which trustees should assess regarding the sustainability and viability of those strategies, the resilience of member security and the fairness of any surplus sharing arrangements.

The ECPA therefore encourages DWP, in its final Regulations and associated materials, to recognise explicitly that employer covenant is a fundamental factor in determining whether surplus sharing is appropriate and how it should be implemented in practice.

The ECPA would be happy to discuss this response further with DWP, including alternative approaches to reflecting covenant in the Regulations, should DWP consider this beneficial. In that event please contact me at helena.mules@wtwco.com

Yours faithfully,

Helena Mules

On behalf of

Employer Covenant Practitioners Association