LCP's response to the Pensions Regulator's Fast Track and regulatory approach proposals

21 March 2023

This document sets out LCP's response to the Pensions Regulator's consultation document setting out its Fast Track and regulatory approach proposals 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 comments on your proposals

We have set out below our answers to the specific questions that you have set. From this you will see that we have a few points of technical detail regarding the proposed operation of Fast Track. Overall, we are supportive of your approach.

We note that Fast Track is no longer covenant-dependent which is a change from the first consultation. We support this change in approach and think it makes sense for the reasons you have set out.

However, we think it is important that you make it very clear (and in particular clearer than it currently is in the documentation) that compliance with Fast Track does not guarantee compliance with the Code, and in particular does not mean that covenant can be ignored or should always be given less consideration. We have commented on a handful of particular areas where covenant may be relevant in our responses to the questions below.

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 Fast Track and regulatory approach document in due course and trust that our comments are helpful.

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About Lane Clark & Peacock LLP

LCP’s response to the questions in the Consultation

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

Yes, as a filter for assessing valuations with the intention of not scrutinising any further if the submission meets Fast track parameters.

In passing, it seems to us that Bespoke does not really exist as a separate concept. All submissions must be within the constraints of the legislation and the Code, and a Bespoke submission is simply one that does not meet all of the Fast Track parameters.

We think it may be helpful for the final documentation to clarify that compliance with Fast Track does not automatically mean compliance with the Code, and that in some cases you would expect trustees to use more conservative assumptions than required under Fast Track (for example in the case of a weak covenant). We assume this is the case. Similarly, it should be clear that following Fast Track does not mean that covenant can be ignored or should be given less consideration.

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

Not of the positioning. We agree with your decision not to embed Fast Track in the Code, for the reasons you give, especially the likely need to make quick changes to aspects of it.

You say remarkably little in relation to bespoke valuations, leaving trustees that wish to go down this route, nothing to go on beyond your Code expectations. One area in which it may be helpful to expand, is the level of evidence and explanation required in the Statement of Strategy. Should there be separate Code-related guidance in relation to bespoke valuations?

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

Yes, this is essential. We note that you intend to produce some Fast Track guidance that will set out the information trustees will be expected to submit as part of their Fast Track submission and that scheme actuaries will be required to confirm as meeting Fast Track parameters.

However, as per our response to Question 1 it should not mean no explanation of covenant is required.

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

This will depend on the exact wording of the confirmation that is required. Most of the confirmations you seek are factual matters, as you say, although satisfaction of the technical provisions and investment risk parameters is calculation dependent.

We strongly encourage you to take any judgement out of the confirmation and in particular (as you have noted) to not require the scheme actuary to essentially confirm compliance with the Code itself.

We suggest wording similar to the below (with any appropriate references added):

I confirm that:

- *The technical provisions are at least as high as the “Minimum technical provisions percentage” of the [Scheme]’s Fast Track Low Dependency liabilities, based on my calculation of the duration of such liabilities as at the valuation date;*
- *The assumptions underlying the [Scheme]’s Low Dependency funding basis are at least as strong as the [Scheme]'s Fast Track Low Dependency basis where such assumptions are prescribed;*
- *The Recovery Plan length is not greater than the relevant Fast Track length, being [6/3] years given the [Scheme] [has/has not] reached its relevant date;*
- *The Recovery Plan makes no allowance for investment outperformance in excess of the technical provisions discount rate;*
- *The Recovery Plan satisfies the prescribed conditions relating to back-end loading; and*
- *The results of my calculation of the Funding and Investment stress test show a lower fall in funding level than the appropriate parameter derived from [Table 2] based on the [Scheme]’s duration.*

This statement only confirms that the above tests and conditions are met and, in particular, does not constitute an opinion on whether or not the legislation and principles in the code are being complied with.

The above confirmation would need to be modified as necessary to confirm whether the position allows for post-valuation experience (see question 15).

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

We don't see the need. Indeed, we think this would add complexity and ambiguity which would be unwelcome and may make confirmation by the scheme actuary more difficult.

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

It would be helpful to see similar analysis to that included in the consultation document but using more recent financial conditions and based on your final decision about how duration will be assessed.

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

No, for the reasons you give. Again, we think this would add complexity and ambiguity which would be unwelcome and may make scheme actuary confirmation more difficult. We agree with your expectation, set out in the Code, that trustees with sponsoring employers in this situation should consider the likelihood of insolvency and make the appropriate funding arrangements depending on their circumstances.

8. Do you agree with our approach of setting the Fast Track technical provisions test as a percentage of the low dependency funding basis liabilities? If no, explain why and what would you suggest as an alternative?

Yes. This seems a practical and sensible test.

9. Do you agree with the limits we have proposed? If no, explain why and what would you suggest as an alternative?

Yes, it seems broadly reasonable to us to construct the limits on the basis of Table 6 (60% growth, 14% corporate bonds, balance in gilts but leveraged two times, subject to a maximum hedge ratio of 100% of the value of the assets) for duration 17 years and above, trending down to the limits set out in table 5 at duration 12 (15% growth, 30% corporate bonds, 48% gilts and 7% cash). However, this is subject to the proviso as to whether duration (based on current market conditions) and 12 is the right measure and number in order to set the point at which significant maturity is reached. We don't think it is and we have covered points on this elsewhere in our responses.

10. Do you agree that for a Fast Track low dependency funding basis measure, the minimum strength of the discount rate basis should be gilts + 0.5% with no inflation risk premium?

Yes, this seems a sensible, conservative discount rate to use for this purpose. However, it would be helpful to clarify that the choice of gilt yield curve can be set by the scheme actuary. Table 5 says that the Bank of England curves are "suitable". We note that there are significant limitations of these curves and, as a result, many consultancies derive their own gilt yield curves. These should be permitted under Fast Track in order to avoid extra costs and complexity.

11. Do you agree that our approach to other assumptions in the Fast Track low dependency funding basis (as set out in Appendix 1) is reasonable? If no, which assumptions would you suggest are amended and how?

Generally, yes, but we have the following comments:

- **Inflation:** the deductions to calculate CPI seem prudent – in our view a reasonable deduction would be 1.0% pre 2030 and 0.1% post 2030, reflecting that long term CPIH is expected to be higher than CPI.

  In order to hedge liabilities accurately there are good reasons to use a best-estimate CPI assumption and incorporate prudence elsewhere in the funding basis.

- **Pension increases:** we note from the consultation document that you intend, in future, to specify assumptions for inflation-linked pension increases subject to caps and collars. In this respect, we do not think specifying a particular model would be helpful here (if this was the intention).

- **Expenses** – the wording here is very ambiguous and on a strict reading the implication is no expense reserve is required in the Fast Track low dependency funding basis. We now understand from conversations with you that the intention is that an expense reserve will be required at least in some cases. We ask you to be as clear as possible in specifying ALL required assumptions to meet Fast

Track – any ambiguity will make it very difficult for scheme actuaries to confirm compliance.

- **Scheme options** – the stated requirement that scheme options should only be allowed for to the extent they increase the liabilities in the low dependency funding basis, effectively prohibits allowing for commutation which is inappropriate. We now understand from conversations with you this is not the intention, and that "other options" here has the same meaning as in Appendix 3 of the Code. We again ask you to be as clear as possible in specifying all required assumptions to meet Fast Track – any ambiguity will make it very difficult for scheme actuaries to confirm compliance.

- More generally, the need to be stronger on every individual assumption to pass the "low dependency funding basis" part of Fast Track is very restrictive – we would prefer the test is an aggregate test similar to the Technical Provisions test.

12. Should we allow more flexibility for smaller schemes in relation to any of the assumptions?

No. Again this would add more complexity for little benefit in our view.

13. Do you agree that the maximum recovery length after significant maturity should be set to three years rather than six? If no, explain why and what you would suggest as an alternative.

We note that given the recovery plan length is measured from the valuation date, this in effect means a recovery plan length of around 21 months from when valuations may be signed off. We think a change is needed here (see Question 14).

We also would like you to clarify whether the six changing to three years is a "cliff edge" based on a binary measure of whether significant maturity has been reached at the valuation date. Would it be better, for a scheme that is close to significant maturity, for the maximum recovery plan length to be the lesser of 6 years, and 3 years after the expected date of reaching significant maturity?

Lastly this is another area where a more conservative approach than Fast Track (ie shorter recovery plans) could be appropriate in some cases, and hence where compliance with Fast Track does not automatically mean compliance with the Code.

14. Do you agree with our approach of using the valuation date as the starting point for the recovery plan length?

No – we think it should start from the date the schedule of contributions is certified as this is from when the recovery plan will operate.

15. Do you agree with our approach to how to allow for post valuation experience in Fast Track recovery plans? If no, explain why and what would you suggest as an alternative?

Yes, and the Fast Track provisions seem to be no different to what is set out in the Code.

We would appreciate clarification as to how Fast Track confirmation would work where post valuation experience is used – would the Scheme Actuary be confirming all tests based on the valuation date position (presumably not where post-valuation experience is allowed for), all tests based on the position at the date of signing the valuation, or some combination?

We note one particular example where the Trustee changes a scheme's investment strategy between the date of valuation and the date of signing, which may materially impact the position against the funding & investment stress test. Where allowance is being made for post valuation experience, should the test be carried out based on the strategy at the valuation date, or at the signing date (we presume the latter?).

16. Do you agree that annual increases to deficit repair contributions should not be more than CPI? If no, what would you suggest as an alternative?

Yes, at a high level but this needs significant clarification including in relation to irregular patterns of contributions. For example, what if contributions step up post the valuation date as a result of a new valuation agreement? What if the first contribution is very high, then there is a significant step down, then a step back up again such that the 3rd contribution is much higher than the 2nd?

We'd also like clarification on whether the linkage is to be based on actual CPI, or the CPI assumption at the valuation date, or whether it could be either.

17. Do you agree with our approach for the stress test? If no, explain why and what would you suggest as an alternative?

Yes, it seems reasonable to base the approach on that required by the PPF in its 2023/24 levy calculation.

However, we would like clarification on the treatment of bulk-annuity "buy-ins". We had assumed they should be treated equally on the asset and liability side, but this does not seem to marry up with the approach being described.

18. Do you agree with the limits we have proposed? If no, explain why and what would you suggest as an alternative?

Yes.

19. Do you agree with how we have allowed for schemes in surplus within the stress test?

Yes, we are supportive of the approach 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.

20. Do you agree it is reasonable to use the Pension Protection Fund Tier 1 asset classes? If no, what do you suggest as an alternative?

Yes, we do.

21. Do you agree that smaller schemes should not have to produce cash flows to calculate projected duration?

Perhaps, but it is not clear that this meets the requirements of the regulations. From our perspective a consistent approach (or at least the option to use a consistent approach) would be preferable.

22. Do you agree with the proxy we have proposed for smaller schemes?

Yes.

23. Do you agree with our definition of smaller schemes for this purpose?

Yes (those with fewer than 100 members). Though we think this should refer to DB members only.

24. Do you agree that six years is a reasonable Fast Track parameter for the allowance of extra accrual in open schemes? If no, explain why and what would you suggest as an alternative?

Yes, we do.

25. Do you agree with our approach for new entrants? If no, explain why and what would you suggest as an alternative?

No (assumed level not to exceed the average level over the three years preceding the current valuation). In practice, we suggest the allowance for new entrants would not be to assume a certain number each year. Such a measure is also clearly unworkable as a limit as, if the limit were (say) 100 new members, you could assume 100 people with £20,000 pa salaries or 100 people with £50,000 pa salaries and get a completely different result. It makes more sense to limit the impact of new entrants by reference to the total pensionable payroll – so for example new entrants not to increase the payroll in real terms.

26. Do you think having no additional restrictions on future service cost will weaken the Fast Track approach significantly?

We don't. We think the extra flexibility is very helpful especially for shared cost schemes. Scheme actuaries will have to certify the Schedule of Contributions in any case so your proposed approach is good.

27. Which of the options for reviewing our parameters do you prefer?

We agree with your deep dive approach every three years in relation to all the Fast Track parameters and we note the need for extraordinary reviews following significant changes in market conditions.

As to your two options under 'business as usual' conditions, we express no preference. Our key concern is for schemes that have adopted Fast Track, not to be forced into Bespoke as a result of your either making changes to the Fast Track parameters as a result of changes in economic and financial conditions, or not making changes sufficiently quickly.

In either case we encourage you to publish the outcome of any review as soon as possible and much sooner than the annual DB funding statement, at least based on current timings – as this often has a significant delay relative to the valuation dates to which it relates.

28. Do you think a different approach to reviewing our parameters is preferred?

No.

29. What further analysis do you think would be helpful to illustrate the potential impacts of any final regulations and code?

We think that you need to revisit your modelling, using more recent market conditions given the significant rise in bond yields during 2022. The modelling should allow for your conclusions regarding duration. The modelling should also allow explicitly for the potential impact on stressed schemes, defined as schemes who may be expected to not be able to meet the new regime.

Regarding your published analysis, we think that the likelihood of schemes "levelling down" their approach to technical provisions is lower than you make allowance for in your central estimate. We also note that even if such "levelling down" takes place, it will be of little comfort to the sponsors of those schemes required to "level up" for whom there is still a large expected cost from Fast Track. We suggest you acknowledge this in the impact analysis.