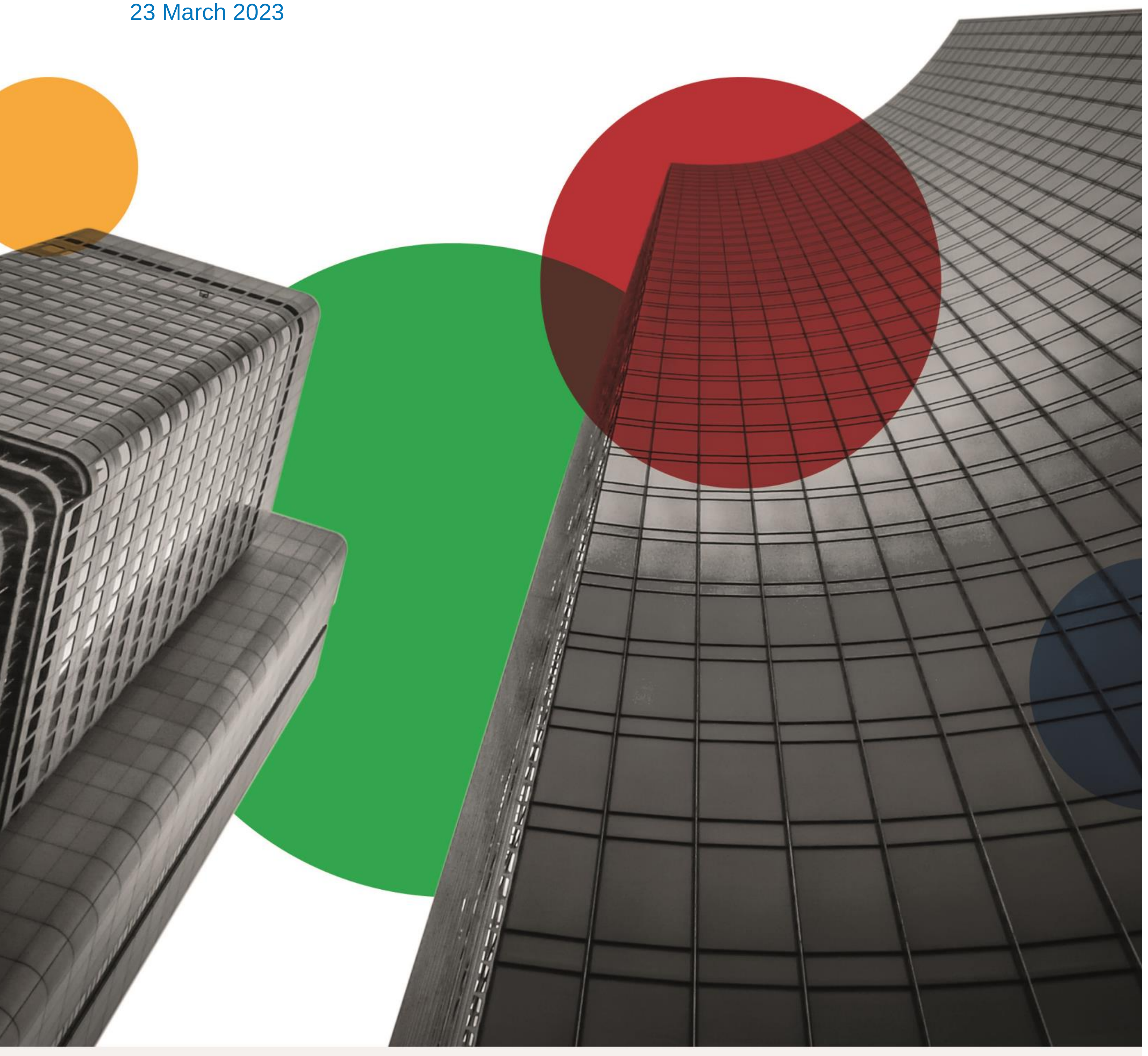
Consultation on the Defined Benefit Funding Code of Practice

Response from ICAS to The Pensions Regulator

23 March 2023



ICAS

Introduction

The ICAS Pensions Panel submitted comments to The Pensions Regulator (TPR) on its Defined Benefit (DB) Funding Code of Practice. Our comments were submitted to TPR online and are replicated below under the heading 'Responses to specific questions'.

Responses to specific questions

Code chapter 6 - Assessing the strength of the employer covenant

Assessing the strength of the employer covenant

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

Response
Yes, broadly speaking we agree with the definitions for visibility, reliability and longevity. However, there is scope for subjectivity in the application of the definitions.

Without TPR's covenant monitoring guidance being available, it is likely that advisers will take an overly cautious approach to evaluating time periods, particularly in view of the new criminal sanctions introduced by the Pension Schemes Act 2021.

Where advisers take an overly cautious approach there will be an acceleration of cash required from sponsoring employers, meaning that there will be less cash available for re-investment in the employer's business or to contribute more to the pensions of employees saving into a Defined Contribution (DC) pension. There is an intergenerational fairness element to the acceleration of cash into DB schemes as these are more likely to benefit older workers (often no longer associated with the employer) rather than younger workers who have not had the opportunity of a DB pension in retirement.

We hope that TPR's covenant monitoring guidance will provide examples and this should increase understanding of the Code and reduce the risk of advisers being overly cautious.

It would be helpful for the covenant guidance to include examples for multi-employer and not-for-profit schemes. For example, if a multi-employer scheme is targeting self-sufficiency, the Code should not require contributions from employers which would result in a buy-out level of funding.

Where a buy-out level of funding has been achieved by a multi-employer scheme or another DB scheme, the funding level will continue to improve as deferred members retire, in such circumstances there is highly likely to be a risk of overfunding.

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

Response
The assessment of cash generation can be complex, for example where an employer's business has long-term contracts, significant working capital cycles or operates in a market which has a high level of cyclicality. However, broadly speaking, we agree with the approach set out for assessing the sponsoring employer's cash flow. The draft Code recognises that it will sometimes be appropriate to use a suitable proxy to assess the sponsoring employer's cash flow and reference to possible alternatives is helpful. We encourage TPR to include some examples of suitable proxies in the upcoming covenant monitoring guidance. For example, it may be appropriate for the assessment of the employer's cash flow to consider cash generation as an average over a small number of years.

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

Response
Yes, we broadly agree with the proposed approach with reservations. We support the list of factors set out as being those which are relevant to the sponsoring employer's prospects. However, we are less clear as to how to quantify those elements in order to determine the employer's covenant reliability and longevity in years. Therefore, while the broad principles set out in the Code are reasonable, the practicalities of applying this aspect of the Code do need to be set out in covenant monitoring guidance.

Question 21
Do you agree with the principles we have set out for contingent assets, i.e. 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?

Response
Yes, we agree with the principles set out in the Code for contingent assets.

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

Response
Yes, we believe that the draft Code deals appropriately with the scenarios for valuing security arrangements.

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

Response
No, we are not entirely in agreement with the approach set out in the draft Code for valuing guarantees.

The term 'unfettered ability' is used in paragraph 156 to describe guarantees where trustees can claim against the guarantor, for example, in a group situation, unless revoked by the trustees. This could be interpreted as the trustees having the power to enforce the guarantee without legal constraint but, in reality, the trustees will be bound by the terms of the guarantee, for example, it may only be enforceable if the employer defaults on a payment to the scheme or if the employer has experienced an insolvency event. We recommend that some clarification wording is included in paragraph 156 so it is clear that 'unfettered' is the ability to enforce the guarantee, subject to terms. Furthermore, we consider that some recognition should be allowed in relation to benefits from guarantees if they are of sufficient time period and value relative to the scheme's significant maturity timescales and covenant longevity period.

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

Response
We do not entirely agree with the approach taken in the Code to the covenant assessment of multi-employer schemes, although we do welcome the inclusion of a Code section about these schemes.

There are some practical difficulties with the design of this area of the Code and the area of the Code on not-for-profit covenant assessments.

We recommend that this section of the Code starts with the trustees being directed to the appropriate Code material based on features of the scheme. The key features impacting on covenant assessment which require consideration are, whether:

- The scheme is segregated or last man standing.
- The scheme is open or closed to future accrual. There is currently no mention in this section of the Code relating to schemes which are open to future accrual.
- The employer derives its cash flow from commercial income or from grants and donations (for charities, cash flow could be derived from a combination of sources in different proportions).

Where the scheme is segregated and closed to future accrual, it will be appropriate for the trustees to take the same approach to covenant assessment as a standalone scheme which is closed to future accrual.

There is an overarching premise that the Code should be applied proportionally but it may be worth emphasising in relation to last man-standing multi-employer schemes that the extent of covenant assessment work should take into account the significance of the employer or smaller employers combined to the overall sustainability of the scheme. Some last man standing schemes have more than 1,000 employer members and others less than 20 so this is a significant issue if a matrix approach is taken to covenant assessment.

Also, for last man-standing schemes there are multiple variables to consider as illustrated by the draft Code and if these are considered for each employer, the number of employers in the scheme will have a significant impact on the resources devoted to the covenant assessment and its cost.

Whether a scheme is open or closed to future accrual is a significant feature as in open schemes some employers will be accruing liabilities, meaning there is a future service accrual risk which needs to be addressed within the covenant assessment. Where an employer is open to future accrual in a last man-standing scheme, the extent of the employer's Section 75 debt is a matter for consideration viz a viz the comparative risk employers present to the scheme. We are of the view that it is not feasible to protect accrued benefits in isolation.

Where an employer's active member numbers in a last man-standing scheme are low there is a greater likelihood that a Section 75 debt may be triggered inadvertently. This is relevant to the trustees consideration of the effectiveness of guarantees and security. We are aware of circumstances where employers and guarantors have agreed to a weakening of the guarantee (without formal recourse to the scheme's trustees) so this possibility should be considered as part of the covenant assessment process.

Where a scheme is a sector based scheme, there may be some compliance benefits in terms of efficiency. However, this will depend on the level of oversight a sector regulator gives to sector-based schemes.

Question 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?

Response
We do not entirely agree with the approach taken in the Code to not-for-profit covenant assessments, although we do welcome the inclusion of a Code section about these schemes.

We note that it is fairly common for not-for-profit sector employers to participate in multi-employer schemes so for some schemes the not-for-profit and multi-employer Code material will both be relevant to their covenant assessments.

Paragraph 166 refers to the need to consider the impact of restricted funds on the use of the employer's cash flow as contributions to the scheme.

Not-for-profit sector organisations, for example, charities, may also have designated funds, where the charity trustees have set aside cash resources to fund a discretionary project. Designated funds will therefore impact on the use of cash flow as contributions to the scheme, especially where a charity has contractual commitments.

There are other scenarios impacting on the availability of charity cash flows as contributions to the scheme. For example, a grant-making charity may award multi-year grant funding to a third party. Under accounting rules, the grant-making charity may be required to recognise the amount of the multi-year award as expenditure in the financial year the award is made, depending on conditions it places on the grantee, although it may already be holding and continue to hold for a period of time the cash and investments it intends to use to fund its grant commitments.

The scope of the work envisaged in paragraph 168 on the assessment of prospects is very considerable and this will impact on the cost involved in making the assessment, especially where the scheme is also a last man standing multi-employer scheme. For example, what would assessing the employer's public profile involve and would comparative assessments covering all employers need to be undertaken?

We believe that a more pragmatic approach is needed to assess the prospects of not-for-profit employers by focusing primarily on the scheme's access to cash and assets.

In undertaking the covenant assessment, it may be more efficient and effective for scheme trustees or their equivalent to consider 'worrying signs' than to undertake a full assessment of the employer's prospects. This is an area for potential further guidance from TPR.

Chapter 7 – Journey planning

Approach to covenant visibility in the journey plan

Question 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?

Response
Yes, we agree that the journey plan should be split between the period of covenant reliability and the period after covenant reliability. However, the tone of the Code focuses on a point in time assessment, whereas in practice the covenant reliability period will continue to extend. We also refer you to our response to question 18 above in relation to the potential for overly cautious approaches to the assessment of covenant reliability.

Period after covenant reliability

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

Response
No, not entirely. In general terms, the covenant reliability period will extend over time, in that as you move one year further, the period of reliability will move out correspondingly. The concept of 'after covenant reliability' is one that is therefore theoretical unless the employer is experiencing distress.

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

Response
No, not entirely. Paragraph 304 of the Code mentions an alternative, albeit less common, use of available cash as making contributions to other DB schemes.

We believe that consideration should also be given to contributions to DC pensions, above the auto-enrolment minimum, being viewed as an alternative use of available cash. We believe that where employers are contributing above the auto-enrolment minimum this should be seen as a good thing and should be viewed in the context of the pace and affordability of DB scheme funding.

Question 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?

Response
No, not entirely. In practice, many schemes are being funded to their long-term funding target and sometimes buy-out with continued cash contributions from employers. For open schemes, the Code includes guidance around the option for open schemes to use a surplus for future accrual of active members.

We would like to see TPR begin to recognise that where schemes are in surplus on a buy-out basis, it may be reasonable to consider the equitability of other stakeholders which may include return of surplus to employers. In particular, where there have been significant historical cash contributions made by the employer over a number of years and subject to suitable downside risk protections.

We would also like to see the Department of Work and Pensions develop regulations which deal with the treatment of trapped surpluses.

When employers are asked to contribute additional deficit recovery contributions, conversations with the trustees can be more challenging due to sponsor concerns about trapped surpluses being created. This can result in alternative solutions being entered into which can be expensive to implement, for example, the setting up of an escrow account or some form of guarantee. If it was more straightforward to recover a surplus, this could reduce the expenditure on often costly time-limited solutions. It could also make conversations between the employer and the trustees more straightforward.

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