

Consultation document

Defined benefit funding code of practice

March 2020

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Executive summary

Making workplace pensions work is at the heart of what we do, but it is also the job of those who fund and manage pension schemes. It is right that our expectations of those accountable for delivering the retirement outcomes that savers expect are clear and properly enforced. This drives our clearer, quicker and tougher approach to regulating all forms of pension arrangements, including defined benefit (DB) schemes.

In its white paper published in 2018 ('Protecting Defined Benefit Pension Schemes'), the government noted that the DB funding framework is working largely as intended but also acknowledged the need for improvements in some key areas. This included greater transparency and accountability around the risks being taken on behalf of employers and members.

It recognised the need for trustees to focus on the long-term strategic issues for their scheme as the landscape matures. It also highlighted grey areas around how trustees should calculate their scheme's technical provisions (TPs) prudently and set an appropriate recovery plan (RP).

This lack of clarity has allowed a minority of trustees and employers to misuse the flexibilities in the system and has made our job of proving non-compliance and taking enforcement action more time consuming.

The government has introduced new requirements in the Pension Schemes Bill to help address these issues. We are publishing our first of two consultations on a proposed revised code of practice on DB funding to reflect the legislative changes and to provide greater clarity on what is expected from trustees and employers. Based on our experience from reviewing thousands of scheme valuations, as well as ongoing engagement with a wide range of stakeholders in the pensions industry, we have identified some key overarching principles that should stand behind all scheme valuations.

However, we need your input and views on these principles and how they can be applied in practice by schemes. It is important to get this right, as it will determine how trustees, employers and their advisers approach scheme funding and our interaction with them for years to come. We are therefore keen to understand if there are any workability issues or unintended consequences arising from what we propose.

We recognise that some of our proposals are a departure from our current approach but many of the core principles build on our recent messages (current code, guidance and Annual Funding Statements). Having a clear benchmark as a basis for discussions between trustees and employers should help speed up negotiations. Many trustees are also already applying good practice in relation to journey planning and risk management and documenting their approach to these. We therefore do not expect our proposals to be too onerous for most schemes. Greater clarity, particularly about long-term planning, also bring benefit to trustees, employers and members alike and greater transparency can help improve confidence in the system. However, there could be significant impacts for some schemes, particularly those that have been running excessive and unjustifiable levels of risk.

Our statutory objectives require us to protect member benefits and reduce risks to the PPF while minimising any adverse impacts on the sustainable growth of employers in the context of DB scheme funding. Striking the right balance between member security and employer costs is therefore important and we welcome views on whether our proposals achieve this. We will undertake a full impact assessment in our second consultation.

Twin-track approach to scheme valuations

In this consultation, we propose that the revised DB code should set a twin track approach ('Fast Track' and 'Bespoke') for trustees to demonstrate to us that their valuations are compliant with legal requirements. This will give trustees and employers greater clarity within a funding regime which remains scheme-specific.

The Pension Schemes Bill introduces a requirement for all trustees to submit to us a statement of strategy outlining their approach to funding and risk management. This is to provide greater transparency and accountability around risk-taking and trustee decision-making. It will also support twin-track compliance.

Fast Track will be relevant for trustees who can submit a scheme valuation and RP that is compliant with our guidelines. Their valuation submission will receive minimal regulatory scrutiny. Fast Track is expected to ease the process for many well-managed and well-funded schemes, as well as help the trustees of small schemes to understand what they need to do.

Bespoke will be relevant for trustees who either choose not to or cannot comply with our Fast Track guidelines (for instance they want to take more investment risk, have affordability constraints or overall have put in place arrangements which are better than Fast Track but do not meet all the guidelines). They will have to submit their valuation together with the statement of strategy and supporting evidence that explain how they meet our principles, the legislative requirements and, where relevant, how any additional risk (assessed relative to Fast Track) is supported. Bespoke arrangements may receive more scrutiny from us, but they are not 'bad' – if done properly, they are equally compliant with the legislation.

Although we are yet to finalise code guidelines and assess their impact, we do not anticipate that the practical consequences of this twin-track approach will be significant. The approach moves us from the current regime where every valuation is 'Bespoke' to a better-defined one, with a significant proportion of schemes likely to adopt the more straightforward Fast Track route, and the Bespoke approach offers more clarity on what good looks like. The submission of more information upfront through the statement of strategy should also enable us to target our resources more efficiently to schemes that require our attention.

Overarching themes

Long-term planning: The Pension Schemes Bill will introduce a requirement for trustees to set a long-term objective (LTO). A cornerstone of this consultation is our expectation that trustees should identify a scheme-specific LTO so that by the time the scheme is significantly mature (15-20 years from now for a scheme of average maturity), it is fully funded on a low dependency basis (potentially in the range of Gilts + 0.5% pa to Gilts + 0.25% pa for Fast Track compliance) and has investments highly resilient to risk. We expect trustees to set a prudent journey plan to the LTO, including an appropriate level of investment de-risking over time. To be clear, low dependency funding will not be required until significant maturity. TPs are stepping stones on the journey to the scheme's LTO.

Employer covenant: We are consulting on the extent to which the employer covenant should remain a key aspect of scheme funding, including how it should be assessed and for how long reliance can be placed on it. We are also consulting on alternative support (such as contingent assets and guarantees) and are seeking views on what reliance should be placed on this support, as well as what characteristics it should have in order to be recognised for funding purposes.

Investment risk: We expect all schemes to take only a level of investment risk that is supportable, and we set out proposals for how trustees could demonstrate whether the risk in their investment strategy is supported (for instance through a simple stress test).

Recovery plans: Where a funding shortfall arises, this should be funded by an appropriate RP. We expect (as outlined in our recent Annual Funding Statements) that RPs should have appropriate length and shape (while minimising any adverse impacts on employers). They should also ensure their scheme is treated fairly compared with other stakeholders.

Open schemes: We also consult on how the framework should apply to open schemes, including our expectation that members' accrued benefits should have the same level of security as accrued benefits in closed schemes. We are also of the view that the accrual of new benefits should not compromise the security of accrued benefits. This does not mean that we are advocating the closure of open schemes.

Future consultations

We will run two consultations. This first one focuses on our proposed approach, our principles and how these could be applied in practice.

We recognise that this consultation document covers a large range of topics and, by necessity, is long and detailed. We have sought to assist the reader by structuring the document into different parts, starting with high-

level discussions, then focusing on application issues. We have included some worked examples (for Fast Track and Bespoke). Questions are highlighted in green at the end of each section and we welcome your views on any that you wish to answer. Details on providing feedback on this consultation can be found in Chapter 1. There is also a companion guide to this consultation which provides an abridged overview of what we are proposing: www.tpr.gov.uk/-/media/theypensionsregulator/files/import/pdf/quick-guide-db-funding-consultation.

Our second consultation, later in 2020, will focus on our draft funding code and will seek views on where regulatory guidelines should be set. The second iteration will be considerably more concise, as this consultation and your responses will have addressed many fundamental issues.

At this stage, we anticipate that the draft code will simply outline the twin-track compliance structure, proposed Fast Track parameters and the principles for those following Bespoke. We will take account of legislative change (Pension Schemes Bill and regulations), responses to the first consultation, prevailing market conditions, schemes' current funding position, and our assessment of impacts. Until this is done, the overall impact on aggregate funding levels cannot be known, but we do not intend that there should be significant increases in deficits across the board.

We currently expect the revised code to come into force in late 2021. We expect robust discussions around both consultations and we welcome a wide range of opinions to ensure that, as the DB funding regime evolves, it is fit-for-purpose for the future.



David Fairs

Executive Director, Regulatory Policy, Analysis and Advice

3 March 2020

Document layout

Part 1: Context

Part 1 sets out the context for this consultation as provided by the DB white paper and the Pension Schemes Bill, our key objectives and how to respond.

Part 2: Theory

Part 2 outlines our proposed new regulatory approach (Fast Track and Bespoke routes to compliance) and covers the theoretical questions to be addressed to develop the code, including insolvency risk and role of the covenant and the key principles we propose should underpin the code.

Part 3: Application (1) Fast Track

Part 3 sets out options for how we envisage the Fast Track route to compliance with legislative requirements could operate in relation to the LTO, TPs, the investment strategy, RPs, and setting TPs and future accruals in open schemes.

Part 4: Application (2) Bespoke

Part 4 covers the situations where trustees decide to prepare a Bespoke funding arrangement. It sets out our proposed assessment criteria using the principles outlined in Part 2, provides some worked examples of Bespoke approaches and discusses how additional support (eg contingent assets and guarantees) could be used.

Part 5: Supporting materials

Part 5 contains supporting material, including worked examples to illustrate how a valuation might work under Fast Track, the evidence and analysis that we have used to develop these consultation proposals, a glossary, and the consultation questions.

Part 1: Context

1. Introduction

TPR consultations

1. The government's white paper 'Protecting Defined Benefit schemes'¹ announced a package of measures to improve DB scheme funding. These measures will be implemented through primary and secondary legislation (the Pension Schemes Bill was introduced in Parliament in January 2020) and a revised DB funding code. The following chapter (Background) sets out the proposals outlined in the DB white paper and the key issues we are seeking to address in greater detail.
2. Our revised DB code will clarify the standards we expect trustees and employers to apply to meet legislative requirements. Greater clarity is required to ensure the flexibilities in the DB funding regime are used appropriately, to embed and drive good practice in relation to the management of long-term risks, to ensure DB schemes' efficient run-off phase, and to support more effective and efficient regulation.
3. We plan to run two consultations to ensure key stakeholders have the opportunity to input their views and to allow sufficient time to develop proposals and a revised code that are fit-for-purpose.

First TPR consultation

4. In this first consultation, we set out our initial proposals for a clearer, more readily enforceable funding framework, which implements the new requirements set out in the Pension Schemes Bill recently introduced in Parliament. We are seeking views on:
 - our proposed approach to the new code (twin-track compliance routes and our approach to prudence and risk-taking)
 - the key principles we propose should underpin the code, and
 - options for how these principles could be applied in practice through more detailed guidelines.
5. In some areas, our views are more defined. In others, we are more agnostic about what the appropriate solution could be. Whatever our views, we are very open to hearing alternative ideas, as we are looking to have as broad a consensus as possible on what 'good' looks like.
6. We welcome comments on any aspect of the proposals in this document. We have provided some specific questions throughout the document (they are also listed in Chapter 18). When thinking about these questions, please consider the following issues:
 - Whether the proposed framework delivers our aims to improve the clarity, objectivity, transparency, and enforceability of the funding regime.
 - Any other ideas on how these aims could be delivered.
 - Risks of unintended consequences and how these could be mitigated.
 - Potential implementation challenges for trustees, employers and advisers and how these could be reduced.
 - The likely impacts on employers, trustees, members and advisers. As we explain in the following chapter, we have not finalised what the code will contain and are therefore focusing on likely qualitative impacts in this first consultation. We will undertake a quantitative impact assessment in the second consultation.

¹ <https://www.gov.uk/government/publications/protecting-defined-benefit-pension-schemes>.

7. We appreciate this is a lengthy consultation. We feel it is necessary to do justice to this complex subject and get sufficient input on the key issues we need to address to set clearer funding standards. We do not expect all respondents to necessarily read the whole document or answer all questions. In particular, many respondents may wish to focus primarily on Part 1 (where we set out the context for this work) and most of Part 2 (where we outline our proposed regulatory approach and the principles which we think should underpin the code). Part 3 and Part 4 (proposed application of the framework through Fast Track and Bespoke routes) address the technical detail. We have also produced a companion guide² to the consultation for those who do not wish to read this document in full or would like to read an overview of the key issues and proposals under consultation first. At this stage, we anticipate that the final code will be shorter and more focused, simply outlining the twin-track compliance structure, proposed Fast Track parameters and the principles for those following Bespoke.

Second TPR consultation

8. Our second consultation later in the year will be on the draft DB funding code itself and the guidelines it will contain, informed by the responses to this first consultation, our impact assessment and any changes to primary and secondary legislation. We will also cover how we intend to regulate DB funding (including enforcement using our powers) and how we propose to ensure the framework and our guidance remain up-to-date. This consultation should be more concise as our first consultation and responses will have addressed many fundamental issues. We also envisage that the code itself will be short and focused.

Engagement with industry

9. Both formal consultations have been and will be supplemented by extensive stakeholder engagement. We have also liaised with actuarial, covenant and investment practitioners to challenge the technical advice provided by our own in-house professionals in developing the consultation.

Timetable

10. The revised DB funding code is being developed in parallel to primary and secondary legislation to ensure a coherent and consistent package. The timing of our consultations and drafting of the code is therefore intrinsically linked to the legislative timetable.
11. Following our first consultation, DWP intends to draft regulations on the detailed requirements set out in the Bill (relating to the funding and investment strategy, statement of strategy and clarifications of terms (eg prudent and appropriate)). This will inform our second consultation on the draft code. We anticipate the new code and associated legislation will come into force at the end of 2021. Our codes of practice are subject to the approval of the Secretary of State for Work and Pensions and are laid in Parliament.

Who this consultation is for

12. We would like to hear from any interested party, in particular trustees, employers, advisers and members of DB pension schemes and their representative organisations.

Closing date

13. This consultation document was published on 3 March 2020. The closing date for responses is **2 June 2020**.

² www.tpr.gov.uk/-/media/thepensionsregulator/files/import/pdf/quick-guide-db-funding-consultation

Responding to the consultation

14. We would encourage you to respond to the consultation by completing the online response form (www.tpr.gov.uk/-/media/theypensionsregulator/files/import/pdf/db-funding-code-of-practice-consultation-questions) available alongside this document on our website. You can also send responses to us by email at DB.Consultation@tpr.gov.uk.
15. Our preference is for responses in electronic format but alternatively, you can post your response form to: Sarah Harvey, Regulatory Policy, Advice and Analysis Directorate, The Pensions Regulator, Napier House, Trafalgar Place, Brighton BN1 4DW
16. If you wish to submit supplementary materials, please note they will be subject to a 20mb limit (any larger documents will therefore have to be sent in batches). If you have any queries about this consultation, please call Sarah Harvey on 01273 349355.
17. We may need to share the feedback you send us within our own organisation or with other government bodies. We may publish this feedback as part of our consultation response. If you want your comments to remain anonymous or confidential, please state this explicitly in your response and we will take the necessary steps to meet your request.
18. However, please be aware that, should we receive a formal request under the Freedom of Information Act, we may be required to make your response available. When responding, please advise whether you are responding as an individual or on behalf of an organisation (and, if the latter, which organisation).

Government consultation principles

19. For the purposes of this consultation paper, we are following the government's consultation principles³. The key principles state that consultations should:
 - be clear and concise
 - have a purpose
 - be informative
 - be only part of a process of engagement
 - last for a proportionate amount of time
 - be targeted
 - take account of the groups being consulted
 - be agreed before publication
 - facilitate scrutiny.

³ <http://bit.ly/ContPrin>.

2. Background

DB white paper and our remit

20. In 2017-2018, the government consulted in a green paper⁴ on a range of measures to help ensure the security and sustainability of DB pension schemes and published its conclusions in March 2018 in the DB white paper.
21. The white paper⁵ concluded that the DB pensions system is not in crisis and most members are likely to get their benefits in full. However, changes were needed to improve its security and sustainability, particularly in recognition that the DB landscape is maturing, with most schemes closed or closing to future accrual. The white paper also stressed that the regime is “designed to respond flexibly to ever-changing conditions, and to provide employers and trustees with a wide range of options in how they manage their pension liability”. However, it also recognised that there were examples of sponsoring employers misusing this flexibility and this needed to be addressed.
22. The white paper identified a range of issues relating to scheme funding (we elaborate on these further in the section below):
 - Trustee decision-making and risk management does not always reflect good practice and our code of practice.
 - Some trustees do not focus sufficiently on the long-term strategy for their schemes and do not anticipate and manage their risks with these long-term goals in mind.
 - There can be a lack of accountability and transparency for trustee actions which can result in poor decision-making and investment outcomes.
 - The lack of clear definition as to terms such as ‘prudent’ (TPs) and ‘appropriate’ (RPs) makes our job of proving non-compliance and taking enforcement action more difficult.
23. To help address these issues, the government announced a range of measures including:
 - TPR to provide greater clarity on the funding standards through a revised code of practice on DB funding, focusing on:
 - “how prudence is demonstrated when assessing scheme liabilities
 - what factors are appropriate when considering RPs, and
 - ensuring a long-term view is considered when setting the statutory funding objective.”
 - Legislative change to introduce new requirements such as a LTO and a DB chair’s statement. Trustees would be required to submit the statement to us and explain “their approach to managing risks to the scheme, including information on how the trustee is meeting the clearer funding standards and how the statutory funding objective (SFO) is being set in line with a long-term funding objective”.

⁴ <https://www.gov.uk/government/consultations/defined-benefit-pension-schemes-security-and-sustainability>.

⁵ See pp 19-28 of https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/693655/protecting-defined-benefit-pension-schemes.pdf.

- Legislative change to “supplement and strengthen” the proposed new DB funding code of practice and to ensure “the Regulator can enforce [the clearer funding standards] or take action in the event of non-compliance (eg through sanctions or fines and improved funding powers putting beyond doubt that it is the responsibility of scheme trustees and sponsoring employers to demonstrate compliance with funding standards or any statutory code)”.

24. The government introduced the Pension Schemes Bill⁶ to Parliament on 7 January to implement the proposals outlined in the DB white paper. The Bill proposes amendments to Part 3 of the Act, including the following:

- A requirement for trustees to determine, review and, if necessary, revise a ‘funding and investment strategy’ to ensure pension and other benefits can be provided over the long term. The strategy must specify the funding level to be achieved and investments to be held. As explained in the Explanatory Notes⁷ to the Pension Schemes Bill, ‘funding and investment strategy’ was referred to as the ‘long-term objective’ or ‘LTO’ in the DB white paper. In this document, we continue to use the term ‘LTO’ as it is commonly used and understood in the pensions industry.
- A requirement for TPs to be calculated in a way that is consistent with the “funding and investment strategy” (ie the LTO).
- A requirement for trustees to prepare and submit to TPR a written statement of strategy (referred to as DB chair’s statement in DB white paper) setting out the scheme’s “funding and investment strategy” (LTO) and supplementary matters. These include the extent to which the LTO strategy is being successfully implemented and remedial steps, main risks to the strategy and how these will be managed/mitigated, and reflections on past decisions and lessons learned.
- A requirement for trustees of all DB schemes that are subject to Part 3 of the Act to send their actuarial valuations to us (the previous requirement was that only schemes with a RP, ie those in deficit, had to do so).
- Amendments to s231 (funding power) to enable us to direct trustees to revise their funding and investment strategy if not compliant.
- Regulation-making powers to allow DWP to make provision in secondary legislation on various matters, including the following:
 - What matters trustees must take into account (including prescribed actuarial methods and assumptions) and principles they must follow when setting their funding and investment strategy, preparing/revising their statement of strategy or determining whether the RP is appropriate.
 - The timings and circumstances for these requirements.
 - The level of detail and form of the statement of strategy.

25. The proposals in this consultation document set out our interpretation of how existing and new Part 3 legislative requirements can be complied with and have therefore been informed by the content of the Bill (see in particular Chapter 5 on General principles). Any amendments to the Bill as it passes through Parliament will be considered in our second consultation on the draft code and in light of any regulations laid by DWP. We are also aware that other possible legislative or policy developments may arise following the Bauer case and Brexit.

⁶ <https://services.parliament.uk/bills/2019-20/pensionschemes.html>.

⁷ <https://publications.parliament.uk/pa/bills/lbill/58-01/004/5801004en.pdf>.

26. Our approach to reviewing our code of practice on DB funding is informed by the policy intent set out in the DB white paper and the new requirements introduced in the Pension Schemes Bill. However, the proposed changes are also in line with our evolving approach and our messages of the last few years. Our current code of practice on DB funding, which came into force in 2014, subsequent supporting guidance (such as Integrated Risk Management (IRM)⁸) and our Annual Funding Statements⁹, already set out our expectations that trustees should take a long-term view and manage risks in an integrated way when planning their approach to scheme funding and investments. Many schemes already apply good practice in these areas (for instance by setting a long-term funding target). Our revised DB code will provide further clarity on what good looks like in relation to these issues, building on our messages of the last few years and existing good practice.

Key issues

27. In this section, we set out the key issues the DB white paper touched on and we are looking to address through our revised DB funding code. Chapter 16 covers in greater detail the evidence and analysis we have used to develop our proposals.

Maturing DB landscape

28. There has been a significant trend over the last decade in DB scheme closures (both to new members and/or to future accrual). Currently, only 11% of schemes are still open to new members and a further 44% of schemes are closed to new members but not to future accrual. Most DB schemes are therefore becoming more mature.
29. As a scheme matures, the growth of pensions that must be paid out increases, which in turn increases the scheme's exposure to becoming 'cash flow negative' and will therefore be more vulnerable to investment underperformance and have shorter horizons to make good any shortfall in funding levels.
30. Many schemes will continue to mature over the next few years, exacerbating the risks associated with poor funding levels and shorter investment horizons. Our key aim is therefore to ensure that trustees of maturing DB schemes can manage their run-off phase effectively and efficiently so that the probability of member benefits being paid in full is increased without unduly affecting the employer's ability to manage and grow its business.
31. The DB white paper considered a range of suitable LTOs for DB schemes, such as:
- running on with employer support (for open schemes)
 - reaching self-sufficiency with low-risk investment strategy and run-off with minimal call on the employer
 - buy-out by a set time, or
 - entering a consolidator vehicle within an agreed timeframe.
32. In line with this thinking, our view is that to improve the resilience of maturing DB schemes and facilitate an efficient and well-managed 'end game' phase for DB schemes, they should progressively reduce their reliance on sponsoring employers as they mature. They should have clear journey plans for how to get to a fully funded, low risk position by the time they have reached a level of maturity such that continuing to remain in deficit could impose additional and unnecessary risks on employers and members. We set out our thinking on this, including considerations around open schemes, in greater detail in Chapter 5 on General principles.

⁸ <https://www.gov.uk/government/consultations/defined-benefit-pension-schemes-security-and-sustainability>.

⁹ See our latest Annual Funding Statement at <https://www.thepensionsregulator.gov.uk/en/document-library/statements>.

Inappropriate use of the flexibilities

33. As the DB white paper recognised, most schemes are well-run and already apply good practice in relation to managing their funding, investment and covenant risks in the context of a LTO beyond the short-term level of funding on a TPs basis. The standards we are looking to formalise more clearly in our revised funding code should therefore broadly be in line with what these schemes already do.
34. However, as a regulator we also see a range of bad practice from poor risk management to inappropriate use of the flexible scheme-specific regime, such as:
- imprudent TPs, ie weak funding targets which assume a level of risk that cannot be supported and result in artificially low deficits
 - double-counting of the covenant: TPs are weak (resulting in lower deficits) because the strong covenant can support more risk while the RP is also long because it is claimed the strong covenant can give trustees more comfort about the affordability of future deficit repair contributions (DRCs)
 - reasonable TP assumptions but an inappropriately risky investment strategy
 - reasonable TPs with RPs overly-reliant on investment outperformance (therefore unwinding some of the prudence from the TPs in the overall funding strategy)
 - unfair treatment compared to other stakeholders such as the trustees being asked to accept a very long RP while significant dividends are being paid out
 - significantly back-ended loaded RPs, which may be pushed out again at the next valuation
 - short-term focus, with closed schemes setting the discount rates based on the current investment strategy with no allowance for any likely future changes in that strategy
 - short-term focus on DRCs over the next three years and lack of contingency planning (banking on higher DRCs being negotiated at the next valuation)
 - reliance on additional support that doesn't provide the comfort it claims to offer (eg a guarantee from a strong company being assumed to provide a strong covenant indefinitely, or reliance on a contingent asset that does not have real value when needed), and
 - trustees unable to justify how the risks the scheme is taking are being managed.
35. We consider that a flexible regime that allows for scheme-specific solutions is important. However, the examples above show that without clear boundaries, it can be misused. In this consultation, we set out proposals for how we could define clearer parameters, which would enable trustees and employers to agree appropriate funding and investment solutions.
36. Equally, many schemes apply good practice (such as setting a long-term funding target and prudent journey plans to reach it – see Chapter 16 on Evidence and analysis) and we would be looking to embed this good practice in the new code.

Lack of accountability and transparency around risk-taking

37. Risk is intrinsic to the DB funding regime and our intention is not to eliminate all risks but to ensure that they are appropriately identified, understood (including how they change over time), and managed. We think greater transparency on trustees' approach to risk-taking, particularly through the statement of strategy proposed in the Bill, could have significant benefits for the following:
- The trustees and members: On the basis that what gets reported gets managed, greater transparency and accountability could help improve risk management practices. This will in turn support better and clearer communications to members.
 - The sponsoring employer(s): Having a clear understanding of the support which the scheme may need helps them better plan for their business without too many surprises.

- TPR: As a risk-based regulator, we aim to be targeted in our interventions and focus on the greatest risks and where we can have the most impact. Greater clarity upfront on the decisions being made by trustees and employers and the level of risk being carried by schemes will support a more effective assessment of the landscape. It will also support more efficient regulation and engagement with trustees and employers.

38. In this consultation (see Chapter 3 on our proposed regulatory approach), we set out our proposals for how trustees could assess risk in a more structured and objective way and for trustees to articulate this assessment in the information they provide to us through the statement of strategy.

Lack of clear standards compromises efficient enforcement

39. The current legislation and regulatory guidance refer to but only provide principles on the concepts of 'prudent' TPs and an 'appropriate' RP. This makes it difficult to take swift, efficient regulatory action where we consider the flexibilities in the funding regime are being misused. There are no clearly understood and agreed standards for prudence and appropriateness, which makes it unnecessarily difficult and time-consuming for us to demonstrate, firstly, that a scheme is not compliant with Part 3 funding and, secondly, what the compliant scheme funding outcome should be.
40. While it is important for there to be a sufficiently 'high bar' to ensure our s231 funding powers¹⁰ are used appropriately and fairly, the lack of clear agreed parameters around what good looks like makes enforcement action around funding unduly inefficient and risks undermining compliance with the law and confidence in the regime.
41. Providing greater clarity on the funding standards in our code (as part of a comprehensive consultation process) and putting the onus on trustees to demonstrate that they comply with their legal obligations and providing this information upfront should help improve the effectiveness and efficiency of DB regulation.
42. Greater clarity will help all schemes better understand how to comply with legislative requirements but will be particularly helpful to the 2,000 or so schemes with fewer than 100 members (representing 36% of schemes but covering only 1% of total membership, assets and liabilities). Typically, these schemes have fewer resources to spend on advice and appear to be less well-governed than larger schemes (see Chapter 16).

We are also evolving the way we regulate so we can be more effective and efficient, more proactive in identifying and mitigating risks, and improve our regulatory oversight. A revised DB funding code will support our objective to be 'clearer, quicker, tougher', as set out in our TPR Future programme¹¹.

¹⁰ Section 231 of the Act gives us the power to set a scheme's TPs, impose an RP and/or schedule of contributions, or modify the rate of the members' future benefit accrual. This power can be used when there has been a failure to comply with the statutory funding requirements, for example when the scheme has put in place imprudent TPs or an inappropriate RP.

¹¹ <https://www.thepensionsregulator.gov.uk/en/about-us/making-workplace-pensions-work>

Part 2: Theory

3. Proposed regulatory approach

Introducing clarity

43. As discussed in the previous chapters, the current wholly principle-based approach has limitations and we think more clarity is needed. Introducing greater clarity presents several challenges that we have considered carefully.

Maintaining the scheme-specific regime

44. The existing regime is 'scheme-specific' as it does not prescribe a single funding standard that must be adopted by all schemes. Instead, it permits trustees to design funding arrangements that are unique to and appropriate for their scheme. The ability of trustees to determine their own funding arrangements is not changing and therefore our revised code will need to strike a balance between clarity and maintaining the scheme-specific regime.

Risk and subjectivity

45. Funding plans are essentially plans for an uncertain future and, therefore, judgement must be exercised, and risks must be taken and managed. The word 'risk' is often used as shorthand to refer to a range of (usually negative or detrimental) potential events.
46. For the purposes of DB funding, we think that the high-level risks can be broadly categorised as the likelihood of the employer weakening or becoming insolvent, investments failing to perform as expected, changes in economic conditions leading material movements in financial assumptions, and scheme demographics changing materially. Please note that there are a multitude of additional risks and sub-categories of risks and, rather than attempt to describe each risk in detail, we may at times throughout this document refer simply to 'risks'.
47. However, we recognise that the aggregated level of 'risk' being run in a scheme will be variable and dependent on all the above factors. Further, the assessment of those risks can vary from person to person, ie the assessment of a risk is subjective.
48. Some of the events above can be managed in different ways. The exposure to a risk can be:
- quantified as having minimal or minor financial impact
 - contained or reduced, for example by investing less in growth seeking assets
 - underwritten, for example by hedging against interest rate or inflation changes or securing a contingent asset, or
 - assessed as sufficiently remote not to require further management, for example, the risk of a s75 debt not being paid on the failure of very strong employer when coupled with a well-funded scheme.
49. For the purposes of this document, we expect all trustees to 'manage' their risks, ie to identify, assess and understand the various risks facing the scheme and then deal with the risks in one or more of the following ways:
- Obtain additional support for one or more risks.
 - Mitigate a risk by taking some action to reduce its severity if it were to materialise.
 - Take no further action if the risk is assessed as remote or of minimal impact, apart from keeping the position under review.
50. We are aware that different boards of trustees could reach different conclusions as to the likelihood or impact of the same event occurring and then manage it different ways and to a different extent. There are therefore a range of reasonable or likely outcomes that a rational trustee board could arrive at.

Our view

51. We conclude that 'clarity' cannot occur without introducing an objective funding standard. For example, if the concepts of prudent TPs and appropriate RPs were to remain entirely subjective, then it is difficult to understand how we and the regulated community could quickly and easily assess whether a funding arrangement is truly compliant with the legislation.
52. Therefore, an 'objective' standard needs to be developed. A scheme's subjective funding arrangement can then be compared to the objective standard and assessed against it. We recognise that pension schemes cannot eliminate risks, but we want to introduce a consistent way of measuring the risks and determining to what extent, and how, they should be managed.
53. As discussed in paragraph 51, there is likely to be a range of acceptable or reasonable outcomes, but we think that, for 'clarity', there needs to be a single reference point for the objective standard. If a range is introduced, then although we will be able to identify and determine which outcomes lie outside the range, it is more difficult to determine where in the range the scheme should be placed for enforcement purposes. Therefore, we think it should be set as a considered single point from the outset.
54. The purpose of this consultation is to work with stakeholders to determine what that objective standard should be, and how we should regulate against it. We have therefore developed an approach that maintains scheme specificity while introducing the necessary objective standard.

Our role

55. The Act expressly obliges us to publish a code of practice on the discharge of duties imposed on trustees of occupational pension schemes by or by virtue of Part 3 of the Act¹². In addition, we have very significant powers under s231 of the Act to correct funding arrangements in certain circumstances. We consider that the combination of these powers means we have an important role to play in setting the 'objective standard'.

Our proposal: Twin-track compliance

56. We propose that trustees can choose to either follow the **Fast Track** approach that will be detailed in the new code or a **Bespoke** route, which would involve the provision of additional evidence by them and further scrutiny by us.
57. It is important to stress that either approach is acceptable and, if done correctly, will be considered by us to be compliant with legislative requirements. Merely following one route or the other does not automatically equate to compliance. The legislation and principles will need to be followed and, if we believe that valuations are not compliant, we will consider taking action. Our intention is not to introduce a 'Minimum Funding Requirement' type regime and we think that what we propose should guard against that.
58. We consider that this approach allows us to introduce some objective clarity by defining what we would consider an acceptable funding solution, while leaving trustees with the ability to reach their own arrangements if they are more appropriate for their circumstances.

Fast Track

59. For Fast Track, we would set out a series of explicit guidelines, which trustees can use to assess whether we would consider their valuation to be compliant with the legislation.

¹² Under s90 of the Pensions Act 2004 (the Act), we must issue a code of practice relating to the discharge of duties imposed on trustees or managers of occupational pension schemes by, or by virtue of, Part 3 (scheme funding). We may revise our codes of practice from time to time and must consult on a draft code (s91).

60. It is important to understand that the Fast Track solution is not trying to be perfect. It is not a risk-free position, nor does it guarantee that the scheme will be able to pay all benefits as they fall due. The reality is that pension schemes are expected to take some risks, but we consider that the Fast Track position would represent a position of 'tolerated' risk for different scheme-specific factors such as maturity and employer covenant. We would like to develop a Fast Track that represents a justifiable, prudent position that most stakeholders would recognise as within the range of reasonable outcomes.

How would it work?

61. The Fast Track model would cover key aspects of funding and investment arrangements, including the funding level and timing of the LTO, TPs (discount rates and possibly other assumptions), RP length and structure, investment risk, and future service contribution rates (open schemes).
62. Most of the guidelines would be objective and quantitative. They could incorporate some scheme-specific factors such as maturity and covenant strength (if reliance on employer covenant is to be included in Fast Track). Certain aspects such as covenant would need to be checked to some extent by us.
63. We would expect trustees to provide their statement of strategy to us with supporting information, but we would seek to make this proportionate and straightforward. Subject to a few basic checks, trustees should not expect any extensive engagement with us on funding unless we had identified potential non-compliance.
64. To be considered Fast Track compliant, a scheme would have to satisfy all aspects individually, as when looked at in aggregate, it would represent our view of what constitutes an acceptable funding and investment outcome or tolerated risk for schemes of different characteristics.
65. However, as stated in paragraph 61, this would not be a risk-free position and trustees would still be expected to exercise judgement, assess and manage their own scheme- and covenant-specific risks, and plan for adverse conditions. We would refer trustees to our current guidance on how trustees can manage the risks associated with scheme funding.
66. Trustees should also note that new requirements for pension scheme governance came into force on 13 January 2019¹³, including the requirement for trustees to have an effective system of governance proportionate to the size, nature, scale and complexity of their scheme. Among other things, trustees (of schemes with 100 members or more) will need to carry out and document an own risk assessment of their scheme. Our forthcoming single modular code, soon to be published for consultation¹⁴, will reflect our expectations in relations to these new requirements.

What proportion of schemes will follow Fast Track?

67. We do not know at this stage how many schemes are likely to choose Fast Track (based on schemes' current funding and investment strategies) as we have not finalised the Fast Track quantitative compliance formulation. This will be done once we have settled on the principles and approaches we are consulting on in this document.
68. We will finalise the Fast Track framework based on our view of appropriate outcomes and considering the Pension Schemes Bill amendments and any changes to the regulations, responses to this consultation, where the landscape is in relation to Fast Track guidelines, and our impact assessment (eg the appropriate balance between member security and costs to employers). We will then consult on our proposed guidelines and parameters in our second consultation.

¹³ Occupational Pension Schemes (Governance) (Amendment) Regulations 2018.

¹⁴ See <https://www.thepensionsregulator.gov.uk/en/document-library/statements/single-code-of-practice-statement> for further information. The code content arising from our two DB funding consultations will form new and amended modules to be added to the single modular code as part of its first update.

69. Chapters 7-12 in Part 3 set out our proposals for how we could develop Fast Track compliance guidelines.

How would it be updated?

70. We are aware that such a detailed framework would need to keep track with market, economic and demographic events. Therefore, we propose that it would be developed in view of prevailing market conditions and would be regularly reviewed and updated as necessary by us (eg if material changes have occurred).
71. We consider that we should review the framework every three years or sooner if there are any material changes to the economic environment. We would not seek to review or amend the fundamental structure of the Fast Track framework but ensure that the Fast Track outputs do not become out-of-date. We will consult on our proposed review process in our second consultation.

Bespoke

72. This option provides trustees and employers with more flexibility to take account of scheme-specific circumstances. Reasons for choosing the Bespoke route could include the following:
- Trustees consider it appropriate to take additional, managed risk relative to the tolerated level of risk accepted in Fast Track. This could be in relation to investment risk, the LTO, the prudence in the TPs, or RP length or structure.
 - Schemes that simply cannot meet some or all Fast Track aspects. This might include those schemes with very weak employers that can only support very long RPs due to significant affordability constraints.
 - Where an aspect of the Bespoke arrangement is different from the Fast Track equivalent but despite the differences, (i) in aggregate the Bespoke arrangement represents an outcome at least as good as the Fast Track outcome overall and/or (ii) the trustees can evidence that there is no additional risk being run in the Bespoke arrangement.
 - Schemes with unusual or complex circumstances or arrangements (eg atypical covenant, contingent support, investment strategy), which we have not been able to accommodate under simple Fast Track guidelines.

How would it work?

73. Although we see Bespoke as providing an alternative for trustees dealing with circumstances that do not easily fit into Fast Track or who wish to approach funding differently, we do not consider that it should be an 'opt-out' from the new regime. We think Bespoke should complement Fast Track and that both should apply a consistent methodology for legislative compliance. Therefore, we would expect trustees following the Bespoke route to adhere to the same principles that underpin Fast Track and the guidance that will be laid out in the new code.
74. Trustees who follow this route would be expected not only to fully articulate their position and decisions to us, but also provide tangible evidence to support their position or, where appropriate, demonstrate the support or mitigation obtained to underpin the additional risks. For example, in the case of a long RP, the explanation needs to be supported by detailed evidence of the affordability constraints or (where affordability is not constrained) evidence of what additional support has been provided to underpin the longer RP.

75. Trustees and employers can also expect some engagement with us after submitting their funding documents (statement of strategy and valuation)¹⁵, although we anticipate that some arrangements will be straightforward to assess and won't require much interaction with trustees. As a risk-based regulator, we may decide not to engage with all trustees who have submitted Bespoke arrangements.
76. In the final code, we intend to provide examples of scenarios we would consider compliant and potentially non-compliant with the legislation to help trustees, employers and advisers. We have outlined some scenarios in Part 4 to give a flavour of how we intend the Bespoke framework to operate.

Objective risk-taking and demonstrating compliance

77. In paragraph 52, we said that we will need to assess scheme-specific funding arrangements against an objective standard. We think that Fast Track position is the appropriate objective standard as it will:
- have been developed following two extensive consultations with our regulated community, approved by the Secretary of State for Pensions and laid before Parliament
 - be easily assessed and known to the trustees and employer in advance of negotiating a scheme-specific arrangement, and
 - be scheme-specific, as it is determined by reference to the scheme's maturity and, potentially (subject to consultation), its employer's covenant support.
78. Arrangements that fully adhere to the Fast Track framework (ie the objective standard) would require little further assessment from us, other than to check compliance with the Fast Track framework. However, fully Bespoke funding arrangements will need to be assessed against the equivalent Fast Track position.
79. We propose to assess a Bespoke valuation using the following criteria:
- How the funding arrangements comply with the legislation and any relevant DB code principles.
 - The extent the funding arrangements diverge from Fast Track as a reference point.
 - How additional risk (if any) is being managed (eg additional support or appropriate mitigations).
 - The quality of the supporting evidence provided by the trustees.
80. As set out in Chapter 2, one of our key aims is to improve the transparency of trustee decision-making and risk-taking, and to support more efficient regulation. We propose to achieve this by asking trustees to evidence objectively a) how and why they have moved away from our level of tolerated risk as defined by Fast Track and b) how they believe any additional risks have been managed (ie supported, mitigated or assessed as remote). The trustees will provide their evidence via the statement of strategy and supporting documents submitted to us.
81. If we think the Bespoke arrangements do not comply with Part 3 of the Act, we would consider whether to take action, using our powers under s.231 of the Act.
82. A fuller description of our proposals in respect of the Bespoke compliance route can be found in Part 4, Chapter 13.

Subsequent valuations

83. It is important to note that we do not anticipate trustees being obliged to always remain within either Fast Track or Bespoke. We expect that trustees will be able to move between the methods of compliance from valuation to valuation depending on the scheme and employer circumstances.

¹⁵ The Pension Schemes Bill as currently drafted requires trustees of all schemes, whether in deficit or surplus, to submit their funding documents to us. Funding documents include the valuation, the statement of strategy and any other documents that may be required by regulations.

Benefits of this approach and increased objectivity

84. We hope the proposed approach will increase the transparency of our regulation. In turn, this should benefit everyone involved:
- Trustees and employers will be able to assess from the outset whether the expected funding arrangements would be compliant with legislative requirements. We anticipate that this will speed up employer/trustee negotiations and focus discussions on the genuine areas of concern for that scheme and employer.
 - Trustees and employers will know when and why we may have concerns about their funding arrangements for the scheme, and what can be done to mitigate these concerns (which in turn would reduce the likelihood of regulatory scrutiny).
 - Advisers will be able to provide advice to their clients with more certainty and will be able to guide their clients in the preparation of the information to be submitted to us when their client does not wish (or is unable) to follow the Fast Track option in the code.
 - Members of schemes can be confident that all parties involved in the custodianship of their pensions have acted appropriately and with full accountability to us.
 - We will be able to identify schemes we do not consider to be compliant with Part 3 of the Act more quickly and effectively and will then be able to communicate those concerns more clearly, with a view to early resolution.
 - If we consider enforcement action is necessary, we will be able to act more quickly and efficiently as the level of subjectivity associated with the various issues will have been reduced.

Engagement and enforcement

85. We propose to consult further and in more detail on our enforcement policy and approach to DB regulation during our second consultation. This section outlines our initial proposal regarding the practical operation of the new funding approach.

Submission of documents

86. Once the valuation documents have been submitted to us (including those schemes which are in surplus, following a new provision introduced in the Bill), we will undertake a high-level review of these valuations (as we do now).
87. This exercise will serve two purposes:
- Verification that schemes following Fast Track meet all its guidelines.
 - Inform our engagement strategy for trustees that have followed Bespoke compliance or in respect of any schemes that have not correctly followed Fast Track but have submitted on that basis.

Bespoke compliance route

88. If a scheme's valuation is selected for further scrutiny, then it will proceed through our 'initial intervention gateway'¹⁶ to decide the level of follow-up activity required.

¹⁶ As part of our TPR Future programme, we have designed and implemented a new operating model, which is described on page 10 of <https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/tpf-future-making-workplace-pensions-work.ashx>.

89. We anticipate that most of our queries will be resolved through 'low' to 'medium' intensity engagement. Particularly complex arrangements or those where the outcome is considerably different than the Fast Track standard are more likely to proceed to 'high' intensity engagement.
90. Initially, we expect that much of our engagement will involve strengthening our understanding of the trustees' approach and eliciting more detailed explanations than those originally provided in the scheme's statement of strategy. However, once trustees become more familiar with the statement and our expectations, we expect this level of engagement to diminish. We will publish guidance about how we expect trustees to complete the statement and examples of good and bad practice.

Enforcement

91. We envisage that a small number of cases will proceed, following initial engagement, to enforcement. We will endeavour to issue a Warning Notice¹⁷ as quickly as possible after it becomes apparent that we do not consider the scheme's funding arrangements to be compliant with legislative requirements.
92. The employer and trustees would be provided with an opportunity to make representations against this position and to provide any additional evidence that had not been provided with the statement of strategy or during initial engagement with us.
93. If, following representations received, we still believe that the Warning Notice establishes grounds to act under s231(1) of the Act, we would seek a decision from our Determinations Panel to use our power under s231(2) ie to set the scheme's TPs or LTO (subject to the Bill) or both as for Fast Track and for any RP to be set over a period that is comparable to the relevant Fast Track length or reasonably affordable for the employer(s).

► Question

- Q1 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?

¹⁷ Our case team procedure can be found at <https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/case-team-procedure-may-2014.ashx>.

4. Employer covenant

94. The employer covenant is the extent of the employer's legal obligation and financial ability to support a DB scheme now and in the future. The legislation does not expressly refer to the role of the employer covenant, but it is a relevant factor for trustee decisions, in particular to determine the appropriate funding and investment risks to take. The covenant is therefore an important scheme-specific security mechanism and has, over time, become a key feature of the regime.
95. It is fundamental to this consultation to have a debate about the role of the employer covenant in the regime and the extent to which trustees should place reliance on it. In this chapter, we discuss the following issues:
- How much reliance should be placed on the employer covenant and the degree to which it is reasonable for DB scheme members to be subject to employer insolvency risk.
 - If some reliance should be placed on the covenant, how this should be factored into a scheme's funding plan.
 - The best way to assess the level of employer support.

Role of the covenant and insolvency risk

96. The current system does not insulate the scheme from the impact of an employer's insolvency. If the employer suffers an insolvency event, then the scheme may not recover the full s75 debt due to it. Therefore, if a scheme is underfunded on a buy-out basis and the employer becomes insolvent, there is a risk that members could lose some of their benefits¹⁸.
97. Those who do not work in the industry, and even some trustees, are often surprised when an employer becomes insolvent and there is a cut in member benefits or a call on the PPF. We have also come across the misconceptions that if a scheme is fully funded on its TPs, then members will get their benefits in full or that a scheme funded at 'self-sufficiency' is fully protected in the event of the employer's insolvency. Given recent high-profile corporate failures, it is important to discuss and be clear about how much residual risk is in the system and to what extent it should be supported or mitigated.
98. At one end of the spectrum, to fully mitigate against the risk of insolvency, all schemes would have to be funded so that all member benefits could be bought out immediately from a reputable insurer. This would make the regime more transparent and objective and reduce almost all risk to member benefits and the PPF. However, this is not the intent behind the scheme-specific funding regime (which is designed to have a degree of residual risk mitigated by the PPF) and it would also cause a substantial, often unaffordable, increase in contributions required from most employers. Analysis of our data shows that the estimated total buy-out deficit across the DB universe at 31 March 2019 was £920bn, compared to £180bn for the estimated aggregate deficit on a TPs basis – a difference of £740bn. This compares to total TPs at 31 March 2019 of £1,900bn, so the difference is significant.

¹⁸ We note that developments in relation to the CJEU judgment in the PSV v. Bauer case may affect this position.

99. Table 1 below sets out the pros and cons of funding on a near risk-free basis:

Pros	Cons
<p><input checked="" type="checkbox"/> Security to members' benefits maximised once full funding is achieved. Benefits would be much less intertwined with employer performance, minimising the risk of losing some pension benefits and one's job at the same time.</p> <p><input checked="" type="checkbox"/> Significant reduction to PPF risk.</p> <p><input checked="" type="checkbox"/> Simpler, more objective valuations less open to subjective interpretation.</p>	<p><input checked="" type="checkbox"/> It would have a material financial impact on most employers and could threaten the viability of the system.</p> <p><input checked="" type="checkbox"/> A funding standard that excludes the employer covenant would compromise the scheme-specific nature of Part 3 of the Act.</p> <p><input checked="" type="checkbox"/> It would be a radical change, and contrary to market expectations and our guidance for over a decade.</p> <p><input checked="" type="checkbox"/> It would drive investments towards low risk/return assets at a much earlier stage, which could have adverse impacts on capital markets.</p>

100. There are other options that still ignore the concept of covenant but don't target such a low risk basis. These take the form of either of the following:

- Requiring schemes to be fully funded at all times on a low dependency basis. Being funded on this basis would mean a scheme could expect to provide member benefits with very limited future support from the employer and, if such support is required, it would be expected to be small relative to the size of the scheme.
- Having no explicit allowance for covenant but still allowing for investment risk to reflect the maturity of the scheme, ie schemes which are immature can afford to take higher levels of investment risk and allow for that in their discount rates used to calculate the TPs. Mature schemes would still need to be fully funded on a low dependency basis as time is not on their side. We consider the issue of maturity in greater detail in Chapter 5 (General principles) and Chapter 8 (Setting the LTO).

101. Both approaches would make the funding regime more transparent and objective than it is currently, as factoring in the employer covenant introduces a degree of additional risk. They would also reduce, but not eliminate, the risk to member benefits and the PPF. They might also cause a substantial increase in contributions required from many employers, particularly if requiring immediate full funding on a low dependency basis. Most of the other pros and cons listed in Table 1 would also apply to some degree. We would like to hear views on the merit of the approaches above.

102. In this consultation, our proposal is to allow trustees to imbed some reliance on the covenant and to allow more immature schemes to assume and take more investment risk on their way to low dependency funding (see Chapter 5 on General Principles for further discussion of these ideas). Although this approach will not eliminate the insolvency risk and some members may still lose some of their benefits (eg it does not remove the risk that benefits are reduced in an insolvency situation), it will:

- improve transparency around and management of the risks being taken by trustees (on behalf of members) and the employer, as trustees will have to make an explicit evaluation of the covenant and other risks the scheme is exposed to
- reduce the impact of employer insolvency on member benefits over time as maturing DB schemes reduce reliance on the covenant and progress towards low dependency funding, and
- improve our ability to act where inappropriate risk is being taken through the provision of better information upfront and having a clearer benchmark against which to assess schemes.

► Question

- Q2 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?

Integrating the covenant into scheme funding

- 103.** If we assume that some reliance should be placed on the employer covenant, the next questions are:
- Whether it should be factored into both Fast Track and Bespoke approaches or just Bespoke?
 - If it should be factored into Fast Track, then into which element of the funding and investment arrangements?
- 104.** We have identified the options below as to how covenant could be integrated into Fast Track (beyond the default assumption that covenant is taken into account when considering whether a RP is affordable). Note that the differences between Option 1 and 2 outlined below are largely presentational. They should be broadly similar in relation to overall cash funding and investment risk.

Option 1 – Covenant integrated into Fast Track TPs via discount rate

- 105.** The employer covenant could feature explicitly in the funding framework and be recognised as a key security mechanism to support assumed/actual investment risk. This is in line with current Integrated Risk Management (IRM) practice. Covenant would therefore be integrated into the TPs via the discount rate. However, we would seek to introduce further clarifications, including:
- a clearer and more formally defined link between covenant strength and TPs (see Chapter 9)
 - additional ‘checks and balances’ regarding RP length and structure, in particular whether the covenant should feature both in TPs (enabling lower TPs and deficits) and the RP through investment outperformance (enabling lower DRCs) (see Chapter 11), and
 - the appropriate level of risk in the investment strategy, which may also include a defined link to covenant strength (see Chapter 10).
- 106.** Adjusting the discount rate to reflect employer covenant would introduce a greater element of risk into Fast Track TPs and undermine our aim of keeping Fast Track relatively clear and simple. An alternative would be to allow reliance on the covenant in the TPs discount rates but only as part of the Bespoke approach. Under this alternative approach, the employer covenant would not feature explicitly in the Fast Track framework but instead TPs would be set at a ‘covenant-independent level’, with the discount rates allowing only for assumed investment risk and associated returns to reflect the maturity of each scheme. Trustees could factor in covenant through Bespoke to justify additional risk.

Option 2 – Covenant reflected in investment outperformance in the RP

- 107.** Instead of a covenant adjustment in Fast Track TP discount rates, covenant could be included as part of the RP in the form of investment outperformance. For Fast Track purposes, a scheme would not be allowed to factor additional investment returns into its TPs, so the TPs would be set at a covenant-independent level such as low dependency. However, we would define levels of asset outperformance that we consider acceptable with reference to employer covenant strength (reflecting the employer’s ability to support investment risk). In other words, we would allow for a higher level of outperformance where employer covenant is stronger, than for a weaker covenant.
- 108.** Any resultant deficit would need to be funded within an appropriate period. We consider that the stronger the covenant, the shorter the RP should be, and we would expect to define guidelines for RP length with reference to covenant strength (see Chapter 11).

Option 3 – Covenant reflected as a scheme resource

109. The options above correspond more closely to current practice. A different approach would be to reflect the value of the sponsoring employer as a resource¹⁹ and integrate it explicitly as a credit to the scheme’s asset base:

- The scheme’s liabilities would be calculated as the present value of future cash flows using a covenant independent discount rate (such as on a low dependency basis) and would be increased by an investment stress (see Chapter 10).
- The scheme’s assets would be calculated as the sum of existing scheme assets plus the present value of committed DRCs, contingent assets secured in the scheme’s favour, some allowance for investment returns based on scheme maturity, and the estimated value of residual (eg uncommitted) employer support.

110. The approach to valuing employer support would require further consideration but could be assessed as:

- the present value of its unencumbered asset base
- the discounted present value of forecast cashflows, or
- another measure of employer value where evidenced (for instance, the market value of the shares in the employer).

Comparison of covenant options

111. Table 2 below sets out the pros and cons of these three broad approaches to integrating the employer covenant into Fast Track:

Option	Pros	Cons
Option 1 Covenant integrated into Fast Track TPs via discount rate	<input checked="" type="checkbox"/> Consistency with current practice in how covenant feeds into valuations. <input checked="" type="checkbox"/> Increases the likelihood of schemes opting for Fast Track. <input checked="" type="checkbox"/> Improved consistency in funding position and member security for schemes with similar covenants (clearer links between covenant, assumed risk and TPs). <input checked="" type="checkbox"/> Easier to identify where a scheme is taking a higher, excessive amount of risk in Bespoke (absent appropriate mitigation). <input checked="" type="checkbox"/> Explicitly recognises covenant as a key security mechanism and therefore allows some schemes to aim for higher	<input checked="" type="checkbox"/> Covenant idiosyncrasies: Although we would expect to update and clarify our view on how employer covenant should be assessed (see below), there remains a risk that different parties could reach different conclusions on the same covenant. <input checked="" type="checkbox"/> Covenant ‘buckets’ could be overly simple: Allocating employers to a finite number of covenant grades (eg CG1-4) may be a very simple way to express a complex issue (how affordability matches across to scheme risks – a discount rate by covenant grade does not fully reflect this assessment). <input checked="" type="checkbox"/> Integrating covenant into TPs makes them less transparent and more complex.

¹⁹ This concept is similar to the Holistic Balance Sheet developed by the European Insurance and Occupational Pensions Authority (EIOPA) as part of their review of the IORP Directive. However, this framework would be based on a different funding requirement/basis than what was proposed by EIOPA and we would not necessarily use any of the EIOPA specifications for how to calculate the value of the employer – much further work would be required to develop this concept.

	investment returns (and so require lower employer contributions).	
Option 2 Covenant reflected in the RP investment outperformance	<input checked="" type="checkbox"/> Could avoid the complexity of integrating covenant in TPs (including how to reflect covenant visibility, as discussed in Chapter 9) and make the balance between funding and investment more transparent. This could be better for long-term risk management planning.	<input checked="" type="checkbox"/> Significant change in approach. <input checked="" type="checkbox"/> Would move subjectivity from the TPs to the RP side (in terms of having to define the relationship between covenant strength and investment outperformance for Fast Track).
Option 3 Covenant reflected as a scheme resource	<input checked="" type="checkbox"/> Assets and liabilities are consistently valued for all schemes. <input checked="" type="checkbox"/> All elements are explicitly valued, enabling a fully transparent and risk-based framework. Risks to members/PPF are more explicit. <input checked="" type="checkbox"/> Easier to assess compliance as more objective. <input checked="" type="checkbox"/> Is in line with best practice in financial services regulation.	<input checked="" type="checkbox"/> Employer support would need to be valued consistently across schemes. This could be complex and expensive. <input checked="" type="checkbox"/> Cash flow based valuations may place undue reliance on future business cash flows where an employer's long-term viability is uncertain. An additional complication could be the complex and varied nature of the employer's other future financial commitments. <input checked="" type="checkbox"/> Vulnerable to gaming. <input checked="" type="checkbox"/> Significant change in approach.

112. We think that option 2 (same Fast Track TPs for all schemes, with covenant reflected in investment outperformance in the RP) has significant benefits as it would simplify TPs and provide greater transparency on the balance between cash funding and investment risk. However, this option is very different from current practice, unlike option 1 (covenant integrated into TPs via discount rate), which is most compatible with what schemes already do. For this consultation, and to enable us to develop options for Fast Track, we have therefore assumed Option 1 as the starting point. However, we would like to hear views on the best way to factor in the employer covenant into funding arrangements.

► Questions

Q3 Integrating covenant into funding

- Do you think it is better to keep the Fast Track route simpler by only factoring covenant into Bespoke (TPs and/or RP)?
- If you think covenant should only feature in Bespoke, how do you think it should be done?
- 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?

Assessing the covenant

113. So we can set out clear options, the remainder of this consultation operates on the assumption that the employer covenant is likely to remain an integral part of scheme funding, and therefore we need to consider how it should be assessed.
114. One of the cornerstones of this consultation is to understand whether we can make the funding regime more objective, while still maintaining its flexibility. It is important that trustees can assess the strength of employer covenant clearly, objectively, proportionately and in accordance with a set of consistent standards. This section of our consultation focuses on how this could be done.

Options for assessing covenant

115. We have previously set out in guidance²⁰ our view of how the employer covenant should be assessed, as well as providing examples²¹ of the characteristics that schemes with different strengths of covenant display.
116. Our guidance is mainly qualitative as it requires trustees to use their specific knowledge of the company (or companies) supporting their scheme to reach a conclusion rather than basing an assessment on any prescribed and clearly-defined financial metrics. However, it highlights areas that trustees should consider to a greater degree (for example, cash affordability) or lesser degree (such as limiting reliance on companies with no legal obligation to support the scheme) in assessing employer covenant strength.
117. To support our goal of improving the transparency and the objectivity around risks being taken, we have considered two main approaches to assessing employer covenant:
- **Option 1: Formulaic approach** – Simplifying employer covenant to a formal calculation or metric (for example: based on affordability or other ratios, or a measure of covenant 'value').
 - **Option 2: Holistic approach** – Retaining the current approach to assessing employer covenant, which allows trustees and their advisers flexibility in weighing up scheme and employer-specific factors. However, we would consider providing new (and potentially more specific) guidance to assessing covenant holistically as part of the revised code and supporting guidance.
118. Under either approach we would guide trustees to continue to focus on the affordability of contributions, the level of available security in the absence of cash affordability, and the implications of stress testing (both at a scheme and employer level).

Option 1: Formulaic approach

119. One approach could be to compare the employer's affordability with a measure of the scheme's reliance on the covenant. For the latter, we suggest that a measure of deficit which is 'covenant-independent' (such as on a low dependency funding basis – see Chapter 8 for further details on the LTO) would be an appropriate benchmark. Not because an employer should be required to fund this deficit (unless the scheme is significantly mature), but to provide an objective and consistent picture of the extent to which schemes rely on the covenant. By comparison, basing covenant strength on an employer's ability to fund a TP deficit (which already pre-assumes a degree of covenant strength) would double-count the covenant and we consider this to be inappropriate.
120. Under this suggested approach, trustees would assess the period over which the low dependency deficit might be affordable from, for example, the employer's forecast reasonably affordable cash flows

²⁰ <https://www.thepensionsregulator.gov.uk/en/document-library/regulatory-guidance/assessing-and-monitoring-the-employer-covenant>.

²¹ <https://www.tpr.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-funding-regulatory-enforcement-policy.ashx>.

(RACF)²². Stronger employers should be able to support their schemes' low dependency deficit within a shorter period than weaker employers.

121. This method could also factor in the impact of downside scenarios – on both the employer (eg in terms of underperformance against trading forecasts) and the scheme (eg in the event of asset values falling). For instance, how readily could an employer support the scheme's low dependency deficit when grossed up by a (TPR-defined) measure of scheme risk? And how could this be impacted by a downturn in the financial strength of the employer?
122. We would seek to define thresholds for each covenant grade rating. The strength of an employer would depend on the number of years it would take to fund the scheme's aggregate low dependency deficit from RACF.
123. Alternatively, this method could be based on other financial metrics (such as a measure of profitability or an estimated covenant 'value') as compared to the 'covenant independent' deficit.

²² Potentially defined as the employer cash flows after all reasonable business costs – including reinvestment in the business (for example, capex for sustainable business growth) and potentially some equitable level of 'value leakage' (eg value leaving the covenant by way of eg dividends, intercompany loans that won't be repaid, material management bonuses).

Value leakage is in recognition of some employers claiming a need to pay shareholder dividends – which leaves them unable to support short RPs. If such value outflow is indeed viewed as necessary for sustainable growth, then this should be factored into the assessment of employer affordability and thus covenant. This is particularly relevant as schemes are typically unsecured creditors and rank ahead of ordinary shareholders and, also, they are not 'willing' investors (as opposed to shareholders who may have invested in a business with the expectation of future returns).

124. The pros and cons of this approach include those highlighted in Table 3 below:

Pros	Cons
<p><input checked="" type="checkbox"/> Greater objectivity and accuracy: ensures TPs are set at a level that is directly and demonstrably commensurate with the covenant strength.</p> <p><input checked="" type="checkbox"/> Greater consistency and comparability across schemes (for example, the ratio of RACF-to-deficit could be directly compared for two different schemes).</p> <p><input checked="" type="checkbox"/> Clearer supportability of risk being taken, given the more direct link with employer's affordability.</p> <p><input checked="" type="checkbox"/> More clearly defined link between cash flows and deficit size could enable a greater number of covenant grade categories (or even a continuum).</p>	<p><input checked="" type="checkbox"/> Difficult for trustees to reach a view on RACF if employers do not generate sufficiently detailed or medium-term cash flow forecasts (ie a one-year cash flow forecast may be insufficient for trustees to form a reliable view on RACF levels over the period their scheme needs funding).</p> <p><input checked="" type="checkbox"/> More detailed forecasts could potentially be generated by the employer. Although there could be an associated cost, this may be appropriate given the employer could benefit from this work if it resulted in a stronger level of covenant and a lower funding deficit. However, if these forecasts were only generated for valuation purposes, they could be insufficiently robust (eg could be tailored to obtain the desired result in terms of scheme funding and may not truly represent the likely performance of the business).</p> <p><input checked="" type="checkbox"/> Difficult to clearly define a reasonable or appropriate level of affordability in a way that could be used readily and consistently by trustees.</p> <p><input checked="" type="checkbox"/> The vast differences between business sectors means that necessary capital expenditure for one business may be unnecessary for another. Determining whether expenditure is essential can be extremely challenging and potentially beyond trustee capabilities, therefore requiring professional advice (at a cost) which may not be otherwise needed.</p> <p><input checked="" type="checkbox"/> We would have no way to readily assess the level of RACF without seeking recourse to the information used by trustees and the employer. This would potentially be very time-consuming and not a proportionate use of our resources in respect of most schemes.</p>

Option 2: Holistic approach

125. In most cases, if trustees have followed our guidance, we are likely to agree with their assessment of covenant. However, the current principle-based approach can sometimes result in inaccurate assessments and, in rare cases, misuse. Our more contentious funding cases often involve challenging trustees' (and/or the employer's) assessment of covenant strength, particularly where our guidance has not been followed. Therefore, if we retain the existing approach, we would seek to tighten and clarify our guidance in the following areas:

Cash affordability

126. We would continue to set an expectation that trustees place a strong focus on the cash affordability of their employer, and that where affordability is constrained, reliance on balance sheet strength should be limited to what the scheme can reasonably expect to access (either by security or another method). This is discussed further in Chapter 14, which covers additional support in Bespoke arrangements.

Consideration of the covenant-independent funding position

127. We would set an explicit expectation that trustees consider (and base their assessment of employer covenant on) the scheme's low dependency funding level, both on a 'business as usual' basis and in a stressed situation (eg by considering the level of investment risk being run by the scheme).

Reliance on indirect covenant

128. Current practice is that trustees can consider wider group support (or 'indirect' covenant) when assessing the covenant of the statutory employer. Our current code acknowledges this position²³.
129. However, we have seen cases where trustees have placed too much reliance on the wider group. We consider that over-reliance on support that is not legally binding, and/or which provides no commensurate improvement in financial support, exposes a scheme to increased and potentially unsupportable risks.
130. We acknowledge current practice and suggest that wider group support should continue to be integrated into the covenant assessment of the statutory employer. However, trustees should recognise that indirect employer support is not in the control of the trustees and can be removed without notice. Reliance upon this should therefore be limited to the short term (for example: one or two years or, at most, the period to the next valuation). This is in line with our most recent guidance on assessing employer covenant.
131. In developing Fast Track, we propose to recognise that trustees' covenant assessment may have considered short-term reliance on wider group support.
132. We would expect any reliance on other entities beyond this time to be underpinned by some form of legal recourse that is directly enforceable by the trustees such as a guarantee or security over assets. These arrangements may vary in nature and scope and we propose that they are reflected in a Bespoke funding arrangement (see Part 4 for how this could work in practice).
133. Furthermore, we consider that where reliance is placed on indirect covenant, there should be a corresponding clear and tangible benefit to the scheme, such as increased DRCs and a shortened RP, over and above what could be achieved solely from the employer's own resources. In our view, if there is no tangible benefit to a scheme from the indirect covenant, then trustees should not factor this into their assessment.

Covenant visibility

134. We propose to place more focus on covenant visibility. As discussed in Chapters 5 (General principles) and 9 (TPs), we consider that in most cases, a sensible trustee should place a reducing level of reliance on the direct employer covenant beyond the period for which there is good visibility (subject to a new assessment at each valuation).
135. For most schemes, practical considerations may limit covenant visibility to the medium term (which we typically consider to be three to five years). In Fast Track, we propose to integrate medium-term covenant visibility into TPs. To the extent that trustees want to place full reliance on employer covenant beyond this typical period, we would expect such reliance to be justified under the Bespoke framework with trustees' analysis.
 - This may be with reference to an employer having legally underpinned cash flows or income for a longer period (eg long-term contracts or a rolling government licence giving greater certainty until the end of a regulatory period). However, trustees should also consider the counter-party risk associated with any such cash flows, and how this could increase over time.
 - Alternatively, trustees may suggest (with evidence) that their scheme has such a small low dependency deficit (as compared with the current size of their employer) that even if their employer suffered significant trading stress, it would remain well able to support the relatively small scheme (even if its deficit were to increase significantly) and so assume a strong covenant beyond the medium term.

²³ Paragraphs 72-74 of Code of Practice Funding Defined Benefits.

Deficit to financial strength

136. We could provide guidance on the level of financial strength that indicates differing covenant grades. We could issue guidance on the ratio of employer cash flows to the scheme's low dependency deficit, which might indicate a particular covenant grade rating. This is like the formulaic approach suggested above but would be guidance only, as opposed to an explicit 'hurdle' to be passed for a certain covenant grade rating to be attributed. Trustees would still be expected to take account of all other factors relevant to their covenant.

Stress testing

137. We would reiterate our expectation that trustees consider stress testing (both on the employer and the scheme) to ensure that they understand how support for their scheme could be affected in downside scenarios. This would include considering the covenant strength in the event that both employer and scheme became stressed, as well as assessing how such events may be correlated (for instance, how likely it is that employer trade could deteriorate at the same time as scheme funding declines).

Worked examples

138. We are often told that worked examples are helpful. We would therefore review and add to the examples of what we see as acceptable and unacceptable of covenant assessments in our current guidance.

Unusual employers

139. We would build on our existing guidance about how covenant assessments (and valuations in general) should be carried out for differing types of schemes or employers. This could include multi-employer schemes (both associated and non-associated) and schemes sponsored by not-for-profit employers.

Comparison of covenant assessment methods

140. The pros and cons of retaining a more holistic approach to assessing covenant include those highlighted in Table 4 below:

Pros	Cons
<p>✓ Avoids the difficulties of applying a one-size-fits-all approach and instead allows flexibility for the trustees (and advisers) to consider all factors and characteristics of the employer and scheme in reaching a more balanced conclusion.</p> <p>✓ Close to current practices (and our historical guidance) and therefore easily adopted by trustees.</p>	<p>✗ Open to inaccurate or inconsistent assessments or (in certain cases) gaming, leading to inaccurate assessment of TPs and inappropriate risk taking. However, the enhancements proposed above (as well as those around RP structure discussed in Chapter 11) should mitigate these risks to some extent.</p>

Independent covenant advice

141. As stated in our existing guidance, we do not expect trustees to seek independent covenant advice in all situations. We recognise that, in many cases, trustees can and do assess covenant strength themselves and this is often appropriate, provided they take account of all relevant guidance in doing so.
142. There are situations where trustees choose not to assess employer covenant, since they set strong TPs which place no reliance on covenant. This too can be appropriate, although we would still expect those trustees to have considered the affordability of any resultant funding deficit, and the implicit fairness of how the scheme is treated compared to other stakeholders (eg equitability).

► Questions

Q4 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?
- 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?
- 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?
- 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?

Q5 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?

Grading the covenant

143. Whatever method we use to assess the covenant, we need to be able to segment the landscape (for instance to set Fast Track guidelines in the code, which vary by covenant strength) or to assess whether valuations submitted to us are compliant.
144. We currently use four covenant grade ratings (CG1-4), which we think we should retain. However, we recognise there could be valid reasons for a greater number of ratings, for instance to provide greater differentiation between schemes that fall within the same (but perhaps fairly broad) covenant grade.
145. We are also mindful that there are a handful of schemes that do not have a sponsoring employer with any business assets (and who could potentially be referred to as 'CG5'). These are sometimes also referred to as SWOSSs (schemes without a substantive sponsor). Other emerging structures include DB superfunds. We will address how SWOSSs and DB superfunds should be covered in the funding code during our second consultation.
146. Regardless of how many covenant grade ratings we use in the code and regulatory approach, this does not prevent advisers and trustees from using a different scale when assessing the covenant, although we would expect any such assessment to be converted to our scale to report to us. We anticipate this would be reasonably straightforward.
147. However many covenant grade ratings we use (eg four or more), it is important to clarify the intended use and inherent limitations of these bands. We think covenant grade ratings provide a useful benchmark for schemes and act as a broad guide to the level of risk they can take. However, the allocation of a covenant grade rating does not provide all the answers for a scheme, particularly in terms of the trustees' approach to investment and funding strategies. There are many scheme-specific factors that trustees should take into account when considering how to manage their scheme, including employer covenant specifics (visibility, employer investment plans), scheme maturity and potentially many others.

► Questions

Q6 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?
- 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?

Understanding the rest of this document

148. This chapter has raised several fundamental concepts on which we welcome feedback. However, in order to draft the rest of this document, we have made the following assumptions:
- Employer insolvency risk will remain to some degree.
 - The employer covenant will be reflected in scheme funding.
 - In Fast Track, we propose that covenant strength should underpin the assumed level of risk in the TPs.
 - We will retain a holistic approach to assessing the covenant (with further clarifications as set out above. These expectations would feature both in the Fast Track and Bespoke approaches.
 - In setting guidelines in the code, we will retain our four covenant grades.
149. These assumptions will be reviewed in light of consultation responses.

5. General principles

150. We have developed some core principles, which we propose should underpin the DB funding code. These principles will supplement primary and secondary legislative requirements and describe how we consider the legislative framework should work in practice.
151. We will develop the Fast Track framework (see Part 3 for proposals) in accordance with these principles, with the expectation that they will also guide the scheme funding work undertaken by trustees, employers and professional advisers under the Bespoke approach (see Part 4). The principles will also underpin any potential enforcement action we take.
152. In this chapter, we discuss the rationale for each proposed principle. There is an element of repetition, but this is deliberate as we have attempted to develop a set of principles that work together and are consistent with each other.
153. For each principle, we have highlighted the most relevant existing and prospective legislative requirements as currently known²⁴. The final legislative package is yet to be finalised as the Pension Schemes Bill is subject to Parliamentary scrutiny and DWP also intends to amend regulations. Some of the principles under consultation may be formalised in regulations. For these reasons, this set of principles may be framed differently in the draft funding code, which will be the subject of our second consultation.

²⁴ Schedule 10 of the Pension Schemes Bill contains amendments to the existing provisions of Part 3 of the Act. The (as at 3 March 2019) are highlighted in italics.

Demonstrating compliance and objective risk-taking

PRINCIPLE	<p>Legislative requirements</p> <ul style="list-style-type: none">★ Trustees must prepare a written statement of strategy of the scheme's funding and investment strategy (described in this document as the LTO) and supplementary matters.★ These include the extent to which the strategy is being successfully implemented and steps to remedy the position, and the main risks in implementing the strategy and how trustees intend to mitigate or manage them.★ The Pension Schemes Bill also includes provisions allowing the Secretary of State to prescribe the matters trustees should take into account and the principles they should follow when preparing/revising the supplementary matters in the statement of strategy, the level of detail required, the form of the statement of strategy, and submission to us²⁵. <p>TPR code principle</p> <ul style="list-style-type: none">★ We expect trustees and employers to be able to understand their scheme-specific funding and investment risks and objectively evidence how these risks have been assessed as remote or minimal or can otherwise be properly managed (ie supported and/or mitigated). Robust evidence should be provided when risks are genuinely unsupportable.★ When demonstrating how risks are managed, trustees should be able to compare the risks they have taken to a tolerated risk position and then demonstrate the mitigation and/or support available.
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Rationale

- 154.** The Pension Schemes Bill introduces a requirement for trustees to prepare a statement of strategy setting out their funding and investment strategy (LTO) and how they propose to manage/mitigate risks to achieving it.
- 155.** DWP intends to make provisions in regulations on the level of detail the statement should contain, what form it should take, and requirements regarding submission to us. The intention, as set out in the DB white paper, is to improve transparency and accountability around how trustees manage risks to their scheme's funding and investments, and place greater onus on them to articulate their position and demonstrate compliance. The proposed principle builds on this aim. It is also consistent with our proposal in Chapter 3 (Proposed regulatory approach) to provide greater regulatory clarity on what 'good looks like' in the context of the scheme-specific funding regime created by Part 3 of the Act by establishing a twin-track approach to demonstrating compliance (Fast Track versus Bespoke approach).

Proposal

- 156.** In practice, we expect the following:
- The statement of strategy would be a straightforward submission from trustees if they follow Fast Track and would include some basic information on their valuation and approach to risk management,

²⁵ As set out in the Pension Schemes Bill's Explanatory Notes (<https://publications.parliament.uk/pa/bills/lbill/58-01/004/5801004en.pdf>) and Delegated Powers Memorandum (<https://publications.parliament.uk/pa/bills/lbill/58-01/004/5801004-DPM.pdf>), this power can be used to ensure the statement contains information that is relevant to support our enforcement functions.

including how they assessed the employer covenant (see Chapter 4) and investment risk (see Chapter 10).

- If adopting a Bespoke approach, the statement of strategy would fully articulate their funding arrangements with an explanation to evidence objectively how and why the trustees have moved away from Fast Track guidelines that represent a position of tolerated risk, and how they believe the additional risks are managed, ie supported, mitigated or assessed as remote or having a minimal impact.

Long-term objective (LTO)

PRINCIPLE	<p>Legislative requirements</p> <ul style="list-style-type: none">★ Trustees must determine a funding and investment strategy (described as LTO in this document) for ensuring that pension and other benefits can be provided over the long term.★ The strategy must specify the funding level the trustees intend the scheme to have achieved and the investments the trustees intend the scheme to hold on the relevant date(s).²⁶★ The Pension Schemes Bill also includes provisions²⁷ which will allow the Secretary of State to prescribe the matters trustees should take into account and the principles they should follow when determining the scheme's funding and investment strategy. This includes requiring trustees to adopt prescribed actuarial methods or assumptions when specifying a funding level. <p>TPR code principle</p> <ul style="list-style-type: none">★ By the time they are (i) significantly mature, we expect schemes to (ii) have a low level of dependency on the employer and (iii) be invested with high resilience to risk²⁸.
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Rationale

- 157.** The Pension Schemes Bill introduces a requirement for trustees to determine a funding and investment strategy (referred to as LTO in this consultation document) which is specific in terms of its funding basis, investment profile and timing. As outlined in the DB white paper, setting a clear LTO for their scheme should help trustees better manage the covenant, funding and investment risks to the delivery of full benefits to members. It also provides a meaningful framework for trustees' long-term decision-making.
- 158.** Journey planning towards a long-term destination is particularly important as most DB pension schemes are maturing and reaching their 'end game' as a result (ie nearing a time in the future when the scheme's assets are rapidly reducing due to the benefits being paid out). This drift towards the end game has accelerated with the significant trend in DB scheme closures in recent years. Our data shows that 89% of DB schemes are closed to new members and, in around half of those schemes, there are no longer any active members accruing new DB benefits (see Chapter 16 on Evidence and Analysis).
- 159.** A scheme's ability to close a funding gap from investment outperformance reduces with increasing maturity and, therefore, trustees should aim for the scheme to be fully funded on a strong target by the time it becomes significantly mature.

²⁶ Schedule 10 of the Bill introduces a new section 221A to the Act

²⁷ As set out in the Explanatory Notes and Delegated Powers Memorandum, this may, for instance, include information about the maturity of the scheme, whether it is open or closed, or the strength of the employer.

²⁸ All these terms (low dependency, significant maturity and high resilience to risk) are explained in the subsections below.

- 160.** As schemes mature, more pensioners receive benefits and it becomes likely that schemes will pay out more money in benefits and expenses than they will receive from investments and contributions ('cash flow negative'). If a scheme is underfunded at this stage and its asset base reduces at a proportionately higher rate than its liabilities, the remaining assets must produce increased returns to close what is now a proportionately bigger deficit. However, because the scheme is mature, there is less time to capture the long-term outperformance from growth assets.
- 161.** Investment volatility becomes a material risk if trustees continue to invest in growth assets when the scheme is cash flow negative. This is because they run an increased risk of having to sell assets in falling markets to meet their benefit payments. This could in turn create significant contribution requests on the sponsoring employer to return to full funding. For a scheme of typical maturity, the time at which they are significantly mature is many years in the future when the ability of the employer to fund the scheme is much less certain. It is therefore prudent for the trustees to plan to have reduced dependency on the employer over the long term.
- 162.** Schemes could be smaller and more manageable (relative to a stable employer) by the time they are significantly mature. However, this depends on whether the employer covenant and ability to support the scheme has remained as strong. It is unlikely that trustees can predict the covenant strength long into the future, and it would be imprudent to rely on the covenant remaining the same.

Proposal

- 163.** There are various suitable LTOs that maturing schemes could aim to achieve, as seen in the examples given in the DB white paper (see paragraph 31). Broadly, these fall into two categories:
- Funding-based LTOs where the scheme reaches a 'low dependency' funding basis and pays out benefits while continuing to be sponsored by its employer(s). Low dependency means that funding and investment strategies are such that there is a low chance of requiring further employer support and, to the extent that such support is required, it is low relative to the size of the scheme.
 - Transaction-based LTOs where the scheme effectively severs the link to its sponsoring employer(s). This includes buy-out and entry into a consolidation vehicle (DB superfund).
- 164.** We propose that, by the time they are significantly mature, schemes should reach a funding-based LTO at least consistent with achieving low dependency from the employer and an investment strategy highly resilient to risk from that point. This principle should apply to all schemes, including those still open to new members and/or future accrual. In practice these schemes will take a long time to reach significant maturity or are not expected to mature at all. 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. The principle further below considers in more detail how open schemes fit into the framework and we set out our proposals regarding Fast Track guidelines for open schemes in Chapter 11.

Why do we propose low dependency funding at the LTO?

- 165.** Our view is that we should not require schemes to fund on the assumption that they will buy out or enter a consolidation vehicle, as these are trustee/employer decisions and these LTO outcomes may require a higher funding level than low dependency. In addition, the cost of buying out scheme liabilities or entering a consolidation vehicle will be driven by market forces and, particularly, the level of supply and demand in the market.
- 166.** Getting DB schemes to reach a low dependency LTO as they become significantly mature would provide DB schemes with a good platform from which to pursue specific end-game strategies of trustees' or the employer's choice. For example, buying out or buying in benefits, entering a consolidator, or continuing to run on a low-risk basis.
- 167.** We prefer the term 'low dependency' to the frequently-used 'self-sufficiency'. We think this better reflects the fact that, even at a strong level of funding, consistent with a low discount rate, a scheme is still exposed to a small amount of risk and is therefore not entirely self-sufficient. To achieve true self-sufficiency, a scheme arguably needs to hold significant additional reserves on top of being fully funded

on a low dependency basis and, even then, is subject to the insolvency risk of the employer, which will usually cause the scheme to wind up.

Why do we think scheme funding should reach low dependency by significant maturity?

- 168.** There are other possible timescales for reaching the LTO (as set out below). We do not think that setting an arbitrary, fixed timeframe for all schemes regardless of their maturity is appropriate in a scheme-specific funding regime and to do so could be disproportionately unfair for very immature schemes. We also consider that a covenant-based timeframe would be too short-term because of the limited period of covenant visibility for most sponsoring employers.
- 169.** We consider that linking low dependency with scheme maturity fits with the goal of improving the resilience of schemes entering the final phase of their life cycle. This resilience is to the risks of future downside market events and/or potential future deterioration of the support provided by the sponsoring employer at a time where schemes are least likely to be able to cope with these events.
- 170.** Table 5 below sets out the pros and cons of the different options for the timing of the LTO:

Arbitrary timeframe	Based on covenant horizon	Based on scheme maturity
<input checked="" type="checkbox"/> If the period is relatively short, provides better protection for members' accrued benefits.	<input checked="" type="checkbox"/> Would ensure a scheme achieves full funding on a low dependency basis before reasonable covenant visibility reduces materially.	<input checked="" type="checkbox"/> Clear and objective (difficult to game).
<input checked="" type="checkbox"/> Easier to regulate and take action.	<input checked="" type="checkbox"/> Differences in employer covenants could make it less easy to regulate and take action.	<input checked="" type="checkbox"/> Scheme-specific and links to when schemes should have reduced volatility risk.
<input checked="" type="checkbox"/> Not scheme-specific.	<input checked="" type="checkbox"/> Could place considerable financial demands on employers and, for many schemes, may be overly prudent.	<input checked="" type="checkbox"/> Easier to regulate and take action.
<input checked="" type="checkbox"/> If the period is relatively short, potential immediate and large impact on whole landscape (costly to employers).	<input checked="" type="checkbox"/> Fluctuations in covenant horizon (an increase or decrease in longer term visibility driven by, eg gain or loss of committed contracts, regulatory changes, technological developments) could undermine the desire for a steady journey plan to low dependency.	<input checked="" type="checkbox"/> May allow too much time compared to the de-risking plans many schemes already have in place, leading to a levelling down of current plans. <input checked="" type="checkbox"/> Increased covenant risk driven by extended period of reliance on employer support (beyond the covenant horizon).

Why do we expect a high resilience to investment risk by significant maturity?

- 171.** By a 'high resilience to investment risk' we mean adopting an investment strategy that ensures only a small funding deficit emerges (on a low dependency basis) if market conditions change materially. Such a strategy is likely to include a significant proportion of assets which broadly match the liabilities and a low proportion of growth-seeking assets that have a high level of short-term volatility in their value.
- 172.** By having a high resilience to investment risk, the trustees will ensure they are limiting their reliance on the employer to fund any future emerging deficits. This is consistent with the principle of low dependency on the employer in the period after reaching a funding position in line with the LTO.

173. Chapter 8 on the LTO sets out in more detail our Fast Track proposals for a low dependency long-term funding target (level and timing) and also considers what expectations the code should set out in relation to other actuarial assumptions and what trustees should do once they have reached their proposed LTO. Chapter 10 considers the Fast Track investment strategy associated with the LTO and along the journey in greater detail.

► Questions

- Q7 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?
- Q8 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?
- Q9 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?

Journey plan and technical provisions (TPs)

PRINCIPLE	<p>Legislative requirements</p> <ul style="list-style-type: none"> ★ Every scheme must have sufficient and appropriate assets to cover its TPs (SFO)²⁹. ★ When calculating TPs, trustees must choose economic, actuarial and demographic assumptions prudently³⁰. ★ TPs must be calculated in a way that is consistent with the scheme’s funding and investment strategy (LTO)³¹. <p>TPR code principle</p> <ul style="list-style-type: none"> ★ We expect trustees to develop a journey plan to achieve their LTO. ★ We expect trustees to plan for investment risk to decrease as their scheme matures and reaches low dependency. ★ TPs should have a clear and explicit link to the LTO, and over time should to converge to the LTO as evidenced by the journey plan.
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Rationale

Why a journey plan?

- 174.** Legislation currently requires schemes to be fully funded on an ongoing basis (SFO) and will require TPs to be consistent with the LTO (Bill). Trustees will also be required to have a written statement of strategy containing their assessment of whether the LTO is being successfully implemented, any remedial action to get back on course and how key risks to implementation would be managed.
- 175.** In line with this, we consider that once the trustees have set a LTO for the scheme, the next step is to develop a journey plan to get there. They can do this by identifying the gap between the scheme’s current level of funding and that implicit in the LTO, and setting a plan, over a suitable period, to close the gap

²⁹ Section 221(1) of the Act.

³⁰ Regulation 5(4) of the Occupational Pension Schemes (scheme Funding) Regulations 2005 (3377).

³¹ Schedule 10 of the Bill introduces a new section 222(2A) to the Act.

through timely and affordable contributions and appropriate risk-taking. They should use TPs at successive valuations as staging posts or steps on this journey towards achieving the LTO.

- 176.** Setting a journey plan also requires trustees to be aware of the risks that may throw the journey plan off-course and prevent the scheme from achieving its LTO. Trustees should therefore identify, evaluate and put plans in place to manage those risks. Each scheme will have its own set of risks to manage along its journey to the LTO, but they should fall into two broad categories:
- Scheme risks – including the risk that investments do not provide the returns expected, inflation is higher than expected, mortality rates are materially lower than anticipated, scheme experience is materially different to that assumed, and the scheme’s expenses are materially higher than expected.
 - Employer risks – including the risk that the strength of covenant afforded to the scheme deteriorates over time (or, in extreme scenarios, disappears due to the employer becoming insolvent at some point on the journey). As a result, the employer cannot provide the cash or other support to the scheme when it is needed.
- 177.** Trustees should have in place processes and systems to regularly monitor these risks and take corrective action to put them back on course as necessary. In the interest of good governance, and for their own risk management purposes, they should record why they consider any actions taken (or not taken) as being consistent with having put the scheme back on course to achieve its LTO.
- 178.** We consider that a journey plan set in this manner, and monitored regularly against evolving experience, will substantially improve the chances of the scheme achieving its LTO. It should help the trustees evidence that their TPs have been set properly, that their funding and investment strategies are aligned for successful delivery of the LTO and that the key risks along the way are being managed.

Why plan to de-risk investments as a scheme approaches significant maturity?

- 179.** We expect low dependency funding and an investment strategy with a high resilience to risk when a scheme is significantly mature. So, it would be sensible for trustees to plan for the assumed level of investment risks to decrease over time as the scheme matures. This would ensure the scheme moves towards low dependency funding and an investment strategy with an appropriate level of risk at significant maturity. Trustees could choose to de-risk sooner.

How should the TPs be consistent with the LTO?

- 180.** TPs define the level of funding a scheme needs to achieve at each point in its lifespan. To achieve a low dependency level of funding by the time a scheme reaches significant maturity, TPs should tend towards low dependency as the scheme matures. The TPs will in effect become milestones along the journey to the LTO. If there is no link between TPs and the LTO, there is no journey plan to reach the LTO.

Proposal

- 181.** We would expect trustees to set TPs that follow their journey plan to low dependency funding. By doing so, the TPs become milestones along the journey to achieving the LTO. If, during the journey to the LTO, there is a deficit measured against TPs, a RP should be put in place to return the scheme to the journey plan path.
- 182.** In Chapter 9 on Fast Track journey planning and TPs, we will set out options for the shape and key drivers of the journey plan and de-risking approach and outline our proposals for the parameters we could define in Fast Track. We will also set out examples in the Bespoke framework of how trustees could take additional risk on the journey to the LTO, provided it is managed appropriately.

► Questions

- Q10 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?

Q11 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?

Scheme investments

PRINCIPLE	<p>Legislative requirements</p> <ul style="list-style-type: none">★ The powers of investment, or the discretion, must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole.★ Assets held to cover the scheme's TPs must also be invested in a manner appropriate to the nature and duration of the expected future retirement benefits payable under the scheme.³² <p>TPR code principle</p> <ul style="list-style-type: none">★ The actual investment strategy and asset allocation over time should be broadly aligned with the scheme's funding strategy (TPs and RP).★ Trustees should ensure their investment strategy has sufficient security, sufficient quality, and can satisfy liquidity requirements based on expected cash flows as well as a reasonable allowance for unexpected cash flows.★ We expect the asset allocation at significant maturity to have high resilience to risk, a high level of liquidity and a high average credit quality.
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Rationale

183. To fund future member benefits, a DB scheme typically relies on a combination of contributions and expected future investment returns on the existing level of assets. Achieving a sensible balance between these two is critical if a funding strategy is to be robust.
184. We have outlined approaches for setting the LTO and TPs based on key factors such as maturity and covenant. However, these depend on the *assumed* level of current and future investment strategy and not trustees' actual asset allocation.
185. We also need to consider the *actual* investment strategy. We have seen instances of trustees submitting funding solutions based on prudent TPs and with an appropriate RP, but where the scheme is carrying a high level of investment risk which clearly cannot be supported. We do not think that this is consistent with the legislative requirement to invest in a manner appropriate to the nature and duration of the expected future retirement benefits. Correspondingly, if trustees were to reflect the actual level of investment risk in the TPs, the employer would be required to support it if there was an ongoing deficit.
186. The assets' primary function is to pay the benefits when they fall due. Therefore, the ability of an investment strategy to deliver this depends on its security, quality and liquidity.

Proposal

187. We do not consider that our role is to direct how trustees should choose to invest in terms of different asset classes. But we do think that actual investment risk and assumed risk underlying the TPs should be broadly aligned and that any excess actual investment risk should be measured and supported. To the extent that the actual investment risk is not supported, we would expect the trustees to take steps to reduce the level of risk.
188. It is important that a scheme's assets are sufficiently liquid to meet predictable cash flows (for example, pensions in payments) as well as unpredictable cash flows (for example, transfers out). A scheme with a

³² Regulations 4(3) and 4(4) of the Occupational Pension Schemes (Investment) Regulations 2005.

high level of growth assets may be forced to sell assets at depressed prices if cash flow demands coincide with a downside investment event. Therefore, we consider that a sufficiently high level of liquidity is important, especially when a scheme is mature.

- 189.** Many pension schemes have increased their allocation to bonds over the last decade to reduce the volatility of their funding level. However, not all bonds are of the same level of quality. Pension schemes' bond investment typically consists of a combination of government bonds (fixed and inflation linked) as well as corporate bonds. The price of both types of bonds will be affected by a change in the general level of government bond yields in the market. The price of a corporate bond will also be affected by any change in the assessment of the likelihood of receiving future coupons/principal payments, as well as any recovery in the event of default. A lower quality bond will typically have greater volatility and lower liquidity than high quality bonds of similar duration. Therefore, we consider that the underlying quality of the assets is important, and scheme's portfolios should carry a high average credit quality.
- 190.** In Chapter 11 on Fast Track investment guidelines, we will consider how trustees can assess and demonstrate whether the level of investment risk they are taking is appropriate and their investment allocation is of sufficient liquidity and quality, particularly in relation the maturity of their scheme.

► Questions

Q12 Relevance of investments for funding – Do you agree that the actual investments and investment strategy are a relevant factor for scheme funding?

Q13 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?
- 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?

Q14 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?

Reliance on the employer covenant and covenant visibility

PRINCIPLE

- ★ Schemes with stronger employer covenants can take more risk and assume higher returns. However, trustees should assume a reducing level of reliance on the covenant over time, depending on its visibility.

Rationale

191. In Chapter 4, we asked for views on the role of the covenant and where and how it should feature in the funding framework, particularly in Fast Track. We said there was a good argument to retain the current approach (covenant underwriting risk in the TPs and qualitative assessment of covenant). The Fast Track options set out in subsequent chapters have been developed on that basis to illustrate how Fast Track could work.

Proposal

192. We do not contest that trustees of schemes with stronger employer covenants can afford to take more risk and so assume higher investment returns. However, we think it is inappropriate to assume indefinite reliance on the covenant and we propose that this should be limited to the period over which there is good covenant visibility. For most schemes, practical considerations will limit visibility to three to five years (and sometimes less).

193. We consider that a prudent trustee should not assume that the employer covenant remains undiminished beyond the period over which they (and employer management) have reasonable visibility. We would therefore expect trustees to place a reducing level of reliance on the employer covenant (and its ability to support investment risk) in the longer term, ie they should assume a lower level of investment risk after the initial period of visibility which is reflected in the calculation of TPs.
194. We are not suggesting that the employer covenant will weaken in the longer term but, given the scheme's trustees have no certainty that it will not, it would be prudent to reduce reliance in the longer term. This is particularly relevant given employer covenant strength can reduce relatively quickly (or, in extreme examples, can rapidly disappear).
195. By the time of the next valuation, trustees would have a renewed visibility over their employer's future strength (ie potentially covering three to five years from the point of that valuation) and could reflect this updated horizon in the funding calculations at that time. In practice this would mean either of the following:
- The covenant is of a similar strength as at the previous valuation. This means that, all other things being equal, the TPs at this valuation can be set at a lower level than expected and lower DRCs will be required in future.
 - The strength of the covenant has deteriorated. However, because the trustees planned (to some degree) for such a covenant deterioration at the original valuation, the scheme received higher DRCs during the period when these were affordable, therefore reducing the deficit which now needs to be funded by an employer which is now less able to do so.
196. If an employer is likely to continue to exist in the longer term, this does not mean the covenant strength will remain undiminished over the same period. This could only be assumed if the trustees could evidence they are certain the current level of financial strength (relative to the scheme's funding level) would also remain undiminished over such an extended period.
197. To the extent that this principle around covenant visibility is appropriate, we consider how this should be reflected within a scheme's Fast Track TPs in Chapter 9. In Part 4, we provide examples of Bespoke scenarios where the trustees have assumed covenant visibility which goes beyond what we would have
198. assumed in our Fast Track guidelines and parameters.

► Questions

Q15 Covenant visibility

- 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?
- 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?

Reliance on additional support

PRINCIPLE

- ★ Schemes can account for additional support when carrying out their valuations provided that it (i) provides sufficient support for the risk(s) being run, (ii) is appropriately valued, and (iii) is legally enforceable and realisable at its necessary value when required.

Rationale

199. Although we consider cash funding of the scheme to be the primary form of support for the scheme, additional support (such as contingent assets or group guarantees) can be an important tool for trustees and employers to navigate funding challenges, and we recognise the value these can provide to underpin risks being borne by schemes.

200. We are keen that these remain a central part of funding solutions, for instance to support long RPs (particularly where shorter ones are unaffordable) or risk-taking in the investments or TPs – particularly if the employer covenant is not otherwise able to support these risks.

Proposal

201. It is important that additional support can be converted into tangible support when needed, without otherwise causing detriment to the employer covenant supporting the scheme. In Chapter 14, we consult on our proposals for how additional support can be used by schemes in Bespoke, and what trustees should consider in respect of this support.

► Question

- Q16 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?

Appropriate recovery plan

PRINCIPLE	Legislative requirements
	<ul style="list-style-type: none">★ RPs must comply with any prescribed requirements and must be appropriate having regard to the nature and circumstances of the scheme³³.★ The Pension Schemes Bill also includes provisions allowing the Secretary of State to prescribe the matters to be taken into account or the principles to be followed in determining whether a RP is appropriate³⁴.
	TPR code principle

- ★ TP deficits should be recovered as soon as affordability allows while minimising any adverse impact on the sustainable growth of the employer.

Rationale

202. The requirement to be fully funded on a TPs basis (the SFO) is a fundamental principle of the Act³⁵. Our view is that it is reasonable to ensure that the employer agrees to a RP that returns the scheme to the SFO as soon as affordability allows. This includes considerations about minimising adverse impacts on the sustainable growth of the employer. Pensions are deferred pay³⁶ and we do not consider it is appropriate for members' benefits to be used as credit for the employer.
203. RPs should be a temporary measure to get the scheme back to full funding if and when a deficit emerges. However, over time this simple view of the RP has been eroded to include behaviours which we consider could place inappropriate risk on the scheme, particularly when considered cumulatively, and which need to be addressed. These include:

³³ Section 226(3) of the Act.

³⁴ As set out in the Explanatory Notes and Delegated Powers Memorandum, this is to clarify what is meant by 'appropriate'. This may include matters such as the length of time taken by trustees to meet the SFO, taking into account whether the employer can afford to pay more into the scheme.

³⁵ Section 221(1) of the Act.

³⁶ Pensions are considered pay as per the Barber judgment in May 1990 - <https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1581004151103&uri=CELEX:61988CJ0262>.

- Certain trustees and/or sponsoring employers asserting that because the employer covenant has been assessed as strong, they are exempt from targeting compliance with the SFO.
- RPs being structured in a way that minimises contributions being paid by the sponsoring employer by placing additional reliance on the assumptions regarding investment returns. This can manifest itself as one or both of the following:
 - (a) Removing some of the prudence assumed in the TPs by allowing asset outperformance in the RP. The longer the RP, the more this has an effect.
 - (b) Back-end loading the RP, and in doing so pushing the bulk of the contributions beyond the date of the next valuation.
- Some trustees of schemes with strong employer covenants have agreed very long RPs, where the employer could easily support a much shorter (and therefore less risky) RP. This results in the covenant being effectively double-counted, from the assumption of less prudent TPs and the payment of lower DRCs for a longer period.
- Some employers often claim to provide a strong covenant but also claim a need to divert cash flows to other stakeholders (in the form of shareholder dividends, for example). In such a case, we would expect the trustees' view on covenant strength to reflect the lower level of residual cash flows after payments to other stakeholders.

Proposal

- 204.** To mitigate these observed behaviours, we aim to provide greater clarity on what we consider to be appropriate RPs in the revised code. We propose, as a key principle, that deficits should be recovered as soon as affordability allows, while minimising any adverse impact on the sustainable growth of the employer.
- 205.** In practice, this does not mean that we necessarily expect deficits to be recovered immediately (for example via a single lump-sum payment) even if this is affordable. As we explain in Chapter 11 on RPs, we consider that where affordable, RPs should be broadly limited to the period for which there is good visibility over employer covenant strength. Our proposal is to set out some limits on RP length for Fast Track compliance accordingly. This is in recognition that, for practical reasons, it is reasonable to allow a short period (eg between one or two valuation cycles) over which deficits can be rectified by strong employers with good affordability. This is to:
- allow investment returns time to come through and avoid unnecessary funding upfront which would prove not to be required
 - allow (to some degree) for short-term volatility in funding levels which could be expected if the scheme is invested in growth-seeking assets, and
 - give the employer some breathing space and scope to plan repayments in an efficient way in view of the competing demands on its cash.
- 206.** When affordability is genuinely constrained, RPs may need to be longer, but constraints would need to be clearly justified and, where possible, supported. For instance, a longer RP could be supported with an appropriate contingent asset to underpin the additional risk being run by the scheme). Any such requirement should also be aligned with requirements to minimise unnecessary value leakage to other stakeholders in preference to the scheme.
- 207.** This principle is consistent with the first principle above (and discussed in Chapter 3) of starting with the lowest or tolerated risk position, of restoring the scheme to full funding immediately at all times, and evidencing any deviation from this position (affordability, sustainable growth).
- 208.** Chapter 11 sets out our proposals for Fast Track guidelines for appropriate RPs, including length and structure.

► Questions

Q17 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?
- 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?

Open schemes

PRINCIPLE

★ Members' accrued benefits in open schemes should have the same level of security as members' accrued benefits in closed schemes.

Rationale

209. There are many types of different open schemes. For example, there are schemes that closed to new members many years ago and now have a very small proportion of active members still accruing new benefits. These schemes have similar characteristics to those that are closed to new benefit accrual. At the other end of the spectrum, there are schemes still open to new members, who are joining at a sufficient rate such that the scheme is not maturing or only maturing very slowly.
210. We think it is important to ensure that members' accrued benefits are protected to the same degree as in closed schemes. We consider that trustees' focus should be to ensure the security of members' accrued benefits rather than to ensure the provision of future benefits.

Proposal

211. We would expect that in normal circumstances the funding strategy (the level of TPs and the RP) for accrued benefits in an open scheme should be set consistently with that in a closed scheme of the same maturity. Trustees who use different assumptions or a different approach to funding because the scheme is open to future accrual or new members would need to explain why this is appropriate in terms of the employer's plans for staying open and the future covenant strength.
212. Chapter 12 on open schemes sets out our proposals for how the Fast Track approach would apply to open schemes (in relation to past service and future accruals) and Part 4 provides some examples of Bespoke approaches open schemes could take.
213. As time passes, future accrual becomes accrued benefits. So, the contribution rate for future accruals should be sufficient to maintain the funding level of accrued benefits over time, especially if the scheme is not fully funded on a TPs basis. While not a strict legal requirement, we would be concerned if contributions in respect of future accrual were so low that future deficits are expected to emerge. We have therefore developed proposals for dealing with future accrual contributions in Fast Track.
214. We think that it is important for trustees value their cost realistically, although this must be balanced with the need to make sure that the proposed framework does not cause disproportionate and unnecessary cost increases.

► Questions

- Q18 **Open schemes, past service** – Should past service have the same level of security, irrespective of whether the scheme is open or closed?
- Q19 **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?

6. Other issues

Scope of the DB code

215. This consultation covers all DB occupational pensions schemes subject to Part 3 funding. We note the following:

Transactions, material detriment and avoidance regime

216. The scope of this consultation is to inform a revised DB funding code, which will set out our view on acceptable funding. Compliance with the funding guidance set out in this code will not override the need for trustees and employers to consider (and take advice on) transactions and their impact on the scheme's funding position separately and put mitigations in place where necessary. For instance, references in this code to value leakage and dividends relate to 'normal' dividends, not material special dividends (see Chapter 11 on RPs for further details).

SWOSSs/DB superfunds

217. A handful of schemes do not have a sponsoring employer with any business assets. These are sometimes also referred to as SWOSSs (schemes without a substantive sponsor). Other emerging models include DB superfunds. We will address how SWOSSs and DB superfunds should be covered in the funding code during our second consultation.

Schemes with unusual employers/benefit structures

218. The Fast Track and Bespoke frameworks set out in this consultation document have been designed to apply to all DB pension schemes in the UK. Every scheme will have individual nuances that make them differ from other schemes, but we consider that the flexibility in the framework should ensure that trustees of most schemes will be able to submit either Fast Track or Bespoke valuations.

219. However, we recognise that some schemes have potentially 'atypical' employer covenants, are supported by employers with atypical business models, or have unusual benefit designs such as:

- multi-employer schemes – both associated and non-associated
- schemes supported by not-for-profit organisations, including charities and public sector
- schemes supported by regulated employers
- schemes with particular legal structures (eg partnerships), and
- schemes with 'unusual' benefit designs (eg automatic annuitisation schemes, cash balance schemes, in-scheme pension purchase schemes).

220. We think all these schemes should be able to fit within our proposed principles and possibly in Fast Track (but if not, in Bespoke). This will, however, require further thinking subject to the more detailed framework being finalised. We will seek views in our second consultation.

Balance of risks and impacts

221. Our statutory objectives remain unchanged. When regulating DB funding, we are required to protect members' benefits and reduce risks to the PPF while minimising any adverse impact on the sustainable growth of employers. This is because a strong, ongoing employer alongside an appropriate funding plan is the best support for a well-governed scheme. The flexibilities in the system, if used properly, greatly increase the likelihood of reaching an appropriate scheme funding outcome that reflects a reasonable balance between the need to pay promised benefits and minimising impacts on employers. This in turn helps the trustees to achieve their key funding objective. We remain of the view that affordability-driven RPs and the use of contingent security are key flexibilities for trustees and employers, and we intend to embed those into the funding framework under consultation.

- 222.** In this document, we are consulting on various options for how we could go about setting clearer guidelines, so we are not yet able to outline what final guidelines will be included in the code. We have sought to illustrate the trade-offs at play for some key elements of the proposed framework (eg LTO) and are seeking views on the merit of the various options being proposed and their possible impacts. The final Fast Track guidelines which will form part of the draft revised code for consultation will be informed by responses to this first consultation. They will also be informed your view of appropriate outcomes, prevailing market conditions, schemes' current positions (there will be a certain degree of 'calibration' to ensure impacts are reasonable) and a full impact assessment. We are looking to embed existing good practice in the revised code and therefore do not envisage that trustees of well-run, well-funded schemes will have to alter significantly what they are already doing.
- 223.** We are also particularly mindful to ensure the proposed framework is practicable and risks of unintended consequences are minimised. A key aim is also to ensure that the proposed framework broadly fits with current practices and does not discourage innovation and creative solutions.

Trapped/ongoing surplus

- 224.** It is important to distinguish between trapped surpluses (on a wind-up basis) and a surplus or overfunding on an ongoing (TPs) basis.
- 225.** There is a potential trapped surplus if a scheme is in surplus on a buy-out basis when wound up. Whether this is an actual trapped surplus and the excess can be returned to the employer depends on scheme rules. Our view is that the risk of trapped surplus is remote and manageable. There are mitigations available that can be used individually or in combination. For example:
- Contingent asset arrangements (such as escrow accounts) can be put in place to provide funding for the scheme to precisely the required s75 level on wind-up.
 - Rule amendments: Employers and trustees could agree that it is in the interests of members to ensure that the ongoing funding level is as high as possible. Therefore, they could agree to amend their scheme rules to ensure there is a return of surplus to the employer on wind-up.
- 226.** The risk of overfunding on an ongoing basis may occur if investment performance is better than prudently assumed. While it is important that trustees make prudent provision for their future liabilities, too much upfront funding may be undesirable if excessive or prolonged. However, we think there are sufficient flexibility in the regime to achieve the right balance between member security and the ability of the employer to manage competing demands on their cash flows effectively and efficiently:
- The Bespoke framework would allow for flexibility in how the funding and investments arrangements are constructed, including the use of additional support, eg to underpin longer RPs than allowed in Fast Track.
 - We are looking to take a pragmatic approach to prescribing maximum RP length and back-end loading guidelines under Fast Track (ie no requirement for full funding to be restored immediately and some limited back-end loading allowed).
 - Trustees can call a new valuation or revise DRCs based on annual updates.
 - Trustees can revise the Schedule of Contributions.
 - A surplus can be used to fund future accrual in open schemes.

Market impacts

- 227.** In this consultation, we propose that schemes should be de-risked as they mature and should be invested with a high resilience to risk at significant maturity. We also propose to set some investment limits in Fast Track, with trustees assessing the level of investment risk in their strategy through a stress test or other method (see Chapter 10). This may result in a higher allocation to bonds for many schemes and raises the question of whether there is sufficient market capacity to accommodate these changes.
- 228.** As explained below, our view is that there is already a clear trend towards significant bond allocation and under the current trends, we expect the average scheme to be able to comply with the most severe stress

test (at significant maturity) in six to eight years. As a typical scheme has 15-20 years to reach significant maturity, we don't expect a significant impact from de-risking from the new DB code for the average scheme. Some outliers (for example a mature scheme invested in 100% equities) would have to make some changes but we consider these changes are necessary.

- The average allocation to bonds from all pension schemes (weighted) is currently 63% (see table on average asset allocation in Chapter 16) and has been steadily increasing by around 3-4% a year for the last five years. The allocation to government bonds (UK gilts and UK inflation-linked bonds) as a proportion of total bonds is over 70%. Currently 41% of DB scheme assets (weighted) are in UK government bonds.
- Assuming this trend continues, we could expect the average weighted allocation to bonds to increase from 63% currently to around 80% in bonds within the next five years. This is based on the existing code that is currently in place and makes no allowance for any change in behaviour as a result of the introduction of this code or any other policy changes. Note that 63% is the weighted average and includes immature and mature schemes. If one includes annuities (currently 4%), as effectively bond-like in their nature, then the allocation is currently even higher at 67%.
- An allocation of 80% bonds (assuming over 70% of these bonds were government bonds as the current data shows) would be appropriate under our proposals on investment risk at the LTO (subject to consultation) for all scheme maturities and covenants assuming a scheme hedges its interest rate exposures fully using LDI (Liability Driven Investments) or alternative products.
- We expect the DB stress test we propose in Chapter 10 to incentivise schemes, particularly mature ones, to invest more in bonds but there are a number of alternative actions that may be used which may reduce the impact:
 - Schemes may choose to increase their level of interest hedging without changing their total bond allocation by using longer dated bonds or by taking advantage of LDI and other leverage/derivative strategies. This would provide a better protection to against a fall in interest rates and a lower level of downside investment risk relative to the liabilities.
 - Some schemes may use additional support such as contingent assets under the Bespoke approach to support the investment risk and therefore avoid the need to de-risk.
- Although government bonds will be an important part of any long-term asset allocation, schemes may choose to make use of corporate bonds or other bond like investments to a greater extent. Therefore, an increase in a scheme's bond allocation does not necessarily mean an increase in the allocation to government bonds.

► Question

Q20 Other issues – Do you agree with our assessment of the issues above and do you have any further comments?

Part 3: Application

(1) 'Fast Track'

7. Introduction to Fast Track

- 229.** In this section, we set out our proposals for how our proposed core principles could be applied in practice under Fast Track across the many variables that make up scheme funding arrangements:
- Setting the LTO (Chapter 8).
 - Defining the shape of the journey plan and setting TPs (Chapter 9).
 - Selecting the investment strategy (Chapter 10).
 - Determining the RP when there is a deficit relative to the TPs (Chapter 11).
 - Setting TPs and future accrual rates for open schemes (Chapter 12).
- 230.** We address each of these factors in turn, examining a range of options, and their advantages and disadvantages. Our review of the consultation responses, as well as our assessment of impacts will inform how we develop the Fast Track parameters and what we propose to codify (this will be the subject of our second consultation). The Fast Track framework will set the benchmark for what we consider to be an acceptable/tolerated level of risk for a particular scheme and its supporting employer.
- 231.** Chapter 15 in Part 5 provides a few simple worked examples to illustrate how Fast Track could work.

8. Setting the long-term objective

PRINCIPLES

- ★ By the time they are (i) significantly mature, we expect schemes to (ii) have a low level of dependency on their employer and (iii) be invested with a high resilience to risk.

Introduction

232. In this chapter, we set out our proposals for the following elements of a Fast Track LTO:

- Setting a funding target that takes account of
 - discount rates
 - other assumptions (relating to members' benefits and choices)
 - expense reserve, and
 - an investment strategy that is consistent with low dependency (ie highly resilient to risk).
- The timing for reaching that funding target, ie what measure of maturity we should use and how we should define 'significantly mature'.
- Whether we should set out ranges or a particular point for the LTO timing and low dependency funding basis.

233. We propose that all schemes, including open schemes, should aim for low dependency at significant maturity as a minimum. We explain in Chapter 12 our rationale for this. In practice, schemes that remain open may take a long time to reach significant maturity, if at all.

Low dependency funding target

234. There are several elements that make up a low dependency funding basis with high resilience to investment risk. The key elements are:

- discount rates
- other assumptions (relating to members' benefits)
- a reserve for future expenses, and
- the assumed investment strategy.

235. It should be noted that some of the Fast Track journey plan and investment options set out in Chapters 9 and 10 would require all schemes to calculate 'low dependency' liabilities. This means that immature schemes would need to be able to make this calculation, as well as mature schemes.

Discount rates

236. We consider that assumed discount rates should be consistent with the expected returns from an investment portfolio of assets that provide a reasonably good match for the scheme's liabilities. We would expect that prudent assumed returns would allow for risks in the asset portfolio that might reduce the return provided to the scheme, for example:

- the short-term volatility of the underlying asset allocation relative to liabilities (this relates to all assets but in particular growth assets (eg equities and low-quality corporate bonds)), and
- any defaults relating to the holding of corporate bonds.

237. Furthermore, the funding target should be such that there is a high chance of the scheme running off without requiring any further employer support and, to the extent such support is required, the level of that support should be low compared to the size of the scheme.

238. We consider that an appropriate funding basis for **Fast Track low dependency could be a discount rate in the range of Gilts +0.5% to Gilts +0.25%**³⁷, for the following reasons (see Chapter 16 for supporting evidence and analysis on the points below):
- Based on modelling carried out by the Government Actuary's Department (GAD), this is likely to represent a level of funding consistent with our definition of low dependency, ie there is a low chance of requiring further employer support and, to the extent that such report is required, the amount of support is low relative to the size of the scheme.
 - A lower funding target (ie discount rate of Gilts + over 0.5%) would be unlikely to provide the level of independence from the covenant that we are expecting schemes to achieve.
 - A higher funding target (ie discount of Gilts + less than 0.25%) would be close to the cost of buying out on current market pricing for significantly mature schemes and so, arguably, result in unnecessary cost for employers.
 - This is broadly in line with existing good market practices for long-term funding targets.
 - Most schemes that would fit the definition of significantly mature (ie have already reached a duration of 14 years or equivalent – see below) already fund to around this level so it is not out of line with current market practice.
239. We consider that expressing the discount rate relative to gilts is appropriate for a low dependency basis consistent with a relatively low risk investment strategy and that a discount rate in the range of Gilts +0.5% to Gilts +0.25% is appropriate in current market conditions. However, if market conditions change in the future, it may be appropriate to change the discount rate. We will cover how we propose to review and update the framework and communicate changes in our second consultation.
240. In this chapter, we seek views on whether we should be setting ranges or fixed points for the Fast Track LTO funding basis and timing to allow for some smoothing. We are also seeking views on the appropriate level for the LTO low dependency funding basis.

► Question

- Q21 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)?

Other assumptions (relating to members' benefits)

Options for Fast Track

241. There are numerous other assumptions required to calculate liabilities (eg inflation, pension increases, mortality, other demographic assumptions – see the table below for a list of main ones), and they can have a significant impact. In particular, as schemes mature, and a higher proportion of the liabilities relate to pensioners, the impact of assumptions for mortality not being borne out in practice becomes significant and can be very material to the scheme funding level.
242. A key question is to what extent we should define assumptions other than the discount rate in Fast Track to ensure an appropriate low dependency funding basis, balancing considerations around proportionality, scheme-specificity, the frequency of changes in the assumptions and risk of gaming or misuse.
243. We have considered the following options for defining assumptions other than the low dependency discount rate under Fast Track:

³⁷ Gilt yield curve or gilt yield with duration appropriate to the scheme's liabilities.

1. No requirements other than the principle that these assumptions, when taken together, should be no weaker than 'best estimate'.
2. We define some of these other assumptions, in particular, where it could be argued that they are not scheme-specific, eg price inflation (RPI and CPI) or future improvements in longevity. The remaining assumptions, when taken together, should be no weaker than 'best estimate'.
3. We define all these other assumptions.

244. We discuss how and at what level we should set these other assumptions (under the options where we would do so) further below.

245. Table 6 below sets out the pros and cons of each of these options:

Option	Pros	Cons
1. Overall 'best estimate'	<p>✓ The trustees and employers of individual schemes are in a much better position to determine the assumptions appropriate to their scheme than we are. Any prescription would lead to less appropriate assumptions being used.</p>	<p>✗ 'Best estimate' isn't a well-defined term for setting actuarial assumptions. It would be difficult for trustees and employers to verify that they had met this requirement.</p> <p>✗ These assumptions can have a significant effect on the calculated level of a scheme's liabilities. Without prescription, these assumptions could be 'gamed' to produce an inappropriately low funding target inconsistent with low dependency.</p> <p>✗ Where assumptions are not defined under Fast Track, more work will need to be done by schemes to determine appropriate assumptions. However, schemes currently do something similar under the current regime, so any extra work should be limited.</p>
2. We define assumptions which are not scheme-specific, with other assumptions no weaker than best estimate overall	<p>✓ Less open to 'gaming' than the no prescription option.</p> <p>✓ The assumptions specified under Fast Track are likely to be those which are most significant to the value of the liabilities, eg inflation and mortality.</p>	<p>✗ We would need to choose which assumptions to specify and which assumptions to leave as scheme-specific. It is not clear how this should be done. Mortality assumptions are particularly difficult to specify across all schemes.</p> <p>✗ Some defined assumptions may be inappropriate for a scheme's circumstances. This approach might drive these schemes out of the Fast Track regime unnecessarily.</p>
3. We define all assumptions	<p>✓ The option least open to 'gaming'.</p>	<p>✗ Some assumptions (eg mortality, pension increase caps and collars) are scheme-specific. It would be impossible to define these assumptions so that they remain appropriate to all schemes.</p> <p>✗ We would need to keep these assumptions under review and change them from time to time. Schemes would need to revise their low dependency assumptions accordingly. This would be unnecessarily burdensome for us and pension schemes.</p>

► **Question**

Q22 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?

246. Depending on which of the above options is chosen, we will need to determine the following:

- Where we define some/all other assumptions in Fast Track, which ones should these be and how should this be done?
- For assumptions not defined by us, how we can verify that assumptions, when taken together, are no weaker than ‘best estimate’?

247. We discuss each of these issues below.

TPR specifying some/all assumptions for Fast Track: which ones and how could this be done?

248. If we defined some or all of the assumptions (in the second and third options above), we would need to determine how to do this.

249. There are numerous assumptions, other than discount rates, that form part of an actuarial basis. The main assumptions are shown in Table 7 below, along with some suggestions for how they could be benchmarked under Fast Track:

Assumption	Notes	Example benchmarking factors
Inflation	Many pensions are linked to RPI.	Market implied RPI inflation based on fixed interest and index-linked gilt yields.
		Allowance for an inflation risk premium (IRP) to the appropriate extent, subject to taking expert evidence.
Differential between RPI and CPI	Most deferred revaluations are linked to CPI and some pensions are linked to CPI.	No more than best estimate for the difference, subject to taking expert evidence.
Pension increases	Depends on expectations and volatility of inflation plus model applied.	Difficult to benchmark because of the different models that exist and the lack of data on pension increase assumptions.
Mortality	Base table could be more scheme-specific, future improvements based on population trends.	Base table often based on socioeconomic factors (eg postcode analysis or medically underwritten mortality study) or an experience analysis if there are a sufficient number of pensioner members.
		Most recent Self-Administered Pension Schemes (SAPS) tables and Continuous Mortality Investigation (CMI) improvements and other available evidence,
Cash Commutation	Effect on liabilities depends on assumptions regarding commutation factors.	Expect to be set at less than 100% of maximum possible. Typically benchmarked against actual scheme experience.
Real salary increases (general and promotional)	Significant for many open schemes, and for cost of new benefit accrual.	For general increases no less than the level of deferred revaluation over the long term (as otherwise creates a strain on withdrawal).

CETVs (Cash Equivalent Transfer Values)	Schemes starting to allow for this in projected cash flows. Could significantly affect the duration of the liabilities.	Difficult to benchmark because of limited historic data and historic data may not be a guide to the future.
Other demographics	Includes allowance for ill-health, proportion married, withdrawals, early retirements.	Benchmarking is typically scheme-specific where there are sufficient members to assess experience and/or the terms on which members can take their benefits. For example, if a member can take some of their benefits unreduced from age 60 and some unreduced from age 65, this is likely to drive the assumptions for when members take early retirement.

250. We think that many of the assumptions in the table above are so scheme-specific in nature that it would not make sense for us to define them. If we are to determine any of these assumptions, we consider these should be restricted to financial assumptions that can be derived from market data (eg RPI and CPI inflation) and mortality assumptions.

► Questions

Q23 Defining assumptions for Fast Track low dependency funding basis

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

Verification that assumptions meet the 'best estimate principle'

251. In the options where we do not specify some or all of the assumptions under Fast Track (in the first and second options in above), we would need some mechanism to verify that the assumptions, when taken together, are no weaker than 'best estimate'.
252. We have considered the following options as to how this could be done:
- No additional requirement**, ie we would use current information disclosures from schemes to do the verification.
 - Additional disclosure requirements** (through information provided to us) to make it easier for us to understand the assumptions schemes have used.
 - A requirement that the **assumptions should be no weaker than another set of 'best estimate' assumptions** – eg compared to those used which represent 'best estimate' for the scheme – such as assumptions used in the employer's pension cost accounting, or assumptions used to set CETVs.
 - The **scheme actuary provides a certificate** stating that the assumptions used (other than the discount rate) are, when taken together, no weaker than best estimate.

253. Table 8 below sets out the pros and cons of each of these options:

Option	Pros	Cons
1. No additional requirement	<input checked="" type="checkbox"/> Least burdensome option.	<input checked="" type="checkbox"/> Option most open to 'gaming' as information currently submitted is limited, ie inflation and salary increase assumptions and some life expectancies for members of different ages.
2. Additional disclosure requirements	<input checked="" type="checkbox"/> Could be implemented with quite limited additional requirements so as not to be too burdensome for schemes to comply with. Yet the option could also allow us to scrutinise a scheme's assumptions in reasonable depth (and avoid the need to open new investigations unnecessarily).	<input checked="" type="checkbox"/> Still somewhat open to 'gaming' as we would not be able to assess whether the scheme-specific assumptions are appropriate to a scheme unless the additional disclosure requirements are substantial (ie including full experience analysis).
3. Comparison with other sets of 'best estimate' assumption	<input checked="" type="checkbox"/> Provides an independent comparator.	<input checked="" type="checkbox"/> Some employers may not have pension cost accounts to make the relevant comparison. <input checked="" type="checkbox"/> This option may be circular as some schemes and employers base their pension cost accounting and CETV on the funding assumptions rather than the other way around. <input checked="" type="checkbox"/> CETV assumptions may not allow for options which members are likely to take, eg early retirement, cash at retirement.
4. Scheme actuary's certificate	<input checked="" type="checkbox"/> Would provide strong verification that the assumptions are set appropriately.	<input checked="" type="checkbox"/> Assumptions for setting the low dependency basis would need to be agreed by the scheme actuary. This would change the balance of power in the scheme funding regime, particularly as the scheme actuary advises the trustees (and not the employer). <input checked="" type="checkbox"/> Would add costs as scheme actuaries would need to do additional work to provide such a certificate.

254. Our preferred option is the second option – additional disclosure requirements. We would need to determine what these should be, and in doing so, balance the potential cost to schemes of making additional disclosures against the need to have sufficient information to make the required assessment.

► Questions

Q24 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?
- 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?

Other assumptions: should some of the assumptions be set prudently?

255. We have put forward some options for setting the other ‘assumptions’ which imply it is reasonable for all assumptions other than the discount rate to be set at ‘best estimate’. However, you could argue that liabilities calculated in this way would not meet the objective of achieving low dependency, because the likelihood of the ‘best estimate’ assumptions not being borne out in practice would be too high. For example, it could be argued that long-term future improvements in mortality are so uncertain that this assumption should be set prudently.

► Questions

Q25 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?

Reserve for future ongoing expenses

256. To achieve low dependency, we consider a reserve for future ongoing expenses would ideally be included in the low dependency liabilities used for Fast Track. However, this may not be necessary if the scheme’s trust deed and rules provides for the employer to reimburse a scheme’s ongoing expenses on an arising basis. For schemes that do not have this provision, we would expect that an explicit reserve should include all future expected ongoing expenses, including PPF levies. We recognise that there are practical difficulties in calculating an appropriate ongoing expense reserve based on assumptions about future expense levels many years into the future. This particularly affects smaller schemes.
257. In the paragraph above, we refer only to ongoing expenses as we have assumed that the low dependency funding basis applies when an employer is solvent with a continuing scheme. A scheme will not be able to ‘run on’ in the normal course of events if the employer suffers an insolvency event. We have therefore not considered the possibility of an express reserve for winding up expenses.

► Questions

Q26 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?

Assumed Investment strategy

258. We do not propose to specify which asset allocation trustees should invest in at significant maturity – our focus is on investment risk. There are many different types of investment strategies which have a high resilience to investment risk. However, on reaching significant maturity, we would expect schemes to adopt a strategy broadly consistent with a low dependency funding basis, or to otherwise explain why they have adopted a different strategy through the Bespoke route.
259. Some examples of appropriate strategies include the following:
- **“Barbell” strategy** – The majority of the assets are invested in gilts and LDI, which provide a very good match for the scheme’s cash flows, with the remaining small proportion of assets invested in a diversified growth portfolio. The growth portfolio is expected to provide the small amount of additional return required to achieve returns above those assumed for the discount rate in the low dependency basis.
 - **Credit-based strategy** – Wholly invested in bonds, the majority of which are high-quality and liquid. This strategy is not aiming for a precise cash flow match nor to remove the re-investment risk. Instead, the strategy is aiming for some addition return over the discount rate to provide a buffer against adverse future experience. This strategy might include a mixture of gilts and corporate bonds, including some illiquid and multi-asset credit.
 - **“Cash flow-driven-investment” strategy** – An extension to the credit-based approach to invest in a portfolio that is expected to deliver cash flows which very closely match the liabilities. Such an approach is likely to include a higher proportion of less risky assets, ie more gilts and high-quality corporate bonds with a low chance of default.
260. In Chapter 10 on the investment strategy, we set out options for measuring the actual level of investment risk associated with any strategy. For example, at the simplest level, we could look at the percentage invested in growth assets. An alternative would be to require schemes to apply a stress test.
261. We also set out proposals for setting a limit on the percentage in growth assets or increase in the deficit as a result of the stress test, which applies when schemes are significantly mature. We consider that having a high resilience would be consistent with having a relatively low percentage of growth assets or a proportionately small increase in the deficit following the application of a stress. As part of our second consultation on the DB code, we will propose some numerical limits.

Scheme maturity

Measures of maturity

262. As set out in Chapter 5 on General principles, we expect schemes to reach low dependency funding when they are significantly mature. Therefore, we need to decide how to measure maturity. There are many different measures of maturity, each having advantages and disadvantages. We consider the four main measures are as follows:
- **Duration of the liabilities**³⁸: This is the mean term of the liabilities weighted by the value of the scheme’s future cash flows. It is measured in years and can be calculated directly using the scheme’s cash flows. Mature schemes have a shorter liability tail and, hence, a shorter duration while immature schemes have a longer duration. An alternative measure, producing a similar answer (where benefit cash flows from year to year are reasonably smooth) is based on the sensitivity of the scheme’s liability to small changes in the discount rate: the more mature the scheme, the lower its sensitivity to changes in the discount rate. The two approaches require different calculations, the former based on

³⁸ Note that this is a technical value derived from the cashflows and not a simple measure of time.

cash flows and the latter based on liabilities, but both produce similar answers when expressed as a number of years.

- **Proportion of remaining cash flows relating to pensioner members:** Future benefit cash flows are calculated based on actuarial assumptions underlying the scheme's liabilities. Cash flows are calculated separately for current pensioners and current non-pensioners. This measure of maturity is calculated by dividing the total amount of future cash flows relating to current pensioners by the total amount of future cash flows for all members.
- **Proportion of scheme assets (or liabilities) paid as benefits:** The amount of benefits expected to be paid out over the next year divided by the current value of the scheme's assets (or liabilities).
- **Proportion of liabilities that relate to pensioner members:** The amount of liabilities relating to current pensioners is divided by the amount of liabilities relating to all members' past service benefits.

263. Whatever measure of maturity is adopted for Fast Track, it needs to be appropriate not only for defining the point at which a scheme is significantly mature but also to measure maturity at different points in a scheme's life, and it should be capable of being measured in a consistent and objective way. An assessment of the different measures of maturity is provided in Table 9 in the appendix to this chapter.
264. The above measures of maturity are sensitive to the assumptions used to project cash flows and calculate liability values. This means that the maturity calculation could be used to game the Fast Track regime or could be done inconsistently across schemes. This might be mitigated in part by using the low dependency basis assumptions under Fast Track. This would not remove sensitivity to changes in assumptions but would, at least, bring an element of consistency to the calculations over time and some consistency between different schemes.
265. We think that a high percentage of assets being paid out as cash flows is the most important reason why schemes need to be properly funded on a low dependency basis at significant maturity and to manage volatility of their asset values. If a scheme is not adequately funded at this stage, then the remaining assets have to provide higher returns to close what is now a proportionately bigger deficit. However, because the scheme is mature, there is less time to capture the long-term outperformance from growth assets. In addition, if the investment strategy does not have a high resilience to risk, then the resulting investment volatility means there is an increased risk of having to sell assets in falling markets to meet benefit payments.
266. Hence, the proportion of scheme assets paid as benefits annually appears to be the most appropriate measure of maturity to use to define when a scheme is significantly mature. However, in practice different schemes will have different funding levels at the time they reach significant maturity. To ensure consistent measurement across all these different schemes, we may want to express the ratio of benefits to a standard liability measure, eg low dependency.
267. There are some disadvantages with using this measure across all schemes, including the following:
- Variability in cash flows year-to-year for smaller schemes, where a few members represent a high proportion of the total liabilities and the timing of retirement and other member options is significant relative to the total cash flows of the scheme.
 - The incidence of CETV payments and retirement lump sums (in small schemes) can distort the measure significantly.
 - Although it has the advantage of being straightforward to calculate at a valuation date, it is just as complicated to determine how this measure is expected to develop over time.
268. On balance, we think the duration of the liabilities would be a more suitable measure to define the point of significant maturity because of the following:
- It avoids the disadvantages (see paragraph above) associated with variability and incidence. of cash flows which the measure 'Proportion of scheme assets/ liabilities paid as benefits' has.
 - Many scheme actuaries will already calculate duration as part of their actuarial valuation.
 - It is relatively straightforward to calculate how a scheme's maturity is expected to develop in the future.

- Although potentially more difficult for non-actuaries to understand, it can be translated into an equivalent 'ordinary' timeframe (eg a scheme can estimate how many years into the future it is expected to reach significant maturity by).

► Questions

Q27 Definitions of maturity

- 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.
- 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?

Time to reach significant maturity

- As a scheme matures, it becomes susceptible to an investment spiral risk if it remains underfunded. This means by an increasingly higher proportion of assets begin to be paid out in the form of benefits each year, and because the scheme is not fully funded, the deficit begins to grow in relation to its liabilities. This may be aggravated further by an investment downside event forcing trustees to sell assets in an unplanned manner (see more details in Chapter 16).
- To stop this risk spiralling out of control trustees would need to either:
 - seek higher investment returns by investing in a strategy which would be inconsistent with having a high resilience to risk, and/or
 - seek substantial additional funding from the employer, which would inconsistent with low dependency on the employer.
- It is important to note that this risk is a direct consequence of the scheme being underfunded, with increasing levels of benefit outflow for mature schemes simply serving to accentuate it. We therefore consider it prudent for trustees to manage this risk by planning to reach full funding on the low dependency basis before the scheme reaches a particular level of maturity, which we define as significant maturity, when the risk may otherwise become unmanageable.
- In the previous section, we discuss in more detail the precise definition of a low dependency funding target, and in Chapter 16 we present evidence to support our preference.
- On the timeframe for reaching full funding on the low dependency basis, we propose that **'significant maturity' should be defined somewhere in the range of duration 14 years to 12 years (or another maturity measure which results in a similar timeframe)**. Duration 14 years to 12 years is broadly equivalent to a point at which the scheme will be paying out 5% or 6% of its liabilities each year as benefits. Anecdotal evidence from some practitioners in the pensions industry suggests that it would be prudent to have the investment spiral risk under control by the time the scheme's annual benefit payments have reached this level. Furthermore, the evidence shows that leaving the scheme underfunded for much longer may have a significant effect on risk by the time the annual benefits have reached about 7-8% of liabilities.
- Analysis we have commissioned from GAD³⁹ shows that whether we require schemes to reach low dependency at a duration of 12 years or 14 years has little effect on the assessed security of members' benefits and likelihood of requiring future funding from the sponsoring employers after that point. This is

³⁹ See Chapter 16 on Evidence and Analysis.

because, once the scheme has reached full funding on the low dependency basis and has an investment strategy broadly aligned with this basis, the risk of the investment spiral has been largely eliminated.

275. However, whether a scheme reaches low dependency at duration 12 years or 14 years (or earlier) does affect the period over which the scheme remains reliant on the employer covenant before reaching low dependency and also the rate at which the employer needs to contribute to get there. For an indication of the typical timescales involved, the average scheme may currently have maturity duration of around 21 years and it may take a little over 15 years for it to reach maturity duration 14 and around another five years to reach maturity duration 12. Chapter 16 (Evidence and Analysis) includes a figure showing the current maturity profile across DB schemes.
276. We intend to test the potential impact of setting significant maturity at a range of duration 14 to 12 years on the journey plans and employer contribution rates of DB pension schemes as part of the modelling work we will undertake to inform our second consultation. We do not wish to place an unnecessary financial burden on employers of DB pension schemes by requiring them to fund their schemes to a low dependency level too quickly. Nor do we wish to allow schemes to aim for low dependency too late and run the investment spiral risk described above. The impact assessment will help us determine whether setting significant maturity at a range of duration 14 to 12 years appropriately balances these risks.

► **Question**

- Q28 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.

Points or ranges for low dependency funding basis and timing

277. **Low dependency funding could be set at a particular level** (ie Gilts +0.25%) **to be reached at a particular point in time** (ie when a scheme reaches a duration of 14 years) in Fast Track. Alternatively, we could set a range of funding levels and timings (eg Gilts +0.5% to Gilts +0.25% and duration of 14 to 12 years).
278. Setting a particular funding level and timing has the advantage of providing clear targets for trustees and employers and our regulatory activities. However, this could create volatility in contribution levels as a scheme approaches significant maturity if, for example, a deficit emerges on the fixed low dependency funding basis at a time close to the fixed point for reaching significant maturity.
279. An alternative would be to allow ranges, eg reaching low dependency funding within [x to y] years (with reference to scheme maturity) and/or calculated using a discount rate of [a to b]. This has the advantage of giving schemes some scope to adapt their journey plan (to a limited degree) to help deal with short-term volatility of investment markets and smooth the level of contributions which employers are required to pay.
280. To help balance the need for a clear, distinct target and allow some smoothing, we propose to set the low dependency funding basis at a particular level (we propose somewhere between Gilts +0.5% to 0.25%) but the timing point as a range (duration 14 to 12 years or equivalent measure).

► **Question**

- Q29 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?

Period after significant maturity

- 281.** However a scheme's LTO is defined, once it reaches significant maturity we expect the scheme to have reached its LTO. This means it should be fully funded on a basis consistent with a low level of dependency on its employer and with an investment strategy that is highly resilient to risk. After this point, we expect the scheme to at least maintain low dependency funding and continue to invest with a high resilience to risk. Fast Track TPs should be set at least equal to low dependency liabilities once a scheme has reached significant maturity. Trustees and their sponsoring employers may also wish to set a further objective to buy out (or buy-in) the liabilities at some point after reaching significant maturity.
- 282.** Trustees should also continue to monitor and manage the remaining investment risks and the other risks their scheme is exposed to, such as longevity risk and administration expenses, which will assume greater importance. Risk management continues to be an important trustee task over this period. Trustees may seek to mitigate some of the longevity risks through, for example, longevity swaps or partial 'buy-ins'.

Appendix – Different measures of maturity

283. Table 9 sets out an assessment of the different measures of maturity.

Measure → Criteria ↓	Duration of the liabilities	Proportion of remaining cashflows relating to pensioner members	Proportion of scheme assets (or liabilities) paid as benefits	Proportion of liabilities that relate to pensioner members
How easily can this be calculated and understood?	<p>This is widely used by scheme actuaries as part of their valuation calculations. It is relatively easy to calculate for all schemes.</p> <p>It may be hard for trustees and sponsoring employers to understand that there is not a 1:1 link between time and duration. Typically, for a closed scheme, each year of time will result in the duration of the liabilities falling by 0.3 to 0.5 years.</p> <p>The calculation of duration varies with different discount rates, ie if the discount rate is high, this results in a lower value for the duration and vice versa. (However, for the purposes for which we want to use this measure, we can fix the discount rate across the board at, say, the Fast Track low dependency discount rate.)</p>	<p>This measure is easily understood and already used by some consultancies.</p> <p>To calculate this measure, trustees need access to cash flows for all future years. These cash flows may not be readily available to smaller schemes or may only be available at additional cost, material relative to the size of the scheme's assets.</p>	<p>This measure is easily understood and already used by some consultancies, particularly in the context of considering future investment strategies and cash flow matching.</p> <p>To calculate this measure at future dates, trustees need access to cash flows for all future years, split between pensioners and non-pensioners. These cash flows may not be readily available to smaller schemes or may only be available at additional cost, material relative to the size of the scheme's assets.</p> <p>But to calculate the scheme's current maturity, trustees don't need any new calculations – the relevant information is available in the most recent scheme accounts.</p>	<p>This measure is simple to calculate and is widely used a rule of thumb for a scheme's current maturity.</p> <p>Less simple if you want to calculate projected maturity levels at future dates.</p>

<p>How easy is it to estimate how a scheme will mature under each measure?</p>	<p>If the measure is based on estimated future cash flows, it is straightforward to calculate duration at all future dates once these cash flows have been calculated. If an alternative measure is used, to estimate duration at future dates maybe more difficult.</p> <p>For a scheme open to new entrants, it would be necessary to make an assumption about the rate of new entrants in future years.</p>	<p>To calculate this measure at future dates, it would be necessary to track how the balance between non-pensioner and pensioner cash flows change as members retire. This would be a very complex calculation.</p> <p>For a scheme open to new entrants, it would be necessary to make an assumption about the rate of new entrants in future years.</p>	<p>As for duration but would also require a projection of the scheme's asset or liability value.</p> <p>For a scheme open to new entrants, it would be necessary to make an assumption about the rate of new entrants in future years as well as the level of contributions paid to meet these new benefits.</p>	<p>To calculate this measure at future dates, pensioner and non-pensioner liabilities would need to be calculated at those future dates. Such calculations would need to take account of the changing balance of pensioner and non-pensioner liability over time.</p> <p>For a scheme open to new entrants, it would be necessary to make an assumption about the rate of new entrants in future years.</p>
<p>How significantly is this measure affected by market conditions?</p>	<p>Duration depends on the assumption used for the calculation of the liabilities, particularly discount rates. As a result, duration may be very sensitive to changes in market conditions.</p> <p>For example, if there was a significant increase in the discount rate, this could result in a material reduction in the calculated duration of the liabilities.</p>	<p>Still affected by market conditions to some degree, particularly changes in future expected inflation. However, less affected than other measures.</p>	<p>Benefits payments are still affected by market conditions to some degree, particularly changes in future expected inflation. However, less affected than other measures.</p> <p>If liabilities are used as the denominator, these could also be affected by changes in the discount rates similarly to the proportion of liabilities that relate to pensioner members.</p> <p>If assets are used as the denominator, there is potentially a big exposure to market conditions. Furthermore, a scheme's funding level will affect this measure of maturity, eg a poorly funded scheme will be rated as more mature, all other things being equal.</p>	<p>Because it's a liability measure, it depends on the assumption used for the calculation of the liabilities, particularly discount rates. As a result, the ratio of pensioner and non-pensioner liabilities may be too sensitive to changes in market conditions. For example, if there was a significant increase in the returns expected on the scheme's assets, this could result in a material increase in the ratio of the pensioner liabilities to the overall liabilities.</p>

<p>What is the risk that this measure can be 'gamed'?</p>	<p>In theory, the calculation of duration could be gamed by changing particular assumptions. For example, by assuming no cash commutation at retirement, the duration of the liabilities could increase significantly.</p> <p>However, we consider this to be a relatively low risk as we would expect trustees, as advised by scheme actuaries, to seek to use realistic assumptions to calculate cash flows and benefits.</p>	<p>Difficult to 'game' although still affected by assumptions to some degree (eg inflation, mortality).</p>	<p>Difficult to 'game' although still affected by assumptions to some degree (eg inflation, mortality).</p>	<p>Relatively difficult to 'game' although still affected by assumptions to some degree (eg inflation, mortality).</p> <p>In addition, the ratio can be materially different depending on the discount rate structure used. For example, if a scheme uses a pre- and post-retirement discount rate approach, this will result in a higher ratio than a single discount rate approach.</p>
<p>How volatile is this measure to membership movements?</p>	<p>Less volatile than other measures, as the overnight change in the duration in respect of the liabilities of members retiring is not normally significant. However, will still be affected by other changes to the scheme membership, eg a member's transfer exercise (for non-pensioners) could significantly decrease the duration of the liabilities.</p>	<p>For smaller schemes, the timing of retirement of individual members with big benefits creates large and sudden changes to the ratio.</p>	<p>Smaller schemes may have volatile cash flows year-by-year, eg one or two members with high proportion of the liabilities retiring and taking a cash lump sum or choosing to take a CETV.</p>	<p>For smaller schemes, the timing of retirement of individual members with big benefits creates large and sudden changes to the ratio.</p> <p>The measure may be too simple as it doesn't reflect that some schemes have lower Normal Retirement Ages (NRAs) (eg age 60) and/or a young pensioner population. Such schemes will still have a long time until the last benefit is paid and therefore may not need to de-risk to the same extent as another scheme which has a higher NRA (eg age 65) and an older pension population. This could be case even when both schemes have the same proportion of liabilities that relate to pensioners.</p>

9. Technical provisions (TPs)

PRINCIPLES

- ★ We expect trustees to develop a journey plan to achieve their LTO.
- ★ We expect trustees to plan for investment risk to decrease as their scheme matures and reaches low dependency.
- ★ TPs should have a clear and explicit link to the LTO and, over time, should converge to the LTO as evidenced by the journey plan.
- ★ Schemes with stronger employer covenants can take more risk and assume higher returns. However, trustees should assume a reducing level of reliance on the covenant over time, depending on its visibility.

Introduction

284. In Chapter 5, we proposed key principles for schemes achieving their LTO based on the assumption that schemes would set a journey plan, with TPs acting as key milestones on the journey, and reduce the levels of investment risk as they mature.
285. In this chapter, we outline our proposals for guidelines on suitable journey plans for achieving an LTO and how TPs could be set in the Fast Track framework. This focuses on an acceptable level of risk that could be *assumed* in the TPs. Chapter 10 on the investment strategy considers the actual level of risk taken by schemes (and what to do if it differs significantly from risk assumed in the TPs).
286. As we explained In Chapter 12, we propose that Fast Track TPs for open schemes should be set consistently with closed schemes of the same maturity.
287. We are seeking views on the following:
- What key factors should determine an appropriate journey plan to achieving low dependency funding, particularly regarding the shape of the de-risking journey and the scheme-specific factors which should be taken into account (eg maturity, covenant).
 - Having decided what journey plans should broadly look like, what parameters we should define with regards to setting TPs in Fast Track (eg discount rates or funding ratios).
 - How we could derive these guidelines and parameters in practice.

Journey plan

288. There are three key factors which will determine what appropriate journey plans should look like:
- The underlying shape of the journey plan, including scheme-specific factors such as maturity and investment risk.
 - The level of covenant support provided by the sponsoring employer.
 - How reliance on covenant may change over the longer term (covenant visibility).

Shape of the journey plan

289. A journey plan to the LTO could take several different shapes. These reflect different approaches to risk-taking and de-risking on the journey to reaching low dependency funding. However, they share a common principle that more immature schemes can assume a higher level of investment return, which can be reflected in the discount rates used to calculate the TPs (see Chapter 5 on General principles). An immature scheme has a longer investment time horizon and therefore, in general, can place more reliance on growth assets out-performing matching assets over the long term and ride out short-term volatility in asset values.

290. Our objective is to provide Fast Track guidelines on acceptable risk-taking on the journey to low dependency funding, while providing some flexibility to reflect the fact that trustees have different investment strategies appropriate for their scheme. This section focuses on assumed investment risk. Actual investment risk is addressed in Chapter 10 (including a consideration of the impact of different journey plan shapes on the investment strategy).
291. Figure 1 below shows three types of journey plan shapes schemes can and do adopt. We need to adopt one approach in order to determine Fast Track TPs:
- **Linear de-risking**
 - **Horizon (or ‘lower for longer’) de-risking, and**
 - **Stepped de-risking.**



292. Each journey plan shape represents a different balance over time between assumed investment risk and member security and so affects the structure of the term-dependent discount rates used to value scheme liabilities (ie they are not ‘flat’ discount rates that reduce at each valuation).
293. All these journey plans imply that the required Fast Track TPs expressed as a proportion of the low dependency funding basis will increase as a scheme matures. For example:
- Under the horizon approach, the pre-horizon period (before the step down in the discount rate at significant maturity) will become shorter at each valuation. This means the overall single equivalent discount rate is moving close to that used in the low dependency basis.
 - Under the stepped and linear approaches, the term-dependent discount rates will reduce over time and so, as the discount rates unwind, the single equivalent discount rate moves closer to the low dependency rate.
 - The choice of method only affects the pace at which TPs approach the low dependency funding level.
294. Other actuarial assumptions which make up valuations are considered in Chapter 8. Our approach to setting these assumptions under Fast Track for TPs would be consistent with the approach we are consulting on for low dependency.

Linear de-risking

- 295.** Under this approach, the assumed level of investment risk and return reduces progressively over time, eg each year or each quarter, as the scheme becomes more mature. The rate of reduction could be linked to:
- a maturity measure, eg years of duration of the liabilities, or
 - linearly from a starting point appropriate to the initial maturity of the scheme moving to a level of investment risk and return consistent with low dependency funding by the time at which the scheme is expected to be significantly mature.
- 296.** Once the scheme reaches significant maturity, the assumed level of risk and return become constant and consistent with the risk implicit in the low dependency basis. Table 10 below sets out the pros and cons of this approach:

Pros	Cons
<p><input checked="" type="checkbox"/> Implicitly presupposes the assumed level of investment risk will converge to the level of risk the scheme will run after it has reached significant maturity. Therefore, it creates a smooth path towards low dependency.</p> <p><input checked="" type="checkbox"/> Assumes the higher level of investment risk at the point at which the visibility of the covenant is greatest and therefore the potential for the employer to provide additional funding following a downside event is the highest.</p> <p><input checked="" type="checkbox"/> Relatively simple to understand.</p> <p><input checked="" type="checkbox"/> Results in a broadly similar pattern for term-dependent discount rates as a pre and post retirement discount rate approach, which is the one most commonly used under the current framework. However, the post-retirement discount rate typically needs to be lower than the low dependency discount rate for these methods to be equivalent (see paragraph 306).</p>	<p><input checked="" type="checkbox"/> Where scheme size is expected to reduce in the near future (as is the case for many closed schemes), this approach assumes that the highest amount of risk (in £ terms) will be taken now rather than later. As a result, if a downside event happens at this time, it will have the largest effect on the schemes funding in £ terms.</p> <p><input checked="" type="checkbox"/> Schemes are expected to broadly align their investment strategy with the level of risk assumed in the TPs (see Chapter 10 on investment strategy). Having a progressive reduction in the level of assumed investment risk and return means the investment strategy will need to be reviewed and changed frequently, requiring appropriate governance from the trustees. For small schemes, this may have resource implications.</p>

Horizon (or 'lower for longer') approach

- 297.** Under this approach, there is one level of assumed investment risk and return in the period before the scheme reaches its LTO and a lower level of assumed investment risk consistent with low dependency funding thereafter. The time at which the scheme is expected to achieve low dependency funding could be linked to the scheme's maturity or another measure (see Chapter 8 on LTO). This approach is sometimes referred to as the 'lower for longer' approach, ie the scheme starts by assuming that it will take lower risk than under a linear approach but maintains that level of risk over a longer period.

298. Table 11 sets out the pros and cons of this approach:

Pros	Cons
<p>☑ Where scheme size is expected to reduce in the near future (as is the case for many closed schemes), this approach assumes that a lower amount of risk (in £ terms) will be taken now rather than later. As a result, if a downside event happens at this time, it will have a smaller effect on the scheme's funding in £ terms, which may increase the security of members' benefits in the long run, relative to a linear de-risking approach.</p> <p>☑ Over time, the value of the liabilities of a closed scheme is expected to reduce in £ terms. As a result, although the relative level of assumed investment risk remains the same over the pre-horizon period, the £ amount of risk will reduce. To the extent that the strength and value of the covenant remains the same over time, this means the level of investment risk will become more easily supportable over time.</p> <p>☑ It may be easier for schemes to plan their future investment strategies based on this approach of having two distinct periods, compared to a linear de-risking approach with regular de-risking.</p>	<p>☒ Unlike the linear approach, there is not a smooth de-risking path towards low dependency funding. In theory, the scheme could continue to assume to take significant amounts of investment risk until just before it reaches significant maturity, when the scheme's assets are potentially less able to recover from a downside event.</p> <p>☒ Results in a very different pattern for term-dependent discount rates to a pre- and post-retirement discount approach, which is the one most commonly used under the current framework. This may therefore represent a significant change from current practice. However, the initial level of TPs may not be that different.</p>

Stepped approach

299. The time before the scheme reaches its LTO is split into a number of periods. During each period, there is a fixed level of assumed investment risk and return allowed for in the discount rates. As the scheme transitions from one period to the next, the level of assumed investment risk and return reduces. For the purposes of the Fast Track approach, these would be fixed time periods (not necessarily of the same length). Many schemes may choose to step up their actual de-risking based on pre-defined triggers such as funding level, which are expected to broadly match the assumed periods.
300. This approach sits somewhere between the linear approach and horizon approach. If there are many short periods, then the approach will be similar to linear de-risking. If there is a small number of long periods, then the approach will be similar to the horizon method. Table 12 sets out the pros and cons of this approach:

Pros	Cons
<p>☑ Potentially, this could represent the best of the linear and horizon method as there is some implicit de-risking in the journey but, by having set periods, it will be easier to plan the scheme's future investment strategy.</p>	<p>☒ More complicated to understand than the linear or horizon method.</p>

Other approaches

- 301.** There are numerous other approaches to de-risking, which could be built into the discount rates based on a combination of the three approaches set out above. For example, we could have a mixture of the horizon and linear approach where there is a fixed level of assumed investment risk and return over an initial period, followed by period of de-risking along a straight line down to a low dependency level.
- 302.** Alternative approaches could be used which implicitly build in de-risking without explicitly linking it to a particular time period. For example, a common approach is the ‘pre- and post-retirement’ method where a higher discount rate is used prior to a member’s pension age and a lower rate thereafter, the overall rate being a function of the scheme’s membership distribution.
- 303.** We would be interested to hear about the other approaches schemes currently adopt and what alternatives people would recommend we consider.

► Questions:

Q30 Journey plan shape for Fast Track TPs

- 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?
- Are there any other journey plan shapes we should consider?
- What unintended consequences might arise from adopting the linear de-risking or horizon method journey plans for Fast Track?

Comparison of the proposed approaches with those commonly in use.

- 304.** To promote effective compliance and to minimise sudden changes across the DB funding landscape, we want to ensure that most schemes can choose to take the Fast Track compliance route without making material changes to their approach to journey planning and setting TPs.
- 305.** Table 13 summaries how four valuation approaches used to calculate TPs compare to the proposed journey plans set out in the previous section:

Valuation approach	Description	How commonly used currently	Comparison to proposed journey plans
Pre- and post-retirement discount rate	<p>Post-retirement discount rate applies to current and future benefits paid to pensioners. Typically, the rate is in line with returns expected on a lower risk investment strategy which broadly match liabilities.</p> <p>Pre-retirement discount rate applies for period up to each member’s retirement. Typically, the rate is in line with the higher expected returns from a portfolio which includes a proportion of growth assets.</p>	Very common.	Broadly aligns with the linear de-risking journey plan.
Single discount rate	A single fixed discount rate, or single fixed addition to a risk-free rate (eg gilts or swaps), which applies over all periods.	Quite common.	Diverges from all the journey plans over time.

Horizon method	One discount rate which applies over an initial period followed by a different discount rate which applies for all period thereafter.	Small proportion of schemes.	Most closely aligns with the horizon journey plan.
Term-dependent discount rates	Discount rates that vary each year based on some assumptions for the scheme's investment strategy in the future. Normally allows for some de-risking in the investment strategy.	Small proportion of schemes.	Normally aligns with our proposed principles so can comply without significant adjustment.

306. We have provided a more detailed explanation of how the different approaches compare below:

- **Pre- and post-retirement discount rate:** If the post-retirement discount rate is set at the low dependency basis discount rate, then the effective discount rate in each year is likely to follow a pattern similar to the linear de-risking approach. As a result, the TPs under the two approaches are likely to be similar at most maturities and so many schemes using pre and post discount rates will be able to comply with Fast Track without adjusting their approach.
- When the level of TPs may differ is when the scheme reaches significant maturity. At this point, the TPs under a pre- and post-retirement discount rates approach are likely to be somewhat lower than the linear de-risking approach because a proportion of the members will not have retired. This could be managed in practice by reducing the post-retirement discount rate to a level slightly below the low dependency discount rate.
- **Single discount rate:** Using a single discount rate (at a higher rate than the low dependency discount rate), which does not change over time, is likely to diverge significantly from the proposed methods as the scheme gets closer to significant maturity. There is no explicit de-risking in a single discount rate approach and consequently, when the scheme is significantly mature, the discount rate could be significantly higher (and the TPs significantly lower) than under our three proposed journey plan approaches.
- Many schemes that currently calculate their TPs using a single discount rate appear to be planning to reduce the discount rate at future valuations as the scheme becomes more mature. If they do reduce the discount rate as planned, this approach may resemble one of the approaches above, depending on how the reduction is applied in practice.
- **Horizon method:** There are a few different horizon methods currently in use. Some of these are more like a pre- and post-retirement discount rate approach (and therefore produce similar results to the linear de-risking approach). Others are more like the horizon method we are suggesting under the new framework, eg a higher discount rate over an initial period of, say, 15 years and a lower discount rate thereafter. For most schemes, it would be a relatively easy change conceptually to ensure the TPs comply with our Fast Track if it was based on the horizon method journey plan set out above.
- **Term-dependent discount rates:** Schemes are increasingly adopting term-dependent discount rates, which allow for assumed de-risking year by year. Schemes are using several different shapes for their de-risking plan. However, such a journey plan should conceptually align with our proposed principles, so that trustees of such schemes should be able to comply with Fast Track without significantly adjusting their approach.

Employer covenant and TPs

307. In addition to the broad shape of the journey plan, we need to consider which factors should affect the shape of the discount rates/TPs in the Fast Track framework. The employer covenant is a key scheme-specific factor which could determine the appropriate assumed level of risk and return to assume in TPs.
308. In Chapter 4 on the role of the employer covenant, we are seeking views on whether reliance should be placed on the employer covenant in the funding regime and, if so, how the covenant should be factored in.
309. Our starting point for the purpose of this consultation is that we should assume schemes can rely on the covenant to underpin additional levels of investment risk assumed in setting discount rates and TPs (in line with current market practice) – albeit subject to our defined limits.
310. Figure 2 below illustrates Fast Track discount rates assuming (illustratively) a linear de-risking shape for the journey plan. We would set baseline TPs which are independent of covenant and define additional lines allowing for higher assumed investment risk in the TPs for different covenant strength up to a maximum assumed investment return allowance (for CG1).
311. While we could envisage schemes assuming additional investment risk under this approach, where evidenced by stronger employer covenant, we would (for the reasons above) expect these lines to converge to the LTO. This would mean there is low dependence on the covenant at the point of significant maturity (unless, for example, underwritten by additional support such as a contingent asset, as discussed in Part 4 (Bespoke framework)).



► Questions:

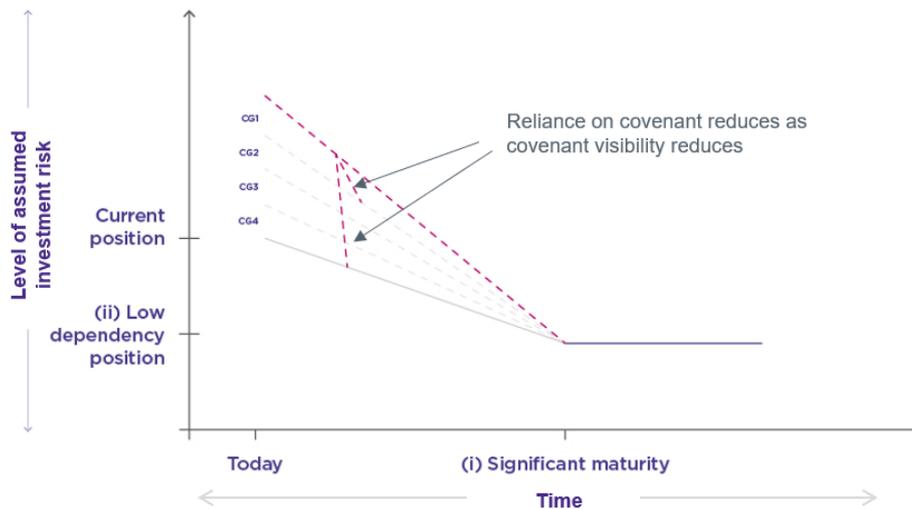
- Q31 Key factors for Fast Track TPs** – Should other scheme-specific factors other than covenant and maturity be considered to define the journey plan and TPs in Fast Track?

Covenant visibility

312. In Chapter 5 on the General principles, we discussed how long covenant should be relied upon. That is, whether *full* reliance on covenant strength should be time-limited to the period over which there is good covenant visibility. Should the concept of a ‘covenant horizon’ be appropriate, we also need to consider, in practical terms, how this should be reflected within a scheme’s TP calculations under the Fast Track regime.
313. Figure 3 below provides a simplified illustration of how the covenant visibility might be allowed for in the discount rate assuming a linear shape for the journey plan. In this example there is assumed to be full

reliance on the strong (CG1) covenant for the short-to-medium period (eg three to five years), with a range of options for what might be appropriate for reducing reliance on the (unknown) covenant beyond that time.

314. We are seeking views on the extent to which covenant visibility should be embedded in the journey plan (ie how much reliance should be placed on the covenant beyond the short and medium term), as detailed in Figure 3 and the questions below.



► Questions

Q32 Extent of reliance on covenant in Fast Track TPs

- 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)?
- 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?
- 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 (for example, over the subsequent five years)?
- 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?

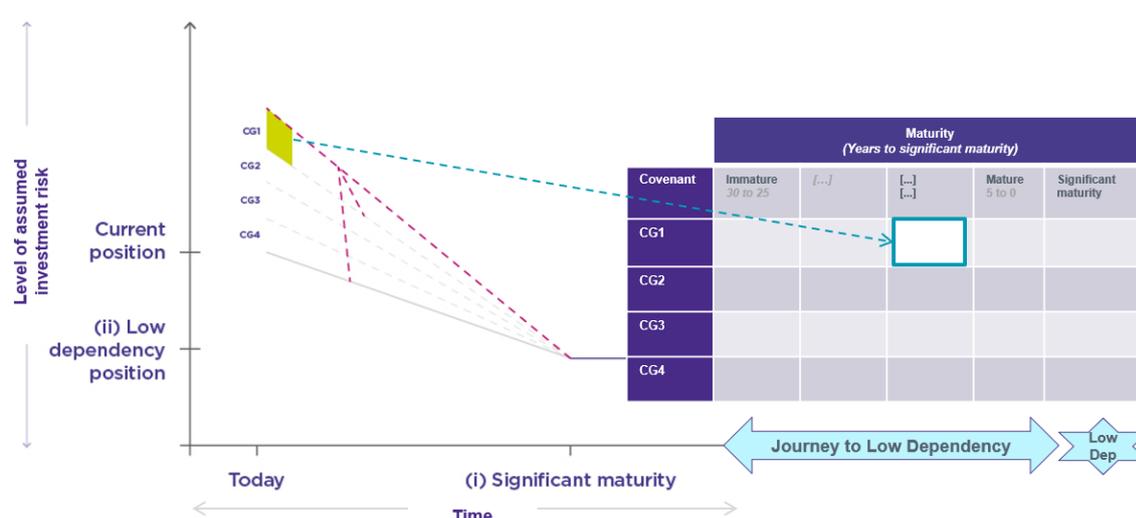
Defining Fast Track TPs

How should Fast Track TPs be expressed

315. The concepts and principles discussed above will inform what parameters we put around acceptable journey plans and TPs under Fast Track.
316. We envisage setting acceptable TPs for Fast Track as a **maturity and covenant-linked matrix of ranges** expressed as either of the following:
- Discount rates** (maximum acceptable):

- **Single equivalent discount rates**, which could be expressed as nominal rates or a premium above the yield on gilts (eg 3.0% to 3.15% pa or Gilts +1.2% to 1.35%). To a large degree this is simply a presentational point, although it would affect how schemes would monitor their funding position and manage their risks. The approach of adding a premium above the yield on gilts is not the same as having a pre-determined fixed margin over gilts, which applies at each valuation. The premium would still be expected to vary in different market conditions.
- **Term/maturity dependent discount rates**, ie a full discount rate structure in line with our preferred journey plan shape. These could be defined as premiums over the gilts curve or year-by-year nominal rates.
- **Target TPs** (minimum acceptable under Fast Track) expressed as a percentage of the TPR-defined Fast Track minimum funding low dependency basis (eg 85% to 88% of low dependency) along the journey plan.

317. Figure 4 below illustrates how it could work:



318. Trustees would set their funding strategy in much the same way as they currently do, in collaboration with the employer and using an IRM framework:

- They would assess the strength of covenant (eg with reference to the new guidance as proposed in Chapter 4).
- They would assess the maturity of their scheme (to an agreed definition on which their scheme actuary will be able to advise).
- Using the table above, they should be able to read off the range of discount rates or TPs as a percentage of low dependency funding and compare with their actual parameters to determine consistency with the Fast Track approach.

319. The greater the reliance on employer covenant, or the more immature the scheme, the more risk can be assumed in the TPs (ie the lower the TPs compared to low dependency) up to the threshold we defined under Fast Track. Depending on the outcome of this consultation on the principle that trustees should assume a reducing level of reliance on the employer covenant over time (depending on its visibility), we may have to make a further assumption about how this will apply in practice. This may affect the construction and presentation of discount rates or target TPs. If necessary, we would provide an additional guideline on its application. We would also specify additional guidelines to ensure consistency between risk implicit in TPs and risk in actual investment strategy (see Chapter 10 on the investment strategy).

320. The pros and cons of each option are set out in Table 14 below:

Option	Pros	Cons
Discount rate – single equivalent rate	<ul style="list-style-type: none"> ✓ Those we regulate are used to thinking about discount rates as a measure of TP strength. ✓ Compared to a full discount rate structure, provides greater scope for schemes to set an underlying discount rate structure that better reflects the trustees' preferred journey plan for the scheme (while still meeting the Fast Track requirements). 	<ul style="list-style-type: none"> ✗ In practice, it could look more like a Minimum Funding Requirement than TPs as a percentage of low dependency, although in practice, the difference may be presentational. ✗ Would need additional guidelines for some of the other key assumptions, where they are defined by us.
Discount rate – full structure	<ul style="list-style-type: none"> ✓ Allows a connection to be then made to the actual investment risk being taken and planned for the future. This is more consistent with an IRM approach. 	<ul style="list-style-type: none"> ✗ This approach is more restrictive than the other approaches. ✗ Would need additional guidelines for some of the other key assumptions, where they are TPR-defined.
TPs as % of low dependency	<ul style="list-style-type: none"> ✓ LTO and low dependency funding is a new requirement – a journey plan target line as a % of this new number may be a natural direction of travel for us to set. And it might be easier to understand and explain. ✓ It seems a less restrictive constraint on the design of TPs and the investment strategy. It may also remove some of the unhealthy focus on discount rates. ✓ It could solve some of the potential issues around prescribing other actuarial assumptions used to calculate TPs. 	<ul style="list-style-type: none"> ✗ The difference with discount rate approaches might just be presentational – depending on how we set it (eg using discount rates).

► Questions

Q33 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?

Deriving parameters

321. There are different methods we could use to determine the acceptable TPs (or maximum discount rates) for the Fast Track approach. We have described three such methods below, each of which is capable of further adaptation to incorporate decisions relating to the relevant consultation questions (such as shape of journey plan, allowance for covenant and the manner in which such allowance is made, whether we would set discount rates or TPs, and limits on investment risk).

322. These methods are not mutually exclusive, and in practice, they are most likely to be used in a complementary way, for example to sense-check results or provide an alternative interpretation of results for a more informed debate on the key factors.

Data driven approach

323. This approach would use our extensive data, and therefore be based on the actual behaviour of schemes, to inform possible lines (or some parameters) that define ‘acceptable’ practice for the level of TPs or discount rates under Fast Track.
324. For example, our data set of discount rates, reported by schemes, could be used to inform us on the structure and range of discount rates used by the universe of schemes. A baseline could be established by focusing initially on, for instance, the median discount rates for all DB schemes adjusted for consistency with the desired shape of the journey plan. The resulting rates could be maintained as term-dependent rates or converted for simplicity to single equivalent discount rates (SEDRs) or used to calculate TPs.
325. The baseline would then be adjusted further to allow for differential risk-taking, if appropriate, according to covenant support available to the scheme. For the purpose of distinguishing by covenant, we have little by way of practice to draw upon, because our data has consistently shown a distinct lack of correlation between covenant strength and risk embedded in the TPs (except, to a limited degree, for CG4 schemes). Any overlay for covenant-based risk in the TPs would have to be decided through other means. We are therefore interested in learning from respondents how schemes decide in practice the level of assumed investment risk considered appropriate based on their assessed covenant strength.
326. Table 15 sets out the pros and cons of this approach:

Pros	Cons
<p><input checked="" type="checkbox"/> Evidence-based approach: uses existing data (subject to limitations) to guide where the majority of the landscape sits.</p> <p><input checked="" type="checkbox"/> Data includes a variety of journey plan shapes and other behaviours encountered in practice.</p> <p><input checked="" type="checkbox"/> Can be used to control the scope and size of the Fast Track framework to take account of potential impacts.</p>	<p><input checked="" type="checkbox"/> Pre-supposes that the selected schemes within the chosen subset are following the right behaviours and are on the right path to deliver.</p> <p><input checked="" type="checkbox"/> Data may not be entirely reliable – plus we must make further assumptions for translating to SEDRs and expressing them as premiums above the yield on gilts.</p> <p><input checked="" type="checkbox"/> This approach quickly becomes circular as schemes’ current behaviour is used to anchor their future behaviour.</p>

TP target: Stochastic modelling

327. In the period before the scheme reaches significant maturity, and consistent with the principle that TPs should reflect the LTO and the level of all risks over time, there should be an explicit link between the TPs and this long-term target. A mapping of the target level of TPs consistent with this could be determined by a stochastic modelling approach aimed at answering the question “What level of assets does the scheme need now so that, with an allowance for reasonable investment returns in the future but no further employer contributions, it is likely to reach low dependency funding at its point of significant maturity with an acceptable degree of confidence?”

328. This approach would require two key assumptions:
- The acceptable level of confidence for the success measure, on which we are inviting views from respondents.
 - How investment strategies may change during the scheme's journey to low dependency, which would be informed by the other aspects of the consultation earlier in this chapter.
329. In addition, there would be numerous other assumptions which would be used in any stochastic model. If we target this approach to setting TPs for Fast Track, we will consult on how best to set those assumptions (they would also be informed by the outcome of the consultation on 'other assumptions' in Chapter 8).
330. The resulting target TPs would be specific to the scheme's current level of maturity and the regulatory requirement for Fast Track would be better expressed as a target percentage of the low dependency funding (rather than a discount rate).
331. The pros and cons of this approach are set out in Table 16 below:

Pros	Cons
<input checked="" type="checkbox"/> Provides deeper insights to the key moving parts and appropriate balance. <input checked="" type="checkbox"/> Reflects how schemes may be approaching the problem. <input checked="" type="checkbox"/> Allows more robust testing under different economic scenarios. <input checked="" type="checkbox"/> May allow us to be less prescriptive on the shape of the journey plan.	<input checked="" type="checkbox"/> Requires a pre-determined success criterion. <input checked="" type="checkbox"/> Size of expected Fast Track segment more difficult to control. <input checked="" type="checkbox"/> Back-solving to a discount rates guideline is complex. <input checked="" type="checkbox"/> Subject to model risk and assumptions, which would be difficult to regulate without some form of model approval regime which would be resource-intensive.

TP target: Deterministic modelling

332. This approach would seek to answer the same question as in the previous approach, but instead of a stochastic model to generate a range of future economic and investment scenarios, a set of deterministic assumptions would be used. This approach would once again reflect a preferred journey plan shape based on the outcome of the consultation in the earlier part of this chapter, making assumptions about expected prudent returns from the appropriate investments.
333. The pros and cons of this approach are set out in Table 17 below:

Pros	Cons
<input checked="" type="checkbox"/> Simpler to apply than the stochastic approach. <input checked="" type="checkbox"/> Allows particular scenarios to be modelled – more conducive to engagement by trustees.	<input checked="" type="checkbox"/> Results are sensitive to judgements made about prudent investment returns. In practice risks could be minimised by agreeing assumptions with an expert industry group.

► Questions

Q34 Method to derive Fast Track TPs

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

- b. Do you have ideas as how to best approach each option?
- c. How do trustees incorporate considerations about covenant strength into their TP assumptions/discount rates?
- d. If a stochastic approach is adopted, what would you consider to be an appropriate confidence level against which to mark the results?
- 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.

10. Investments

PRINCIPLES

- ★ The actual investment strategy and asset allocation over time should be broadly aligned with the scheme's funding strategy (TPs and RP).
- ★ Trustees must ensure their investment strategy has sufficient security, sufficient quality, and can satisfy liquidity requirements based on expected cash flows as well as a reasonable allowance for unexpected cash flows.
- ★ We expect the asset allocation at significant maturity to have high resilience to risk, a high level of liquidity and a high average credit quality.

Introduction

- 334. Future investment returns are one of the most important factors in meeting future cash flow obligations when they fall due. Schemes with a longer time horizon and ones with strong employers can afford to take more investment risk and potentially benefit from the greater returns.
- 335. We do, however, see many schemes rely heavily on investment returns to meet future cash flows but with limited or no support from the sponsoring employer if an adverse investment outcome occurs.
- 336. We consider it is very important to set out clear expectations on investment as part of the revised DB funding code. For example, we do not think that two virtually identical schemes with exactly the same benefit cash flows and level of funding should be treated the same if the level of investment risk is very different (eg one is invested in 100% equities and the other is invested in 100% long-dated government bonds).

Defining investments and risk

- 337. Investment risk depends on a number of factors, including, but not limited to, the following:
 - diversification
 - allocation to growth (return seeking) assets, and
 - Amount of interest rate/ inflation/ currency hedging.
- 338. Throughout this document, we use the terms 'growth' and 'matching' assets (see Glossary in Chapter 17). We realise that many schemes use a variety of methodologies to allocate their assets, but we think this is a useful distinction, although we acknowledge its limitations. There are also a wide range of views as to what should be included in the 'growth' and 'matching' categories and how assets with characteristics of both (eg property) might be treated. However, for simplicity we have used equities as an example of a growth asset and UK gilts as an example of a matching asset.

Application in Fast Track

- 339. Our aim is to consult on the appropriate *level of investment risk* that a scheme should take. For the avoidance of doubt, we are not proposing setting guidelines that promote or prohibit any category or type

of investment. Our proposals are underpinned by the principles set out above and discussed in Chapter 5 (note that they would apply to both Fast Track and Bespoke approaches).

340. In order to develop Fast Track investment compliance guidelines, we need to address the questions below and welcome views on our proposals:
- A. The reference point from where to measure investment risk.
 - B. How to measure investment risk.
 - C. The appropriate maximum level of risk (for a significantly mature scheme as well as other maturities) in Fast Track.
 - D. What we would expect if a scheme exceeded the maximum allowable risk under Fast Track.
 - E. Additional requirements around liquidity and quality.
341. All quantitative examples are *indicative/illustrative* at this stage and are subject to change following the outcome of this consultation, developments in other elements of the framework and our impact assessment.

Reference point from which to measure investment risk

Liabilities versus assets as a reference point

342. Typically, schemes are concerned about a deterioration in funding caused by an adverse investment scenario and, therefore, it makes sense to include the **liabilities** as a reference point to measure risk. A reference point only based on assets (for example cash) would ignore the sensitivity of liabilities to a change in interest rates and/or inflation. Therefore, we consider that the appropriate reference point is either:
- a **scheme-specific measure of the liabilities**, or
 - a **reference investment portfolio that represents the interest rate and inflation sensitivity of the liabilities of an average scheme**.
343. Pension schemes have different inflation sensitivities depending on their individual pension increases and the sensitivity of their liabilities to inflation will therefore vary. Some schemes will have many tranches of their pensions that have different level of sensitivities to inflation (for example, if pension increases are inflation-capped at a certain level) or indeed different types of inflation (for example RPI or CPI). We therefore think that a scheme-specific measure of liabilities is more appropriate to measure risk from.
344. However, we note that including a stress of the liabilities (should we opt for a stress test to quantify the risk – see sections below) may be more burdensome for smaller schemes. We therefore consider below whether the second option (reference investment portfolio) would be an appropriate one for smaller schemes.

Which measure of the liabilities?

345. Focusing on the first option, there are a number of possible measures of the liabilities that could be used as a reference point under Fast Track:
- **Fast Track TPs basis**
 - **Fast Track low dependency basis** (eg somewhere in the range of Gilts +0.5% to Gilts +0.25% – see Chapter 8), or
 - **Gilts ‘flat’ basis** (ie fully in line with the return on Gilts).

346. We consider the pros and cons of each option in Table 18 below:

Option	Pros	Cons
Fast Track TPs basis	<ul style="list-style-type: none"> ✓ Same measure as is used for funding. 	<ul style="list-style-type: none"> ✗ Not a low risk position as it allows for a higher level of investment returns as the scheme is more immature. ✗ Unlikely to be used as a measure of liabilities if a scheme was trying to remove all its interest rate/ inflation risk through hedging. ✗ Scheme-specific measure so doesn't enable easy comparisons across different schemes.
Fast Track low dependency basis (eg somewhere in the range of Gilts +0.5% to 0.25%)	<ul style="list-style-type: none"> ✓ Consistent with the long-term funding basis under Fast Track. ✓ Consistent measure across all schemes. ✓ Allows a scheme to think about risk as a deterioration of the low dependency funding level or an increase in deficit. 	<ul style="list-style-type: none"> ✗ Although a low risk measure, it still allows a small degree of return/ risk and is consistent with a portfolio with a small allocation to equities or one which has corporate bonds, both of which have a degree of risk. ✗ A scheme trying to reduce as much risk as possible vs its liabilities is unlikely to use a Gilts +0.5%-0.25% to value the liabilities for hedging purposes.
Gilts 'flat' basis	<ul style="list-style-type: none"> ✓ A lower risk, more conservative measure. ✓ Consistent with a matching portfolio of UK gilts and UK inflation-linked gilts with little or no risk of default. ✓ Closer to buy-out pricing for a typical scheme with a mix of active, deferred and pensioner members. ✓ Consistent measure across all schemes. 	<ul style="list-style-type: none"> ✗ A new basis/ new calculation of liabilities in addition to the TPs and the low dependency basis used for the LTO.

347. Both the TPs and low dependency basis have a discount rate that implicitly assumes a level of investment risk in the form of a portfolio with equities or corporate bonds or both. Some equity investments have future cash flows (dividends) but these are not guaranteed and, as such, are a poor match to the liability cash flows. Corporate bonds do have a set of expected future cash flows, but they are subject to risk of default. Both asset classes are key components of many investment portfolios and we encourage their use. However, we consider, from a theoretical perspective, that the lowest risk position from which to measure risk is a pure gilts measure which provides an investment with predictable cash flows with minimal default risk. On the other hand, there are some advantages of using a low risk alternative (Fast Track low dependency) from a practical perspective.

348. After careful consideration, we do not think that Option 1 (TPs) is appropriate as a reference point to measure investment risk from as this measure already assume a degree of investment risk. We prefer either Option 2 (Fast Track low dependency basis) or Option 3 (Gilts flat basis).

Simpler approach to measuring risk for small schemes

349. Using any of these two measures of liabilities (Fast Track low dependency or Gilts flat basis) may carry the cost of extra calculations by the scheme actuary as the liabilities would need to be re-calculated with the stress (should we go down the option of a stress test to quantify the risk – see below). We therefore propose a simpler approach to address the cost issue for smaller schemes. For the avoidance of doubt, this applies only to the liabilities.

Using a reference portfolio as a proxy for liabilities

350. For the purpose of developing Fast Track compliance guidelines for investment risk, we propose allowing smaller schemes to use a simple reference portfolio to represent their liabilities if they wish. This portfolio would consist of fixed-interest gilts and inflation-linked gilts represented by market indices of an appropriate duration. This would be for the purpose of measuring the investment risk of the liabilities with a standard assumption as to the proportion of liabilities that are sensitive to inflation.
351. We expect larger schemes to calculate scheme-specific sensitivity of their liabilities to interest rates and inflation. This would typically be done by the scheme actuary. This approach would also be available for smaller schemes that may choose to use a scheme-specific approach.
352. Small schemes for this purpose could be defined as follows:
- The **number of members** (for example, fewer than 100).
 - The **size of assets** (for example, less than £20m).
 - The **size of liabilities measured on Fast Track TP basis** (for example, less than £20m).

How could we construct a reference portfolio to represent the liabilities?

353. According to our data, the average inflation sensitivity for schemes is approximately 70% and we would therefore propose using a reference portfolio consisting of fixed-interest gilts and inflation-linked gilts that has around 70% sensitivity to inflation. For a significantly mature scheme, a reference portfolio as a proxy to liabilities could have the following characteristics:
- 100% invested in government bonds (fixed and inflation-linked),
 - 70% inflation sensitivity, and
 - duration of 14-12 years.
354. For more immature schemes, a portfolio with longer dated fixed-interest government bonds and longer dated inflation-linked government bonds would be appropriate. One approach would be to allow schemes to use a mix of the significantly mature liability reference portfolio and an immature liability reference portfolio, with a higher duration, depending on their level of maturity. A more mature plan will have a higher weight to the significant maturity reference portfolio and vice versa.
355. The above Fast Track guideline is clearly a simplification and makes no allowance for the specific types of inflation increase or indeed the profile of the liabilities. For small schemes with a fairly typical benefit structure, this approach should work well. If a small scheme has a very different profile or has an inflation sensitivity materially different from 70%, then they should seriously consider asking their scheme actuary to perform the sensitivity analysis on the liabilities, as is the case for larger schemes.

► Questions

Q35 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?
- 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?
- 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?
- 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?

Methodology for measuring investment risk

Two options to quantify investment risk

- 356.** We see schemes using various methods to measure investment risk but, for Fast Track, we would like to specify a methodology that is:
- not overly complex
 - easy to apply (acknowledging the limitations of a simpler approach), and
 - is consistent across schemes.
- 357.** Moreover, we want to avoid the situation where two identical schemes have a different measure of investment risk because of the specific model they have used to calculate the investment risk. We see two possible approaches to measuring the investment risk:
- **Defining a percentage of growth assets, or**
 - **using a simple stress test.**
- 358.** We set out a worked example (with illustrative numbers) in Chapter 15 to illustrate how a stress test would work.

Percentage growth assets

- 359.** Under this approach, we express the current asset allocation as a percentage in growth assets and a percentage in matching (or non-growth) assets. Growth assets are typically return-seeking and do not have a high correlation to the liabilities. Conversely, matching assets are correlated to the liabilities but have low return expectations. The percentage allocation to growth assets is then compared to a maximum permitted threshold that varies by maturity.
- 360.** As mentioned before, some asset classes do not fall neatly into growth or matching and have characteristics of both. To use this approach, we would need to be clear on the allocation between growth and matching assets. An example allocation is set out in Table 19 below:

Asset Class	% Growth	% Matching
Equities	100	0
Hedge funds	80	20

Insurance funds	60	40
Property	75	25
Corporate bonds	25	75
Government bonds	0	100
Cash	0	100
Deferred or immediate fully insured annuities	0	100
Other asset classes	100	0

Simple stress test

- 361.** This approach stresses the assets and the liabilities (or liability reference portfolio for smaller schemes) by a set of factors, typically a fall in long-term bond yields combined with a fall in level of growth assets. Under such a stress, growth (return-seeking) assets fall and matching assets (for example, bonds) increase as they generally have an inverse relationship with bond yields. The value of liabilities is not affected by a stress in growth assets but is affected by a fall in interest rates/ bond yields which typically increases their value.
- 362.** Our preferred approach is to use a simple stress test to measure investment risk, as it captures not only the investment risk associated with growth assets (equities, etc) but also the degree of interest rate and inflation risk relative to the liabilities. Moreover, a scheme that hedges all or part of its exposure to interest rates and inflation will report a lower stress in funding level than one that does not hedge. We consider such a distinction is appropriate and would not be possible under the first option (% growth / matching) as it just looks at the allocation to growth assets in isolation.

Defining a pensions stress test

Key characteristics

- 363.** There is not one universally accepted stress test. Several countries in Europe use their own stress test to measure investment risk within the pension framework. Although all different, stress tests within the pensions regime typically take the form of an instantaneous fall in the market value of growth assets (which typically impacts the value of the assets), combined with a fall in level of bond yields, which typically increases the value of the liabilities as well as the value of the bonds held as part of the assets.
- 364.** Table 20 below summarises what we see as essential requirements for an appropriate pensions stress test to measure investment risk. It is important for any stress test to capture the risk of growth assets and interest rate risk relative to the liabilities.

Characteristics of a good pensions stress test	
Risk level	Should represent a downside investment scenario with an associated probability (1 in x years).
Standardised and Objective	A test should be objective so that two identical pension schemes with exactly the same asset allocation show the same numbers.
Flexible	We should have a degree of control of how the test is designed to change the stresses if required.

Growth assets	Fall in value.
Matching assets	Increase in value as the market value of bonds increases as interest rates/ bond yields fall.
Liabilities	Increase significantly in value as the value of liabilities increases as interest rates/bond yields fall.

Which stress test?

365. A number of stress tests (described in Table 21 below) are currently in use in the UK and other European countries. Some of these are specifically related to pension schemes and others relate to other areas of finance.

Brief description of existing stress tests	
PPF	Used by the PPF as part of the levy calculation and familiar to many UK schemes.
PRA	Not a pensions stress test but one that is used for the banking and insurance sectors in the UK. Fairly complex with multiple stresses applied to many different sub-asset classes.
EIOPA	A standard test used in Europe to measure the risk of pension schemes on the same basis. Fairly complex with multiple stresses applied to many different sub-asset classes.

366. In addition, we could design our own stress test for the purpose of measuring investment risk in Fast Track. We have set out below the pros and cons for all these options in Table 22 below.

Option	Pros	Cons
PPF stress test	<ul style="list-style-type: none"> ✓ Already familiar to the UK pensions industry as it is used for the levy calculation. ✓ Fairly simply to apply to assets as there are a limited number of high level categories. ✓ Guidance already available in terms of how to apply the test in more complex situations, for example, when using derivatives. ✓ Potential to amend the stress test and the sub-asset classes that are stressed by working with the PPF in the future. 	<ul style="list-style-type: none"> ✗ Relies heavily on the existing categories of the current scheme return. ✗ Not designed for the purposes of measuring the risk in relation to long-term funding. ✗ PPF liabilities are different from those of an ongoing DB scheme so the stresses will need to be applied to a new liability measure.

PRA stress test	<input checked="" type="checkbox"/> Consistency with other sectors (banks, insurers).	<input checked="" type="checkbox"/> Complicated and costly to implement. <input checked="" type="checkbox"/> Currently aimed at UK banks, building societies and insurers and therefore does not take account of specific risks relating to the funding of pension schemes.
EIOPA stress test	<input checked="" type="checkbox"/> Consistency across Europe.	<input checked="" type="checkbox"/> Reasonably complex to implement. <input checked="" type="checkbox"/> Unfamiliar to many small and medium UK pension schemes. <input checked="" type="checkbox"/> Launched recently so industry still getting used to the test. <input checked="" type="checkbox"/> Bond yields increase in the stress test. Pension schemes are typically concerned with a fall in bond yields.
Separate TPR stress test	<input checked="" type="checkbox"/> Full flexibility to focus on risks from a funding perspective. <input checked="" type="checkbox"/> Can be set at any risk tolerance (currently the PPF test is based on a one in six-year downside event).	<input checked="" type="checkbox"/> Scheme would need to understand two separate tests to measure investment risk, one for the PPF and one for us. <input checked="" type="checkbox"/> Schemes may question why they were assessing investment risk twice even though the objectives are different. <input checked="" type="checkbox"/> New methodology and guidance required on how to apply the test.

- 367.** Our preference is to use a TPR-defined stress test for the purpose of measuring investment risk so that we can specify it in a way that meet our needs and review and potentially revise it from time to time to ensure it remains appropriate. However, we are also conscious that DB schemes already use the PPF stress test for levy purposes and that there would be advantages, from a burden point of view, to use one single stress test for DB pensions. This approach allows us the flexibility to depart from the PPF stress test in the future if it is deemed necessary.
- 368.** We therefore think that the stresses and methodology adopted by the PPF would provide a good starting point to develop an appropriate stress test for funding. The PPF stress tests has the following broad stresses (as at the time of writing):
- Equities fall by 15-19%.
 - Property falls by 5%.
 - Bond yields down by 0.75% (meaning that government bonds increase in value by between 2% and 18% depending on their maturity).
- 369.** For schemes with PPF (section 179 valuation) liabilities greater than £1.5b, it is mandatory to use a PPF Bespoke test which takes into account the maturity of assets to a greater extent, as well as any use of derivatives. The PPF Bespoke option is also available for schemes under £1.5bn of PPF liabilities if they

wish to use it. For the purpose of the DB funding stress test, we propose using the same approach and the same threshold to allow for consistency, and to avoid schemes having to carry out two tests for the purposes of stressing their assets.

- 370.** We are aware that the PPF will review its stress test in the coming months. The levels of stress for individual sub-asset classes and the actual sub-asset classes that might be used are typically reviewed during this process. We do not expect this review to change significantly our view that using the PPF stresses would provide a good starting point. We will also discuss with the PPF how we could develop a common stress test that works for both our purposes.
- 371.** We are working with the PPF on revising the existing asset class information that we will require schemes to submit. We are keen to ensure that schemes should only need to submit one set of asset class data and we recognise that there is merit in expanding/amending the asset classes used to provide a better insight into the level of investment risk. This objective is shared by both the PPF and TPR and, with this in mind, we plan to issue a joint consultation on amending the scheme asset class information.

Limitations of any stress test

- 372.** It is important that any stress test used is relatively simple to perform and easy to understand. This inevitably leads to some simplifications, which are stated below:
- Most stress tests assume a parallel change in bond yields across the yield curve. This does not capture the risk associated with a flattening or steepening of the yield curve but captures the key duration risk of the assets/liabilities.
 - The stresses are assumed to occur instantaneously, which in reality is unlikely. However, if one builds in a change occurring over a period of time, then an important additional assumption is the return of each asset class. This makes the calculation more complicated. On balance, an instantaneous stress strikes the right balance between capturing the key aspects of volatility whilst maintaining simplicity.

How should the result of the stress test be expressed?

- 373.** The stress test will typically lead to a change in the assets and the liabilities, with an increase in the deficit (or decrease in the surplus) after the stress compared to before.
- 374.** There are three main options as to how to express the impact of the stress test (all ratios):
- 1 **Change in surplus or deficit */ starting liabilities* (preferred)**
 - 2 **Assets at start / liabilities at start/(assets after stress / liabilities after stress) -1**
 - 3 **Change in deficit / starting assets**

**Surplus/deficit = assets – liabilities defined below (low dependency/Gilts flat)*

***Note that for the stress test purposes, liabilities = low dependency liabilities or Gilts flat liabilities*

- 375.** Although these options are similar when a scheme has assets similar to the low dependency or Gilts flat liabilities, they differ significantly when a scheme has assets materially lower than these liabilities. This is particularly the case with immature schemes (when the TPs are much less than low dependency) and/or when a scheme is significantly underfunded.
- 376.** In general, when assets are lower than low dependency/Gilts flat liabilities, Option 1 will give the lowest result and Option 3 the highest. If Option 3 is chosen, then an underfunded or immature scheme will face a tougher test than a well-funded or mature one.
- 377.** We consider Option 1 is preferable and is consistent with the concept of liabilities being the appropriate place to measure risk from.

► Questions

Q36 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?
- 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?
- 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?
- 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 appropriate level of maximum investment risk in Fast Track

378. Having determined which reference point to measure risk from and which measure of risk to use, we would need to specify a threshold for the maximum acceptable level of investment risk under Fast Track.
379. In the sections below, we focus and seek views on the following:
- What considerations and principles should we follow in defining an acceptable maximum risk level for a significantly mature scheme at low dependency under Fast Track?
 - Based on these considerations, what would these investment limits for a significantly mature scheme look like?
 - What considerations and principles should we follow in defining an acceptable maximum risk level for an immature scheme under Fast Track?

Considerations for defining a maximum level of investment risk for a significantly mature scheme

380. In establishing an appropriate maximum threshold for investment risk under Fast Track, we think it is logical to start at the point at which a scheme reaches significant maturity. When a scheme is significantly mature, it should have low reliance on the sponsoring employer, ie low dependency funding. From an investment risk perspective, this means a scheme should have an investment portfolio with a high resilience to investment risk.
381. To set an appropriate maximum risk for a significantly mature scheme, we think it is helpful to consider the following:
- The downside risk of possible low investment risk portfolios.
 - The expected return of possible low investment risk portfolios to ensure they are consistent with the discount rate used in the Fast Track calculation of the low dependency liabilities.

(a) Downside risk of low investment risk portfolios

382. Focusing on the key investment risks of (i) a fall in growth assets and (ii) a fall in bond yields, it follows that a low risk investment portfolio should have low risk (relative to the liabilities) in each of these areas.
383. We consider that acceptable investment portfolios consistent with low dependency should protect the funding level of the scheme and, in an adverse investment scenario (growth assets falling and bond yields falling), suffer only a small deterioration in funding level.

384. For growth assets, the allocation to these asset classes should be low to avoid a fall in market value. For interest rate risk, the asset portfolio should have a duration similar to that of the liabilities. If we consider modelling we commissioned from GAD (see Chapter 16), which looks over a longer time period, we can see the impact of the level of growth assets on low dependency funding level. The 10% growth portfolio has low risk in the short term but leads to a significant deterioration in probability of a fall in funding over the long term. The portfolios of 20% and 25% growth assets show a better trade-off between the medium term and long term. This is illustrated in Table 23 below.

Probability of funding level falling below 95%	Short term (3 years)	Medium term (5 years)	Longer term (12 years)
10% growth	4%	12%	37%
20% growth	12%	17%	22%
25% growth	14%	18%	20%

(b) Expected return of low investment risk portfolios (consistency with assumptions for LTO)

385. In addition, according to the investment principle set out in Chapter 5, the expected returns of the actual asset allocation for a mature scheme should be broadly consistent with the assumptions used to value the liabilities of a mature scheme. Under Fast Track, this is the low dependency basis. With this in mind, a prudent expected return on **actual** asset allocation should be broadly consistent with the discount rate used for the low dependency basis (which we propose could be somewhere in the range of Gilts +0.5% and Gilts +0.25% (subject to consultation)).
386. We have taken the approach throughout the document of looking at the discount rate first and considering the impact of this on associated asset allocations afterwards. This logic flows from the legislative approach, which places the focus on funding and the assumptions associated with discount rate.
387. Mapping a discount rate to a set of asset allocations may appear straightforward but is complicated by two factors. Firstly, the best estimate assumptions of asset classes vary significantly between investment managers and consultancies. Secondly, the allowance for prudence has historically been applied in a variety of ways by different trustees and consultancies, leading to a large variation in the allowance from scheme to scheme.
388. In our experience, long-term best estimate expected returns of growth assets used by trustees, investment consultants and fund managers vary, but typically fall in the range Gilts +3% to Gilts +5% net of fees. For example, this would mean a portfolio with 20% growth assets would have an expected return of between Gilts +0.6% to Gilts +1.0% (assuming the rest of the portfolio is invested in Gilts). Clearly, there needs to be a small reduction for prudence, but any adjustment should be relatively small as we are considering a low risk funding and investment strategy. In our view, an investment portfolio with a higher level of growth assets than 20% is unlikely to have a prudent expected return consistent with the low dependency funding basis at significant maturity.

Maximum level of investment risk for a significantly mature scheme under fast track

389. In view of the above, we consider an appropriate maximum level of investment risk in Fast Track for a significantly mature scheme that has reached low dependency funding to be consistent with a portfolio of 20% growth assets. As noted in Chapter 16 (Evidence and analysis), the GAD modelling of higher risk investment strategies suggests that the trade-off between higher expected returns in the long term and the associated higher short-term risk becomes important. For example, increasing the proportion of growth assets in the investment strategy increases the expected returns and therefore the chance of reaching buy-out funding. But it also brings increased volatility to the funding level, and thus increases the

likelihood of the trustees having to resort to the employer for additional funding. Other higher risk strategies repeat this pattern.

- 390. Under the PPF stress test (one in six years), this equates to around 4% deterioration in funding level assuming the bonds held mean that the portfolio, as a whole, has a similar interest rate and inflation sensitivity to that of the liabilities. A '1 in 20 event' would lead to a significantly higher deterioration than 4%. In our view, a portfolio with a higher level of growth than 20% would not be consistent with a portfolio with a high resilience to risk.
- 391. A 20% growth allocation also provides an appropriate balance of short, medium and long-term risks as measured by the probability of falling below a 95% funding level (see GAD modelling) and is broadly consistent with the LTO discount rate after making a small deduction for prudence.
- 392. Assuming that schemes continue the trend of the last ten years of increasing their allocation to bonds, then the average scheme allocation to non-bonds is likely to be less than 20% by 2028, at which point a scheme of average maturity now will be approaching significant maturity as defined by a duration of 14-12 years (see Chapter 8). The maximum at significant maturity is therefore unlikely to impact a scheme of typical maturity now.

Considerations for defining a maximum level of investment risk for an immature scheme under Fast Track

- 393. We currently see DB schemes that are of average maturity or are immature, investing a significant proportion of their assets in growth assets. This is generally appropriate as they are benefiting from a longer-term horizon and do not have the negative cash flow constraints of mature schemes that can crystallise losses after an adverse investment event. There are, however, risks associated with a portfolio that has higher volatility versus the liabilities. In particular, employer insolvency can crystallize any deficit and may occur after an adverse investment market event. Getting the appropriate balance between the expected return and the medium and long-term risks are therefore important.
- 394. We discuss below the following factors below, which we think we should consider in setting investment limits for immature schemes under Fast Track:
 - The shape of the de-risking journey plan.
 - Downside risk in the medium and long term.
 - Whether covenant should be factored in and how.

Shape of the de-risking journey plan

- 395. As discussed in Chapter 9 on TPs, there are two main approaches to journey planning, namely the linear de-risking method and the horizon method (the stepped approach being a mixture of these two).
- 396. When setting an appropriate level of investment risk for a more immature scheme not close to significant maturity, it is important to make sure it is consistent with the assumed journey plan. In Chapter 9, we are consulting on which journey plan shape might be appropriate for setting TPs in Fast Track. Each shape will have different pros and cons from a purely investment perspective, as set out in Table 24 below:

Journey plan shape	Pros	Cons
Linear de-risking	<ul style="list-style-type: none"> ✓ Gradual reduction in investment risk over time, no cliff edges ✓ Allows very immature and open schemes 	<ul style="list-style-type: none"> ✗ An immature plan now may de-risk significantly over time even if the size of the plan relative to the employer is gradually decreasing over time. ✗ Schemes which are very immature may

	<p>to continue to take higher levels of investment risk.</p> <p><input checked="" type="checkbox"/> Would require schemes that are currently very mature (close to significant maturity that are potentially negative cash flow) to reduce their level of investment risk.</p>	<p>take very high levels of risk with associated large downsides at a time when the scheme is its largest in real terms.</p>
Horizon	<p><input checked="" type="checkbox"/> Allows a scheme that is current immature to factor in the decreasing size of the scheme relative to the company in the future and hence in £ terms a lower level of risk in the future for the same asset allocation.</p> <p><input checked="" type="checkbox"/> Simpler approach and no need to have different investment risk for different maturities.</p>	<p><input checked="" type="checkbox"/> For schemes that are currently mature and close to significant maturity, Fast Track will allow a high level of risk.</p> <p><input checked="" type="checkbox"/> Would require an immediate reduction in risk for many current immature schemes?</p> <p><input checked="" type="checkbox"/> Without smoothing there would be a cliff edge in acceptable risk when a scheme moves from mature to fully mature ie as it reaches significant maturity.</p>

397. Different journey plan shapes will have different implications for the level of investment risk for different maturity segments as shown in Table 25 below:

Investment risk	Very immature	Average mature	Mature	Significantly mature
Linear de-risking	<p>HIGH</p> <p>High level of risk assuming a strong covenant – likely to be set with reference to maximising return.</p>	<p>HIGH/MEDIUM</p> <p>Likely to allow a typical scheme to maintain the average asset allocation of 60% bonds.</p>	<p>MEDIUM/LOW</p> <p>Likely to allow a lower level of investment risk than horizon as this gradually reduces with linear de-risking.</p>	<p>LOW</p> <p>Same under both approaches.</p>
Horizon	<p>MEDIUM</p> <p>Likely to result in a material reduction in allowable investment risk for a typical scheme in this segment.</p>	<p>MEDIUM</p> <p>Likely to result in a modest decrease in allowable investment risk for the typical scheme.</p>	<p>MEDIUM</p> <p>Likely to allow a higher level of investment risk with a cliff-edge when scheme reaches significant maturity.</p>	<p>LOW</p> <p>Same under both approaches.</p>

Downside risk in the medium and long term

398. Once the shape of the journey plan has been decided, the level of acceptable risk should be determined by considering the downside risk of the investment portfolio over both the medium and long-term horizon. We intend to use further modelling from GAD to inform our decision.
399. Expected return of the investment portfolio should be consistent with the discount rate used for the calculation of TPs. We note from a range of long-term forecasts provided by investment managers and advisers that the risk premium of growth vs matching assets (best estimate) is in the range of 3-5% pa. To

ensure consistency, we consider that acceptable investment portfolios should have a best estimate return slightly higher than the discount rate with an allowance for prudence that increases as the investment strategy becomes riskier.

Consideration of the covenant

400. Regardless of the journey plan assumed above (linear de-risking or horizon or another approach in between), one should consider if allowance should also be made for the strength of covenant in determining an acceptable maximum level of investment risk.
401. In general, we consider that schemes with a stronger covenant are able to support a higher level of downside investment risk than schemes with a poorer covenant although, the degree of support is likely to be scheme-specific.
402. We have set out in Table 26 below the pros and cons of including an allowance for the covenant in the Fast Track investment test:

Option	Pros	Cons
Setting levels of maximum investment risk with reference to covenant and maturity	<ul style="list-style-type: none"> ✓ Consistent with the principle of schemes with strong covenants being able to take more investment risk. ✓ Allows high levels of investment risk only when supported by a strong covenant. ✓ Schemes with a CG1 covenant get the benefit of additional investment risk as well as lower TPs. 	<ul style="list-style-type: none"> ✗ Heavy reliance on covenant assessment. ✗ Small schemes may feel they need to pay for a covenant assessment to justify a strong covenant and hence take more investment risk.
Setting levels of maximum investment risk with reference to maturity only	<ul style="list-style-type: none"> ✓ Simple to apply. ✓ Avoids the cost/time required for covenant assessment to determine the maximum level of acceptable investment risk. 	<ul style="list-style-type: none"> ✗ Is not consistent with the principle that, in general, a stronger covenant is in a better position to support downside investment risk than a weaker covenant.

► Questions

Q37 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?
- 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?
- c. Should the allowance for prudence be higher for an investment portfolio with a higher level of risk?

- 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?

Trustee options – scheme’s investment risk is higher than the Fast Track threshold

403. We propose a simple ‘Pass or fail’ test to assess whether a scheme complies with the investment risk in Fast Track (as measured by the stress test or other method, which will be outlined in Fast Track subject to this consultation). We expect trustees’ investment advisers to assess the scheme’s assets as part of their ongoing risk management. If a scheme has investment risk in excess of the tolerated risk set out in Fast Track, the trustees can do one of the following:
- Reduce their level of investment risk to within the acceptable threshold (if they wish to comply with Fast Track).
 - Demonstrate through the Bespoke route how they intend to support excess risk in accordance with the principles and approach set out in Bespoke (see Chapters 13 and 14).

Other requirements relating to liquidity and quality

404. In the Fast Track approach above, we have focused on setting a test for the level of investment risk, in particular, the reference point to measure risk from, the methodology to measure risk and an acceptable level of risk by maturity. We think there are additional considerations that should be set out as part of the Fast Track and Bespoke frameworks, namely in the areas of quality and liquidity of the portfolio.

Liquidity

405. For all schemes, but in particular for mature schemes, it is important that a scheme’s assets are sufficiently liquid to meet predictable cash flows (for example, pensions in payments) as well as unpredictable cash flows (for example, transfers out). Also, a scheme with a high level of growth assets can be forced to sell assets at depressed prices if cash flow demands coincide with a downside investment event. For all the above reasons, a high level of liquidity is important, especially when a scheme is mature.
406. Typically, the liquidity of an investment is determined by two factors:
- The liquidity of the underlying investment (equities, bonds, property, etc).
 - For pooled funds, the frequency of the dealing date (daily, monthly, etc).

Quality

407. As explained in Chapter 5 (General Principles), many pension schemes have increased their allocation to bonds over the last ten years to reduce the volatility of their funding level. It is therefore important to consider bonds in a little more detail. Pension schemes’ bond investment typically consists of a combination of government bonds (fixed and inflation-linked) as well as corporate bonds. The price of both types of bonds will be affected by a change in the general level of government bond yields in the market. The price of a corporate bond will also be affected by any change in the assessment of the likelihood of receiving future coupons or principal payments as well as any recovery in the event of default.
408. We saw in 2007 and 2008 when concerns regarding corporate bonds were significant, that many corporates bonds returned large negative returns compared to government bonds that posted modest positive returns. This divergence was most acute for lower quality bonds and, in particular, high yield. It is

therefore important to ensure that any methodology to measure risk takes account of the quality of the bonds a pension scheme holds.

- 409. As it currently stands, the PPF stress test makes a distinction between investment grade and sub-investment grade (under its bespoke test) but all investment grade qualities (AAA to BBB) are treated the same.
- 410. Finally, government bonds typically offer a greater level of liquidity than corporate bonds and the liquidity of corporate bonds tends to decrease as the quality of the bonds decreases with high yield bonds having a much lower liquidity than investment grade corporate bonds. This illiquidity issue become more profound at times of market stress with corporates offering very poor liquidity during the financial crisis.
- 411. In summary, quality impacts the level of investment risk (that is partially captured by the stress test) as well as liquidity. Low quality bonds typically suffer a negative impact from both factors during times of market stress.

Possible approaches (in addition to the measuring investment risk) in order to ensure the level of illiquidity/credit risk is not excessive

- 412. In view of the above considerations around liquidity and quality, we have outlined below a number of possible approaches to setting out appropriate constraints of the investment portfolio under Fast Track for a significantly mature scheme:

Option 1: Principle-based approach

- 413. We would provide some general guidelines rather than quantitative approach as set out in Options 2-6.

Option 2: Minimum allocation to high-quality bonds (investment grade and above) and/or cash

- 414. There is clearly some overlap with the stress test here, but we are looking at this from a liquidity perspective rather than a risk perspective. For example, a minimum of 80% of the portfolio in high-quality bonds and/or cash might be reasonable.

Option 3: Minimum allocation to assets that can be realised within a specified period of time (one day, one week, etc)

- 415. This is similar to Option 2 but is making a more subtle distinction between various asset classes. This allows greater flexibility but requires a more complicated calculation with a degree of subjectivity as some investments have good liquidity in normal times but have poor liquidity under stress (for example Corporate bonds). One could set the threshold by maturity. For example, 20% of the portfolio within three months for significantly mature schemes with a lower proportion for more immature plans.

Option 4: Minimum level of liquidity to meet expected (and unexpected) cash flows

- 416. This looks at liquidity in the context of meeting the expected cash flows for a certain period, along with a reasonable allowance for unexpected cash flows from, for example, transfer value activity and is therefore scheme-specific. This is a more complex test to apply as one needs to know the individual cash flows to perform the analysis. The advantage is a more customised liquidity test. For example, sufficient liquidity within three months to meet expected cash flows but an additional 10% of liabilities for unexpected cash flows.

Option 5: Setting an overall maximum expected return on the assets (versus gilts)

417. Under this approach, one places a limit on the maximum expected return for a scheme at maturity to ensure the illiquidity and quality premium and associated risk is not too high. The rationale is that expected return is typically due to a combination of the following:
- A higher level of market risk (captured with the stress test).
 - A lower level of credit quality (partially captured with the stress test).
 - A lower level of liquidity (not captured under the stress test).
418. In our experience, a long-term best estimate return of greater than 1.0% is typically a concern in that the scheme is likely to be taking too much of the combined risks above and is therefore unlikely to have a low resilience to risk.
419. A long-term best estimate expected return maximum of around Gilts +1% pa for a significantly mature scheme would be broadly consistent with acceptable portfolios that meet the stress test and the discount rate of Gilts +0.5% to +0.25% pa.

Option 6: Average credit quality

420. This option would require a scheme that is significantly mature to calculate its average credit quality. This can be done with reference to a credit rating agency using a scoring system. For securities that are not rated (this would include mainly non-fixed income asset classes) they should be treated as 'other'.
421. This is potentially complex if one looks at each individual security, but one can reduce burden significantly by allowing an average asset class to be used per investment manager rather than having to go down to the individual security. This should retain the robustness of the test but make it simpler and quicker to calculate and apply.
422. Once the methodology of the test is established, one needs to decide on the appropriate minimum average credit quality. We consider that a sensible minimum credit quality is A and allows reasonable flexibility for a portfolio to combine UK government bonds (currently rated AA) with range of UK corporate bonds.
423. Table 27 below provides an example of a scoring system:

AAA	4
AA	3
A	2
BBB	1
Other	0

424. For example, a portfolio of 20% equities, 80% gilts would give a score of $80\% \times 3 + 20\% \times 0 = 2.4$ which is higher than the score of 2 associated with A.
425. We have set out in Table 28 below the pros and cons of each approach. These need not be mutually exclusive: several of the tests could apply in combination. We do not have a single preferred option, although we think that Options 3 and 4 are likely to be more appropriate as explanations for Bespoke arrangements.

Option	Pros	Cons
Qualitative	<input checked="" type="checkbox"/> Simple to understand.	<input checked="" type="checkbox"/> Open to interpretation.

		<input checked="" type="checkbox"/> Difficult for a qualitative approach to work in Fast Track.
Minimum allocation to Cash and high-quality bonds	<input checked="" type="checkbox"/> Easy to apply. <input checked="" type="checkbox"/> Simple guideline would work well with a Fast Track regime.	<input checked="" type="checkbox"/> Not scheme-specific.
Minimum allocation to assets that can be realised within a certain period	<input checked="" type="checkbox"/> A more customised approach taking into account the specifics of the asset allocation.	<input checked="" type="checkbox"/> More complex. <input checked="" type="checkbox"/> Requires an analysis by asset class that may vary significantly depending on individual product and structures. <input checked="" type="checkbox"/> Difficult to apply easily to Fast Track.
Sufficient liquidity to meet expected (and unexpected) cash flows	<input checked="" type="checkbox"/> Scheme and liability specific.	<input checked="" type="checkbox"/> More complex to apply. <input checked="" type="checkbox"/> Open to different interpretation, for example, how liquid are Corporates in a market stressed scenario.
Maximum expected return	<input checked="" type="checkbox"/> Simple to understand. <input checked="" type="checkbox"/> Limits the combination of credit quality and illiquidity. <input checked="" type="checkbox"/> Simple enough to be applied to Fast Track.	<input checked="" type="checkbox"/> Expected returns for the same asset class may vary between advisers and schemes.
Average credit quality	<input checked="" type="checkbox"/> Treats the portfolio as a whole and is more aligned with the principle we have set out. <input checked="" type="checkbox"/> Guidance exists under PPF test of how to categorise credit quality.	<input checked="" type="checkbox"/> An additional calculation to perform but reasonably simple if one allows this to be applied to asset mandates and not the individual security level.

► Questions

Q38 Defining guidelines for liquidity and quality of the investment portfolio in Fast Track

- Do you think we should define some guidelines around liquidity and quality in Fast Track?
- If so, what are your views on the options outlined above? Are there other approaches you favour?
- What limits would you set on the above criteria and why?
- How would the above change for a more immature plan?

11. Recovery plan (RP)

PRINCIPLES

- ★ TP deficits should be recovered as soon as affordability allows while minimising any adverse impact on the sustainable growth of the employer.

Introduction

426. A deficit on a TPs basis can emerge when:

- scheme experience (eg investment returns, membership experience) has not turned out as planned, or
- trustees have had to modify their assumptions about the future (for example, where their view of the covenant, their expectations for future investment returns, or their expectations for mortality rates have changed).

427. Under current practice, the funding deficit will typically be addressed through a RP that comprises a balance of employer contributions and investment returns.

428. This chapter addresses expectations for how RPs should be constructed under Fast Track. To be clear, we are not expecting RPs to fund a scheme's entire deficit on a low dependency funding basis (unless the scheme is significantly mature). Instead, and in line with current practice, it is the scheme's TPs deficit which is to be funded (the TPs having been set taking the scheme's LTO, maturity and employer covenant strength into account).

429. As discussed in Chapter 5 on General principles, we propose that trustees should seek to agree a RP as short as employer affordability allows, provided doing so does not impede the employer's sustainable growth. We think this is particularly important given the decreasing visibility of covenant strength beyond the short to medium term and the inherent risk that the covenant could weaken in the future, meaning that trustees cannot be sure that DRCs will be paid in the longer term (ie credit risk).

430. We are seeking views on the key elements which would make up an appropriate RP for Fast Track compliance:

- RP length.
- RP structure (eg back-end loading).
- Allowance for investment outperformance.
- Changes to RPs at subsequent valuations.
- Equitability of treatment.

431. Our objective is to ensure employers have sufficient flexibility in how they manage DRCs without unduly increasing risks to the scheme.

Recovery plan length

432. Under Fast Track, we propose to set clear limits on the maximum length of an RP. There are two broad options: 1) Different RP lengths by covenant grade or 2) Same RP length for all schemes regardless of covenant grade.

433. However, where a scheme is very mature or there are pressing concerns about the ongoing viability of the employer (eg a need to fund the TPs deficit sooner than any TPR-defined limits), we would expect this to be the most relevant factor in agreeing a RP.

Different RP lengths by covenant grade

- 434.** In this option, RP length would vary by covenant grade, with a requirement for RPs to be shorter for schemes for stronger covenants.
- 435.** We propose that schemes relying on stronger covenants should seek to agree RPs that are no longer than six years from the valuation submission, particularly considering the following:
- A period of two valuation cycles (six years) is broadly consistent with the maximum period of covenant visibility, which we consider is unlikely to be longer than three to five years for most employers (and in many cases could be much shorter).
 - Six years is broadly in line with industry averages. The average RP length⁴⁰ is currently around seven years⁴¹ for all schemes in deficit, five and a half years for ‘Strong’ (CG1) schemes and seven years for ‘Tending to strong’ (CG2) schemes.
 - Many strong (CG1) employers could recover TP deficits much faster than this (often immediately or within a year). However, providing some flexibility to spread contributions over a longer timeframe reduces the risk of overfunding and smoothing of contributions can also help employers manage their cash flows and business planning. At the same time, a relatively short RP would avoid the risks associated with longer RPs (namely the inherent and increasing uncertainty about the ability of employers to pay DRCs in the longer term).
- 436.** We recognise that many schemes with weaker covenants (CG3 and CG4) may not be able to support a six-year RP, particularly as their TP deficit is likely to be comparatively larger than for schemes with stronger covenants. They may therefore need a longer period than schemes with stronger covenants to get back to full funding (even though this would typically go beyond the visibility of the covenant). Under Fast Track we could allow longer RPs for these schemes, subject to trustees and employers taking account of our guidance on equitability (as discussed below).
- 437.** Table 29 below illustrates what RP length limits could look like for Fast Track purposes. It is important to note that these numbers are **illustrative** at this stage to promote a discussion on the concept of varying RP length. We will consult on the final limits on RP lengths in our second consultation, informed by the extent to which other RP flexibilities should be allowed under Fast Track (see below), our modelling of impacts (including the level at which we set low dependency funding and the timing for significant maturity), and responses to this first consultation.

For covenant to be assessed as (and for TPs to be set in line with this)	(Illustratively) RP length must be shorter than
CG1 (Strong)	6 years (or shorter?)
CG2 (Tending to strong)	6 years
CG3 (Tending to weak)	9 years
CG4 (Weak)	12 years

⁴⁰ See <https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/scheme-funding-analysis-2019>, Table 3.3 Average RP length by scheme characteristics (schemes in deficit only).

⁴¹ See Figure 17 on Distribution of RP lengths by covenant grades in Chapter 16 (Evidence and analysis).

438. We are seeking views on whether a much shorter RP for strong (CG1) covenants, eg three years, may be reasonable. This would be more consistent with the higher affordability we expect such employers to have but it may not provide sufficient flexibility to allow the scheme a reasonable window to manage investment volatility. It could therefore increase the risk of overfunding (although this risk could be manageable for some schemes, for instance via the payment of some DRCs into an escrow account secured in the scheme's favour).
439. Another key principle is that there should be consistency between (i) the strength of covenant assumed in the TPs and (ii) the length and structure of the RP. If a scheme's deficit cannot be funded within an appropriately short period (and with an appropriate structure, as discussed below), then we would query whether the covenant used to calculate the TPs is truly as strong as claimed.
440. In this case, we would typically not recognise the RP as being compliant with Fast Track and we would expect the trustees to submit a Bespoke valuation with supporting evidence as to why the RP needs to be longer. We would also expect trustees to demonstrate that they have secured appropriate alternative support to underpin the additional level of risk that the scheme is being asked to bear (see Chapter 11).
441. This is particularly relevant in scenarios where covenant strength is based on an employer having a strong balance sheet, but weak cash flows. This is because there is a real risk that these assets will not be available to the scheme at the point it needs to rely on them, for example because they:
- have been pledged as security for bank debt
 - have been utilised or sold to enable the employer to continue trading, or
 - no longer have material value because they are inextricably linked to a business which is in decline.
442. This also includes 'stressed' schemes (in the weak, CG4 category), ie whose employers may have significant affordability constraints to the extent that they cannot comply with the maximum RP length (illustratively, 12 years). We consider these schemes in Part 4 (Bespoke).
443. To the extent that there are covenant visibility issues (for example, significant concerns regarding the longer-term viability or strength of the employer), we would expect any such horizons to override our RP length guidance and for a shorter RP to be agreed.
444. In Part 4 (Bespoke approach), we outline how contingent assets and parental guarantees could support longer RPs or enhance the covenant underpin assumed in TPs.

Same RP length for all

445. An alternative to this approach could be to set an expectation that trustees of all schemes should seek to agree a RP that is no longer than, say, six years, and for a longer RP to be acceptable only where:
- the underlying covenant strength relied upon is demonstrably weaker (eg CG3 or CG4)
 - where it can be evidenced that a compliant RP is not affordable (such assertions would need to be demonstrated via the Bespoke approach), and
 - the scheme is being treated equitably.
446. Table 30 below outlines the pros and cons of both approaches:

Different RP length by different covenant grade	Same RP length for all schemes
<p>✓ Better reflects different affordability constraints and allow more schemes to opt for Fast Track.</p> <p>✗ More complex and somewhat arbitrary as there is no straight-forward relationship between covenant grades, affordability and RP length.</p>	<p>✓ Simpler to understand.</p> <p>✓ More objective, less arbitrary difference between different covenant grades.</p> <p>✗ Does not reflect different affordability of</p>

<p>☒ May incentivise some trustees and employers to agree funding strategies based on weaker TPs (reflecting potentially spurious assessments of weaker covenant strength) and to benefit from longer RPs that still meet the Fast Track guidelines. However, there are mitigations to this, such as clearly defined expectations around equitable treatment, and the fact that we will perform an independent assessment of covenant strength as part of our ongoing assessment of valuations.</p>	<p>different covenant strengths, potentially limiting the number of weaker schemes that could submit Fast Track valuations.</p>
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RP length near or at significant maturity

447. Another key consideration is how long a RP should be under Fast Track when a scheme is significantly mature. We consider that **RP lengths**, particularly for weaker covenant schemes with longer RPs, **should get shorter as the scheme gets closer to being significantly mature** and achieving low dependency funding. This is consistent with our principle for schemes' LTOs and to ensure they have sufficient funds to meet all benefit payments and mitigate the risk of disinvesting assets at depressed prices.
448. If we assume that RPs should be shorter, another key question is whether and how maximum RP lengths under Fast Track should taper as the scheme approaches significant maturity.

Recovery plan structure

449. The structure of RPs and the relative level of DRCs in different years of the plan also need to be appropriate. Excessive back-end loading within the RP (eg with a greater proportion of DRCs committed in the latter years) may be of concern to us. We currently see a number of schemes with back-ended loaded RPs which are not achievable based on the employer's forecasts. These are potentially being agreed as a way of either:
- minimising contributions paid into the scheme until the next valuation (at which time the hope may be that the scheme's funding shortfall will have reduced and contribution levels can be renegotiated), or
 - artificially shortening the RP length (and in doing so, to be less of an outlier compared with other schemes and less likely to attract regulatory scrutiny).
450. Bullet payments are an extreme form of back-end loading, which we also see. In such cases, the early years of the RP typically have extremely low (or even nil) DRCs, with the majority of DRCs committed in the last year(s).
451. However, we recognise that it may be reasonable for DRCs to increase by small amounts annually, where employer performance is expected to improve in line with market factors (eg inflation-linked increases).
452. Another consideration is the potential for over-funding on a TPs basis, particularly for shorter RPs. If an employer is required to pay a high level of contributions in the first three years of the RP, this means it is more likely that the next valuation following the original plan will reveal a surplus, which the employer may not easily be able to use.
453. A balance therefore needs to be struck between inappropriate back-end loading and the potential for over-funding. We would like to seek views as to whether, for Fast Track purposes, we should do any of the following:
- **Prohibit back-end loading or payments in later years apart from increases linked to a suitable inflation measure** (such as CPI).
 - **Have guidelines which define the shape of a RP.** For example, in Fast Track we could require a minimum proportion of DRCs to be committed to the first half of the RP and/or broadly consistent amounts each year over the initial period. For instance, at least 50% of total DRCs would have to be

paid in the first three years of a six-year RP. Different thresholds would have to be devised for different RP lengths and covenant strengths. This would allow more flexibility but would be more complex.

Investment outperformance

454. Some trustees make allowance for investment outperformance in the RP, ie they assume higher investment returns over the recovery period than what has been assumed (prudently) in the TPs. This has the effect of reducing the level of DRCs needed in the RP. However, if the scheme's assets fail to achieve the higher return assumed, the deficit will not reduce as expected and additional DRCs will be required at the next funding valuation. Allowance for asset outperformance in the RP therefore increases the overall risk that the funding strategy does not result in full funding. Investment outperformance also has more of an effect the longer the RP is.
455. We consider allowance for investment outperformance removes some (and sometimes most) of the prudence in the discount rates used to calculate TPs. This is because by allowing for higher investment returns over the recovery period, the scheme's funding strategy is relying on higher assumed investment returns than the discount rates. This reduces transparency around the overall risks being taken.
456. We therefore propose that for the Fast Track framework, **asset outperformance (above that assumed in the TPs) should not be used when calculating the RP**. Allowance for investment outperformance could be deemed acceptable with appropriate justification, eg using contingent security, in Bespoke.
457. The effect of removing asset outperformance in the RP on the level of DRCs required would depend on how the scheme's funding strategy is currently structured. For example, some schemes may currently set TPs with a significant margin for prudence (more than usually required given the covenant strength) and then make a material allowance for asset outperformance in the RP. For Fast Track purposes, this strategy could be reshaped so the margin for prudence in the TPs is reduced and asset outperformance in the RP removed. This could result in the same average assumption for asset returns over the lifetime of the scheme and DRCs, which are at broadly the same levels. Alternatively, trustees could submit a Bespoke valuation and evidence how any asset outperformance assumed in the RP is appropriately underwritten, for instance by additional support such as a contingent asset, or is offset by very prudent TPs to the extent that the outcome is at least as good as Fast Track overall.

Future recovery plans

458. For Fast Track purposes, we would like to seek views on various options as to how much 'rolling forward' or 're-spreading' could be allowed, ie where the agreed RP end date is extended at the next valuation (so DRCs are effectively re-spread). Main options include:
- **RPs should not be 'rolled forward'** unless there has been a material worsening in a scheme's funding position and/or a weakening in the employer's affordability.
 - **RPs could be 'rolled forward' at future valuations** as long as they meet the requirement for the maximum RP lengths in line with the Fast Track guidelines and provided the trustees have assessed and are comfortable with the covenant visibility.
 - **More nuanced guidelines** could be defined, such as:
 - if the deficit has reduced in line with expectations, we would expect the same end date to be maintained
 - if the deficit has reduced more quickly than expected, we would expect the same end date to be maintained, resulting in lower annual DRCs
 - if the deficit is a little higher than expected, we would accept the same level of DRCs resulting in a new RP, as long as the new end date was not more than three years after the current one

- if the deficit has grown significantly, we would expect at least the same level of annual DRCs and the guidelines on RP length to apply from the new valuation date.

Equitability

- 459.** We also propose to set clear expectations on scheme equitability for both Fast Track and Bespoke approaches. Equitability relates to the treatment of the scheme compared with historical and expected payments to other stakeholders, particularly where these payments represent ‘value leakage’, such as value leaving the covenant through dividends, intercompany loans that are unlikely to be repaid or material management bonuses.
- 460.** To be clear, references to ‘value leakage’ (particularly dividends) relate to ‘normal’ or ‘business as usual’ payments that are affordable from the employer’s ongoing trade. Exceptional distributions (for example, a large one-off dividend equivalent to a significant proportion of business value) are deemed to be ‘transactions’ and we expect trustees to consider these in line with our guidance on corporate transactions.
- 461.** In other words, a Fast Track compliant valuation (with due consideration given to equitability) would not give an employer licence to make large distributions without consideration of its pension scheme and appropriate consultation with the trustees.
- 462.** We recognise that ‘equitability’ is very difficult to reduce to a specific ratio or quantum (given scheme and employer specificity) and we expect that guidance on equitability (in the context of scheme funding) will be qualitative and with reference to scheme-specific circumstances, particularly employer covenant strength. For example:
- For stronger employers (CG1 or CG2), provided RPs are appropriately short and in line with our proposed thresholds (not longer than, for example, six years, as well as meeting our expectations in other areas, including back-end loading), we would not expect to be concerned by a proportionately high level of covenant leakage as long as:
 - the employer remains strong after the covenant leakage, and
 - the leakage does not cause a need for the RP to be subsequently extended (eg at the next valuation).
 - For weaker employers (CG3 or CG4), we would expect DRCs to be maximised or, often, prioritised over all forms of covenant leakage, other than where such leakage can be demonstrated to trustees and us to be absolutely necessary for the sustainable growth of the employer. However, we are likely to remain sceptical about arguments that there is any ‘necessary’ level of value leakage that is in the long-term interest of the sustainability of weaker employers and the schemes they support.
 - Where trustees consider value leakage is justified, particularly in the instance of weaker covenants and longer RPs, we expect them to seek suitable protections to compensate their scheme for the resultant deterioration in covenant. This includes, for example, security over employer assets, or ‘upside sharing mechanisms’ so that, in the event employer performance improves in future, the scheme can receive increased DRCs. We consider that such contingent arrangements represent good practice for trustees’ integrated risk management.
- 463.** Broadly speaking, we will be less concerned with equitable treatment provided the RP is within our Fast Track limits for CG1 and CG2 covenants (illustratively, six years). Our focus would be on schemes with longer RPs and/or weaker covenants.
- 464.** In some cases, the level of DRCs needed for a valuation to be Fast Track compliant may require a business to reduce payments elsewhere. This may drive a reduction in the payment of dividends (or other methods of ‘value leakage’). For the avoidance of doubt, we do not automatically recognise dividends as an essential business cost and consider that the payment of these in preference to paying an appropriate level of DRCs is likely to be detrimental to the covenant.

465. Trustees will be able to explain, through the Bespoke approach (see Part 4), why the agreed RP is different to the requirements set out in Fast Track. However, in the absence of detailed evidence, we are unlikely to recognise a need to pay dividends as reasonable justification for an overly long RP, particularly where additional support such as a contingent asset has not been provided to underpin the additional risk associated with this longer RP.
466. For the avoidance of doubt, the approach to equitability outlined above relates to valuations under Part 3 and our approach to our powers under s231(2) of the Act. We may adopt a different view when considering whether to pursue a Contribution Notice or Financial Support Direction as these are different regulatory functions based on different legislation.

► Questions

Q39 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)?
- 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?
- c. Do you think Fast Track RP lengths should be shorter for schemes nearing and/or at significant maturity? If so, to what extent?

Q40 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?

Q41 Fast Track guidelines on investment outperformance – Should investment outperformance not be allowed in Fast Track RPs? What do you think the impacts may be?

Q42 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?
- b. If a scheme's funding deficit is higher than expected, what guidelines should apply for the appropriate length of the new RP?
- c. Would the idea of 're-spreading' be more acceptable where a scheme has a long period before it becomes significantly mature?

Q43 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?

12. Open schemes

PRINCIPLES

- ★ Members' accrued benefits in open schemes should have the same level of security as members' accrued benefits in closed schemes.

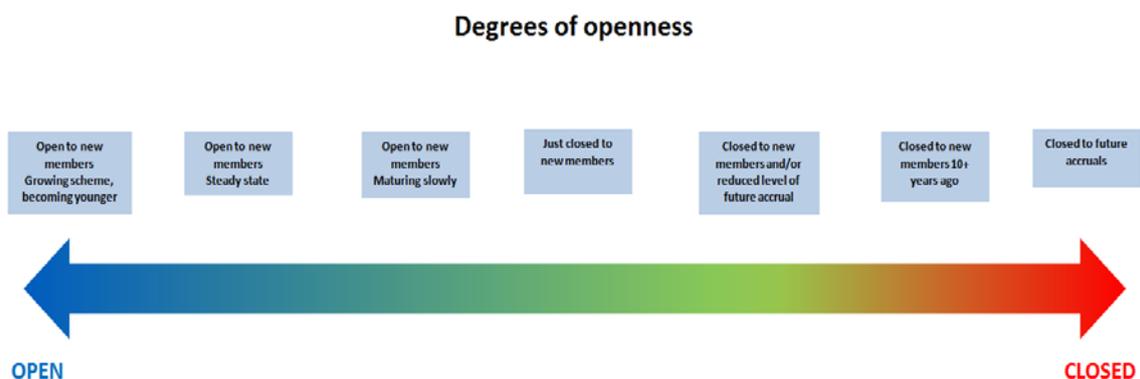
Introduction

467. Although a sizeable minority of schemes are closed to future accrual, the majority of schemes are still open to future accrual and, of those, an important proportion of members and assets under management are in schemes open to new members⁴². It is therefore important that the DB funding code addresses open schemes. In Chapter 5 on General principles, we discussed the concept of ensuring that members' accrued benefits in open schemes are protected to the same degree as in closed schemes while making sure the funding framework does not unduly increase the cost of future accruals, which could lead to scheme closures.

468. In this chapter, we will cover:

- our proposal to treat past service liabilities (TPs) and future accruals separately and for all schemes to have the same LTO of low dependency funding at significant maturity
- options for the calculation of TPs under Fast Track, and
- options for how trustees of open schemes should calculate the cost of future service and the contribution rate required under Fast Track.

469. There is a wide range of open schemes, from schemes which closed to new members some time ago, where future accrual is small compared to past service liabilities, to schemes which remain open to new entrants, where future accrual is significant and anticipated to remain so. In developing the proposals below, we have kept these differences in mind to make sure the new DB code will cater for all types of open schemes. This is illustrated in Figure 5 below:



470. Open schemes are typically less mature than closed schemes, reflecting the fact that new benefits continue to accrue for active members. Some open schemes, particularly those open to new entrants, are considerably less mature than closed schemes and, at least in theory, are expected to remain immature indefinitely. We have kept this feature of open schemes in mind when developing our proposals.

⁴² In 2019, 89% of DB schemes were closed to new members and half of these were still providing new accruals but to a closed and declining group of employees (see Chapter 16 (Evidence and analysis)).

Past service vs future service

471. Typically, open schemes treat past and future service liabilities separately. Legislation requires schemes to set TPs in respect of their past service liabilities. Future service liabilities are typically measured over the period covered by the schedule of contributions which is five years or the RP period if longer. Typically, future service liabilities are expressed as a percentage of active member payroll. In this consultation document, we use this approach – we outline below proposed Fast Track guidelines for past service (TPs and future service).

► QUESTION

Q44 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?

Long-term objective (LTO) for open schemes

472. We expect all schemes to achieve low dependency on their sponsoring employer by the time they are significantly mature to ensure an orderly run-off phase.
473. Many schemes are open to new accrual but closed to new entrants. These schemes are typically less mature than closed schemes. All other things being equal, the only difference between a scheme open to new accrual (but not new entrants) and a closed scheme is that the open scheme will take longer to become significantly mature. Therefore, when such a scheme becomes significantly mature, we expect it to have low dependency on its sponsoring employer and an investment strategy with a high resilience to risk in the same way as a closed scheme.
474. Some schemes are open to new entrants as well as new accrual. Many of these schemes are not expected to mature (or only expected to mature slowly) as the addition of new entrants will broadly maintain the balance of active members and pensioners. However, we consider that these schemes should also have a LTO defined in the same way as closed schemes, as:
- having such a LTO (and journey plan to it) will help trustees plan for the possibility of closure to new entrants
 - this would avoid funding and investment cliff-edges on closure to new entrants – the LTO would be unaltered by closure, and
 - as much as possible, we want the funding regime to apply consistently to all schemes.
475. We acknowledge that if such schemes do continue to admit new entrants and do not mature then the scheme will not actually reach significant maturity. We are content that such a scheme retains the same flexibility in its funding and investment strategies that all immature schemes have, as described in Chapters 9 (TPs) and 10 (Investments).
476. In practice this means that to follow Fast Track, trustees of all open schemes will also have to set a low dependency funding target of Gilts +0.5% to Gilts +0.25% pa at duration 14-12 (subject to consultation) with an investment strategy which has a high resilience to risk.

► Question

Q45 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?

Technical provisions/Journey plan (past service liabilities)

477. We have considered various options for the calculation of TPs (past service liabilities) for open schemes under Fast Track:

Option A: Open schemes must set TPs consistently with closed schemes.

478. In order to comply with Fast Track, TPs would be set using a discount rate no higher than that which would apply to a closed scheme of the same maturity (in relation to past service benefits) and covenant strength. Other assumptions would be set based on the current membership of the scheme (ignoring future new joiners) including an assumption for salary increases when applicable.

Option B: Open schemes may set lower TPs than closed schemes.

479. This is on the basis that open schemes have a longer time until they become significantly mature than closed schemes (some are not expected to mature at all) and longer investment horizons. Because of this extra flexibility, they can expect higher investment returns over the long-term which can be reflected in their discount rate assumptions. Some may argue that requiring open schemes to set their TPs at the same level as a closed scheme would be unnecessarily cautious. The higher expected returns may even generate trapped surpluses.

480. Table 31 below sets out the pros and cons of each option:

Option	Pros	Cons
Same approach as closed schemes	<p>✓ All schemes (open and closed) are treated consistently.</p> <p>✓ If an open scheme were to close to new entrants or close to future accrual in the future, its TPs would be unchanged. Therefore, there would be no 'cliff-edge' effects in liabilities/deficits associated with scheme closure.</p>	<p>✗ Potential for over-funding/ trapped surpluses (if scheme remains open).</p>
Lower TPs as longer investment horizon	<p>✓ Reflects the longer investment time horizon an open scheme has compared to a closed scheme.</p>	<p>✗ Inconsistent treatment of open and closed schemes.</p> <p>✗ Causes a 'cliff edge' whenever a scheme closes to new entrants and/or future accrual.</p>

481. Our preferred approach is Option A, ie trustees of open schemes should set TPs in the same way as closed schemes. This would have the following consequences:

- Consistency of approach for all schemes, open or closed. Open schemes that close to new entrants or future accrual will not need to materially change their TPs assumptions. Although there is likely to be some changes to the technical provision due to the removal of the link to salary increases on active member's benefits (which typically reduces the TPs).

- Open schemes arguing that longer investments time horizons give them the flexibility to have lower TPs than closed schemes would not comply with Fast Track, so would have to use the Bespoke approach (see Chapter 13 for examples of Bespoke scenarios).
- Schemes open to new entrants that do not mature will, in theory, never become significantly mature and reach low dependency funding. Their TPs calculated at each valuation will continue to be based on discount rate assumptions consistent with their (unchanging) maturity.

► Question

Q46 Fast Track TPs for open schemes – What option do you favour and why? Are there other options we should consider?

Future service liabilities and contribution rate

- 482.** As well as having an LTO and setting TPs in relation to past service benefits, open schemes need to calculate the cost of future service benefits and the contribution rate required to meet those costs.
- 483.** Various methods are used to calculate these costs based on the scheme's expected membership profile (such as Projected Unit Method and Attained Age Method). Therefore, we do not think it is appropriate to determine which method ought to be used in Fast Track. Trustees should continue to use a method appropriate to their circumstances. We are more concerned about the assumptions being used to calculate the cost of future accrual. This is addressed in the sections below.

Actuarial certification

- 484.** Legislation⁴³ requires the scheme actuary to certify a scheme's schedule of contributions such that the scheme is expected to be 100% funded on its TPs assumptions by the end of the period covered by the schedule of contributions. This is by the end of the RP or after five years, whichever is later.
- 485.** Trustees do not necessarily have to use the same assumptions to calculate future service costs as they use to calculate TPs (past service liabilities). However, as benefits accrue, they form part of a scheme's TPs at future valuation dates. This means that any difference between the assumptions used to calculate future service costs and TPs has to be accounted for somewhere for the purpose of the scheme actuary's certification of the schedule of contributions. Any difference is usually accounted for by either of the following:
- Making an adjustment to DRCs (ie increasing them to reflect the new deficit that is expected to emerge from future service benefits).
 - Making a further assumption for the purpose of the scheme's RP, often by assuming that the scheme's assets will produce higher returns than the discount rate used to calculate the TPs. In Chapter 10, we consider whether allowance for investment outperformance should feature in Fast Track RPs.

Assumptions for future service costs

- 486.** We recognise that Part 3 of the Act does not expressly impose any obligations in respect of future service costs, however that does not eliminate the need for trustees to address the issue, therefore Fast Track

⁴³ s227(5) & (6) of the Act. Regulation 10 and Schedule 1 of The Occupational Pension Schemes (Scheme Funding) Regulations 2005.

needs to provide some guidance on the best practice. We have considered various options for the calculation of future service costs for open schemes under Fast Track, as follows:

Option A: same discount rates

The same discount rate assumptions must be used to calculate future service costs as are used to calculate TPs.

Option B: discount rate reflects future service maturity

As Option A, except the discount rate may reflect the fact that future service benefits will (almost certainly) be more immature than the maturity of past service benefits.

Option C: best estimate

Best estimate discount rates may be used to calculate future service costs.

Option D: no requirements

No requirements will be placed on future service cost calculations.

487. We recognise that there are other methods to set discount rates for future service contribution rates. One example is to use different pre- and post-retirement discount rates. This has implications for how the three options above would play out.

488. The example set out in Figure 6 below illustrates how these options for calculating the cost of future service benefits under the Fast Track would work. A scheme calculates the minimum TPs allowed under Fast Track using the percentage of low dependency liabilities figure from the box indicated by the blue arrow. The options for calculating minimum future service costs allowed under the Fast Track approach are indicated by the red arrows.

Example scheme has 15 year duration for past service and 25 year duration for future service:

- A. Use past service assumptions for future service
- B. Separate maturity measure for past and future service
- C. Best estimate approach for future service
 - I. using maturity measure as for past service
 - II. using maturity measure as for future service

Years to LTO	25-30	[...]	[...]	5-10	0-5
Maturity (duration)	24+	22-24	[...]	14-16	12-14
Discount rate (presented as % low dependency liab.)	[...]	[...]	[...]	[...]	[...]
Best estimate discount rate (presented as % low dependency liab.)	[...]	[...]	[...]	[...]	[...]

TPs (past service) discount rate

Best estimate assumptions

489. Option C above allows future service costs to be determined based on the same assumptions as TPs, except schemes can set the discount rate for these costs equal to best estimate investment return assumptions on the scheme's investments. The best estimate return for this purpose could be set as either of the following:

- The **trustees' best estimate** of their scheme's investment return on assets expected to fund the future service costs.
- A **rate set by TPR** to be consistent with the Fast Track compliant discount rates used to calculate TPs. We would need to set compliant best estimate return assumptions. We could do this based on the reference asset portfolios used to determine the investment stress test or the proportion of allowable growth-seeking assets under Fast Track (see Chapter 10).

490. Table 32 below sets out the pros and cons of each of the options for setting future service costs:

Option	Pros	Cons
A: Same assumptions as TPs	<ul style="list-style-type: none"> ✓ Most straightforward option – a single set of assumptions is used throughout. This makes it clear how schemes can comply with Fast Track. ✓ Most straightforward option when it comes to the scheme actuary's certification of the schedule of contributions. 	<ul style="list-style-type: none"> ✗ Does not reflect the fact that future service liabilities are very likely to be more immature (and have a longer duration) than past service liabilities.
B: Same assumptions as TPs (but reflecting maturity of future service benefits)	<ul style="list-style-type: none"> ✓ Would provide trustees with some flexibility to determine future service costs and contributions rates, which reflect the different maturities of future service liabilities and past service liabilities. ✓ Compared to the above approach, might also help to avoid schemes developing trapped surpluses. ✓ Compared to approaches based on best estimate assumptions, there is little risk of deficits being created at future valuations. This is because the contributions paid should broadly equal the value of past service benefits accrued over the inter-valuation period. 	<ul style="list-style-type: none"> ✗ Inflexible (although not as inflexible as above option). There is a greater risk of trapped surplus than the approaches below but less than the option above. ✗ Might make it more difficult for the scheme actuary to certify the schedule of contributions than the approach above. This is because the contributions paid in respect of future service may not be worth exactly the same as the value of the past service benefits which will accrue over the period of the schedule. ✗ Potentially more complex than Option A as, depending on the structure of the discount rates, past and future service liabilities may be calculated using different assumptions.
C: Best estimate assumptions	<ul style="list-style-type: none"> ✓ This would provide trustees with flexibility to determine future service costs and contributions rates which reflect the circumstances of their scheme. ✓ Could be used to set contribution rates to avoid unnecessary over-funding/ trapped surplus. 	<ul style="list-style-type: none"> ✗ Flexibility for trustees to use their own best estimate investment return assumptions is out of line with the concept of Fast Track. ✗ Under the option that we determine best estimate assumptions, we would need to set best estimate returns for all asset classes. This would be more complex and difficult to tailor to all the circumstances of all schemes. ✗ Future service contribution rates might be

		set at such a low level that deficits would be expected to emerge as inter-valuation accruals become past service.
D: No requirements on future service cost calculations	<input checked="" type="checkbox"/> This would provide trustees with flexibility to determine future service costs and contributions rates which reflect the circumstances of their scheme. <input checked="" type="checkbox"/> Could be used to set contribution rates to avoid unnecessary over-funding.	<input checked="" type="checkbox"/> Flexibility that is more in line with Bespoke. <input checked="" type="checkbox"/> Future service contribution rates might be set at such a low level that deficits would be expected to emerge as inter-valuation accruals become past service.

491. Our preferred approach is Option B, ie the same assumptions must be used to calculate future service costs as are used to calculate TPs, except the discount rate used may reflect greater immaturity (represented, for example, by a higher duration of the liabilities) of future service benefits. We consider this provides the best balance between:

- ensuring the provision of future accruals should not compromise the security of accrued benefits, and
- having a consistent approach which applies across all Fast Track schemes,
- whilst not systematically over-funding the scheme.

► Questions

Q47 Fast Track guidelines for calculating future service costs

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

Schemes in surplus and future service contributions test

- Open schemes that have a surplus measured against TPs sometimes reduce their future service contribution rate below the future service cost for a period, effectively using the surplus to make up the difference.
- We consider it a prudent approach to pay for new benefits as they accrue based on TP assumptions. A surplus (measured against TPs) can be used to offset contributions only if and when it emerges. We prefer this approach to one that which decreases the future service cost by relying on future returns, which may or may not be realised.
- We propose to continue to allow these approaches under the Fast Track framework, as long as a scheme has a surplus (or, at least, not have a deficit) measured against its TPs and the scheme is expected to have a surplus by the end of the schedule of contributions where the reduced rates are set out.

► Question

Q48 **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?

Part 4: Application

(2) 'Bespoke'

13. Bespoke framework

key features

- 495.** In Chapter 5 (Proposed regulatory approach), we outlined our proposal to introduce a twin-track compliance regime and described Fast Track and Bespoke compliance at a high level.
- 496.** This chapter and the next cover our more detailed proposals for how the Bespoke framework could operate in practice. We discuss:
- our proposed assessment criteria for Bespoke arrangements (paragraphs 497 to 501)
 - some anticipated circumstances where trustees might opt for a Bespoke arrangement, including illustrative examples (paragraphs 502 onwards), and
 - the use of additional support (eg contingent assets or guarantees) in Bespoke arrangements (Chapter 14).

Assessment criteria

- 497.** We currently assess all valuations submitted to us (from trustees of schemes in deficit) and will continue to do so. We also note that the Bill includes a provision to require all schemes, including those in surplus, to submit their valuations. Fast Track valuations will be checked against Fast Track criteria (as set out in preceding sections) while we propose to assess a Bespoke valuation by reference to the following criteria:

A. Consider how the Bespoke arrangement complies with legislation and any relevant DB code principles

- 498.** We would consider how the submitted arrangements comply with relevant legislation and we propose that the principles in Chapter 5 should also apply where trustees have followed a Bespoke route.

B. Assess the Bespoke arrangement using Fast Track as a reference point

- 499.** We would consider the extent to which (and why) the Bespoke arrangement deviates from Fast Track assumptions and parameters. We would examine whether the difference from the 'Fast Track equivalent' (in this chapter we refer to this as the FTE) position results in a weaker outcome overall or means that the scheme is running additional risks (such as lower TPs, longer RP etc).

C. Assess how additional risk (if any) is being managed

- 500.** We would expect trustees to clearly articulate and demonstrate how any additional risk they are taking (and which has not been assessed as remote or minimal) is being managed through a combination of appropriate mitigations and/or additional support. We would expect those trustees unable to comply with Fast Track to provide additional support, or, failing that, to take some action to mitigate the risk (ie reduce its severity) if it were to materialise.

D. The quality of the supporting evidence provided by the trustees

- 501.** The explanations provided by trustees must be supported by robust evidence provided in their statement of strategy. We would need to be comfortable that the funding solution has been developed by reference to an accurate assessment of the scheme-specific factors, additional risks and, if appropriate, any support provided by the employer and/or the wider group or mitigation actions. In the case of stressed schemes, we would expect robust and evidence explanation of why the approach taken is the only outcome available to the trustees.

► Question

Q49 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?

Common Bespoke features and illustrative examples

- 502.** We envisage three main reasons why trustees might choose to submit a Bespoke arrangement:
- An aspect of the Bespoke arrangement is different from the Fast Track equivalent (FTE) but despite the differences, (i) in aggregate the Bespoke arrangement represents an outcome that is at least as good as the Fast Track outcome overall and/or (ii) the trustees can evidence that there is no additional risk being run in the Bespoke arrangement.
 - Where trustees consider it appropriate to take additional, managed risk relative to the tolerated level of risk set out in Fast Track.
 - Where trustees are unable to meet some or all standards expected in Fast Track (eg stressed schemes).
- 503.** We initially considered whether these scenarios could be integrated into Fast Track. However, we found that adapting the framework to accommodate all of these features and their variables overly complicated Fast Track and undermined our aim of simplicity. However, we do not want to discourage trustees and employers from using flexibilities available to them, nor to undermine trustees who simply cannot submit Fast Track compliant valuations.
- 504.** In this chapter, we describe these Bespoke categories in greater detail and consider some examples that illustrate how we would assess these funding arrangements and how we would expect trustees to evidence their position in the statement of strategy.
- 505.** These examples are illustrative (eg based on specific options for Fast Track which are subject to consultation and therefore are not final). They have been deliberately simplified to illustrate different aspects and principles and to help consultees understand how the Bespoke framework is intended to work. The illustrations are not exhaustive, and we recognise that for most schemes, reality will be more complex.

A. Same or better outcome than Fast Track

- 506.** To comply with Fast Track, a scheme would have to meet *all* key Fast Track aspects (ie quantitative parameters and guidelines) separately. In summary, these would cover:
- setting an appropriate LTO based (as a minimum) on low dependency funding, high resilience to investment risk and a target date that represents significant maturity
 - setting TPs that are at least as strong as defined for the scheme's maturity and covenant strength
 - agreeing a RP that does not exceed TPR-defined lengths (for the covenant relied upon) and which meets other RP guidelines (eg on back end loading, investment outperformance, etc)
 - taking investment risk within Fast Track limits, and
 - setting future service contribution rates according to Fast Track levels.
- 507.** However, we anticipate situations where the trustees' funding arrangement does not meet one or more of these individual Fast Track aspects but, overall, the outcome is the same or better than Fast Track. We would expect trustees to demonstrate that this is the case.
- 508.** We provide some possible examples of these situations below:

Example 1: LTO – Bespoke assumptions

- In setting their long-term low dependency funding basis, the trustees have adopted mortality rates significantly higher than the standard mortality table. They have assumed a long-term rate of improvement slightly lower than the assumption recommended by us under Fast Track. This means targeting a lower funding basis than the LTO we recommended for Fast Track.
- They based their decision on analysis they commissioned on the scheme's mortality rates and historic improvements in mortality. This analysis showed the scheme-specific mortality rates have been worse than the UK population average and are not improving as quickly.

TPR assessment: Compliant – no additional risk

- Although the trustees have chosen a lower funding target for their LTO than the FTE, this change does not result in additional risk because the assumptions reflect the real nature of the scheme's demographic profile and liabilities.
- The trustees can provide the relevant demographic data that was assessed by the scheme actuary to evidence why their assumptions are appropriate and scheme-specific.

Example 2: LTO – CDI strategy

- A significantly mature scheme is invested 100% in Cash Driven Investment (CDI) backed by a combination of UK inflation-linked bonds, UK fixed interest gilts and UK investment grade corporate bonds.
- The arrangement fails the Fast Track investment stress threshold but the scheme is using the Fast Track equivalent TPs which are equal to low dependency. The trustees' statement of strategy explains that the failure is caused by the level of corporate exposure and that the stress test is only applied to specified asset maturity categories.
- They provide evidence of the expected pattern of cash flows from the CDI product matching the expected cash flows from liabilities.
- They demonstrate there is sufficient liquidity to deal with unexpected cash flows (for example, transfers out). The expected return overall and the average credit quality is consistent with what we would expect from a portfolio with a high resilience to risk.

TPR assessment: Compliant – no additional risk

- The trustees have adequately demonstrated that because of the quality of the assets, their investment strategy runs no additional risk as compared to a scheme investment strategy that passed the stress test.
- **NOTE:** We would have been concerned if the scheme had been invested 100% in CDI backed by a high level of private debt, high yield bonds, emerging market bonds. Central / best estimate forecasts may show this type of CDI portfolio providing the expected cash flows to match the liabilities but there are significant risks:
 - The level of corporate fund defaults increases in a time of market stress leading to expected cash-flows from corporate bonds being lower than expected and insufficient to meet expected liability cash flows.
 - Due to the lower quality of bonds held, they are likely to have greater market volatility, particularly in times of market stress, which may lead to forced selling at depressed values if liability cash flows are different from expected.
 - Liquidity for these asset classes is typically lower than for high quality investment grade bonds and government bonds and can deteriorate dramatically in times of market stress, this could make it difficult to sell any of these assets if liability cash flows are different than expected. In summary, the scheme may therefore experience the impact of a perfect storm of impaired

market value/higher level of corporate bond defaults at a time of vanishing liquidity. Such a combination of factors played out over a prolonged period of time during and immediately after the 2007-2008 financial crisis.

Example 3: Longer-term reliance on covenant

- A closed scheme is sponsored by an employer that primarily operates under a rolling 15-year contract to provide services to the UK government. The employer is profitable and has free cash flow which is reasonably high relative to the size of the scheme. The trustees assess the covenant as tending to strong (CG2) with reference to our guidance.
- The trustees consider that this gives them longer-term visibility of the strength of covenant than implied under the Fast Track guidelines (illustratively, three to five years) and they are confident that their covenant will remain CG2 for at least eg 10 years.
- They adopt discount rates in their TPs which assume moderately higher investment returns (with associated higher risk) over the initial eg 10-year period. TPs are therefore weaker than Fast Track.

TPR assessment: Compliant – no additional risk

- Although we would ordinarily consider that additional risk arises from the longer-term view of the employer's strength in this case, the trustees have undertaken full due diligence on the legal and financial aspects and have taken appropriate professional advice. They have provided evidence that:
 - their employer has legally underpinned cash flows/income, for instance by reference to a long and committed order book, which provides comfort over the employer's longer-term viability,
 - they have assessed there to be minimal *counter*-party risk (such as the risk that the contract could be removed, and/or a competitor come into this market, and
 - they have received advice on the legal certainty regarding cash flows and are confident that the terms could not be *easily* varied.
- We therefore conclude that the detailed evidence provided justifies the longer reliance on employer covenant, and the assumption that it can underpin investment risk for a longer period.
- **NOTE:** We would have concerns if:
 - the trustees had assumed that the contract would be renewed on the same terms and, therefore, they could rely on the same level of support indefinitely, or
 - the terms of the contract could be varied, as the trustees would be unable to demonstrate there will be a legally certain income stream over the 10 years, and
 - the resultant TP deficit were not funded in an appropriate period (e.g. if the RP was longer than, illustratively, six years).

B. Additional risk relative to Fast Track

509. In other situations, trustees may decide to diverge from Fast Track and their Bespoke arrangement will represent additional risk over and above the tolerated level of risk assumed in Fast Track. We would expect trustees to demonstrate in their statement of strategy how this additional risk is being managed and supported (unless they face significant affordability constraints and the scheme is stressed – see section C below).
510. In this context, we use the word 'risk' to represent the additional risks run by the trustees as a result of targeting a lower or weaker position than in Fast Track. For example, an LTO that targets less than low dependency funding, is premised on higher investment risk or a date for achieving the objective after significant maturity.

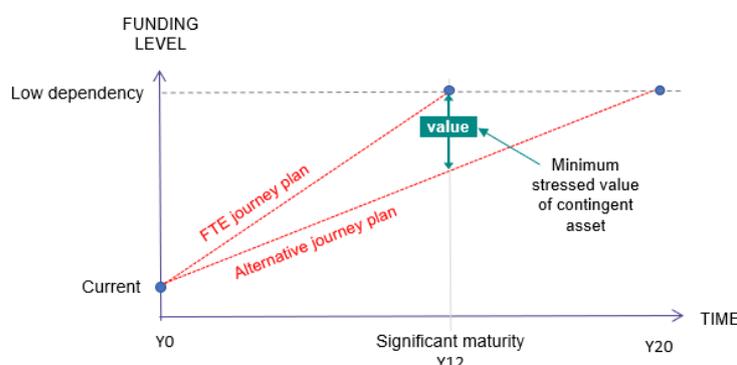
511. We consider that there are two broad categories types of additional support:

- Contingent assets: The additional risk is underwritten by contingent security which is of sufficient value (based on an appropriate valuation) and is realisable when required. We discuss in greater detail our expectations around the use of contingent support in Chapter 14.
- Guarantee support: eg from the employer or the wider group.

512. We provide a few examples below:

Example 4: Low dependency targeted later than significant maturity

- The scheme’s actuary calculated that the scheme would reach ‘significant maturity’ (as defined in Fast Track) in 12 years. However, the trustees have selected a target date of 20 years from the effective date of their valuation to reach low dependency funding.
- The trustees secured a contingent asset of sufficient stressed value that would be released in an insolvency event.
- Figure 7 below illustrates this:



NB An alternative approach could involve the trustees setting the current TPs to be lower than the FTE. In that case the value of the minimum stressed value of the contingent asset would still be calculated in the same way.

TPR assessment: Compliant – additional risk is managed (by additional support)

- Although the scheme is carrying more risk than the FTE position, the trustees have properly managed the risk by securing support.
- This security has been valued properly and is available when needed so the trustees have evidenced that this supports the additional risks associated with running a significantly mature scheme.

Example 5: Back-end loaded RP

- For valid business reasons, a CG3 employer needs to materially reduce the scheme’s DRCs for the next three years but is prepared to commit to DRCs over the subsequent six years which are sufficient to fund the TP deficit (eg the nine-year RP is consistent with the FTE but is back-end loaded).
- The employer shares its detailed business plan with the trustees who take independent covenant advice. The covenant advice recommends that, on balance, the employer’s plan is reasonable and likely to result in a stronger covenant in the medium to long term. The trustees are comfortable that this strategy is necessary and reasonable.
- The proposal includes a hiatus on dividends and other forms of value leakage until (at least) the scheme has received the level of DRCs that it would have received under an FTE RP (eg at least 3

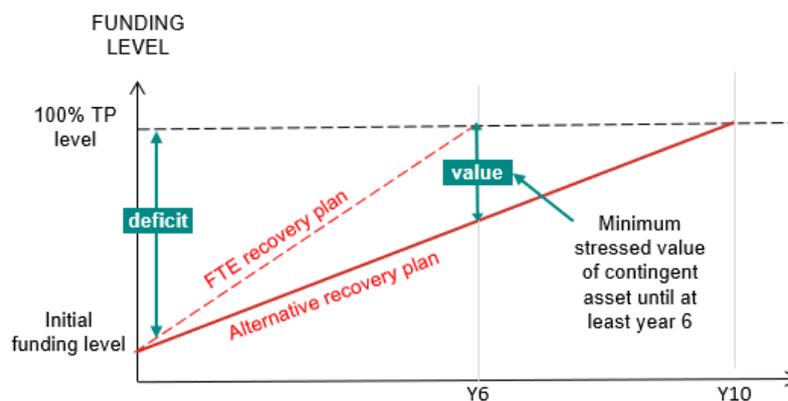
years) and the trustees/management consider that alternatives (eg raising new debt to fund the investment plans) would be detrimental to the covenant.

TPR assessment: Compliant – additional risk is managed (mitigated)

- The trustees have provided good evidence on the need to delay DRCs and this is properly detailed in their statement of strategy.
- They have assessed the risk of short-term insolvency as remote and have further mitigated the additional exposure to employer covenant deterioration by ensuring no dividends or any other value leakage occurs in years one to three. The dividend suspension is supported by a legally binding agreement.
- **NOTE:** We would be concerned if:
 - The trustees and employers could not evidence there was a genuine financial need for DRCs to be postponed.
 - The employer looked vulnerable to *insolvency* in the short to medium term.
 - The scheme was not being treated equitably with the employer’s other stakeholders. For example, there was no ‘risk-share’ in place (such as the legally binding agreement not to pay *dividends* in the period of employer re-investment).

Example 6: Long RP

- A scheme closed to future accrual is sponsored by an employer that the trustees have assessed as strong (CG2) and so they have set TPs consistent with Fast Track for that covenant grade.
- However, the trustees have agreed a 10-year RP on the basis that the scheme’s sponsoring employer cannot afford more as it is cash poor but asset rich. This is much longer than the appropriate RP length under Fast Track for CG2.
- In mitigation, the trustees have secured a contingent asset of sufficient stressed value to cover scheme’s exposure to being underfunded for a longer period. The asset will be automatically released at the end of the RP if the scheme has not reached the SFO.
- Figure 8 below illustrates this:



TPR assessment: Compliant – additional risk is managed (supported)

- The trustees have security that underwrites the risk of a longer RP. It has been properly valued and can be accessed when and if it is needed.
- **NOTE:** We would call into question the trustees’ covenant assessment of CG2 if the employer could not support a relatively short RP and was not willing or able to provide adequate contingent security.

Example 7: Stronger TPs but longer RP

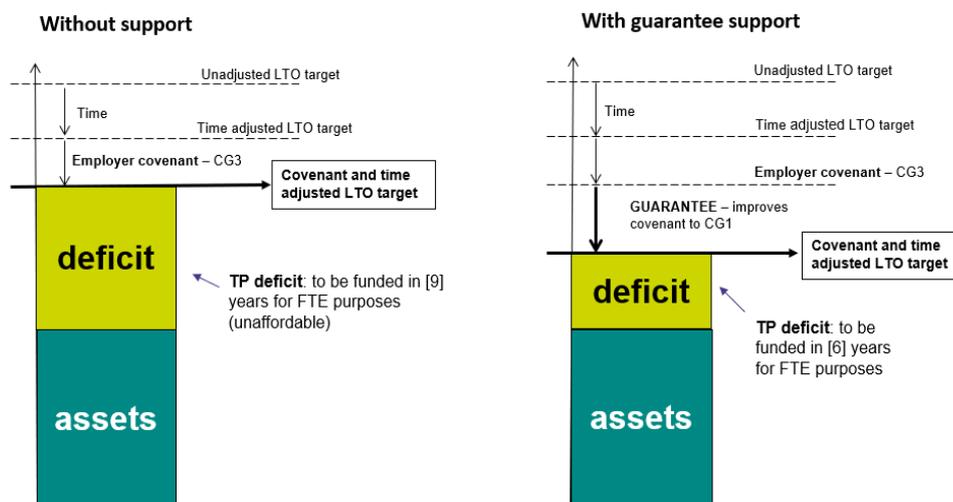
- The trustees of a closed scheme have set a LTO in accordance with the Fast Track guidelines. They have also set TPs using the same low dependency assumptions. This means the TPs are significantly higher than the Fast Track minimum, resulting in a larger TP deficit.
- To fund this deficit, they have agreed a RP of 10 years, which is longer than Fast Track length for their CG2 employer covenant.
- The scheme's investment strategy passes the Fast Track investment stress test.
- The trustees were concerned about the longer reliance on the employer for DRCs and they have agreed with the employer an information-sharing protocol and a conditional payment in the schedule of contributions if there is any change to the employer covenant strength.

TPR assessment: Compliant – (i) better than FTE and also (ii) managed risk

- The trustees demonstrated that higher contributions are being paid than if the Fast Track TPs and RP had been adopted. This 'equivalence test' would be done by comparing aggregate DRCs that would be payable under the Fast Track approach with the sum of total actual planned contributions over the Fast Track RP period. The other guidelines about back-end loading, investment outperformance and equitability were met.

Example 8: Underpinning covenant with a guarantee

- The Fast Track guideline for a CG3-sponsored scheme is a recovery plan of no more than nine years (note that this is subject to consultation). However, the corresponding DRCs are not affordable by the employer.
- The employer's parent company, which is capable of providing a CG1 level of employer covenant, grants the scheme a guarantee that (i) covers its low dependency deficit at the outset but will increase if the low dependency deficit increases, (ii) is not time-limited, and (iii) guarantees the payment of DRCs if the employer cannot.
- The trustees therefore assume that the scheme's covenant has improved to CG1 and agree TPs and an RP that meet the Fast Track guidelines for a CG1-sponsored scheme.
- Figure 9 below illustrates this:



TPR assessment: Compliant – additional risk is managed (supported)

- The trustees have secured a legally enforceable guarantee for an appropriate value and time period and from a sufficiently robust counterparty. This justifies assuming (for funding purposes) that the

covenant of the direct employer is that of the parent. The resulting lower deficit is to be funded over a period commensurate with the improved covenant.

- **NOTE:** If the guarantee had expired after the six-year RP period then we would consider that it only supported the RP, not that it provided a full covenant equivalence. We would therefore consider that even if the scheme was fully funded on a TPs basis, the TPs were too low for the employer covenant.
- We discuss our proposals regarding the use of guarantees in greater detail in Chapter 14.

Example 9: Weaker TPs – based on strong long-term covenant

- A closed scheme is sponsored by an employer the trustees have assessed as strong (CG1). The employer has suggested, and the trustees have agreed, that investment de-risking is unnecessary and that the current covenant strength should be fully reflected in TPs discount rates over the 20-year period before reaching low dependency (ie with the assumed investment returns and risk being maintained for this period at a level commensurate with a CG1 covenant).
- This approach means that the discount rates assumed allow for significantly higher investment returns (with associated high risk) over the medium term to long term than the Fast Track approach, resulting in the TPs being substantially lower for 20 years. The trustees have obtained contingent support to underwrite the additional risk.
- The legally enforceable contingent support obtained by the trustee is of sufficient stressed value to underwrite additional investment and insolvency risk over the 20-year period and realisable when needed (for example cash, or property not occupied by the employer, which can be readily converted to cash by the trustees without harming the employer).

TPR assessment: Compliant – additional risk is managed (supported)

- The mitigation obtained appropriately underwrites the additional risk created by diverging from the Fast Track position, it is consistent with the principles, and the trustees' statement of strategy and supporting documentation explain this clearly.
- **NOTE:** We would have concerns if the trustees had simply assumed that the covenant would remain strong over the entire period and failed to seek additional support or otherwise manage the additional risk.

Example 10: Lack of journey planning so TPs inconsistent with LTO

- The trustees of a closed scheme have an LTO to buy-out out in 25 years' time when the scheme is expected to be significantly mature. The trustees have adopted a single discount rate to calculate the TPs.
- The single discount rate is based on prudent expected returns on the current investment strategy which can be supported by the current covenant. The trustees plan to maintain the current investment strategy indefinitely. This approach means the TPs are substantially lower than in Fast Track.

TPR assessment: Potentially not compliant – failure to adequately manage additional risks

- This approach is not consistent with the principles as there is:
 - no link between TPs and the LTO (journey planning) which means that the trustees cannot *demonstrate* that their TPs will reach the LTO and are therefore prudent
 - no plan *for* the level of scheme-based or investment risks to decrease over time, and;
 - an *assumption* that the reliance on the covenant can be maintained at a similar level over a very long period.

- The trustees have provided no evidence to support their approach and merely confirm their personal views that they have a strong employer who can support all the risks indefinitely.

Example 11: High allocation of growth assets

- The trustees of an open scheme have assessed their employer covenant as CG2 and are heavily invested in equities. The scheme's investment profile fails the stress test.
- The trustees have secured a contingent asset to support the excess investment risk being run as compared to a Fast Track compliant investment strategy. The contingent asset is of sufficient liquidity to be converted to cash by the scheme in an adverse investment event (without adverse impact on the employer covenant). The trustees' lawyers have confirmed that the asset will be released in appropriate amounts if the investment returns are below the anticipated level at subsequent valuations.

TPR assessment: Compliant – additional risk is managed (supported)

- The additional investment risk is adequately supported, the funding arrangement is consistent with the principles, and the trustees' statement of strategy and supporting documentation explain this clearly.
- **NOTE:** We would not consider that investing only in growth-seeking assets on the grounds that the scheme is open to new members would be a sufficient justification.

Example 12: High allocation to growth assets, strong covenant

- The trustees of a small immature closed scheme are heavily invested in growth assets. The scheme's sponsoring employer is very large and has been assessed as strong (CG1) and the RP agreed is in line with FTE for this covenant grade (for example, less than six years). The scheme's investments have failed the Fast Track stress test.
- The trustees confirm in their statement of strategy that they have properly managed the increased risk because of the following:
 - The downside risk of the potential investment underperformance can be supported in the short term by their employer. The employer has cash flows and assets considerably more than the amount quantified by the trustees as 'at risk' and has provided a commitment to make good any downside event within the very short term, ie six months.
 - The trustees have a unilateral power to set contributions under the trust deed and rules.
 - The trustees have a contingency plan detailing the lower risk asset allocation they would move to in the event of a deterioration in the covenant (which is consistently monitored by the trustees).

TPR assessment: Compliant – additional risk is managed (supported and mitigated)

- Additional investment risk is being taken but is supported by the employer and the trustees have demonstrated that possible downside deficits can be comfortably met by the employer's cash assets. Further, the additional risk has been mitigated by the contingency plan and the trustees' ability to unilaterally call for additional contributions.
- **NOTE:** This is a situation where the covenant is significantly strong in relation to the size of the scheme. Less strong CG1 covenants (for example, those which are not able to underwrite investment risk in the very short term) might not get through Bespoke without a contingent asset to underpin the additional risk.

Example 13: Open scheme with weaker TPs

- The trustees of a scheme open to both future accrual and new entrants have set TPs with a discount rate significantly higher than the FTE for an initial period of three years then de-risking gradually down to a low dependency level by significant maturity assuming no future accrual after the initial period.
- The trustees justify this approach by demonstrating:
 - the employer covenant is strong with good visibility over this initial period and therefore could rectify any downside scenarios at the valuation after this three-year period;
 - that the employer has provided contingent support of sufficient (and realisable) value to underwrite the additional investment risk this strategy incurs, and
 - an appropriately evidenced commitment from the employer to keep the scheme open to new entrants and accrual over this initial three-year period (meaning the scheme will not mature).
- They have agreed to review this approach at each valuation, it is temporary.

TPR assessment: Compliant – additional risk is managed (supported and mitigated)

- The arrangement is consistent with the principles, the additional investment risk is supported and the closure risk has been mitigated. Further it is a temporary arrangement that can be unwound at the next valuation (which would mitigate long-term risks).
- **NOTE:** We would be concerned if the trustees only put forward *unsupported and unevidenced* explanations such as that the scheme is open and therefore it:
 - has a much *longer* investment time horizon than a closed scheme
 - is not under *pressure* to dis-invest to meet pension payments as contributions and investment income cover current pension payments many times over
 - can invest in a wider pool of investments than a closed scheme, or
 - can achieve a higher level of return with the same level of risk as a closed scheme.
- Of course, if the trustees could provide good evidence and demonstrate appropriate risk management, then the above explanations could be acceptable.

C. Inability to meet the Bespoke criteria

513. We expect in some circumstances that there will be genuine reasons why the trustees and employer cannot agree a funding arrangement that meets the Bespoke criteria (ie following the code principles and managing additional risk).
514. For example, ‘stressed schemes’, which are poorly funded and whose sponsor is too weak to adequately fund the scheme, often have very long RPs or take unsupported investment risk. To be clear, we would only regard a scheme as fitting into this ‘stressed’ category if it was not possible for it to access sufficient contingent support, for example security over an asset or a parent company guarantee. We expect trustees to exhaust all avenues of potential support before concluding that their scheme is ‘stressed’. The reality is that, other than the status quo, there are very few alternatives for these stressed schemes (including being able to afford entry into a Superfund). Generally, the options are as follows:
- Winding up the scheme (whether the decision is made by the trustees or us): This would trigger the s75 debt, which would probably make the employer insolvent and cause job losses, so this will not be an attractive solution in all but the rarest situations.
 - Regulated Apportionment Agreements (RAAs): These are only available in very specific circumstances and under tight controls.
515. Trustees of these stressed schemes may often wish to take more investment risk than we would expect for a CG4 employer and doing so will run the risk of investment losses which cannot be made good by increased employer contributions (ie the investment risk is unsupported). This would be inconsistent with the principle regarding unsupported risks. However, it is not clear what alternative should be adopted, as

if employer affordability is genuinely constrained, then we would not be able to use our powers, for instance to increase contributions.

516. We set out below two broad approaches in respect of these stressed schemes that we might expect trustees to take and to explain to us under the Bespoke framework:

- Trustees take an acceptable level of investment risk but agree a very long RP.
- Trustees set a short RP but take higher levels of investment risk.

517. The pros and cons of each approach are set out in the table below:

Option	Pros	Cons
Trustees take an acceptable level of investment risk, but have to accept a longer RP (eg > CG4 thresholds as set out by TPR)	<ul style="list-style-type: none"> ✓ It could limit PPF’s potential losses if the investments fail to perform as expected. ✓ Approach would be compatible with our principles (trustees should not take unsupported risks; deficits should be recovered as soon as possible based on affordability). 	<ul style="list-style-type: none"> ✗ It could restrict the trustees’ ability to invest in a way that delivers members benefits in full. ✗ RPs could potentially be extremely long (eg +30 years) or some schemes may not be able to come up with a viable RP.
Trustees agree a shorter RP (eg compliant with our Fast Track guidelines for a CG4 scheme) but seek an increased investment risk	<ul style="list-style-type: none"> ✓ If the investment strategy delivers it could in theory remove any future PPF liability and allow trustees to deliver PPF+ or full benefits (but that very argument undermines the principles – see last point in the ‘Cons’ column). 	<ul style="list-style-type: none"> ✗ May not actually deliver the investment returns anticipated and the potential loss to the PPF would increase. ✗ The constraint on RP length could drive significantly higher investment risk. ✗ Undermines the principle that trustees should not take risk that is not supported.

518. Our view is that ‘stressed schemes’ should not run additional risk over and above the tolerated FTE level (with reference to, for example, scheme maturity) and, therefore, that these schemes’ trustees should not seek to increase investment risk just to be able to submit a FTE RP. This is because the employer is unlikely to be able to make good significant reductions in funding level due to investment losses or, by doing so, risks damaging the covenant. Therefore, we would expect trustees to meet the TPs and investment Fast Track guidelines for a CG4 employer and report a long RP under the Bespoke regime supported by evidence demonstrating how affordability has been assessed.

519. In addition to taking managed investment risk, we would expect trustees to take other steps to limit the risk of the scheme’s position deteriorating, such as ensuring a robust risk management framework is in place, considering whether future accrual should stop and whether it is appropriate to wind up the scheme. We would also expect trustees to maximise the support available to the scheme by taking steps to ensure that the employer:

- limits the flow of value away from the employer (for example, through dividend restrictions)
- prevents detriment to the scheme’s claim on the covenant, for example as a result of the employer’s debt financing, and
- improves the scheme’s security through a contingent asset from the employer or formal group support if available (even if this security does not fully mitigate the excess risk being run).

520. The example below illustrates the proposed approach:

Example 14: Stressed scheme with a long RP

- The trustees of a closed scheme determine the scheme's LTO and define a de-risking journey plan to reach this target by the time it reaches significant maturity in 20 years. The trustees, on advice, conclude that the covenant is weak (CG4). They therefore set TPs based on the appropriate Fast Track basis. The scheme's investment strategy passes the Fast Track investment stress test. The trustees have a robust risk management plan in place.
- The trustees and the employer acknowledge the employer's limited ability to fund the resulting TPs deficit and agree that a 15-year RP is the shortest affordable plan.
- This lack of affordability, coupled with the employer having no unencumbered assets that could be secured in the scheme's favour, and there being no associated company that could provide support, leads the trustees to conclude that their scheme is 'stressed'.
- Employer management provides binding commitments that no dividends will be paid without trustee approval and that the scheme will receive a committed share of profitability above current forecast levels, eg a negative pledge and a contingent payment mechanism, respectively.

TPR assessment: Compliant – additional risk is managed (mitigated)

- There is additional risk as the RP is longer than the FTE. However, it complies with the principle of affordability as the trustees have agreed as short an RP as is affordable and have provided evidence on the employer's limited affordability. They have also evidenced that there are no potential areas of additional support.
- They have also mitigated the risk of value leakage from the employer with the legally binding protections regarding the scheme's treatment and the contingent payment mechanism provides a potential upside for the scheme (albeit the current likelihood of extra payments is low).

521. We would consider these schemes compliant with Part 3 of the Act (through the Bespoke route), even though the RP may be significantly long.

Non-viable funding arrangements

522. In some situations, a scheme may be so 'stressed' that the actuary is unable to certify the schedule of contributions as they must confirm that, in their opinion, the SFO will be met by the end of the RP period.

523. Our view is that schemes with non-viable RPs would not be compliant with the code and with Part 3 legislation, but we acknowledge that if there are no additional funds available, then the use of s231 powers would not be appropriate. There are currently few other regulatory tools we could use to improve the outcome for those schemes. It may be appropriate in certain circumstances to wind the scheme up, but although this would protect the PPF from further exposure, by crystallising the s75 debt, it will almost certainly result in the employer's insolvency and possible job losses.

524. The DB green paper considered some options to help address schemes with significant affordability constraints such as benefit reductions, but these measures were not taken forward in the DB white paper. However, the greater clarity around funding standards in the new code should help provide a better picture of the extent of these issues. We hope that the transparency of the new regime will shine a spotlight on these situations and we can start to gather data in order to assess the extent of the problem in the future and work with DWP and stakeholders to develop possible solutions

► Questions

Q50 Bespoke examples

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

Q51 Stressed schemes

- a. Assuming that affordability is genuinely constrained, are very long RPs 'appropriate' and therefore compliant with the Act?
- 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)?
- c. For schemes with unviable RPs, should an exception be made for them in terms of the level of acceptable investment risk?
- d. Are you aware of situations other than stressed schemes where the trustees and employer would have difficulties meeting the Bespoke compliance principles?

14. Additional support

PRINCIPLE

★ Schemes can account for additional support when carrying out their valuations provided that it (i) provides sufficient support for the risk(s) being run, (ii) is appropriately valued, and (iii) is legally enforceable and realisable at its necessary value when required.

Introduction

525. Additional support may represent a source of real value to schemes as it can provide support that is not otherwise available from their statutory employer or can enhance a scheme's existing claim. Furthermore, the existence of such support can give trustees a stronger negotiating position in future discussions with their employer/group.
526. We envisage that the assets of the sponsoring employer and the assets or support of its wider group will play a leading role in Bespoke funding solutions, as illustrated in the examples in the preceding chapter - particularly to support and underwrite additional risks being taken.
527. To be clear, formal and legally binding reliance on additional support differs from reliance on 'indirect employer covenant' (as discussed earlier in Chapter 4) which is non-legally binding, and should ideally not be relied upon beyond the short term.
528. In this chapter, we discuss the types of additional support available to schemes and our expectations around how they should be assessed and accounted for. We envisage providing some guidance on this in the DB funding code to help trustees and employers. Broadly speaking, there are two main types of additional support provided to schemes and throughout this section we refer to them as follows:
- Contingent asset support – Where a scheme can place increased reliance on an asset owned by its employer, its wider group or another entity (such as cash, property, business assets, intellectual property or securities).
 - Guarantee support – Where a scheme is provided with legal recourse to a party other than its employer in pre-defined situations or is given improved recourse to its employers (for example: in a multi-employer scheme, the ability to claim up to the entire s75 deficit on all employers).

Trustee's risk assessment

529. In line with the principle we set out in Chapter 5, we would expect trustees who are considering using additional support to address the following:
- Assess:** identify the additional risks arising from the Bespoke arrangements.
 - Access:** when or in what circumstances will those risks crystallise and therefore when the additional support will be needed.
 - Quantum:** assess how much support will be needed in those circumstances.
 - Quality:** assess whether the additional support (asset or guarantee) will have the necessary value at that time and that it will be legally accessible/enforceable.
530. The types of risks that the trustees may need to assess could include, relative to the tolerated level of risk in Fast Track:
- an LTO that targets a lower funding basis than low dependency
 - an LTO that targets a timeframe longer than significant maturity
 - weaker TPs
 - longer RP

- RP with significant back-end loading
- RP with significant investment outperformance
- significant RP re-spreading
- a high level of investment risk, and
- increased exposure to employer insolvency (for example, by placing reliance on the employer covenant beyond a period of reasonable visibility).

When will the support be needed?

531. It is important that the trustees can access the additional support when the scheme needs it, so they need to think carefully about the situations where they might call it.
532. Every scheme and employer's circumstances are different, and the Bespoke arrangements will also be unique as they will be tailored to fit those conditions. We cannot therefore define exactly the situations where a particular risk will be crystallised and the support should be accessible. However, we expect trustees to approach this in a logical and consistent manner and be able to clearly explain why they are satisfied that the support provided is acceptable.
533. We would expect a scheme not to release its claim over the support while the additional risk still exists. However, we recognise it may be appropriate for the size of the scheme's claim to reduce as the level of incremental risk reduces.
534. In many situations, we expect the additional support to be available on the employer's insolvency in addition to on the crystallisation of other risks.
535. Example – Part 1:

A scheme's FTE RP length would be nine years; however, the trustees agree to a 15-year RP, subject to contingent asset support from the employer.

STEP A: Assess the risk

The trustees determine that the scheme will be underfunded for a longer period with reliance on the employer covenant far beyond the period it can reasonably be forecast. Therefore, there is a risk that the scheme could be exposed to a weakening employer, with the potential for DRCs to be delayed/missed or even an employer insolvency, as well as the risk of investment underperformance.

STEP B: Access to support

We would expect, at the very least, the security to be accessible in the event of the employer's insolvency before the end of the RP and at the end of the RP period if the scheme's funding has failed to reach the SFO.

How much support is needed?

536. As a minimum, we would expect trustees to determine whether the additional support is of sufficient value to underpin the additional risk by reference to the difference between FTE and Bespoke. This is consistent with the sections in Chapter 3 and 13 **where we talk about the FTE and measuring against Fast Track**. However, the support that is appropriate for their scheme may be more than the minimum required when benchmarked against Fast Track and the trustees should be mindful that Fast Track is a regulatory tool, it carries its own risks and is not the 'perfect' funding solution.
537. Trustees should ask themselves whether the support would be able to put the scheme's funding back in the position it would have been in had Fast Track been followed. For instance, in the case of additional support for an RP longer than that recommended in Fast Track, we would expect its recoverable value to be all times at least equivalent to the level of 'delayed DRCs' (ie the difference in a Fast Track compliant RP and the proposed 'alternative' RP).

538. Example (Part 2)

A scheme's FTE RP length would be nine years; however, the trustees agree to a 15-year RP, subject to contingent asset support from the employer.

STEP C: Quantum – how much?

The trustees instruct their advisers to ensure that the recoverable value at least equals (i) any deficit that may exist at the end of the RP, and ideally, (ii) on insolvency the difference between the amount received and the amount that would have been received had the trustees followed Fast Track.

Quality of the support

539. Trustees need to be confident not just of the value of the support when they enter into the arrangement but that it will be of sufficient value to support the downside events at the time they will need to access the support.
540. In relation to additional support for a scheme's ongoing risks, such as investment underperformance, we expect trustees to be able to demonstrate and evidence how the scheme would be able to access the additional support in a way that would not cause damage to the employer covenant or the sustainable growth of the employer. This would include, for instance, considering whether an asset could readily be converted to cash without impeding employer trading, or if a guarantee could be called upon without adversely affecting company reserves.
541. The legal structure of the additional support is as important as the underlying quality of the asset or strength of guarantor. If the support cannot be accessed by the trustees easily and when it is required, then we would not consider that it appropriately mitigates the risks.
542. Given the very scheme-specific nature of the risks that will be supported, we don't think that creating new TPR standard documentation is appropriate, but we would expect trustees to obtain their own legal advice on when and how the support can be accessed. However, we would welcome suggestions for how we could implement a more standardised framework.
543. Example (Part 3)

A scheme's FTE RP length would be nine years. However, the trustees agree to a 15-year RP, subject to contingent asset support from the employer.

STEP D: Quality of the support?

The trustees have determined that the scheme needs a contingent asset worth at least £x to support the risks during the 15-year RP. The employer suggests security over a tangible asset (property).

The asset can be used to generate cash at the end of the RP or on the employer's insolvency (if it occurs sooner), eg by selling the property or borrowing against it. The trustees obtain an independent valuation confirming the property's current value comfortably exceeds the level of cover they require. The trustees decide there is no reason for the asset's value to fall, but that they will keep it under frequent review (with an independent valuation at least every three years and with more frequent reviews for market indicators that the asset could have declined in value).

The trustees' lawyers confirm that the release criteria are acceptable.

Contingent assets

544. Our view is that longer-term risks being run by schemes are typically better underpinned by contingent asset support (particularly where of sufficient quality and value) than guarantee support which could have reducing value beyond the guarantor's 'covenant visibility'.

- 545.** We recognise that there are various types of assets, both tangible and intangible, over which schemes could be provided legal security. Some assets have clear, demonstrable and readily recoverable market value – such as cash, gilts, and properties that are not occupied by the scheme’s employer or its wider group.
- 546.** Other contingent assets have a commercial value that may be closely linked to the ongoing strength of the employer, such as properties that are in use by the employer, trade debtors, stock, and brands or other intellectual property that may have less value to other parties. Their value to a scheme may be more complex to assess given this could significantly decline at the same time as the employer covenant deteriorates, which is the time when the contingent asset may be needed by a scheme. These types of contingent asset may still be acceptable for Bespoke purposes but would be less clear-cut and therefore require further evidence from trustees and potentially greater scrutiny by us.
- 547.** Regardless of the type of asset, trustees should be focussing on the recoverable value of the contingent asset when it will be needed. Because this could include a scenario where the employer is insolvent, we would always expect trustees to assess the ‘stressed value’ of any contingent assets.
- 548.** While we do not want to dissuade trustees and employers from taking advantage of contingent asset support, there may be situations where trustees should consider procuring expert valuation advice. Although the value provided by contingent assets shouldn’t be outweighed by the cost of valuing, implementing and monitoring them, a contingent asset may represent such a material proportion of future scheme support that valuation advice becomes imperative.
- 549.** Regardless of the materiality of a contingent asset to a scheme, we do not consider it appropriate for trustees to ascribe a higher value to a contingent asset than the value listed in the employer’s audited accounts unless they obtain an independent valuation.
- 550.** We will set out some broad guidance on valuing contingent assets in the new code but welcome views on the issues discussed and the extent to which we should set out some detailed requirements or whether such details should be left entirely to trustee discretion.

Guarantees

- 551.** If another entity is prepared to stand in the place of the statutory employer and to underpin a scheme’s liabilities, then that can be a very valuable form of additional support and can represent an enhancement to a scheme’s employer covenant.
- 552.** However, as noted above, we would be concerned if a guarantee is being used as justification for a longer RP given there will typically be reduced visibility about a guarantor’s financial strength in the longer term (much as there would be for the employer).
- 553.** Instead, we consider guarantee support is more appropriate as an underpin for higher investment risk in the shorter term, provided the (smaller) TP deficit is funded in an appropriate short timeframe (see example 8 in the preceding chapter).
- 554.** Guarantees can vary in value - from providing schemes with a fixed (and potentially small) level of support, up to unlimited support covering all scenarios (including s75 debt cover on wind up). The greater the value of the guarantee, the more likely it is that the Bespoke arrangement will be assessed as compliant (subject to it coming from a sufficiently robust counterparty).
- 555.** In particular, we consider that the employer covenant can be said to have been fully provided by the guarantor (for the purposes of assessing the funding arrangements) if the guarantee provided the following:
- Guarantees at least the scheme’s entire low dependency funding deficit at the time required. For example, the guarantee is for a floating amount at least equal to the full low dependency deficit at any point in time, as opposed to being capped at the low dependency deficit at the point where the guarantee is provided.

- Guarantees the payment of all the DRCs.
- Is not time limited.
- Funds any deficit in an appropriate period – that is, the resultant TP's deficit from any assumed improvement to the covenant should be funded within the period that is commensurate with our Fast Track guidelines for RPs. For instance, if the covenant improves to a 'CG2' level because of the guarantee support provided, the resulting deficit should be funded within no more than, illustratively, six years.

556. We recognise that full guarantees (in the terms set out above) may not be available to some schemes, and we do not wish to dissuade trustees from agreeing lower levels of guarantee support.

557. For example, a guarantee that provides for only the TP deficit or a capped amount may still have real value to a scheme but should not be seen as providing full covenant replacement. In this case, trustees may wish to consider the 'blended' support that such a 'partial guarantee' could provide.

► Questions

Q52 Trustees' assessment of additional support in Bespoke arrangements – Do you have any views on the framework we have set out for trustees to assess the appropriateness of additional support in Bespoke arrangements? If you disagree, what do you suggest?

Q53 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?

Q54 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?

Q55 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?

Q56 Guarantees

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

Alignment with PPF regime

558. We recognise that there may be crossover between the documentation and support used for PPF-levy reduction purposes, and those used for scheme funding purposes. The PPF standard documentation is normally calculated with reference to the PPF's exposure (typically lower than the deficit on a TP or LTO basis) and we expect that contingent security arrangements supporting scheme funding are likely to cover a greater financial level and potentially a broader range of circumstances. The differences in the level of cover and the release terms of PPF levy support means the standard legal documentation used by the PPF may not be adequate for scheme funding arrangements under Bespoke.

559. Trustees should not automatically assume that a PPF-compliant asset would be appropriate for funding purposes and it may be necessary for trustees to take additional advice on this. This does not mean that a PPF levy compliant contingent support arrangement should not be given any credit, but trustees should consider the support arrangement in the context of the framework outlined above and be prepared to explain any reliance on the arrangement as part of their statement of strategy.

Other possible mitigations

560. In this chapter, we have so far focused entirely on contingent asset and guarantee support. We recognise there are other types of arrangements that help trustees minimise risk, including the following:

- **Negative pledges** – Trustees might take some limited comfort that negative pledges protect the employer covenant, for example those which prevent the leakage of value from the employer covenant (such as via dividends) or which prohibit security being granted over employer assets in favour of other creditors.
- **Contingent contributions (scheme funding-linked)** – Some schemes have contingent contribution mechanisms: whereby additional payments are made by the employer in the event of the scheme's funding deficit being greater than expected (or sitting outside of an acceptable range). We recognise that these may be of value to the scheme, provided trustees are comfortable that necessary payments can be afforded by the employer.
- **Contingent contributions (employer performance-linked)** – We recognise that performance-linked contributions (for example 'profit sharing' mechanisms) can be of significant value to schemes and we encourage trustees to seek such arrangements. This is particularly relevant where RPs are long (as incremental future payments can reduce the duration of contributions) and can provide valuable upside for a scheme if set at appropriate levels. They can also be an effective way of ensuring that schemes are treated equitably as compared with payments made to other creditors (including, but not limited to, shareholder dividends). However, we note that these do not provide downside support for a scheme (in the way that other mechanisms discussed in this section do), and we would expect trustees to place limited comfort on such arrangements in agreeing funding levels and RPs.
- **Blended support** – Contingent support arrangements that have characteristics of guarantees and security over assets. For example, a scheme may have first ranking security over an intercompany balance. Such an arrangement may be valuable to a scheme, but we would expect trustees to consider the value of the underlying asset and explain the reliance placed on this in their statement of strategy.

561. To the extent that trustees place reliance on these types of arrangements, we would expect this to be explained to us under the Bespoke framework.

► Question

Q57 Other mitigations – Can you think of any other types or arrangements which can help trustees mitigate risks?

Reporting additional support to TPR

562. We propose that trustees should be required to confirm the following in the statement of strategy:

- their assessment of the additional risks presented by their Bespoke arrangement
- what additional support they have relied upon
- the scenarios in which the support can be called upon
- why they consider it supports additional risk
- that they received legal advice on the enforceability of the arrangement and that the support can be accessed when needed
- where contingent asset support is relied upon
- the value placed on any contingent assets and their stressed value (eg the anticipated value after an event has occurred in which the trustee is able to enforce its security up to and including a hypothetical employer insolvency)
- whether they received an independent valuation of the asset or if not, why not

- where guarantee support is relied upon
 - who the guarantee is provided by, and what amount (in £ terms or relative to scheme metrics) is guaranteed
 - the trustees' view on the impact of the guarantee on the employer covenant, and how this strength has been reflected in the agreed RP
 - any steps taken by the trustees to ensure that the value of any contingent support is being protected

563. Trustees would also be expected to be able to provide evidence that supports their valuation and the explanations made in their statement if requested to do so but we don't anticipate that this supporting evidence should be submitted unless requested.

▶ **Question**

Q58 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?

Part 5: Supporting materials

15. Worked examples

564. The purpose of this chapter is to provide two worked examples (one for a closed scheme and one for an open scheme) to illustrate how a valuation under Fast Track might work and help respondents understand the proposals set out in Part 3 (Fast Track approach).

Illustrative Fast Track requirements

565. Many aspects of the Fast Track funding requirements are yet to be determined and are subject to this consultation and further analytical work. When developing these worked examples, we have assumed the following purely illustrative Fast Track guidelines:

566. **LTO** definitions:

- Low dependency funding calculated using a discount rate of 0.5% pa in excess of gilt yields appropriate to the duration of the scheme.
- Price inflation assumption used is defined by us. All other actuarial assumptions are determined by agreement between trustees and employer and are required to be overall no weaker than best estimate.
- Low dependency funding must be reached when the scheme reaches a duration of 14 years.
- An investment strategy which results in a stress test of less than 5%.

567. **TPs** must be greater than or equal to an amount calculated as follows:

- Calculate the value of past service liabilities using low dependency assumptions.
- Calculate the duration of these liabilities using low dependency assumptions.
- Multiply the value of past service liabilities using low dependency assumptions by the ratio set out in Guidelines Table A below. This ratio is set by us from time to time and varies by scheme duration and covenant grading.

568. **RP**:

- Maximum length of RP is set by us from time to time and varies by covenant grading. See Guidelines Table B below.
- No back-end loading or deficit re-spreading is permitted and assumptions used to calculate DRCs must be the same as used to calculate TPs. In particular, investment returns over the RP must be equal to the TPs discount rate.

569. **Investment strategy**:

- A stress test is carried out, which includes a maximum permissible stress. See Guidelines Table C below.
- The maximum permissible stress is set by us from time to time and varies by duration and covenant grading.
- The stress test involves a fall in growth assets, combined with a fall in interest rates and a slight fall in inflation. It is the same as the PPF levy stress test. Full details of the stress are shown on the PPF website (https://www.ppf.co.uk/sites/default/files/file-2018-10/1819_investment_risk_appendix_0.pdf).
- Stresses for different asset classes are as follows:
 - Global equities: 16%
 - UK equities: 19%
 - Property: 5%
 - Long corporates: +5%

- Long gilts: +15%, and
- Long inflation-linked gilts: +18%.

570. Future service costs: All assumptions used to calculate future service cost must be the same as those used to calculate TPs, except that the longer duration of future service liabilities can be reflected in the discount rate used to calculate future service costs.

Guidelines Table A: Fast Track minimum TPs ratio by covenant and maturity⁴⁴

Duration (years)	CG1	CG2	CG3	CG4
14 or less	100%	100%	100%	100%
...				
19 - 20		92%		
...				
21 - 22		89%		
22 - 23		86%		
...				
Over 28		74%		

Guidelines Table B: Fast Track maximum RP lengths

	CG1	CG2	CG3	CG4
RP (years)		6 years		

Guidelines Table C: Fast Track maximum investment stress (measured as deterioration in the ratio of assets to liabilities on low dependency basis)

Duration (years)	CG1	CG2	CG3	CG4
14 or less	5%	5%	5%	5%
...				
19 - 20		10%		

⁴⁴ The data in Guidelines Tables A-C has been deliberately edited to highlight only the relevant information for the following examples.

...				
21 - 22		12%		
22 - 23		13%		
...				
Over 28				

Example 1: Closed scheme

571. Table 34 below summarises the key facts relating to this scheme.

Facts: Scheme assets = £550m. Covenant grade rating = CG2. Scheme duration = 21.3 years.		
Fast Track feature	Details	Pass/ Fail
LTO	Set using Fast Track assumptions. Low dependency liabilities = £670m.	✓
TPs	TPs agreed by trustees and employer = £600M. Greater than the Fast Track minimum (=£670m x 89% = £596m).	✓
RP	Deficit = £50m. RP is equal to maximum Fast Track RP length of six years with DRCs of £9m pa.	✓
Investment stress	Investment stress is 9.5%. This is less than the maximum Fast Track stress of 12%.	✓
Overall	Complies with Fast Track.	✓

Detail

572. The trustees and employer agree they wish to follow the Fast Track approach. They adopt the Fast Track LTO (as defined above). Therefore, the scheme has a low dependency funding basis calculated using a discount rate of 0.5% pa in excess of gilt yields appropriate to the duration of the scheme. The price inflation assumption is set by us and the other low dependency basis assumptions are set by the trustees so that, overall, they are no weaker than best estimate. So, the scheme passes the LTO assessment under Fast track. ✓
573. The scheme actuary calculates that the scheme's liabilities measured on these assumptions are £670m. This is a measure of the scheme's long-term target. The scheme's TPs will approach this figure as the scheme matures and moves closer to significant maturity.
574. The trustees decide, having taken independent covenant advice, that the employer covenant has a covenant grade of CG2 (Tending to strong) and that they don't have longer than typical visibility about how the employer covenant will develop in future, ie they only have good visibility over around three to five years.
575. The scheme actuary calculates that the scheme has a duration of 21.3 years, using the low dependency assumptions. The ratio used to calculate minimum TPs is 89%, taken from the entry in Guidelines Table A

for covenant rating CG2 and duration of between 21 and 22 years. Therefore, in order to meet Fast Track requirements, the scheme needs to have TPs equal to or greater than £670m x 89% = £596m.

576. The trustees and employer agree the TPs assumptions and the scheme actuary calculates the value of the TPs as shown in Table 35 below:

Valuation balance sheet	£m
Value of assets	550
TPs	600
Surplus/ (deficit)	(50)

577. The scheme's TPs (£600m) are greater than the Fast Track minimum TPs (£596m). So, the scheme passes the TPs guidelines under Fast Track.
578. The scheme has a deficit of £50m.
579. The Fast track RP has a maximum of six years, taken from the entry in Guidelines Table B for covenant grade rating CG2. The trustees and employer agree a six-year RP with annual contributions of £9m. Assumptions used to calculate the DRCs are the same as those used to calculate the scheme's TPs. So, the scheme passes the RP assessment under Fast Track.
580. The scheme actuary certifies the schedule of contributions based on the above TPs, deficit and RP.
581. The trustees carry out the Fast Track investment stress test, as set out below. The scheme is invested in the following way:
- Global equities 25%
 - UK equities 5%
 - Property 10%
 - Long gilts 30%
 - Long inflation-linked gilts 30%
582. As shown in Table 36 below, the stress test is applied to both the assets (in the proportions stated above) and also to the liabilities (measured on the low dependency assumptions described above).

	Before stress	After stress
Global equities (25%)	137.5	115.5
UK equities (5%)	27.5	22.3
Property (10%)	55	52.3
Long gilts (30%)	165	189.8
Long inflation-linked gilts (30%)	165	194.7
Total assets	550	574.5
Liabilities on low dependency basis	670	763
Assets to liabilities (low dependency)	-120	-188.5

583. The assets to liabilities (low dependency basis) deficit has deteriorated by £68.5m. This change, expressed as proportion of the liabilities on low dependency basis is 10.2%⁴⁵, which is less than the maximum of 12% as set out in Guidelines Table C, so this passes the investment stress test under Fast Track. ✓
584. The trustees submit the valuation to us. In their statement of strategy, the trustees declare that the valuation complies with Fast Track and provide relevant evidence.
585. We review the trustees' submission and confirm that no further action is necessary. ✓

Example 2: Open scheme

586. Table 37 below summarises the key facts relating to this scheme.

Facts: Scheme assets = £220m. Covenant grade rating = CG2. Past service duration = 22.6 years. Future service duration = 28 years.		
Fast Track feature	Details	Pass/ Fail
LTO	Set using Fast Track assumptions. Low dependency liabilities = £300m. Future service rate on LTO assumptions = 40% of pay.	✓
TPs	TPs agreed by trustees and employer = £260m. Greater than the Fast Track minimum (=£300m x 86% = £258m)	✓
RP	Deficit = £40m. RP is equal to maximum Fast Track RP length of six years with DRCs of £7m pa.	✓
Future service	Future service rate = 30% of pay. Greater than the Fast Track minimum (=40% x 74% = 29.6% of pay)	✓
Investment stress	Investment stress is 10.4%. This is less than the maximum Fast Track stress of 13%.	✓
Overall	Complies with Fast Track.	✓

Detail

587. As in the first example, the trustees adopt the Fast Track LTO. The scheme actuary calculates that the scheme's liabilities measured on the low dependency assumptions are £300m. The scheme actuary calculates a future service cost of 40% of pay using the low dependency assumptions.
588. The scheme actuary calculates that the scheme has a duration of 22.6 years in respect of accrued benefits, using low dependency basis assumptions. The ratio to use to calculate the minimum TPs is 86% appropriate to the scheme's duration, taken from the entry in Guidelines Table A for covenant grade CG2 and duration of between 22 and 23 years. In order to meet Fast Track requirements, the scheme needs to have TPs equal to or greater than £300m x 86% = £258m.
589. The ratio to use to calculate the minimum future service contribution rate is 74% appropriate to the scheme's duration, taken from the entry in Guidelines Table A for covenant grade CG2 and duration of 28

⁴⁵ = 68.5 / 670.

years and above. In order to meet Fast Track requirements, the scheme needs to have a future service contribution rate of equal to or greater than $40\% \times 74\% = 29.6\%$ of pay.

590. The trustees and employer agree the scheme's TPs assumptions and the scheme actuary calculates the value of the TPs as shown in Table 38 follows:

Valuation balance sheet	£m
Value of assets	220
TPs	260
Surplus/ (deficit)	(40)

591. The scheme's TPs (£260m) are greater than the Fast Track minimum TPs (£258m). So, the scheme passes the TPs assessment under Fast Track. ✓
592. The scheme has a deficit of £40m.
593. The scheme actuary calculates a future service cost of 30% of pay. This is greater than the Fast Track minimum (29.6%). So, the scheme passes the future service assessment under Fast Track. ✓
594. As in example 1, the trustees and employer agree a six-year RP. Annual contributions of £7m are agreed. The scheme passes the RP assessment under Fast Track. ✓
595. The investment stress test is also passed. The scheme is invested as follows:
- Global equities 25%
 - UK equities 10%
 - Property 5%
 - Long gilts 25%
 - Long inflation-linked gilts 35%
596. As shown in Table 39 below, the stress test is applied to both the assets (in the proportions stated above) and also to the liabilities (measured on the assumptions in low dependency).

	Before stress	After stress
Global equities (25%)	55	46.2
UK equities (10%)	22	17.8
Property (5%)	11	10.5
Long gilts (25%)	55	63.3
Long inflation-linked gilts (35%)	77	90.9
Total assets	220	228.6
Liabilities on low dependency basis	300	344.2
Assets to liabilities	-80	-115.6

- 597. The assets to liabilities (low dependency basis deficit) has deteriorated by £35.6m. This change, expressed as proportion of the liabilities (low dependency) is 11.9%⁴⁶. This is less than the maximum of 13% as set out in Guidelines Table C so this passes the investment test under Fast Track. ✓
- 598. The trustees submit the valuation to us. In their statement of strategy, the trustees declare that the valuation complies with Fast Track and provide relevant evidence.
- 599. We review the trustees' submission and confirm no further action is necessary. ✓

⁴⁶ $35.6/300 = 12\%$.

16. Evidence and analysis

- 600.** The main purpose of this chapter is to provide some additional background information to put into context the proposals we are consulting on. This chapter also sets out the following:
- Describes certain features of the DB landscape, observable from our data and research⁴⁷ as well as from our casework and publications of external commentators. These have informed the design of the proposed funding framework.
 - Explains why we consider scheme maturity to be an important influence on funding decisions over the future, at least for closed schemes, and why it should be a key aspect of the new framework.
 - Summarises the results of research commissioned from GAD on how we might set the more detailed parameters to define low dependency for Fast Track.
 - Reviews evidence from external commentators on the extent to which pension schemes already incorporate, as a matter of good practice, long-term objectives and associated journey plans to deliver them.
 - Emphasises that fair treatment for the pension scheme remains a key issue for us, and re-iterates, using previously published evidence, that while most schemes remain affordable for their employers, there is a mixed picture for some.
 - Sets out our views on the challenges faced by some small schemes.

The current DB landscape

- 601.** The Purple Book 2019⁴⁸ dataset showed that there were 5,422 private sector DB pension schemes in the UK, with combined assets of just over £1.6 trillion and covering 10.1 million members as at March 2019. 42% of members were already drawing their pensions.
- 602.** Deeper analysis (see below) shows that the underlying DB landscape is wide and diverse. One of our challenges has therefore been to design the new funding framework in a way that is applicable across this diverse range of schemes.

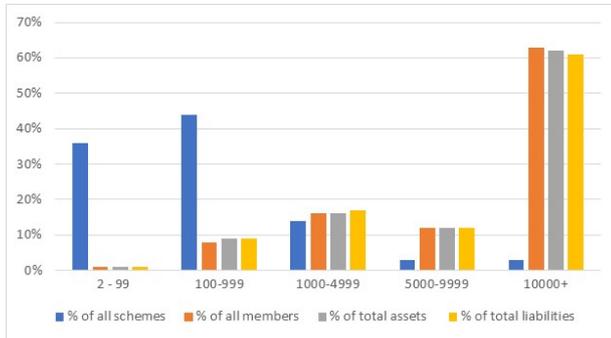
⁴⁷ Various charts in this chapter are based on our own analysis. The underlying data for assets and liabilities is sourced from information supplied by each scheme in its latest Scheme Return, rolled forward to a common date for all schemes (31 March 2019 unless otherwise stated) using methods, assumptions and limitations explained in <https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-analysis-tranche-fourteen-review-2019.ashx>.

⁴⁸ <https://www.ppf.co.uk/purple-book>

DB schemes are highly skewed by size

603. 75% of members belong to 354 of the largest schemes (7% of all schemes), each with more than 5,000 members. Between them, they cover 75% of the total assets and liabilities. A little under 2,000 schemes (36% of all schemes by number) have fewer than 100 members each. Together they account for just 1% or less of total scheme memberships, assets or liabilities.

Figure 10: Distributions by scheme size



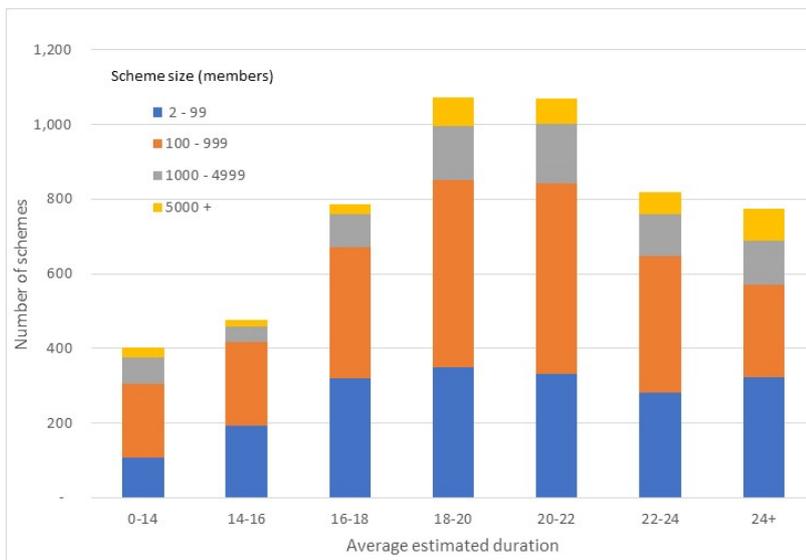
Source: Purple Book 2019

The DB landscape is largely comprised of members who are not accruing new benefits

- 604.** The Purple Book also reports that 89% of DB pension schemes are now closed to new members. Among these, half are still providing new accruals, but only to a closed and declining group of existing employees, while the other half are closed to new accruals altogether. Consequently, both groups are maturing, the former less rapidly than the latter.
- 605.** Overall, the trend showing the decline in provision of new DB accruals has continued, with the number of private sector employees still accruing new DB benefits having reduced from 3.5 million in 2006 to 1.1 million in 2019.
- 606.** Although 70% of members are currently in schemes that are open to new benefit accrual, only 11% of members are actually accruing new benefits.

About 15% of DB schemes are already quite mature

Figure 11: DB landscape by number of schemes, size and maturity



Source: TPR calculations at March 2019 based on scheme return data

Table 39: Estimated benefit outgo (as % of Broadly Hedged liabilities) by duration

Average estimated duration ⁴⁹	0-14	14-16	16-18	18-20	20-22	22-24	24+
% of schemes	7%	9%	15%	20%	20%	15%	14%
Approximate benefit outgo (% of liability) ⁵⁰	5% or more	4%-5%	3%-4%	2.5%-3%	2%-2.5%	1.5%-2%	1.5% or less

Source: TPR calculations at March 2019 based on model generated benefit outflows using scheme return data

- 607.** Fewer than 10% of schemes have reached a high level of maturity whereby the amount of benefits being paid out each year may be 5% or more of liabilities.
- 608.** A significant proportion of schemes (over 40%) are currently paying out benefits each year in the region of 2.5%-5% of liabilities. Most of these schemes are expected to reach a high level of maturity in the next decade.
- 609.** The remaining schemes (about 50%) are at a more modest level of maturity where the benefits being paid out each year may be less than 2.5% of liabilities. The majority of these are expected to reach a high level of maturity in the following decade, and those who continue to grant future accruals or remain open to new members may mature at a slower rate or not at all.

The trend in risk reduction continues

Figure 12: Weighted asset allocation

Year	Equities	Bonds	Other
2007	60%	30%	10%
2010	42%	40%	18%
2013	35%	45%	20%
2016	30%	51%	19%
2019	24%	63%	13%

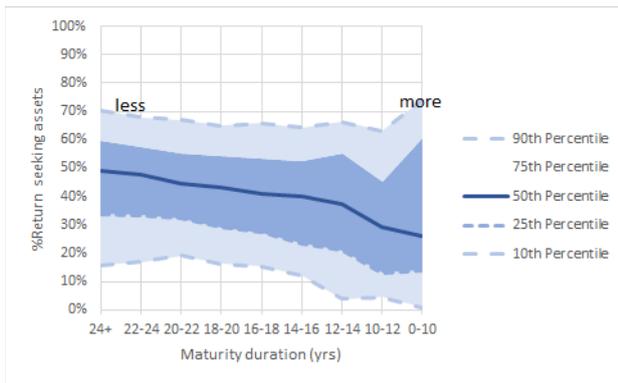
Source: Purple Book 2019

The average allocation to equities in investment strategies, currently at 24%, has reduced by more than half in the last decade. During the same period, the allocation to bonds has increased substantially to almost 63%. This excludes the impact of the use of leverage and/or derivatives to improve the matching characteristics of the bonds held.

⁴⁹ We are consulting on the appropriate measure of scheme maturity, but for the purpose of this analysis, and for consistency with the maturity-related modelling presented elsewhere in this chapter, we have defined scheme maturity as the mean term of accrued liabilities weighted by the value of future cashflows discounted at Gilts +0.5%.

⁵⁰ This is an approximate mapping, recognising that while there is a strong correlation between the maturity duration and the benefits paid (as a percentage of liability), there is no strict one-to-one relationship between them. Liabilities have been measured using a discount rate of Gilts +0.5%. Benefit cashflows have been estimated using limited data points from scheme return data which may not be as accurate and up-to-date as the information held by each scheme.

Figure 13: Return-seeking asset allocations by scheme maturity



Additionally, the allocation to annuities has increased from 2% in 2016 to 4% now. This may be due to increased risk transfer exercises known as buy-ins.

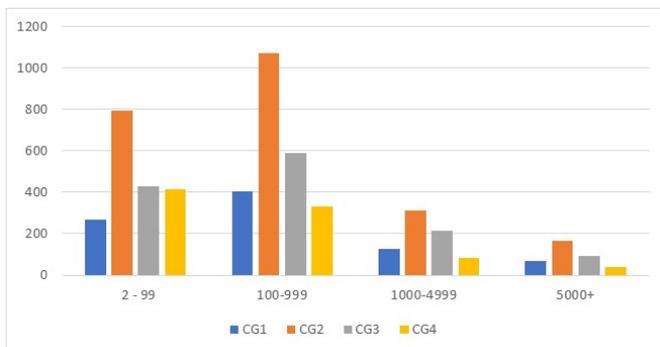
We believe this de-risking is a consequence of schemes becoming better funded and more mature. Indeed, our data also shows a tendency towards a reduction in return-seeking assets⁵¹ as schemes mature. This is consistent with de-risking plans we come across in practice.

We expect this trend to continue as a greater proportion of the landscape becomes more mature.

Source: TPR calculations at March 2019 based on TPR-assessed covenants

Most DB schemes are sponsored by stronger employers

Figure 14: Number of schemes by size and covenant



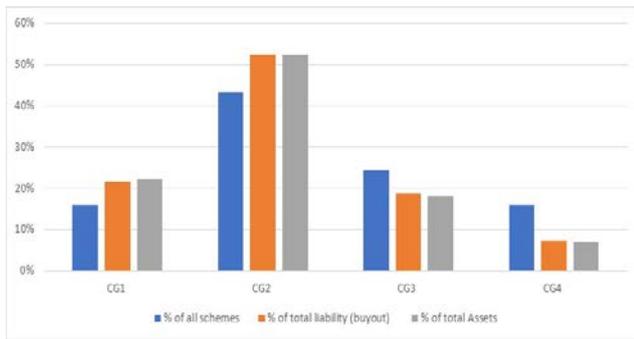
The majority of schemes are sponsored by Strong and Tending to strong (CG1 and CG2) employers across the size range.

Small schemes are not necessarily confined to the weaker employers (CG3 and CG4), nor are large schemes confined to the stronger employers.

Source: TPR calculations at March 2019 based on TPR-assessed covenants

⁵¹ For this purpose, return-seeking assets are defined to include the following weightings: 100% equities, 75% property, 100% commodities, 60% insurance policies, 80% hedge funds, 25% corporate bonds, 100% 'other'.

Figure 15: Percentage of schemes, assets and liabilities by covenant



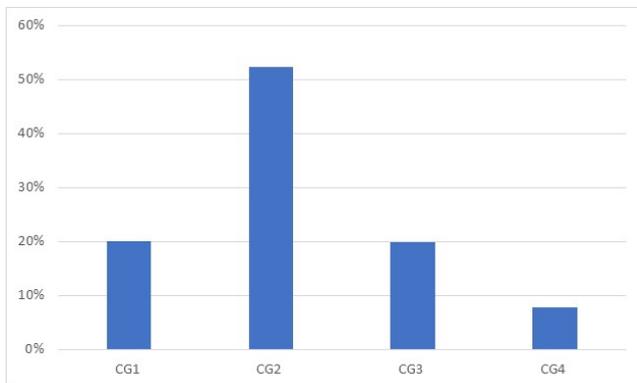
The stronger employers account for almost 60% of all schemes, and between them 70% to 75% of all assets and liabilities.

The weaker employers (also sponsor a significant proportion (about 40%) of all DB schemes. However, they account for a much smaller proportion of total liabilities (between 25% and 30%).

Source: TPR calculations at March 2019 based on TPR-assessed covenants

Most deficits are in schemes with the stronger employers

Figure 16: Percentage of total buy-out deficits by covenant



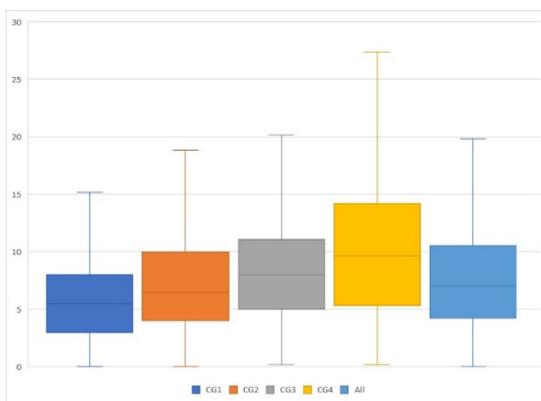
Schemes with stronger employers account for 70% of total deficits on the buy-out basis.

The weakest employers (CG4) account for less than 10% of total deficits.

Source: TPR calculations at March 2019 based on TPR-assessed covenants

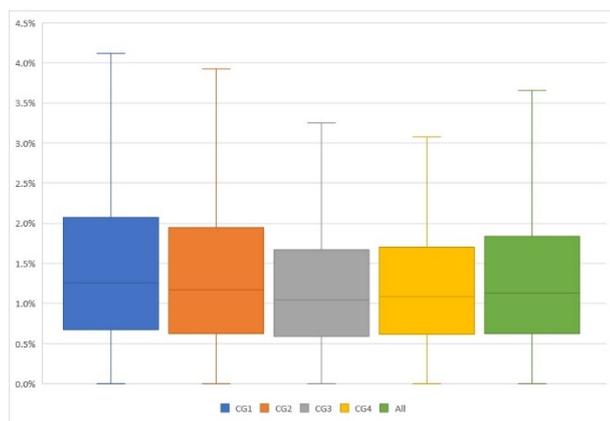
Deficits are being recovered on average over seven years by payment of DRCs at about 1.25% of buy-out liability

Figure 17: Recovery plan lengths (years)



Source: TPR calculations at March 2019 based on TPR-assessed covenants

Figure 18: DRCs as a percentage of buy-out liabilities



Source: TPR calculations at March 2019 based on TPR-assessed covenants

- 610.** The rate at which deficits are recovered should depend on a number of scheme-specific factors including the size of the TPs deficit, the strength of the employer, and the resources available to apply towards reducing deficits.
- 611.** Our data shows (see charts⁵² above) that deficits were typically being recovered on average over seven years. 50% of all schemes are recovering their deficits over periods between 4 and 11 years but there is a wider range for the others. The median RP periods for strong employers are nearer five years, while those for weak employers are nearer 10 years.
- 612.** 50% of all schemes in deficit are paying DRCs which are between 0.6% and 1.8% of the scheme's buy-out liability, with a much wider range for others. The median DRCs are nearer 1.25% of liability for the stronger employers and nearer 1% of liability for the weaker ones.

DB landscape will continue to mature over the next few years

- 613.** We expect the next two decades to mark a fundamentally different shift in the management of DB schemes. Our analysis (see chart below⁵³) suggests that benefit outflows from most DB pension schemes may be close to their peak already⁵⁴ and are expected to fall gradually over the following three decades as the impact of scheme maturity takes hold.
- 614.** Looking at this in another way, we estimate that almost one quarter of the accrued benefits of DB schemes will need to be settled by the end of the next decade due to the effect of ageing alone (that is as members reach pension age and draw their pensions). Similar proportions are expected to have been settled in each of the following two decades. The impact of future accruals will have the effect of delaying

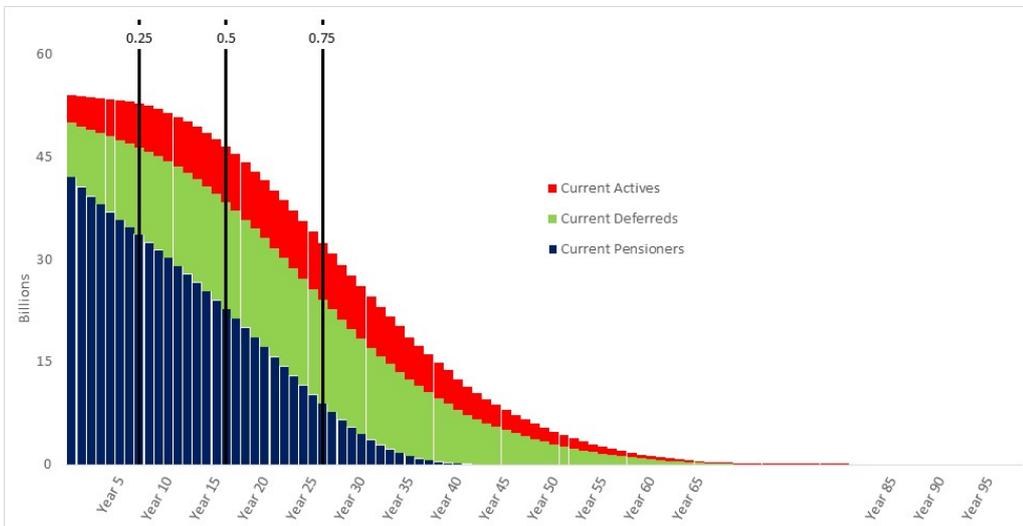
⁵² In both these charts, the coloured boxes show the range of data for 50% of the schemes in each covenant category. The horizontal line in each box shows the median position – half of the schemes are above this line and the other half below it.

⁵³ TPR estimates for illustration only, based on data reported by UK pension schemes, and a number of assumptions. Assumes all schemes closed to future accruals and all members commute 20% pension at retirement. No allowance for any large-scale transfers or for the effect of any risk transfer/buy-out activity.

⁵⁴ On a constant price basis.

this process somewhat, while that of transfers out of DB schemes, either individually or due to buy-out and risk transfer activity, will have the opposite effect.

Figure 19: Expected cash flow payments from DB schemes (constant money)



Source: TPR calculations at March 2019 based on scheme return data

- 615. During this period, we expect most schemes to become cash flow negative, meaning benefit outflows to pensioners will exceed the sum of investment income from the scheme’s assets and contributions from employers and members⁵⁵. In other words, schemes will have to start using their accumulated scheme assets more and more to meet their growing benefit outflows. Consequently, the overall DB landscape will begin to downsize (in terms of assets and liabilities, but not necessarily at the same rate unless schemes are fully funded).
- 616. Individual schemes will, however, be affected differently depending on how their maturity profiles develop over the future to interact with other scheme-specific features. Among closed schemes, the more mature ones will run-off more rapidly than the less mature ones. Schemes remaining open to accruals of new benefits for existing members will continue to grow in real terms for a few years until the existing members retire or leave, while those that remain open to new members may continue to grow for much longer.

Why scheme maturity matters to individual schemes

- 617. There are no commonly accepted definitions of scheme maturity, but for individual schemes, maturity may be characterised by the amount of benefits being paid out each year as a percentage of the scheme’s liability (preferably an objective measure of liability for comparability across schemes). Our research suggests that the range may be from 1% or less of liability on a low-risk measure (Gilts +0.5%) for very immature schemes, through to 7% or more for the very mature schemes. Around half of the DB schemes

⁵⁵ Some independent surveys show that many schemes are already cash-flow negative, although definitions may vary, and some of the more recent analysis may be unduly influenced by large scale transfers out which may not persist at the same level in future. See for example Mercer’s European Asset Allocation Survey 2019 (large schemes), Buck’s Mid-market Pensions Review 2019 (schemes with assets between £10m-£1bn), and LCP’s publication ‘Chart your own course - Navigating the pensions journey’, all of which show a significant proportion of schemes surveyed being already cash-flow negative (but on different definitions).

might currently be regarded as immature (maturity durations of 20 or more) and, for them, benefit outgo may currently be around 2% or less of liability, while for a minority of the more mature schemes (durations of less than 14) it may be nearer 5% or more. Cash flow negativity may typically set in anywhere in-between, depending on the level of contributions into the scheme. We are of the view that by the time benefit outflow reaches around 5% of liability, the risks due to scheme maturity are beginning to take hold and need to be managed carefully.

- 618.** The reason for this is that mature schemes have limited timeframes to recover from a sustained period of underperformance by the scheme's investments, or from investment shocks⁵⁶. These are risks we have been raising in recent Annual Funding Statements. The impact on funding and investment decisions can be two-fold. First, liquidity management and cash flow matching become far more important in order to avoid the risk of having to sell assets in depressed market conditions to meet the benefit outgoings. Additionally, where such schemes are still underfunded, trustees and employers need to be aware that the scheme's assets may be depleting rapidly and if they are still relying on asset outperformance to close the funding gap, then either additional strain will be placed on the investment strategy and/or more reliance placed on employer contributions, which could also become more volatile.
- 619.** A working party of the Institute and Faculty of Actuaries⁵⁷ described this effect on the scheme's funding as 'running faster to keep up'. This means that as an underfunded scheme gets more mature and its benefit outflow increases, the level of contributions required (as a percentage of the scheme's liabilities) to keep the funding level from falling also increases. Additionally, the amount by which the contributions increase is linked directly (among other things) to the level of benefit outflow. Some simple examples⁵⁸ below illustrate this:

Table 20: Contributions required to maintain funding level by funding level and maturity

		FUNDING LEVEL			
		70%	80%	90%	100%
Contribution required to maintain funding level (% of liability)	Immature	0.6%	0.4%	0.2%	0.0%
	Mature	1.5%	1.0%	0.5%	0.0%

Note: In these examples, the immature scheme is assumed to have an annual benefit outflow equal to 2% of liability, while that of the mature scheme is assumed to be 5%.

- 620.** Given that for most schemes, the pension deficit contributions are less than 2% of their liability, the above figures illustrate the additional strain on the scheme's funding due to its maturity if it remains underfunded by the time it has reached a high level of maturity.

⁵⁶ See, for example, the illustration in our 2016 Annual Funding Statement: <https://webarchive.nationalarchives.gov.uk/20160701134008/http://www.thepensionsregulator.gov.uk/docs/db-annual-funding-statement-2016.pdf>

⁵⁷ Institute and Faculty of Actuaries: Mature Pension Schemes – onwards and forwards: Analysis by the Running Off Mature Schemes Working Party, May 2018. Available at <https://www.actuaries.org.uk/system/files/field/document/Running%20Off%20Mature%20Schemes%20Working%20Party%20slide%20pack%20vFINAL%20FINAL%2020180614.pdf>

⁵⁸ The working party provided examples for schemes with 80% funding level, we have extended them for other funding levels. For simplicity these examples assume no investment outperformance. The working party shows other examples with such allowance but notes that as maturity increase the potential credit from this source should diminish anyway.

- 621.** This observation is consistent with research from others. For example, Redington⁵⁹ has likened the drag on the scheme's funding to the wind-chill factor, caused by what they refer to as the sequencing risk associated with a negative cash flow profile. This means that the sequence of returns matters when the scheme is paying out from its accumulated assets. For example, a heavy setback early on which causes the scheme to sell assets in a depressed market to pay benefits may put the scheme in a position from which it is hard to recover. Redington go on to suggest that this effect is not captured by standard risk measures such as VaR or volatility, and consequently risk management for mature schemes requires a different set of risk lenses in order to properly evaluate the risk in the scheme.
- 622.** These findings are consistent with our own research as well as observations from our case teams in some mature schemes. We consider them to be an important aspect of the design of the long-term funding objective.

Defining the long-term objective (LTO)

- 623.** The analysis above shows why it is important for schemes to plan ahead and build up their funding levels such that, after they have reached a high level of maturity, they are not relying on excessive risk-taking, which places an unnecessary (even unaffordable) burden on the employer. This concept needs a more precise definition for practical application. We asked GAD to provide financial analysis to help inform the key considerations around the design of an LTO, which would be consistent with the requirement that a DB pension scheme should have low dependency on its employer for additional funding once it has reached significant maturity.
- 624.** More specifically, we asked them to examine whether it was possible for a significantly mature scheme (say one at duration 14 – see below for reasons why) which had already reached 100% funding on a low dependency target to deliver its remaining benefit payments in due course with a high degree of certainty and with minimal recourse to the sponsoring employer. What might be the reasonable combinations of low dependency funding bases and practical low-risk investment strategies which could deliver such outcomes?
- 625.** GAD provided analysis⁶⁰ to assess the implications on expected member outcomes of setting the low dependency funding target at different levels (assuming discount rates of up to 1% in excess of gilt yields) and stochastically modelling the progress of a model scheme, in the absence of any further support from the employer using a number of investment strategies as follows⁶¹:

⁵⁹ Walking uphill: How to manage negative cash flows, Redington, 2017 <https://www.redington.co.uk/article/walking-uphill-manage-negative-cashflows/>

⁶⁰ 'Modelling the long-term funding objective: likely outcomes of different approaches', 14 February 2020. Available at: www.tpr.gov.uk/-/media/theypensionsregulator/files/import/pdf/modelling-long-term-funding-objective.

⁶¹ These are illustrative. In practice, low dependency does not mean zero dependency. Also, investment strategies may be more complex than those modelled and the impact of the economic scenarios will vary according to the risk exposure in each.

Table 40: Investment strategies used in GAD modelling

Investment strategy	Asset allocation percentages				Level of interest rate and inflation hedging	Target long-term return %pa
	Growth assets	Matching gilts	3x leveraged LDI	Corporate bonds		
Core hedged	20	70	10	0	100%	Gilts +1%
Corporate bond	10	25	10	55	55%	Gilts +1%
More cautious	10	85	5	0	100%	Gilts +0.5%
More adventurous	25	62.5	12.5	0	100%	Gilts +1.3%
Core hedged variant	33.3	50	16.7	0	100%	Gilts +1.6%
Corporate bond variant	37.5	15	7.5	40	37.5%	Gilts +1.6%

Base case

- 626.** GAD’s base case analysis assumed a low dependency funding target based on a discount rate of Gilts +0.5% (approximating to 93% of buy-out cost before expenses). They assumed that schemes will reach full funding on this target by the time they are “significantly mature”, which for this purpose was assumed to be at maturity duration 14.
- 627.** The ‘core hedged’ and ‘corporate bond’ strategies were considered suitable illustrative investment strategies targeting a long-term return of 1% in excess of gilts.
- 628.** The base case results (see table below) showed that in 72%-82% of scenarios, the scheme reached buy-out funding levels within the next 25 years. In the remaining scenarios, there was a risk of at least some of the benefits not being paid, but the overall member losses could be contained to within 2% (before any allowance for PPF protection)⁶².

⁶² It should also be noted that, while the success measures presented above appear reasonable, the range of possible outcomes remains relatively wide and, in some scenarios of market conditions considered, support would be required from the employer or the PPF.

Table 41: GAD base case results

Indicative low dependency target	Long-term investment strategy	Target long-term return	Likelihood of achieving buy-out funding within 25 years	Member losses
Gilts +0.5%	Core hedged	Gilts +1%	72%	2%
Gilts +0.5%	Corporate bond	Gilts +1%	82%	1%

- 629.** When tested against alternative investment strategies, it was clear that the ‘more cautious’ investment strategy (targeting Gilts +0.5%) would not generate sufficient long-term returns to deliver full benefits with a high probability. On the other hand, for higher risk investment strategies the trade-off between better expectations in the long term and the associated higher short-term risk became important. For example, increasing the proportion of growth assets in the ‘corporate bond’ strategy increases the expected returns and, therefore, the chance of reaching buy-out funding. But it also brings increased volatility to the asset value, and thus increases the likelihood of the scheme falling into the investment spiral and the trustees having to resort to the employer for additional funding. Other higher risk strategies repeated this pattern⁶³.
- 630.** The 25-year projection period was considered to be adequate for the bulk (about 75%) of the remaining liability to have run-off by the end of it. Extending the projection period to 40 years had minimal impact on the likelihood of buy-out or on member losses.

Alternative low dependency strategies

- 631.** The implications of setting low dependency ‘strength’ at different levels were also modelled by GAD, with the results compared against the base case below:

Table 42: Comparison of different low dependency targets and investment strategies against base case used in GAD modelling

Indicative low dependency target	Long-term investment strategy	Target long-term return	Likelihood of achieving buy-out funding within 25 years	Member losses
Gilts +0.25%	Core hedged	Gilts +1%	89%	1%
Gilts +0.25%	Corporate	Gilts +1%	93%	0%
Gilts +0.5%	Core hedged	Gilts +1%	72%	2%
Gilts +0.5%	Corporate	Gilts +1%	82%	1%
Gilts +0.75%	Core hedged	Gilts +1%	54%	4%
Gilts +0.75%	Corporate	Gilts +1%	64%	2%
Gilts +1.0%	Core hedged	Gilts	66%	5%
Gilts +1.0%	Corporate	Gilts	72%	4%

⁶³ See GAD’s report: www.tpr.gov.uk/-/media/thepensionsregulator/files/import/pdf/modelling-long-term-funding-objective.

- 632. It can be seen that strengthening the low dependency funding target to Gilts+0.25% is beneficial to member security by providing greater resilience to future risks and significantly improving the chances of reaching buy-out. However, it has an associated cost on employers in the pre-LTO period when they would need to provide additional funding to reach the higher target.
- 633. On the other hand, weakening the low dependency funding target to Gilts +0.75% or Gilts +1.0% appears detrimental to member security as it reduces the chances of reaching buy-out significantly and thus leaving members exposed to higher risk for longer.
- 634. A further consequence of weakening the low dependency target is that investment risk needs to be increased through a heavier allocation to more volatile assets, in search of the additional return required. This increases the short-term risk, with similar consequences to those discussed above.

Time to significant maturity

- 635. Our starting point was to set significant maturity at duration 14. This is because we consider that around this time in a scheme life, the impact of maturity could begin to have a material effect on scheme's funding if it is still underfunded. So, it seems prudent to expect schemes to reach a position of low dependency before this happens. Anecdotal evidence from various practitioners suggests a suitable 'tipping point' for this purpose to be when a scheme's benefit outgo is of the order of 5% of liabilities, and our data suggests that this may be happening broadly when the scheme has reached maturity duration of 14-12. A scheme of average maturity, may take a little over 15 years to reach maturity duration 14 and around another five years to reach maturity duration 12.
- 636. The impact of bringing forward or delaying the time when a scheme reaches full funding on the low dependency basis was investigated by GAD and found to have a minor effect on the chances of achieving buy-out in the subsequent years. In other words, whether the base case is run from duration 17 or 12 instead of 14 makes little difference as long as the scheme is fully funded on the low dependency basis and the investment strategy is broadly aligned with it.
- 637. However, there are other implications. The quicker schemes are required to reach the low dependency funding target, the higher the necessary contributions for employers (especially for schemes who are already very mature and underfunded). On the other hand, the longer schemes have to reach low dependency, the longer the scheme funding is exposed to risks from employer insolvency. This is a trade-off we will be examining in greater detail in our second consultation, once some of the conceptual matters in this consultation have been settled.

Our preliminary conclusions

- 638. While the GAD modelling has its limitations, it nevertheless shows that an LTO can be set so that there is a high likelihood of a typical mature closed scheme funded at a low dependency level and invested on a low risk basis being able to survive on its own with minimal reliance on employer support. It also shows that, in the design of the LTO, there is clearly a balance to be struck between the cost to employers and risk to members from having a stronger or weaker low dependency target, a longer or shorter period until significant maturity and the acceptable balance between short- and long-term investment risk in the period after significant maturity.
- 639. In particular, the analysis shows that setting a discount rate of between 0.25% pa and 0.5% pa in excess of gilt yields for a scheme with a duration of 14 years would appear to fit the definition of low dependency. This is because there is a low chance of requiring any further support from the employer and a very low chance of that support being significant relative to the original size of the scheme. It also shows that, to protect member benefits, it is important to maintain an investment strategy that is highly resilient to risk.

How are trustees currently planning to deliver benefits?

- 640.** Since most DB schemes are now closed to new members (and, to a lesser extent, closed to future accrual), we expect scheme maturity issues to assume greater significance for setting funding and investment strategies in the future. In the context of scheme funding, the important consideration is the interaction between (a) the level of assets, the degree of underfunding and the amount of benefits paid out, and (b) the scheme's ability to close the funding gap from investments and new contributions in a reasonable timeframe given the scheme's maturity. The above analysis shows that funding to a level where these risks are minimised will become increasingly important as schemes approach high levels of maturity.
- 641.** Anecdotal evidence suggests that many schemes already claim to do this by setting a LTO, often expressed as a secondary funding objective, and a plan for delivering it. For example, Aon's Pension Risk Survey 2019⁶⁴ shows that
- 92% of schemes surveyed claim to have a LTO.
 - The majority (78%) are targeting either buy-out or 'strong' forms of "self-sufficiency"/low-risk positions.
 - Two out of three schemes are planning to reach their long-term target within 10 years.
 - Methods for delivering the LTO vary. While most schemes have factored an element of asset performance as well as additional contributions beyond the agreed funding plan to reach the long-term target, the larger schemes are more likely to be relying on asset performance.
- 642.** Another survey by Willis Towers Watson (WTW)⁶⁵ shows the following:
- 33% of schemes surveyed are targeting buy-out.
 - 37% are planning to run-off the scheme over time with minimal reliance on the employer.
 - 27% envisaged managing investment risk over the long term. Our understanding of this is that they would seek higher levels of investment risk underpinned by the employer stepping in to provide further support if necessary.
 - Only 3% of schemes said their plan did not fall into any of these categories.
- 643.** Delivery of the LTO requires a suitable journey plan to get there. Information from external surveys reveals mixed practice among schemes.
- 644.** In the WTW survey, 86% of schemes surveyed said a long-term journey plan was either in place or under development.
- 645.** The Aon survey probed deeper into the quality of the journey plans and uncovered the following:
- 23% of the smaller schemes (under £100m) and 70% of the larger schemes had a robust journey plan. We interpret this as one that has been stress-tested and modelled so it is known how it will evolve in different scenarios.

⁶⁴ Covering 170 UK schemes with individual schemes ranging from fewer than 500 members (15% of schemes) to more than 10,000 members (28% of schemes) and asset sizes ranging from less than £100m to more than £1bn: https://retirement-investment-insights.aon.com/u-k/aon-global-pension-risk-survey-2019-uk-findings-chapter-1-long-term-targets-report?_ga=2.14436020.204533150.1571675519-1637887178.1562850956.

⁶⁵ What next for DB? 2018 Defined Benefit Survey, covering 159 large schemes with typical (median) scheme having assets of around £800m and 6,000 members.

- 36% of the smaller schemes and 19% of the larger schemes had a basic journey plan which we believe was expected to take the scheme to its LTO but had not been subject to rigorous challenge or testing.
- 40% of the smaller schemes and 10% of the larger ones considered an aspirational plan to be adequate. This is one where the LTO has been set higher than the TPs, but there are no formal plans on how to deliver this objective.

646. Survey information also shows schemes having taken steps in recent years to reduce the time they allocate to reach their LTO. In the most recent Aon survey, 63% of schemes said they expect to reach their chosen LTO within 10 years, compared with 43% two years previously. 32% of schemes said they are now expecting to take between 10 and 20 years compared with 50% two years ago.

647. The conclusion we draw is that the concept of a LTO is not new to the majority of schemes. However, there is a variable picture regarding the extent to which schemes link this objective to their funding and investment strategies. Where journey plans do exist, their quality seems to vary, from those that are robust and more likely to deliver the LTO, to others which are less likely to deliver because they have not taken full account of the risks they are likely to face along the way.

Fair treatment for the pension scheme

648. Deficit contributions should reflect the size of the scheme's deficit (on varying bases) and the employer's ability to reduce the funding deficit as soon as possible without endangering its sustainable growth.

649. In the analysis accompanying our most recent Annual Funding Statement⁶⁶, we presented data showing a consistent and growing disparity between dividend growth and stable DRCs across companies of all sizes. We view this as an indication that over recent years, successively smaller proportions of corporate cash flows have been used by many companies to pay down pension deficits as compared with payments to the shareholders.

650. Similar studies by other organisations confirm the general picture of dividend payments considerably exceeding contributions to pension schemes. For example:

- An analysis by Lane Clarke and Peacock⁶⁷ of the accounting disclosures by FTSE100 companies during 2018 shows that pension contributions among the FTSE 100 companies remained at a similar level to the previous year, at around £13bn, while dividend payments increased from £80bn to £90bn.
- Another analysis by Hymans Robertson⁶⁸ of the accounting disclosures, up to 31 March 2018, of FTSE350 companies sponsoring DB schemes showed that actual spending on DB pensions fell 5% to £19bn over the previous year at a time when company earnings increased by 26%.

⁶⁶ Annual Funding Statement analysis 2019, <https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-analysis-tranche-fourteen-review-2019.ashx>.

⁶⁷ LCP Accounting for pensions 2019. Analysis based on FTSE 100 companies reporting during 2018.

⁶⁸ Putting pensions in context: FTSE350 Pensions Analysis 2018. Analysis based on information reported in year-end accounts up to 31 March 2018.

- 651.** We have made clear in recent years that equitable treatment is a key concern in scheme funding discussions. More recently, our Annual Funding Statement 2019⁶⁹ has provided greater clarity on this, including setting out expectations that schemes with stronger employer covenants should have shorter RPs, and where schemes have weaker covenants, we expect DRCs to be prioritised over other forms of 'value leakage'.
- 652.** To the extent that inappropriate RPs (including inappropriate splits of corporate cash) are agreed, we have powers (under s231(2) of the Act) to impose an alternative RP. This is a powerful tool in requiring employers to provide a fairer level of cash to their DB schemes. A notable example is our recent intervention in relation to the Southern Water Pension Scheme⁷⁰.

Affordability of pension deficits

- 653.** The Hymans report also provides more detailed insight at the individual company level. It shows that 93% of the FTSE350 companies have IAS19 deficits which are less than 10% of their market cap, and that 90% of companies are able to pay off their IAS19 deficit with less than six months earnings. Our interpretation is that the same analysis, if repeated on a more prudent TPs basis, would show a similar message (albeit with less stark metrics).
- 654.** Analysis we provided in the government's DB green paper in 2017⁷¹, covering all companies who sponsor DB schemes (not just FTSE350), explored the burden of existing DRCs on the employers' business. This showed that, where profit before tax (PBT) ⁷² data was available (for 84% of employers), around half were paying less than 20% of their reported profits as pension contributions. At the other end, 20% of employers were either loss making or paying pension contributions that were in excess of 100% of their reported profits (although this takes no account of any additional support from the employer's wider corporate group).

⁶⁹ <https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-annual-funding-statement-2019.ashx>.

⁷⁰ <https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/regulatory-intervention-section-89-southern-water.ashx>

⁷¹ Security and Sustainability in Defined Benefit Pension Schemes, Cm 9412, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/595105/security-and-sustainability-in-defined-benefit-pension-schemes-print.pdf.

⁷² There is no single measure of affordability that gives definitive conclusions. However, we consider that at the aggregate level DRC to PBT ratios give a reasonably prudent illustration of the affordability situation. PBT data was not available for 16% of employers (for example, because income statement information is not included in their small company accounts).

- 655.** We also provided analysis in the green paper looking at affordability through an IRM lens. This considered potential outcomes in the round, based on risk embedded in current funding and investment strategies and the covenant support available for both. The assessments were based on a range of information including our internal risk indicators⁷³.
- 656.** This analysis showed that the overwhelming majority (89%) of members were in schemes which were either in surplus or, if there was a deficit, then either the covenant was deemed sufficient to provide adequate support to the scheme as and when needed⁷⁴, or the funding and investment strategies employed were deemed adequate in the prevailing circumstances. Among the remaining minority, some were thought to be in schemes with the potential to benefit from wider group support, leaving a smaller minority (about 5%) of DB members in schemes where the prospect of additional support appeared uncertain.
- 657.** The DB green paper noted that, while it is hard to find evidence of pension deficits driving companies into insolvency, there are clearly some employers for whom the pension deficits are a significant call on their resources.
- 658.** Therefore, an important consideration for us in the design of the proposed framework has been to recognise that, while most schemes look to be affordable for their employers, there is nevertheless a minority for whom affordability is an issue. Accordingly, some of the detailed parameters of the proposed new funding framework will be informed by a full impact assessment which will form part of our second consultation.

Covenant visibility

- 659.** This consultation considers whether scheme trustees should be allowed to place reliance on employer covenant, particularly in Fast Track, and, if so, whether any such reliance should be reduced beyond the period for which it can be realistically forecast.
- 660.** Analysis carried out internally highlights that the 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. The ratio does not vary significantly for different covenant grade bands (eg a CG2 scheme is just as subject to change as a CG3 scheme).
- 661.** While this analysis reflects covenants which are improving or worsening between valuations, it highlights that a significant proportion of schemes' covenant grade ratings are likely to change during subsequent valuation cycles. Furthermore, this does not take account of the number of schemes whose covenant has weakened, but not sufficiently to warrant a covenant downgrade.
- 662.** This analysis also highlights a smaller proportion (around 5-10%) of schemes whose covenant grade declines by more than one covenant grade rating over the same six-year period.
- 663.** Given the above, we consider it reasonable to allow credit for employer covenant only to the extent that trustees have visibility over it and can evidence it.

⁷³ See sections 122-128 and Annex 2 of DB green paper for a description of the methodology applied, assumptions made and limitations of the results.

⁷⁴ Based on TPR's own assessments using publicly available employer data.

Small schemes

- 664.** Our data suggests a very heavily skewed landscape by size of scheme. There are about 2,000 small schemes (fewer than 100 members) which account for 35% of all schemes by number but less than 1% by membership, and in aggregate, small schemes account for only 1% of assets or liabilities in the DB universe.
- 665.** We have no evidence that smaller schemes exhibit higher financial/economic risk than the rest of the universe. While there are differences between individual schemes, in general small schemes have a slightly lower proportion of active memberships, are on average a little better funded and have shorter RPs. They have similar headline asset allocations to the larger schemes but perhaps less hedging. While the covenant of the employers backing small schemes is on average marginally weaker, but not significantly so, their deficit contributions as a percent of profits are significantly higher than for larger schemes. History has shown higher insolvencies among smaller schemes, as borne out by the PPF experience and its capacity to absorb them.
- 666.** However, smaller DB schemes do tend to display poorer governance standards, with trustees placing less emphasis on assessing fitness and propriety of new trustee board members and their arrangements for managing conflicts of interest. Research⁷⁵ carried out on our behalf showed that fewer than half of the trustees of small schemes (48%) had a documented process to assess the fitness and propriety of new trustees, compared with those of large schemes (62% and 82% respectively), and that a third of all trustees had no documented conflicts policy and no register of interests for the trustee board.
- 667.** From a funding perspective, the same research also showed some weakness generally among trustees of smaller schemes to adhere to the guidance in our DB code, particularly around taking and managing risk. Specific areas of concern to us based on these surveys, as well as learnings from an initiative to engage directly with a sample of small schemes, include the following:
- A failure by some trustees to include appropriate contingency planning within their risk management frameworks.
 - A reluctance by some trustees to properly assess the employer covenant or robustly assess business investment plans put forward by employers.
 - An increase in the percentage of trustees reporting that they take no actions to ensure their scheme is treated fairly among competing demands on the employer.
 - Affordability constraints limiting the ability of trustees to pay for substantive independent advice (where those trustees do not feel they have sufficient technical knowledge and/or capacity to perform their own analysis).
- 668.** We conclude from this evidence that the issues for small DB schemes revolve around governance, proportionality and cost efficiency. We consider the proposed framework, with its greater clarity and its clear Fast Track path, should help trustees and employers of small schemes to develop more robust and cost-efficient funding and investment strategies.

⁷⁵ Summarised in DB Research Response, Sept 2018 available on TPR website at <https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-research-response-2018.ashx>.

17. Glossary

Act	The Pensions Act 2004.
Actuarial valuation	Required by s224 of the Act, it is a comparison by the actuary of the value placed on scheme assets with the TPs and an assessment of any future contribution requirement. Calculation of the TPs is usually based on full member-by-member data.
Asset allocation	The way in which a scheme's investments are apportioned between different asset classes, ie equities, property, bonds, cash etc. A scheme's asset allocation is a key feature of its investment strategy and would be expected to reflect its overall objectives, attitude to risk, need for liquidity etc.
Buy-out	Securing scheme liabilities with annuities, written in names of individual members, purchased from a regulated insurance company.
Buy-out liabilities	Also referred to as 's75 liabilities' or 'solvency liabilities'. A measure of scheme liabilities based on the cost of securing scheme benefits with annuities purchased from a regulated insurance company. It can also refer to the scheme actuary's estimate of these liabilities.
Closed scheme	A scheme where no members are accruing future service benefits. Note that other publications, such as the Purple Book, may use a slightly different definition.
Covenant (or employer covenant)	The level of financial support available to a pension scheme from its employers and, if applicable, any guarantors or other contingent support. We assess covenant strength using a four-point rating scale ranging from CG1 (Strong) to CG4 (Weak).
Covenant assessment	An assessment of employer covenant strength. The covenant is typically assessed at each scheme valuation, taking account of the employer's financial strength and the scheme's funding needs. It should be regularly monitored for change between valuations.
DB Superfund	An occupational pension scheme set up for the purpose of effecting consolidation of DB pension schemes' liabilities.
Defined Benefit (DB)	A type of pension benefit where there is a promise to pay a particular level of benefits on retirement or death (if earlier). The pensions are worked out using a formula, defined in the scheme's rules, that is usually related to the members' pensionable earnings and length of service.
DB funding code ('the code')	TPR's code of practice relating to the funding of DB schemes. The current version came into force on July 2014 (GB) and July 2015 (NI) and can be found at:

<https://www.thepensionsregulator.gov.uk/en/document-library/codes-of-practice/code-3-funding-defined-benefits->

Deficit	In general terms, this refers to the shortfall arising when a DB scheme's assets are insufficient to fund scheme liabilities. It can be measured in different ways depending on the way the liabilities are calculated (eg liabilities on a buy-out basis, on a TPs basis, PPF basis etc).
Deficit repair contributions (DRCs)	Contributions made by employers to a scheme in order to address a TPs deficit, in line with the Schedule of Contributions and the recovery plan.
Discount rate	This is a rate of compound interest used to calculate the present value of a sum due at a later time. This action discounts the sum due to its value today. It inherently assumes that the present value is invested and must earn the chosen discount rate to achieve the sum due at the later time.
Dividends	A dividend is a distribution of a portion of a company's earnings or reserves, decided by the board or directors, to a class of its shareholders. Dividends are typically issued as cash payments.
Downside scenario	A negative event that could adversely impact the position of a scheme. This includes (but is not limited to) a downturn in the financial strength of the employer or a change in economic markets causing a negative impact on the funding level of the scheme.
Duration	A measure of scheme maturity expressed as a number of years. It represents the mean term of the liabilities weighted by the value of the scheme's future cash flows or, alternatively, it is based on the sensitivity of the scheme's liability to small changes in the discount rate. In this consultation and supporting analysis, where duration is used as a measure of scheme maturity, we have made the calculation using a discount rate of Gilts +0.5% at the effective date for consistency and comparability between schemes.
Effective date or valuation date	An actuarial valuation or an actuarial report considers the funding of a scheme as at a particular date, known as the effective date. The effective date will be earlier than the date on which calculations are done.
Enforcement action (TPR)	The use of the range of powers available to us in the event of non-compliance or breach of statutory duties (such as fines, appointing Independent Trustees, s.231 orders). This potential use follows a risk-based approach which considers the threat posed and available mitigation and is informed by gathering and analysing information.
End game	The stage of life for a closed DB scheme when it is paying out a high level of benefits relative to the size of the scheme. By this time, the trustees' focus would most likely be to manage the scheme using low risk strategies to discharge their remaining

liabilities (which may include awaiting opportunities for buy-out or entering a superfund).

Fully funded

A pension scheme that has sufficient assets to provide for all the accrued benefits it owes and therefore can meet its future obligations. As with 'deficit' and 'surplus' it is not an absolute measure in itself but depends on the way that the liabilities are measured. For example, a scheme can be fully funded on a TP's basis but still have a deficit on a buy-out basis.

Funding basis

The set of assumptions used to calculate the value of a scheme's liabilities. For example, it will include assumptions about future investment returns on the scheme's assets and members' life expectancies.

Gilts

Sterling-denominated bonds issued by the British government and listed on the London Stock Exchange. Gilts whose proceeds (ie coupons and redemption amount) are fixed are known as fixed-interest, conventional, or nominal, gilts. By contrast, gilts whose proceeds are linked to the Retail Prices Index are known as index-linked gilts.

Gilts +x% pa

This formulation is used throughout the document to refer to annual interest rate(s) or discount rate(s) calculated as a fixed annual amount, x%, in excess of the yield(s) on gilts. The gilts yield(s) could be expressed as a single spot yield, appropriate to the duration of a scheme's liabilities, or a yield curve (which includes a spot rate for each future year).

Growth assets (also referred to as return seeking assets)

Pension schemes hold growth assets, also known as 'return seeking investments', because they want a positive return over time to grow the scheme assets.

Investment in growth assets involves taking risks to target the desired return. Many different types of growth asset are available to pension schemes and involve taking different types of risk to seek that return.

Investment spiral risk

In a mature scheme which is not fully funded, the assets may be depleting at a faster rate than its liabilities because a high proportion of assets have to be paid as benefits (in full). If the scheme is looking to close the funding gap using investment returns alone, then the required return from its investments increases because of its limited timeframe and reducing assets. As a higher proportion of the assets are paid out as benefits, there is a ratchet effect, and the scheme enters an investment spiral of ever increasing required rates of return to discharge its remaining liabilities. This may be aggravated further by an investment downside event forcing trustees to sell assets in an unplanned manner.

Investment strategy

The strategy undertaken by trustees (after consulting with the employer) about how to invest pension assets with the appropriate level of risk and governance considerations.

Investment outperformance	The extent to which investments perform compared to an agreed measure of the liabilities (TPs) over a specific time period.
Journey plan	A scheme's trustees' plan to reach their long-term objective (LTO). This will include a description of how the scheme's TPs and investment strategy will evolve over time to those underlying the LTO.
Key principles	<p>The eight key principles explained in the consultation consider the following:</p> <ul style="list-style-type: none"> • Demonstrating compliance and objective risk taking • Long-term objective • Journey plan and TPs • Scheme investments • Reliance on the employer covenant and covenant visibility • Reliance on additional support • Appropriate RP • Open schemes
Long-term objective (LTO)	Introduced by the Pension Schemes Bill where it is described as a 'funding and investment strategy', a new requirement for trustees to set a long-term objective for their scheme with regards to the desired funding target, the time taken to get there and the investments that will be held.
Low dependency	Where a scheme's funding and investment strategies are such that there is a low chance of requiring further employer support and, to the extent that such support is required, the amount of support is low relative to the size of the scheme.
Matching assets	<p>Trustees are legally required to invest assets backing DB liabilities in a way that's appropriate to the nature, timing and duration of the expected future retirement benefits payable under their scheme. To help achieve this, many schemes hold 'matching assets' in order to manage investment risk relative to the liabilities.</p> <p>Different types of matching asset match the liabilities in different ways, with varying degrees of accuracy and with different levels of expected return. A scheme's matching asset portfolio may comprise only physical (ie non-derivative) assets, eg fixed or index-linked gilts, corporate bonds, long-lease property and some forms of infrastructure. However, it is common practice for matching asset portfolios to use derivatives as well, to increase the level of matching achieved. This type of approach is known as liability driven investment (LDI).</p>
Maturity	A measure of how far a scheme is through its lifetime. A scheme whose membership is predominantly made up of active members and which is open to new entrants is immature. A scheme whose membership is predominantly made up of pensioners and which is closed to new entrants is mature.

Open scheme	A scheme where some or all members are accruing future service benefits. Such a scheme may or may not be open to new entrants.
Part 3 valuation, or scheme funding valuation	An actuarial valuation meeting the requirements of Part 3 of the Pensions Act 2004 concerning the funding of DB pension liabilities, which apply to any actuarial valuation received by trustees (on or after 30 December 2005) that is based on an effective date of 22 September 2005 or later.
Pension Schemes Bill (2019-2020)	The bill laid before parliament on 7 January 2020 which includes provisions on DB scheme funding to implement commitments made in the DB white paper.
Pension Protection Fund (PPF)	This is a corporate body established under the Act. The PPF was set up to provide compensation to members of eligible DB pension schemes when there is a qualifying failure event in relation to the employer and where there are insufficient assets in the pension scheme to cover the PPF level of compensation.
Recovery plan (RP)	<p>A recovery plan is defined in s226 of the Act. Where there is a funding deficit at the effective date of the actuarial valuation, the trustees must prepare a plan to achieve full funding in relation to the TPs (the SFO). The plan to address the deficit is known as a recovery plan.</p> <p>The RP length is the time that it is assumed it will take for a scheme to eliminate any deficit at the effective date of the actuarial valuation, so that by the end of the RP it will be fully funded in relation to the TPs.</p>
Rolling forward or re-spreading	Where an RP is extended in circumstances where no additional deficit has arisen. The deficit is taken at a point of time and rolled forward with a number of years of interest.
s75 debt	Section 75 of the Pensions Act 1995 provides for the calculation of a debt due from the employer on the buy-out basis if a scheme winds up or if an employer becomes insolvent or ceases to participate in a multi-employer scheme.
s75 liabilities	See Buy-out liabilities.
Schedule of Contributions (SoC)	A requirement of s227 of the Act for trustees to prepare a "Schedule of Contributions" ie a statement showing (a) the rates of contributions payable towards the scheme by or on behalf of the employer and the active members of the scheme, and (b) the dates on or before which such contributions are to be paid.
Scheme assets	The assets owned by and/or available to a scheme.
Scheme liabilities	The amount equivalent to the present value of the future benefit payments, which can then be compared to the market value of the assets. The liabilities can be calculated used different funding bases (eg buy-out basis, TPs basis, PPF basis etc).

Scheme funding position	The funding position of a scheme is how its current market value of assets compares with its liabilities. It can be expressed as a ratio of the scheme's assets and liabilities (known as the funding level) or as the difference between the assets and liabilities (referred to as a surplus or deficit).
Significantly mature	When a scheme is very mature, its membership is predominantly made up of pensioners and it is cash flow negative, paying out a significant proportion of its assets out as benefits every year.
Single effective discount rate (SEDR)	A single composite rate made up of constituents of the different rates reported, allowing for the maturity of scheme liabilities. The value of scheme liabilities calculated using the SEDR will equal the value of the scheme liabilities calculated using the discount rates reported.
Statement of strategy	The Pension Schemes Bill introduces a requirement for trustees to prepare and submit to TPR a written statement of strategy setting out the scheme's "funding and investment strategy" (LTO) and approach to risk management.
Surplus	In general terms, this refers to the excess arising when a DB scheme's assets are more than sufficient to fund scheme liabilities. It can be measured in different ways depending on the way the liabilities are calculated (eg liabilities on a buy-out basis, on a TPs basis, PPF basis etc).
Statutory employer	The statutory employer refers to an employer who has a legal obligation under statute to the scheme. A scheme may have more than one statutory employer.
Statutory funding objective (SFO)	Section 222(1) of the Act requires every scheme to have sufficient and appropriate assets to cover its TPs (ie it must be fully funded on an TPs basis).
Stress test	Subjecting the scheme to a hypothetical scenario in which its liabilities, assets and/or employer covenant become stressed. This is to help trustees to understand how support for their scheme could be affected by such scenarios.
SWOSS	Scheme without a substantive sponsoring employer, for example where a scheme's sponsoring employer is a shell or special purpose vehicle without any (substantial) ongoing trade.
TPR Future programme	A programme of work we have undertaken to become a stronger and more effective regulator.
Technical provisions (TPs)	TPs are defined in s223 of the Act as the funding measure used for the purposes of Part 3 valuations. The TPs are a calculation undertaken by the actuary of the assets needed at any particular time to make provision for benefits already considered accrued under the scheme using assumptions prudently chosen by the trustees. In other words, what is required for the scheme to meet

the SFO. These include pensions in payment (including those payable to survivors of former members) and benefits accrued by other members and beneficiaries, which will become payable in the future.

Twin-track compliance route

Fast Track and Bespoke funding arrangements.

Fast Track: A set of clear and quantitative compliance guidelines that will be defined in our code. Trustees (and employers) will be able to use these to assess whether we would consider their valuation to be compliant with the legislation. As long as all aspects are satisfied, there will be minimum regulatory involvement.

Bespoke: An option providing trustees and employers more flexibility for scheme-specific circumstances or where, for certain reasons, they are otherwise unable to comply with the guidelines in Fast Track. Decisions in this route will need to be fully articulated and may mean higher regulatory involvement.

White paper (DB)

The DB white paper published by DWP in March 2018:
<https://www.gov.uk/government/publications/protecting-defined-benefit-pension-schemes>.

18. Consultation questions

Chapter 3: Proposed regulatory approach

Q1 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?

Chapter 4: Employer covenant

Q2 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?

Q3 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)?
- b. If you think covenant should only feature in Bespoke, how do you think it should be done?
- 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

Q4 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?
- 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?
- 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?
- 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?

Q5 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?

Q6 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?
- 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?

Chapter 5: General principles

Q7 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?

Q8 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?

Q9 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?

Q10 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?

Q11 Journey planning

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

Q12 Relevance of investments for funding

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

Q13 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?
- 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?

Q14 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?

Q15 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?
- 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?

Q16 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?

Q17 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?
- 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?

Q18 Open schemes, past service

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

Q19 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?

Chapter 6: Other issues

Q20 Other issues

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

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

Q21 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)?

Q22 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?

Q23 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?
- 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?
- 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?

Q24 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?
- 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?

Q25 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?

Q26 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?

Q27 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?

Q28 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.

Q29 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?

Chapter 9: Technical provisions (TPs)

Q30 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?
- b. Are there any other journey plan shapes we should consider?
- c. What unintended consequences might arise from adopting the linear de-risking or horizon method journey plans for Fast Track?

Q31 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?

Q32 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)?

- 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?
- 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 (for example, over the subsequent five years)?
- 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?

Q33 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?

Q34 Method to derive Fast Track TPs

- a. Do you prefer a particular approach? If so, why? Is there another approach that would be suitable?
- b. Do you have ideas as how to best approach each option?
- c. How do trustees incorporate considerations about covenant strength into their TP assumptions/discount rates?
- d. If a stochastic approach is adopted, what would you consider to be an appropriate confidence level against which to mark the results?
- 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.

Chapter 10: Investments

Q35 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?
- 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?
- 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?
- 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?

Q36 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?
- 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?
- 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?

- 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.

Q37 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?
- 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?
- c. Should the allowance for prudence be higher for an investment portfolio with a higher level of risk?
- 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?

Q38 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?
- b. If so, what are your views on the options outlined above? Are there other approaches you favour?
- c. What limits would you set on the above criteria and why?
- d. How would the above change for a more immature plan?

Chapter 11: Recovery plan (RP)

Q39 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)?
- 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?
- c. Do you think Fast Track RP lengths should be shorter for schemes nearing and/or at significant maturity? If so, to what extent?

Q40 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?

Q41 Fast Track guidelines on investment outperformance

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

Q42 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?

- b. If a scheme's funding deficit is higher than expected, what guidelines should apply for the appropriate length of the new RP?
- c. Would the idea of 're-spreading' be more acceptable where a scheme has a long period before it becomes significantly mature?

Q43 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?

Chapter 12: Open schemes

Q44 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?

Q45 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?

Q46 Fast Track TPs for open schemes

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

Q47 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?
- 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?
- c. Would our preferred approach (Option B) make it difficult for scheme actuaries to certify schedules of contributions?

Q48 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?

Q49 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?

Chapter 13: Bespoke framework key features

Q50 Bespoke examples

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

- 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?

Q51 Stressed schemes

- a. Assuming that affordability is genuinely constrained, are very long RPs 'appropriate' and therefore compliant with the Act?
- 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)?
- c. For schemes with unviable RPs, should an exception be made for them in terms of the level of acceptable investment risk?
- d. Are you aware of situations other than stressed schemes where the trustees and employer would have difficulties meeting the Bespoke compliance principles?

Chapter 14: Additional support

Q52 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?

Q53 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?

Q54 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?

Q55 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?

Q56 Guarantees

- a. Should we treat guarantee support differently to asset backed support?
- 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?
- c. Other mitigations – Can you think of any other types or arrangements which can help trustees mitigate risks?

Q57 Other mitigations

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

Q58 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?