Defined benefit funding code of practice consultation

RESPONSE FROM ICAS TO THE PENSIONS REGULATOR

2 September 2020

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Background

ICAS is a professional body for more than 22,000 world class business men and women who work in the UK and in more than 100 countries around the world. Our members have all achieved the internationally recognised and respected CA qualification (Chartered Accountant). We are an educator, examiner, regulator, and thought leader.

Almost two thirds of our working membership work in business; many leading some of the UK's and the world's great companies. The others work in accountancy practices ranging from the Big Four in the City to the small practitioner in rural areas of the country.

We currently have over 4,000 students striving to become the next generation of CAs under the tutelage of our expert staff and members. We regulate our members and their firms. We represent our members on a wide range of issues in accountancy, finance and business and seek to influence policy in the UK and globally, always acting in the public interest.

ICAS was created by Royal Charter in 1854.

General comments

We are broadly supportive of the direction of travel set out in the consultation document and we believe that the twin track approach to compliance within the Funding Code of Practice will be a good way of enabling TPR to target its resources more effectively. The approach will also give clarity to both trustees and employers as to what is expected of them. We also support the integrated risk management model which will continue to underpin how schemes are managed and regulated.

We have responded to selected questions only and our responses to these are set out in the Appendix.

We are content for our response to the consultation to be made public. Any enquiries should be addressed to Christine Scott, Head of Charities and Pensions at cscott@icas.com.

Appendix

Responses to consultation questions

Chapter 3: Proposed regulatory approach

Question 1
Twin track compliance. Do you think twin track compliance is a good way of introducing objectivity into a scheme-specific regime? What are your views on the proposals set out above? If you disagree, what do you propose instead?

Response
We are broadly supportive of the direction of travel of the proposed regulatory approach, in particular for closed schemes, and we believe that the twin track approach to compliance within the Funding Code of Practice will be a good way of enabling TPR to target its resources more effectively. The approach will also give clarity to both trustees and employers as to what is expected of them. We also support the integrated risk management model which will continue to underpin how schemes are managed and regulated.

It makes sense that under the new approach schemes can move between fast track and bespoke. It will be appropriate for schemes within fast track to establish from time to time whether they continue to meet the criteria but the flip flopping of schemes between regimes too frequently should be avoided.

We are aware of concerns expressed by the industry that the twin track approach could result in schemes not taking sufficient risk within their investment strategies, i.e. schemes seeking to meet the fast track criteria taking insufficient risk and this having a knock on effect on the investment strategies of schemes taking the bespoke route. This would put an additional, potentially unnecessary, cash demand on the employer.

With the proposed regulatory approach intended to operate over the very long-term and concerns about its impact on the investment strategies of schemes, it would make sense to undertake a post-implementation evaluation of twin track in, say, three to five years of commencement.

Given the impact of the COVID-19 pandemic on the covenants of sponsoring employers (particularly those in the worst hit industries) and on schemes, it is inevitable that this will impact on the number of schemes likely to be eligible for fast track.

Extremely low interest rates generally and the low rates applied to the calculation of scheme liabilities could also impact on the eligibility of schemes for fast track. We have already seen contribution holidays as a result of the COVID-19 pandemic and this needs to be considered by TPR in assessing whether a scheme's recovery plan length is reasonable. Recovery plans may now need to be a bit longer than envisaged in the consultation.

We note that, during August, TPR made an announcement recognising that the fast track approach will need to be adjusted to take account of the impact of low interest rates. This should therefore increase the number of schemes likely to be eligible for fast track, compared to no action being taken by TPR in this regard.

If fewer schemes are eligible for fast track than initially envisaged, it is likely that TPR will have to spread its resources more thinly across schemes taking the bespoke route, leading to TPR having to target its resources even more effectively to ensure that schemes requiring more intense supervision receive it.

We recommend that the impact of COVID-19 pandemic on the operation of the twin track approach is considered by TPR in the next consultation on the Code of Practice which is currently expected in spring 2021. This would be with a view to ensuring the new approach is sufficiently flexible to deal with any future economic shocks, including the ability to revisit the criteria for fast track as is currently planned in relation to the impact of low interest rates.

We understand that TPR intends to move forward with the implementation of a revised Code of Practice and recommend that the industry is kept up to date with any further changes to the planned timetable for the second consultation and for the implementation of the new Code. We recognise that the Code cannot be finalised until the final legislative package is available and would urge TPR to ensure that the Code is not implemented in haste, given the current circumstances.

Chapter 4: Employer covenant

Question 2
Insolvency risk and reliance on covenant. Do you think the risk of member benefit reductions on insolvency is an acceptable part of the existing regime and that trustees should be able to place some reliance (whether implicit or explicit) on the employer covenant? To what extent do you think this should be the case? Do you think this risk is well understood by scheme members?

Response
We believe that trustees should place some reliance on the employer covenant. Not doing so would have implications for sponsoring employers and other key employer stakeholders by placing greater demands on the employer's cash flow.

There is no practical and effective way to remove entirely the risk of member benefit reductions on the insolvency of an employer but we believe that placing some reliance on the employer covenant reduces, rather than increases, the risk to member benefits across the population of schemes as a whole.

Most companies will still be in existence in the medium to long-term. In managing their schemes, trustees need to understand the employer's business drivers and the risks carried by the employer covenant and the broader prospects for the employer's industry sector (both downside and upside risk). Essentially trustees need to manage their scheme based on an analysis of strengths, weaknesses, opportunities and threats (SWOT).

Therefore, we believe it should be possible for schemes to meet the criteria for fast track even when their deficit recovery plan is longer than the visibility of the employer covenant.

We do not support the introduction of more ratings bands for the employer covenant as this could create spurious accuracy given that an employer covenant assessment is made up of both quantitative and qualitative elements.

We believe that people generally have difficulty understanding pensions. In terms of DB scheme members, we believe that most really do not understand that there is a risk of not receiving all the DB benefits they expect. Equally people do not understand the extent of benefit from investment and longevity risk being underwritten by their employer rather than on the individual in DC schemes.

The PPF also provides a significant underpin for members, mitigating to a large extent the employer insolvency risk.

While it is important for scheme members to gain a better understanding of the risk of benefit reductions, this is a sensitive area, for example, there are commercial sensitivities around the communication of sponsor covenant strength and communicating risks specific to the sponsor could cause members undue concern.

A way of addressing these tensions could be for member communications to explain the risk in general terms, although any 'health warning' should be carefully worded, for example, through explaining what the trustees are doing to secure member benefits.

Chapter 5: General principles

Question 7
Low dependency on the long-term objective (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?

Response
Yes, we agree that schemes should have a low level of dependency on the employer by the time they are significantly mature.

The cystallisation of any downside risks when a scheme is mature could have a very significant cash impact on the employer, so low dependency on the employer covenant is strongly desirable.

We believe that as schemes move towards meeting their long-term objective consideration should be given to including flexibility within the funding plan between valuations. It is important that employers continue to support schemes and for that support to reflect how well the employer is doing, therefore, some scope to increase deficit funding contributions in between valuations would assist in reducing the scheme's dependency on the employer.

However, for some schemes meeting an LTO may not be achievable, for example, where agreeing a funding plan that is affordable for the employer is challenging and the covenant horizon is longer than the average: some charities and other non-profit distributing entities may be in this position. Therefore, a 'comply or explain' approach towards adopting an LTO may be workable whereby trustees not adopting an LTO have to demonstrate that risks are being managed appropriately according to covenant strength.

We recommend that TPR includes definitions for 'significant maturity' and 'maturity' in the next Code of Practice consultation.

Question 8
Timing of the LTO. What factors should influence the timing of reaching the LTO? Do you think that the timing should be linked to maturity?

Response
Yes, we agree that the LTO should be linked to the maturity of the scheme.

The LTO needs to factor in the insolvency risk of the employer covenant and the need to treat other key stakeholders such as shareholders, creditors and employees not in the DB scheme equitably.

Question 12
Relevance of investments for funding. Do you agree that the actual investments and investment strategy are a relevant factor for scheme funding?

Response
Yes, we agree that actual investments and the scheme's investment strategy are a relevant factor for scheme funding.

It is important for the level of anticipated investment returns to be considered as part of scheme funding to manage the risk that the scheme will become overfunded. While many schemes are far away from a scenario when they become overfunded, consideration could be given to a change which allows any surplus to be returned to the employer. This may provide encouragement for a faster rate of funding for pension schemes.

Another factor which needs to be considered is the ability of the employer to mitigate any downside risk which could come to fruition in relation to the performance of scheme investments.

Question 13
Broad consistency of investment and funding strategies.
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 technical provisions (TPs)), should trustees have to demonstrate that the investment risk taken can be managed appropriately? If not, why not and what would you suggest?

Response
Yes, we agree that the investment strategy should be broadly consistent with the level of current and future investment risk in the funding strategy. However, where a scheme could meet the fast track criteria but takes more risk and therefore falls within bespoke, the trustees should be required to explain why they have taken this approach and provide evidence to support their decision. This may include providing evidence that the employer is able and willing to support any downside risk, including where contingent funding mechanisms are in place or where there is longer-term visibility of employer covenant.

In relation to b), trustees need to be able to demonstrate that investment risk can be managed appropriately, i.e. that downside risk can be underwritten by the employer. This means that the trustees will need evidence from the employer that it can do so and/or of additional security to be provided.

The investment strategy needs to be proactively managed by the trustees and not just reviewed every three years to coincide with the funding valuation. However, the need to micro-manage the strategy should be avoided and the investment strategy should be set with this in mind.

The funding valuation takes place on a set date. However, point in time valuations are not in themselves a sufficient basis on which to determine the needs of the scheme so it is important to look beyond the scheme's position on a particular day when agreeing a funding plan.

In our response to question 7, we also mention the possibility of adjusting the funding plan between valuations if circumstances change. A well thought out plan would likely include criteria which, if met, would trigger a review.

Question 15
Covenant visibility.

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

Response
In response to a), we believe that covenant visibility is an element which should be considered by the trustees in determining the extent to which they intend to rely on the covenant. However, the trustees' understanding of both micro and macro level risks relevant to the employer covenant are also key considerations and the time horizon for these risks extend beyond the period of covenant visibility. Therefore, trustees need to have a good understanding of the scheme's strategy for managing the employer covenant and an understanding of the type of scenarios and events that can impact on the employer covenant, in particular downside risk.

An approach to the employer covenant which is too prudent could inhibit the employer's ability to invest in the sustainability and growth of the company which would be counter-productive to scheme members and to other key stakeholders.

In response to b), we agree that in general there is reduced visibility beyond 3-5 years. However, for some employers which for example: have a strong position in a sector with a positive outlook; have long-term contracts; or a cash generating asset base, and a strong risk mitigation culture, then it would be reasonable for trustees to consider the visibility of covenant to be longer than this.

Question 16
Use of additional support. Should additional support, such as contingent assets and guarantees, be allowed in scheme's funding arrangements provided they are sufficient for the risk being supported, appropriately valued, legally enforceable and realisable at their necessary value when required?

Response
Yes, we would encourage the use of contingent mechanisms. The use of additional support highlights the importance of timely and effective covenant reviews and significant reliance on the covenant adviser.

Question 17
Appropriateness of recovery plans and affordability as a key factor
a) Should employer affordability be the key factor to determine the appropriateness of a recovery plan? 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 technical provisions and size of deficits) to have a commensurately shorter recovery plan?

Response
In response to a), we agree that employer affordability should be a key factor in determining the appropriateness of recovery plan length. However, affordability should be viewed in the context of both treating all key stakeholders equitably and allowing investment in the sustainable growth of the employer. Such an approach would also avoid excessive dividends being paid to investors.

In response to b), we also agree that schemes with a stronger employer covenant should have a commensurately shorter recovery plan.

Recovery plans should be no longer than they have to be and again this emphasises the importance of the covenant review.

Chapter 11: Recovery plan

Question 39
Fast track guidelines on recovery plan length
a) What are your views on the principles set out above in relation to recovery plan length under fast track? In particular, do you have views on what may be appropriate recovery plan length thresholds for different covenant strengths? Is it helpful to frame these in terms of the typical multiple of valuation cycles (i.e. three years)?
b) Do you consider it would be more appropriate to have a single maximum guidance recovery plan length and to expect trustees (under the bespoke framework) to justify any plans that are longer than this?
c) Do you think fast track recovery plan lengths should be shorter for schemes nearing and/or at significant maturity? If so, to what extent?

Response
In response to a), we agree that it is appropriate for covenant strength to influence recovery plan length. Also, as we have referred to previously, we believe that the affordability of contributions should be considered in conjunction with the equitable treatment of other key stakeholders. Additionally, the ability of the employer to invest in the on-going sustainability of their business, i.e. to invest in the employer covenant is also an important factor which should be considered.

In response to b), we think it would be reasonable to have a single maximum recovery plan length and for trustees to justify any plans longer than this, under the bespoke framework. However, trustees should still be required to justify recovery plan length, with perhaps more evidence provided for those at or reaching the maximum permitted.

In response to c) we believe it is reasonable for schemes nearing and/or at significant maturity under fast track to have shorter recovery plans than other schemes.

Chapter 14: Additional support

Question 52
Trustees' assessment of additional support in bespoke arrangements
Do you have any views on the framework we set out for trustees to assess the appropriateness of additional support in bespoke arrangements? If you disagree, what do you suggest?

Response
We are supportive of the framework set out to assess the appropriateness of additional support in bespoke arrangements.