In Depth

The future of defined benefit scheme funding

The Pensions Regulator consults on a new framework

March 2020

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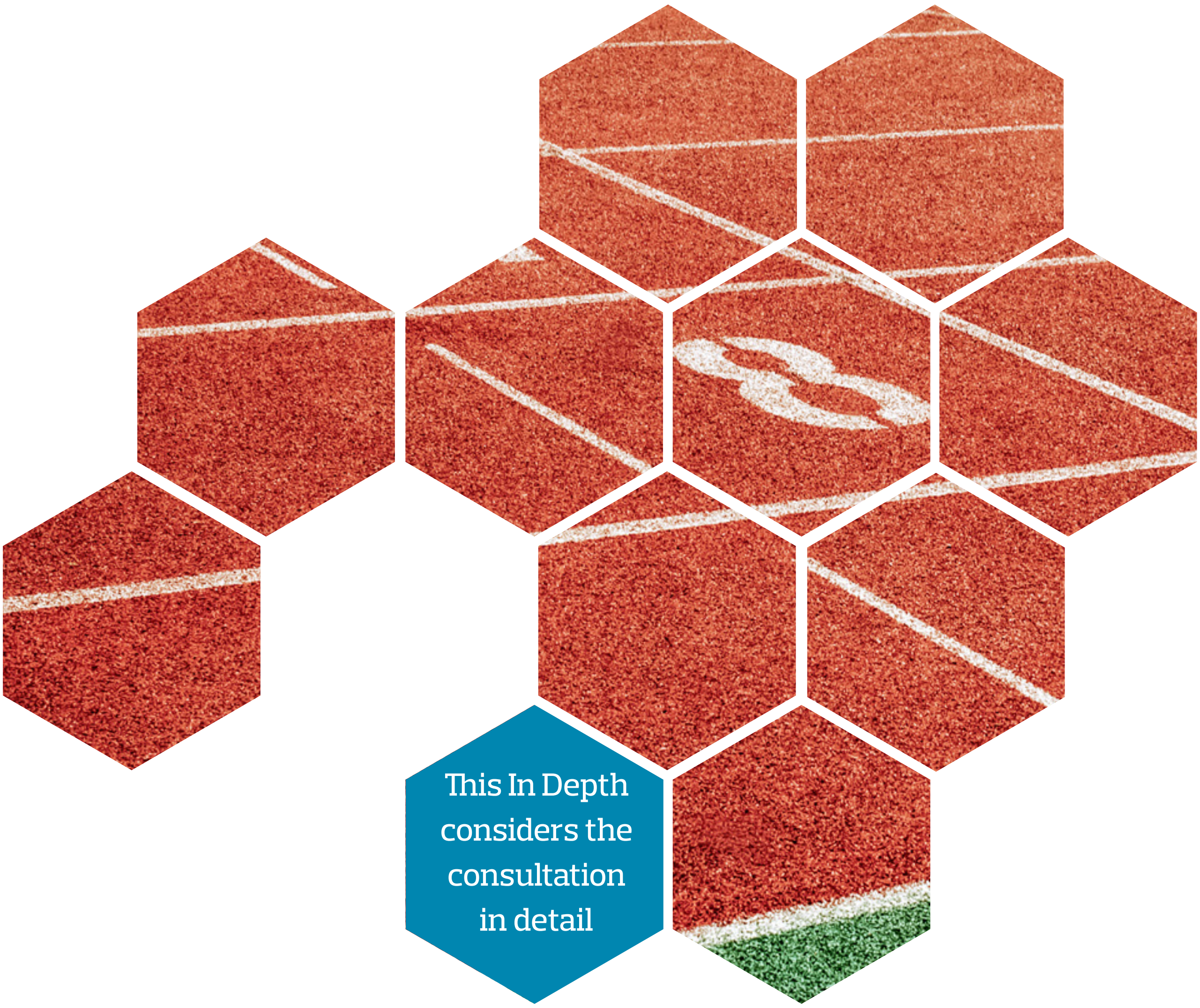
Contents

In a nutshell

For two years, the pensions industry has known that a revised code of practice for funding defined benefits is on the horizon. Following delays, in part caused by Brexit, the first of two consultations on the revised code has been launched.

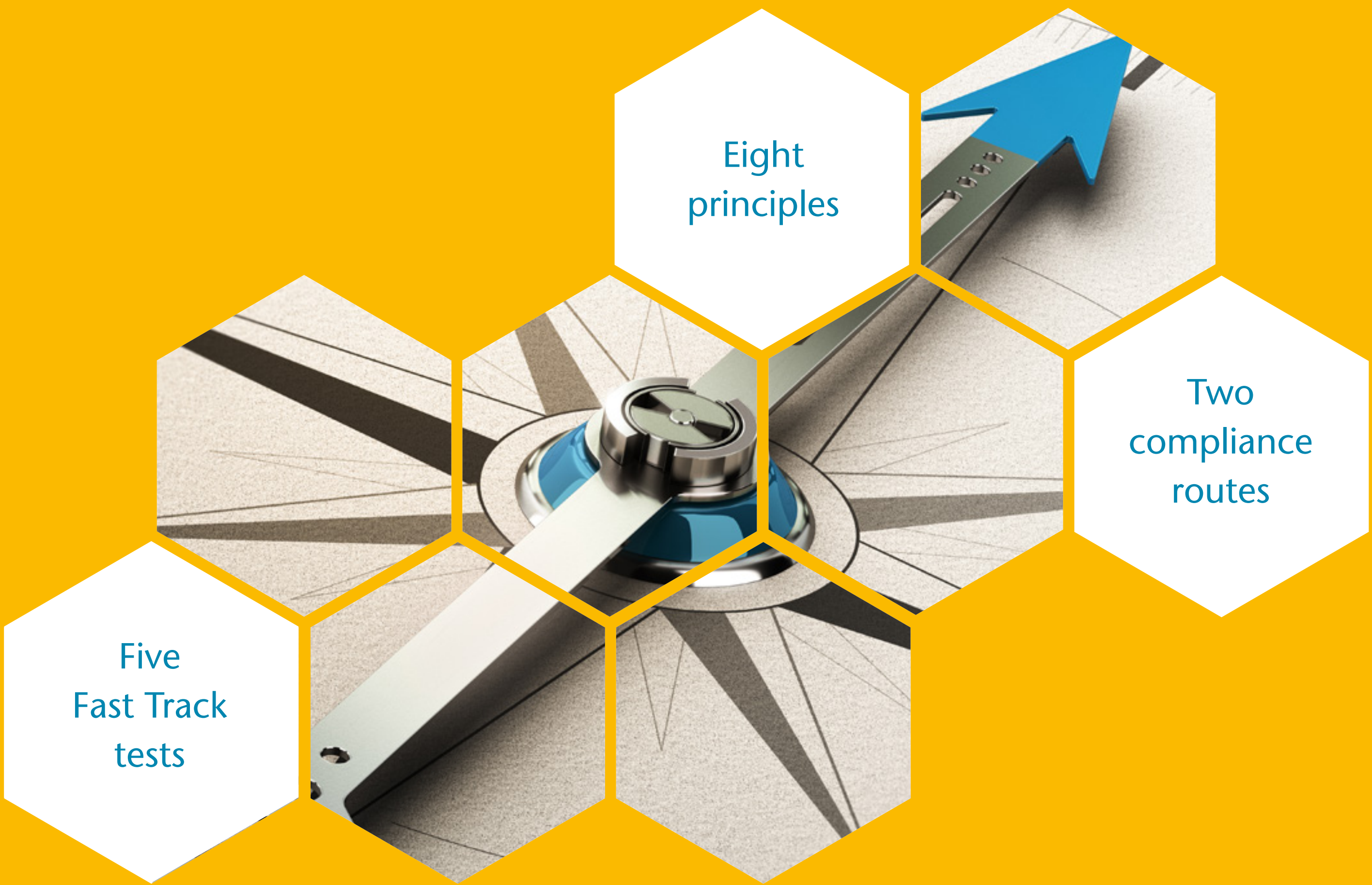
This In Depth considers that consultation in detail, including the eight core principles that have been proposed, and an analysis of the tests that will need to be passed for compliance under the Regulator's 'Fast Track' approach, or used as a benchmark for those schemes adopting its more flexible 'Bespoke' approach.



Background and overview

The rationale for revising the code of practice on funding defined benefits was set out in the DWP's White Paper, "Protecting Defined Benefit Pension Schemes", issued in March 2018. The DWP noted that, while the scheme funding regime is working largely as intended, providing the flexibility for individual scheme circumstances to be taken into account, some improvements are needed. It proposed to strengthen the Pensions Regulator's (TPR's) ability to enforce funding standards, through a revised code focusing on:

- How prudence is demonstrated when assessing scheme liabilities;
- Appropriate factors when considering recovery plans; and
- Ensuring a long-term view is considered when setting the statutory funding objective.



On 3 March 2020, TPR launched a consultation on a revised code, which attempts to address these issues, by giving greater clarity on what schemes are expected to do, and an updated framework that it will use to test compliance.

That consultation proposes the following key components:

- **Eight core principles** with which schemes will be expected to comply - these comprise of seven 'technical' principles plus an eighth under which trustees should be able to demonstrate compliance;
- **A two-track compliance framework**, requiring schemes to opt for a Fast Track or Bespoke approach, with the former being tightly defined and the latter having greater flexibility while still meeting the eight principles; and
- **A series of tests under the Fast Track approach**, covering key aspects of funding and investment, and allowing for long-term objectives.

The consultation is taking place as the Pension Schemes Bill progresses through Parliament. TPR's proposals are closely aligned to the legislative changes proposed in the Bill, which includes three measures that would be particularly relevant under the proposed new funding framework.

Firstly, a requirement for the Chair of trustees to sign off a written 'statement of strategy', detailing:

1. The scheme's 'funding and investment strategy' for ensuring that benefits can be provided over the long term, including the funding level the trustees intend to achieve "as at the relevant date or relevant dates" and the investments intended to be held on this date or dates; and
2. Supplementary matters including the extent to which the strategy is being successfully implemented, the main risks faced in doing so, and any significant decisions taken that are relevant to the strategy.

The funding and investment strategy will require the agreement of the employer (unless such agreement is not required to set contributions). The supplementary matters will require consultation with the employer.

Secondly, technical provisions will need to be calculated in a way that is consistent with the strategy, and regulations will allow recovery plan requirements to be more heavily prescribed.

Thirdly, TPR's powers under section 231 of the Pensions Act 2004 will be extended to enable it to give a direction "requiring the trustees or managers to revise the scheme's funding and investment strategy in accordance with the direction", where it appears to TPR "that the trustees or managers have failed to comply with any of the requirements of section 221A (funding and investment strategy) or regulations under that section".

This additional power, linked to the introduction of clearer guidance on what is deemed acceptable, could make it substantially easier for TPR to use its powers to direct the funding and investment strategies of pension schemes.

In preparing this In Depth, we have explained the proposals using a structure that we feel best captures the requirements, and their implications, rather than in the order in which they are set out in the consultation.

A new set of principles

The consultation proposes eight core principles, to underpin the revised code, with which schemes will be expected to comply when submitting their funding plans.

Those principles are outlined below, with Aon's comments in blue.

Principle 1
Demonstrating compliance and objective risk taking

TPR expects trustees and employers to be able to understand their scheme-specific funding and investment risks and objectively evidence how these risks have been assessed as remote or minimal or can otherwise be properly managed (i.e. supported and/or mitigated). Robust evidence should be provided when risks are genuinely unsupportable.

When demonstrating how risks are managed, trustees should be able to compare the risks they have taken to a tolerated risk position and then demonstrate the mitigation and/or support available.

Compliance can be demonstrated using either a Fast Track or Bespoke approach. In Fast Track cases, TPR does not expect to undertake substantial checks.

Principle 2
Long-term objective (LTO)

By the time they are significantly mature, TPR expects schemes to have a low level of dependency on the employer and be invested with high resilience to risk.

This principle will be central to the revised code and introduces for the first time a requirement that schemes look to the long term. The rationale for introducing such a principle now is the maturing of the typical DB pension scheme.

Starting with the wave of closures to new entrants in the 2000s, through the closures to future accrual in the 2010s, DB pension schemes have been maturing. As the liabilities of schemes increasingly become pensions in payment, and cashflow demands increase, the ability to withstand shocks reduces.

Principle 3
Journey plan and technical provisions (TPs)

TPR expects trustees to (i) develop a journey plan to achieve their LTO and (ii) plan for investment risk to decrease as the scheme matures and reaches low dependency. TPs should have a clear and explicit link to the LTO, and over time should converge to the LTO as evidenced by the journey plan.

Although many schemes have discussed, and even agreed, long-term targets, fewer have agreed a journey plan to get there, and fewer still a plan that sets out how TPs will strengthen over time. For schemes with different pre- and post-retirement discount rates, these allow for a convergence towards the lower post-retirement discount rate as a scheme matures but this may not be sufficient under the revised code.

Principle 4
Scheme investments

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

The funding code may directly impact on investment strategy for some schemes. The potential level of prescription on investment under the Fast Track approach (see below) is a new development for the scheme funding regime, and is likely to have a greater impact on more mature schemes.

Principle 5
Reliance on employer covenant and covenant visibility

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

TPR emphasises that in most cases there is unlikely to be covenant visibility beyond 3 to 5 years. This represents a change from the current position under which covenant visibility is often implicitly assumed for longer periods. The consultation does make it clear that, by the time of the next valuation, trustees would have renewed visibility over their employer's future strength (i.e. potentially covering 3 to 5 years from that valuation).

The impact of the allowance for covenant visibility may be particularly significant for mature schemes with strong employer covenants. The implication of the consultation is that maturity is likely to become a more significant factor than strength of covenant in determining TPs and investment strategy.

Principle 6
Reliance on additional support

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

The use of additional support (see below) can justify additional flexibility for schemes using the Bespoke approach. However, TPR emphasises that reliance on formal and legally binding additional support differs from reliance on 'indirect employer covenant', which is non-legally binding.

Principle 7
Appropriate recovery plan

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

This principle is long-established but the devil may be in the detail for recovery plans under the Fast Track approach (see below).

Principle 8
Open schemes

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

Open schemes are generally more immature and mature more slowly than closed schemes, so, whilst schemes will be treated consistently, as lower TPs will be required for more immature schemes, the funding requirements may be less onerous for open schemes.

Compliance with these principles will be expected for all schemes, whether trustees opt for the Fast Track or Bespoke approach.

Two-track framework

The consultation proposes a two-track approach to compliance, which attempts to balance the need for greater clarity with continued flexibility.

The Fast Track approach involves a series of rules or tests designed to demonstrate compliance with the core principles. Although the tests are expected to be rigid, they will reflect the scheme's circumstances, including its covenant strength and maturity.

The Bespoke approach is available for schemes that cannot, or choose not to, comply under the Fast Track approach. It will have more flexibility to take account of a scheme's specific circumstances but will require trustees to explain how and why they diverged from the requirements of the Fast Track approach, and how any additional risk is being managed. Valuations under the Bespoke approach may receive more regulatory scrutiny, but it is not a second-best option.

Importantly, valuations under the Fast Track and Bespoke approaches, if done correctly, will be equally compliant.

Trustees will not be required to maintain their previous approach at subsequent valuations. They will be able to switch between the Fast Track and Bespoke approaches as circumstances change. The Fast Track framework will set a baseline of 'tolerated risk', which will develop in line with prevailing market conditions.

Fast Track compliance

The consultation proposes a number of options for tests under the Fast Track approach, which address five aspects of funding: the LTO, TPs, the recovery plan, future service and investments.

None of the tests are yet final. It is worth noting that, although TPR has expressed preferences for specific requirements in some areas, the consultation does explore other options, setting out the pros and cons. We summarise the key tests, how they are expected to apply, and some of the implications.

Failing any element under the Fast Track approach would mean that the scheme would not achieve Fast Track compliance.

Fast Track tests	Pass/Fail
1. Long-term objective (LTO)	✔
2. Technical provisions (TPs)	✔
3. Recovery plan	✔
4. Future service	✔
5. Investment	✘
Overall	✘

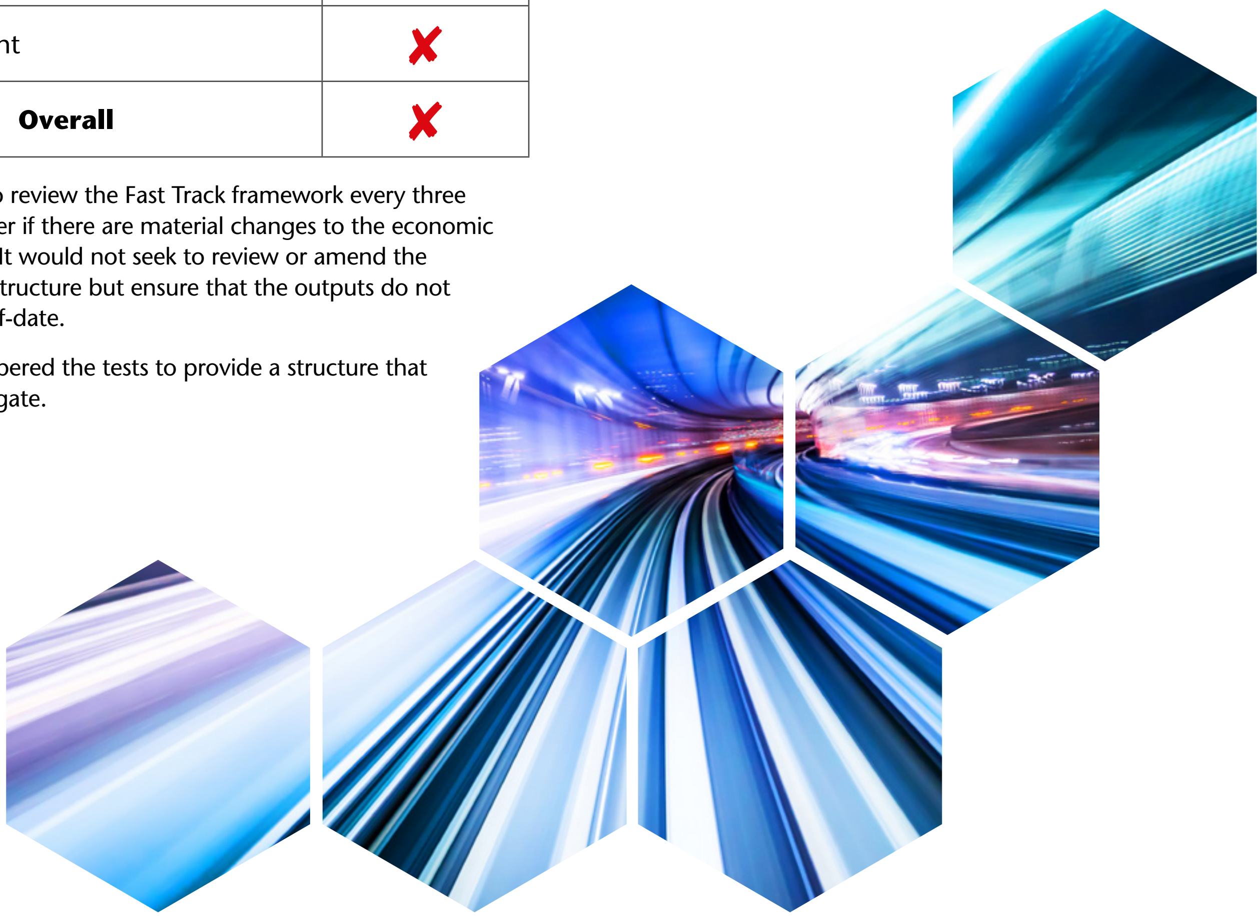
TPR expects to review the Fast Track framework every three years, or sooner if there are material changes to the economic environment. It would not seek to review or amend the fundamental structure but ensure that the outputs do not become out-of-date.

We have numbered the tests to provide a structure that is easy to navigate.

1. LTO tests

The concept of a long-term objective (LTO) is front and centre of the consultation. The overall requirement, under both the Fast Track and Bespoke approach, is that schemes should have a stated LTO to be fully funded on a low dependency basis by the time the scheme is significantly mature. For the Fast Track approach, the consultation provides some indications of what that means, in four areas:

- Discount rate;
- Other assumptions;
- Journey plan; and
- Expenses.



1A. LTO discount rate

The Fast Track LTO discount rate is expected to be set within the range of 0.25% to 0.5% p.a. above gilt yields

The first part of the Fast Track LTO test proposed is for the discount rate. It was widely trailed before the consultation launched that TPR would be consulting on selecting a discount rate somewhere in this range, so this comes as no surprise. In our September 2019 In Depth on Pension scheme funding (analysing valuations completed up until July 2019), we found that, where clients had already adopted a long-term target, the vast majority used a discount rate of gilts plus 0.5% p.a. or lower, and almost half used a rate below gilts plus 0.25% p.a.

1B. LTO other assumptions

A scheme's LTO should use other assumptions that are no weaker than best estimate

Although the discount rate is the most important assumption when calculating liabilities, other assumptions clearly play an important part, particularly when considered overall. TPR proposes that these should be 'best estimate', when taken together, and suggests that it may prescribe assumptions such as price inflation and future improvements in longevity.

While no conclusion has been reached, we consider it reasonable that trustees be asked to confirm that their other assumptions are no weaker than best estimate.

1C. LTO journey plan

Schemes should plan to reach their LTO by the time the scheme has a duration of 14 to 12 years

This part of the LTO test relates to timescales. TPR proposes that "significant maturity" be defined as when a scheme has a duration somewhere in the range of 14 to 12 years. TPR states that an average scheme may take 15 to 20 years to reach significant maturity (i.e. in 2035 to 2040).

The concept of duration is explained in the box below.

Duration – a measure of the scheme's maturity. TPR defines it as the mean term of the liabilities weighted by the value of the scheme's future cashflows, and calculates it using a discount rate of gilts plus 0.5% p.a. in the consultation.

In less technical terms, it might be considered the 'average' payment date of the scheme's benefit outgo.

The duration calculated will depend on the assumptions used; TPR suggests that it will use the low dependency assumptions.

As a rule of thumb, duration might be expected to reduce by one year every two years for a closed scheme.

For schemes that currently have low duration, the consultation does not indicate whether there will be any transitional flexibility under the Fast Track approach. It appears likely that where such schemes seek flexibility they will need to use the Bespoke approach.

1D. LTO expenses

A scheme's LTO should ideally include a reserve for future ongoing expenses

TPR notes that a reserve for future ongoing expenses, including PPF levies, "would ideally be included" but that this might not be necessary if the scheme's trust deed and rules provide for the employer to reimburse ongoing expenses as they arise. TPR states that it has not considered the possibility of an express reserve for wind-up expenses, because the LTO applies when an employer is solvent.

Of all the LTO tests, this is currently the least clear.

2. TPs tests

Schemes will need to develop a journey plan to achieve their LTO and set technical provisions (TPs) that are consistent with this journey plan.

TPR expects trustees to develop a journey plan to achieve their LTO

TPR expects trustees to plan for investment risk to decrease as their scheme matures and reaches low dependency

TPs should have a clear and explicit link to the LTO and, over time, should converge to the LTO as evidenced by the journey plan

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

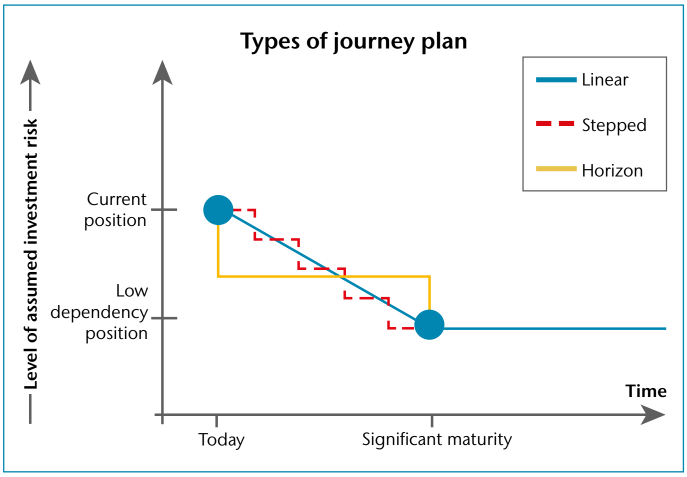
TPR sets out alternative proposals for how TPs should be tested against ranges depending on maturity and covenant strength, to be set out in guidance. It considers:

(a) Maximum acceptable discount rates, and

(b) Minimum acceptable target TPs, expressed as a percentage of the long-term target

TPR sets out three options for the shape of the journey plan – which will determine how TPs are strengthened with increasing maturity:

- Linear de-risking;
- Stepped de-risking; and
- Horizon (or 'lower for longer') de-risking.



Maturity is likely to be measured by duration of the liabilities (see box on page 10). Once this reaches 14 to 12 years, the scheme would be expected to set the TPs equal to the long-term target.

Although TPR seeks views on whether reliance should be placed on employer covenant in the funding regime and, if so, how the covenant should be factored in, their "starting point" is that schemes should be able to rely on it to underpin additional levels of investment risk in discount rates. Under the Fast Track approach, TPR considers how the TPs might be related to covenant strength - using their well-established method of rating the employer covenant in one of four Covenant Groups:

- Strong (CG1);
- Tending to Strong (CG2);
- Tending to Weak (CG3); and
- Weak (CG4).

With regard to covenant visibility, TPR asks whether there should be a maximum period of full covenant reliance for Fast Track TPs – for example, five years – or whether covenant reliance should be assumed to decline in the much shorter term, or even immediately.

TPR envisages setting acceptable TP thresholds that vary by covenant strength and maturity, with lower discount rates (or higher TPs) for more mature schemes and schemes that have a weaker employer covenant, and which are consistent with the journey plan to the long-term target.

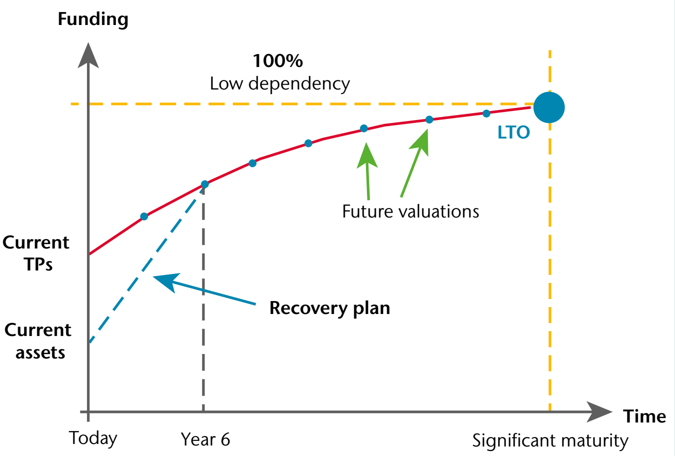
If the discount rate approach is adopted, additional guidance on other TP assumptions would be needed to ensure these are no weaker than best estimate.

TPR notes that trustees would set their funding strategy in much the same way as they currently do, in collaboration with the employer and using an Integrated Risk Management (IRM) framework. They would:

- assess the strength of their employer covenant (with reference to new TPR guidance);
- assess the maturity of their scheme; and
- using a table produced by TPR, compare their discount rate (or TPs as a percentage of the long-term target) against thresholds based on covenant strength and maturity.

Following these steps, we would expect Fast Track TPs to move further towards the long-term target at each valuation.

TPs are stepping stones on the journey to a scheme's LTO

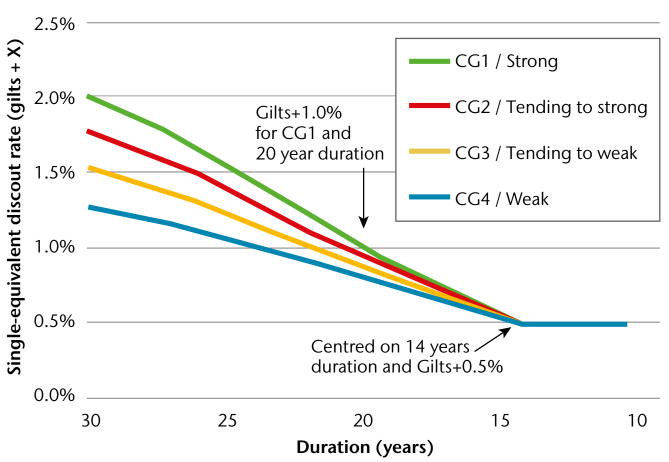


Based on the above structure, a number of implications are worth considering:

- As noted above, TPR expects to review the Fast Track framework at least every three years, so the parameters may well change from valuation to valuation.
- Duration becomes a key measure for trustees and employers to understand, including what it is now and how it is expected to change over time. Although duration is well defined as a concept, assumptions can make a material difference. Allowing for commutation, transfer payments or pension increase exchanges at retirement will all shorten duration and potentially require a scheme to use TPs that are closer to its long-term target.
- Covenant rating could have significant implications. Although trustees should currently consider the implications of covenant strength, under the new framework the differences between covenant ratings would be codified for the first time. In addition, if TPR reaches a different conclusion to the trustees on covenant categorisation, this might make the difference between passing and failing under the Fast Track approach.
- The journey plan might require the discount rate to fall to gilts plus 0.5% p.a. (assuming that is used for the long-term target) by the time the scheme reaches duration of 14 years. While many schemes have a post-retirement discount rate of gilts plus 0.5% p.a., that is only reached when the last member reaches retirement, which may not occur at the time when duration hits 14 years.
- Understanding how long the scheme will take to hit the 14 to 12-year duration range is a question that most schemes will not have considered. TPR has suggested that this might take 15 to 20 years for a typical scheme. For some schemes, it will take considerably less than 15 years or considerably more than 20 years.
- If a threshold based on a single equivalent discount rate is adopted, it may not allow for direct comparison, depending on a scheme's current approach to setting discount rates. Common approaches include having different pre- and post-retirement discount rates, term-dependent discount rates (e.g. gilts plus 2% p.a. for 10 years and gilts plus 0.5% p.a. thereafter) and declining discount rates (e.g. gilts plus 2% p.a. falling to gilts plus 0.5% p.a. over a 15-year period).
- The discount rates in TPR's framework will strengthen based on maturity. If a maturing scheme is fully funded on the maximum discount rate at a valuation and experience is in line with its assumptions, it will no longer be fully funded by the next valuation. To continue to be fully funded under the Fast Track approach, schemes may need to generate additional investment return or obtain additional contributions. This ratcheting up means that TPs will need to converge on a long-term target in order to continue to be compliant.

Although TPR did not publish tables of likely threshold discount rates in the consultation, it did give some pointers in comments and examples. Based on these, Aon has produced an indicative range of single equivalent discount rates (SEDRs), varying by covenant rating and duration. While we await the final tests, these are intended to provide an initial indication of whether a scheme is likely to be able to meet this Fast Track test.

Aon illustrative Fast Track discount rates
(single equivalent rates)



A key feature of these discount rates is that they are more sensitive to duration than to covenant rating. For example, the chart indicates that a scheme in covenant group 4 (weak) with a duration of 20 years would have the same maximum discount rate as a scheme in covenant group 1 (strong) with a duration of 17.5 years.

3. Recovery plan tests

3A. Recovery plan length

Recovery plan length should be no greater than outlined in Fast Track guidance

TPR sets out the following maximum lengths for illustrative purposes, but also states that, alternatively, the same length (say, 6 years) could be used with a longer period acceptable only where the covenant strength is demonstrably weaker, a compliant recovery plan is not affordable (which would need to demonstrated under the Bespoke approach), and the scheme is being treated equitably.

Illustrative maximum recovery plan lengths under the Fast track approach

Covenant rating	Strong (CG1)	Tending to strong (CG2)	Tending to weak (CG3)	Weak (CG4)
Maximum recovery plan length (years)	6 or less	6	9	12

Where a scheme is very mature or there are pressing concerns about the ongoing viability of the employer, TPR would expect this to be the most relevant factor in agreeing a recovery plan. Maximum recovery plan lengths may taper as a scheme approaches significant maturity.

Recovery plan structure

Recovery plans should not allow for investment outperformance or be back-end loaded. There may also be restrictions on re-spreading previous recovery plans

The structure of the recovery plan is expected to be subject to a number of tests, as outlined below.

3B. No asset outperformance

The Fast Track approach will prohibit the recovery plan from assuming outperformance of assets above that used in the discount rate for the TPs.

This is likely to be the most material of the tests of structure. Allowance for asset outperformance is a common feature of many recovery plans, recognising that the scheme's short-term investment strategy has a higher expected return than that allowed for in the discount rate used for the TPs. In our September 2019 In Depth on Pension scheme funding, we found that one half of schemes allowed for an element of additional return in their recovery plans.

Schemes that would otherwise fail this test may choose to restructure their valuation to allow for a higher return in the TPs (provided this passes test 2, above) – which would reduce TPs and be reflected in the recovery plan. TPR has suggested that including additional allowance for returns in the TPs is preferable to a higher assumption for returns in the recovery plan.

3C. No significant back-end loading

The recovery plan must also not be back-end loaded (except for increases linked to a suitable measure of inflation, such as CPI).

In practice, many schemes operate some form of back-end loading by linking contributions to inflation. Covering all approaches in the Fast Track tests may be difficult, as schemes use RPI, CPI and fixed increases to increase their contributions. So, the type of inflation-linkage might cause a scheme to fail to meet the test – but, if that were the only reason for failure, compliance under the Bespoke approach might be very straightforward.

3D. Other recovery plan tests

In addition to the three tests above, TPR proposes two further tests:

- there may be restrictions on 're-spreading' existing deficit reduction contributions at subsequent valuations – perhaps with 'nuanced guidelines' such as that at least the same level of contributions be maintained where the deficit has grown significantly; and
- the recovery plan must be 'equitable', when compared with payments to other stakeholders, particularly where these payments represent 'value leakage', such as where value leaves the company through dividends, intercompany loans that are unlikely to be repaid or significant management bonuses.

As with other tests, these are open to consultation rather than being pre-determined, but it is less clear how these tests might apply. They do, however, reflect ongoing concerns expressed by TPR, so may not be considered new.

The test of equitability is expected to be qualitative, although for weaker covenants (CG3 and CG4) TPR would expect deficit reduction contributions to be maximised or, often, prioritised over all forms of covenant leakage.

4. Future service tests

Accrued benefits in open schemes should be treated in the same way as those in closed schemes, and contributions for future service should be based on the assumptions used for the TPs except the discount rate – which can reflect the maturity of future service benefits

Although many schemes are closed to future accrual, a significant number are still open, including some that are open to new members; such schemes tend to be larger than average. Aon's Global Pension Risk Survey 2019 found that 35% of schemes were open to future accrual, including 8% that were also open to new members.

TPR's preferred approach for open schemes is:

i) for past service liabilities, set the TPs consistently with closed schemes; and

ii) for future accrual, use the same assumptions as for the TPs except the discount rate – which may reflect the maturity of future service benefits (which would almost certainly be more immature).

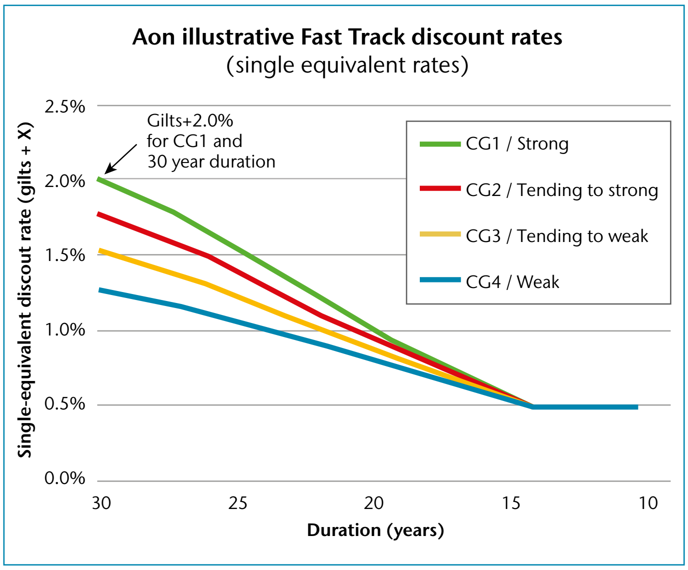
Open schemes will therefore require a long-term target and a journey plan to reach that target in the same way as for closed schemes. However, as open schemes are likely to mature less quickly than closed schemes, it will take longer to reach the long-term target – potentially significantly longer (and theoretically never where an open scheme has a stable membership profile).

Future service rate

Unlike closed schemes, open schemes need to calculate the cost of future service. Legislation allows some flexibility for the assumptions, and the consultation considers a range of options for Fast Track compliance.

TPR's preference is for the same assumptions to be used to calculate future service costs as are used to calculate TPs, with one exception. TPR recognises that the average time to payment of new accrual is typically far longer than the average time to payment of past service benefits, so it proposes allowing adjustment to the discount rate for the different maturity.

The chart below shows how the discount rate might vary, depending on the duration of future service benefits and the employer covenant rating.



If a scheme has a surplus, this can be used to meet the cost of future service. However, in these circumstances, TPR proposes that the cost of future service would need to be based on the assumptions used for the TPs (i.e. not allowing for a different discount rate for future service based on the maturity of accrual).

5. Investment tests

Since the concept of Integrated Risk Management (IRM) was introduced, it has been widely recognised that the link between employer covenant and investment has been the most challenging aspect – specifically whether the employer covenant can support the level of investment risk being run.

The Fast Track test for investment addresses this directly.

5A. Investment stress test

Investment risk quantified using the Fast Track stress test should be no greater than a threshold, potentially based on maturity and covenant strength

TPR prefers a simple stress test to measure investment risk under the Fast Track approach, and for this to be compared to specified maximum investment risk.

TPR states that its preference is for a TPR-defined stress test. However, it believes that the PPF's stress tests would be "a good starting point", and quotes the following stresses from those tests:

- Equities fall by 15 to 19%;
- Property falls by 5%; and
- Bond yields fall by by 0.75% p.a. (meaning that government bonds increase in value by between 2% and 18%, depending on their maturity).

For the stressing of liabilities, larger schemes would be expected to carry out their own assessment of the change in the value of liabilities, on a prescribed basis. However, the consultation suggests that smaller schemes (perhaps those with fewer than 100 members, or with assets or liabilities below £20m) could opt to use a simple reference portfolio to represent their liabilities.

TPR's preferred option for expressing the stress test is:

$$\frac{\textbf{Change in surplus or deficit}}{\textbf{Starting liabilities}}$$

Calculations would be carried out on either the scheme's basis for its long-term target or on a 'gilts plus 0%' basis.

With regard to the maximum investment risk, TPR sets out its extensive considerations on the aspects that might be taken into account, and proposes that it might vary by maturity and covenant strength. However, the specification of maximum stresses is limited to illustrative requirements set out in worked examples:

- A maximum stress of 5%, irrespective of covenant strength, for significantly mature schemes (i.e. with duration of 14 years or less); and
- Where the employer has a 'tending to strong' (CG2) covenant rating, a maximum stress of 10%, for a duration of 19 to 20 years, 12% for a duration 21 to 22 years, and 13% for a duration of 22 to 23 years.

An advantage of the PPF stress test is that schemes and advisers are familiar with it. However, it also has limitations. Many schemes submit bespoke PPF stress tests, recognising that their portfolios do not align with the PPF test's calculations. The limitation most commonly encountered is perhaps its inability to fully allow for liability driven investment (LDI) – which uses leverage to increase interest rate and inflation hedging.

TPR proposes, as for other elements of the Fast Track approach, a simple 'pass or fail' test. It notes that trustees with investment risk in excess of the tolerated risk can do one of the following:

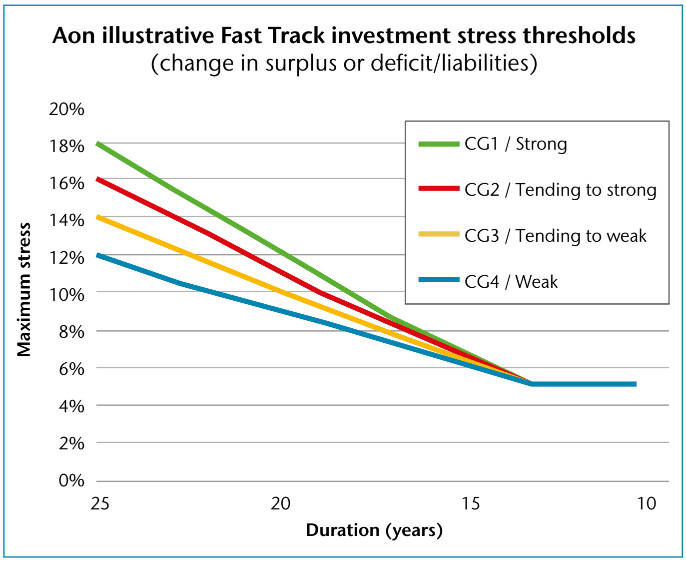
- Reduce their level of investment risk to within the acceptable threshold; or
- Demonstrate through the Bespoke route how they intend to support excess risk.

One potential outcome is that the Fast Track approach will not be used for schemes with more complex investment strategies, and that they use the Bespoke approach instead. This may mean that a very large number of schemes, including many that might otherwise wish to use the Fast Track approach, will feel compelled to use the Bespoke approach. TPR might conclude that adapting the test to better deal with LDI would be a worthwhile amendment to its proposals.

While investment strategies can be tested fairly easily, allowing for a maximum stress in an investment strategy has no single answer, as it depends on factors such as diversification, and the degree of hedging and leverage. Quite different investment strategies could result in similar stressed positions.

Conversely, quite similar investment strategies could behave quite differently under a stress test. Hedge funds can span a huge variety of products, for example, with very different characteristics and grouping assets under convenient headings can generate unrepresentative outcomes under simple stress tests.

As with threshold discount rates, TPR has not published tables for threshold investment stresses. However, it has provided pointers in the consultation that has enabled Aon to produce a range of indicative stresses, varying by covenant rating and duration.



Considering potential asset allocations that would meet the threshold stresses, the table below sets out examples of the maximum allocations to growth assets.

For this type of stress test, the level of hedging is critical. This can be seen in the differences between maximum allocations to growth assets where investments are fully hedged and where they are moderately underhedged.

Global equity has been used here because relevant figures are provided in the consultation document. Most schemes have diversified portfolios, but it isn't clear how those would be treated.

Comparing this test to the discount rate test in 2, the discount rate threshold appears to be more restrictive than the investment stress threshold. This is as we would expect given the margin for prudence in discount rates. For example, a scheme with a maximum single equivalent discount rate of gilts plus 1.05% p.a. (CG2, 22-year duration) would have an investment stress threshold of 13%. That suggests a maximum allocation to growth assets in the region of 72% (if fully funded and fully hedged), which would support a target return significantly higher than the discount threshold. However, if the scheme was only 80% funded and not fully hedged, the maximum allocation to growth assets could be around 36%, which would give a narrower margin for prudence in the discount rate, depending on the growth assets chosen.

Scheme 1 – 80% funded; 80% hedged (of assets)

Aon illustrative maximum allocations to growth (Global equity) assets				
Duration (years)	Covenant Group			
	CG1	CG2	CG3	CG4
14	6%	6%	6%	6%
17	20%	17%	15%	12%
20	34%	29%	23%	18%
23	49%	40%	32%	24%

Scheme 2 – 100% funded; 100% hedged

Aon illustrative maximum allocations to growth (Global equity) assets				
Duration (years)	Covenant Group			
	CG1	CG2	CG3	CG4
14	28%	28%	28%	28%
17	47%	44%	42%	39%
20	67%	61%	56%	50%
23	86%*	78%	69%	61%

**A theoretical maximum. In practice, it may not be appropriate to have a growth allocation this high with a 100% hedge.*

5B. Investment test for liquidity and quality

Additional considerations should be set out as part of the Fast Track framework, with regard to quality and liquidity

In addition to an investment stress test, TPR sets out six options for a separate test on the quality and liquidity of a scheme's assets:

1. A principles-based approach, under general guidelines provided by TPR;
2. Minimum allocation to high-quality bonds and/or cash;
3. Minimum allocation to assets that can be realised within a specified period of time;
4. Minimum level of liquidity to meet expected (and unexpected) cash flows;
5. Overall maximum expected return on the assets (versus gilts); and
6. Average credit quality.

TPR asks whether it should define guidelines around liquidity and quality for the Fast Track approach, and seeks views on the options specified and other approaches. It has no preferred option, but considers that options 3 and 4 are likely to be more appropriate under the Bespoke approach.

Fast Track examples

The gamut of tests will impact on different schemes in different ways, depending on their particular combinations of covenant strength, maturity, funding level and investment strategy.

We set out two examples to illustrate the differences, with particular focus on variation in maturity – between schemes A and B.

Scheme A is a closed scheme with duration of 21 years. It is 80% funded (£80m assets, £100m liabilities) using a pre-retirement discount rate of gilts plus 2% p.a. and a post-retirement discount rate of gilts plus 0.5% p.a., giving a single equivalent discount rate of gilts plus 1.03% p.a.. It has an asset allocation of 60% liquid, diversified growth assets and 40% LDI. The LDI provides a hedge of 100% of assets. The recovery plan length is 8 years, and deficit reduction contributions are £2.5m a year. Under the Fast Track approach, Scheme A is restricted as follows:

Scheme A	Current funding position	Fast Track thresholds and consequential funding requirements			
		Covenant Group			
		CG1	CG2	CG3	CG4
SEDR (gilts plus x)	1.03%	1.13%	1.04%	0.96%	0.87%
TPs (£m)	100	97.9	99.8	101.4	103.3
Deficit (£m)	20	17.9	19.8	21.4	23.3
Recovery plan length (years)	8	6 (or less)	6	9	12
Contributions (£m p.a.)	2.5	2.97	3.3	2.37	1.94

The TPs could be higher or lower (making the deficit higher or lower) depending on Scheme A's covenant rating, but they are required to be in relatively narrow ranges (with a difference of less than 6% between the highest, of £103.3m, and the lowest, of £97.9m.)

Annual deficit reduction contributions are higher for stronger covenant ratings, despite a lower deficit, due to the shorter maximum recovery plan lengths.

The LTO liabilities are £111.7m. The investment stress thresholds allow a shock to the LTO funding level of between 9.7% (CG4) and 13.2% (CG1). The investment strategy gives a stress of 12%, despite a diversified growth portfolio and high level of hedging. The scheme would fail the investment stress test if the covenant rating was CG3 or CG4.

Scheme B has similar features to Scheme A except that it has a duration of 17 years. The same pre- and post-retirement discount rates also produce TPs of £100m but in this case the single equivalent discount rate is gilts plus 0.78% p.a.. Under the Fast Track approach, Scheme B is restricted as follows:

Scheme B	Current funding position	Fast Track thresholds and consequential funding requirements			
		Covenant Group			
		CG1	CG2	CG3	CG4
SEDR (gilts plus x)	0.78%	0.74%	0.72%	0.69%	0.67%
TPs (£m)	100	100.7	101.0	101.6	101.9
Deficit (£m)	20	20.7	21	21.6	21.9
Recovery plan length (years)	8	6 (or less)	6	9	12
Contributions (£m p.a.)	2.5	3.44	3.50	2.40	1.82

The TPs would need to be higher (making the deficit higher) for any covenant rating, within an even narrower range than for Scheme A (just over 1%).

Annual deficit reduction contributions are higher for stronger covenant ratings, but are significantly lower for CG4, due to the longer maximum recovery plan length. In practice, however, it is questionable whether TPR would permit a reduction in contributions that had been deemed affordable.

The LTO liabilities are £104.8m and the investment stress thresholds allow a shock to the LTO funding level of between 7% (CG4) and 8.5% (CG1). The investment strategy gives a stress of 10.4%, which would fail the investment stress test regardless of covenant rating.

Bespoke compliance

We expect that most schemes would need to make changes in order to meet the Fast Track tests; however, TPR does not expect its proposals for a twin-track approach to be too onerous for most schemes to implement. This suggests that TPR believes that the Bespoke approach should provide sufficient flexibility for schemes that do not consider the Fast Track route to be appropriate – or even possible, without considerable and potentially detrimental changes.

TPR explains that:

- Arrangements should meet the core principles and will be assessed using the Fast Track tests as a reference point;
- Additional information will need to be submitted to TPR – explaining how and why the scheme has differed from the Fast Track position and how any additional risks are being managed;
- Decisions made will need to be fully articulated and evidenced;
- There may be higher regulatory involvement – although, as a risk-based regulator, TPR may decide not to engage with all trustees adopting the Bespoke approach; and
- The Bespoke approach would not be a 'bad' or second-best option, and, if done correctly, would be equally compliant under legislation.

TPR states that the Bespoke approach might be the appropriate option in certain circumstances, including where:

- The trustees wish to take additional, managed risk relative to the tolerated risk under the Fast Track approach – in relation to investment risk, the LTO, prudence in the TPs, or the recovery plan length or structure;
- Outcomes are at least as good as under the Fast Track approach, overall, but not all of the Fast Track tests are met;
- Employers face significant affordability constraints so simply cannot meet all of the Fast Track tests; or
- Schemes have unusual or complex circumstances or arrangements (eg atypical covenant, additional support, investment strategy) which the Fast Track approach does not accommodate.

TPR sets out examples of scenarios under which schemes would and would not achieve Bespoke compliance; scenarios under which a scheme might be compliant include where:

- Scheme specific mortality rates are higher than under standard mortality tables, based on analysis;
- A cash-driven investment (CDI) investment strategy fails the Fast Track investment stress test, but the trustees evidence matching cashflows and demonstrate sufficient liquidity to deal with unexpected cashflows;
- A rolling 15-year government contract allow for longer-term covenant visibility; and
- Additional support mitigates additional risks.

Further examples are included in the consultation and more are likely to be provided in the revised code.

Stressed schemes – TPR notes that stressed schemes should not run additional risk over and above the tolerated 'Fast Track equivalent' risk and should not increase investment risk just to be able to submit a Fast Track compliant recovery plan. Therefore, it would expect such a scheme to meet the CG4 employer Fast Track guidelines for TPs and investment, and report a long recovery plan length under the Bespoke regime supported by evidence of assessment of affordability.

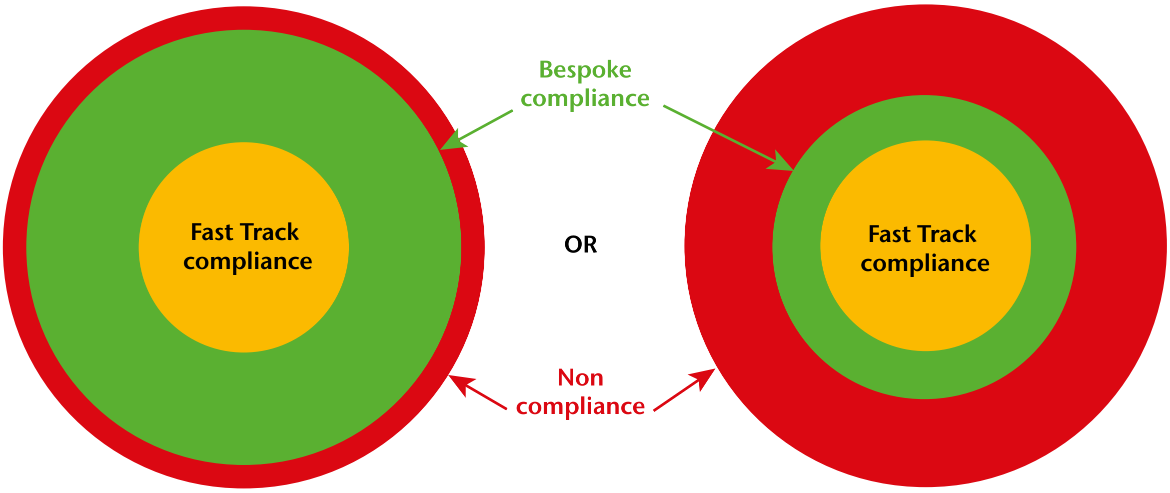
TPR anticipates that most queries relating to Bespoke compliance will be resolved through low or medium intensity engagement. Where the arrangements are complex or the outcome is considerably different from the Fast Track standard, high intensity engagement is more likely.

It envisages that a small number of cases might proceed to enforcement. In these cases, TPR may seek to use its powers to set the scheme's TPs, LTO and/or recovery plan in line with the Fast Track requirements.

There is significant uncertainty as to how far schemes will be allowed to deviate from the Fast Track standard before they are deemed to be non-compliant.

In particular, will the current approaches of most schemes be permitted under the Bespoke approach, perhaps with some minor amendments – consistent with TPR's expectation that its proposals will not be "too onerous for most schemes"? Or will schemes need to be close to the Fast Track requirements - with the Fast Track standard being a clear benchmark with stringent restrictions on deviation. The two potential outcomes are depicted below.

The Bespoke approach - how flexible will it be?



In responding to questions at Aon's Pensions Conference in Bristol, where the consultation was launched, TPR confirmed that the extent of a scheme's deviation from the Fast Track standard would not be the only criteria it would use. A funding plan very close to Fast Track might be rejected if TPR took the view that the scheme or sponsor could do more but had chosen not to, while a more divergent funding plan might be deemed compliant if the scheme and sponsor were already taking all possible steps.

Additional support

TPR envisages that the assets of the sponsoring employer and the support of its wider group will play a leading role in Bespoke funding solutions, particularly to support and underwrite additional risks being run. It highlights two main types of additional support:

- Contingent asset support; and
- Guarantee support.

TPR's view is that longer-term risks being run by schemes (such as extended recovery plan lengths) are typically better underpinned by contingent asset support, rather than guarantee support which could have reducing value beyond the guarantor's 'covenant visibility'. TPR considers guarantee support as more appropriate as an underpin for higher investment risk in the shorter term – provided the (smaller) TPs deficit is funded in an appropriate short timeframe.

TPR also notes that other types of arrangement might help trustees minimise risk, including:

- Negative pledges;
- Contingent contributions linked to scheme funding;
- Contingent contributions linked to employer performance; and
- Blended support - with characteristics of guarantees and security over assets.

TPR proposes that the following would need to be included in the trustees' statement of strategy (see page 5):

- their assessment of the additional risks presented by the Bespoke arrangement;
- what additional support they have relied upon;
- the scenarios in which the support can be called upon;
- why they consider it supports additional risk;
- that they received legal advice on the enforceability of the arrangement and that the support can be accessed when needed;
- where contingent asset support is relied upon;
- the value placed on any contingent assets and their stressed value (e.g. the anticipated value after an event has occurred in which the trustees are able to enforce the security up to and including a hypothetical employer insolvency);
- whether they received an independent valuation of the asset or, if not, why not; and
- where guarantee support is relied upon:
  - who the guarantee is provided by, and what amount (in £ terms or relative to scheme metrics) is guaranteed;
  - the trustees' view on the impact of the guarantee on the employer covenant, and how this strength has been reflected in the agreed recovery plan; and
  - any steps taken by the trustees to ensure that the value of any contingent support is being protected.

Trustees would also be expected to provide evidence that supports their valuation and the explanations made in their statement on request.

Implications and next steps

While the consultation is extensive, there are a lot of unknowns.

- In relation to the Fast Track approach, there are strong indicators of how this will work, but various options are open to consideration;
- In relation to the Bespoke approach, the degree of flexibility relative to Fast Track, and the extent of regulatory involvement, is unclear; and
- In relation to the core principles, it is not clear whether these are fixed or potentially subject to amendment.

With regard to implementation, a key issue for TPR is how many schemes will be able to use the Fast Track approach. This in turn will be of interest to the trustees and employers of other schemes, as it will impact on the level of resources TPR can apply to schemes using the Bespoke approach.

For larger schemes, our data indicates that most do not meet the Fast Track tests currently. While many schemes meet some, or most, of the tests, few meet all of the tests. At Aon's Pensions Conferences in early 2020, around 60% of attendees expected their schemes to use the Bespoke approach, with that percentage rising to over 80% for larger schemes.

The position is likely to be similar for the large number of smaller schemes – in particular, the 2,000 or so with fewer than 100 members to which TPR refers.

Nevertheless, we expect trustees to want to understand the Fast Track approach, as it provides the benchmark against which they will be tested, whether or not they use it.

- For schemes that already meet the Fast Track tests, understanding Fast Track may be important in ensuring that they do not unintentionally fall back on the Bespoke approach - this could result from a change in their circumstances or the market (e.g. a fall in the funding level), changes to the thresholds applicable to them under the tests (e.g. the gradual strengthening of test 2) or changes to the tests (e.g. a reduction to the specified margin above gilts for the TPs or LTO);
- For schemes that are close to meeting all of the Fast Track tests, making relatively minor changes to meet them may have regulatory and other benefits - so understanding what changes would be required is likely to be important; and
- For schemes that do not expect to use the Fast Track approach, understanding it remains important, as we expect schemes to be judged against the Fast Track standard under the Bespoke approach. Under the Bespoke approach, trustees will need to explain how and why the scheme has differed from the Fast Track position and how any additional risks are being managed, in their submission to TPR.

Next steps

This consultation is just the start of the process. It runs until 2 June, and there will be a second consultation later in 2020, on the detail of TPR's revised code of practice. The proposals for eight core principles, a two-track framework and Fast Track tests are all subject to change. But while aspects of the proposed framework may change, we expect the fundamentals of the framework to remain.

Trustees and employers may wish to take action now:

- Read, and consider responding to, the consultation. While trustees and employers can respond directly, you are welcome to pass your comments to your Aon consultant, as input into our response;
- Start considering the long-term objective (if you have not already done so) - what it might be, how you might get there, and how you would justify it to TPR; and
- Check how your scheme fares against the Fast Track tests, as they are currently proposed - how far away you are, and how much change would be required to get there.

Your Aon consultant has tools to test your scheme against those proposed, and to benchmark your scheme against others.

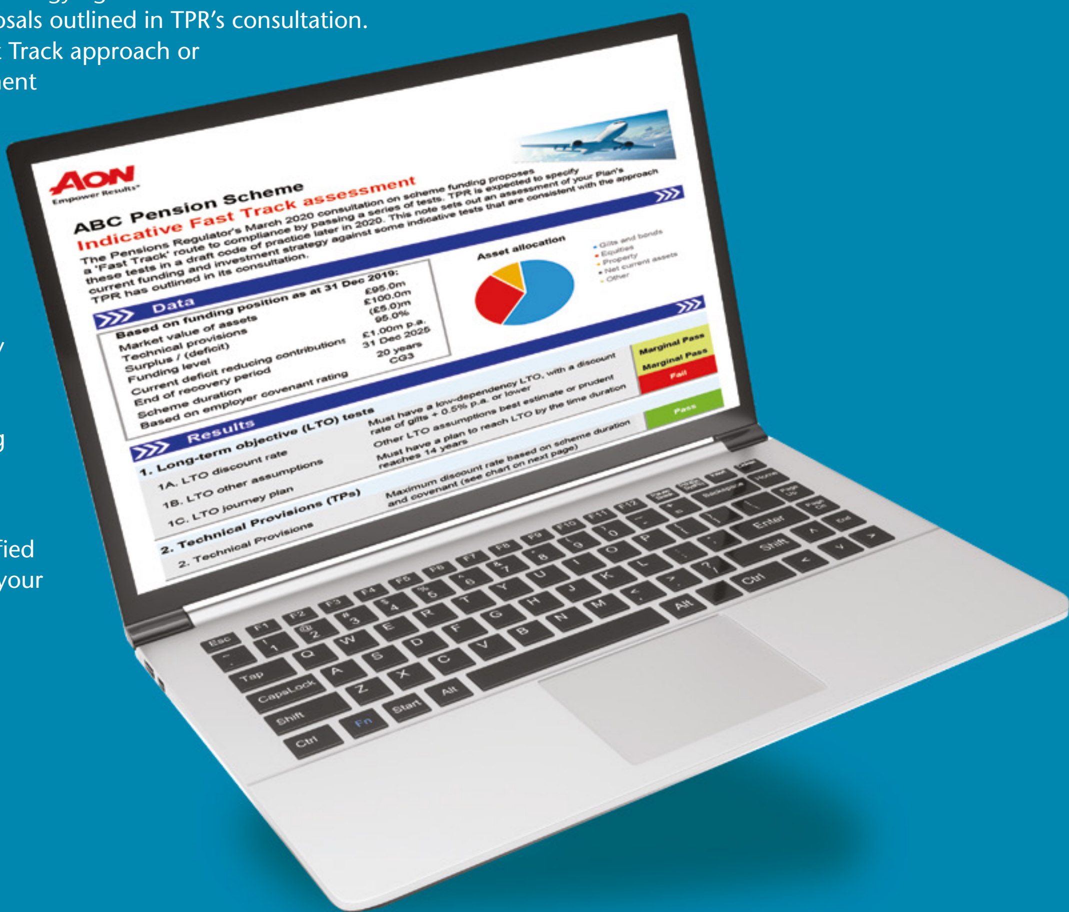
The revised code of practice is expected to come into force towards the end of 2021, although trustees, and some employers, are likely to wish to take account of TPR's proposals in valuations undertaken before then.

Indicative Fast Track Assessments

Aon has developed a tool that can provide an assessment of your scheme's funding and investment strategy against indicative Fast Track tests, based on the proposals outlined in TPR's consultation. Whether you expect to use the Fast Track approach or the Bespoke approach, this assessment will help you to understand what actions your scheme may need to take to comply under TPR's proposed framework.

For those considering using the Fast Track approach, it can provide comfort that your current funding and investment strategy may satisfy the tests, or identify any 'gaps' to allow you to assess the likely impact on your scheme of adapting to achieve Fast Track compliance.

For those expecting to use the Bespoke approach, any gaps identified will be areas on which to focus for your submission to TPR.



ViewPoints

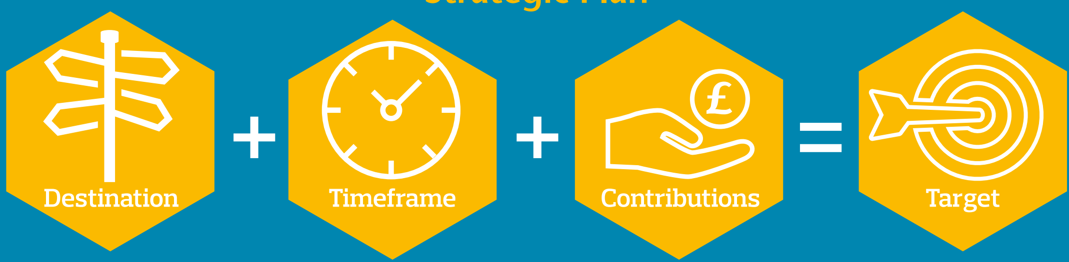
We have developed a framework, called ViewPoints, to support trustees in meeting the Pensions Regulator's requirements around Integrated Risk Management in a proportionate and pragmatic way – and in particular in aiming to take better risk management actions now, and put in place realistic contingencies for risks that are not hedged. This has been used by around 325 clients and has proved hugely popular in terms of helping trustees take a step back, and discuss important strategic issues without being over-influenced by jargon and technical points.

The first stage of the ViewPoints framework is a questionnaire for trustees and key stakeholders at the sponsor which explores each individual's beliefs and understanding around funding, investment and covenant. The second stage of the ViewPoints framework is to develop a Long-Term Funding Target together with a plan to reach it.

We use ViewPoints Develop live in meetings to help trustees and company representatives to develop a long-term plan through investigating all the key variables together:

- The funding destination (e.g. low dependency, consolidator or buy-out);
- The desired timeframe, taking account of covenant reliance, maturity, and any other scheme-specific issues;
- The available contributions, in normal and stressed scenarios; and
- What asset returns are required, considering both downside risk and triggers to de-risk.

Strategic Plan



Case Study

We ran a ViewPoints workshop for a scheme that is fully-funded on a technical provisions basis. This was attended by the Trustees, as well as senior company representatives and their advisers. All attendees completed the ViewPoints survey ahead of the session, which provided initial discussion points and allowed both the Trustees and Company to set out their thoughts on the long-term future of the scheme.

ViewPoints Develop was then used interactively to consider this further – with the realisation that the timeframe to buy-out was not as far away as previously thought. The collaborative discussions covered potential future de-risking, along with the design of an intermediate self-sufficiency target. By the end of the workshop all parties understood each other's objectives and had agreed long-term goals for the Scheme.

To understand how ViewPoints could help with your Integrated Risk Management, please call your usual Aon Consultant.

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About Aon

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