ICAEW
REPRESENTATION 25/23

DEFINED BENEFIT FUNDING CODE CONSULTATION

Issued 24 March 2023

ICAEW welcomes the opportunity to comment on the Defined Benefit Funding code consultation published by The Pensions Regulator on 16 December 2022, a copy of which is available from this link.

For questions on this representation please contact our Business Law team at representations@icaew.com quoting REP 25/23.

We broadly support the framework and principles set out in the draft Code. The Pensions Regulator's objectives of protecting members' benefits and reducing the risk of claims on the Pension Protection Fund must, however, be balanced against minimising any adverse impact on business growth. There are some aspects of the Code where we think this balance may be put at risk, for instance, where a formulaic approach is adopted, and we highlight these in our response.

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This ICAEW response reflects consultation with the Pensions Sub-Committee of ICAEW's Business Law Committee and other experts. The Pensions Sub-Committee includes representatives from public practice and others in the pensions sector.

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KEY POINTS

1. We understand and broadly support the framework and principles set out in the draft Code.
2. It is, however, important that the Code does not becomes either overly rigid in its application or formulaic. The risk is that this would result in unnecessary cost for schemes and/or business or potentially result in non-commercial decisions being made. This could affect the competitiveness of some businesses. The ultimate risk is that the short-term cost of contributions for some employers forces insolvency when funding objectives are achievable in the longer term. The Pensions Regulator's objectives of protecting members' benefits and reducing the risk of claims on the Pension Protection Fund must, therefore, be balanced against minimising any adverse impact on business growth.
3. In our responses which follow, we have focussed on the covenant aspects of the draft Code and we expand on the general points we have made above.

ANSWERS TO SPECIFIC QUESTIONS

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

4. We believe any scheme funding strategy must be based on a thorough understanding of the financial ability of the employer to support the scheme. This should include an assessment of how this may change over time. It should also include an assessment of the risk that the employer may not ultimately be able to adequately support the scheme, such that members do not receive their benefits in full.
5. Generally:
   - where anticipated cash flows are not supported by forecasts, these should be treated with greater caution than those cash flows which are supported by forecasts.
   - over time cash flows become increasingly less certain and susceptible to changing circumstances.
6. However just because an employer does not forecast beyond the short term, does not mean its future cash flows should be discounted unreasonably. Many businesses are strong, operate in mature markets and it should not be assumed these will simply disappear beyond the medium term; businesses adapt and change over time.
7. Longevity is not simply based on the sustainability and predictability of historic/current cash flows; it also reflects the employer's ability to access funding and investment and to deal with downturns. That resilience is often largely dependent on its balance sheet strength, whereas cash flow is the focal point of the Code.
8. While visibility and longevity are key considerations when determining reliability, their function as distinct periods is unclear (other than the reference to them as being included in the statement of strategy or where the period of longevity is before the 'relevant date'). They are not for example included as a component part of the maximum risk test – supporting the level of investment risk or largest deficit increase supportable by the covenant.
9. We comment:
   - the period of visibility is straightforward - it is determined solely by the employer's actual forecasts. It does not appear to have a specific function in determining the funding strategy, other than the reliability period is an extension of it.
   - the definition of the period of reliability is straightforward. However, this period will be central to the scheme's funding strategy (as it determines the period of maximum investment risk and is a key consideration when setting recovery plans). There is therefore a risk that it could become a major point of dispute between advisers and/or employers and/or trustees. Unless there are specific circumstances, such as an employer's reliance on a fixed-term contract or price control period (for utilities), any assessment must, by definition, be very subjective. It is questionable therefore whether

an advisor could say with certainty that the period of reliability should, or can, be a specific period. It is also conceivable that advisers will seek to caveat any opinion. A range for a period of reliability would seem an appropriate measure.

- the definition of the period of longevity is also straightforward. However, it is not particularly evident as to how trustees can draw the distinction between the period of reliability and period of longevity. Those trustees who are lay trustees or undertake management roles at the employer may also see no reason why the employer would not be around to support a scheme at any particular point in time.
- except for where the period of longevity ends before the relevant date, the exact function of the period of longevity within scheme funding strategy is not clear.

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

10. We understand that specific guidance on assessing the employer covenant is to be issued shortly. It would have been helpful to have had that guidance at the same time as the consultation, so that a full response could be provided on all covenant-related matters.
11. With the proposed shift away from covenant gradings to a series of individual metrics/pillars for covenant assessment, we think it would have been useful for trustees (and advisers and employers) to have had sight of worked examples, showing how the various metrics/pillars will be calculated/valued and how the interplay between them will operate.
12. We generally agree with the basis on which an employer's free cash flow should be assessed, although we suggest that this will again be subjective, as between parties.
13. We comment:
    - Why is there reference to 'reasonable operational costs'? Is there a suggestion that trustees (and advisers) should challenge the reasonableness of operational costs?
    - Is replacement capex deductible as that enables a status quo as opposed to sustainable growth?
    - It is proposed that investment for sustainable growth should be excluded from the calculation of free cash flow. Why? - given that enhancing the employer covenant may improve the security of members benefits.
    - It is proposed that DRCs to other schemes should be excluded from free cash flow. Why? – as such payments will be under existing recovery plans and are therefore 'committed'.
    - There is no reference to liquid assets whereas this is specifically noted when assessing cash for recovery plan purposes (para 298)
    - More guidance would be welcome as to a) how sponsors should allocate free cash between multiple schemes and b) how trustees of different schemes should determine whether this reasonable.
    - It is suggested that in some circumstance trustees should make adjustments to forecasts (eg, to apply sensitivity analysis to assumptions and to consider the impact of transfer pricing arrangements etc.) Why? - if an employer's cash flows include the effect of transfer pricing agreements (which are tax approved), then those are the cash flows available to support the scheme. Why should the maximum supportable risk be increased to a level which is not supportable by the sponsor's cash flows.
    - The guidance states that, where forecasts are unavailable, it may be appropriate to use EBITDA or other proxies for cash flow, or to use average cash-flows where an employer's business is cyclical. This implies that it is acceptable to use historical information as a proxy for future information (where there is no line of vision) and to use that information to determine reliability and the maximum risk test. This seems to be totally at odds with the detailed approach expected where forecasts are available.
    - Historically a sponsor with no forward-looking information would probably have had its covenant grading lowered given the emphasis on covenant being forward-looking; this

approach seems to ignore the covenant risk inherent in having no forward-looking information.

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

14. A sponsor's prospects are central to its longevity. We agree that trustees should consider a wide range of factors when assessing this component of the employer's covenant.
15. We comment:
    - The draft Regulations list the matters to be considered when assessing the financial ability of the employer to support the scheme. These include the cash flow of the employer, the likelihood of an insolvency event and "other factors which are likely to affect the performance or development of the employer's business, as set out in a Code. We assume the 'other factors' are covered by paragraphs 144-147 of the Code, although it is unclear why the risk of employer insolvency (and its potential outcome) is included in 'other factors' whereas it is a specific point in the Regulations; given this has long been an issue of proportionality (in terms of being undertaken at all and to what level of detail when it has been undertaken), we think further clarity is required here.
    - Paragraph 143 of Code refers to the reliability of cash support post visibility being determined as part of the trustee's assessment of employer prospects. However, in paragraphs 144-147 no reference is made to reliability of cash support or how the employer's prospects tie into the reliability period. Reference is however made to prospects informing the trustees' view on the maximum period in which trustees can reasonably assume that the employer will remain in existence to support the scheme, ie, the employer's covenant longevity.
    - The approach prescribed by the Code will, if followed in its entirety, require work to be undertaken that will be significantly greater than that which is currently undertaken by trustees and/or advisors who are taking a proportionate approach to covenant analysis. Greater clarity needs to be provided as to proportionality and what will be acceptable.
    - A step-change in the depth of analysis that is required will have major cost implication for schemes and sponsors; those costs may then increase given the subjectivity of the various metrics which will likely lead to unnecessary discussion and disagreement.

21. Do you agree with the principles we have set out for contingent assets, ie, that i) it is legally enforceable and ii) it will be sufficient to provide that level of support? If not, what would you suggest as an alternative?

16. The principles set out are helpful. It is important that trustees understand how they can access value in a contingent asset and what value that contingent asset will have in a scenario where it is needed to support the Scheme. However, the statement that only these contingent assets can contribute to covenant strength potentially excludes other types of support accessible by trustees and which can provide value in certain scenarios.
17. For example, this might include: intercompany agreements in complex multi entity groups, parent company guarantees which might only have value in some insolvency scenarios, contingent assets which provide support for a period only and asset backed funding structures; the lack of reference to the latter arrangements may cause confusion.
18. There should be flexibility within a principles-based approach for all types of additional covenant support beyond the employer to be considered and to be allowed to contribute to strength in the consideration of covenant.
19. There is a risk that a too narrow or restrictive approach to this might discourage some types of covenant support from being provided when their provision would be covenant enhancing and better than the alternative of no additional support.

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

20. We agree that the approach set out for valuing security arrangements is reasonable. It should also be proportionate. For example, a full estimated outcome statement considering multiple entities of a global group may not be proportionate if the group is strong and assumed to continue as a going concern, however an asset which has a volatile value may need to be assessed more frequently than every third year.
21. We would note that the draft Regulations and Code allow additional contribution to covenant strength from security arrangements, but limited credit for balance sheet strength without security. This distinction risks being unfair and fails to recognise why company directors would not wish (from a commercial perspective) to take steps to grant security in favour of, and prefer, a sponsor's pension scheme to any other creditor, for example in circumstances where:
    - the sponsor has a resilient debt-free balance sheet: granting security to the scheme would be seen as a negative by its suppliers, creditors, insurers etc
    - where the sponsor has a resilient balance sheet but with unsecured lender debt; such facility agreements will likely contain negative pledges, whereby the lender would require prior ranking security in the event a scheme were to be granted security – again a negative for other stakeholders.
22. It is particularly concerning that this may also make it harder to argue that transactions that weaken the balance sheet (where there is no security) are detrimental to covenant and potentially undermines the employer insolvency test in such circumstances which considers recoveries to the scheme from both secured and unsecured assets and wider support.
23. It would be helpful if the guidance provided by TPR and the PPF is consistent so that trustees are not required to value security arrangements in different ways for different purposes.

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

24. The broader guidance on valuing guarantees appears reasonable. As noted in Q22, it would be helpful if the guidance provided in this respect was consistent between TPR and PPF albeit noting the different timeframe of consideration of guarantees by these organisations.
25. We understand the value of a "look through" guarantee to a scheme in circumstances where an employer has limited affordability and the risk of additional cash requirements are substantial and beyond its means. However, we believe that these arrangements are, and will be, relatively rare as the intention of most guarantors is not to be seen as an employer or quasi-employer, but to support a scheme when its sponsor is unable to meet its obligations.
26. The suggestion that they are preferable needs to be considered in the context of the implications of such a structure. For example, it risks not only devaluing the common form of S75 guarantee (often in the PPF format) which enables an unfettered claim to be made against the guarantor for non-payment of a contribution through to the s75 debt on insolvency, but actually deterring guarantors from providing such guarantees (which provide considerable enhancements to covenant).
27. We would also point out that it could be interpreted that a director of a sponsor is being asked to sign a schedule of contributions which is only affordable because of the cash available from the guarantor. In this situation, if the commitment to fund is perceived to be outside the sponsor's capability, there might be issues in relation to directors' duties. All that is required if, for example, the covenant might ordinarily be deemed 'strong' due to such a s75 guarantee, is to ensure the recovery plan length aligns with a 'strong' covenant which is very different from assessing the guarantor for affordability purposes.

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

28. In principle we agree with the approach although we would suggest that the list of matters to be considered should also include the difference between associated and non-associated multi-employer schemes. It would also be helpful to have some guidance on the practical implications of the various matters listed that might impact trustees' decision-making. We assume this will be included in the forthcoming covenant guidance.

25. Do you agree with the approach we have set out for not-for-profit covenant assessments? If not, what would you suggest as an alternative?

29. We welcome the inclusion of additional guidance in relation to the approach to assessing covenant of NFP entities. However, it is unclear what the definition of 'material' is for NFPs whose activities include both commercial operations (normally undertaken by a non-employer subsidiary with profits potentially covenanted to the sponsor parent) and are funded by donations (or other discretionary income/subscriptions).

30. We comment:
    - We agree that where an NFP's activities include material commercial operations then these should be reviewed in line with guidance elsewhere in the Code.
    - Where the sponsor is an NFP, when assessing the cash flows available for the scheme, trustees and their advisors will need to consider the amount of cash that the organisation could reasonably allocate to activities relating to its core purpose. Much of this expenditure could be considered discretionary, when compared to other cash outflows and therefore represents a cash outflow that might be considered available to the scheme. However, unless an NFP is able to fulfil its stated aims then its longevity will be threatened.
    - It would be helpful if the Code could recognise this challenge explicitly, as well as the need for NFP's to maintain reserves within their stated reserves policy, and state how trustees should take into account such expenditure when assessing cash flow.
    - Many NFPs hold substantial liquid investment assets that could be available to supplement operational cash flows and support the pension scheme. The Code does not make specific reference to how these should be treated. Further guidance would be helpful to inform not only the trustees' assessment of covenant strength, but also their consideration of affordability, supportable risk and recovery plan length.
    - Although qualitative considerations (such as reputation and governance) have merit, the requirement to take into account the "competition for income from other organisations" is very wide ranging.

27. Do you agree with the way in which we have split the journey plan between the period of covenant reliability and after the period of covenant reliability? If not, what would you suggest as an alternative?

31. Generally, we agree with approaching the strategy by reference to a period of reliability but we note the subjectivity issue raised in Q18.

32. However, if covenant reliability is rolled forward at each valuation (if justifiable), the end date of covenant reliability and the relevant date may converge, pushing out the date that trustees de-risk to being at, or close to, the significant maturity of a scheme. Generally, it would also be helpful to highlight in supporting guidance how various contingent arrangements could be incorporated into covenant reliability considerations and reflected in different journey plans. It is acknowledged that contingent assets are relevant to assessing covenant reliability, but this link is not made here – can you clarify?

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

33. We agree:

- it is helpful to codify the nature of the relationship between covenant and investment risk.
- undertaking a stress test on the scheme's funding level is a generally accepted method to consider the potential impact of the scheme's investment strategy on funding and the potential requirement on the sponsor to provide additional financial support.
- the impact should be considered in terms of a scheme's overall funding level rather than the absolute impact.
- a better funded scheme should have more latitude to take investment risk than a less well funded scheme where both benefit from the same level of sponsor support. However, we believe this distinction could be set out more clearly in the Code itself.

34. We recognise TPR's desire to establish a simple and proportionate measure for the application of a stress test, particularly for smaller schemes, and that 1-in-6 VAR represents such a measure and may be a more proportionate approach for smaller schemes.
35. However, we are concerned that the use of a single measure such as VAR, when used in conjunction with the 'maximum risk equation' (see further comments in Q30), could turn IRM into a formulaic exercise that over-simplifies the investment, covenant and funding risks to which the scheme is exposed and risks eliminating the ability for judgements to be made and reasonable conclusions to be reached, especially in distressed situations.
36. We note that 1-in-6 VAR is the minimum measure to be adopted. However, there is a clear risk that this will become the only stress test adopted by most schemes.
37. We believe a more flexible, principles-based process should be endorsed as the primary approach for all schemes. This would give trustees a range of methods to consider downsides, which may in turn allow a more focused approach to covenant, concentrating on the key risks identified.

29. Do you agree that if trustees are relying on the employer to make future payments to the scheme to mitigate these risks, then the trustees should assess the employer's available cash after deducting DRCs to the scheme and other DB schemes the employer sponsors?

38. The stress test seeks to consider the extent to which the employer may be able to fund additional funding stress beyond its current commitments. We agree therefore that contractual obligations to pension schemes should be deducted from any assessment of free cash flow, in the same way as other ongoing contractual obligations.
39. This should include any contingent obligations to the scheme(s) that might arise based on forecast performance (eg, performance related pension contributions).
40. We would also note that scheme funding downsides could be inter-linked with downsides experienced by the sponsor and/or other pension schemes it supports – which could create additional demands on cash flow and reduce the level of cash availability to support additional DRCs. All relevant parties might benefit from more clarity in the Code or related guidance as to how such scenarios might be considered.

30. Do you agree that this approach is reasonable for assessing the maximum risk that trustees should take during the period of covenant reliability?

41. We have significant concerns over the adoption of a formulaic approach to establish the boundaries of IRM, as appears to be the case with the proposal to set the maximum level of investment risk by reference to affordability, reliability and contingent assets.
42. As noted in Q28 above, the use of the proposed maximum risk equation could turn IRM into a formulaic 'box-ticking' exercise that over-simplifies the investment, covenant and funding risks to which the scheme is exposed.
43. The reduction of IRM to the component parts of a simple formula (based on subjective and inherently judgemental inputs) could also significantly reduce the level of interaction between scheme advisers and the benefits (for members and in terms of costs over the longer term) of working together to consider holistic risks and the 'sense check' this brings. The three

elements of covenant – affordability, reliability and contingent assets - for example, could be considered entirely independently of any scheme metrics other than DRCs.

44. Further, many funding negotiations are already the subject of challenge over each proposed actuarial assumption. The creation of a funding formula based around component parts of affordability, reliability, contingent assets and 1-in-6 VAR (all of which can be considered subjective in their own right) creates more areas for disagreement between trustees and sponsor directors and will reduce the ability to consider risks holistically. It may also put pressure on trustees to adopt the maximum level of permitted risk, in order to minimise the contribution demands on sponsors.

45. Whilst we acknowledge the formula may have benefits to TPR for the purposes of clarifying an acceptable level of investment risk by reference to covenant (and is therefore a useful example for the purposes of regulation) we consider that the Code should (in line with its general thrust) emphasise the value of a principles-based approach, rather than a formulaic one.

46. Such an approach would ensure schemes have the flexibility to adopt a scheme specific and holistic approach to IRM, rather than via the application of an overly simplistic mathematical equation, based on subjective and inherently judgemental inputs. It would also ensure that schemes do not waste valuable resources in applying a formulaic approach when not required – for example where covenant is clearly strong enough to cover the level of risk trustees intend to take, or where covenant is clearly insufficient to support the level of risk required.

47. In our view there are also some fundamental issues with the maximum risk formula:
    - The formula requires trustees to establish a single figure for each of affordability (£s), reliability (years) and 1-in-6 VAR, despite each being hugely subjective and open to interpretation and argument.
    - The proposed approach of requiring a comparison of affordability to an annualised stress test means that the impact of changes to either affordability or reliability could create significant additional exposure to investment risk.
    - It is unclear from the formula whether the minimum stress test is the absolute 1-in-6 VAR, or whether it is the deficit arising from a 1-in-6 VAR event; presumably the latter.
    - It is unclear whether liquid assets are included within affordability, and if they are, whether they should be compared to an annualised stress test.
    - It is unclear how different types of contingent assets should be reflected in the stress test, particularly where they would not deliver additional cash to the scheme in a downside funding event (for example, and insolvency only guarantee).
    - It is unclear how the formula would apply to multiple employer schemes.
    - Schemes supported by sponsors that are not stressed, but cannot meet additional DRCs (ie, have zero affordability, for example due to negative cash flows or DRCs that already exceed cash flows) would not be permitted to take any investment risk at all.
    - A reduction in DRCs would have the effect of increasing affordability, thereby permitting more investment risk.

48. In addition, there are three highly subjective figures (affordability, reliability and contingent assets) which will justify the maximum level of investment risk. There will probably be circumstances where the application of the formula will result in a higher level of investment risk than is currently the case and this may not be in the members' interests.

49. The decision to take investment risk based on an assessment of future financial performance should not be taken lightly and the importance of judgement and appropriate prudence should be emphasised – the adoption of a formulaic approach runs the risk that such judgement will be circumvented. We should add that the judgement can be with or without the appointment of an independent covenant adviser, but clearly trustees need to assess the specific circumstances, their knowledge and independence and the points we have raised in paragraph 46 above.

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

50. Yes, but note Qs 18 and 27. We also think that, for schemes where covenant longevity is a concern, there should be consideration given to whether a scheme should adopt a higher funding target, over and above being fully funded on a low dependency funding basis.

Recovery plans

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

51. We believe the extended scope of the wording set out in the draft Code is of itself helpful, given the literal interpretation of the wording of draft Regulation 20(8):

    '…… trustees or managers must follow the principle that funding deficits must be recovered as soon as the employer can reasonably afford.'

    may lead to unintended consequences, with employers having to make greater deficit contributions (and as a result be subject to shorter recovery plans) than may be either appropriate or necessary. This may end up being to the detriment of the employer and, in turn, scheme members.
52. Affordability is a key consideration when determining an appropriate recovery plan but there are other factors that trustees may wish to take into account, such as a scheme's ongoing journey plan and the preferences and/or objectives of the employer.
53. Whilst generally supportive of steps taken to improve the security of members' benefits, we do not believe that the draft Regulations should be restrictive and require a 'one size fits all' approach. The principle of repaying a deficit as soon as an employer can 'reasonably afford' has been part of TPR's approach to covenant since its early inception. However, this was removed from TPR's Code of Practice on Funding in 2014 and TPR has been subject to an objective of 'minimising the impact on sustainable growth of an employer'. This has enabled trustees and employers to take advantage of flexibilities aligned to a scheme's specific circumstances. It has in particular enabled trustees to have regard to the competing interests of an employer's other relevant stakeholders, whilst ensuring the scheme is treated equitably, when determining the level of deficit contributions payable and the length of the recovery plan.
54. We therefore see the extended scope of the 'reasonable affordability and pace of funding' wording in the draft Code as generally helpful in providing a steer as to TPR's interpretation of the draft Regulations. However, we remain concerned that, in the event of strict interpretation of the draft Regulations, the wording/guidance in the draft Code may not enable that flexibility unless there is some revision to the wording of the Regulations.
55. The 'reasonable alternative uses' is referenced as TPR's third step in how trustees should determine the level of contributions that an employer can reasonably afford, having already (at steps 1 and 2) assessed the 'employer's available cash' and the 'reliability of that available cash'. We have previously noted our views on the subjectivity and risks associated with such formulaic calculations.
56. In particular here we would note (at para 298) that assessing available cash covers the aggregation of the employer's free cash flow (as defined in the covenant section of the Code) AND the employer's 'liquid assets' – defined for this purpose as balance sheet assets (after reasonable working capital requirements) that can be readily converted into cash, including for example: cash balances, intercompany debtor balances relating to pooled/swept cash, proceeds of debt or equity raises… to the extent not already factored into cash).
57. As previously noted, there is no reference to 'liquid assets' in the covenant section of the Code, with specific reference in the covenant section to the trustees' assessment of 'free cash flow' being primarily based on management forecast cash flow information, not certain 'cash related' assets which may form part of an employer's balance sheet.

58. It is unclear to what extent trustees should take account of such balance sheet assets (assuming they are not retained to offset debt in which case we assume they would not be taken into account), given the historic nature of certain group strategies. For example, there is a significant difference between the available cash generated on an annual basis (current and forecast) and what may have built up over time and been used to finance wider group operations via cash pooling/sweep, as opposed to being used for deficit contribution purposes. We anticipate the forthcoming covenant guidance will clarify this.

59. The ‘reasonable alternative uses’ wording enables trustees to determine if any of the ‘available cash’ could reasonably be used by the employer, other than for DRCs.

60. We believe the three alternative uses identified (investment in sustainable growth, covenant leakage and discretionary payments to other creditors) are reasonable and would likely capture most of the circumstances where the interest of an employer’s competing stakeholders and fair treatment are concerned.

61. We have these further comments:

- The discretionary payment use could be extended to ‘stakeholders’ and not ‘creditors’; whilst ‘special’ dividends and intra-group loans would presumably be caught under ‘covenant leakage,’ it is possible that other parties who are not creditors could receive discretionary payments (eg, loans to third parties, speculative investments, payments to other DB schemes over and above an agreed schedule of contributions etc)
- Transformative investment or M&A would not be specifically covered by the ‘reasonable alternative uses’ as this would not necessarily be designed to be an investment in the sustainable growth of the employer, more a ‘step change’ in its (and the wider group’s) circumstances; in our view this would be a reasonable alternative use (subject to its separate consideration as a ‘transactional activity’ and assessing material detriment in the usual manner).
- The level of ‘available cash’ may not be flat over the period that trustees consider ‘available cash’ to be ‘reliable’, given fluctuations in underlying cash flows and risks; a single number will obscure all the nuances of those underlying cash flows and risks that are gained through qualitative commentary – see also Q30, above, highlighting our concerns over the use of ‘single figures’ for affordability and reliability.
- In our view there should be some further commentary on ‘not for profit’ entities given the need to consider the purposes of the charity, restricted and designated funds, need for compliance with reserves policy etc.
- Certain entities are subject to legislative requirements in relation to dividends/distributions so any view of reasonable alternative uses would need to take account of this and consider any excess over and above statutory levels.

62. Of concern also is that trustees, in considering the reasonableness of the ‘reasonable alternative uses’ included in an employer’s forecasts, either find themselves going beyond their role and end up seeking to direct how management run the employer’s business or having to exercise considerable judgement in coming to an outcome on the reasonableness of the ‘reasonable alternative uses’. In extreme circumstances there could be a risk of them being seen as ‘shadow directors’. There is no issue with an approach of challenge and understanding relevant cash flows relating to (for example) sustainable growth investment (and seeking some ‘quid pro quo’ in return) but trustees would need to be mindful of not being perceived as driving management decisions. This could lead to unintended and unnecessary confrontations between sponsors and trustees.

40. Do you agree with the description in the draft Code of the interaction between the principle that funding deficits must be recovered as soon as the employer can reasonably afford and the matters that must be taken into account in regulation 8(2) of the Occupational Pension Schemes (Scheme Funding) Regulations 2005?

63. As noted in Q39, we view affordability as the key consideration, but are of the view that the additional scheme related matters, such as those outlined in Regulation 8(2), remain of relevance to trustees when determining an appropriate recovery plan.

64. The principle of ‘reasonable affordability’ is not in our view a new one in practice, with the term ‘reasonable’ allowing trustees to take account, and employers to take advantage, of flexibilities to fit a scheme’s specific circumstances.

65. The draft Code seeks to give primacy to "reasonable affordability” as it states these matters are ‘subject to the overriding principle that the deficit must be recovered as soon as the employer can reasonably afford’.

66. It could (as an unintended consequence) become the only driver if the proposed amendment to Regulation 8 of the Occupational Pension Schemes (Scheme Funding) Regulations 2005 is made.

67. For example, our interpretation of this statement is that for very strong covenants, the draft Regulations would require any deficit to be recovered immediately (effectively upon signing of the recovery plan), which is contrary to current practice where many strong employers would seek to spread contributions over a reasonably short period for which there remained a very high confidence of receipt. It also potentially puts pensions funding in conflict with other regulatory bodies, such as Ofgem which expressly provides for such spreading of contributions for regulated utilities which are typically viewed as very strong covenants.

68. We are concerned that requiring immediacy of contributions irrespective of covenant strength would result in a very significant short-term deviation of funds from capital investment programmes, thereby having a potentially material impact on the longer-term sustainability of the sponsor and, more widely, UK economic growth. Where the covenant can underwrite the risk of spreading these contributions, it is not immediately clear that there is any significant value to a scheme of requiring this immediacy of repayment, whereas the broader economic consequences could be significant. Furthermore, the requirement could disincentivise employers from agreeing to a more prudent funding target, if they were compelled to pay contributions over a short time period.

69. In such a scenario, it is arguable that an immediate repayment of the deficit (or very short recovery plan) should, under the Regulations, be the Recovery Plan and consideration of the other matters in Regulation 8(2) would seem to be irrelevant. Trustees would then find themselves in a situation where, effectively, they apply no weight to any of the matters in Regulation 8(2), because they are irrelevant once they have applied the ‘reasonable affordability’ principle.

70. We would also note that, for some schemes, the primacy of affordability of contributions by the employer does not fully take into account broader affordability considerations such as for:
    - shared-cost schemes (ie, where members also contribute in an agreed proportion); and
    - non-associated multi-employer schemes where there are many employers with varying levels of affordability.

71. We think “reasonable affordability” should be included in Regulation 8(2) as one of the matters that trustees should take into account when determining a recovery plan. If, however, the draft Regulations remain as drafted, TPR should provide a more detailed explanation of how the principle and the matters in Regulation 8(2) interact, as this is not entirely clear from the draft Code.

72. The draft Code (at para 305) provides some guidance to trustees of the factors they should consider when determining the reasonableness of alternatives uses for available cash. These however do not refer to, and are distinct from, Regulation 8(2). If reasonable affordability is retained as an overriding principle, the matters in Regulation 8(2) remain relevant factors when considering potential alternative uses for available cash. By their omission from para 305, it is not clear whether this is how the matters in Regulation 8(2) are intended to interact with the overriding principle.

73. We note the consultation on TPR’s regulatory approach and Fast Track is being treated separately from the consultation on the draft Code. In our view, the overriding principle that

deficits must be recovered as soon as the employer can reasonably afford does not seem to sit comfortably with the 6-year recovery plan target under Fast Track. We do not have any objections per se to the length of such a recovery plan, but for this to work with the Regulations we consider that reasonable affordability would need to be included in Regulation 8(2) and not as an overriding principle.

74. Finally, we would also question how this proposed overriding principle interacts with TPR's statutory objective to minimise any adverse impact on the sustainable growth of an employer, albeit recognising the proposed carve outs to 'affordability' for investment in sustainable growth.

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

75. We agree that the trustees' assessment of reliability of available cash is one factor to be incorporated into discussions over the length of the recovery plan. We recognise that, under the draft Code, it is a key element of the trustees' assessment of the employer covenant and affordability of contributions (albeit as set out in Q30 and others above, we have concerns over the adoption of a 'single figure' period for reliability, given its subjectivity).

76. However, various other factors should be taken into account, such as the reasonable alternative uses of cash. We would also note 'available cash' may not be flat over the period that trustees consider 'available cash' to be 'reliable', given fluctuations in underlying cash flows and risks.

77. Schemes may well face a range of circumstances, including constrained affordability, so it is important that trustees are given the flexibility to agree a recovery plan that they consider appropriate in all the specific circumstances. For example, where affordability is constrained, it may be necessary to extend a recovery plan beyond the period of reliability. Similarly, trustees may be comfortable in allowing a longer recovery plan period if adequately supported by contingent assets, such as guarantees or ABC funding structures.

42. Do you agree with the principles we set out when considering alternative uses of cash? If not, which ones do you not agree with and why? What other principles or examples would it be helpful for us to include?

78. We have assumed this question refers to contents in paras 307-320. We comment on those principles in turn:

- para 307 – *the lower the funding ratio, the less reasonable it will be to use available cash for discretionary payments or to effect covenant leakage* – generally we agree deficit contributions should be prioritised here.
- para 308/309 – *the more mature the scheme, the greater the need for available cash to be paid to the scheme in the near term* – we agree such a scheme would have less time for investment returns to redress changes to the employer covenant and consequently, discretionary uses that reduce liquidity in the short term could be of heightened concern. However, we would also note less mature schemes would expect to be reliant on the employer covenant for longer (with the employer covenant also underpinning investment risk) and consequently would also be concerned about discretionary payments, particularly where such payments might be expected to impact the sponsor's prospects.
- para 310/311 - *available cash should not be used for discretionary payments or to effect covenant leakage where this would require DRCs to be paid after the period in which available cash is considered reliable* - we agree that using available cash for discretionary payments or to effect covenant leakage, where it would result in DRCs extending beyond the reliability period, could be of concern to trustees. However, we make the following observations:

- we have a fundamental concern that leakage and discretionary payments are examples of 'corporate events' and should therefore be addressed as transactions (and subject to that guidance) rather than here.
- the counter view of the concept is that discretionary payments that do not result in DRCs extending beyond the reliability period are by implication, permissible. Taken together with the point raised above, this potentially sets an unhelpful precedent for transactions, which should be considered on their own merits.
- the draft Code does not differentiate between regular cash outflows (eg, a consistent dividend policy) and material one-offs (eg, a special or one-off dividend). As highlighted above, we consider that the latter typically represents a 'corporate event' and should be considered on its own merits.

- paras 312/313 - *allocation of available cash between DB schemes sponsored by the employer should be fair considering the position of those schemes* - where an employer has obligations to multiple pension schemes, we agree that in most circumstances it should seek to treat those schemes fairly, reflecting the specific consequences of those schemes. However, we are conscious that where there are fundamental differences between schemes (eg, size, finding level, industry schemes) it may be appropriate to treat schemes differently in a way that could look 'unfair'; for example, making a discretionary payment to buy out a small competing scheme.
- paras 314 - 317 - *investment in the employer's sustainable growth will be a reasonable use of available cash where the trustees are confident of resulting benefit to the scheme and employer* – generally, we agree that sustainable investment is reasonable where it is expected to benefit or maintain the employer covenant during the timeframe in which the scheme will rely upon it.
- para 318 – *guarantors* – generally, we agree it is reasonable to include the guarantor in any affordability assessment where the guarantee is a 'look through' one in nature and extends to all the employer's obligations (note this should be read in conjunction with our other comments on 'look-through' guarantees).
- para 319/320 – *employers' obligations* - generally we agree that employers should provide sufficient information for trustees to assess affordability, including alternative uses of cash (as defined or otherwise).

79. We consider the following further examples/principles could be included:
    - In the spirit of proportionality, we would suggest that, where the employer covenant is very strong (eg, large sponsor/small scheme) and there is a very short recovery plan (say 3-years or less), the Code includes some allowance for those sponsors to be able to allocate capital as they see fit, so that the trustees and the sponsor do not need to undertake a review of, or justify, cash being distributed by way of 'reasonable alternative uses'; this would exclude 'material events' such as one-off dividends, transformational change etc.
    - Some guidance around the retention of cash/liquid assets as a 'reasonable alternative use'.

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

80. No, as noted in Q21, too restrictive an approach could limit the ways that contingent asset structures could be used to manage and mitigate against risk.

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

81. The expectations set out for trustees with stressed employers are broadly in line with existing guidance and we generally agree with these.

82. However, para 334 highlights that “if trustees take unsupported investment risk in this scenario the scheme’s technical provisions should nonetheless be calculated in accordance with…”. We think there is an opportunity here (where it is a weak covenant) to highlight that increasing prudence in technical provisions for example to target achieving being more than fully funded on a low dependency funding basis may also be appropriate.

83. To the extent that para 335 implies that trustees should not take account of PPF ‘drift’ then we suggest the Code makes this a matter that trustees should take into account when considering stressed schemes.

ICAEW RESPONSE TO CONSULTATION ON ‘FAST TRACK AND OUR REGULATORY APPROACH’

84. This response covers consultation questions 1-3 and 5-7 which are those to which the issue of covenant is most relevant.

85. The main concern is that the Fast Track approach is explicitly based on a set of parameters which exclude covenant, essentially for the purposes of simplicity. This is not only a major shift with potentially severe risks to the PPF and the overall pensions landscape, but it is also inconsistent with the embedded position of covenant in the draft Regulations, draft Code and proposed Statement of Strategy.

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

86. We note that Fast Track is now positioned as separate from the Code so that it can changed periodically as necessary, without requiring an amendment to the Code. We agree with this strategy. However, we believe it should be emphasised that covenant is a key consideration for Fast Track compliant schemes, and that the Statement of Strategy must include an assessment of the employer covenant and supportable risk.

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

87. We note that the consultation describes Fast Track as ‘one possible approach that aims to provide trustees with a simpler path to demonstrating compliance’ than Bespoke, and as representing TPR’s view of tolerated risk for a scheme; it does not represent minimum compliance. It is described as a tool by which TPR ‘filters’ TPR interventions. If a scheme meets all the Fast Track quantitative parameters, TPR is unlikely to scrutinise an actuarial valuation further.

88. Such descriptions are helpful. One concern that arose from the initial consultation on the draft Code was that Fast Track would be viewed by TPR as its preferred default option. While it is noted in this consultation that this is not the case, it would also be helpful if TPR could make it clear that there will be no regulatory preference for either approach and that it remains open for trustees to adopt either approach at each actuarial valuation.

89. Further, we believe it would be useful for TPR to explicitly state that, in some cases, more prudent assumptions may be appropriate (for example with a weak covenant) and give examples of where a trustees’ assessment of covenant may lead them to conclude that adopting principles in line with Fast Track is not appropriate.

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

90. Fast Track is presumably intended to reduce the regulatory burden on schemes adopting this approach and to enable TPR to allocate resources more efficiently. It therefore makes sense that Fast Track should come with such a lower level of burden, provided there is sufficient data available as required by TPR, for example to identify those schemes where Fast Track may not be appropriate (such as those with a weak covenant).

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

91. No comments made.

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

92. Fast Track does not provide for a stated level or range of covenant strength within its parameters or otherwise provide for covenant to be taken into account in the discount rate – even for very weak or very strong covenants.

93. Various rationales are given in ‘Practical considerations’ for this:
    - in recent (post tranche 10) valuation submissions the relationship between the strength of the employer covenant and the nominal average discount rate ‘no longer seems to hold’. We find this argument weak since the data presented from tranche 7-9 valuations does show this relationship and there may have been other reasons for lower correlations in post tranche 10 discount rates. It supports the argument that covenant may not be consistently incorporated in discount rates, meriting further investigation into actuarial practice, but does not support the argument that covenant should not be incorporated in discount rates.
    - Levels of DRCs as a percentage of TPs liabilities do not tend to vary by covenant grade: in practice, negotiations around affordability are highly scheme specific and cannot be reduced to such a direct relationship.
    - Employer covenant strength itself is stated to be volatile and to change over time, which is correct; but this does not support the argument that schemes cannot therefore maintain a consistent funding target over time; if this was the case then there would not be a case for Bespoke funding.
    - It simplifies the approach by focusing on cash funding and investment risks ‘irrespective of covenant assessment.’ TPR acknowledges that this could be seen as a departure from current guidance and regulatory approach; indeed, this is a major departure and would be seen as such by all pension stakeholders. It is also conceptually incorrect – for covenant underpins the ability of sponsors to provide cash funding; and it also undermines the whole practice of IRM since those schemes adopting Fast Track will see no reason to adopt it.
    - Fast Track can and will be used by schemes with very weak or very strong covenants irrespective of the regulatory expectation. We do not understand why ‘it would be very difficult to isolate those schemes with a very high insolvency risk’ since this is what TPR expects of covenant assessment under the draft Code.
    - As acknowledged by TPR, Fast Track is a compromise within pre-set parameters. As a practical way forward, we propose that Fast Track should be made more proportionate for schemes in differing circumstances by expressly excluding covenants which are assessed as very weak or very strong.

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

94. We reiterate our introductory comments. Fast Track guidance risks devaluing the place of covenant across scheme actuarial valuations unless appropriate regulatory statements are made in this guidance which focus on the need for Fast Track to follow legislation and Code principles; a key principle given is the need for the Statement of Strategy to include the trustees’ assessment of the employer covenant, informing how much risk the covenant can support.

7. Do you believe it would be useful to include an additional set of parameters for schemes where the employer has a high insolvency risk? If yes, how should schemes in this category be defined and where should the Fast Track parameters be set?

95. It would be useful to allow for schemes where the employer has a high insolvency risk to be excluded from Fast Track altogether, based upon the covenant assessment. If this approach is not taken, TPR should set out clearly that Fast Track may not be suitable for all schemes (eg, if there are concerns over employer longevity or high insolvency risk), provide examples of where this may be the case and how a sponsor could be classified as falling into such a category. Further, we recommend considering a further filtering mechanism whereby additional information is provided to, or expected by, TPR where covenant concerns have been identified. This could be through the Statement of Strategy.