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LCP's response to the Pensions Regulator's draft Defined Benefit funding code of practice

21 March 2023

This document sets out LCP's response to the Pensions Regulator's draft Defined Benefit funding code of practice published on 16 December 2022 (the "Consultation").

Who we are

LCP is a firm of financial, actuarial, and business consultants, specialising in pensions, investment, insurance, energy, health and business analytics. We have around 1,000 people in the UK, including 160 partners and over 300 qualified actuaries.

The provision of actuarial, investment, covenant, governance, pensions administration, benefits advice, and directly related services, is our core business. About 90% of our work is advising trustees and employers on all aspects of their pension arrangements, including investment strategy. The remaining 10% relates to insurance consulting, energy, health and business analytics. LCP is authorised and regulated by the Financial Conduct Authority and is licensed by the Institute and Faculty of Actuaries in respect of a range of investment business activities.

Our overall thoughts

We have set out below our answers to each of the specific questions that you have set.

Stepping back from the detail, whilst most of what is in the proposed Code is welcome, and we can now begin to see how the new regime is taking shape, there are still a number of areas where the regulations and/or the Code fall short and may lead to unintended negative consequences for DB schemes and their members. We have identified six areas on which we expand in our blog "TPR's funding code –six to fix", published on 3 February 2023. We signpost to each of them in the body of this response.

We are happy for LCP to be named as a respondent to the Consultation and happy for our response to be in the public domain. We are happy for you to reference our comments in any response.

We look forward to seeing the final version of the Code and related documents in due course and trust that our comments are helpful.

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LCP's response to the questions in the Consultation

The funding regime

1. Are there any areas of the summary you disagree with or would like more/less detail? If yes, what areas and why?

This short Chapter provides a useful overview of the new funding regime and we agree with much of its content. We have the following comments:

- Para 18 – We question whether you should continue to refer to a long-term objective (LTO). Although this language was used in the 2018 White Paper and in your 2020 consultation, it does not appear in the draft regulations and is somewhat confusing given other language in the Code. In particular, this phraseology is not linked to the need to achieve full funding on the low dependency funding basis at the relevant date. We think you should remove reference to the LTO in the first bullet in Para 18.

- Para 20 – Our understanding is that where the scheme's Trust documentation provides that trustees are not required to agree contributions with the employer, the effect of the interaction of the proposed legislation with the existing legislation is such that the trustees will also not be required to agree the funding and investment strategy with the employer. We suggest that you caveat para 20 appropriately.

- Para 24 – Whilst it is true, assuming the regulations remain as currently, that the scheme's relevant date is set solely by the trustees (ie does not appear to require employer consent), our understanding is that this can only be given effect if the employer agrees to the funding and investment strategy (assuming the situation we describe immediately above does not hold). We suggest that para 24 caveats this trustee power accordingly.

- Para 27 – Noted, but our understanding is that the trustees are not necessarily required to implement such a low dependency investment strategy on and after the relevant date, which you make clear in para 56. Perhaps a cross-reference would be appropriate?

- Para 36 – We agree that a higher funding level may be targeted, such as buyout. Would it be useful to make clear that in such an event, compliance will nevertheless continue to be assessed by reference to low dependency, as we believe the law requires?

- Para 48 – We think the wording should be tighter, as our understanding is that the new regime will be switched on by reference to valuations with effective dates on or after a certain date (which we understand is intended to be 1 October 2023). We note in passing that the draft regulations don't appear to provide for this, but assuming that they will when in final then we think that para 48 should say that the first submission of the Statement of Strategy is with the first valuation with an effective date on or after 1 October 2023.

  More generally, for schemes which are already significantly mature, we would like clarification on when the new requirements apply (eg to have a low dependency investment allocation and be fully funded on a low dependency funding basis). Is it once their first valuation under the new regime is signed off, or is it by 1 October 2023 regardless of when their valuation is because it will then be law? It seems to us on practical grounds that it has to be once the first valuation under the new regime is signed off.

Separately, we are concerned with the full force of the new requirements coming into play at say each scheme's first actuarial valuation with a valuation date falling on or after 1 October 2023. This will be challenging for a number of schemes, especially those that have already reached or are close to reaching significant maturity. A proportion of such schemes will need to collectively de-risk their investment strategies over the next few years, and also swiftly get up to full funding. We think that some easements are needed in the early years of the new regime to avoid significant impacts for mature schemes, which may also be at risk of causing wider systemic impacts in bond markets. And as we also mention in item 2 of our "six to fix" blog, we think that the regulations should make it explicit that a scheme does not need to be fully funded at all times once it is significantly mature. If it falls below full funding, there should be a permitted transition period to return to full funding.

Low dependency investment allocation

2. Do you agree with the principles for defining a matching asset that i) the income and capital payments are stable and predictable; and ii) they provide either fixed cash flows or cash flows linked to inflationary indices? If not, why not and what do you think is a more appropriate definition?

Yes, these seem appropriate criteria for describing matching assets. We also support your intention not to limit in the Code the assets that can be considered for cashflow matching purposes.

3. **Do you agree with our approach for defining broad cash flow matching? If not, why not and what would you prefer?**

Yes and we welcome your pragmatic interpretation of this aspect of the draft regulations, but ultimately it will be the Courts that decide what "broadly cashflow matched" (and "highly resilient") means. Such legal precedent and advice could end up requiring something considerably stricter than is set out in the Code. (See also item 3 of our "six to fix" blog.)

We welcome the commentary and your consideration around systemic risks in the bond market in your consultation documentation. However:

- There is a lingering risk that schemes that are already significantly mature will have to change investment strategies in very short timescales and this creates a short-term systemic risk once the regulations come into force. The scale of this risk will of course depend on how many schemes are significantly mature when the regulations come into force – and hence depends on where you land on the measure of maturity.
- There is also a risk that the clarification of legal interpretation over time could create considerable new systemic risks in the bond markets, as all DB schemes look to comply over a short period with narrowing legal opinion on "broadly cashflow matched" and "highly resilient" if this comes to pass. It is clearly important that this risk is avoided if at all possible, given the events of late 2022.

As mentioned in item 3 of our "six to fix" blog, we would like to see more flexibility in the regulations than is implied by the terms "broadly cashflow matched" and "highly resilient". One simple option would be to change "and" to "or", so that schemes either need to be "broadly cashflow matched" or "highly resilient".

4. **Do you think the draft adequately describes the process of assessing cashflow matching? What else would be appropriate to include in the code on this aspect?**

We think you mean assessing broad cashflow matching? On this basis, the Code seems sufficient. We particularly welcome the statement in para 70 that a scheme that assumes some cash flow matching for a portion of its liabilities combined with high levels of hedging for interest rate and inflation consistent with the duration of its liabilities would be sufficient to be deemed broadly cash flow matched.

5. **Should the code set out a list of the categories of investments into which assets can be grouped for the purposes of the funding and investment strategy? If so, what would you suggest as being appropriate?**

We don't see the need to, presumably, tabulate which investment types are 'matching' and which are 'growth'. We think it best to keep the Code principles based.

6. **Do you agree that 90% is a reasonable benchmark for the sensitivity of the assets to the interest rate and inflation risk of the liabilities?**

Whilst we believe this is likely to be a reasonable benchmark for many schemes, given the legal requirement is only to be broadly cashflow matched, we think it would be helpful for the Code to have more flexibility. We note a 90% requirement would mean in practice schemes need to target something higher, which may be challenging for some schemes.

We think it would be helpful if the Code explicitly confirmed that bulk annuity assets (ie insurance buy-ins) should be treated as an asset of the scheme for these purposes (rather than just considering the non-insured assets).

7. **Should we, and how would we, make this approach to broad cash flow matching more proportionate to different scheme circumstances (eg large vs small)?**

We don't see the need for you to say any more than you do in para 74.

In para 72, we think that the brackets in the first bullet should read "(assuming appropriate maturities, durations and inflation linking for the bonds)".

8. **Do you agree with our approach that a stress test is the most reasonable way to assess high resilience?**

Yes, we support using a stress test in order to measure investment risk, particularly as this approach has been used in PPF levy work for some time and so is well understood.

9. **Do you agree that setting the limit of a 4.5% maximum stress based on a one year 1-in-6 approach is reasonable? If not, why not and what would you suggest as an alternative?**

   Yes, we believe this is a reasonable limit. Having said this, we are supportive of the approach in Fast Track which effectively means that better funded schemes have more flexibility in their investment strategy. We would like to see a similar approach in the regulations and Code in general.

   We think it would be helpful if the Code explicitly confirmed that bulk annuity assets (ie insurance buy-ins) should be treated as an asset of the scheme for these purposes (rather than just considering the non-insured assets).

10. **Do you agree that we should not set specifications for the stress test but leave this to trustees to justify their approach? If not, what would you suggest as an alternative?**

    Yes, for Code purposes, this is appropriate. Specification should only be needed in Fast Track.

11. **Do you agree with our approach for not expecting a detailed assessment of liquidity for the low dependency investment allocation (LDIA) since we have set out detailed expectations in relation to schemes' actual asset portfolios?**

    Yes, we agree, given the expectations set out in Chapter 11 of the Code.

Low dependency funding basis

12. **Do you agree with our approach for not expecting a stochastic analysis for each assumption to demonstrate that further employer contributions would not be expected to be required for accrued rights, but rather focussing on them being chosen prudently? If not, what would you suggest as an alternative?**

    Yes, we agree and welcome the statements in paras 93-94 of the Code. However, we note that the regulations do not constrain the meaning of "employer contributions are not expected to be required" to being not expected under all reasonable, foreseeable scenarios. We think that the regulations should be aligned with this wording in the Code.

13. **Do you agree that the two approaches we have set out for the discount rate for the low dependency funding basis are the main ones most schemes will adopt? Should we expand or amend these descriptions, if so, how?**

    Yes, we agree that these are likely to be the two approaches that most schemes will adopt and we note that the language you have used does not preclude the use of another approach.

    We don't see the need for you to say any more in the Code on these two approaches.

14. **Should we provide guidance for any other methodologies?**

    We don't see the need for this at this stage.

15. **Do you agree with the guidance and principles set out in Appendix 3 and 4? Are there any specific assumptions here you would prefer a different approach? If so, which ones, why and how would you prefer we approached it?**

    In these Appendices you have set out an encouragement for use of evidence-based assumptions or incorporating extra prudence in their absence. We are generally supportive of this, though we note for smaller schemes they are less likely to have statistically credible experience, and this could lead to use of excessive prudence in aggregate if this thinking is applied to every single assumption. We also note that there may be circumstances where past experience is not expected to be representative of the future, but trustees may have a good idea what future experience will be. This does not seem to be contemplated in Appendices 3 and 4.

    We also question how this need for prudence interacts with the need for accurate cashflow analysis in determining the low dependency investment allocation (eg para 65). In this case there is a focus on understanding accurate assumptions which would tend to mean best estimates rather than prudent assumptions – this seems a little contradictory.

    We also have some comments on specific areas of content in Appendix 3 as follows:

    - Commutation – we disagree that assumed factors should always be no lower than current factors. Commutation factors can reduce in practice and indeed this has been the recent trend given rises in gilt yields. It should be possible to reflect a reduction in terms post valuation where it is expected or even agreed. It should also be possible to reflect where commutation terms are linked to market conditions.

- Age difference – use of “No lower” seems incorrect – what is prudent depends on the gender divide of the scheme.

We have the following comments in relation to Appendix 4:

- We think the guidance under the heading of “immature schemes” can be shortened and clarified. For example, the second and third sentences seem unnecessary and the first needs to be clarified so that expenses from the relevant date are picked up.

- We agree with your thoughts in relation to schemes where there is a requirement for the employer to pay expenses, noting the overfunding risk should the trustees decide to establish a reserve. However, we think you should preface your remarks in this section along the lines of “Whilst we do not expect an expense reserve to be established as a matter of course….” in order to make clear that this is the starting position.

Para 354 refers to idiosyncratic risk in relation to smaller schemes and explicitly refers to retirement plans of members being a significant issue. We think that idiosyncratic longevity risk is also significant for smaller schemes and there should be explicit references in the Code, particularly in Appendix 3, for additional prudence being needed for such risks.

Relevant date and significant maturity

16. Do you agree that a simplified approach to calculating duration for small schemes is appropriate?

We see no need for this but recognise that others may appreciate this easement.

In para 119 the construction *“if the trustees consider it convenient”* is odd. Why not if the actuary considers it convenient? Under the current construction we would need trustee instruction in every case in order to be pragmatic about this calculation.

17. Do you think setting an earlier point for significant maturity within Fast Track as compared to the code (as described in option 3 in this section of the consultation document) would be helpful for managing the volatility risk of using duration? If yes, where would you set it and why?

We do not support Option 3 (or indeed Option 2); We do not think either option would solve the key problem of volatility, and hence schemes would still find it very difficult to plan for low dependency. Moreover, Option 2 in particular, would add extra complexity and cost for little benefit.

Our strong preference, if a duration measure is to be retained in the regulations, is for Option 1 – using a fixed set of low dependency assumptions.

Alternatively, a different measure could be used (such as pensioner liabilities comprising a certain percentage of total liabilities). Whichever measure is settled on it is important that there is stability so that schemes can plan their investment de-risking journey.

For the avoidance of doubt, we don’t believe that a duration measure of 12 based on current conditions is appropriate as it will mean many schemes will need to de-risk much more quickly than they had previously anticipated, given current higher gilt yields and consequent shorter durations. In turn, this is likely to exacerbate systemic risks in the bond markets.

(See also item 5 of our “six to fix” blog.)

Assessing the strength of the employer covenant

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

We note your reference to “supportable risk principles”. These principles are not explicitly badged as such in the regulations but can be inferred from those under the headings of “Investment risk on journey plan” and “Risk in relation to calculation of liabilities on journey plan” in Schedule 1 of the regulations. It might be useful to make this cross reference to the regulations in the Code.

You set out the definitions of visibility, reliability, and longevity in para 132. These are a useful means by which an assessment of an employer’s financial ability to support the scheme can be ascertained, noting that for many employers uncertainty increases markedly as one looks further into the future. We do not have alternative suggestions.

In relation to reliability, as this is dependent on the employer’s prospects (amongst other things), it seems that for some employers the reliability period could extend significantly into the future, up to and beyond the relevant date. It might be useful to make reference to this possibility (of reliability going beyond the relevant date), partly to mitigate the risk that some trustees are unnecessarily cautious when assessing the reliability period.

Given the key role of reliability it would also be useful to provide further commentary on how schemes could evidence a longer reliability period – though this may come in the new covenant guidance.

There seems to be a tension with the regulations as they seem to suggest that no matter the strength of the employer covenant, as the relevant date is approached de-risking must occur. We think that so long as there is reliability over available cash (or contingent assets) there is no need to de-risk, other than in a managed way in the immediate run up to the relevant date.

We think that there needs to be some mention of stressed scenarios when it comes to assessing employer strength, such as investment risk crystallising during the journey to significant maturity. This could be by means of a cross-reference to other parts of the Code, such as that on journey planning (see para 185 onwards).

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

We agree with the approach. On a point of detail we think that you should introduce this section of the Code by linking explicitly to the regulations given that the regulations say that in assessing the financial ability of the employer to support the scheme, one of the matters to be considered is the cash flow of the employer, as set out in the Code. Alternatively, the reference to the Code should be removed from the regulations.

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

We agree this approach. On a point of detail we think that you should introduce this section of the Code by linking explicitly to the regulations given that the regulations say that in assessing the financial ability of the employer to support the scheme, one of the matters to be considered is the other factors which are likely to affect the performance or development of the employer's business, as set out in the Code. Alternatively, the reference to the Code should be removed from the regulations.

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

Yes, these principles seem sensible to us.

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

Yes, we do, including the requirement to reassess their value at each actuarial valuation as a minimum.

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

Yes, we do and we agree that the reliance that can be placed on such guarantees, given that they typically come from other entities in the employer's group, typically reduces with time.

One further point that could be added to para 158 could be in relation to the limitations in the value of guarantees that have conditionality built in. i.e. where the guarantee falls away on certain events, such as trustees changing a scheme's investment strategy or the Pensions Regulator seeking to use powers in relation to the scheme, so that effectively trustees may lack clarity on whether in future they will be able to make a claim on the guarantee in certain circumstances.

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

Yes, we do and accept that it is appropriate to give just a few pointers in the Code since covenant assessment across a number of employers will be very dependent on the specifics of the scheme and its situation.

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

In general, yes, the points that you make under the headings of assessing cash flow, assessing prospects and contingent assets (paras 165-169), seem reasonable to us.

However, we consider that it would be helpful to recognise that it can often be more challenging to establish what a not-for-profit employer's free cash flow is because of the more subjective and judgemental aspects of estimating the impact on future prospects of allocating the employer's income in different ways. For example, the cash flows available to fund pension contributions might be significantly limited by the risk of negative public perception of the level of donations used to support charitable objectives and those allocated to supporting the other expenses of an organisation. Allocating a perceived greater than necessary proportion of income to expenses such

as pensions could have a negative impact on a not-for-profit employer's prospects and its ability to support its pension scheme over the longer term.

We therefore request the wording in relation to not-for-profit schemes is tightened up so it is clear that you are looking for pension schemes to be funded at a reasonable level, but not so it unduly impacts on the sponsor's charitable purpose. In particular, we ask that you reflect similar wording to that which appears in Appendix B of your existing covenant guidance under the heading "Assessing sustainable growth plans" – specifically that "sustainability" is an alternative to "sustainable growth", the comments about the risks around donor perception and that taking too high a proportion of donations as contributions may reduce the likelihood of future donor support. We feel this would help to balance the wording in the current draft Code.

Journey planning

26. Do you agree with how we approached how maturity has been factored into the code? If not, what would you suggest as an alternative in particular with reference to the draft regulations?

There is a good deal of discussion about maturity in relation to journey planning in the consultation paper and we note the treatment of open schemes. We support what is being said here. By contrast the Code has a brief mention of maturity (paras 183-184) which seem to add little to para 178 of the Code.

In passing, we make the same comment on para 175 of the Code as we have on para 20. Our understanding is that where the scheme's Trust documentation provides that trustees are not required to agree contributions with the employer, the effect of the interaction of the proposed legislation with the existing legislation is such that the trustees will also not be required to agree the funding and investment strategy with the employer. We suggest that you caveat para 175 appropriately.

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

Yes, we do. However, we note that in practice the covenant reliability period will be updated at each valuation, likely being pushed further into the future assuming the employer remains sufficiently strong, and so schemes may not actually start to de-risk investments until they approach significant maturity. This could also lead to an actuarial gain arising in the technical provisions at each valuation as assumed de-risking is postponed – leading to overfunding issues. Similarly, we note that it could lead to an inflated cost of accrual for open schemes.

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

Yes, this seems like a reasonable approach.

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

Yes, we do (para 192) but we note that this deduction in isolation may be insufficient as these other schemes may also suffer a downside event at the same time as the scheme being stressed does and we suggest this aspect is incorporated into the Code.

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

Yes, subject to our comment immediately above.

For the period after covenant reliability:

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

Yes, subject to our answer to question 27. Moreover, the risk around overfunding that we highlight in our response to question 27 is a potential concern for sponsors in particular.

32. Do you agree with our approach of not being prescriptive regarding the journey plan shape?

Yes, we think this is essential. This is a key period for the scheme and it is important that the Code, whilst setting down some principles, is not overly constraining.

We think there is something missing from the Code when you introduce the graphic at para 227. It is more than possible that the covenant remains reliable right up to the point of significant maturity, although this is not known at the outset. How is a de-risking plan meant to operate in such a situation?

33. Do you agree with our approach that the maximum risk trustees should assume in their journey plan is a linear de-risking approach where they are taking the maximum risk for the period of covenant reliability?

Yes (para 225). It is important to have this backstop.

Statement of Strategy

34. Do you agree with our explanation of the Statement of Strategy and are there areas it would be helpful for us to expand on in this section?

This part of the Code (Chapter 8) seems to say very little beyond what is set out in the regulations. Only paras 240-241 and parts of paras 242 and 243 seem not to be sourced from the regulations.

We understand that you are considering what data to collect and how exactly to collect it. Will you be producing a template? If so, it would be useful to see a draft of this at an early juncture. It will be of particular importance to establish how this Statement of Strategy links with the Statement of Investment Principles (required under entirely separate legislation) and the Statement of Funding Principles which appears to be unaltered by the legislation.

Technical provisions

35. Do you agree with how we have described the consistency of the technical provisions with the funding and investment strategy? If not, why not and what would you suggest as an alternative?

Yes, we agree, subject to one point. Your interpretation (see paras 262-263) follows on naturally from the legislation with the following exception.

Para 263 says that where the valuation effective date falls before the relevant date, then in respect of the period following the relevant date technical provisions *"must be calculated in a way that is consistent with the low dependency funding basis assumptions*". By contrast, draft regulation 20 (amending current regulation 5) seems to cover only the situation where the valuation effective date falls after the relevant date. We think you should weaken your statement in para 263 as the word "must" implies a legal duty which is not set out in the draft regulations.

Separately, we presume that the Code requirement generally is a minimum and schemes can take a more prudent approach – we think this should be made clearer.

36. Do you agree that open schemes could make an allowance for future accrual – thereby funding at a lower level - without undermining the principle that security should be consistent with that of a closed scheme?

Yes, we do (paras 272-283). We assume this includes an appropriate allowance for new entrants.

We note that in essence these new requirements mean that for the first time some open schemes will need to seek sponsor contributions on the assumption that, at some point in the future, the scheme will close to new members. This will likely increase the contributions payable to some open schemes and this could lead to further scheme closures. There is also no acknowledgement of shared-cost arrangements in the draft Code or the draft regulations (eg this includes open schemes where the cost of accrual in the rules is split eg one-third member and two-thirds employer). Implementing the Code could be particularly challenging for such schemes.

37. Do you agree that this should normally be restricted to the period of covenant reliability? If not, why not and what do you suggest as an alternative?

Yes, we do (para 278). Having said that we note that some open schemes may wish to evidence a reliability period of much longer than the six-year timeframe which you seem to believe is appropriate for the majority of schemes. More guidance on how to evidence this would be welcomed by open schemes as it could have a large impact on their journey plan and thus on the cost of funding. This is particularly true for multi-employer "last man standing" schemes.

38. Do you agree with our principled based approach to future service costs? If not, why not and what you suggest as an alternative?

Yes, we do (paras 281-283).

We note that a continuing flow of new members, for whom the regular contributions are more than sufficient to provide for the additional technical provisions arising from that additional service, can in some cases help to improve the overall funding level of the scheme and thus improve the security for all members,

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Recovery plans

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

We welcome the Code discussion on the assessment of the appropriateness of the recovery plan and in particular that on the assessment of the employer's reasonable affordability. However, it will ultimately be for the Courts to decide what "As soon as employers can reasonably afford" means. There is a risk that, following a major business/pension scheme failure (eg the next Carillion), a future Court could decide that pension contributions should have been prioritised above what it deems 'discretionary' spend (eg dividends or even some capital investment). Such legal precedent would have a major impact on employers to DB schemes, significantly shifting the delicate balance that directors currently take in balancing their responsibilities to all stakeholders.

Vague terms within law that are subject to interpretation (eg "reasonably") can create new risks for all stakeholders and in this case we think this aspect of the regulations should either be removed (and left to the Regulator to police, as currently), or clarified, eg by explicit reference to and recognition of the need for sponsors to balance competing demands.

(See also item 4 of our "six to fix" blog.)

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

We think that the regulations in this area should be carefully considered and amended because we don't think they fit well together as currently drafted. First, as set out in our response to question 39 above, we are of the view that the new "reasonably afford" regulation wording needs to be adjusted to reduce the risk that Courts interpret this differently to the Code. Second, assuming some version of "reasonably afford" remains in the new regulations, we are then struggling to see the need for retaining the full list of items in regulation 8(2), which in any event have always seemed to us to be mostly irrelevant when considering the suitability of recovery plans

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

Yes (para 301).

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

Yes to the principles.

However, some of the wording around recovery plans in chapter 10 is unclear and will lead to regulatory confusion. This particularly applies to the five principles covered from para 307 onwards. For example, we think that 307 can be interpreted in a number of different ways, leading to unhelpful arguments between advisors, trustees, sponsors and the Regulator. If we unpick the Code words:

- What does "low" funding level mean? 70% or 90%?
- By using the word "more", do you mean "more" compared to what has happened in the past with this particular scheme? Or "more" compared to a scheme with a higher funding level? Or "more" compared to the amount spend on discretionary payments or (or do you mean "and"?) covenant leakage?
- When you say "as the funding level improves" – what do you mean? By how much does it need to improve?

We ask you to decide all your recovery plan principles through a similar lens and to be as clear as possible about what you expect (where you have clarity in your own minds) and to be clear that you are more flexible in other areas.

43. Do you agree with our approach to post valuation experience? If not, why not and what you suggest as an alternative?

Yes (paras 290-292) and this may be necessary in order to certify the schedule of contributions.

44. Do you agree with our approach to investment outperformance? If not, why not and what you suggest as an alternative?

Yes broadly (paras 293-295). However, we note there is an apparent inconsistency between what is said in para 295 about covenant supporting investment outperformance and the requirement for deficits to be paid off as soon as the employer can reasonably afford. If the covenant can support additional investment

risk, then surely it can afford to just pay off the deficit sooner? We would appreciate further clarification on this in the Code.

We note stressed schemes may need to take additional investment risk which may not be supportable as is described in the Code – is the intention here that no investment outperformance is allowed in recovery plans but such plans can be as long as is required to repair the deficit? We would welcome clarification here, particularly in cases where as a consequence of taking your proposed approach the numbers just don't "add up" (but the numbers DO add up if a pragmatic approach that continues to allow for sensible outperformance is adopted).

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

We don't see this as necessary for the Code. In fact we think more specific detail could restrict flexibility which would be unwelcome.

Investment and risk management considerations

46. Do you agree with our approach that, while trustees' discretion over investment matters is not limited by the funding and investment strategy, we expect investment decisions by trustees should generally be consistent with the strategies set out in the funding and investment strategy? If not, why not and what you suggest as an alternative?

Yes, we agree (para 322) and with your rationale for this (para 323).

However, we would like to get further clarification on your statement (in para 321) that the regulations require that "For the purposes of their funding and investment strategy, trustees must *plan to be invested in* accordance with the requirements for a low dependency investment allocation from the relevant date". While we agree that the requirements set out in draft regulations 5 and 6 require trustees to assume that they invest in line with the low dependency investment allocation when setting the funding basis, could it not be argued that they do not compel the trustees to necessarily actually invest accordingly?

47. Do you agree with the examples we have given for when trustees investment strategies may not mirror their funding and investment strategy? Are there other examples we should consider?

We agree with the examples you have given (paras 324-325). They seem to be sufficient for the purpose of the Code.

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

We welcome your recognition that for some schemes "the situation is fundamentally incompatible with the funding regime" and the guidance that follows in relation to "unsupported investment risk". However, we do not see this pragmatic approach as being compatible with the legislation, as the legislation does not acknowledge the existence of such situations. We would like the regulations to be clarified in this regard – we think the pragmatic approach described in the Code is sensible. (See also item 1 of our "six to fix" blog.)

We also note that under the Code you would expect trustees of stressed schemes to consider ceasing accrual – it is not clear how this would work for schemes where members have legal protections in relation to future accrual (eg utilities). We think some clarification here would be helpful.

49. Do you agree with the principles we have set out regarding risk management? Are there other aspects it would be helpful for us to include?

Yes and no respectively. And, as the consultation document suggests might be possible (para 228), we think that this material best sits in the forthcoming Single Code of Practice.

50. Do you agree with the principles we have set out regarding liquidity? If not, why not and what you suggest as an alternative?

Yes (paras 347-372), but maybe this material, as it relates to the Investment Regulations, should be set out in the Single Code and be simply signposted in the Scheme Funding Code.

51. Do you agree with how we have approached security, profitability and quality? If not, why not and what you suggest as an alternative?

We have nothing to add to our answer to Q50.

52. Are there other aspects it would be helpful for us to include?

No.

Systemic risk considerations

53. Do you agree with the above considerations? If not, please explain.

We broadly agree your comments on herding to bonds and gilts, subject to the two bulleted points we made in our response to Question 3.

We agree your comments on herding to Fast Track, though we note that some sponsors will argue for "levelling down" to this basis.

54. Do you think there are any areas of systemic risk that should be considered further in in light of our draft code? If yes, please explain.

We reprise below the point made in item 6 of our "six to fix" blog.

One significant risk conspicuous by its absence from the draft Code is climate risk. There is plenty within the Code on the importance of understanding risks in general, and on integrated risk management, so the fact that a search for the word "climate" returns zero hits is both surprising and disappointing.

We think that you should highlight your key expectations on integrating climate risks into covenant, funding and investment risks in the Code – lending more weight to your already published guidance in this area and giving schemes clarity on what is required. If not, it seems likely that the many schemes who have not already started integrating climate risk into their risk management decisions will continue to not do so for the time being – potentially leading to perpetuating additional systemic risk in the DB universe.

Other points

- The Code is silent on the practical treatment of bulk annuity assets held by (many) schemes (otherwise known as insurance buy-ins). To avoid confusion and debate, we think it would be helpful if the Code explicitly confirms that they should be treated as another asset of the scheme. Such assets are clearly "broadly cashflow matched" and "highly resilient", but the Code should confirm that it is the entire scheme assets, as a whole, that need to fit these requirements (rather than just the non-insured assets). Similarly, it should be the duration of the whole scheme (including insured members) which is measured to determine the date of "significant maturity".

- The Code has two side references to "superfunds". Whilst helpful, we remain in the dark about your and DWP's intentions as to how these vehicles can be helpfully used by schemes to strengthen the protection for the members.

- Appendix 1 appears to need some further work to update it for the new requirements relating to the new regime. For example, paras 385 and 386 should cross refer to agreement also now being needed on the funding and investment strategy. And we suggest the list in para 387 should be extended to cover new scheme actuary calculations under the new Code, for example duration.