Appendix 1

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Which category best describes you or your organisation?	Professional Body
Please confirm whether you would like us to list your organisation on our list of respondents to this consultation:	Yes, I wish my organisation to be included on the list of respondents.
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Consultation questions and response form:

Chapter 3: Proposed regulatory approach

1. Twin-Track compliance

Do you think twin-Track compliance is a good way of introducing objectivity into a scheme-specific regime? What are your views on the proposals set out above? If you disagree, what do you propose instead?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

Context

The question suggests that the current funding regime is not objective. It is the view of the ECPA that there is very little wrong with the current regime, which is clearly understood having evolved over a period of 15 years through the co-operation and collaboration of advisers, trustees, employers and TPR.

There is an old adage 'if it isn't broken, don't try to fix it'. It is not obvious what particular problem TPR is trying to fix here and now certainly does not appear to be an ideal time to introduce wholesale changes to the funding regime.

The current impact of COVID-19, the recession that is to come and BREXIT to follow means that the UK is in very different place to when consultation was started. This has served both to underline the importance of scheme-specific funding, and suggests that now is not the best time for such a fundamental change in the DB funding regime.

The current circumstances underline that Employer Covenant is dynamic and must therefore be integral to trustees' practical journey to buy-out, because making broad assumptions about covenant and/or ignoring it is dangerous and possibly negligent, even if the assumptions are prudent.

Protecting members' benefits is not just about funding assumptions and investment strategy, it's also about management of a concentrated, dynamic credit risk – the ability of the sponsor to support the scheme now and in the future.

Regardless of the funding assumptions and investment risk, Fast Track or otherwise, and regardless of the current funding level, the fact is that members are dependent on the covenant to underwrite the risks in the scheme until it is bought out or enters into a commercial consolidator.

Merits of a twin-Track Approach

Taken in the abstract, the general concept of a twin-Track approach has merits, but care needs to be taken that in seeking to streamline the valuation process, risk management isn't sacrificed. There is therefore a balance to be drawn - higher prudence should be the 'price' for choosing Fast Track, and if that that price is not high enough, too many schemes with unsupportable risk will go unchallenged, endangering the system and the security of members' benefits.

On the other hand, if TPR is too prescriptive and restrictive within Bespoke, fewer schemes will choose Bespoke, or employers will face an unnecessary drain on cash. This would be a disincentive for future support and investment in DB sponsoring employers, reducing the security of members' benefits. This could also lead to the closure of well-run, efficient, and good quality open DB schemes and damage the outlook for members of all but the most mature schemes.

We set out below our observations on the most critical considerations for a twin-tracked approach.

1. Scheme specific funding regime

The DB funding regime is scheme-specific. Whilst a fast track element may be helpful to both TPR and certain schemes, its introduction should not influence the way the scheme-specific regime operates for schemes in general. There is a danger that Fast Track could become a tick-box exercise.

2. A Fast Track "short-cut" should incorporate more prudence

A Fast Track system may be attractive to schemes if it enables them to operate with lower advisor costs and less management time. It may also be attractive to TPR if it enables TPR to streamline its process and focus its resources on other schemes.

For this to work, however, there needs to be a higher level of prudence incorporated in the Fast Track regime to mitigate the lack of scheme-specific analysis undertaken. Trustees, employers, members and TPR must be comfortable that the scheme-specific covenant risks (which would be likely to be identified if analysed more thoroughly) will be properly managed.

If Fast Track is not sufficiently prudent, schemes may carry too much covenant risk, or funding or investment risk, and employers may not pay sufficient contributions early enough, resulting in a threat to members' benefits and reputational risk to the industry.

3. A Bespoke approach should retain the ability to be scheme specific

We believe the Bespoke regime should be fully independent of Fast Track, and compliance with the scheme specific funding requirements under the Bespoke route should not be measured relative to the Fast Track regime. Each case should be judged on its own merits and whether or not, given the resources available, the bespoke funding, investment and security package will lead to members' benefits being paid in full with an acceptable level of certainty.

The consultation suggests that bespoke investment and funding strategies should be mapped to the Fast Track "objective standard"; limits the allowable divergence from this "objective standard" within Bespoke; and demands additional mitigation or contingent support to bridge the areas of divergence within this allowable tolerance.

The proposal to treat Fast Track as an "objective" standard is flawed in two respects: first, many pension schemes are far more complex, with many interacting elements, and need a scheme-specific approach; and, secondly, the standard described is not objective, but rather TPR's subjective view, which will change over time. Indeed, the consultation implies that this "objective" standard will not be settled until later in the consultation process, when its potential impact can be assessed.

More recently, TPR has stated that it is likely to revisit the illustrative Objective Standard, taking account of the changed COVID environment. This cannot therefore be viewed as an "Objective Standard". The key test of whether a scheme complies with the scheme-specific funding regime ought to be how it meets its prescribed (by legislation) obligations and not by TPR's subjective interpretation of them. The proposed approach seeks to give TPR's view higher prominence than the regulations.

4. A Bespoke approach should not be too prescriptive

If prescriptive parameters within “Bespoke” are enforced by TPR (in comparison to well managed and thought through integrated funding solutions that are appropriate for a specific scheme and sponsor), the risks are clear – a weaker sponsor:

- Shorter recovery plans = increased cash from sponsor = weaker sponsor
- Reduction in income-generating assets of scheme = increased cash from sponsor = weaker sponsor.
- Reduction in income-generating assets = increased cost of future accrual - leads to scheme closure and reduced employer ability to attract and retain talent = weaker sponsor.
- Reduction in direct allowable covenant strength duration = reduction in income generating assets of scheme …. = weaker sponsor
- Reduction in the duration of the impact of parent company guarantees on covenant = disincentive for wider group contractual support for scheme = weaker sponsor
- Unnecessary prohibitions on distributions to stakeholders = disincentive to invest = weaker sponsor

5. Unintended Consequences – view from an Employer Covenant perspective

Scheme sponsors and the security of members’ benefits will have heightened risks if the employer covenant is summarised, downgraded or removed in either the TPR Code or subsequent regulation.

- Under the scheme specific funding regime, employer covenant needs to be measured in the context of the scheme it is supporting.
- The complexities of covenant strength, in the context of complex pension obligations, cannot be quantitatively modelled without losing the majority of the many characteristics that make up that covenant.
- Developing a journey plan requires assessment of covenant strength to determine appropriate levels of investment risk and affordability of DRCs.
- Covenant strength and affordability should be compared to risk metrics such as ‘Value at Risk’ and ‘Contributions at Risk’.
- Achieving journey plan requires ongoing assessment of covenant strength and the ability to respond to change / corporate events (e.g.COVID-19).
- Changing covenant strength could necessitate revisions to the journey plan, funding assumptions and investment strategy.

The downgrading or removal of the employer covenant from scheme funding and investment decision could result in inappropriate decisions for all but the most prudent strategies. Such prudent strategies would inherently be inappropriate as the “standard” against which proper scheme-specific strategies should be measured.

Chapter 4: Employer covenant

2. Insolvency risk and reliance on covenant

Do you think the risk of member benefit reductions on insolvency is an acceptable part of the existing regime and that trustees should be able to place some reliance (whether implicit or explicit) on the employer covenant? To what extent do you think this should be the case? Do you think this risk is well understood by scheme members?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

Context

Pensions, in both defined benefit and defined contribution schemes, cannot provide good member outcomes at an affordable cost without taking some risk:

- In the context of defined contribution schemes, it is well recognised that investment in growth assets during the accumulation phase plays a significant part in providing these good member outcomes.
- In the context of defined benefit schemes, the employer covenant protects members from some of the risks associated with investing in growth assets.

A strong employer covenant provides better security than setting a high level of Technical Provisions. If no benefit (in terms of lower employer contributions) is derived from enhancing covenant (for example through group support) then sponsors have no incentive to find ways of doing so.

Regrettably, reduced benefits on employer insolvency will remain unless there is a change to the levels of PPF compensation. However, on balance, the failure of the employer covenant (i.e. employer insolvency) can be an acceptable risk in the context of improving expected member outcomes, providing this risk is properly monitored and managed

It therefore follows that trustees should be able to place reliance on the employer covenant. The extent to which this should be the case will be scheme-specific and depend very much on the nature of the employer covenant, and its relationship to the scheme (and other schemes supported by the employer).

Role of covenant Assessment in lowering insolvency risk

Since the introduction of Pensions Act 2004, the introduction of its scheme-specific funding regime, and the establishment of TPR, employer covenant has been a central element of developing an appropriate funding approach.

It is essential that investment decisions and funding assumptions reflect the ability of sponsors to support downside experience over the long term. This can only be achieved by having a detailed understanding of covenant strength, including insolvency risk and how this may change over time.

Whilst the strength of employer covenant can change over time, this does not mean that it should necessarily be assumed to do so. Although covenant ‘visibility’ by way of forecasts and business plans rarely extends beyond 3-5 years, some covenants are obviously stronger than others over the longer term. They have a greater “durability”. For example, utility companies and entities involved in long term transport, infrastructure and education sectors are more likely to be durable than a company that makes printing presses, regardless of the horizon on forecasts.

Member understanding

More could be done to educate members about the risks associated with DB schemes as they are often seen as ”bullet-proof” until an insolvency event has happened. Particularly given pensions freedoms, it would be sensible for trustees to provide members with a balanced understanding of the strengths and risks associated with their DB benefits, perhaps in the annual statement.

Neither the risk of a failure of an employer nor the benefits that employer covenant provides are well understood by members. It is not surprising that these elements are not well understood, as members have a poor understanding of pensions in general, and pension risk, in particular.

Fortunately, defined benefit schemes have trustees who do understand these matters and can be professionally advised to bolster their understanding and take appropriate decisions in the best interests of members.

Although it is beyond the scope of this consultation exercise, it would be appropriate for TPR to work with other bodies (such as the Money and Pensions Service) and the pensions industry to support improved member understanding of pensions, including these covenant risk points.

3. Integrating covenant into funding

a. Do you think it is better to keep the Fast Track route simpler by only factoring covenant into Bespoke (TPs and/or RP)?

<u>The response to this question reflects the expert views of employer covenant professionals of the ECPA</u>

We absolutely disagree with this. Employer covenant should and must be factored into both Fast Track and Bespoke. Failure to understand covenant will lead to Fast Track schemes being exposed to unnecessary risks:

- Even within Fast Track, schemes rely on the employer until the scheme is fully funded on a high resilience basis, or has been bought out or transferred to a commercial consolidator.
- Developing a journey plan requires assessment of covenant strength to determine appropriate levels of investment risk and affordability of DRCs. Covenant strength and affordability should be compared to risk measures such as ‘Value at Risk’ and ‘Contributions at Risk’.
- Achieving journey plan requires ongoing assessment of covenant strength and ability to respond to change / corporate events (e.g. COVID-19, BREXIT).

If Fast Track is to be used as a short-cut, there needs to be a higher level of prudence incorporated in the Fast Track regime to mitigate the lack of scheme-specific analysis undertaken. Trustees, employers, members and TPR must, therefore, be comfortable that the scheme-specific covenant risks (which would be likely to be identified if analysed more thoroughly) will be properly managed. It is also important to ensure there remains tangible benefits for sponsors who wish to take actions to strengthen the covenant.

The notional examples of the multi-dimensional nature of employer covenant noted within our response to Q3b serve to illustrate that the approach to covenant should not be either ignored or short-circuited, even within Fast Track.

As long as trustees can demonstrate the strength of employer covenant, it is reasonable for this to be reflected in the Fast Track Technical Provisions.

b. If you think covenant should only feature in Bespoke, how do you think it should be done?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

Allowance for covenant should be scheme-specific and applied to both Fast Track and Bespoke.

The fundamental point is that funding should be scheme-specific and must take into account the strength of the employer covenant. Under the scheme specific funding regime, employer covenant needs to be measured in the context of the scheme it is supporting.

The complexities of covenant strength, in the context of complex pension obligations, cannot simply be quantitatively modelled without sacrificing a thorough assessment of the majority of the many characteristics that make up that covenant. Such assessments should focus on:

- the current and future affordability of contributions (taking into account competing demands for cash)
- long term viability of the employer (given market position and sector outlook)
- insolvency risk (and mitigation options); and
- asset cover for the scheme (taking into account creditor priorities)

Scheme sponsors and the security of members' benefits will have heightened risks if the employer covenant is summarised, downgraded or removed in either the TPR Code or subsequent regulation.

We think that it would be helpful to articulate the dimensions of employer covenant with some illustrative, notional scenarios – demonstrating how non-formulaic and multi-dimensional evaluating covenant (and as a consequence, funding schemes) be. Whilst these examples are fictional, they seek to bring out examples of the types of situation that Trustees and employer covenant professionals may encounter.

Scenario	***Comment***	***Covenant approach***
Employer is a substantial participant in a market heavily impacted by Covid-19. The market is expected to remain sound in the medium / long term – but there has been a substantial short term disruption and financial impact; and significant measures have needed to be taken by management to respond to market conditions.	*An assessment based on historic financial information could be grossly misleading. What matters in covenant terms is the future – and how the employer can best manage through current market difficulties to "come out the other side" in a good position to support its scheme.*	*Highly customised and focused on (i) understanding the realistic spectrum of outcomes and their timing; (ii) the steps needed to manage through current difficulties – including any accommodations needed; and (iii) how best to fund the scheme in a current environment of deep uncertainty; whilst (iv) ensuring that the scheme is treated equitably with other stakeholders in line with TPR guidance.*

Employer is a very recent acquisition by a leveraged group. The group has breached lending covenants and this has been well-publicised. The lenders have a share pledge over the employer. The employer continues to trade well and itself has no external debt – but does rely on Group Treasury for investment cash. Group cash is constrained.	*It might seem from historic information that this employer could – depending on the scale of its scheme – have been in some variant of the "strong" covenant category. However, subject to investigation, there is a risk that its access to growth capital may now be constrained; and its ownership future may be uncertain. Further, the well-publicised wider Group problems might be causing associative damage to the employer in the market.*	*A real focus is needed on the employer's prospects in its current environment; the associated risk factors; and its alternative strategic options. The position may actually lead to "no change" in covenant strength and scheme affordability if it continues to thrive independently and can finance its growth organically. However, the position will need a careful analysis – including of the impact of group difficulties – and close monitoring pending some form of longer term resolution.*
Employer is a "cash flow" business; owning a number of subsidiaries; and with a strong published consolidated net asset position relative to the scheme's size. However, the net assets substantially comprise goodwill on the acquisition of other "cash flow" businesses. The markets for certain of its subsidiaries have been recently impacted by technological change.	*This fact pattern may be the precursor to many outcomes. On the one hand, the affected subsidiaries could struggle against emerging technological obsolescence – leading to substantial goodwill impairments and a reduction in the employer's consolidated net assets and free cash flow. On the other, the subsidiaries could be well-placed to take advantage of the technological changes in the market.*	*A focus of the covenant review would be on the impact of technological change in the subsidiaries' markets – and how these changes might affect those companies' prospects in the short, medium and long term. This would then feed into understanding the impact at the employer (consolidated) level: if the impact is negative, it could affect access to capital, lending covenants etc and require intensive monitoring and review by the Trustees – in addition to diminished affordability. If positive, it could be the precursor to a disposal or listing at a stellar price – or even a buyout of the scheme.*
Employer is a substantial market participant - but has customer concentration around a small number of key contracts. Whilst it has generated substantial historic cash flow and has no external debt, it now needs to invest heavily in new technology to maintain its market position. If it succeeds, it could thrive and grow. Failure in the technological implementation could lead to a rapid atrophying of its customer base. The CEO has just resigned to take a job at a key competitor.	*A simple market "league table" analysis, coupled with a review of historic financial metrics, might suggest that the employer is in a strong position. However, the fact pattern brings out how fragile – or positive - the employer's prospects might in fact be.*	*The covenant review would be multi-dimensional – considering not only the financial and market impact of losing one or more contracts; but also understanding the impact of the CEO's departure and the company's skills and ability in the implementation of new technologies. Once again, a "point in time" evaluation is likely to require careful ongoing monitoring. Again, a negative outcome could be catastrophic – but achieving the technological transformation could be very positive for the company's market position, and covenant, going forward.*

c. If we were to integrate covenant into Fast Track guidelines, do you prefer option 1, 2 or 3 or some other approach for reflecting the employer in scheme valuations, and why? If another approach is appropriate, what do you think this should be?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

We prefer Option 1 (Technical Provisions via discount rate). This recognises that member security is provided by a combination of assets and covenant support.

This option maintains the current integrated approach to scheme funding and clearly links funding and investment to covenant strength. It also requires a proper assessment of the key components of covenant and drives a scheme specific approach.

This option should apply to both Fast Track and Bespoke. Making this clearer for Fast Track may have the added benefit of making this point more clearly to those schemes that do not currently make this link. The Purple Book, for example, indicates low correlation between covenant strength (as assessed by TPR) and discount rate.

We would oppose the introduction of Options 2 as this effectively starts from a premise that schemes must be funded to a level that assumes no sponsor support. We do not believe that this is commercially acceptable, particularly for schemes that are open to new members and/or future accrual. It then incorporates covenant strength in the recovery plan, despite this option seeking to address concerns on the visibility of covenant over time. Option 2 does not appear to properly allow credit for covenant strength / weakness or take into account affordability for individual employers. Whilst we appreciate the perception of additional transparency of option 2, we think it unlikely that few parties would benefit from such transparency i.e. if they don't get how covenant interacts with TPs in option 1, they are unlikely to get it under option 2 either.

We strongly oppose Option 3 which relegates covenant assessment to a modelled metric with no assessment of the key drivers of covenant strength and will lead to trustees being far less informed and will, undoubtedly, increase risks for many schemes and members. This appears similar to the EIOPA approach a few years ago – which was unanimously rejected by the whole industry, including by the Her Majesty's Government.

4. Covenant assessment

a. Should a holistic approach to assessing employer covenant be retained (but with further guidance to assist trustees), or should we seek to define a more prescribed, formulaic approach?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

As illustrated within our response to Q3b, covenant is non-formulaic and multi-dimensional.

Employer covenant is measured relative to the scheme it supports and is simply too important to distil into a formula. It is therefore essential that a holistic approach is retained. This will enable scheme-specific funding approaches to be followed which properly reflect the nature of employer covenant.

- Corporate strength (which is based on a wide range of dynamic factors) in the context of substantial funding obligations, cannot be quantitatively modelled without losing sight of the many characteristics that make up the covenant.
- A formulaic approach was suggested by EIOPA, as part of a "Holistic Balance Sheet" scheme funding approach, when the latest IORP Directive was developing, and the approach was unanimously rejected by interested parties, including the UK Government.
- A formula may be appropriate for creditors operating a large portfolio of small exposures (such as banks, trade credit insurers and the PPF), however this is not the case for pension schemes with one very large exposure to a single sponsor. This necessitates a holistic approach.
- Although formulaic techniques may have a place in portfolio management and control, and may give high-level indications of strengthening or weakening across a large population (e.g. from a regulatory perspective for QIS studies etc.), they are not appropriate for individual scheme decision-making purposes, where members' pensions are at stake.

Given the complexities of employers and within schemes, current covenant assessment techniques should prevail. These have proven successful in ensuring risks (and strengths) are identified, measured, and explicitly taken account of in decision-making processes.

Prescriptions are likely to detract from those best-practice processes, not add to them. This seems to run contrary to the overall message from TPR that risks within DB schemes should be better identified, better measured and explicit appropriate risk mitigation put in place.

b. If the former (holistic approach), what amendments/clarifications to our existing guidance on covenant do you consider may be necessary? Do you agree with the ones suggested above? Is the structure and content of our existing employer covenant guidance helpful and accessible to trustees? If not, what would make it better?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

As noted in our response to part a, it is essential that a holistic approach is retained.

ECPA Guidance

The consultation notes that TPR's guidance is mainly qualitative, and we consider that this will need to be maintained, given the complexities of employers and the scheme-specific nature of the analysis required. Indeed, the Employer Covenant profession, through the ECPA, have produced a number of guides including "***Principles of covenant assessment for scheme valuations: A practical guide for advisors, trustees and sponsors***" which through necessity runs to over 30 pages. A link to that document is here:

https://ecpa.org.uk/principles-of-covenant-assessment-for-scheme-valuations-a-practical-guide-for-advisors-trustees-and-sponsors/ .

This document is part of our consultation response. We recommend that TPR should promote, or at least mention, this document within its guidance.

Use of Ratios

The consultation notes that any ratios provided would be for guidance only and would not become a specific hurdle rate. It is essential that this is “for guidance only” given that covenant is not simply a measure of “cash flow to low dependency deficit”, but an integrated, dynamic analysis of the employer(s) profit, cash flow, balance sheet, market position, future outlook etc. Any ratios could also be volatile over a short period even in normal trading conditions and therefore would not provide a stable, maintainable view of covenant.

Indirect Covenant

Within the consultation it states that indirect covenant support from an employer’s wider group can be relied upon for up to 3 years (“the period to the next valuation”). However, it goes on to say that direct covenant support can only be relied upon for 3-5 years, unless the employer has, for example, “legally underpinned cash flows” from e.g. government (i.e. negligible counterparty risk).

We do not support the notion that covenant visibility be restricted to 3-5 years (refer to our response to Q15a), and also question the surprising implication from these statements that TPR believes that indirect covenant support can be factored into Trustee analysis for almost the same period as direct covenant support.

As outlined in our response to Q5, we believe that indirect covenant support can, and should, be reflected in the covenant assessment only if it is relevant to do so, taking account of the “legal obligation to support the scheme”. This is another example of why the approach should be both holistic and scheme-specific.

Covenant Durability

We would like to see a greater focus on ‘covenant durability’ rather than a general assumption that covenants will automatically weaken over time. In many cases, as scheme funding improves, relative covenant strength will improve.

Whilst the strength of employer covenant can change over time, this does not mean that it should necessarily be assumed to do so. Although covenant ‘visibility’ by way of forecasts and business plans rarely extends beyond 3-5 years, some covenants are obviously stronger than others over the longer term. They have a greater “durability”.

For example, utility companies and entities involved in long term transport, infrastructure and education sectors are more likely to be durable than a company that makes printing presses, regardless of the horizon on forecasts.

Our answer to Q15 provides greater analysis of this area.

Other

We support the other suggested areas of focus in any future guidance, of undertaking stress testing, using worked examples and expanding the focus to cover unusual employers (e.g. NAME schemes).

c. If the latter (formulaic approach), what do you think of the proposed RACF approach? How would you propose that covenant could be explicitly defined in a clear, consistent and measurable manner? What other metric(s) may be appropriate?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

As illustrated within our response to Q3b, covenant is non-formulaic and multi-dimensional.

We do not support the proposed RACF approach, or any other formulaic approach, as our response to Q4a above explains.

d. Alternatively, would it be appropriate to require employer covenant to be assessed in a prescribed (formulaic) way for Fast Track purposes, and only allow for a more holistic approach under the Bespoke framework?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

It is essential that a holistic approach be retained, whether under a Bespoke or Fast Track framework. This will enable scheme-specific funding approaches to be followed, which properly reflect the nature of employer covenant. As stated previously, employer covenant is too complex and important to be distilled into a formula.

5. Reliance on indirect covenant

Do you think that the strength of the wider commercial group should be factored into the sponsoring employer's assessment? If so, how, and to what degree?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

As illustrated within our response to Q3b, covenant is non-formulaic and multi-dimensional.

Under the holistic approach, all relevant factors can be incorporated in the overall assessment of covenant.

Covenant analysis should clearly define the legal obligation and financial ability to support the scheme. In some cases the strength of the wider group may provide additional support to the sponsoring employer, and hence to the scheme, even if not directly to the scheme itself. Alternatively, a weak group may weaken the covenant of the sponsoring employer.

It should be the role of the Trustee to explain the strength of the reliance on such external factors. Whilst such external factors may not fit within a "legal certainty" framework, they can have a significant impact on the ongoing financial ability of the employer to meet its obligations to support the scheme now and in the future.

It is essential that this kind of indirect covenant support be reflected and is another example of why the approach should be both holistic and scheme-specific.

6. Covenant grades

a. Should we use a greater range of covenant grades to set guidelines in the code and assess schemes and, if so, what would be an appropriate number of grades?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

As illustrated within our response to Q3b, covenant is non-formulaic and multi-dimensional.

Grading is not an end in itself. Whilst it may be useful within a framework, the key element of covenant strength is the employer's ability to put sufficient cash, or assets than can be converted into cash, into the scheme as and when required. Its ability to do this will vary dependent upon the funding and investment risk of the scheme i.e. it is scheme specific. This can only be achieved via integrated funding.

Having four covenant grades for TPR's own internal purposes appears fit for purpose and the current regime is clearly understood. Unless there is a clear rationale for increasing the number of grades, such a step may lead to time and energy being wasted on deciding between whether a marginally different grading is appropriate, rather than focussing on fundamental issues of affordability etc.

Different advisory firms have different definitions and a varying number of ratings. We do not see this as being inconsistent with TPR maintaining a four grade system, as firms can map these easily to TPR’s in the vast majority of cases.

b. Would there be sufficiently different characteristics between a greater number of grades, such that a set of trustees could reasonably and reliably assess covenant strength without requiring professional advice?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

As illustrated within our response to Q3b, covenant is non-formulaic and multi-dimensional.

Since the introduction of Pensions Act 2004, the introduction of its scheme-specific funding regime, and the establishment of TPR, employer covenant has been a central element of developing an appropriate funding approach.

It would be reckless to promote the exclusion of professional advice in relation to funding (actuarial) or investment advice. It is similarly reckless to promote the removal or exclusion of professional covenant advice, since the ongoing strength and viability of the employer is fundamental to the continuance of every scheme and risk underwriting until full buy-out or transfer to a commercial consolidation is achieved. Any attempt to promote a DIY approach is certain to lead to schemes facing greater risk.

Trustees are not typically in a position to judge the appropriate number of grades, and nor do they have perfect knowledge of how to apply these grades to their own scheme. In reality, there is a spectrum of possible employer covenant strengths.

Moreover, the assessment of covenant strength is not simply about deriving a covenant rating, it is about managing a concentrated credit risk. This requires establishing and maintaining an appropriate understanding of a sponsor’s viability (i.e. profitability and cash flows), its operational and financial structure, insolvency risk and asset cover in the event of default. Effective assessment can only be undertaken by experienced, independent professionals.

Chapter 5: General principles

7. Low dependency LTO

Should all DB schemes have a low level of dependency on the employer by the time they are significantly mature? If not, what do you think would be an appropriate expectation to ensure trustees manage the run-off phase for their scheme effectively and efficiently?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

Although it is reasonable to say that many DB schemes should have a low level of dependency on the employer by the time they are significantly mature, it is a step too far to say that this should apply to *all* schemes.

Each scheme is different, and should be funded using a scheme-specific approach (e.g. a small mature scheme may not be any strain on a large strong employer). We believe that a more generic reference to a “low probability of funding default or loss to members’ benefits” is more consistent with a scheme-specific funding regime.

With regard to the LTO itself, schemes that are open to accrual will be different, due to their longer expected period until they are significantly mature. Schemes that are open to new entrants are completely different again, as they may never become significantly mature. Not only do both these types of open scheme have different funding considerations to schemes that are closed to future accrual, they have different funding considerations to each other.

Your consultation acknowledges the existence of schemes that are open to new entrants and accrual, stating: “as long as they remain immature, they will continue to run on with employer support and will be able to assume and take more investment risk like all immature schemes.” (paragraph 164); and: “if such schemes do continue to admit new entrants and do not mature then the scheme will not actually reach significant maturity”. (paragraph 475). However, your proposals then go on to treat them in exactly the same as closed schemes. We cover this issue further in our responses to Q47.

8. Timing of the LTO

What factors should influence the timing of reaching the LTO? Do you think that the timing should be linked to maturity?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

As with many aspects of the funding regime, the factors that influence when a scheme reaches its LTO should be scheme-specific. In many cases, linking this to maturity would be reasonable although, as you suggest within the consultation document, there are other possible timescales for reaching the LTO.

You refer in the consultation document to the possibility of using a covenant-based timeframe and consider this to be short-term, because of the limited period of covenant visibility for most sponsoring employers. However, as you imply, this will not always be the case. For example, a covenant-based timeframe may be a reasonable and robust approach for a scheme that is already close to significant maturity and there is an employer with good covenant strength. We would like to see a greater focus on ‘covenant durability’ rather than a general assumption that covenants will automatically weaken over time.

Consequently, we believe it would be appropriate for factors other than maturity to be taken into account when assessing when a scheme can be considered to reach its LTO. We agree that it is not appropriate to use an arbitrary, fixed timeframe as part of this. However, there would be merit in making allowance for both covenant horizon and scheme maturity. This could be achieved through making an additional reference to covenant horizon within your objective.

Therefore, taking account of our suggestion in Q7 that reference is made to a “low probability of funding default or loss to members’ benefits” rather than “a low level of dependency on the employer”, the overall revised code principle may become:

“By the time they are significantly mature and beyond an appropriate covenant horizon, we expect schemes to have low probability of funding default or loss to members’ benefits.”

9. High resilience to risk at the LTO

Do you think that the investment portfolio should be highly resilient to risk when schemes reach their LTO? If not, what do you suggest?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

As noted in our responses to Q7 and Q8, we consider it more appropriate to require schemes to have a “low probability of funding default or loss to members’ benefits” rather than “a low level of dependency on the employer” by the time they are significantly mature. A consequence of this is that a scheme’s investment portfolio may not need to be “highly resilient to risk” if there are adequate mitigating factors, such as the support of a strong enduring covenant or contingent assets.

Therefore, given that there may be factors that enable schemes to maintain some investment risk, we consider a better statement would be that to say “the investment portfolio should be consistent with low probability of funding default or loss to members’ benefits when schemes reach their LTO”.

10. Risk-taking for immature schemes

Is it reasonable for less mature schemes, which would have more time to reach low dependency funding, to assume and take relatively more investment risk than a mature scheme?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

Yes, and this is particularly the case for schemes that have the benefit of a strong employer covenant and positive cash flow expectations which means they are less impacted by volatility in investments. This applies all the more for schemes that admit new entrants, and is a reason why proper, and separate, consideration needs to be given to such schemes.

Pensions in both defined benefit and defined contribution schemes cannot provide good member outcomes at an affordable cost without taking some risk. In the context of defined contribution schemes, it is well recognised that investment in growth assets during the accumulation phase plays a part in providing good member outcomes.

Of course, there may be other exceptions to this. For example, it may be appropriate or reasonable for a mature scheme with a strong employer covenant to take more investment risk than a less mature scheme that has a weaker employer covenant.

11. Journey planning

What are your views of the rationale above for the journey plan? Do you think there is a better way for trustees to evidence that their TPs have been set consistently with the LTO?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

There are many possible routes for the journey to the LTO, and trustees should have the flexibility to follow the one most appropriate for their scheme.

Turning to the LTO itself, as noted in our responses to Q7 to Q9, we do not consider it necessary to require both low dependency funding and an investment strategy with a high resilience to risk when a scheme is significantly mature. Rather, we consider it appropriate that the aggregate level of risk is low at this point. How a journey plan is structured needs to be linked to this concept.

Whatever the journey plan may become, we agree that it is appropriate for trustees to document how a scheme is aiming to achieve its LTO, together with the risks associated with this journey plan and how these risks will be managed. We also agree with the expectation that a recovery plan should be put in place to return the scheme to the journey plan path if deficit emerges during the journey to the LTO. However, we also have the scenario that surplus emerges against TPs during the journey to the LTO. This would seem a very likely scenario if restrictions are placed on covenant visibility, and an existing covenant conclusion stays in place at subsequent valuations. Whilst paragraphs 224 to 226 address dealing with surplus, the reality is that employers that maintain their covenant strength may provide deficit contribution funding that, with hindsight, may become unnecessary.

It is worth noting at this point that the White Paper (“Protecting Defined Benefit Pension Schemes”), from which the Pension Schemes Bill took originated, noted that a suitable LTO could be for a scheme to run-on with employer support (for open schemes). For these types of schemes, the journey plan to the LTO will – and should – be very different to those schemes that are approaching maturity. Consequently, this needs to be reflected in the journey plan elements of the final code.

12. Relevance of investments for funding

Do you agree that the actual investments and investment strategy are a relevant factor for scheme funding?

Not Answered.

13. Broad consistency between investment and funding strategy

a. Should the investment strategy be broadly consistent with the level of current and future investment risk assumed in the funding strategy? If not, why not?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

In many cases we would expect a scheme’s current investment strategy to be broadly consistent with the level of current investment risk within the funding strategy, with adaptations made to investment strategy to reflect any assumed changes in future investment risk. However, what is most important is that trustees set investment strategy in an appropriate way for their scheme, on an integrated funding basis, taking account of employer covenant and the employer's ability to make good any funding strain.

b. If it is not broadly consistent, for instance where trustees want to take additional investment risk (than that assumed in the TPs), should trustees have to demonstrate that the investment risk taken can be managed appropriately? If not, why not and what would you suggest?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

The discount rates underlying the TPs can be chosen prudently with regard to the expected return on assets. This means that the same discount rate can be chosen in different ways: a lower expected return with a lower margin for prudence, or a higher expected return with a greater margin for prudence.

It should not be assumed that investment risk is purely a bad thing. With increased investment risk comes an increased level of long-term expected returns, and it is through delivery of long-term returns that we get good member outcomes, whether in defined benefit or defined contribution schemes. It is not unreasonable for a scheme that invests for the long-term, benefitting from strong enduring employer covenant strength, that around 75% of benefits paid out are met by investment returns rather than directly by contributions.

To the extent that future pension benefits are not going to be met by existing assets and future investment returns, they will need to be met by future contributions. Consequently, there is a danger that a focus on reducing investment risk will lead to increases in contribution levels and this would be contrary to TPR's objective of making sure employers balance the needs of their defined benefit pension scheme with their sustainable growth objectives. Alternatively, the benefits offered would have to be reduced to reflect the contributions affordable and risk that could be tolerated, which may lead to insufficient retirement incomes, and increased dependence on the State.

14. Liquidity and quality at maturity

Do you think that security, quality, and liquidity become more important as a scheme becomes significantly mature? In particular, do you think that the scheme's asset allocation at significant maturity should have a high level of liquidity and a high average credit quality?

Not answered

15. Covenant visibility

a. Do you think it is prudent for reliance on employer covenant to be reduced beyond the period over which there is reasonable visibility? If not, why not?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

Although this may be prudent for mature schemes, we are not of the view that this should be a requirement for all schemes.

As illustrated within our response to Q3b, covenant is non-formulaic and multi-dimensional.

We include as Appendix B (to follow), as part of our response to the consultation, a contemporaneous ECPA paper *"Time horizons and the employer covenant: the importance of a dynamic analysis of sponsor longevity*". The content of that paper is such that we believe it adds significantly to current thinking around the concept of corporate longevity and covenant endurance.

Whilst the future of any employer is not guaranteed, some employers are inherently more robust than others. Even without explicit visibility beyond the near future, there can be very good grounds for rationalising that the covenant support will continue to be available beyond that point – 'covenant durability'.

Just because an employer could weaken, that does not make it appropriate to assume it will. Scheme funding is always a balance, which requires judgement. The extent to which trustees should rely on the employer is one element of that judgement and should be considered in the scheme-specific context of all the judgements being exercised. A covenant assessment involves not only an initial assessment, but regular review points, including formal assessments at future triennial valuations and monitoring of the employer covenant over the inter-valuation period.

The consultation includes evidence and analysis at section 16. With reference to covenant visibility, it states that TPR's analysis shows that "covenant grade rating has (in recent years) typically changed for approximately one in four schemes between triennial valuations. Considered over two valuation cycles, this ratio increases to approximately one in three" (paragraph 660). Whilst this may reflect your analysis of the universe of schemes you regulate, reflecting your approach to assessing covenant for a large population of schemes, we do not feel such analysis should be used to drive policy. The limitations of a high-level desktop analysis will be well understood and must be noted if being used as evidence to set out the high level of volatility of covenant ratings.

Our experience leads us to believe that covenant ratings are significantly less volatile than this. Furthermore, whilst the emphasis is on "changes" to covenant rating, it seems odd to include in these statistics those which have improved, and then use that as evidence to justify why covenant should be assumed to worsen and therefore removed from TPs beyond 3-5 years.

Covenant is a fundamental pillar of integrated funding, and there are significant concerns that the impact of the consultation proposals, if implemented, would be to reduce the general market view of the importance of covenant – despite the fact that trustees will remain reliant on covenant until a scheme is bought-out, wound up or entered into a consolidation vehicle.

This is at a time when TPR is advising trustees of the importance of actively engaging with sponsors, so that they can better understand the impact of COVID-19 on the sponsor's business, and increasing their level of covenant monitoring activity. It has taken a long time for DB schemes and sponsor covenant to be given due consideration in corporate transactions – and even allowing them to take centre stage where appropriate. The rights of pension schemes (and the PPF) could be weakened by reducing the prominence of covenant. Covenant is different to normal credit risk, due to the Type A events framework which allows trustees to act to protect the covenant.

As valuations follow a 3-year cycle, reflecting any changes to covenant strength – weakening or strengthening – is already embedded within the existing process.

It is also worth noting that, for closed schemes on a journey plan to an LTO, the improvement in the LTO funding level should naturally reduce the scheme's reliance on the covenant. As the relativity of the scheme to the sponsor becomes less significant over time, this will, all things being equal, improve the covenant and security of members' benefits. Assuming a weakening of the covenant over time in all cases runs contrary to this fact.

b. How much visibility do you think most trustees can have over the employer covenant? In the absence of evidence to the contrary, do you think it is reasonable for most schemes to assume there is reduced visibility beyond 3-5 years?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

See our response to Q15a.

Trustees and their advisers can, for the most part, take a reasoned view of the longer-term covenant, noting that this will be based on judgement rather than legal certainty. Covenant assessment is not immune from risk, in the same way that investment decisions taken by trustees also carry default risk and other funding assumptions are rarely borne out in practice.

We note that banks/bond markets are happy to lend for up to 30 years when they are comfortable with a "covenant" based, in part, on a long-term sector outlook. Market capitalisation of publicly quoted companies are not restricted to 3-5 times profit multiples – indeed where a company is measured in this way, it would typically become an acquisition target.

An assessment of covenant risk would include consideration of factors such as the sponsor's market position, market dynamics, diversification, competitive advantage, barriers to entry, financial scale and capacity, and trend analysis. These factors are not suited to any formulaic approach.

Companies often have to make similar analysis when deciding whether to embark on a significant capital investment project or infrastructure investments (something the government is trying to encourage pension schemes and insurers to allocate funds to which will provide long term returns). It seems absurd that one set of trustees are being encouraged to invest in companies – to take a long-term view - but the trustees of schemes within such investee companies are not.

Although a full and formal assessment of covenant risk should coincide with each triennial valuation, it is also crucial for trustees to monitor potential changes to covenant risk as part of overall scheme risk management. This is relevant as this approach provides an opportunity to create an action plan to help mitigate against covenant deterioration between valuation dates.

16. Use of additional support

Should additional support, such as contingent assets and guarantees, be allowed in scheme's funding arrangements provided they are sufficient for the risk being supported, appropriately valued, legally enforceable and realisable at their necessary valued when required?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

Additional support should be allowed, and indeed encouraged.

Whilst the conditions described are laudable aims, it is important not to make the hurdle so high as to dissuade potential providers of such support from doing so. It is better to have this additional support, even if it does not provide the cast-iron protection suggested. It is important that there is sufficient incentive for the employer (in terms of this being reflected appropriately in funding/contributions) to provide additional support.

Parental company guarantees, for example, can result in a legal commitment to support an employer now and in the future, making it much more likely that a parent will step in and provide investment cash / improvement support or cure a default, so as to prevent a call being made under the guarantee. The importance of this, especially for overseas parents, should be recognised.

17. Appropriateness of RPs and affordability as key factor

a. Should employer affordability be the key factor to determine the appropriateness of a RP? If not, what should it be?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

Affordability is certainly a key factor – but the crucial importance of sponsor longevity in scheme funding means that the sustainability of the employer is also crucial. For example, maintaining a cash buffer for M&A opportunities; or investing in R&D (or even to protect against a "rainy day") may all be legitimate reasons for spreading scheme contributions in such a way which helps the covenant flourish and grow; rather than unduly "choking it" or limiting room for manoeuvre in response to commercial opportunities or negative "events" such as Covid-19.

Whilst uncommon, a number of open schemes operate in a shared cost environment where member contributions are variable too. In such cases, member affordability is also important, and hence the requirement to consult under the Consultation Regulations.

There are also scheme-specific considerations which may impact the RP. Pensions are long term, and valuations are a budgetary check along the way. Smoothing contributions may be preferable in that context, even where an employer could afford more. There is also the need to ensure that employers are able to balance any contribution demands placed on them with sustainable growth objectives.

b. Is it reasonable to require schemes with a stronger employer covenant (and a resulting reduction in prudence in the assumed TPs and size of deficits) to have a commensurately shorter RP?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

As a general principle we would expect sponsors with stronger cash-flows (relative to their scheme deficit) to implement short recovery plans.

It is not necessarily preferable however to require employers to pay extra contributions, especially if the employer can put the resources to better, possibly covenant-enhancing, use. Regardless of the funding assumptions and investment risk, Fast Track or otherwise, and regardless of the current funding level, fundamentally members are dependent on the covenant to underwrite the risks in the scheme until it is bought out or transferred to a commercial consolidator. Until that point is reached, the best security for members is provided through a strong covenant.

It should also be noted that an employer's covenant could be considered strong if has a very large asset base and long-term viability. In those circumstances a longer recovery plan could be considered acceptable if overall default risk is low.

Once again, the better approach is a scheme-specific one which can reflect the particular circumstances of both the scheme and sponsor (and members e.g. in shared cost schemes) in what is, after all, a collaborative approach to providing member benefits.

18. Open schemes, past service

Should past service have the same level of security, irrespective of whether the scheme is open or closed?

<u>The response to this question reflects the expert views of employer covenant professionals of the ECPA</u>

The question appears to focus only on investment and funding risk, ignoring covenant strength, notwithstanding that a viable employer provides the ultimate security.

It is very important to differentiate between schemes that are open to new accrual and those that are open to new entrants too. Whilst you acknowledge the existence of schemes that still admit new members, you do not give any further consideration to them, beyond suggesting that trustees' focus on the security of accrued benefits rather than also be concerned with the provision of future benefits.

It should not be forgotten that pension schemes are there to provide benefits to members. The consultation document notes how only 11% of schemes are still open to new members but it does not take account of the fact that many of the schemes open to new members are larger than average. These schemes account for 21% of the PPF's Purple Book dataset membership.

There were around 1.1 million active members of private sector occupational DB schemes accruing future service benefits during 2019, as noted with the PPF's Purple Book 2019.

Whilst providing the same level of security is a reasonable aim, the method of achieving this can be very different. For example, a scheme with positive or neutral cashflow can take a longer-term view of investments and cope with periods of volatility, because it can pay benefits out of contributions or investment income, without the need to sell assts. This, in turn, can justify investing in more volatile assets with higher expected returns. TPs for these schemes can therefore be lower. Employer Covenant analysis in such circumstances should concentrate on the employer's ability to cope with the level of investment and funding risk being taken as a whole.

An open scheme that has a similar current maturity to a closed scheme can be expected to have a longer period until significant maturity is reached and, therefore, should have a correspondingly longer journey plan to its LTO. The framework needs to allow for this.

Trying to shoehorn all schemes into the same funding approach will unnecessarily increase the cost for open schemes which, of course, is likely to lead to them closing, something TPR has stated that it wishes to avoid.

19. Open schemes, future accruals

Do you think it would be good practice for trustees to ensure that the provision of future accruals does not compromise the security of accrued benefits?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

Pensions accrue over members' working lives in a manner contracted with the sponsoring employer. Active members do not place a distinction between past and future accruals, and it is not as stark as you present it. Every day of new accrual becomes past service the following day. It would not appear appropriate to invest this past service conservatively simply because it is past service, but what is important, is how the scheme is funded overall, and the strength of employer covenant supporting it.

Since future accrual comes with future service contributions, this can mitigate cashflow concerns which can be present in schemes with no contribution income, enabling trustees to take a long-term view of investments and withstand short-term asset volatility.

It is not a simple matter to separate the impact of future accruals, especially for a scheme open to new members, and your proposal would not capture the complexity. Unnecessarily overstating the liability value placed on accrued benefits, and restricting the level of investment risk (and expected returns), will serve to increase the cost, increase the likelihood of closure and could itself serve to weaken the employer covenant.

Although it is not part of TPR's formal objectives to support future accruals within defined benefit schemes, we are sure that you would agree that it would not be appropriate for TPR's funding code to cause irreparable damage to future accrual for up to 1.1 million members. An appropriate balance needs to be achieved between the security of accrued benefits and the provision of future accruals to avoid this. This is consistent with your view, stated within paragraph 467, of "making sure the funding framework does not unduly increase the cost of future accruals, which could lead to scheme closures".

Chapter 6: Other issues

20. Other issues

Do you agree with our assessment of the issues above and do you have any further comments?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

Whilst we agree that the issues you have raised are worthy of discussion, we do not always agree with your assessment of them.

Employer covenant can also be a significant strength to a scheme, enabling better outcomes in relation to:

- Adoption of cost-effective, truly scheme-specific strategies.
- Enabling open schemes to remain open, and to follow a different path from closed maturing schemes.
- Intergenerational fairness, through "smoothing" and avoiding trapped surpluses (which would benefit future generations more).
- The ability to cure future risk events, even where those risks are viewed as "low".

Chapter 7: Introduction to Fast Track

No questions

Chapter 8: Setting the long-term objective (LTO)

21. Fast Track low dependency discount rate

What are your views on our proposal that the appropriate low dependency funding basis for Fast Track should be with a discount rate somewhere in the range of Gilts +0.5% to Gilts +0.25%? Where in the range do you think it should be and why? If you disagree, what do you think would be a more appropriate basis and why (please provide evidence)?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

As mentioned above, protecting members' benefits is not just about funding assumptions and investment strategy, it is also about management of a concentrated, dynamic credit risk – the ability of the sponsor to support the scheme now and in the future. Regardless of the funding assumptions and investment risk, Fast Track or otherwise, and regardless of the current funding level, fundamentally members are dependent on the covenant to underwrite the risks in the scheme until it is bought out.

In headlining a Low Dependency funding basis, there is a danger that this is misconstrued as a "No Dependency" funding basis, and that schemes carry risks that they cannot afford to correct if no cognisance is made of covenant, either at maturity or on the journey to maturity.

Irrespective of what the underlying discount rate is, there are risks in using any particular asset class as a measure for assessing a low dependency funding basis for Fast Track. There can also be difficulties in setting rates where data is sparse, such as where scheme liabilities have a high duration.

As a general principle we would expect stronger, more durable covenants, to have great flexibility in the discount rate when determining the Low Dependency funding basis.

22. Options for defining other assumptions for Fast Track low dependency funding basis

Which of these options should be used to set assumptions for low dependency funding under Fast Track? Are there any other options we should consider? Are there any other pros and cons we should consider?

Not answered.

23. Defining assumptions for Fast Track low dependency funding basis

a. **What are the most significant assumptions (other than discount rates) for the calculation of the Fast Track low dependency liabilities?**

Not answered.

b. **If we were to specify some or all of the assumptions to calculate the level of Fast Track low dependency liabilities, which assumptions should we specify and how should we do this? Do you have views on the suggested benchmarking factors in the table above?**

Not answered

c. If we determined mortality assumptions, how could we balance the scheme-specific nature of mortality with the desire to ensure a level of consistency in the assumptions used by different schemes?

Not answered

24. Low dependency basis – verification that other assumptions meet the best estimate principle

a. Which of these options do you prefer to verify that other assumptions used for low dependency liabilities under Fast Track meet the ‘best estimate’ principle and why? Are there any other pros and cons we should consider? Are there any other options we should consider?

Not answered.

b. If we decided to require schemes to provide additional information about their assumptions, what information should we require schemes to provide compared to the current requirements?

Not answered.

25. Other assumptions for Fast Track low dependency basis – prudence

a. If we specified certain assumptions, should we aim for those to be best estimate or to be chosen prudently

b. Given the uncertainty around assumptions such as future improvements in mortality should we: i) define these assumptions in Fast Track and ii) set the assumptions prudently?

Not answered

26. Low dependency liabilities – reserve for future ongoing expenses

a. Should the low dependency liabilities carry an expenses reserve? If so, should this only be a requirement for schemes that self-fund their expenses?

b. To what extent should we define the reserve for future expenses under Fast Track? Should we just provide guidance on how to calculate an appropriate reserve? As part of that, what level of ongoing expenses is it reasonable to allow the employer to pay directly without any reserve?

c. If we defined guidelines on expenses for Fast Track, how should we reflect the proportionally different level of expenses incurred by schemes of different sizes? Could we adopt a sliding scale of percentages of liabilities based on the size of the scheme or a fixed element and proportionate element of expenses?

Not answered

27. Definitions of maturity

a. Should maturity be defined as duration for the purpose of prescribing significant maturity under Fast Track? If not, which measure would you favour and why? Note that whatever measure we use, it needs to be applicable not only to the time at which we would expect a scheme to reach significant maturity but also at all earlier times in the scheme’s life.

b. Whichever method is used to determine maturity, we need to use actuarial assumptions to make the calculation. Should we require that the Fast Track low dependency assumptions are used for this purpose? What other assumptions could be used?

Not answered.

28. Defining the timing point for significant maturity

What are your views on our proposal to set significant maturity (used to define the timeframe for reaching the LTO) for Fast Track to be in the range of a scheme duration of 14 to 12 years (or equivalent on a different maturity measure)? If you disagree, what would be a more appropriate timeframe and why? Please provide evidence.

The response to this question reflects the expert views of employer covenant professionals of the ECPA

The balance to which you refer in the consultation between placing an unnecessary cash drain on employers – which might unnecessarily weaken the employer covenant and the security of members' benefits - and avoiding the investment risk spiral is important, and your impact assessment will help with this judgement.

Allowance should be made for employer covenant within the framework, both during the journey to, and on reaching, significant maturity, as the overall impact of the investment risks will be less severe for schemes with a strong employer covenant when they reach significant maturity, due to the ability to call on additional contributions from the employer where necessary.

Table 39 at Paragraph 606 indicates that a number of schemes are already at durations below 14 years, and more will become so by the time the new regulatory approach is in force. It will be important for you to address what transitional arrangements might be available for any such schemes that are not at their LTO at that time.

In line with our comments elsewhere, that Fast Track assumptions ought to be set prudently in order to meet their purpose, this would suggest that a scheme duration of 14 years should be used. However, the financial impact on schemes and their sponsoring employers of using this end of the scale is likely to be significant.

Industry analysis suggests that for schemes closed to new members, but that continue to provide ongoing benefit accrual for existing active members, the date of reaching significant maturity can vary by up to 5-10 years depending on which measure is chosen within the 12 to 14 year range.

29. Points or ranges for low dependency funding basis and timing point

Do you think our proposal to set a particular level for the low dependency funding basis and/or a range for the significant maturity timing associated with the LTO would be helpful to schemes to manage volatility and allow some smoothing? If not, what would you suggest?

Not answered

Chapter 9: Technical Provisions (TPs)

30. Journey plan shape for Fast Track TPs

a. Which shape of journey plan is most appropriate to define for calculating the Fast Track TPs and why? Does this vary depending on the circumstances of the scheme?

Not answered

b. Are there any other journey plan shapes we should consider?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

Not for Fast Track. For Bespoke, there are likely to be others that are scheme-specific and justified by scheme characteristics (for example those with strong, enduring covenants where covenant strength is subject to ongoing monitoring, and/or those open to new entrants where no maturing is expected).

c. What unintended consequences might arise from adopting the linear de-risking or horizon method journey plans for Fast Track?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

As noted in other answers herein, protecting members' benefits is not just about funding assumptions and investment strategy, it's also about management of a concentrated, dynamic credit risk – the ability of the sponsor to support the scheme now and in the future. Regardless of the funding assumptions and investment risk, Fast Track or otherwise, and regardless of the current funding level, fundamentally members are dependent on the covenant to underwrite the risks in the scheme until it is bought out.

Absent ongoing covenant assessment, schemes following any method run the risk of being unable to meet downside experience during the journey plan.

There is also the possibility that the scheme does not actually progress in the way expected. This could mean that schemes change investments in line with the journey plan, but then have to reverse the changes at a subsequent valuation when actual experience is reflected. However, this can happen whatever approach is adopted.

31. Key factors for Fast Track TPs

Should other scheme-specific factors other than covenant and maturity be considered to define the journey plan and TPs in Fast Track?

Not answered

32. Extent of reliance on covenant in Fast Track TPs

a. Should we define a maximum period of acceptable full covenant reliance for Fast Track TPs? For example, a general guideline of five years? Or should covenant reliance be assumed to decline in the much shorter term (or immediately)?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

We do not consider that the concept of covenant horizon should be included within the funding code. Consequently, a maximum period of acceptable full covenant reliance for Fast Track TPs should not be defined.

We provide our reasoning for continued reliance on covenant in our response to Q15, and this applies for Fast Track too.

b. What level of covenant support should subsequently be assumed? Should there be an assumption of a single covenant grade reduction (eg CG1 to CG2), a reduction to assumed returns in line with a weak covenant, or something else?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

Covenant should be assessed based on the employer's financial position and outlook in the context of its pension obligations. No automatic reduction in covenant in the future should be assumed – it should be reflective of a reasoned view of the longer-term covenant – noting that this will be based on judgement, not legal certainty, and not immune from risk in the same way that investment decisions taken by trustees also carry return and default risk and actuarial assumptions also carry risk.

The concept that an automatic reduction in covenant strength in some way reduces risk and improves the security of members' benefits is misplaced. In reality, such a blind, uninformed reduction in assumed covenant strength would serve to transfer other risks (e.g. diversified investment risk) onto a single, concentrated, dynamic credit risk – the ability of the sponsor to support the scheme now and in the future. Ignoring this risk, or increased reliance on the underlying characteristics, risks placing an unnecessary cash drain on employers – which might unnecessarily weaken the employer covenant and the security of members' benefits.

We refer to our answer to Q15 as part of our answer to this question.

c. Over what period should any reduction in reliance take place? Should this be immediate (eg a reduction to a lower covenant reliance in the sixth year) or more gradual (eg over the subsequent five years)?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

We do not think that the approach taken for the journey plan to low dependency impacts any need for covenant visibility. As noted in our response to Q15 and Q32a, the concept of covenant horizon should not be included within the funding code and, consequently, a maximum period of acceptable full covenant reliance for Fast Track TPs should not be defined. Covenant risk, like any other risk, should be identified, measured and monitored.

If a reduction in reliance on covenant is to be included, a more gradual approach is likely to be more appropriate than an assumed immediate reduction. One of the reasons for this is that, if the covenant remains strong in practice, there will be a large source of surplus at a subsequent valuation, with this surplus being largest where the model adopts an approach of reducing reliance immediately. Adopting a more gradual approach to any assumed reduction in covenant visibility will help minimise this type of impact.

d. Does the need for a covenant visibility overlay depend on the approach taken for the journey plan to low dependency? For example, is this a more relevant consideration where the horizon journey plan shape is used?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

We do not think that the approach taken for the journey plan to low dependency impacts any need for covenant visibility. As noted in our response to Q15 and Q32a, the concept of covenant horizon should not be included within the funding code and, consequently, a maximum period of acceptable full covenant reliance for Fast Track TPs should not be defined.

33. How Fast Track TPs should be expressed

Which option do you think is preferable for defining TPs/journey plans under Fast Track and why? What are the practical issues associated with each option? If you disagree with these options, what would you suggest and why?

Not answered.

34. Method to derive Fast Track TPs

a. Do you prefer a particular approach? If so, why? Is there another approach that would be suitable?

Not answered

b. Do you have ideas as how to best approach each option?

Not answered

c. How do trustees incorporate considerations about covenant strength into their TP assumptions/discount rates?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

In our experience, Trustees take a number of approaches on how to incorporate covenant strength into their assumptions.

Good practice takes significant account of covenant within an integrated funding approach. The important point is that all risk are identified, measured and monitored and that the employer has the demonstrable ability to underwrite those risk i.e. it has the ability to put sufficient cash into the scheme, when required, over a reasonable period.

d. If a stochastic approach is adopted, what would you consider to be an appropriate confidence level against which to mark the results?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

This will vary massively depending on the covenant strength and maturity.

An undoubted, and enduring, covenant supporting a scheme with neutral cashflow could justify a confidence level close to 50%. Any adverse experience could be weathered without putting member security in danger.

On the other hand, a very weak covenant supporting a scheme with negative cashflows will need a much higher confidence level.

It is important to remember that model risk is significant, and flexibility, together with an acknowledgement that models are fallible, will be important.

e. Do you have any data or modelling results which you think would provide useful evidence for the baseline TPs or covenant overlay? Please provide full details of methodology/data limitations.

The response to this question reflects the expert views of employer covenant professionals of the ECPA

Employer covenant is measured in the context of the scheme it supports. The complexities of corporate strength, in the context of complex pension scheme obligations, cannot be quantitatively modelled without losing sight of the many characteristics that make up the covenant.

The notional examples of the multi-dimensional nature of employer covenant noted within our response to Q3b serve to illustrate that the approach to covenant should not be either ignored or short-circuited, even within Fast Track.

Chapter 10: Investments

35. Which reference point from which to measure investment risk in Fast Track

a. Would a measure of the liabilities be an appropriate position to measure investment risk from? If not, why not?

Not answered.

b. Do you prefer a liability measure on the low dependency basis (Gilts +0.5% to +0.25%) or a Gilts flat basis? Why? Are there any other liability measures that would be suitable?

Not answered.

c. Would a liability reference portfolio approach (as a proxy for liabilities) for smaller schemes be more proportionate and practical? If so, how should a small scheme be defined for this purpose (number of members, assets or liabilities)? What would be an appropriate threshold?

Not answered.

d. Would a reference portfolio consisting of gilts and inflation-linked gilts with a duration similar to the liabilities be appropriate as a proxy for the liabilities for smaller schemes? If not, how would you go about constructing a reference portfolio as a reference point from which to measure risk for smaller schemes?

Not answered.

36. Methodology to measure investment risk in Fast Track

a. Would a simple stress test to measure investment risk in Fast Track be the most preferable option? If not, why not? Are there other measures of investment risk that

are more suitable, taking account of the desire for a relatively simple and objective measure?

Not answered.

b. Do you agree with the proposed principles for an appropriate pensions stress test, namely a fall in growth assets and a fall in interest rates? If not, what do you suggest?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

We think this is a sensible starting point for establishing a suitable stress test.

c. What are your views on which stress test we should use? Do you think the PPF stress test (Bespoke and simple approach) would be a good starting point?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

A fundamental flaw within the document is that it appears to treat the result of any stress test as a result in its own right and ignores the covenant strength (i.e. the ability of the employer to cope with the risk inherent within any funding and investment strategy). A scheme running a higher degree of funding and investment risk with the support of an employer that is able to underwrite these risk is inherently more secure than a scheme running much less funding and investment risk, but with no employer ability to underwrite the downside.

The PPF stress test attempts to measure the "loss given default" i.e. where the probability of default is 100%. That is appropriate for PPF purposes – the PPF concentrates on the "what if the sponsor goes bust" scenario. That is not the appropriate scenario for ongoing funding purposes. Trustees should concentrate on the ability of the sponsor to absorb downside risk. A full Estimated Loss model stress test is required, which takes account not only of stressed quantum of liability, but also the probability of default, which in this case should reflect the ability of the sponsor to weather the downside.

The PPF stress test seems a sensible starting point for these calculations, but only in as much as it can quantify the downside, and logistically it makes sense for the schemes to have to submit information only once.

We agree that there is merit in expanding/amending the asset classes used to provide better insight into the level of investment risk. We note that the use of a "Bespoke" approach is not seen as less favourable for the purposes of the PPF levy calculations, and suggest that where the Bespoke approach is highlighted in your consultation document, it is seen in a similar light.

d. Which of the ways to measure the impact of the stress would you prefer and why? Is there an alternative method not listed that would work better? If so, please describe it.

The response to this question reflects the expert views of employer covenant professionals of the ECPA

The output from any stress test should not be a determining factor. The ability of the employer to underwrite the risk must be the overriding factor.

37. Approach to defining maximum levels of investment risk for schemes of different maturities in Fast Track

a. What are your views on the proposed methodology for setting maximum thresholds for investment risk for significantly mature schemes in Fast Track? If you disagree, what would you suggest?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

Any measure of scheme risk that takes no account of covenant is fundamentally flawed. The output from any stress test should not be a determining factor. The ability of the employer to underwrite the risk must be the overriding factor.

b. In relation to acceptable portfolios and consistency with discount rates, is it reasonable to use a best estimate return premium for growth assets over long-term gilts in the range of 3-5% pa?

Not answered

c. Should the allowance for prudence be higher for an investment portfolio with a higher level of risk?

Not answered

d. What are your views on the considerations we have set out to determine investment limits for immature schemes (journey plan shape, downside risk and covenant)? In particular, should the maximum level of investment risk for immature schemes vary by covenant under Fast Track?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

Determining investment limits for immature sections could lead to unintended consequences, which could ultimately lead to these schemes maturing or having to close earlier than intended (if open).

We agree that schemes with a stronger covenant are able to support a higher level of downside investment risk than schemes with a weaker covenant, but the degree of support is likely to be scheme-specific. Immature schemes, in particular, should therefore be given sufficient flexibility to establish a level of investment risk that is suitable given their specific circumstances.

Although, in practice, most immature schemes might follow the Bespoke approach, it is important that both the Fast Track and Bespoke elements of the regime support the ability for an appropriate level of investment risk to be taken.

38. Defining guidelines for liquidity and quality of the investment portfolio in Fast Track

a. Do you think we should define some guidelines around liquidity and quality in Fast Track?

Not answered

b. If so, what are your views on the options outlined above? Are there other approaches you favour?

Not answered.

c. What limits would you set on the above criteria and why?

Not answered

d. How would the above change for a more immature plan?

Not answered.

Chapter 11: Recovery plan (RP)

39. Fast Track guidelines on RP length

a. What are your views on the principles set out above in relation to RP length under Fast Track? In particular, do you have views on what may be appropriate RP length thresholds for different covenant strengths? Is it helpful to frame these in terms of the typical multiple of valuation cycles (ie three years)?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

A recurring theme of the consultation is how your consultation blurs the distinction between Fast Track and Bespoke approaches. Although this part of the consultation is addressing Fast Track, it includes several references to Bespoke which indicate the same principles will apply, with departures from Fast Track only being permitted with separate explicit support. This approach is not appropriate and is likely to have unintended consequences.

We agree that in principle, for schemes that are closed to new members, RPs should be as short as employer affordability constraints allow, ensuring that the level of DRCs is not prejudicial to the sponsor's sustainable growth. This should maximise DRCs and adherence to journey plans whilst there is a line of vision in relation to cash affordability.

We agree that, if there is to be a Fast Track framework, there needs to be some fixed parameters on maximum RP length. As a general principle the framework should include an objective standard of longer maximum RPs for schemes with weaker sponsor support covenant, rather than an RP length which is standard across the board.

Whilst there can be no right answer, we think that 3 year cycles in line with actuarial valuations is a reasonable methodology for this purpose, on the basis that maximum RP lengths are no greater than, and broadly in line with, medians currently seen by TPR in its anecdotal evidence for schemes of similar maturity.

For that reason, we believe the illustrative maximum length of 6 years (CG1/2), 9 years (CG3) and 12 years (CG4) is not unreasonable and sets a bar for compliance with Fast Track but with an expectation that these RPs would not be gamed by those employers across the covenant spectrum, where an employer would prefer to argue down their covenant strength to enable the adoption of a longer recovery plan.

Where no independent covenant advice is taken, it would be very easy to agree the maximum RP length available for the relevant TPR-calculated covenant strength, when in reality those sponsors could afford higher DRCs/agree shorter RPs based on an equitable sharing of cash across the relevant case-specific stakeholders. Equitable treatment of the scheme should be observed across the board.

b. Do you consider it would be more appropriate to have a single maximum guidance RP length and to expect trustees (under the Bespoke framework) to justify any plans that are longer than this?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

No. See the comment in Q39a above about the read across to Bespoke. Any Bespoke plan should be scheme-specific and justified by its own characteristics. There should be no comparison or direct mapping with additional mitigation with the Fast Track criteria.

As noted in the response to Q39a, we do not believe that an “objective standard” for any Fast Track framework should be based on all schemes having the same RP length. Further, we do not believe that an illustrative maximum length of 6 years RP would allow many of those schemes TPR is seeking to ‘fit’ within the Fast Track framework to do so from an RP perspective, irrelevant of any other framework parameters. By extending that maximum standard RP length the risk of gaming the position increases significantly.

It is unclear from paragraph 445 of the Consultation whether the 3 exclusions would fall within the Bespoke approach (only the second bullet mentions Bespoke) but assuming any of those exclusions are intended to fall within the Fast Track parameters, it seems at odds with a framework which is ‘built’ around fixed parameters for there to be exclusions which could still be deemed compliant when, in all other cases, such exclusions would fall within the Bespoke approach.

However, any framework also needs to allow for non-standard market conditions, such as the current coronavirus/COVID-19 pandemic, where other stresses on employers may make a longer recovery plan more appropriate.

c. Do you think Fast Track RP lengths should be shorter for schemes nearing and/or at significant maturity? If so, to what extent?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

On the basis that schemes should be achieving low dependency funding (as part of its LTO) by the time the scheme reaches significant maturity, it appears reasonable, in principle, for RPs to become shorter at that time and taper as the journey plan towards low dependency funding reaches its end point.

We note TPR focuses on, in particular, weaker covenant schemes but we would suggest a fixed parameter framework should encompass all schemes.

We would anticipate that RPs should naturally taper to meet the stated LTO and only diverge where that LTO can no longer be achieved for whatever reason. This would be noted from the statement of strategy from the scheme Chair. Whether a scheme would still remain within Fast Track (if it could still meet all parameters on an ongoing basis with a revised LTO) or have to fall within Bespoke is a separate matter but in principle it would appear reasonable (if the statement of strategy is reasonable) for the Fast Track approach to remain available to such schemes with TPR having the ability to consider the reasons for a revised LTO with the scheme

40. Fast Track guidelines on RP structure

Should the extent of back-end loading be limited to increases which are in line with inflation (in the absence of appropriate additional support such as a contingent asset

being provided)? Or should there be more flexibility subject to a significant proportion of DRCs being committed in the early years of the plan? If inflation-linked increases are acceptable, what measure of inflation do you consider would be an appropriate benchmark?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

Again, we refer to the distinction between Fast Track and Bespoke.

We believe that limiting 'back end loading' to increases which are in line with inflation does not reflect the reality of the commercial world. The Fast Track framework should be able to recognise commercial realities.

There will be many sponsors who, at any particular time, will be in the process of, considering or embarking on, new growth or restructuring strategies which will require investment (or other cash outflows) in the short to medium term but which are anticipated to provide a return on that investment (or other upside) for the benefit of all stakeholders down the line.

It is not unreasonable for a RP to reflect that sponsor strategy, assuming the scheme is being treated equitably across the relevant stakeholder base. That will require trustees to assess the sponsor's plans, in order to agree such a RP for reasonableness and equitable treatment.

Equally it is unrealistic to expect certain sponsors and/or wider groups to provide additional support such as a contingent asset to bridge the position. Some form of performance-linked metric may be appropriate as additional DRCs outside of any RP.

We have no objection in principle to there being a link to a % of DRCs being payable by half the length of the RP, although 'at least 50%' may not always be appropriate, depending on the length of the RP. In our view, perhaps a better link might be for there to be an expectation that the next RP should, all things being equal, reduce in length by three years; where it does not reduce in line with expectation, then perhaps this should be an area of review for TPR to determine the reasons, which may or may not be linked to the reasonableness of historic 'back end loading' of DRCs.

As regards the appropriateness of benchmarks for inflation linked increases, we do not have a specific view.

41. Fast Track guidelines on investment outperformance

Should investment outperformance not be allowed in Fast Track RPs? What do you think the impacts may be?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

Again, we refer to the distinction between Fast Track and Bespoke. For Fast Track, no allowance for investment outperformance should be permitted. This extra conservatism is the price for streamlined regulation

For the purposes of the Fast Track framework and in order to ensure a level of consistency across all schemes, we agree with TPR's proposal:

- that asset outperformance (above that assumed in the TPs) should not be used when calculating the RP

- where allowance for investment outperformance may be deemed acceptable, it should fall within the Bespoke approach

This would ensure (for Fast Track purposes) that any margin for prudence in the TPs is reduced; where trustees wish to set a significant margin for prudence in the TPs and/or evidence how any asset performance assumed in the RP is appropriately underwritten, then that could fall quite appropriately within the Bespoke approach and outside of any fixed framework parameters..

We are concerned by the implication that, by extension, Bespoke approaches should also not be allowed to reflect outperformance absent explicit support (e.g. contingent security). Fast Track is not a benchmark for all schemes, but a conservative basis to facilitate demonstrating compliance.

This may make fewer schemes eligible for Fast Track, or it may lead to schemes revising their approach and taking prudence out of Technical Provisions.

42. Fast Track guidelines on future RPs

In what circumstances should/could outstanding RP payments be re-spread at subsequent valuations? In particular:

a. If a scheme's funding deficit has reduced (at least) in line with the expectations at the previous valuation, would it be appropriate to maintain the same end date? Or would it be pragmatic to re-spread the remaining deficit over a renewed period?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

The basic principles should be that:

- a sponsor should be paying a level of DRCs which are equitable as regards the sponsor's other relevant stakeholders and which are sufficient, but not prejudicial to its sustainable growth; this amount should be assessed at each valuation and not seen as an automatic 'roll forward' of a similar sum
- each valuation should be seen as a 'stepping stone' towards reaching the LTO and low dependency funding levels by the time the scheme reaches significant maturity

The statement of strategy and ongoing covenant strength will therefore be significant factors in determining the level of risk trustees take (or can take) as the journey plan (and TPs) converge towards meeting the LTO, such that RPs should then reduce in line with the 'run in' towards the end of that journey plan.

We do not agree that a generic roll forward of RPs whereby the RP length remains the same from valuation to valuation is an objective standard; an objective standard should recognise a generic expectation that RPs should reduce from valuation to valuation whilst accepting RP lengths may need adjustment for a variety of factors, including, but not limited to, economic factors, scheme-specific matters, sponsor-specific matters or changes to risk-taking and de-risking along the journey plan.

In any event, the recovery plan should be directly linked to the affordability of the employer as part of an integrated funding approach.

In these circumstances we would expect as a general rule that the same RP end date (not RP length) be maintained.

However, for any proposed RP, we think that the level of DRCs should be reconsidered at each valuation to take account of the various factors 'in play' at that time and that the level of DRCs should be agreed on the basis of equitable treatment and sustainable growth.

For example, whilst we would not want to see any unnecessary reduction in DRCs, an increase in DRCs could be reasonable from valuation to valuation, notwithstanding a reduction in the deficit (at least) in line with expectation. Trustees should be alive to this rather than merely accepting a roll forward on DRC quantum which could see the RP end date brought forward or maintained with an adjustment to risk-taking.

b. If a scheme's funding deficit is higher than expected, what guidelines should apply for the appropriate length of the new RP?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

In these circumstances, the covenant strength is likely to be a relevant factor at the time of the valuation in question. This may have weakened as a result of the increased funding deficit or be a factor in its increase.

If the covenant strength has weakened during the period, we see no reason in principle why the illustrative Fast Track framework for RPs based on covenant strength could not allow a scheme to be 're-positioned' within the framework.

If the covenant strength remains 'as was', again the framework should allow for that, unless the scheme needs to seek a Bespoke approach if it should fall outside those parameters.

What remains critical is that there does not need to be an automatic roll forward of DRC quantum but comfort that the level of DRCs remains equitable and is maximised without prejudicing the sponsor's sustainable growth

c. Would the idea of 're-spreading' be more acceptable where a scheme has a long period before it becomes significantly mature?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

We see this as more acceptable given the increase in volatility-related factors but as above, any level of DRCs must remain equitable and be maximised without prejudicing the sponsor's sustainable growth.

43. Equitability

What are your views on the concept of 'equitability' in respect of how a scheme is treated compared with other stakeholders? Should any requirements be qualitative (in line with the commentary above) or should trustees also be expected to consider a specific metric? If so, what might be an appropriate measure of equitability (for example, comparing the ratio of DRCs to dividends, or the size of scheme deficit to the 'stake' of other stakeholders) and how could this reflect a scheme's superior creditor status over shareholders?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

The concept is sound, but its application is complex. Equitable treatment as between relevant stakeholders cannot be referenced to a specific metric but will be case-specific (given the actual relevant stakeholders in each case) and depend on covenant strength.

In principle any view will therefore be qualitative and based on the reasonableness of the 'carve up' of cash, given the scheme/sponsor-specific circumstances.

Whilst it would be possible to reflect the relative share as between relevant stakeholders on a case-by-case basis, that relative share does not fit within a fixed set of parameters, given the variety of variables and stakeholders in any given situation.

Generally, there will be an expectation of some or greater levels of dividends (or other forms of covenant leakage) where the covenant strength is at the stronger end of the covenant rating spectrum.

Again, although, we are concerned by your reference (paragraph 465) that the Bespoke approach would need to explain "why the agreed RP is different to the requirements set out in Fast Track." There is no reason to suppose that any specified constraints for Fast Track approval would be appropriate benchmarks for a Bespoke Recovery Plan.

Chapter 12: Open schemes

44. Treating past service and future service liabilities separately in Fast Track

What are your views on our proposed approach to outlining code guidelines for open schemes. Should any other approach to calculating future service liabilities be considered?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

Schemes that are open to either future accrual or to new members and future accrual should be able to demonstrate a sufficiently strong covenant. Absent such strength of covenant, the investment and funding strategy is likely to be such that the cost of future accrual is prohibitive.

We disagree with the way you segment schemes into open and closed schemes with reference to future accrual. Schemes that are only open to future accrual have much more in common, in this context, with schemes that are closed to future accrual. Both types are on a path to having pensioners only over some predictable timeframe. However, schemes that are also open to new members, by contrast, have no such end in sight. You appear to acknowledge this by noting that such schemes "...at least in theory, are expected to remain immature indefinitely."

We believe schemes that are open to new members warrant separate treatment completely to reflect this fundamental difference, and expect you will be aware of the amendment made to clause 123 of the Pension Schemes Bill for schemes that are expected to remain open to new members. Although your consultation was issued before the amendment was made, it is important that your response to the consultation takes account of it.

As the consultation document stands, you state that your new code will cater for all types of open scheme, but we fail to see how it will do so for schemes open to new entrants. The sole recognition that such schemes are different appears to be the expectation of a longer time to reach significant maturity, although you then suggest that trustees of open schemes should set TPs in the same way as closed schemes. This immediately exposes the difficulty of attempting to shoehorn all schemes into the same framework, and your consultation appears contradictory in this respect. At the same time, you seek to target a date (significant maturity) to reach the LTO and yet acknowledge that such schemes are not expected to reach significant maturity.

Given your clear views about schemes that are open to new members, perhaps the better course is to prohibit them from using Fast Track completely. In line with our previous responses, though, the Fast Track parameters should have no bearing whatsoever on how such schemes should comply with the funding regulations under the Bespoke route.

45. Fast Track LTO for open schemes

Should the LTO (low dependency at significant maturity) for an open scheme be the same for a closed scheme? If not, how should they differ?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

As noted above, schemes that are open to either future accrual or to new members and future accrual should be able to demonstrate a sufficiently strong covenant. Absent such demonstrable strength of covenant, the investment and funding strategy is likely to be such that the cost of future accrual is prohibitive. Given the complexities of covenant strength, the Bespoke approach is likely to be more appropriate for those schemes. We consider that schemes open to future accrual should be treated as Bespoke.

If you exclude schemes that are open to new entrants from your definition of open schemes, then using the same framework for the LTO is sensible. Indeed, that is why we think the segmentation between open and closed schemes should be based on new entrants, rather than future accrual.

However, when considering the term to significant maturity for schemes open to new accrual, allowance should be made for the impact that the expected accrual will have on its maturity. It would be inappropriate to assume that accrual ceases when the reality is that accrual is expected to continue. Although the option of using the Bespoke route is available for such schemes, this would be no comfort if Fast Track TPs are used as a ‘benchmark’ within the Bespoke route.

In addition, we fundamentally disagree with your suggestion that schemes which are open to new entrants should be treated in the same way.

We think it is contradictory to say that schemes that are open to new members, and therefore not expected to reach significant maturity, should nevertheless have a LTO based on reaching significant maturity.

We are not convinced by your three stated justifications:

1. *Having a LTO to help plan for the possibility of closure to new entrants* - Trustees may very well wish to consider the implications of closure to new entrants, but this is very different from setting an integrated funding strategy based on it happening.
2. *Avoiding cliff-edges on closure to new entrants* - All this would do is create an unnecessary cliff-edge immediately, as noted above.

3. *Funding regime to apply consistently to all schemes* - Schemes are different and fundamental differences such as this require specific consideration.

Although you state that you are not advocating the closure of open schemes, all these justifications seem to point to an underlying position that open schemes should expect to stop admitting new entrants.

According to the latest Occupational Pension Schemes Survey released by the Office of National Statistics, there are still 1.1 million active members of private sector defined benefits schemes (with a further 6.3 million such members in the public sector). The needs of these members should be given proper consideration and we believe that your consultation falls short of this.

46. Fast Track TPs for open schemes

What option do you favour and why? Are there other options we should consider?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

Open schemes should be able to reflect a slower rate of maturing than closed schemes, if supported by actuarial projections (including future accrual). Not only does this reflect the expected progress of the scheme, but it is further justified by the likely cashflow position, which mitigates the risk of needing to sell assets at depressed prices.

There seem to be two approaches to deal with this:

1. Set Fast Track in line with your preference (Option A) and expect that most open schemes will follow the Bespoke route. As mentioned elsewhere, in this case, it is important that the Fast Track parameters are not used as a ’benchmark’ when assessing the Bespoke approach.

2. Set Fast Track in line with Option B and expect more open schemes to follow Fast Track.

Under either approach, schemes that are open to new members need their own separate regime to reflect the expectation that they will not mature.

We note that you prefer Option A on the basis that there would be no ‘cliff-edge’ effect in liabilities/deficits associated with scheme closure. However, the consultation does not recognise the likelihood that Option A will automatically bring forward that cliff edge and, if open schemes use the Fast Track approach, this itself will put future accrual at risk and, potentially, damage future member outcomes. The impact of this should not be understated.

You suggest Option A protects against the impact of schemes closing to new entrants. The more likely outcome is that your approach will cause more schemes to close to new entrants. Whilst this might be an outcome that makes it more straightforward for TPR to meet its objectives, it produces a significantly worse outcome for members, and an adverse impact on pension provision more generally.

In addition, any approach that causes otherwise unnecessary additional cash contributions form sponsors will, for reasons mentioned elsewhere in the document, have the effect of weakening the covenant and the security of members benefits for all but the strongest of employers.

47. Fast Track guidelines for calculating future service costs

a. Which options do you favour and why? Are there any other options for calculating future service costs which should be considered, for example pre-and post-retirement discount rates?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

As noted above, schemes that are open to either future accrual or to new members and future accrual should be able to demonstrate a sufficiently strong covenant. Absent such demonstrable strength of covenant, the investment and funding strategy is likely to be such that the cost of future accrual is prohibitive. Given the complexities of covenant strength, the Bespoke approach is likely to be more appropriate for those schemes. We consider that schemes open to future accrual should be treated as Bespoke.

b. If Option C (best estimate) were adopted, how should the best estimate return assumption be determined? Are there any options other than those described above that we should consider?

Not answered.

c. Would our preferred approach (Option B) make it difficult for scheme actuaries to certify schedules of contributions?

Not answered.

48. Funding future service using past service surplus

Do you think that this approach to funding future service using past service surplus is reasonable? If not, why not? What else would you suggest?

Not answered

Chapter 13: Bespoke framework key features

49. Criteria for assessing Bespoke arrangements

What are your views on the criteria we propose to use to assess Bespoke arrangements? If you disagree, what would you change and why? What else should we consider?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

We fundamentally disagree with your proposed approach of assessing the Bespoke arrangement using Fast Track as a reference point.

Fast Track should be deliberately conservative to facilitate a short-cut route to compliance. Schemes following this route will not have to demonstrate the same level of analysis as those following Bespoke, so it is right that they have a higher hurdle to jump. The stronger funding basis requirement is the price to pay for this light touch regulation and reduction in professional advisor costs and management time.

You portray the Fast Track approach as the "correct" one and would seek appropriate justification to depart from this under Bespoke. We think you should consider the Bespoke, scheme-specific, approach to be the "correct" one, and expect Fast Track to layer additional caution on top, to justify its short-cut approach. Although a Bespoke valuation should be prudent, it should not have the multiple layers of prudence that become a necessity under Fast Track, to enable Fast Track to be a suitable short-cut route to compliance.

Many aspects of Fast Track, as we have noted in our responses, are appropriate if Fast Track is viewed as a short-cut. If, as you appear to be heading towards, Fast Track is actually viewed as the “correct” answer when assessing Bespoke proposals, then the assumptions in Fast Track should be revisited to be less burdensome and unnecessarily cautious when applied to the universe of schemes.

The principles refer to a "tolerated risk position" against which trustees should consider their own risks. You appear to equate this with the Fast Track risk position, which is not the same thing at all.

50. Bespoke examples

a. Do you have any comments on the assessments we have made in the examples above?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

The over-arching principle that the Fast Track position is used as a base for assessing a Bespoke valuation is inappropriate, as explained in our response to Q49 above.

The examples here are consistent with a flawed approach that a Fast Track valuation is a suitable benchmark, although they are helpful in demonstrating your views about how you expect the Bespoke approach may operate. They are less helpful when considering the likely impact this will have on many schemes, driving up cost unnecessarily and reducing the overall level of benefits provided to members. As noted above, any approach that requires otherwise unnecessary additional cash contributions from sponsors will, for reasons mentioned elsewhere in the document, have the effect of weakening the covenant and the security of members benefits for all but the strongest of employers.

The positive aspects of the examples you provide would give the justification suggested, however, it is the notes that provide more insight.

There are two specific examples on which we have further comments, although this should not be interpreted as support for the approach in the other examples:

Example 3

It is not clear why you think it consistent to place reliance on the covenant for a longer (e.g. 10-year) period, but at the same time require the deficit to be paid over the standard period (e.g. 6 years). A Bespoke approach should be allowable in both aspects.

Example 13

A running theme throughout our responses is that schemes that are open to new entrants should not be shoehorned into the same framework. The notes in this example highlight why that is our belief.

The concerns you raise are, in our view, exactly the characteristics of a scheme that is open to new entrants that justify such an approach. In particular:

- they do have a longer investment time horizon
- they do have positive cashflows which mitigate the risk of needed to sell assets at depressed values
- they can access a wider pool of investments, especially illiquid assets
- they can achieve a higher level of return with the same level of risk as a closed scheme

This seems to suggest that your view is that schemes that are open to new entrants are adopting an incorrect approach, and the sooner they close to new entrants, the better. We consider it neither within your remit, nor appropriate, to attempt to drive national pension policy in this way.

Regulating such schemes in this way will impose unnecessary additional burdens on employers (and members in shared cost schemes), with the likely corollary that they will close, and the overall level of pension provision to members will reduce, and the security of members benefits will reduce for all but the strongest of employers.

b. Could you provide other examples (relevant to your own scheme experience or that of schemes you advise) of arrangements which you think will follow the Bespoke route? Why do you think these arrangements would be compliant?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

Protecting members' benefits is not just about funding assumptions and investment strategy, it is also about management of a concentrated, dynamic credit risk – the ability of the sponsor to support the scheme now and in the future. Regardless of the funding assumptions and investment risk, Fast Track or otherwise, and regardless of the current funding level, fundamentally members are dependent on the covenant to underwrite the risks in the scheme until it is bought out or transferred to a consolidation vehicle .

This current environment of COVID-19 and BRIEXIT also underlines that Employer Covenant is dynamic and must therefore be integral to trustees' practical journey to buy-out, because making broad assumptions about covenant and/or ignoring it is dangerous and possibly negligent, even if the assumptions are prudent.

The notional examples of the multi-dimensional nature of employer covenant noted within our response to Q3b serve to illustrate that the approach to covenant should not be either ignored or short-circuited, even within Fast Track.

We therefore think that, given the direction of travel evident within the consultation, of downgrading or even ignoring the complexities of covenant (with the exception of closed schemes that are already materially on their path to significant maturity, and/or small schemes that are attracted by the low-cost option of Fast Track to achieve compliance) trustees of most well-run schemes will be forced to choose the Bespoke route so that they are able to properly recognise and take account of covenant.

The reasons for being able to meet compliance via the Bespoke route will be varied and scheme-specific, and will undoubtedly focus on the covenant characteristics of the scheme – its "risk capacity" to justify why and how the Bespoke, scheme-specific approach is the most appropriate approach.

c. In example 2 (LTO–CDI strategy), could it be appropriate, in your view, to be able to use a higher discount rate/lower value of TPs (low dependency basis) than in Fast Track? If so, in what circumstances and by how much?

Not answered.

51. Stressed schemes

a. Assuming that affordability is genuinely constrained, are very long RPs ‘appropriate’ and therefore compliant with the Act?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

Yes. A very long recovery plan may be appropriate where affordability is genuinely constrained if there is a belief that there is a sustainable business, despite the long recovery plan, that is able to make the contributions. Factors that should be considered in assessing whether it is appropriate to include the risks that the covenant and scheme are exposed to during this period, and what value could be lost by the scheme as a consequence of entering into the plan rather than taking a different course of action, if available. The risks should be considered on an ongoing basis, and the setting of a very long recovery plan, whilst appropriate at the time, may change as a result of the changes in either the likelihood or quantum of the risks identified.

In these situations, the trustees should typically seek protections to ensure that they capture any positive upside when affordability becomes less constrained, ensure the scheme is being treated equitably, and/or seek contingent asset support.

b. Alternatively, should we make an exception to the principles and allow the trustees of stressed schemes to take unsupported investment risk, or more risk investment risk than other CG4 schemes (schemes with weak employers)? What checks and balances should we put in place in addition to those mentioned above (equitable treatment, risk management)?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

Yes. It may be appropriate in some cases to take a level of investment risk that improves the chances of addressing the deficit. This affordability constraint should however be demonstrable and evidence provided that the trustees and sponsor have exhausted every route to strengthen the covenant.

Such schemes are in a difficult place and will require a compromise solution. Such a solution will involve consideration of many issues, ranging from what will maximise member outcomes, to what will minimise risk to the PPF, and can be expected to involve many parties. For those schemes funded below PPF levels, we would expect the consent of the PPF to be required as ultimately it will bear any downside risk.

Due to the various scenarios, both predictable and unpredictable, that could exist, we suggest that a principles-based framework is most appropriate in this area.

c. For schemes with unviable RPs, should an exception be made for them in terms of the level of acceptable investment risk?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

Where schemes have clearly unviable RP's we would advocate early transfer to, or at least liaison with, the PPF.

d. Are you aware of situations other than stressed schemes where the trustees and employer would have difficulties meeting the Bespoke compliance principles?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

Yes. If themes within the consultation are adopted, it seems very likely that many schemes would have significant difficulties. There are three particular features which will make compliance very difficult:

1. Being open to new entrants and setting an integrated funding policy accordingly.
2. Schemes which provide a strong, enduring covenant (if they are forced to ignore covenant at significant additional unnecessary costs).
3. Funding under shared cost schemes, where member contributions are expected to change in response to valuation results.

Although all these features can be accommodated under the present regulatory framework, by adopting scheme-specific funding approaches, they do not appear likely to satisfy your blanket approach to Bespoke.

As noted above, any approach that causes otherwise unnecessary additional cash contributions from sponsors will, for reasons mentioned elsewhere in the document, have the effect of weakening the covenant and the security of members benefits for all but the strongest of employers.

Chapter 14: Additional support

52. Trustees' assessment of additional support in Bespoke arrangements

Do you have any views on the framework we set out for trustees to assess the appropriateness of additional support in Bespoke arrangements? If you disagree, what do you suggest?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

We are broadly supportive of the framework proposed and consider it is important for trustees to understand any additional risks being run, alongside the benefit of the support provided, including, but not limited to, the estimated realisable value of the support at the time it may be required.

The following framework is likely to encompass the areas that arise in practice:

- Assess: as suggested
- Quantum: as suggested
- Value: Assess the value of the additional support and how this changes with time and the circumstances when the additional support is need

- Valid: is the additional value accessible/enforceable
- Purpose: establish a clear understand of why the additional support is being provided

The consultation states that there is no desire to dissuade trustees from lower levels of guarantee support than is described in paragraph 555, and we consider this is an important message to continue to convey given the incremental value that can be provided by contingent assets or guarantees that do not cover the entire low dependency funding deficit.

53. Accessing additional support

When do you think trustees should be able to access the additional support? Does it depend on the Bespoke arrangement and the type of risk that it supports?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

This is scheme-specific and dependent on the arrangement in place. It would be best practice for trustees to be aware of the risks being run, and how the additional support addresses, or at least mitigates, those risks. This should be backed up by professional advice.

54. Assessing the value of additional support

Should trustees be required to assess the stressed value of any contingent asset? What other guidance do you think we should set out on the recoverable value of contingent asset support?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

It would be best practice for trustees to understand the stressed value of any contingent asset. However, this should not be the only consideration, or sole focus.

Given it is likely to be very specific to a scheme, sponsor and asset circumstance, we do not believe that any guidance issued should be overly prescriptive. Illustrative case studies usually form useful guidance for trustees in these circumstances.

55. Independent valuation

Should trustees always be expected to seek an independent valuation of contingent assets, or should it depend on asset value and/or type? If this should be based on value thresholds, how should these be defined? How frequently should we expect trustees to seek an independent valuation? Should trustees be expected to regularly monitor contingent asset value in the intervening period?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

This is likely to be case specific, depending on the nature of the asset, its materiality to the covenant or funding strategy, the volatility of its value and the cost and accuracy of any valuation assessment etc.

In practice trustees need as a first step to explain how they have sought to place a value on the asset in all circumstances, either by reference to the value of the asset or the risk that the additional support is covering. There may be circumstances where it is clear that the asset is of adequate value to support a given risk that is being covered. Whether the additional support needs an independent view on value will be driven by the type of asset and its complexity, the quantum of risk that it is covering, and the likelihood of the risk materialising.

Trustees, as part of the framework, should understand how the value of the additional support could change and set a monitoring process that is appropriate based on those risks. It would seem logical for trustees to reconsider that assessment as part of the valuation cycle, as a minimum.

We do not consider it should be necessary to prescribe the frequency of re-valuation, as each asset should be considered on its own merits.

56. Guarantees

a. Should we treat guarantee support differently to asset backed support?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

We consider that guarantees can be hugely beneficial to covenant, as a strong, legally binding statement of wider group intent and support to the scheme and sponsor. Not only does the existence if a valuable guarantee improve outcomes in a distress or fail situation, it can also act as a "life-support" mechanism, encouraging the wider group to invest in and improve the viability and outlook of the employer, when it might otherwise allow the employer to fall into insolvency.

Guarantee support is usually harder to assess and quantify than asset-backed support. However, it is arguably no less valuable, and indeed is sometimes more valuable, if uncapped, as compared to the fixed value of an asset which the trustee has security over.

Whilst it would be best practice for trustees to understand the stressed value of any contingent asset, including a guarantee, this should not be the only consideration or sole focus.

b. Should trustees rely on guarantee support to change the covenant grade assessment or do you think in these circumstances the supporting entity should become a statutory employer instead?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

We consider it appropriate for covenant ratings to take into account guarantee support, where appropriate.

It is unclear what benefit might be derived from making a supporting entity a statutory employer. For example:

- If the guarantor was an overseas entity, this may create cross-border issues.
- Trustees would need to take detailed legal advice on scheme structure (such as partial wind up and last man standing issues), and detailed covenant advice to assess the implications of the possible order of sponsor insolvency, on the trustees' ability to recover s75 debts.
- The new guarantor employer may just be responsible for its nominal share of the pension liability as statutory employer, rather than liable for the full guaranteed amount.

- For single-employer schemes that become multi-employer and where there is still ongoing accrual, this could also create s75 debt issues (when one employer subsequently ceases to employ any active members).
- It is likely to be a much less attractive option for sponsors and could result in weaker covenants than if a guarantee was given proper recognition.

Banks often lend to UK entities on the basis of a parental guarantee; they do not make the parent a primary obligor for the debt. A pension scheme obligation is no different.

For these reasons we do not believe it should be a requirement that guarantors become statutory employers.

57. Other mitigations

Can you think of any other types of arrangements which can help trustees mitigate risks?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

There are numerous arrangements that trustees can agree with sponsors to mitigate risks, including but not limited to:

- Dividend and profit sharing mechanisms – requiring contributions to the scheme as a % of dividends paid or linked to profitability or cash flows
- Employer information-sharing protocols
- Letters of credit
- Creditor subordination agreements e.g. subordination of intercompany creditors
- Various forms of negative pledges
- Surety bonds

58. Reporting information on additional support

Is there any reason why it would be unreasonable to expect trustees to undertake the analysis and provide the information outlined above? Is there additional information that should also be provided to us?

The response to this question reflects the expert views of employer covenant professionals of the ECPA

The proposed reporting requirements seem reasonable and the list of items to be provided appears quite comprehensive.