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Pension Board

Wednesday 25 March 2020 at 6.00 pm
Board Room 2 - Brent Civic Centre, Engineers Way, Wembley HA9 0FJ

Membership:

Members	Representing
Mr Ewart	Independent Chair
Councillor Members	
Councillor Crane	Brent Employer representative
Councillor Kabir	Brent Employer representative
Co-opted Members	
Bola George	Member representative (Unison)
Chris Bala	Pension Scheme Members Representative
Robert Wheeler	GMB Trade Union

For further information contact: Joe Kwateng, Governance Officer
joe.kwateng@brent.gov.uk; 020 8937 1354

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www.brent.gov.uk/committees

The press and public are welcome to attend part of this meeting

Notes for Members - Declarations of Interest:

If a Member is aware they have a Disclosable Pecuniary Interest* in an item of business, they must declare its existence and nature at the start of the meeting or when it becomes apparent and must leave the room without participating in discussion of the item.

If a Member is aware they have a Personal Interest** in an item of business, they must declare its existence and nature at the start of the meeting or when it becomes apparent.

If the Personal Interest is also significant enough to affect your judgement of a public interest and either it affects a financial position or relates to a regulatory matter then after disclosing the interest to the meeting the Member must leave the room without participating in discussion of the item, except that they may first make representations, answer questions or give evidence relating to the matter, provided that the public are allowed to attend the meeting for those purposes.

***Disclosable Pecuniary Interests:**

(a) **Employment, etc. -** Any employment, office, trade, profession or vocation carried on for profit gain.

(b) **Sponsorship -** Any payment or other financial benefit in respect of expenses in carrying out duties as a member, or of election; including from a trade union.

(c) **Contracts -** Any current contract for goods, services or works, between the Councillors or their partner (or a body in which one has a beneficial interest) and the council.

(d) **Land -** Any beneficial interest in land which is within the council's area.

(e) **Licences-** Any licence to occupy land in the council's area for a month or longer.

(f) **Corporate tenancies -** Any tenancy between the council and a body in which the Councillor or their partner have a beneficial interest.

(g) **Securities -** Any beneficial interest in securities of a body which has a place of business or land in the council's area, if the total nominal value of the securities exceeds £25,000 or one hundredth of the total issued share capital of that body or of any one class of its issued share capital.

****Personal Interests:**

The business relates to or affects:

(a) Anybody of which you are a member or in a position of general control or management, and:

- To which you are appointed by the council;
- which exercises functions of a public nature;
- which is directed is to charitable purposes;
- whose principal purposes include the influence of public opinion or policy (including a political party of trade union).

(b) The interests a of a person from whom you have received gifts or hospitality of at least £50 as a member in the municipal year;

or

A decision in relation to that business might reasonably be regarded as affecting the well-being or financial position of:

- You yourself;

a member of your family or your friend or any person with whom you have a close association or any person or body who is the subject of a registrable personal interest.

Agenda

Introductions, if appropriate.

Apologies for absence and clarification of alternate members.

I have attached a number of appendices (12) to the report.

8 2019 Triennial Valuation Results and Funding Strategy Statement 403 - 452

This report sets out the results of 2019 triennial actuarial valuation and the Funding Strategy Statement (FSS) to the Committee for consideration and approval.

I have attached appendices to the report some of which are excluded from the press and public for reasons set out below in item 14.

9 Abatement of Local Government Pension on re-employment 453 - 460

This report provides the Committee with information regarding the reduction or suspension of a Local Government Pension on account of further employment within Local Government after an individual has retired (Abatement).

Information about the abatement practices of other Local Authorities is set out in Appendix 1 while further explanation of the current policy and proposed change is set out in Appendix 2.

10 Review of Investment Strategy 461 - 480

This report presents the analysis and results of the investment review carried out by Hymans Robertson. The review, that follows on from the 2018 strategic investment review and the Fund's 2019 Actuarial Valuation, was to review the current investment strategy and analyse the ability of alternative strategies to meet the Fund's strategic objectives.

I have attached an appendix to the report.

11 Update on Responsible Investment, Climate Change Risk and Environmental, Social and Governance (ESG) issues 481 - 510

This report provides an update on Environmental, Social and Governance (ESG) considerations with regards to strategic investment decisions, in particular how the fund is continuing to manage the risks of climate change.

I have attached appendices to the report some of which are excluded from the press and public for reasons set out in item 14.

12 Date of next meeting

The next scheduled meeting will be confirmed at the Council's Annual Meeting in May 2020.

13 Any other urgent business

Notice of items to be raised under this heading must be given in writing to the Head of Executive and Member Services or his representative before the meeting in accordance with Standing Order 60.

14 Exclusion of Press and Public

The following reports are excluded from the press and public as they contain the following category of exempt information as specified in Paragraph 3, Schedule 12A of the Local Government Act 1972, namely: "Information relating to the financial or business affairs of any particular person (including the authority holding that information)".

15 London CIV update 511 - 562

The purpose of this report is to update the committee on recent developments within the London CIV (LCIV).

I have added 3 appendices to the main report.

16 Appendices to Triennial Valuation report 563 - 638

17 Appendix to report - ESG Issues 639 - 640

Date of the next meeting:
To be confirmed after the Council Annual Meeting in May 2020

Please remember to ***SWITCH OFF*** your mobile phone during the meeting.

- The meeting room is accessible by lift and seats will be provided for members of the public.

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Brent

MINUTES OF THE PENSION BOARD
Tuesday 22 October 2019 at 6.00 pm

PRESENT: Mr Ewart (Chair) and Councillor Crane, Councillor Kabir, Ms George and Mr Wheeler

1. **Apologies for absence**

   Received from Mr Chris Bala.

2. **Declarations of interests**

   None declared.

3. **Minutes of the previous meeting - 13 June 2019**

   RESOLVED:

   That the minutes of the last meeting held on 13th June 2019 be approved as an accurate record.

4. **Matters arising**

   None.

5. **Pensions Administration Update**

   This report updated the Pensions Board on various pensions' administration matters as part of its remit to oversee the administration of the Brent Pension Fund. The report also reviewed the performance of the LPP contract against agreed Service Level Agreements (SLA's) during September 2019. Mr Ravinder Jassar (Head of Finance) introduced the report and drew Members' attention to the tables within the report, which showed contract statistics for cases that had been processed, grouped by category and progress by month in the last 6 months.

   He continued that the amount of cases carried forward had improved significantly since April, a reflection of all the backlog of cases inherited from the previous administration provider which were being actioned or reviewed by LPP. Members heard that a total of 9 complaints were outstanding in April, 7 of which had been resolved since. He added that complaints were being dealt with as swiftly as possible with lessons learnt from them and processes and procedures updated accordingly.

   Mr Jassar gave an update on Annual Benefit Statements (ABS), a statutory responsibility for the scheme manager to issue to all eligible active and deferred members by 31 August each year. By the deadline date, there were a small number of records where queries from year end returns had not been resolved in time and for those members, an ABS could not be produced as employers had not been forthcoming with the relevant information. The vast majority of those employers were schools that were closed over the summer months and could not respond to LPP's queries in a timely manner. He further updated that 34% of the outstanding queries had been resolved and ABS issued to members and it was expected that all queries would have been resolved by the end of March 2020. Progress was being regularly monitored and tracked as part of the monthly contract management and performance meetings with LPP.

In respect of data cleansing, a separate project commissioned to review, cleanse and fix any errors identified in member data, Members heard that phase 1 of the project was completed ahead of the 2019 triennial valuation. Mr Jassar drew Members' attention to appendix 3 of the report, which provided a status update for all work streams at the completion of phase 1 and added that officers would work closely with the Hymans Roberts (Investment Adviser) on the second phase of the project.

In the discussions that followed, Members expressed a preference to scrutinise the complaints about the service and with that in view, requested a further report on complaints to the next meeting. It was also suggested that in order to improve smaller employers' submissions for the purposes of ABS, consideration should be given to engagement with CVS Brent.

RESOLVED:

i) That the pensions administration update be noted;

ii) that a report on complaints on the service be submitted to the next meeting of the Board.

6. **LGPS Update**

This report updated the Board on recent developments within the LGPS regulatory environment and recent consultations issued by the Ministry of Housing, Communities and Local Government. Mr Sawan Shah (Senior Finance Analyst) introduced the report and informed Members that the HM Treasury (HMT) launched a consultation on draft regulations, guidance and directions to implement the exit payment cap which was set at £95,000. He drew Members' attention to the Local Government Association (LGA) response paper, appended to the report, which raised concerns on the feasibility and consequences of implementing the Policy in the manner set out in HM Treasury's Consultation Document.

Mr Shah then gave an update on the McCloud case; transitional protections that protected older judges and firefighters from the public sector pension scheme changes in 2015. Members heard that on 14 May 2019, the scheme advisory board (SAB) published an advice note covering the implications of McCloud/Cost Cap in relation to the 2019 fund valuations. He then outlined the key points from the Advice Note and added that the Fund Actuary had produced a summary regarding the various approaches in which the McCloud risk can be managed. Given that no remedy had been agreed by 31st August 2019, it would leave Funds to consider locally, how best to manage the uncertainty and risk.

In respect of Governance, Mr Shah informed Members that the Scheme Advisory Board (SAB) commissioned Hymans Robertson to examine the effectiveness of current LGPS Governance Models and to consider alternatives and enhancements to existing models which can strengthen LGPS Governance, going forwards. Hymans Robertson undertook a process of engaging extensively with stakeholder groups and fund types to consider four governance models, each of which would be assessed against set criteria. The results found that there was a majority preference in adopting a governance model which combined improved practice with greater ring fencing of the LGPS within existing structures. In addition to this, the results found that there was a preference for clearer ring-fencing of Pension Fund management from the host authority, including budgets, resourcing and pay policies.

Following the analysis of these results, Hymans Robertson proposed that an outcome based approach to LGPS governance, with minimum standards, should be adopted rather than a prescribed governance model. In addition to this, Hymans Robertson proposed updating of relevant guidance and training requirements. Following the approval of the good governance report, the Scheme Advisory Board (SAB) has asked Hymans Robertson to assist with the next stage of this project which will involve the defining of good governance outcomes and options for assessment of these outcomes. Further details of the results and analysis undertaken by Hymans Robertson were set out in Appendix 3 to the report. Overall the Fund supported these recommendations, in particular, clearly clarifying the standards expected in areas of governance and administration.

Members welcomed the report and RESOLVED:

That the report on the recent developments in the LGPS be noted.

7. **Brent Risk Register 2019**

This report presented the updated Risk Register for the Brent Pension Fund Pensions Administration Service. Mr Saagar Raithatha (Finance Analyst) in introducing the report stated that having a strategy and register in place enabled the scheme manager to identify and manage scheme risks alongside established reporting mechanisms. He added that key elements of the strategy were discussed at a recent working party set up with the scheme manager, administrator and select employers for feedback and comment. The Register and the Risk were attached to this report in Appendices 1 and 2, respectively.

Mr Raithatha drew Members' attention to a new risk that had been added relating to the McCloud judgement which would potentially increase pension fund liabilities.

In welcoming the report, the Chair thanked officers for producing a comprehensive and better formatted register and RESOLVED:

That the Brent Risk Register 2019 be noted.

8. **The Pensions Regulator (TPR)**

This report presented the outcome of The Pensions Regulator's (TPR) engagement sessions with Local Authorities. Mr Ravinder Jassar (Head of Finance) informed the

Board that the sessions were started as TPR identified a slowdown in improvements across LGPS funds and wanted to gain a better understanding of the reasons for this. The reviews and meetings with TPR, based on the Code of Practice 14: Governance and administration of public service pension schemes. covered various risk areas including the following:

Administration, data and communication
Internal controls and complaint handling
Contributions, employer compliance and funding affordability
Pension Board knowledge and understanding, relationship between Board and Scheme manager and conflicts of interest
Fraud, mitigation of scams and cyber security

The meetings gave TPR a strong insight into current governance and administration practice and standards of LGPS funds as a result of which a number of recommendations were made across each element. He drew Members' attention to the key points as set out within the report and added that the recommendations made by TPR were agreed. He continued that the cyber security policy including penetration testing had been submitted to TPR. In response to Members' request, Mr Jassar undertook to re-send the link to the TPR on-line pensions training.

In welcoming the report, members RESOLVED:

That the outcome of the Pension Regulator's engagement sessions be noted.

9. **Brent Pension Fund's approach to Responsible Investment and Environmental, Social and Governance issues**

This report set out the Fund's proposed approach to further integrating Environmental, Social and Governance (ESG) considerations into its strategic decision making, in particular how the Fund intended to take in the short and medium term to manage the risk of climate change. Mr Ravinder Jassar introduced the report and highlighted that the Brent Pension Fund Committee took Responsible Investment ("RI") seriously, aware that ESG factors can influence the Fund's ability to achieve long term sustainable returns. The Fund's RI commitment is reflected in the Fund's Investment Strategy Statement.

He continued that ESG criteria of its existing investments were assessed on an ongoing basis, including regular interaction and challenge of the Fund's investment managers (including the Fund's asset pool, London CIV). ESG also remained a key consideration when assessing the relative merits of any potential new Fund investments, in addition to ongoing education programme to increase overall knowledge.

The Fund's policy on RI is informed by its fiduciary duty to its members and employers, rather than by purely ethical considerations. Accordingly, the Fund did not disinvest from companies for purely non-financial reasons, not least because this could lead to legal challenge. He outlined different climate related scenarios which Hymans, the Fund's actuary and investment advisors, would model to help funds explore any challenging questions. To that end, it was proposed to undertake a carbon footprint exercise for the Fund in order to improve its understanding of the Fund's holdings. Officers would work with our investment advisors, Hymans, to scope out this project further and report back to the committee. Following this, recommendations on the measurement of and actions related to carbon emissions would then be presented to the committee for approval. Mr Jassar then referenced collaboration with other investors and groups including the Local Authority Pension Fund Forum (LAPFF) which had the potential to help influence and improve market best practice standards, as well as strengthening the voice of pension funds.

Members welcomed the report and RESOLVED:

(i) To note the overall report with regards to position on responsible investment and climate change;

(ii) To note the further work proposed with regards to scenario analysis, carbon footprint analysis and consideration of alternative index-tracking funds.

10. **Investment Monitoring report on Fund Activity for Q2, 2019**

This report updated members on the Fund’s activity for quarter 2, 2019. Mr Ravinder Jassar (Head of Finance) introduced the report and informed Members that the Fund returned ahead of benchmark in the Q2 2019, continuing the strong start to 2019 and over the quarter the fund grew from just over £856m to almost £897m. He anticipated an increasing trend in Q3 which will be reported to the next meeting. Mr Jassar clarified manager ratings and provided business updates as set out in the report.

Members welcomed the report which had been presented to Brent Pension Fund Sub-Committee and RESOLVED:

That the investment monitoring report for Q2 be noted.

11. **Brent Pension Fund: Annual Report and Accounts 2018/19**

This report presented the draft Pension Fund Annual Report and audited Annual Accounts for the year ended 31 March 2019. Mr Sawan Shah (Senior Finance Analyst) informed Members that there had been no major changes to the audited Annual Accounts since the submission of the Draft Annual Accounts to the Sub-Committee. He continued that only minor amendments and additional clarifications were made to the draft accounts by Grant Thornton (Council’s auditors) and signed off. He highlighted the following main items:

The value of the Fund’s investments increased from £831.1m to £856.4m and total contributions received from employers and employees totalled £52.1m for the year, an increase on the previous year’s £49.9m. Total benefits paid to scheme beneficiaries, in the form of pensions or other benefits, totalled £45.9m, an increase on the previous year’s £38.9m. He added that as in 2017/18, the Fund was in a positive cash-flow position because its contributions exceed its outgoings to members.

Members welcomed the report which had been presented to Brent Pension Fund Sub-Committee and RESOLVED:

That the Annual report and accounts for 2018/19 be noted.

12. **Review of Fund benchmarks and performance targets**

The purpose of this report was to review the Fund's investment benchmarks and performance targets at an individual asset class level. Mr Sagaar Raithatha (Finance Analyst) explained that The Fund required benchmarks so that 'gaps' or problems with performance can be identified and performance improvements can be achieved through investigating causes and identifying the best solutions. He drew Members' attention to the recommendations to the Fund's benchmarks and performance targets (attached at appendix 1). Mr Raithatha added that at an individual asset class level, it was proposed to adopt new benchmarks and performance targets set against Capital Dynamics Private Equity, Baillie Gifford Multi Asset, Ruffer Multi Asset, Alinda Infrastructure, Capital Dynamics Infrastructure and LCIV CQS Multi Credit.

In noting that the changes would be incorporated in the next quarterly reporting of Fund activity, Members RESOLVED:

That the proposed changes to the Funds investment benchmarks and performance targets be noted.

13. **Equitable Life Proposal**

The report outlined proposed changes to the Equitable Life, a legacy Additional Voluntary Contributions (AVC) provider for the Brent Pension Fund. Mr Sawan Shah (Senior Finance Analyst) explained that AVCs were potentially a tax efficient way to save money for retirement in addition to the main Local Government Pension Scheme, allowing members to retire early or with a higher pension. He clarified that the scheme, provided by Equitable Life, affected about 25 members only and was not part of the assets of Brent Pension Fund.

Members welcomed the report which had been presented to Brent Pension Fund Sub-Committee and RESOLVED:

The Equitable Life proposal as set out within the report be noted.

14. **Date of next meeting**

It was noted that the next meeting will be held on 25th March 2020.

15. **Any other urgent business**

Appointment of Employer Representative.

Mr Ravinder Jassar informed the Board that the process for the appointment of Employer representative on the Board to replace Mr Steer had begun. He added that in order to generate greater interest in the appointment, he would give a short presentation at the next meeting of Employers' Forum.

16. **Exclusion of Press and Public**

RESOLVED:

That the press and public be excluded from the consideration of the following reports as they contain the following category of exempt information as specified in Paragraph 3, Schedule 12A of the Local Government Act 1972, namely:
“Information relating to the financial or business affairs of any particular person (including the authority holding that information)"

17. **London CIV Update**

The purpose of this report was to update the Board on recent developments within the London CIV (LCIV). Mr Sawan Shah (Senior Finance Analyst) provided updates on personnel at the LCIV and the confirmation of the appointment of J.P. Morgan as the new sub-fund manager of the LCIV Emerging Market Equity Fund, subject to the completion of the Investment Management Agreement (IMA). Members also received updates on multi asset credit fund and infrastructure fund and noted that the proposal submitted by the LCIV in August 2019 for the Infrastructure Fund had been granted permission. He referenced MiFID II which reclassified local authorities from professional to retail client status. Members heard that the Fund submitted its application to opt-up to professional client status for alternative asset classes and that the London CIV had confirmed its approval.

In welcoming the update, Members RESOLVED:

i) That the recent developments with the London CIV be noted;

i) That the transition arrangements relating to the LCIV Emerging markets fund be noted.

18. **2019 Triennial Valuation**

The purpose of this report was to update members on the progress of the 2019 Triennial Valuation and the next steps. The report had been presented to Brent Pension Fund Sub-Committee meeting at which Members approved the draft FSS (Funding Strategy Statement) for consultation with employers. Mr Ravinder Jassar (Head of Finance) drew Members’ attention to the draft FSS attached as appendix 1 to the report and the key changes since the last valuation in 2016. He continued that following consultation with other employers within the Fund, an updated report would be submitted to the Sub-Committee and the Board.

Members welcomed the report which was first presented to the Sub-Committee meeting and RESOLVED:

i) That the progress on the triennial valuation be noted;

ii) that the Whole Fund results be noted;

iii) that the current draft of the Funding Strategy Statement (FSS) be noted;

iv) to note that the draft FSS will be consulted with employers, as required by LGPS Regulations, and reported to the next meeting in 2020 for formal ratification.

The meeting closed at 8.00 pm

MR. D EWART
Chair

Brent	**Pension Board** 25 March 2020
	Report from the Director of Finance

Brent Risk Register

Wards Affected:	N/A
Key or Non-Key Decision:	N/A
Open or Part/Fully Exempt: (If exempt, please highlight relevant paragraph of Part 1, Schedule 12A of 1972 Local Government Act)	Open
No. of Appendices:	Two 1. Risk Register 2. Risk Strategy
Background Papers:	None
Contact Officer(s): (Name, Title, Contact Details)	Minesh Patel, Director of Finance Ravinder Jassar, Head of Finance

1.0 Purpose of the Report

1.1 This report presents the updated Risk Register for the Brent Pension Fund Pensions Administration Service.

2.0 Recommendation(s)

2.1 The board is asked to note the report.

3.0 Background

3.1 Effective risk management is the foundation of sound corporate governance and for the LGPS the focus should be on all aspects of the scheme's operation, not just investment matters. Having a strategy and register in place is a way for the scheme manager to identify and manage scheme risks and it is considered good practice to have a strategy and register in place alongside established reporting mechanisms.

3.2 Using guidance from The Pensions Regulator and CIPFA, together with Brent's internal risk management resources, a process was undertaken in 2018 to produce a risk management strategy that was unique to Brent's circumstances. This involved a workshop that identified all of the relevant risks, assessed those risks in terms of likelihood, understanding risk management and contingency planning, monitoring risks and documentation in a register.

3.3 It is recognised that risk management works well when the administering authority, the Pension Board and employers work together. All parties then understand each other's capacity and appetite for risk. Key elements of this strategy were discussed at a recent working party set up with the scheme manager, administrator and select employers for feedback and comment. The Risk Strategy is attached to this report in Appendix 2.

3.4 It has been agreed in previous Board meetings that the Risk Register would become a standing agenda item at these meetings, with new risks and any changes to classifications of risks being reported to the board.

3.5 Key changes to the Risk Register:

- The risk register has been updated to reflect completion of phase 1 of the data cleanse project and the 2019 triennial valuation;
- A specific risk has been added in relation to the impact of coronavirus (COVID-19).

The board is asked to notify the scheme manager if it disagrees with these classifications and present any new risks that they would like to be considered.

3.6 The revised Risk Register is attached at Appendix 1 and it is proposed to present any changes or updates to this document to the Pension Board at every meeting.

4.0 Financial Implications

4.1 There are no specific financial implications associated with noting this report.

5.0 Legal Implications

5.1 None arising directly from this report

6.0 Equality Implications

6.1 None arising directly from this report

7.0 Consultation with Ward Members and Stakeholders

7.1 Not applicable for this report.

8.0 Human Resources/Property Implications (if appropriate)

8.1 None arising directly from this report

Report sign off:

Minesh Patel
Director of Finance

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		The London Borough of Brent Pension Fund Risk Register 2020								
Index	**A**	**B**	**C**	**D**	**E**	**F**	**G**	**H**	**I**	**J**
1	**Risk Area Disaster Recovery**	**Risk & Outline**	**Likelihood**	**Impact**	**Score**	**Control**	**Owner**	**Test**	**Next Review**	**Comment 1**
1.1	Operational Disaster Recovery Plans Brent	Loss of or unable to access admin systems for: a) Pensions b) Payroll c) Pensioner payroll	**1**	**10**	**10**	Brent Council Business Continuity Procedures	Brent	Annual	2020	Brent Council disaster recovery plan in place
1.11		Pension Systems I.T.	**1**	**10**	**10**	Database of all: a) Advisors b) Suppliers c) Contracts	Brent	Annual	2020	Held as hard copy by Brent Council's Legal Department
1.2	Operational Disaster Recovery Plans LPP	Loss of or unable to access LPP admin systems for pensions	**1**	**6**	**6**	LPP Shared Service Agreement.	LPP	Annual	2020	From 1 October 2018 LPP disaster recovery plan in place as part of their Shared Service Agreement with Brent Council
1.21		LPP Pensions Admin System (Altair) used by Brent Council Employers, Maintained Schools and Academy's	**1**	**6**	**6**	LPP Shared Service Agreement	LPP	Annual	2020	LPP have a recovery plan in place for their pension admin platform Altair (External provider Aquila/Haywood)
2	**Risk Area Business Continuity Planning**	**Risk & Outline**	**Likelihood**	**Impact**	**Score**	**Control**	**Owner**	**Test**	**Next Review**	**Comment**
2.1	Business Continuity	LPP Financial Standing	**1**	**10**	**10**	LPP Service Contract	Brent	Annual	2020	Brent Council discuss LPP budget at regular contract monitoring meetings.
3	**Risk Area Risk Planning**	**Risk & Outline**	**Likelihood**	**Impact**	**Score**	**Control**	**Owner**	**Test**	**Next Review**	**Comment**
3.1	Risk Planning And Monitoring	Not monitoring: a) Risk and the risk plan b) And amending it as required c) Or adding new areas of risk as they appear Will lead to the risk plan being: a) Inaccurate b) Known risks not being accounted for c) No plans to address these risks	**1**	**10**	**10**	Risk Plan	Brent	Annual	2020	The Risk Register is monitoring and reviewed by the Scheme Manager and the Pensions Board. Areas of risk are when required: a) Updated b) Amended c) New risks added if identified
4	**Risk Area Data Security**	**Risk & Outline**	**Likelihood**	**Impact**	**Score**	**Control**	**Owner**	**Test**	**Next Review**	**Comment**
4.1	Data Security	External attack, loss of data, locked out of data, poor internal procedures can lead to an increased risk of attack from: a) outside b) or internal fraud	**2**	**10**	**20**	Brent Council Data Security Procedures	Brent	Annual	2020	Procedures on data security in place, systems kept up to date with latest security updates
4.12		Not backing up data regular using secure backup systems	**2**	**10**	**20**	Data Back Up Procedures.	Brent	Annual	2020	Data is backed up on an incremental basis daily and fully backed up weekly, data kept in secure sites.
4.13		a) Clean desk polices not being adhered to: b) Cabinets left open or not locked c) Documents left out overnight d) Documents left on colleagues desk when they are away e) Computer not locked when operator leaves their desk	**2**	**5**	**10**	Brent Council Data Security Procedures	Brent	Annual	2020	Possibility of: a) Sensitive data being seen by unauthorised persons b) Data theft c) GDPR breached e) Brent Councils reputation put at risk
4.14		Taking laptops away from desk that are not password protected with encryption, using them on public transport Not storing laptops in secure location when not in use	**1**	**5**	**5**	Brent Council Data Security Procedures	Brent	Annual	2020	This can lead to: a) Large losses of sensitive data b) Unauthorised people seeing sensitive data while on public transport c) Breach of GDPR d) Breach of Councils policies and dismissal from service
4.2	General Data Protection Regulations	General Data Protection Regulations (GDPR) came into effect 25 May 2018, failure to comply with GDPR will lead to: a) Complaints b) Data breaches c) Possible fines d) Loss of reputation	**1**	**10**	**10**	Brent GDPR Policies	Brent	Annual	2020	Brent has GDPR policies in place and publishes GDPR privacy notices: a) Online b) Yammer c) In news letters d) In communications to its members, employers, academy's, maintained schools
4.21		Sending sensitive data by email ensuring it will be sent to the right recipient and encrypted, or using a secure transmission system	**2**	**8**	**16**	Brent GDPR Policies	Brent	Annual	2020	Sensitive data being sent to an unauthorised person or business leading to breach of GDPR
4.3	Cyber Security	Unlawful cyber access or attacks could be serious for a scheme and its members, and could in the end result in identity theft, loss of data or even loss of financial assets	**2**	**10**	**20**	Brent Council Data Security Procedures LPP Cyber Security Procedures	Brent	Annual	2020	Both Brent and LPP have significant cyber security policies and procedures in place to prevent and deter cyberattacks. The impact of a cyber attack could be significant, so it is important for these to be permanently up to date.
5	**Risk Area Pension Administration**	**Risk & Outline**	**Likelihood**	**Impact**	**Score**	**Control**	**Owner**	**Test**	**Next Review**	**Comment**
5.1	(Backlog) LPP Pension Administration Post Capita Handover November 2018	Backlog of work from Capita: a) Delay in administrative processing because of incomplete scheme data b) Increased administration costs c) Members benefits being delayed d) Increase in complaints e) Places an unwarranted and costly drain on Brent resources	**5**	**10**	**50**	LPP Shared Service Agreement	Brent	Monthly	Monthly	Extra resource outside of BAU provided by the LPP, phase 1 complete. Plan in place to treat the backlog inherited from Capita is being done as a separate project so resources not take away from BAU administration. Phase 2 under consideration.
5.2	(Scheme Data) Scheme Data Provided to LPP by Capita for: Maintained Schools Academy's Employers	Missing common and Scheme Specific data not provided by employers, maintained schools and academy's leads to delay in progressing administration for members	**5**	**10**	**50**	LPP Data Check November 2018	Brent	Annual	2020	LPP run a test of the data sent by Capita October 2018 Common Data 98% improved from 2017 Scheme Specific data 93% same as 2017
5.3	Record Keeping Planning	Not updating the record keeping plan to take into account changes of circumstances thorough the year could lead to a failure to take corrective action leading to a drop in the quality of scheme data or delays in processing member benefits	**5**	**10**	**50**	RKP 2019	Brent	Monthly	Monthly	Brent record keeping plan to be created to deal with poor common data and scheme Specific data being below requirements as highlighted the LPP November 2018 data check. Phase 1 of data cleanse project is now complete. Officers are working with LPP to identify requirements of phase 2 of the project.

5.4	(Employer Data) Maintained Schools Academy's Employers Supplied Data to Capita	Failure by Maintained Schools, Academy's, Employers to provide data accurately and on time to the LPP results in poor scheme data held by the LPP	5	10	50	PAS 2018	Brent	Annual	2020	Employers to export data monthly to LPP system highlighting data problems by import validation, also reporting from the admin systems of missing files leads to early indication of employers having data problems Training to be provided to employers by the LPP on using the systems and what LPP requires from employers Revised PAS sets out what employer need to be doing
5.5	Loss of Key Staff Members	Specialist nature of the work means there are relatively few staff members with knowledge of the Local Authority Pensions Regulations and Pensions Administration requirements. Significant knowledge gap left if specialist staff leave, likely to cause short-term disruption.	4	8	32	Training Plan	Brent	Annual	2020	Key Officers to ensure processes are documented and knowledge is being passed on to other members of the team, to ensure limited disruption in the event of an unexpected absence or leaving the position. Training events delivered by external parties are available and staff are encouraged to attend External Support is available to mitigate this risk, both from external advisors and LPP who manage the fund's administration
5.6	Impact of Coronavirus (COVID-19)	Increase in staff who are unwell leading to: a) Delays in administrative processing and increase in backlog cases b) Member benefits being delayed c) Increase in complaints d) Difficulties in meeting key deadlines such as year-end Delays in implementing the agreed investment strategy due to volatile financial markets.	10	7	70	Brent Council Business Continuity Procedures LPP Business Continuity Procedures Hymans Robertson Business Continuity Plan (as Fund Actuary and Investment Advisors)	Brent	Ongoing	Ongoing	Situation is being monitored on an ongoing basis. Staff to observe Government and NHS guidance which is being updated on a regular basis. Increase in use of flexible working and remote working technologies should workplaces be required to be shut. The Fund will not experience any issues in payment of member benefits as a result of market movements. The Fund will continue to hold a well-diversified portfolio of investments and maintain a long-term perspective.
6	**Risk Area Plan Events**	**Risk Outline**	**Likelihood**	**Impact**	**Score**	**Control**	**Owner**	**Test**	**Next Review**	**Comment**
6.1	Pension Plan Events Planning	Plan events such as: a) Annual benefits statements b) Year end reporting to the TPR c) Accounting d) Pension increases e) Plan valuations f) All require planning in advance to ensure completion on time	4	10	40	Plan Calendar	Brent	Annual	2020	Plan Calendar to identify events: a) What work is required b) What recourses will be used c) Completion and sign off
6.12		Pension projects such: a) GMP reconciliation b) Changes in legislation that needs to be actioned c) GMP equalised for men and woman	5	10	50	Plan Calendar	Brent	Annual	2020	To allow longer term planning for items such as: a) GMP reconciliation b) New legislation coming in to effect c) Ensure Plan events are completed on time d) Prepare for GMP equalisation
6.2	Active Benefits Statements 2019/20	Failure to have the necessary correct and accurate data will lead to: a) Statements not being sent b) Possible delay sending statements whilst this data is obtained and systems updated	6	10	60	LLP Shared Service Agreement	Brent	Annual	2020	Data improvement being carried out under RKP 2019
6.21		Annual Benefits Statement dependant on: a) Common Data b) Scheme Specific data c) Data being improved from the RKP 2019 (RKP 2019 to be finalised December 2018)	5	10	50	LLP Shared Service Agreement	Brent	Annual	2020	Improvement to common and Scheme Specific data being carried out under RKP 2019
6.3	Deferred Member Benefit Statements 2019/20	Incorrect Statuses, no address, missing data to calculate leads to: a) Statements not being issued b) statement inaccurate c) Incorrect valuation and liabilities for the Plan.	5	10	50	LLP Shared Service Agreement	Brent	Annual	2020	Member data is being dealt with under the 2019 Record keeping Plan
6.4	Year End Return	Failure to complete year end return and submit on time leads to fines	2	10	20	PAS 2018 & Plan Calendar	Brent	Annual	2020	All Plan calendar events to be recorded with plans to ensure they are carried out, better planning for EOY with pro active action to get employers to provide data on time in place. Training session provided to employers to assist completion.
6.5	Admission Agreements	Failure to process an admission agreement within the time frames set on in LGPS regulations can lead to transferring employers pension entitlements being delayed, legal issues stopping the agreement from being implemented and costs incurred that can not be recovered	5	10	50	Internal Controls	Brent	Annual	2020	Process for admission agreements to be strengthened
6.52		Not having procedures and processes to processes and monitor agreements are on track and any reason for delayed identified and acted on could lead to delays in implementation of the agreement	5	10	50	Internal Controls	Brent	Annual	2020	Monitoring for admission agreement to be improved
6.53		Oversight of the legal team and ensuring that they are processing the legal agreements in the time set out in the procedures and requirements of admission agreements is a major factor on processing an admission agreement on time	5	10	50	Internal Controls	Brent	Annual	2020	Overseeing of the legal team on admission agreement by the Scheme Manager to ensure no delays and prompt processing of agreement becomes a priority
6.54		Failure to keep to rules and regulation on admission agreement will require this failure to be reported to the TPR	5	10	50	Internal Controls	Brent	Annual	2020	Breeches log to bring attention of failing and lessons learned in processing admission agreements
7	**Risk Area Auto Enrolment**	**Risk Outline**	**Likelihood**	**Impact**	**Score**	**Control**	**Owner**	**Test**	**Next Review**	**Comment**
7.1	Auto Enrolment	Failure to process auto enrolment on time leads to: a) Member complaints b) Members unable to opt out or in c) Delayed administration d) Possible action by the regulator to improve or be fined	1	40	40	Auto Enrolment Procedures	Brent	2020	2020	Auto enrolment checked monthly for: a) Enrolment b) Opt outs c) Opt Ins d) Auto Enrol Renewal, as part of Brent procedures for pensions and payroll
8	**Risk Area Regulatory**	**Risk & Outline**	**Likelihood**	**Impact**	**Score**	**Control**	**Owner**	**Test**	**Next Review**	**Comment**
8.1	Anti Fraud Initiatives Mortality Existence	Benefits paid to people not entitled to benefits from the LGPS	2	5	10	2019 Anti Fraud Plan	Brent	Annual	2020	Administration processes check for fraud
8.2	Pension Board Training	Pension Board members not having the appropriate degree of knowledge and understanding to perform their duties. Pension Board member not having the right knowledge to make informed decisions and challenge Officers of the Council	1	5	5	Pension Board Training Plan	Brent	Annual	2020	Regular training is provided via a training programme for Pension Board members All Pensions Board members to complete and pass the TPR public pensions course online

8.3	Pension Board Conflict Of Interest	Conflicts of interest must be declared in the Register of Interests Failure to declare an interest can lead to serious consequences and pose a risk to the Plan and possibly member	**1**	**5**	**5**	Conflict of Interest Register	Brent	Annual	2020	The register of interests and other relevant documents are circulated to the Pension Board for ongoing review and are published on the Brent Council's website
8.4	Governance	Failure to have good governance plans in place which are reviewed and monitored can lead to: a) Poor administration b) Increased administration costs c) Poor investment outcomes d) Increased levels of risk e) Not understanding what the risks are and having plans to manage the risk f) Statutory requirements not being met such as: g) Annual benefits statements not being produce and sent out h) Pension saving statements not being produce and sent out i) Year end returns late	**1**	**3**	**3**	Multi areas cover governance: a) Plan Rules b) Business Plan c) PAS 2018 d) Scheme Manager e) Pensions Board f) Pensions Sub Committee.	Brent	Annual	2020	Governance is monitored by: a) Scheme Manager b) Pensions Board c) Pensions Sub Committee d) Internal and External Controls
8.5	Failure to make provision for oversight of the administration of the Plan	Failure to ensure that overall oversight is in place and carried out can lead to: a) Breaches of the law b) Poor administration and record keeping c) Unauthorised payments d) Poor administration being allowed to continue e) Failure to meet deadline on time f) Possible fines g) Fraud to occur h) Loss of confidence and reputation for the Council	**1**	**2**	**2**	The Pension Board assists the Scheme Manager in the provision of oversight of how the Plan is administered	Brent	Ongoing	2020	The oversight of the plan is carried out by the Scheme manger with assistance from the Pension Board
8.6	Discretions	A decision to add pension or disregard a reduction on pension for early payment leads to increased costs to the employer	**1**	**5**	**5**	Chief Financial Officer	Brent	Annual	2020	Discretions under review on early retirement with actuarial reduction, Discretions are covered under LGPS Rule 30 (2&5) In preparing such a statement the Council must have regard to the extent to which the discretions are exercised to avoid a loss of confidence in the service provided
8.7	Data Protection Breaches	Breaches not recorded and failure to report a breach to the regulator can lead to fines and loss of reputation	**3**	**6**	**18**	Breaches Log	Brent	Monthly	Monthly	Breaches log to monitor all breaches and report of breached to the regulator
9	**Risk Plan Funding & Accounting**	**Risk & Outline**	**Likelihood**	**Impact**	**Score**	**Control**	**Owner**	**Test**	**Next Review**	**Comment**
9.1	The Fund's Assets Insufficient To Meet Long Term Liabilities	Pension Fund Assets not sufficient to pay: a) Pension benefits b) Transfers c) Death benefits d) Could lead to raising of pensions contributions e) Plan has to reduce benefits f) Reassessment of the funding strategy	**2**	**10**	**20**	Public Sector Payroll Controls	Brent	2020	Monthly	Contributions are checked on a monthly basis Overdue Contributions: Employers Academy's Maintained Schools Are actively chased
9.11			**1**	**10**	**10**	The Funding Strategy Statement	Brent	Tri Annual	2022	A report on the 2019 Triennial Review (including the Funding Strategy Statement) will be presented to the Pension Board at the March 2020 meeting.
9.12			**1**	**10**	**10**	Fund's Funding Level Assessment	Brent	Monthly	Monthly	The Fund receives regular performance reports on its investments from the custodian. The Fund actuary, Hymans Robertson, completes a valuation of liabilities every 3 years.
9.2	Impact of McCloud judgement on Long Term Liabilities	Court of Appeal ruling that transitional protections were unlawful on the grounds of age discrimination could increase employer contributions.	**5**	**8**	**40**	Triennial valuation/ Funding Strategy Statement	Brent	Quarterly	Ongoing	Working with the Fund's actuary, Hymans Robertson, to mitigate the impact of this judgement.
9.3	Pension Contributions not Paid by: Maintained Schools Academy's Employers a) On time b) Or not at all c) Refusal to pay	Effects the Plans abilities to: a) Pay out benefits b) Braking the law on pension contribution collections. c) Unnecessary costs for chasing for contributions. d) Continuing non payment for pension contributions will lead to: e) Breaches for the payment of pension contribution regulations f) Being reported for breaches as required by law g) Delay benefits beginning paid h) Can lead to delays in accounting for pension contributions	**2**	**10**	**20**	PAS	Brent	2020	2020	Procedures in place to deal with pension contributions not being made or late
9.31			**2**	**10**	**20**	PAS	Brent	Annual	2019	Engaging with: a) Employers b) Academy's c) Maintained Schools d) With working parties and employer forums e) LPP to provide more support in this area
9.32			**2**	**10**	**20**	PAS	Brent	2020	2020	Contributions are monitored on a monthly basis and late or non payers reported. 2019 Revised PAS to include fines for non compliers
9.4	Pension Plan Accounting	Failure to comply with accounting regulations will lead to serious consequences: a) Possible fines b) Loss of reputation	**2**	**10**	**20**	Annual audit	Brent	Annual	2020	Accounts for the year to 31 March 2019 signed off by auditors Grant Thornton
9.41			**1**	**10**	**10**	Triennial valuations	Brent	Tri Annual	2022	2019 Triannual in final stages, next triannual valuation 2022
9.42			**1**	**10**	**10**	The Funding Strategy Statement	Brent	Tri Annual	2022	A report on the 2019 Triennial Review (including the Funding Strategy Statement) will be presented to the Pension Board at the March 2020 meeting.
9.43			**1**	**10**	**10**	Fund's Funding Level Assessment	Brent	Monthly	Monthly	The Fund receives regular performance reports on its investments from the custodian. The Fund actuary, Hymans Robertson, completes a valuation of liabilities every 3 years.

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London Borough of Brent

Risk Strategy

Table of Contents

1. Introduction

1.1 This is the Risk Strategy for the London Borough of Brent Fund ("the Fund"), which is part of the Local Government Pension Scheme ("LGPS") managed and administered by the London Borough of Brent ("the Administering Authority").

The Risk Strategy details the Fund's approach to managing risk including:

- the risk approach adopted for the management of the Fund, attitudes to risk, how risk is managed and implemented
- risk management responsibilities
- the procedures that are adopted in the Fund's risk management process
- the key internal controls operated by the Administering Authority and other parties responsible for the management of the Fund

2. Strategy objectives

2.1 In relation to understanding and monitoring risks, the Administering Authority aims to:

- integrate risk management into the procedures, internal controls, and the day-to-day activities of the Fund
- raise awareness of the need for risk management by all those connected with the management of the Fund including, the Pensions Board, maintained schools, academy's, employers and other partners
- minimise the probability of negative outcomes for the Fund and its stakeholders
- establish and maintain a robust framework and procedures for identification, analysis, assessment and management of risk, and the reporting and recording of events, based on best practice and TPR guidance of risk
- ensure consistent application of the risk management methodology across all Fund activities, including projects and partnerships.

2.2 To assist in achieving these objectives in the management of the Fund, the Administering Authority will aim to comply with:

- the CIPFA Managing Risk publication
- the Pensions Act 2004
- the Pensions Regulator code of practise 14 as related to risk
- the pensions Regulator Essential guide to the public service code as related to risk

3. Purpose of the strategy

3.1 The Administering Authority recognises that effective risk management is an essential element of good governance in the LGPS. By identifying and managing risks through an effective policy and risk management strategy, the Administering Authority can:

- demonstrate best practice in governance
- improve financial management
- minimise the risk and effect of adverse conditions
- identify and maximise opportunities for improvement and a reduction in risk along with better outcomes for members
- minimise threats

3.2 The Administering Authority adopts best practice risk management, which supports a structured and focused approach to managing risks, and ensures risk management is an integral part in the governance of the Fund at a strategic and operational level.

4. Effective date

4.1 This policy is to go before the Pension Board on 24 July 2018 for approval and will be in effect from that date.

5. Review

5.1 To be viewed quarterly by the Scheme Manager and the Pensions Board and updated as required, or if the risk management arrangements, or other matters included within it, merit reconsideration.

6. Scope

6.1 This Risk Strategy applies to all members of the Pension Board and the Pensions Fund SubCommittee, including scheme member and employer representatives. It also applies to officers involved in the management of the Fund including the Chief Finance Officer (Section 151 Officer), Head of Finance and the Head of Pensions.

6.2 Advisers and suppliers to the Fund are also expected to be aware of this Policy, and assist officers, Committee and Sub-Committee members and Board members as required in meeting the objectives of this Policy.

7. Risk Management Philosophy

7.1 The Administering Authority recognises that it is not possible to eliminate all risks. Accepting and actively managing risks is therefore a key part of the risk management strategy for the Fund.

7.2 In managing risk, the Administering Authority will:

- ensure that there is a proper balance between risk taking and the opportunities to be gained
- adopt a system that will enable the Fund to anticipate and respond positively to change
- minimise loss and damage to the Fund and to other stakeholders who are dependent on the benefits and services provided
- make sure that any new areas of activity (new investment strategies, further joint-working, framework agreements etc.), are only undertaken if the risks they present are fully understood and taken into account in making decisions.

7.3 The benefits of a sound risk management approach include better decision-making, improved performance and delivery of services, more effective use of resources and the protection of reputation.

8. CIPFA and the Pensions Regulator’s Requirements

8.1 CIPFA Managing Risk Publication

CIPFA has published technical guidance on managing risk in the LGPS. The publication explores how risk manifests itself across the broad spectrum of activity that constitutes LGPS financial management and administration, and how, by using established risk management techniques, those risks can be identified, analysed and managed effectively.

The publication also considers how to approach risk in the LGPS in the context of the role of the administering authority as part of a wider local authority and how the approach to risk might be communicated to other stakeholders.

8.2 The Pension Regulator's Code of Practice

The Public Service Pensions Act 2013 added the following provision to the Pensions Act 2004 relating to the requirement to have internal controls in public service pension schemes.

249B Requirement for internal controls: public service pension schemes

1) The scheme manager of a public service pension scheme must establish and operate internal controls which are adequate for the purpose of securing that the scheme is administered and managed: (a) in accordance with the scheme rules, and
(b) in accordance with the requirements of the law.

(2) Nothing in this section affects any other obligations of the scheme manager to establish or operate internal controls, whether imposed by or by virtue of any enactment, the scheme rules or otherwise.

(3) In this section, "enactment" and "internal controls" have the same meanings as in section 249A." Section 90A of the Pensions Act 2004 requires the Pensions Regulator to issue a code of practice relating to internal controls. The Pensions Regulator has issued such a code in which he encourages scheme managers (i.e. administering authorities in the LGPS) to employ a risk based approach to assessing the adequacy of their internal controls and to ensure that sufficient time and attention is spent on identifying, evaluating and managing risks and developing and monitoring appropriate controls.

The Pensions Regulator's code of practice guidance on internal controls requires scheme managers to carry out a risk assessment and produce a risk register which should be reviewed regularly.

The risk assessment should begin by:

- setting the objectives of the scheme
- determining the various functions and activities carried out in the running of the scheme, and
- identifying the main risks associated with those objectives, functions and activities.

The code of practice goes on to say that schemes should consider the likelihood of risks arising and the effect if they do arise when determining the order of priority for managing risks, and focus on those areas where the impact and likelihood of a risk materialising is high. Schemes should then consider what internal controls are appropriate to mitigate the main risks they have identified and how best to monitor them. The code of practice includes the following examples as issues which schemes should consider when designing internal controls to manage risks:

- how the control is to be implemented and the experience of the person(s) performing the control
- the level of reliance that can be placed on information technology solutions where processes are automated
- whether a control is capable of preventing future recurrence or merely detecting an event that has already happened
- the frequency and timeliness of a control process
- how the control will ensure that data are managed securely, and
- the process for flagging errors or control failures, and approval and authorisation controls.

The code states that risk assessment is a continual process and should take account of a changing environment and new and emerging risks. It further states that an effective risk assessment process will provide a mechanism to detect weaknesses at an early stage and that schemes should periodically review the adequacy of internal controls in:

- mitigating risks
- supporting longer-term strategic aims, for example relating to investments
- identifying success (or otherwise) in achieving agreed objectives, and
- providing a framework against which compliance with the scheme regulations and legislation can be monitored.

8.3 The Administering Authority adopts the principles contained in CIPFA's Managing Risk in the LGPS document and the Pension Regulator's code of practice in relation to the Fund. This Risk Strategy highlights how the Administering Authority strives to achieve those principles through use of risk management processes and internal controls incorporating regular monitoring and reporting.

9. Responsibility

9.1 The Administering Authority must be satisfied that risks are appropriately managed. For this purpose, the officers are responsible for ensuring the process outlined below is carried out, subject to the oversight of the Pension Board.

However, it is the responsibility of each individual covered by this Strategy to identify any potential risks for the Fund and ensure that they are fed into the risk management process.

10. The London Borough of Brent Pension Fund Risk Management Process

10.1 The Administering Authority's risk management process is in line with that recommended by CIPFA and is a continuous approach which systematically looks at risks surrounding the Fund's past, present and future activities. The main processes involved in risk management are identified in the figure below and detailed in the following sections.

(1)	Risk Identification
(2)	Risk Analysis
(3)	Risk Control
(4)	Risk monitoring

10.2 Risk identification (1)

The risk identification process is both a proactive and reactive one. Risks are identified by a number of means including, but not limited to:

- formal risk assessment exercises overseen by the Scheme Manager, Pension Board, and Pension Sub Committee
- performance measurement against agreed objectives
- monitoring against the Fund's business plan to be available Q4 2018
- findings of internal and external audit and other adviser reports
- feedback from the Pension Board, maintained schools, academy's, employers and other stakeholders
- liaison with other organisations, regional, national associations, and professional groups

Once identified, risks will be documented in the Fund's risk register, which is the primary control document for the subsequent analysis, control and monitoring of those risks.

10.3 Risk analysis (2)

Once potential risks have been identified, the next stage of the process is to analyse and profile each risk. Risks will be assessed by considering the likelihood of the risk occurring and the effect if it does occur, with the score for likelihood multiplied by the score for impact to determine the current overall risk rating, as illustrated in the table below.

Risk level Reasoning		**Likelihood**	**Impact**	**Score**	**Risk Types**	**Risk Planning**	**Expected Outcomes**
Risk Level	%	1 Least Likely 10 Most Likely	1 Least Likely 10 Most Likely	Likelihood Times Impact			
Low	1 to 20	1	10	10	Risk known	Planned for in advance	Countered by plans and procedures in place if needed
Green Low							
Low to Medium	20 to 50	2	10	20	Risk possible concerns	Monitored	Monitored and plans in action or more actions will be put in place if required
Yellow Low to Medium							
Medium to High	50 to 75	5	10	50	Risk manageable	Managed	Active and pro active longer term plans in place, subject to close monitoring and rapid action if required
Orange Midium to High							
High	75 to 100	8	10	80	Risk having a major impact	Planned actions in place	Action plans in place, monitored weekly, longer term before risk will reduce
Red High							

When considering the risk rating, the Administering Authority will have regard to the existing controls in place and these will be summarised on the risk register.

10.4 Risk control *(3)*

The Head of Finance (Pensions) will review the extent to which the identified risks are covered by existing internal controls and determine whether any further action is required to control the risk, including reducing the likelihood of a risk event occurring or reducing the severity of the consequences should it occur.

Before any such action can be taken, Pension Board and Pension Sub Committee approval may be required where appropriate officer delegations are not in place.

The result of any change to the internal controls could result in any of the following:

- Risk elimination, for example, ceasing an activity or course of action that would give rise to the risk.
- Risk reduction, for example, choosing a course of action that has a lower probability of risk or putting in place procedures to manage risk when it arises.
- Risk transfer, for example, transferring the risk to another party either by insurance or through a contractual arrangement.

The Fund's risk register details all further action in relation to a risk and the owner for that action. Where necessary the Administering Authority will update the Fund's business plan (Due Q4 2018) in relation to any agreed action as a result of an identified risk.

10.5 Risk monitoring (4)

Risk monitoring is the final part of the risk management cycle and will be the responsibility of the Pensions Board. In monitoring risk management activity, the Pension Board will consider whether:

- the risk controls taken achieved the desired outcomes
- the procedures adopted and information gathered for undertaking the risk assessment were appropriate
- greater knowledge of the risk and potential outcomes would have improved the decision-making process in relation to that risk
- are there any lessons to be learned for the future assessment and management of risks.

11. Reporting and monitoring

11.1 Progress in managing risks will be monitored and recorded on the risk register. The risk register, including any changes to the internal controls, will be provided on a quarterly basis to the Pension Board.

The Pension Committee will be provided with updates on an ongoing basis in relation to any significant changes to risks (for example where a risk has changed by a score of 10 or more) or new major risks (for example, scored 25 or more).

As a matter of course, the Pension Fund Board will be provided with the same information as is provided to the Pension Committee (or Pension Sub-Committee as appropriate) and they will be able to provide comment and input to the management of risks.

In order to identify whether the objectives of this policy are being met, the Administering Authority will review the delivery of the requirements of this Strategy on a quarterly basis taking into consideration any feedback from the Pensions Board and Pensions Sub Committee.

12. Key risks to the effective delivery

12.1 The key risks to the delivery of this Strategy are outlined below. The Pension Board will monitor these and other key risks and consider how to respond to them following updates and recommendations from officers:

- Risk management is not embodied into the day to day management of the Fund and consequently the objectives of the Policy are not delivered
- Changes in Pension Board membership and/or senior officers mean key risks are not identified due to lack of knowledge
- Insufficient resources are available to satisfactorily assess or take appropriate action in relation to identified risks
- Risks are incorrectly assessed due to a lack of knowledge or understanding, leading to inappropriate levels of risk being taken without proper controls
- Lack of engagement or awareness of external factors means key risks are not identified
- Conflicts of interest or other factors lead to a failure to identify or assess risks appropriately
- Risk plan is not monitored to ensure actions to reduce risk have been taken and new risks that have been identified are not recorded, monitored and carried out, will lead to risk mot being managed in line with Risk Policy

13. Risk Register Appendix A

The Risk Register Appendix A :

1 Risk Area Disaster Recovery
2 Risk Area Business Continuity Planning
3 Risk Area Risk Planning
4 Risk Area Data Security
5 Risk Area Pension Administration
6 Risk Area Plan Events
7 Risk Area ns
8 Risk Area TPA Transition
9 Risk Area Regulatory
10 Risk Plan Funding & Accounting

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Brent	**Pension Board** 25 March 2020
	Report from the Director of Finance

Pensions Administration Update

Wards Affected:	ALL
Key or Non-Key Decision:	Non-Key
Open or Part/Fully Exempt: (If exempt, please highlight relevant paragraph of Part 1, Schedule 12A of 1972 Local Government Act)	OPEN
No. of Appendices:	1. LB Brent Performance Report
Background Papers:	N/A
Contact Officer(s): (Name, Title, Contact Details)	Minesh Patel, Director of Finance Ravinder Jassar, Head of Finance Sawan Shah, Senior Finance Analyst

1.0 Purpose of the Report

1.1 This report updates the Pensions Board on various pensions administration matters as part of its remit to oversee the administration of the Brent Pension Fund.

2.0 Recommendation(s)

2.1 The board is recommended to note the report.

3.0 Pensions Administration Performance Report

3.1 The administration of the Brent Pension scheme was transferred to LPP on 1 October 2018. This report reviews the performance of the LPP contract against agreed Service Level Agreements (SLA's) during January 2020.

3.2 The Pensions administration team are holding monthly meetings with LPP to monitor the performance of the contract looking at both the individual month and trends across months.

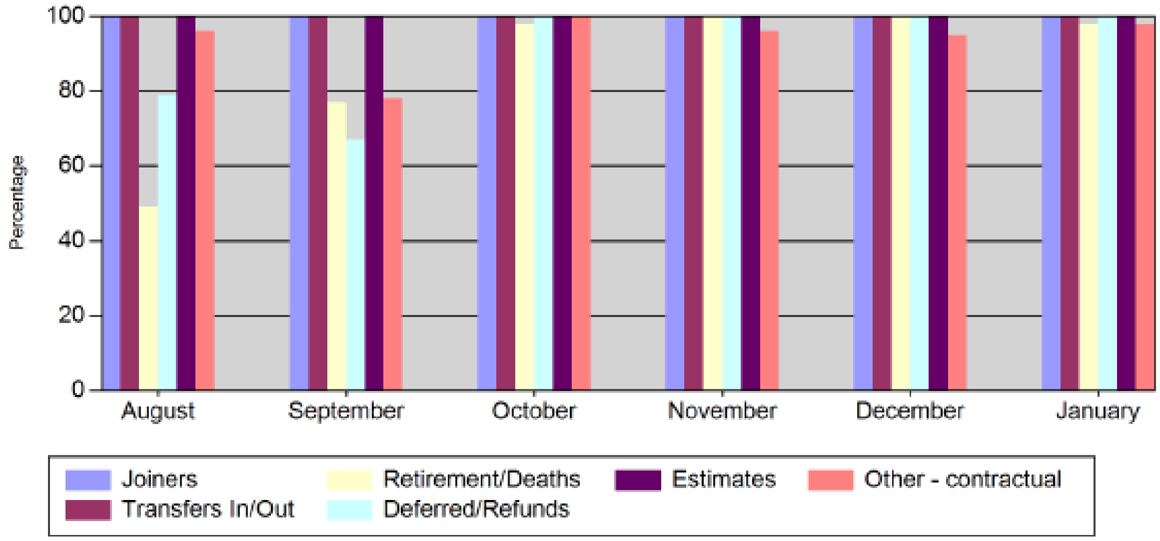
3.3 As of 31 January 2020, the Brent Pension Fund had 7,126 active members, 6,971 pensioners (including dependants), and 7,857 deferred pensioners.

3.4 Table 1 shows contract statistics for cases that have been processed, grouped by category. This includes cases bought forward, received, completed, completed on time and carried forward. Chart 1 below shows progress by month for the last 6 months.

Table 1:

Description	B/fwd	Rec'd	Complete	On Time	% OT	C/fwd	Average Completed Time	Average Elapsed Time
Joiners	42	114	91	91	100.00	65	44	77
Transfers In/Out	294	62	52	52	100.00	304	50	73
Retirement/Deaths	706	75	71	70	98.59	710	35	77
Deferred/Refunds	475	149	118	118	100.00	506	114	160
Estimates	31	40	30	30	100.00	41	24	41
Other - contractual	169	72	89	88	98.88	152	24	35
Total	1717	512	451	449	99.56	1778		

Chart 1:



3.5 In detail, since August, the percentage of cases completed for joiners, transfers in/out and estimates has been maintained, whereas for retirements and deferred/refunds has remained at the same level since October.

3.6 The amount of cases carried forward has increased marginally since August. This is due to a higher volume of cases in January following the Christmas period.

3.7 Table 2 provides detail on the number of cases that have been completed early. Overall 45% of the 449 cases completed on time were completed early.

Description	1 Day Early	2 Days Early	3 Days Early	4+ Days Early
Joiners	16	5	0	19
Transfers In/Out	3	0	3	30
Retirement/Deaths	10	10	7	9
Deferred/Refunds	4	8	20	14
Estimates	2	0	3	5
Other - contractual	11	12	8	3
	46	**35**	**41**	**80**

3.8 Since August 2019, 6 new complaint cases have been received. Of the 8 cases that were outstanding in August, 7 cases were resolved. Brent and LPP are taking action to ensure that these cases are resolved swiftly however the complex nature of some cases means that this is not always possible. In addition, following the completion of each case a process is undertaken to ensure any lessons learned are reviewed and consequently, if necessary, processes and procedures updated.

3.8 Appendix 1 sets out further details on complaints, performance, cases completed and pensions helpdesk performance for an extended period of 1st February 2019 to 31st January 2020.

4.0 Employer Training Session

4.1 During February 2020, an employer training session was held for all employers participating in the Brent Pension Fund. The purpose of this training session was to engage with employers and provide them with key information ahead of year end.

4.2 Ahead of the training session, Brent officers and LPP issued a survey to all employers to receive feedback on service provision, training requirements, areas for improvement and other relevant issues. The survey had a high response rate and based on these results, officers put together a tailor made training session to address the comments and feedback received.

4.3 Brent officers provided attendees with an overview of the Fund and its relationship with LPP in addition to mapping out key responsibilities of both the Fund and its employers.

4.4 LPP were also in attendance at this session and were able to provide employers with in depth training in use of the Your Fund portal in order to submit electronic forms and resolve outstanding year end queries. LPP also provided training on the employer's year end return. All Fund employers are required to submit this return by 30th April 2020.

4.5 Overall feedback received from attendees was positive and the session was seen to be both useful and informative. The success of this session has already been experienced and this was seen with a significant reduction in outstanding end of year queries.

4.6 All employers including those unable to attend the session were sent training material from the day and a future session will be arranged later in the year.

5.0 Valuation

5.1 Members will be aware, through previous reports presented and training sessions held, that the Fund is required by law to undertake an actuarial valuation every three years. The Fund is nearing the completion of the 2019 valuation. Further details of this process and its results have been presented in the valuation report attached to this agenda.

6.0 Financial Implications

6.1 There are no direct financial implications from this report.

7.0 **Legal Implications**

7.1 Not applicable.

8.0 Equality Implications

8.1 Not applicable.

9.0 Consultation with Ward Members and Stakeholders

9.1 Not applicable.

10.0 Human Resources

10.1 Not applicable.

Report sign off:

Minesh Patel
Director of Finance

London Borough of Brent

Performance Indicators

The LPP Pensions Administration Service is measured against key performance indicators that measure compliance, efficiency and effectiveness of the service.

Workflow summary

The table below shows a summary of the total top 12 cases received for the period of 1st February 2019 to 31st January 2020 and a breakdown of the on-time percentage for the last 3 quarters. Further graphical representation of this information is shown on the following pages.

Overall performance over the last 12 months was 96.96%.

Top 12 Cases	Received	Completed	On Time	On Time %	Q1	Q2	Q3
Joiners	1,352	1,318	1,235	93.70	78%	100%	100%
Transfers In	270	136	134	98.53	86%	100%	99%
Transfers Out	392	351	339	96.58	80%	100%	100%
Estimates - Members	372	354	349	98.58	94%	100%	100%
Estimates - Employers	89	84	83	90.44	93%	100%	100%
Retirements	646	450	437	97.11	94%	100%	100%
Deferred Benefits	701	506	504	99.60	97%	100%	100%
Refunds	889	849	845	99.53	97%	100%	100%
Deaths	329	196	190	96.94	93%	100%	100%
Correspondence	764	733	709	96.73	90%	100%	99%
Add Contributions	7	6	6	100	N/A	100%	100%
Divorce	19	14	14	100	100%	100%	100%
Totals	**5,830**	**4,997**	**4,845**	**96.96**	**91%**	**100%**	**99.83%**

(Completed figures calculated as at 25th February 2020)

Cases completed

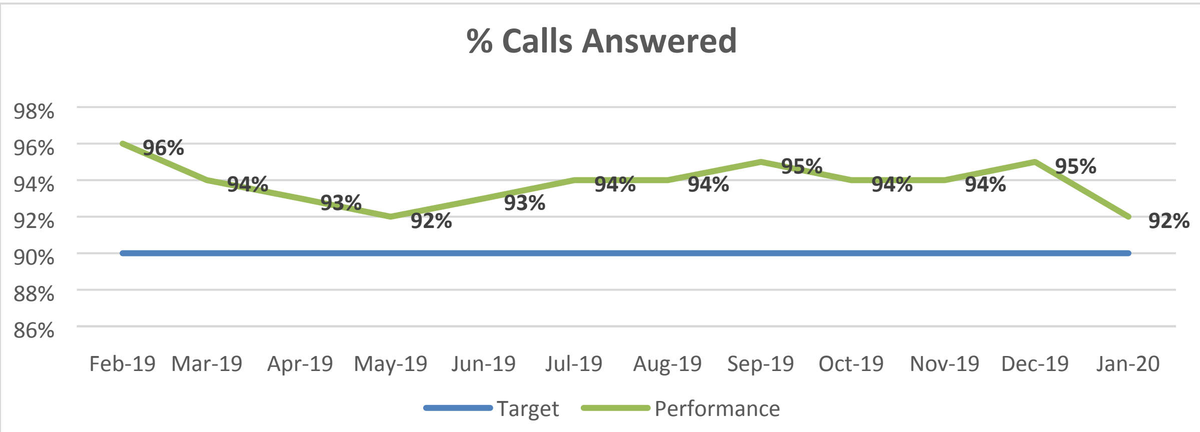
Of the 4,845 cases completed on time 3,090 were completed early as detailed below

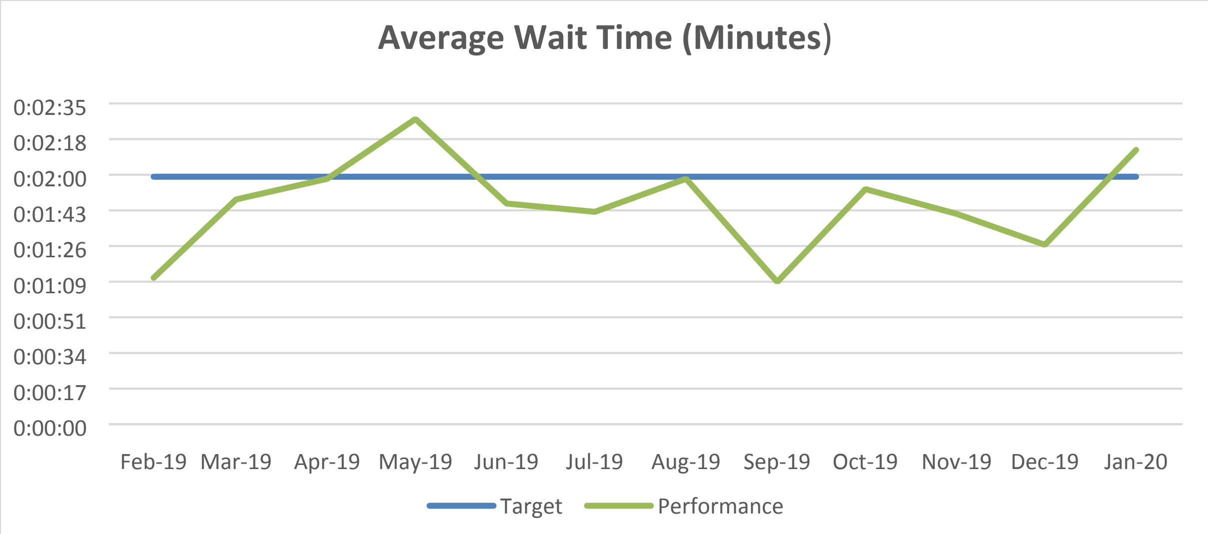
Description – Top 12 cases	1 Day Early	2 Days Early	3 Days Early	4+ Days Early
Joiners	124	33	31	557
Transfer In	14	9	6	165
Transfer Out	44	12	8	113
Estimates - Members	52	22	14	79
Estimates - Employers	11	2	5	19
Retirement	53	18	8	267
Deferred Benefits	71	24	15	325
Refunds	103	34	46	259
Deaths	14	12	7	152
Correspondence	116	56	19	156
Add Contributions	0	3	0	1
Divorce	1	1	7	1
Totals	**604**	**226**	**160**	**2,100**

(Completed figures calculated as at 25th February 2020)

Pensions Helpdesk Performance

Performance across our Pensions Helpdesk is below. The data is in respect of all LPP clients. We are working to provide client specific data.





Complaints

A dedicated Complaints Manager was appointed in June 2019 and has monthly meetings with the pension administration operational teams to identify service improvements from the lessons learned from the complaints received.

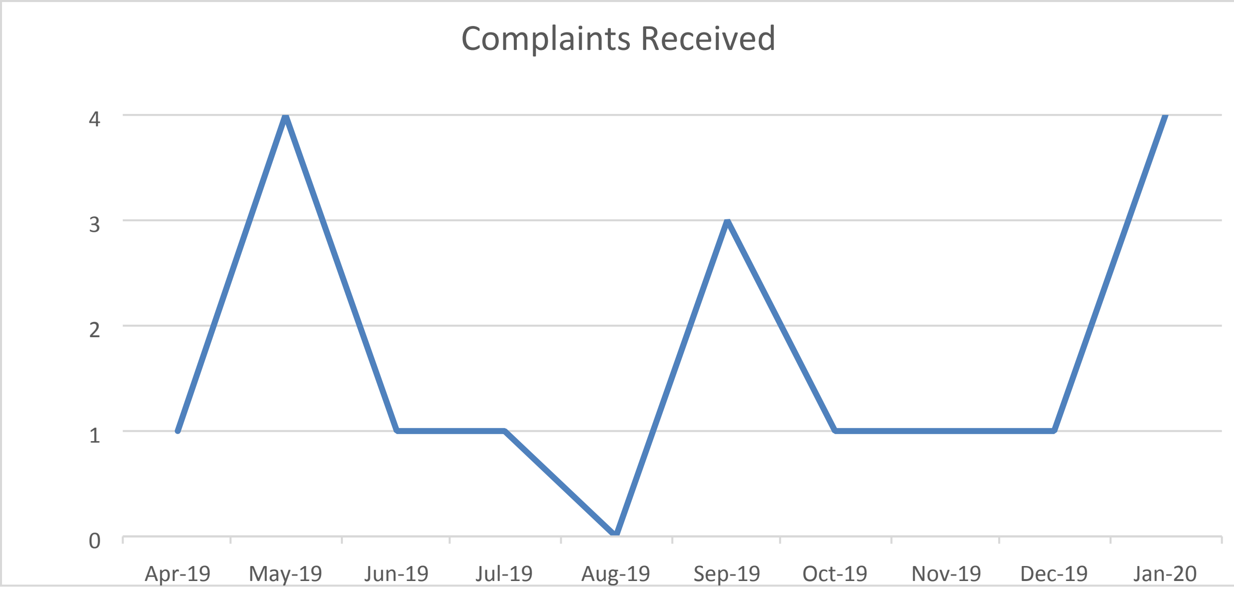
Brent received 3 complaints during Quarter 3 2019/20 (October 19 – December 19):

Month	Total	Topic and No. of complaints	% of Complaints Attributed to LPP	% of Complaints Upheld or not
October 2019	1	Delays – 1 Payments - 0 General Service – 0 Regulatory – 0	100%	100% Upheld
November 2019	1	Delays – 0 Payments - 0 General Service – 0 Regulatory – 1	100%	Complaint case still being investigated
December 2019	1	Delays – 0 Payments – 0 General Service – 1 Regulatory – 0	100%	100% Upheld

The last column of the table confirms whether a complaint was upheld, regardless of the route cause – LPP, employer or a third party.

- 6 complaints were received for Brent during Q1 (April 19 - June 19)
- 4 complaints were received during Q2 (July 19 - Sept 19)

In line with LPP overall complaints, General Service-related complaints are responsible for almost half of all complaints received from Brent members. A review of the complaints received identified that most complaints received over the last 3 quarters are in relation to historical cases which had been processed prior to LPP providing the service to Brent.



Dispute resolution procedure

There were 3 dispute resolutions received during the period 1st April 2019 to 31st December 2019.

Where a member is unsure of their benefit entitlement or has problems with their benefits, the Local Pensions Partnership (LPP) should be contacted. If a member is not satisfied with any decision, they have a right to ask for it to be re-examined under the formal complaints procedure, which is officially called ‘internal dispute resolution procedure’. The formal complaints procedure has 2 stages and full details can be obtained from the LPP by either phone on 01708 952299 or by writing to Local Pensions Partnership, PO Box 1383, Preston, PR2 0WR.

Brent	**Pension Board** 25 March 2020
	Report from the Director of Finance

LGPS Update

Wards Affected:	ALL
Key or Non-Key Decision:	Non-Key
Open or Part/Fully Exempt: (If exempt, please highlight relevant paragraph of Part 1, Schedule 12A of 1972 Local Government Act)	Open
No. of Appendices:	1. Good Governance – Hymans Robertson Phase I Summary 2. Good Governance – Hymans Robertson Phase II Summary 3. Good Governance – Action Plan 4. UK Stewardship Code – Hymans Robertson Summary 5. LGPC Bulletin – November 2019 6. LGPC Bulletin – December 2019 7. LGPC Bulletin – January 2020 8. LGPC Bulletin – February 2020 9. Technical Bulletin – TPR Consultation 10. DB Funding Code of Practice Consultation 11. DB Funding Consultation Guide 12. DB Funding Consultation Questions
Background Papers:	▪ N/A
Contact Officer(s): (Name, Title, Contact Details)	Minesh Patel, Director of Finance Ravinder Jassar, Head of Finance

1.0 Purpose of the Report

1.1 The purpose of this report is to update the committee on recent developments within the LGPS regulatory environment and any recent consultations issued by the Ministry of Housing, Communities and Local Government (MHCLG) which have would have a significant impact on the Fund.

2.0 Recommendation(s)

2.1 The Committee is asked to note the recent developments in the LGPS.

3.0 Detail

McCloud Case

3.1 On 21 December 2018, it was reported that the Court of Appeal ruled that transitional protections that protected older judges and firefighters from the public sector pension scheme changes in 2015, were unlawfully discriminatory. This case is known as the 'McCloud case'.

3.2 The Supreme Court denied the Government leave to appeal the McCloud and other associated cases on 27 June 2019 confirming that as 'transitional protection' was offered to members of all the main public service pension schemes, the difference in treatment will need to be remedied across all those schemes including LGPS. As the remedy will involve 'levelling up' member benefits, it is expected that any agreed outcome will increase the cost of LGPS pensions, however there is no certainty about how much this additional cost will be. Further information on the McCloud case has been provided in previous LGPS updates to the committee.

3.3 Given that no remedy had been agreed by 31st August 2019, Funds have been left to consider locally how best to manage the uncertainty and risk. The Fund Actuary has acted in line with SAB's advice and valued all member benefits in line with the current LGPS Regulations. The Fund has also elected to make an approximate allowance for the potential impact of McCloud in the 2019 valuation in the assessment of employer contribution rates by including a slightly higher required likelihood of reaching funding target.

3.4 As part of the external audit of the Pension Fund accounts, the auditors requested an estimate of the potential impact of McCloud, and if material, reflect the changes in the accounts. This was estimated at £3m at whole fund level in 2018/19. Depending on the liability profiles on different employers, the impact will vary across different employers.

3.5 It is understood that the LGPS will be treated separately from the rest of the public sector in respect of the McCloud remedy and that the remedy will involve the extension of some form of underpin to members in scope who are not currently offered protection.

3.6 It is expected that decisions relating to members in scope, the extent of final salary service protection, the requirement for retrospection and the inclusion of ancillary benefits (transfers, survivors etc) will be determined centrally by the LGPS. No remedy will be implemented before the end of financial year 2020/21. Therefore an estimate of the potential impact of McCloud will have to be included in the 2019/20 accounts.

3.7 Once the final remedy is known, it is expected that LGPS Funds will be required to identify affected cohorts, liaise with employers to obtain retrospective data, amend records, revisit calculations, uplift pensions in payment, communicate with the affected members while ensuring throughout, that the project has the appropriate level of governance.

4.0 Good Governance

4.1 As a result of significant cuts to local government funding over the last decade, the pooling of LGPS Investments and the increasing complexity in scheme benefits and administration, the Scheme Advisory Board (SAB) commissioned Hymans Robertson to examine the effectiveness of current LGPS Governance Models and to consider alternatives and enhancements to existing models which can strengthen LGPS Governance going forwards.

4.2 Hymans Robertson undertook a process of engaging extensively with stakeholder groups and fund types to consider four governance models, each of which would be assessed against set criteria. The process undertaken enabled identification of best practices within current governance arrangements as well as identification of additional ideas to strengthen governance within the current regulatory framework.

4.3 Results found that there was a majority preference in adopting a governance model which combined improved practice with greater ring fencing of the LGPS within existing structures. This involved the introduction of guidance or amendments to LGPS Regulations to enhance existing arrangements by increasing the independence of the management of the fund and clarifying the standards expected in key areas. In addition to this, results found there was a preference for clearer ring-fencing of Pension Fund management from the host authority, including budgets, resourcing and pay policies.

4.4 Following the analysis of these results, Hymans Robertson proposed that an outcome based approach to LGPS governance, with minimum standards, should be adopted rather than a prescribed governance model. In addition to this, Hymans Robertson proposed updating of relevant guidance and training requirements.

4.5 Following the approval of the good governance 'Phase I' report, the Scheme Advisory Board (SAB) asked Hymans Robertson to assist with the next phase of this project, which involved the defining of good governance outcomes and options for assessment of these outcomes. Further details of the initial results and analysis undertaken by Hymans Robertson are set out in Appendix 1.

4.6 Phase II of the good governance review was concluded by Hymans Robertson in November 2019 and several proposals were made regarding the production of further guidance and outcomes to be undertaken by administering authorities. These proposals were split into six main areas covering:

- General
- Conflicts of interest
- Fund representation
- Knowledge and understanding of the LGPS
- Service Delivery of the LGPS function
- Compliance and Improvement

4.7 In summary, key proposals involved the publishing of an annual governance compliance statement to set out how compliant administering authorities have been with governance requirements within the LGPS. It is envisaged that the governance compliance statement will act as a summary, evidencing the Fund's position on all areas of governance and compliance. In addition to this, a proposal was made for guidance to be introduced for key individuals within the LGPS such as officers and pension committee members to have the appropriate level of knowledge and understanding to carry out their duties effectively. Hymans Robertson concluded by proposing that all administering authorities undergo a biennial independent governance review to be assessed by a SAB panel of experts. Further details of the proposals outlined by Hymans Robertson are set out in appendix 2.

4.8 Hymans Robertson have recommended that 'Phase III' of the good governance review contain draft changes to the current set of LGPS guidance produced by MHCLG. Next steps will also include SAB working in conjunction with the National Framework on establishing an independent governance review framework while also producing ten to fifteen KPIs for administering authorities to report the Fund's performance against.

4.9 Overall, the Fund supports these recommendations and in advance of this becoming part of formal regulations, the Fund has produced an action plan, to assess its compliance levels against each of the proposals made. This is set out in appendix 3.

5.0 UK Stewardship Code

5.1 The Financial Reporting Council (FRC) has published an updated UK Stewardship Code, which has taken effect from 1 January 2020. The Code represents a new best practice standard for both asset owners and asset managers alike.

5.2 The requirements of the revised Code for asset owners and managers extend to establishing clear stewardship objectives, integrating stewardship in investment strategies, and adhering to a clearer and more elaborate set of reporting requirements. The Code comprises a set of 12 'apply and explain' Principles for asset managers and asset owners, and six Principles for service providers, including investment consultants.

5.3 Notable amendments to the UK Stewardship Code include the requirement for signatories to explain their organisation's purpose, investment beliefs, strategy and culture, and how these enable them to practice stewardship. Signatories are also expected to show how they are demonstrating this commitment through appropriate governance, resourcing and staff incentives. In addition to this, signatories are expected to take ESG factors, including climate change, into account and to ensure investment decisions are aligned with the needs of clients. Appendix 4 outlines further details to the key changes in the Code.

5.4 Organisations will remain signatories to the UK Stewardship Code until the first list of signatories to the 2020 Code is published. Existing signatories to the

Code will be required to submit a Stewardship Report that meets the FRC's reporting expectations in the 2020 Code by 31 March 2021 to continue to be listed as signatories to the UK Stewardship Code. Reports must be signed off at a Board level, by Chair, Chief Executive or Chief Investment Officer. Brent Pension Fund are currently awaiting further guidance for the construction of the Stewardship Report. Once received, officers will put together a draft report for the Board to consider ahead of submission.

6.0 Defined Benefit Funding Consultation

6.1 The Pensions Regulator (TPR) issued a consultation on 3 March 2020 to seek views on principles for a new code of practice on defined benefit pension scheme funding.

6.2 In the Department for Work and Pensions (DWP) 2018 white paper 'Protecting Defined Benefit Pension Schemes', the government noted the defined benefit (DB) pensions funding framework is working largely as intended but acknowledged the need for improvement in a number of key areas and in particular:

- The need for trustees to focus on long term strategic issues as the scheme matures.
- A lack of clarity about how to set prudent technical provisions and an appropriate recovery plan.
- The need for greater transparency and accountability around the risks being taken.

6.3 Much of the current funding regime will remain, such as three yearly valuations and the requirement to determine technical provisions and maintain an appropriate recovery plan. However, the Pensions Schemes Bill introduces new requirements to help address the areas requiring improvement. The Pensions Regulator's consultation document is the first of two such consultations intended to inform a new DB funding code of practice to replace the existing code and reflect the legislative changes while providing trustees and sponsors with greater clarity on what is expected.

6.4 This first consultation set out in Appendix 10 highlights the key principles that The Pensions Regulator think should underpin the new framework. The second consultation, planned for later in 2020, will consider a draft code with more specific details reflecting feedback received from the first consultation.

6.5 The closing date of this consultation will be on 2 June 2020. Officers will be considering and formulating a response over the next few weeks. The Pensions Regulator anticipates that the new code of practice will come into force in late 2021. Comments from any member of the Board regarding the consultation should be sent to Rav Jassar ahead of the closing date.

7.0 Financial Implications

7.1 This report is for noting, so there are no direct financial implications. However, the outcome of the consultations could have financial implications for the Fund, in particular the exit cap and the outcome of the McCloud case. Further work will be done with the Fund actuary to analyse the implications and report back to the committee.

8.0 Legal Implications

8.1 Not applicable.

9.0 Equality Implications

9.1 Not applicable.

10.0 Consultation with Ward Members and Stakeholders

10.1 Not applicable.

11.0 Human Resources

11.1 Not applicable.

Report sign off:

Minesh Patel
Director of Finance
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HYMANS ROBERTSON

Good governance in the LGPS

July 2019

Addressee

This report is addressed to our client, the Scheme Advisory Board for the Local Government Pension Scheme in England and Wales (SAB).

This Report has been prepared for the benefit of our client, the SAB. As this Report has not been prepared for a third party, no reliance by any third party may be placed on the Report. It follows that there is no duty or liability by Hymans Robertson LLP (or its members, partners, officers, employees and agents) to any party other than the SAB. If this report is shared with any third party, it must be shared in its entirety.

Thanks to contributors

We are indebted to all those who responded to the survey and engaged in interviews and events that helped inform this report. We are grateful to you for being generous with your time and expertise, for your confidence in sharing your experiences openly and for responding so constructively and creatively.

Your views on current best practice, areas for improvement and creative and practical ideas for further strengthening governance in the LGPS are reflected in the proposals we present to SAB here.

We hope that your contribution will help further strengthen and future-proof governance in the LGPS.

Contents

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Executive summary

Governance in the LGPS is evolving to accommodate new developments in the last decade, including oversight by The Pensions Regulator, introduction of Local Pension Boards, increasing complexity in scheme benefits and administration, local government funding cuts and pooling of LGPS investments which has changed the role of local pensions committees and the way LGPS administering authorities work with one another.

The SAB commissioned this report to examine the effectiveness of current LGPS governance models and to consider alternatives or enhancements to existing models which can strengthen LGPS governance going forward.

Given the unique nature of the LGPS, guaranteed by administering authorities and funded to a large degree by tax-payers, a criterion specified by SAB is that any models considered must maintain strong links to local democratic accountability.

Process

We engaged extensively with all stakeholder groups and all fund types via an online survey (140 respondents), one-to-one conversations through interviews and seminars (153 respondents), speaking engagements, a workshop with the Association of Local Authority Treasurers (ALATS), and discussion with the CIPFA Pensions Panel and the Society of County Treasurers (SCT).

We focussed on the following criteria for assessing governance arrangements; Standards, Consistency, Representation, Conflict Management, Clarity of Roles and Responsibilities and Cost. We were asked by SAB to consider how existing and alternative governance models fared against these criteria.

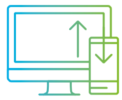
We considered four governance models:

- **Model 1:** improved practice
- **Model 2:** Model 1 plus greater ring-fencing
- **Model 3:** joint committee; and
- **Model 4:** separate Local Authority body.

These models were described in qualitative terms with the recognition that some of the characteristics attributed to one model could also be replicated in another model and that the final solution may draw on the features of more than one model.

Results and themes from survey responses

The online survey responses indicated a first preference for governance Model 2 (greater ring-fencing) followed by support for Model 1 (improved practice). Respondents recognised that governance models along these lines may need independent monitoring to add bite and ensure consistency of application. »



140 respondents to our online survey

one-to-one conversations

153 attendees at interviews and seminars

discussions with CIFPA and SCT

Respondents favour developing a set of standards that all funds are required to achieve...

Model 2 was also the clear preference in additional surveys at the PLSA conference in May* and other events (*Models 1 and 2 between them had more than 70% support).

Few respondents supported Model 3 (joint committee) citing no benefits over existing arrangements and considerable added complexity as the main reasons. Some respondents could see value in Model 4 (separate LA body), including one trade union for whom a version of this was the favoured model. However, for most this value was outweighed by concern about weakening relationships with councils who are key sponsors of the scheme and a belief that establishing this model would incur disproportionate cost to any benefits that could be delivered.

Through the written responses, interviews and other engagement, many stakeholders pointed out that their existing models provided many of the features and benefits of Models 1 and 2. Many had found good solutions to some of the challenges faced within the current structure and welcomed the opportunity to share these with peers and learn from others' experiences. This process enabled us to identify

i. Some best practice within current governance arrangements that is delivering good outcomes and may have potential for wider application across the LGPS; and

ii. Additional ideas for further strengthening governance within the current regulatory framework.

We have included these in the report.

Conclusions

- It is clear from survey responses that governance structure is not the only determinant of good governance. Funds with similar governance models deliver different results and good examples exist across a range of different set ups.
- Survey respondents were also clear that establishment of new bodies is not required, although this should be facilitated for funds who wish to pursue other arrangements voluntarily. Instead, the focus should be on greater specification of required governance outcomes from within the existing structures, and a process to hold funds to account for this.
- Respondents favour developing a set of standards that all funds are required to achieve, drawing on current best practice and not imposing disproportionate burden on administering authorities or disrupting current practices that deliver good outcomes already.
- Respondents emphasised that independent review is needed to ensure consistency in application of standards.

Key proposals

1. **'Outcomes-based' approach** to LGPS governance with minimum standards rather than a prescribed governance model.

2. **Critical features of the 'outcomes-based' model** should include:
   (a) robust conflict management including clarity on roles and responsibilities for decision-making;
   (b) assurance on sufficiency of administration and other resources (quantity and competency) and appropriate budget;
   (c) explanation of policy on employer and scheme member engagement and representation in governance; and
   (d) regular independent review of governance – this should be based on an enhanced governance compliance statement which should explain how the required outcomes are delivered.

3. **Enhanced training requirements** for s151s and s101 committee members (requirements for s101 should be on a par with LPB members).

4. **Update relevant guidance and better sign-posting.** This should include 2014 CIPFA guidance for s151s on LGPS responsibilities and 2008 statutory guidance on governance compliance statements. This guidance pre-dates both TPR involvement in LGPS oversight, local pension boards and LGPS investment pooling.

We also set out suggested actions for implementing these proposals if agreed by SAB.

1. Introduction

Context, purpose and scope

Governance in the LGPS is evolving to accommodate new developments in the last decade, including oversight by The Pensions Regulator, introduction of Local Pension Boards, increasing complexity in the scheme benefits and administration, local government funding cuts and pooling of LGPS investments which has changed the role of local pensions committees and the way LGPS administering authorities work with one another.

The purpose of the survey, undertaken for SAB, was to identify ways of further strengthening LGPS governance in the face of these new challenges, setting a bar for standards that all funds should achieve, drawing on current best practice and not imposing additional unnecessary burden on administering authorities or disrupting current practices that deliver good outcomes already.

Given the unique nature of the LGPS, guaranteed and funded to a large degree by council tax-payers, a critical condition specified by the SAB was that any proposals must maintain strong links to local democratic accountability.

In developing the proposals made in this report, we consulted with many LGPS stakeholders. As expected, there were many different views and suggestions made to improve the governance arrangements in the LGPS. We have reflected many of these views in the body of the report, particularly where a view or proposal was articulated by several parties, and where possible we have indicated why some of these views or suggestions have not been taken forward in the final proposals. The proposals submitted to SAB in this report are those we believe would deliver improved governance at proportionate cost and reflect a consensus across most stakeholders.

We recognise that there are a small number of administering authorities (such as London Pensions Fund Authority and the Environment Agency) with unique arrangements. While we engaged with both of these funds to understand their perspectives and approaches to governance we recognise that some of the potential governance models as set out in the survey may not be appropriate, or even possible, for these bodies.

2. Process

The aim of the work we have undertaken was to deliver proposals to the Scheme Advisory Board that:

- Identify and address any actual or perceived issues within current LGPS governance arrangements, including conflicts for LGPS host authorities;
- Are based on a wide consultation to increase the likelihood of stakeholder support;
- Are proportionate and can be readily implemented; and
- Maintain local democratic accountability.

Process

The process we used is described below:

1. **Fact-find phase:** We carried out interviews based on an open-scripted questionnaire with a diverse range of experienced officers, elected members and other stakeholders in order to identify any issues within current LGPS governance arrangements. The outcome and conclusions were shared with SAB in order to assist in developing the governance models which were consulted on in the online survey.
2. **Online survey:** We conducted a wider consultation in the form of an online survey on the governance models identified by SAB. Input was sought from all relevant parties including s151 officers, s151 officers of non-administering authorities, pension fund officers, elected members, pension board members including scheme member and employer representatives as well as other interested parties and organisations.
3. **Other engagement activities:** In addition to the survey, we engaged stakeholders through other activities such as interviews, seminars and speaking events to capture as wide a view as possible.
4. **Report:** This report sets out the outcomes of our consultation activities including a full analysis of the key issues and proposals for addressing these issues, including commentary on any required legislative or guidance changes were these would realise significant benefits.

Who we consulted

In conducting our wider consultation, we engaged directly with all stakeholder groups and all fund types via:

- Online surveys which were sent to all relevant contacts on SAB's and Hymans Robertson's databases. These were also sent to any individual or organisation that requested them out with the initial mailing lists. In total, 140 responses were received to our online surveys by the closing date.
- One-to-one interviews were carried out with individuals or organisations by request or where further clarification of online responses were sought. Organisations included PSAA, NAO, CIPFA, SLT, Unite and Unison.
- Some organisations, such as CIPFA and PIRC, provided their own written submissions.
- Three seminars were held with open invitations to collate feedback from larger group.

There are 87 [1] funds within the LGPS in England and Wales. We had direct feedback from representatives at 76 of these split across the various designations used by SAB in their annual report (see **Table 1**).

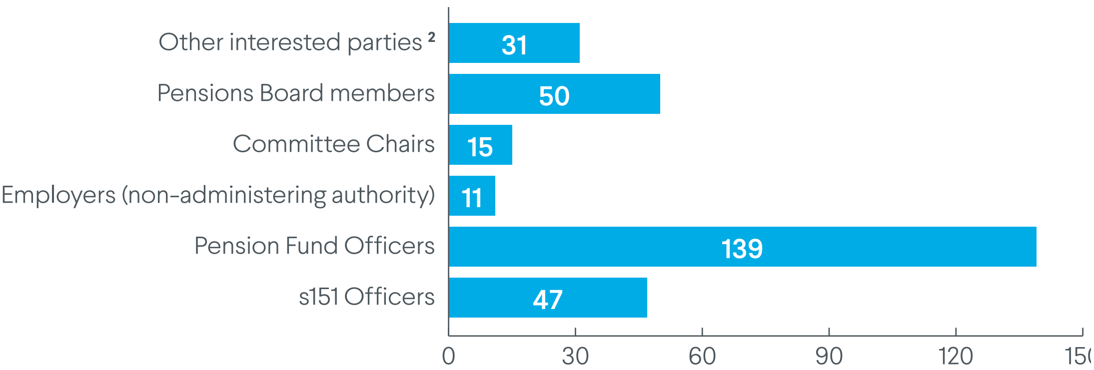
We engaged with a wide variety of stakeholders as set out in **Chart 1** below.

In addition, we have presented and collected feedback at key events over the period including the PLSA conference, CIPFA Pensions Panel, meetings of the Society of County Treasurers, Society of Welsh Treasurers and ALATS. Our findings and proposals reflect feedback from all of these.

Table 1: Respondents from LGPS funds in England and Wales, as designated by SAB annual report

			Interaction through	
	Universe	**Responses**	**Survey**	**Interview**
Unitary Authorities	12	11	24	17
London Boroughs	31	22	20	25
County Councils	27	26	64	55
Welsh Funds	8	8	15	14
Metropolitan Boroughs	6	6	8	17
Other	3	3	2	3
Independent responses			7	22
TOTAL	**87**	**76**	**140**	**153**

Chart 1: Stakeholders we engaged



1 Excluding admission body funds, passenger transport funds and the environment agency closed fund.

2 Including trade union representatives.

3. Survey results

The online survey issued as part of the consultation is set out in **Appendix A**. We sought views on four potential governance models SAB chose to consult on. All were assessed by respondents against criteria agreed with SAB. This was done through a combination of numerical scoring and free form commentary.

A summary of the numerical scores are set out below for each of the four structures:

- **Model 1 (Improved practice)** Introduce guidance or amendments to the LGPS Regulations to enhance the existing arrangements by increasing the independence of the management of the fund and clarifying the standards expected in key areas.
- **Model 2 (Greater ringfencing)** Clearer ringfencing of pension fund management from the host authority, including budgets, resourcing and pay policies.
- **Model 3 (Joint committee)** Responsibility for all LGPS functions delegated to a joint committee comprising the administering authority and non-administering authorities in the fund. Inter-authority agreement (IAA) makes joint committee responsible for recommending budget, resourcing and pay policies.
- **Model 4 (New Local Authority Body)** An alternative single purpose legal entity that would retain local democratic accountability and be subject to Local Government Act 1972 provisions.

In carrying out the survey, respondents were asked whether each of the models shown would have a positive or negative impact on each of the following criteria:

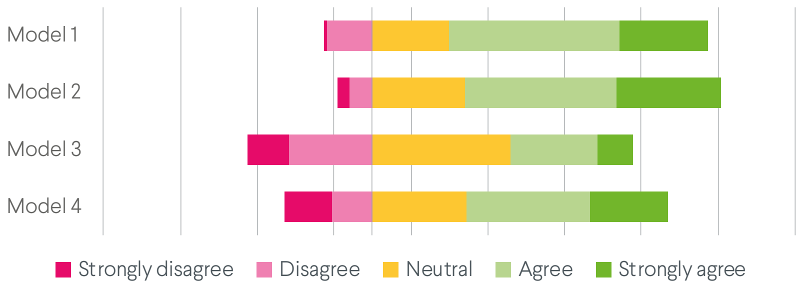
1	**Standards**	The model enables funds to meet good standards of governance across all areas of statutory responsibility including TPR requirements.
2	**Clarity**	The model delivers clarity of accountability and responsibility for each relevant role.
3	**Conflict**	The model minimises conflicts between the pension function and the host local authority, including but not limited to s151 officer conflicts (in operational areas such as budgets, resourcing, recruitment and pay policies and in strategic areas such as funding and investment policy).
4	**Consistency**	The model minimises dependence on the professionalism of individuals and existing relationships to deliver statutory responsibilities.
5	**Representation**	The model allows for appropriate involvement in decision-making for key stakeholders (including administering authority, non-administering authorities, other employer and member representatives).
6	**Cost**	The cost of implementing and running the model is likely to be worthwhile versus benefits delivered.

The following charts summarise the extent to which respondents agreed that each model delivered against the six criteria. The further to the right the line appears, the more strongly respondents favoured the model against the criteria.

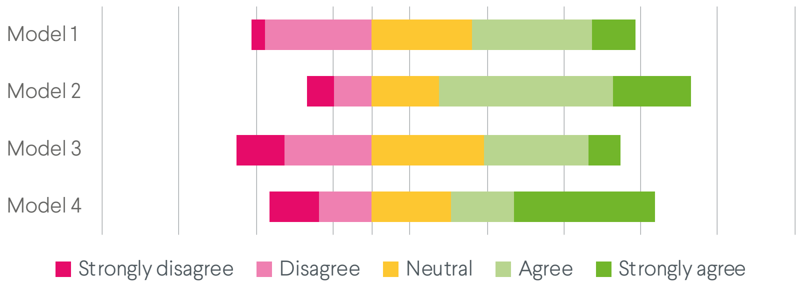
Comments on survey responses

- Across all questions and criteria, respondents gave the highest scores to Model 2, followed closely by Model 1.
- Model 4 scored reasonably well on questions relating to criteria 1 to 4. A minority of respondents supported this model or some variation on it. For example, one of the trade unions favoured a variant of Model 4 with a changed role for local councillors because they believe that it could reduce potential governance conflicts they see in the role of local councillors who must act in the best interests of scheme members and at the same time in the interests of local tax-payers. However, the majority of respondents raised concerns over the question of appropriate involvement in decision making. These respondents felt that democratic accountability may be weakened in this model or the influence of the lead local authority, who is the guarantor of last resort for the fund, would be diluted. The model also scored very poorly on cost or value for money with a majority of respondents feeling that the model would be very expensive and disruptive to implement.
- Model 3 received weakest support overall. Respondents felt that the model would be complex to set up and manage and would deliver no perceived improvements in governance outcomes.
- The sentiment reflected within the commentary in the responses was also strongly in favour of Models 1 and 2, with many respondents identifying features of Models 1 and 2 that are already delivered in their current structure.
- However, responses also recognised that in order to achieve governance improvements through Models 1 and 2, the governance regime needs to include independent monitoring or review of local fund arrangements to ensure that everyone attains a minimum standard and that those beyond that level seek continuous improvement.

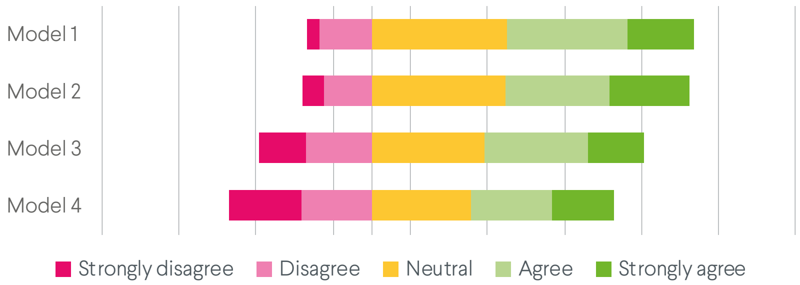
The model enables funds to meet the required standards



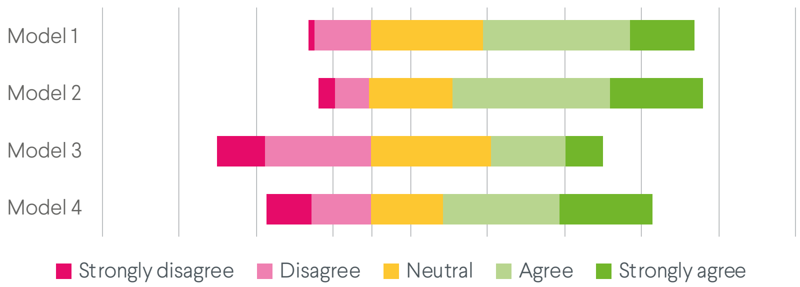
The model minimises conflicts between the pension function and the host local authority



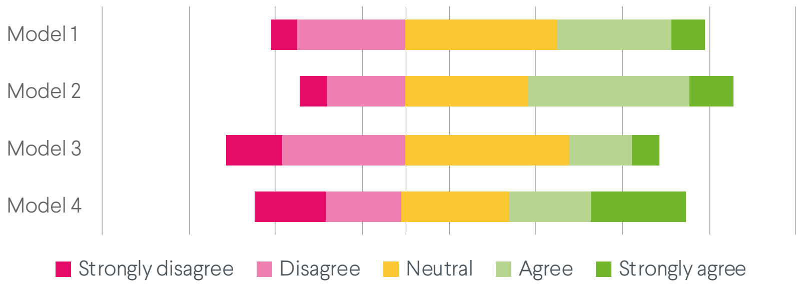
The model allows for appropriate involvement in decision-making for key stakeholder



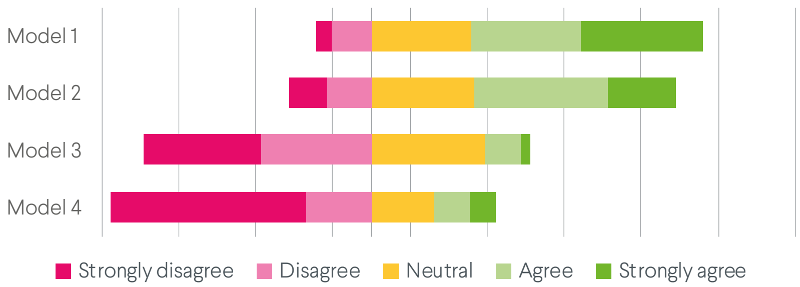
The model delivers clarity of accountability and responsibility for each relevant role



The model minimises dependence on professionalism and relationships to deliver statutory responsibilities

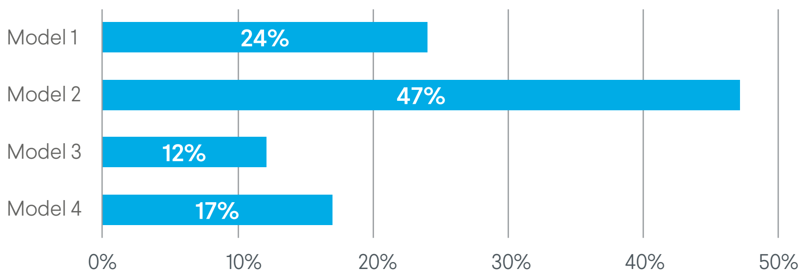


The cost of implementing and running the model is likely to be worthwhile versus benefits delivered



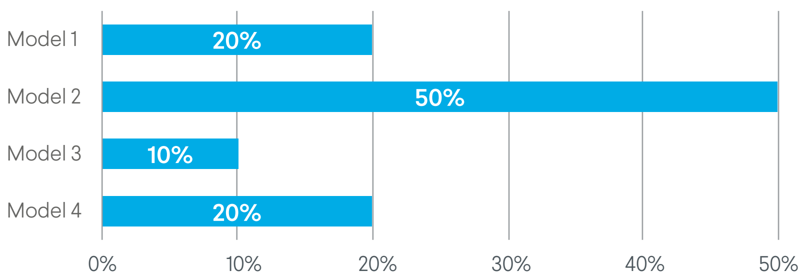
PLSA

Which structural governance model do you prefer from the four models discussed?



Webinar

Which structural governance model do you prefer from the four models discussed?



Additional survey data

In addition to the online survey, we asked attendees at our PLSA session and other events a set of questions on their preferences.

Around 70% of respondents favoured Models 1 or 2.

Very similar results (from a smaller sample size) were recorded at our webinar.

4. Survey themes

The following section reflects some of the views raised during various conversations. Direct quotations reflect a specific point made by an individual which we judged to be representative of views of a number of respondents. Comments not in quotations are our expression of views expressed by a significant number of respondents.

Key:

CC	County Council
Met	Metropolitan
LB	London Borough
TU	Trade Union

Standards

1. There was an almost unanimous view that there should not be a single model of LGPS governance imposed on all funds.

2. The view 'one size does not fit all' was frequently stated by respondents from all categories of respondent.

3. There was a strong view from respondents that members of pension committees should be mandated to have the same level of training as local pension board members.

4. A small minority expressed the view that this would lead to problems getting elected members to sit on pension committees.

5. The fact that pension committee members can change due to elections or being moved around can cause problems with consistency and maintaining knowledge and skills.

   "It is a perversion that LPB members require a higher degree of training than elected members."

   Officer, LB

   "[The] biggest issue is stability at elected member level. Too much turnover."

   Officer, LB

6. Several respondents said that guidance from several sources caused confusion as to which was current, which was relevant and what are 'musts' (mandatory) and 'shoulds' (guidance or best practice):

   "Funds are currently pulled in too many directions by lots of guidance – CIPFA, SAB, TPA etc."

   Officer, CC

   "[Guidance from numerous sources] muddies the waters between what is statutory guidance and what isn't."

   Independent Advisor

7. The idea of extending the existing concept of peer challenge to include pensions was mentioned by some respondents. (Committee Chair CC, s151 CC and officers Met)

Clarity of decision-making

1. Some respondents felt that there was already a clear framework around decision making within their authority but other reported that there was very little clarity around where key decisions were made.
2. Two funds suggested that it was unclear who was responsible for decisions around outsourcing the administration function; was it the pension committee, s151 officer, full council?
3. One fund reported it very difficult for the council's constitution to be updated - the updates required for pooling have still not been made.
4. Greater clarity around decision-making is a good idea: "Some decision-making conventions are lost in the mists of time."

   Officer, CC

Consistency

1. Commentary on Models 1 and 2 recognised that some sort of monitoring, enforcement or independent review would be needed to ensure that the required standards and governance outcomes are delivered.
2. There was strong support for the professionalism of s151 officers and the role they play.
3. A few respondents noted that the work pressures on s151 officers is greater than ever before and worried about their scope to devote the necessary time to the fund.

   "My s151 is incredibly supportive and helpful but I accept s151s at other funds are not as engaged or are engaged in the 'wrong way'".

   Officer, CC

   "Separation would actually push s151s away from the fund, leading to less responsibility and engagement with the fund, leading in turn to less expertise and worse decisions. Better to get s151s more closely involved so they understand the requirements of the LGPS and make better decisions."

   Officer, CC

4. A number of respondents stated that "Statutory/ fiduciary duty clarity would be useful."

Conflicts

1. Most respondents felt that there was acknowledgement of the potential conflict faced by elected members and officers and that those potential conflicts were managed well.

2. However, it was not unusual for respondents to suggest that there needed to be better distinction between the employer and administering authority role.

   "No one in the council understands the difference between the 'council' function and the 'pension' function."

   Officer, LB

   "The make-up of panel/committees is not working – too much political interference."

   LPB Chair

   On conflicts:
   "I don't see abuses. The ability is there for there to be abuse but it doesn't happen."

   Officer, CC

   "LGPS is full of conflict, s101 committees are beholden to the council who are mainly focused on council tax-payers."

   TU

3. Some pointed out that concentrating on conflicts missed some of the advantages of LGPS funds being part of local authorities.

   "[This review] should address the many advantages and benefits of working for a large, well-run and modern council.

   s151 CC

   "[s151] role involves tensions, not conflicts. Tension can't always be seen as a bad thing."

   Officers, Met

Budgets and resourcing

1. There was a range of approaches when it came to budget setting. In some instances, the budget available to the pension fund was determined as part of the wider council budget setting process with little or no input from pension officers and no role for the pension committee. Other funds reported that budget setting and in-year management of the budget was the responsibility of pension officers and that the local authority's s151 was 'kept informed'.

   "It hadn't occurred to me that the [pension] committee could get involved with budget setting. Guidance on that would be good."

   Officer, LB

   "Potential problems include transparency in the AA of its costs. Recharges of time. Costs recovered by the AA via the PF."

   LPB Chair

2. There was also a split in terms of whether funds had the ability to set their own staffing or whether they were subject to recruitment freezes or downsizing exercises that apply to the main council.

   "[There should be] resourcing such that there is the quality and competence to deliver their statutory duties"

   s151, CC

   One s151 expressed "disbelief that blanket hiring bans and pay policies affected the pensions section. s151's should be flexible enough to understand how to 'spend' resources. If they need to pay differently for pensions to get the right experience/quality."

   s151, CC

   When it comes to budgeting and workplans
   "...the s101 committee decides including requests for extra resource if required."

   Chair of Committee. CC

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Representation

1. Most respondents felt that there was a role for some sort of scheme member presence on pension committees. although there was a difference of opinion about whether this should be a voting role or an observer role. A number of funds suggested that the scheme member role should not be limited to trade union representative. All agreed that the majority representation must lie with the administering authority.

   "Less than 50% of our members are in a union."

   s151, CC

   "Representation is key – members must have a say"

   TU

   "Other employers reps and member reps should have voting rights [on the committee]. That's right and should happen."

   Chair of Committee, CC

   "We are warm towards the idea of an independent advisor/trustee who sits on committees."

   s151, CC

   "We want to improve things for our members in terms of governance, transparency and representation."

   TU

2. There were strong views on both sides about the value that local pension boards bring. Some feeling that they increased bureaucracy without adding value while for others they had become a useful part of the fund's governance arrangements.

   "I welcome the involvement of the Pension Board it adds value, second opinion."

   Chair Committee, CC

   One respondent believed that joint committee and local pension boards "give scheme members and other employers a voice and avoids duplication."

   s151, CC

   "Many administering authorities see boards as threats rather than opportunities. There are still boards who are dictated to. Need administering authorities to release tight control."

   Chair of LPB

3. There were a range of practices in how funds engaged with employers:

   "As s151 of a non-admin authority, I didn't feel engaged in the pension fund, it was something that was dictated to me every few years."

   s151 speaking of their time in a non administering authority

   "Employer liaison is tricky as your participating employers often don't see it as a priority."

   s151, CC

5. Examples of current best practice

It was apparent during our conversations that many funds exhibited excellent examples of good governance but that practices across funds were not consistent. This section captures some of the examples of best practice that we identified.

Regular governance reviews

A number of funds confirmed that they use internal audit to provide assurance on administration and governance matters. Some reported an annual programme of work with different aspects of delivery being assessed each time.

Other funds had commissioned external governance reviews in order to receive an independent assessment of their current arrangements.

Committee membership and effectiveness

A large number of funds stated that they required pension committee members to attain the same level of knowledge and expertise as local pension board members. This was achieved through training policies which set out clearly how the fund will deliver training and assess its effectiveness.

One fund reported how members of the pension committee are required to sign a declaration stating that they will act in the interests of the fund and not be influenced by party political matters. One view is that councils should waive the requirement for political representation on committees to allow the most appropriate members to sit, rather than allocate places according to political party.

Most funds have some sort of scheme member representation on pension committees and a small number allow scheme member representatives to vote.

Independence

A number of funds reported that there was a clear understanding of, and separation between, the functions of the pension fund and the local authority which recognised the specialist nature of the LGPS. This was typically achieved through one or more of the following features:

- A dedicated Head of Pensions role which was at an appropriately senior level within the authority's structure.
- A recognition by elected members serving on the pension committee that, when carrying fund specific business, they were acting on behalf of scheme members and all of the employers in the fund, not simply their own local authority.
- Independent business planning and resourcing decisions made by pension fund officers and signed off by the pension committee and s151. This allows the pension fund to plan and resource appropriately to deliver its strategic objectives.
- Pension fund not subject to same recruitment freezes or restructuring exercises applied at a council level. Some funds reported using market supplements to attract appropriately skilled staff, where a strong business case could be made.

Focus on quality of service to scheme members

Some funds were prepared to 'go the extra mile' in terms of the quality of service delivered to scheme members. This might involve encouraging face-to-face interaction between pensions staff and scheme members (particularly when considering complex or emotive matters), producing a range of communications aimed at active, deferred and pensioner members or holding annual member meetings to raise awareness of current issues.

6. Proposals

The proposals we set out for consideration by SAB are informed by feedback from stakeholders. Many are things which well-run funds already do.

- **Table 1** shows the proposals in summary.
- **Table 2** sets out the rationale for each proposal and, if SAB agrees with proposals, suggested actions to implement.

Table 1: Summary of proposals

1	**'Outcomes-based' approach** to LGPS governance with minimum standards rather than a prescribed governance structure.
2	**Critical features of the 'outcomes-based' model** to include: a. Robust conflict management including clarity on roles and responsibilities for decision making. b. Assurance on sufficiency of administration and other resources (quantity and competency) and appropriate budget. c. Explanation of policy on employer and scheme member engagement and representation in governance. d. Regular independent review of governance - this should be based on an enhanced governance compliance statement which should explain how the required outcomes are delivered.
3	**Enhanced training requirements** for s151s and s101 committee members (requirements for s101 should be on a par with LPB members).
4	**Update relevant guidance and better sign-posting.**

Table 2: Rationale for proposals and suggested actions

	Proposal	Why	Suggested actions
1	**'Outcomes-based' approach** to LGPS governance rather than a prescribed governance structure.	We observe (and the survey evidences) that different administering authorities with the same governance structure can have different outcomes in terms of quality and standards of governance. All the governance models in the SAB survey can deliver good or bad governance outcomes. Focussing on the desirable traits and outcomes expected of LGPS governance will enhance governance in a more reliable and cost-effective manner than prescribed changes in structure. Further, we do not believe it is appropriate to impose a 'one size fits all' approach.	i. SAB should consult on: • Desirable features and attributes of LGPS governance arrangements; • The outcomes governance arrangements should be expected to deliver; and • How each administering authority might evidence that its own governance model displays the required attributes. ii. Once identified and agreed through consultation, the desirable features and expected outcomes should be set out in statutory MHCLG guidance (replacing the 2008 CLG guidance).

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Table 2: Rationale for proposals and suggested actions (continued)

	Proposal	Why	Suggested actions
2	**Critical features of the 'outcomes-based' model** to include: a. Robust conflict management. b. Assurance on sufficiency of administration resources (quantity and competency) and appropriate budget. c. Explanation of policy on employer and scheme member engagement and representation in governance. d. Regular independent review of governance.	The detailed specification of the desirable features and expected outcomes of an 'outcomes-based' model are beyond the scope of this project and should be determined in a second stage of work and through consultation. However, based on responses to the survey we propose a small number of critical elements to ensure this approach is effective. These proposals are shown below under 2(a) – (d).	SAB to consider making these features mandatory but determining other aspects of the detailed specification of features and expected outcomes in a further phase of work (as per Proposal 1).
2a	**Robust conflict management.** Administering authorities should be able to decide locally how they will evidence this requirement including for example: • Published conflicts policy. • Protocols for setting and managing budgets. • Schemes of delegation. • Documented roles and responsibilities of elected members on s101 committees, s151 officers and pension fund officers.	Elected councillors and s151 officers have multiple competing statutory responsibilities, within their roles in the LGPS and in wider council responsibilities. High professional standards and experience help them to navigate. Additional measures specific to their LGPS duties can help reduce conflicts and perception of conflicts. Many administering authorities already have a conflicts policy or alternative arrangements to help reduce the risk of conflicts including, for example, schemes of delegation or well defined and documented roles and responsibilities.	SAB should consider making this a mandatory feature of any 'outcomes-based' governance model.

Table 2: Rationale for proposals and suggested actions (continued)

	Proposal	Why	Suggested actions
2b	**Assurance administration and other resource (quantity and competency) sufficient to meet regulatory requirements and budget appropriate.** This will require a transparent approach to setting and managing budgets. Administering authorities should be able to decide locally how they will evidence this requirement including for example: • Benchmarking. • External expert advice. • Internal or external audit. • Review by LPB with appropriate expert advice. Administering authorities may need freedom to use market supplements to attract and retain staff and should not be tied to council staffing policies such as recruitment freezes.	The administrative burden on the LGPS has increased significantly due to increasing complexity (pre- and post-Hutton benefits) and the massive growth in employer numbers. At the same time, there is increased scrutiny from TPR and risk of fines and other regulator interventions. It is critical that pension administration teams are sufficiently well resourced with competent personnel and appropriate administration systems. This aim must be supported by transparent processes for setting appropriate budgets. Pensions administration is a specialist role and, at the current time, it is difficult to attract and retain staff. Many administering authorities already have pay and recruitment policies relevant to the needs of their pension functions rather than being tied to the general policies of the council.	SAB should consider making this a mandatory feature of any 'outcomes-based' governance model.
2c	**Explain policy on employer and member engagement and representation in governance.** At the current time, employer and member representation (with or without voting rights) should be encouraged but not compelled. Decisions on the approach to member representation should remain a local matter but administering authorities should explain their approach.	Most administering authorities have non-administering authority employer and scheme member representatives. Non-administering authority employers are often chosen to represent certain employer constituencies (e.g. academies, FE, charities and housing associations). In some cases, scheme member representatives have voting rights. ››	SAB to consider making these features mandatory but determining other aspects of the detailed specification of features and expected outcomes in a further phase of work (as per Proposal 1).

Table 2: Rationale for proposals and suggested actions (continued)

	Proposal	Why	Suggested actions
		Many survey respondents support greater encouragement to include scheme member reps on s101 committees. However, administering authorities prefer some local flexibility on this, including how representatives are selected and whether they have voting rights. Importantly, administering authorities should retain majority voting representation because of the statutory responsibilities they bear.	
2d	**Regular independent review of governance** to assess effectiveness of administering authority's governance arrangements in the context of the desirable features and expected outcomes set out in guidance on an 'outcomes-based' model. This should be based on an enhanced governance compliance statement which should explain how the required outcomes are delivered. Guidance should not prescribe the approach but could set out acceptable methods which may include: i. Internal or external audit assessment; ii. Scrutiny by LPBs; iii. A peer review process.	It is important that any 'outcomes-based' approach is policed. Self-assessment is insufficient. Independent review is required for a more objective assessment. We discovered that some funds do this on a regular basis already using a variety of approaches including internal and external audit and other external experts and advisors.	SAB should consider making this a mandatory feature of any 'outcomes-based' governance model.

Table 2: Rationale for proposals and suggested actions (continued)

	Proposal	Why	Suggested actions
3	**Enhanced training requirements** for s151s and s101 committee members. This is to include all s151 officers, not just those currently with administering authority responsibilities.	**s151s:** Current CIPFA training does not have specific pensions modules. CPD for those at or close to s151 level would be more effective and have impact sooner than changes to exam syllabus, although the latter would also have longer term benefit. Greater understanding of the LGPS amongst the wider s151 community may also reduce perception of conflicts. **s101 committees:** Currently the training requirements for Local Pension Board members (which are statutory) are more onerous than those tor s101 committee members. Survey respondents felt this inconsistency was unacceptable and that s101 training should be on a par with LPB requirements.	i. CIPFA to develop a CPD module for s151 practitioners in the LGPS. ii. SAB / MHCLG statutory guidance to require training for s101s to be on a par with members of Local Pension Boards.
4	**Update relevant guidance and provide better sign-posting.** It would also be helpful to provide greater clarity to officers and elected members on their statutory and fiduciary obligations. As well as sign-posting, there should be clarity on the status of current and future guidance (e.g. statutory and therefore compulsory or best practice)	The main guidance relevant to governance includes: i. CIPFA guidance for s151s in respect of LGPS responsibilities (2014); and ii. CLG's statutory guidance on governance of governance compliance statements (2008). Both pre-date PSPA 2013, involvement of TPR in LGPS governance and investment pooling. Both must be updated.	i. CIPFA to review and update guidance for s151s in respect of LGPS governance. ii. MHCLG to review and update statutory guidance on governance. In particular, this should put greater emphasis on non-investment aspects of governance such as administration. iii. SAB should consider commissioning legal input to give greater clarity on statutory and fiduciary responsibilities of s151 officers and s101 elected members. iv. SAB or MHCLG should provide greater clarity on the status of current and future guidance (e.g. statutory and therefore compulsory or best practice.)

Table 3: Other ideas considered but rejected or out of scope

	Proposal	Reason for non-recommendation
1	**Separate s151 for pension fund.**	• A benefit would be specific focus on LGPS matters and therefore greater depth of understanding. • However, this is unlikely to help reduce conflicts (the pension fund s151 still has fiduciary responsibility to local tax-payers and may report to council s151) and may not be practical for smaller funds with greater resource constraints.
2	**Compulsory benchmarking.**	• Concerns because benchmark data not like for like (e.g. same cost per member but different service); and (ii) risk this drives lowest common denominator results instead of innovation in service delivery • We recognise that benchmarking has a place and would welcome the development of more sophisticated forms of benchmarking that focus on the quality of the service delivered.
3	**Legal separation of pension fund accounts.**	• Requires change in primary legislation. • Pension fund accounts already separated, audited and shown in Pension Fund Annual Report (annual report is a statutory requirement). • It is unclear what additional benefit there is in legal separation of PF accounts form administering authority/council.
4	**Mandating extension of audit to include an opinion on suitability of LGPS governance arrangements.**	• Some funds commission an external (or internal) audit view voluntarily. • NAO has confirmed that this could only be mandated through legal separation of pension fund accounts (see above). • Concerns on some external auditors' lack of LGPS knowledge and lack of continuity due to changing personnel. • Preference to allow flexibility in approach to independent assessment of governance arrangements and their efficacy.
5	**Removing s151 from decisions around admin budgeting due to conflicts.**	• s151 has statutory responsibility.
6	**Merger of funds to facilitate different governance models.**	• Weakened link to local democratic accountability. • Outside of the scope of the project.

Table 4: Suggested follow up work beyond the scope of this report

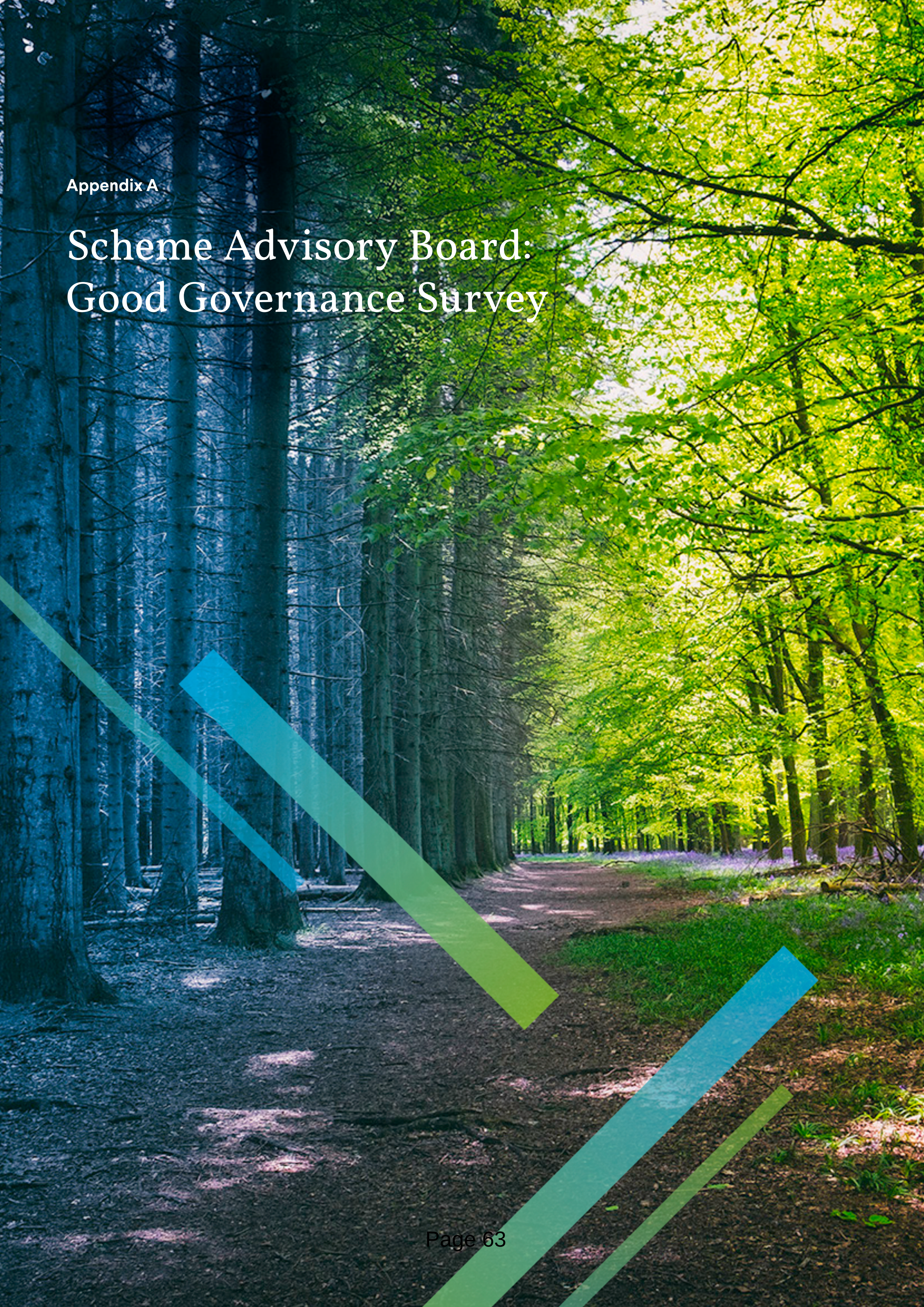
	Suggested follow up work	Why
1	**SAB to consult on detailed specification of desirable features and expected outcomes from an 'outcomes-based' model.**	• Important to get buy-in and support for the practical details of an 'outcomes-based' governance model.
2	**CIPFA and MHCLG to update existing guidance.**	• Existing guidance is out of date.
3	**Commission legal work to provide greater clarity on statutory versus fiduciary obligations (s151 and s101 committee members).**	• Statutory responsibilities take precedence. • Currently unclear.
4	**SAB to consider a 'Good Administration' review.**	• Survey respondents expressed interest in some work to set out what good administration looks like, examples of current best practice, good approaches to meeting the needs of scheme members and employers, and greater clarity on what standards will be required to satisfy TPR. • This will help administering authorities to be clear what standards they must achieve in order to provide 'assurance' that administration resources are sufficient in quantity and competency, identify any gaps and determine what practical steps they might take to address those gaps.
5	**SAB to consider a review of the role of Pension Boards in LGPS.**	• Very mixed reports on the role and success in working with Pension Boards in the LGPS.

Table 5: 'Outcomes-based' model - concept illustration

	Outcome: examples	How to demonstrate that your governance model complies: examples
1	**Robust conflict management.**	• Conflicts policy. • Scheme of delegation or decision matrix setting out who makes what decisions. • Transparent process for approving budgets. • Documented roles and responsibilities of elected members on s101 committees, s151 officers and pension fund officers.
2	**Assurance administration and other resource (quantity and competency) sufficient to meet regulatory requirements and budget appropriate.**	• Benchmarking. • External expert advice. • Internal or external audit. • Review by LPB with appropriate expert advice. • Process for setting administration budget. • Policies in respect of recruitment and market supplements to attract and retain staff.
3	**Explain policy on employer and member engagement and representation in governance.**	• Set out approach to employer and member engagement e.g. communication plan, AGM, employer liaison and support. • Set out approach to participation of non-administering authority employers in governance of fund e.g. representatives of academies, admitted bodies, FE, charity sector, etc. • Set out approach participation of scheme members in governance (e.g. observers, voting members, how selected, etc.) and rationale for approach.
4	**Regular independent assessment of governance arrangements.**	State method e.g. • Internal or external audit assessment; or • Scrutiny by Local Pension Board; or • External expert / consultant; or • Peer review process. Describe scope and approach e.g. • Reviewing policies, meeting minutes. • Reviewing committee efficacy in decision-making, etc.

Appendix A

Scheme Advisory Board: Good Governance Survey



The following pages replicate the online Good Governance survey on governance models for the LGPS. The survey closed on 31 May 2019.

Introduction

The Scheme Advisory Board has commissioned Hymans Robertson to review LGPS governance structures and practices. This survey is part of a key part of the project and we are keen to collect views from as wide a range of stakeholders as possible. Further details on the scope and background to the project can be found on the SAB website.

To help inform this survey and the options for governance change presented for feedback, views were sought from a representative range of LGPS stakeholders (including pension fund officers, section 151 officers, trade unions and other advisors) in order to understand the issues and challenges that the current LGPS governance arrangements present.

Examples of issues cited by respondents included:

- **Clarity:** There is sometimes lack of clarity over roles and responsibilities.
- **Conflicts:** A number of stakeholders raised the issue of perceived conflicts of interest between the fund and the council, in particular for the section 151 of the administering authority given his or her responsibilities for the financial management of other council functions. It was suggested these could manifest themselves in terms of the strategic decisions taken by the fund in respect of funding (contribution rate decisions) and investment or in respect of allocating resource to the pension fund.
- **Consistency:** It is widely recognised that there are many examples of good practice within the LGPS and that section 151s and pension funds manage these conflicts well. However, it was noted that this good practice largely relies on the professionalism and good will of individuals and the ethos of the authority. There is very little regulation or guidance that would safeguard the situation if such high standards were absent.
- **Representation:** The issue of appropriate representation was raised, in particular for non-administering authorities. Some respondents suggested that there could be improvements in the way administering authorities engage with the other employers in the fund on administration resourcing as well as funding, contributions and investment matters.
- **Standards:** It was also noted that LGPS funds evidence varying levels of compliance with the standards for administration, funding and investment set out in statutory legislation, relevant guidance and the TPR Code of Practice 14.
- **Miscellaneous:** Other issues raised included lack of continuity in committee members; shortage of in-house skills, expertise and subject matter knowledge in investment and funding; and restrictions on recruitment and pay policy for the pensions function.

Please use the box below to provide details of any additional issues which you believe the Board should address as part of this exercise.

Comment box provided.

The criteria

Based on the issues raised by stakeholders, the Board has agreed 6 criteria which will be used to assess any proposed changes to LGPS governance arrangements.

Standards	The model enables funds to meet good standards of governance across all areas of statutory responsibility including TPR requirements.
Conflict	The model minimises conflicts between the pension function and the host local authority, including but not limited to s151 officer conflicts (in operational areas such budgets, resourcing, recruitment and pay policies and in strategic areas such as funding and investment policy).
Representation	The model allows for appropriate involvement in decision making for key stakeholders (including administering authority, non-administering authorities, other employer and member representatives).
Clarity	The model delivers clarity of accountability and responsibility for each relevant role.
Consistency	The model minimises dependence on the professionalism of individuals and existing relationships to deliver statutory responsibilities.
Cost	The cost of implementing and running the model is likely to be worthwhile versus benefits delivered.

Please use the box below to provide details of any additional criteria which you believe the Board should consider as part of this exercise.

Comment box provided.

Governance models in this survey

The Scheme Advisory Board would like to hear your views on four governance models set out below.

Option 1 – Improved practice: Introduce guidance or amendments to LGPS Regulations 2013 to enhance the existing arrangements by increasing the independence of the management of the fund and clarifying the standards expected in key areas.

Option 2 – Greater ring fencing of the LGPS within existing structures: Clearer ring-fencing of pension fund management from the host authority, including budgets, resourcing and pay policies.

Option 3 – Joint Committee (JC): Responsibility for all LGPS functions delegated to a JC comprising the administering authority and non-administering authorities in the fund. Inter-authority agreement (IAA) makes JC responsible for recommending budget, resourcing and pay policies.

Option 4 - New local authority body – an alternative single purpose legal entity that would retain local democratic accountability and be subject to Local Government Act provisions.

It is recognised that a one size fits all approach may not be appropriate.

Final recommendations by SAB could be variations on the models described here, taking account of your feedback. Any regulation changes needed will be fully assessed before SAB makes final recommendations. We have not provided detailed costing of each of the models presented in the survey. The cost of implementation would in any case vary across different funds, but, generally, the effort and cost to implement increases as we move from Option 1 to Option 4. Detailed costing of any recommendations emerging from this exercise would be undertaken prior to implementation.

In the next section we set out a brief description of each of the options along with the opportunity for you to provide your views on how well each option compares against the agreed criteria.

For brevity the option descriptions have been included on the next two pages, followed by the response form (which was identical for all four options).

Option 1 - Improved practice

Features

- SAB guidance on minimum expected levels of staffing and resourcing;
- SAB guidance on representation on pension committees and expected levels of training for those on pension committees and officers with an LGPS role. Additional guidance could also be considered on the best practice for pension boards.
- Legal clarification on the fiduciary and statutory duties of key individuals within LGPS funds.
- LGPS regulations set out enhanced process for consulting on FSS and ISS to ensure greater voice for the full range of employers in the fund.

Option 2 - Greater ring fencing of the LGPS within existing structures

Features

- The pension fund budget is set at the start of the financial year with reference to its own business plan and service needs.
- Any charges to the fund in respect of support services provided by the host authority, for example legal support, HR and procurement is included in the budget up front.
- Pension fund related expenditure then comes directly from the fund. This removes the common practice whereby pension fund expenditure is paid though the host authority's revenue account to be recharged at a later date.
- The section 151 of the administering authority would retain responsibility for the pensions function but recommendations on budget (including administration resources required to meet TPR standards) would be made by a pension fund officer to the pensions committee which would be responsible for agreeing the budget. (Alternatively, the pension fund could have a separate s151 officer to reduce conflicts currently faced by s151s.*)
- The pension committee would be responsible for agreeing the budget as well as approving any changes to that budget during the financial year.
- The cost of staffing would be met through the fund including any additional costs such as market supplements or redundancy strain.
- Changes to the Audit and Accounting Regulations 2015 could be considered to make the fund accounts legally separate and subject to a separate audit.

In addition to the budget related aspects outlined above further steps could be taken which would give funds greater autonomy over employment policies. The model is analogous to the fund being treated as an internal business unit of the council.

- Staff will continue to be employed by the host council but polices over certain HR matters such as recruitment and the payment of market supplements will be delegated to the pension committee.
- Decisions over other matters pertinent to the fund, for example investment in new administration technology, would also lie with the pension committee.
- Decisions around the structure of the pension function would be for the fund's management team to make with the approval of the pension committee.*

* Further consideration is required as to whether these practices could simply be encouraged by regulatory bodies or whether it is possible and/or desirable to find a mechanism by which these could be mandated.

Option 3 - Use of new structures: Joint Committees (JC)

Features

- The scheme manager function and all LGPS decision making, which currently sits with the administering authority, would be delegated to a section 102 JC. The committee would comprise all the local authorities who currently participate in the fund as employers.
- Consideration could be given to the representation of other employers and scheme members on the JC.
- Assets and liabilities still sit with the existing administering authority.
- Employment of staff and contractual issues dealt with through a lead authority or a wholly owned company. This could be codified within an Inter Authority Agreement (IAA).
- The IAA would stipulate that the budget will be agreed by the JC. s151s of the constituent local authority employers retain a fiduciary duty to the local taxpayer but the IAA would distance them legally from budget setting responsibilities in respect of the pensions function.

Option 4 - New local authority body

Features

An alternative single purpose legal entity that would retain local democratic accountability and be subject to Local Government Act provisions.

This might be through a combined authority route or through a public body established by statute.

- The new body must retain a strong link to democratic accountability.
- Employment of staff and contractual issues dealt with by the new body.
- Assets and liabilities transferred to the new body.
- Separate accounts based on CIPFA guidance.
- Funded by an element of the contribution rate and by a levy on constituent authorities.
- Officers in the new body are responsible only for the delivery of the LGPS function.

Please use the voting buttons to indicate to what extent moving from existing arrangements to Option (1, 2, 3 or 4) would achieve each of the criteria.

Standards	The model enables funds to meet good standards of governance across all areas of statutory responsibility including TPR requirements.	Strongly disagree 1 2 3 4 5 Strongly agree
Conflict	The model minimises conflicts between the pension function and the host local authority, including but not limited to s151 officer conflicts (in operational areas such budgets, resourcing, recruitment and pay policies and in strategic areas such as funding and investment policy).	Strongly disagree 1 2 3 4 5 Strongly agree
Representation	The model allows for appropriate involvement in decision making for key stakeholders (including administering authority, non-administering authorities, other employer and member representatives).	Strongly disagree 1 2 3 4 5 Strongly agree
Clarity	The model delivers clarity of accountability and responsibility for each relevant role.	Strongly disagree 1 2 3 4 5 Strongly agree
Consistency	The model minimises dependence on professionalism and relationships to deliver statutory responsibilities.	Strongly disagree 1 2 3 4 5 Strongly agree
Cost	The cost of implementing and running the model is likely to be worthwhile versus benefits delivered.	Strongly disagree 1 2 3 4 5 Strongly agree

Please provide any comments you may have regarding Option 1/2/3/4 in the box below.

Comment box provided.

Finally, respondents were asked:

Are there any alternative governance structures not covered between Option 1 – Option 4 which you believe the Board should consider?

Comment box provided.

Appendix B

Abbreviations

Abbreviations

ALATS	The Association of Local Authorities' Treasurers Societies
CIPFA	The Chartered Institute of Public Finance and Accountancy
CLG	Communities and Local Government (former name of MHCLG)
CPD	Continuous Professional Development
FE	Further Education
JC	Joint Committee formed under s102 of the Local Government Act 1972
LA	Local Authority
LGPS	Local Government Pension Scheme
LPB	Local Pension Board
MHCLG	Ministry of Housing, Communities and Local Government
NAO	National Audit Office
PF	Pension Fund
PIRC	Pensions and Investment Research Consultants Ltd
PLSA	Pension and Lifetime Savings Association
PSPA 2013	Public Service Pensions Act 2013
PSAA	Public Sector Audit Appointments
s101	A committee established under s101 of the Local Government Act 1972
s151	An officer with responsibilities under s151 of the Local Government Act 1972
SAB	Scheme Advisory Board for the Local Government Pension Scheme in England and Wales
SCT	Society of County Treasurers
SLT	Society of London Treasurers
SWT	Society of Welsh Treasurers
TPR	The Pensions Regulator

Good governance in the LGPS

Phase II report from Working Groups to SAB

November 2019

Process

Following on from the presentation of the Good Governance Report to the SAB on 8 July 2019, the Board agreed to constitute two working groups to take forward the proposals included in the report. Hymans Robertson were appointed to assist the working groups in this next phase of the good governance project.

The first working group (Standards and Outcomes Workstream) was asked to focus on specifying clearly the outcomes and standards that the SAB wishes to see achieved by funds under the proposed approach, and how these outcomes should be evidenced.

The second working group (Compliance and Improvement Workstream) was asked to focus on establishing the compliance regime that will be required to independently assess funds against this framework.

This report has been prepared for the SAB by both working groups and includes detailed implementation proposals for their workstream including a list of the changes required to guidance to implement this framework.

Thanks to contributors

Thank you to the following who contributed to the working groups and this report.

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Contents

HYMANS ROBERTSON

This report was collated and published by Hymans Robertson LLP.

Terminology

Atypical administering authorities

This report has been drafted largely using terminology relevant to the majority of administering authorities who are local authorities. However, it is recognised that there are some administering authorities which do not fit this model. In taking forward any of the proposals outlined in this report it will be necessary to ensure that principles can by applied universally to LGPS funds and that any guidance recognises the unique position of some funds.

Use of terms

Throughout this document the following terms have a specific meaning unless the context makes clear that another meaning is intended:

Administering authority refers to a body listed in part 1 of Schedule 3 to the LGPS Regulations 2013 that is required to maintain an LGPS pension fund. In particular the term is used here when such a body is carrying out LGPS specific functions.

For example "Each administering authority must publish an annual report."

Committee. A committee formed under s101 of the Local Government Act 1972 to which the administering authority delegates LGPS responsibilities and decision making powers. Alternatively, can refer to an advisory committee or panel which makes recommendations on LGPS matters to an individual to whom the administering authority has delegated LGPS decision making responsibility.

For example "The pensions committee should have a role in developing the business plan."

Host authority refers to a council or other body that is also an administering authority but is used to refer to that body when it is carrying out wider non-LGPS specific functions.

For example "Delivery of the LGPS function must be constant with the constitution of the host authority."

The fund carries a more general meaning and is used to refer to the various activities and functions that are necessary in order to administer the LGPS.

For example "Taking this course of action will improve the fund's administration".

Alternatively, the term is used in the context of the scheme members and employers who contribute to the LGPS arrangements of a specific administering authority.

For example "The number of fund employers has increased in recent years."

Workstream 1: Standards and outcomes

Proposals and background

A. General

1. It is envisaged that all the proposals made in this document will be enacted via the introduction of new statutory governance guidance which will supersede current and previous guidance, although it will contain elements of existing legislation and guidance where appropriate. This guidance would be issued on behalf of MHCLG, although MHCLG may seek assistance on drafting the guidance.
2. In order to improve the accountability for fund governance, it is proposed that each administering authority must have a single named officer who is responsible for the delivery of the pension function. ("the LGPS senior officer"). This may be the S151 officer, assuming they have the capacity, LGPS knowledge and internal assurance framework to assume that role. Alternatively, the LGPS senior officer role may be undertaken by another officer who has the remit of delivering the LGPS function in its entirety and who is likewise suitably qualified and experienced and has the capacity to assume this role. This should be a person close enough to the running of the fund that they have sight of all aspects of the fund's business. The role of the responsible person should be assigned through the host authority's scheme of delegation and constitution. If the person who undertakes this key role within the host authority changes it may be necessary for the role of the responsible person to be reviewed.
3. In order to improve the transparency and auditability of governance arrangements, each fund must produce an enhanced annual governance compliance statement, in accordance with the statutory governance guidance, which sets out details of how each fund has addressed key areas of fund governance. The preparation and sign off of this statement will be the responsibility of the LGPS senior officer and it must be co-signed by the host authority's s151 officer, where that person is not also the LGPS senior officer. The expectation will also be that committees and local pension boards would be appropriately involved in the process.

A.1	MHCLG will produce statutory guidance to establish new governance requirements for funds to effectively implement the proposals below. ("the Guidance").
A.2	Each administering authority must have a single named officer who is responsible for the delivery of all LGPS related activity for that fund. ("the LGPS senior officer").
A.3	Each administering authority must publish an annual governance compliance statement that sets out how they comply with the governance requirements for LGPS funds as set out in the Guidance. This statement must be signed by the LGPS senior officer and, where different, co-signed by the S151 officer.

B. Conflicts of interest

1. Administering authorities must evidence that conflicts, and in particular, potential and perceived conflicts, as well as actual conflicts are being identified, monitored and managed. Some administering authorities currently only follow the conflicts of interest requirements of the host authority which are typically focused on the elected member register of interest and code of conduct. The Guidance should require all administering authorities to publish a specific LGPS conflicts of interest policy and should stipulate the areas that the policy should address. In addition to registering interests, this will include information on how it identifies, monitors and manages conflicts, including areas of potential conflict that are specific to the LGPS as listed:

- Any commercial relationships between the administering authority or host authority and other employers in the fund/or other parties which may impact decisions made in the best interests of the fund. These may include shared service arrangements which impact the fund operations directly but will also include outsourcing relationship and companies related to or wholly owned by the Council, which do not relate to pension fund operations.
- Contribution setting for the AA and other employers.
- Cross charging for services or shared resourcing between the AA and the fund
- Dual role of the AA as an owner and client of a pool
- Local investment decisions
- Any other roles within the Council being carried out by committee members or officers which may result in a conflict either in the time available to dedicate to the fund or in decision making or oversight. For example, some roles on other finance committees, audit or health committees or finance cabinet should be disclosed.

Each administering authority's policy should address:

- How potential conflicts of interest are identified and managed;
- How officers, employer and scheme member representatives, elected members, members of the local pension board and advisers and contractors understand their responsibilities in respect of ensuring that conflicts of interest are properly managed;
- Systems, controls and processes, including maintaining clear records, for managing and mitigating potential conflicts of interest effectively such that they never become actual conflicts;
- How the effectiveness of its conflict of interest policy is reviewed and updated as required;
- How a culture which supports transparency and the management and mitigation of conflicts of interest is embedded.
- How the specific conflicts that arise from its dual role as both an employer participating in the Fund and the administering authority responsible for delivering the LGPS for that fund are managed.
- In putting together such a policy it is recognised that membership of the LGPS is not, in and of itself, a conflict of interest.

Each fund should be required to make public its conflicts of interest policy.

2. During the Phase I survey a number of respondents said that it would be very helpful to define the extent of fiduciary duties in respect of the individuals, committees and boards involved in LGPS governance. The SAB working group came to the conclusion that that while clarification on the fiduciary question is desirable, the complex legal considerations mean that this is beyond the scope of this project. The Group is aware that the SAB has separately undertaken to collate various references to fiduciary duties and public law principles and provide a guide which illustrates how these might be applied to the LGPS. It would be helpful for The Guidance to make reference to the SAB's findings in this area.

B.1 Each fund must produce and publish a conflicts of interest policy which includes details of how actual, potential and perceived conflicts are addressed within the governance of the fund, including reference to key conflicts identified in the Guidance.

B.2 The Guidance should refer all those involved in the management of the LGPS, and in particular those on decision making committees, to the guide on statutory and fiduciary duty which will be produced by the SAB.

C. Representation

1. The initial phase of the Good Governance review highlighted that many pension committees now have non-administering authority employer and scheme member representatives although local practice varies as to whether these members have a vote. Primary legislation in the form of the Local Government Act 1972 allows local authorities wide discretion over committee appointments and delegations and this issue ultimately remains one of local democracy.

   The Guidance should require that all administering authorities prepare, maintain and publish their policy on representation and to require that they provide:

   - the rationale for their approach to representation for non-administering authority employers and local authority and non-local authority scheme members on any relevant committees; and
   - the rationale as to whether those representatives have voting rights or not.

   Best practice would suggest that scheme member representation in some form is a desirable goal for administering authorities. In addition to representation on committees, administering authorities should state other ways in which they engage their wider employer and Scheme membership

   The Guidance should also acknowledge the important principle that administering authorities may wish to retain a majority vote on decision making bodies in order to reflect their statutory responsibilities for maintaining the fund.

C.1 Each fund must produce and publish a policy on the representation of scheme members and non-administering authority employers on its committees, explaining its approach to representation and voting rights for each party.

D. Skills and training

1. The Good Governance Review noted the need for enhanced levels of training for key LGPS individuals. While there exists a statutory duty on members of local pension boards to maintain an appropriate level of knowledge and understanding to carry out their role effectively, no such statutory duty applies to those sitting on s101 committees.

   The Guidance should mandate a similar knowledge and understanding requirement for those carrying out a delegated decision-making role on s101 committees as well as officers involved in the fund. At committee, knowledge should be considered at a collective level and it should be recognised that new members will require a grace period over which to attain the requisite knowledge.

   Training should be delivered as part of a supportive environment and committee and board members will not be required to undertake tests, although it is recognised that best practice would include assessments or other means to identify gaps in knowledge.

   The Guidance should clarify that the expectation is that the TPR requirements that apply to Local Pension Boards should equally apply to Committee and senior officers within the context of an appropriate LGPS specific framework, for example the CIPFA knowledge and skills Code of Practice and Framework (currently being updated). As a minimum those sitting on pension committees or the equivalent should comply with the requirements of MiFID II opt-up to act as a professional client but the expectation is that a higher level and broader range of knowledge will be required.

   Training records must be maintained.

2. There should be an LGPS training requirement for s151 officers (or those aspiring to the role) as part of their CPD. An appropriate level of LGPS knowledge must be attained by S151 officers of an administering authority. A level of LGPS knowledge should also be attained by S151 officers of other public bodies participating in the LGPS, although it is not expected that that they should have the depth and breadth of knowledge required of the S151 officer of an administering authority. This should be specified and administered by an appropriate professional body.

D.1	Introduce a requirement in the Guidance for key individuals within the LGPS, including LGPS officers and pensions committee members, to have the appropriate level of knowledge and understanding to carry out their duties effectively.
D.2	Introduce a requirement for s151 officers to carry out LGPS relevant training as part of their CPD requirements to ensure good levels of knowledge and understanding.
D.3	Administering authorities must publish a policy setting out their approach to the delivery, assessment and recording of training plans to meet these requirements.
D.4	CIPFA and other relevant professional bodies should be asked to produce appropriate guidance and training modules for s151 officers and to consider including LGPS training within their training qualification syllabus.

E. Service delivery for the LGPS function

The Good Governance Review proposed that LGPS funds should be able to evidence that their administration and other resource (quantity and competency) is sufficient to meet regulatory requirements and that their budget is appropriate to deliver this. In this context administration refers to all of the tasks and processes required to deliver the Scheme and is not limited to the calculation and payment of benefits. This definition encompasses a funds accountancy function, investment support, employer liaison, systems, communications etc.

1. Clarity around roles, responsibilities and decision making are central to good delivery of the LGPS function. The Guidance should require funds to document roles and responsibilities and develop, maintain and publish a "roles and responsibilities matrix" which sets out who within the organisation is responsible for final sign off, implementation, oversight and recommending the key decisions that the fund is required to make.

   The "roles and responsibilities matrix" should reflect the host authority's scheme of delegation and constitution and be supported by a clearly documented management structure.

2. The Guidance should require that each administering authority must develop, maintain and publish an administration strategy which sets out its approach to the matters mentioned in regulation 59 (2) of the LGPS Regulations 2013 and the Guidance. We recommend that the Board ask that this proposal to be implemented by MHCLG within the LGPS Regulations at their earliest opportunity.

3. A series of some 10 to 15 key indicators or measures of standards of LGPS service delivery to members and employers should be agreed. These indicators should be drawn wherever possible from current reporting structures. All administering authorities must be required to report against these as part of their governance compliance statement.

   It is acknowledged that there are inherent difficulties in drawing conclusions when comparisons are not always on a true like for like basis but it is preferable to introduce measures now and seek to improve the measurement approach over time.

4. Each Administering Authority has a specific legal responsibility to administer the LGPS within their geographical region and to maintain a specific reserve for that purpose. It is important therefore that the fund's budget is set and managed separately from the expenditure of the host authority.

   Budgets for pension fund functions should be sufficient to meet all statutory requirements, the expectations of regulatory bodies and provide a good service to Scheme members and employers. The budget setting process should be one initiated and managed by the fund's officers and the pension committee and assisted by the local pension board.

Required expenditure should be based on the fund's business plan and deliverables for the forthcoming year. The practice should not simply be to uprate last year's budget by an inflationary measure or specify an "available" budget and work back to what level of service that budget can deliver.

The body or individual with delegated responsibility for delivering the LGPS service should have a role in setting that budget. Typically, this will involve the pension committee being satisfied that the proposed budget is appropriate to deliver the fund's business plan but it is recognised that other governance models exist within the LGPS. Whichever approach is used, it should be clearly set out in the roles and responsibilities matrix and be consistent with the host authority's scheme of delegation and constitution.

E. Service delivery for the LGPS function (continued)

Where a proposed budget is approved, the senior LGPS officer will confirm in the governance compliance statement that the administering authority has approved the budget required to deliver the pensions function to the required standard. If the budget is not approved, the senior LGPS officer will declare that in the governance compliance statement, including the impact of that on service delivery as expressed in a reduced business plan.

These statements in the governance compliance statement will be co-signed by the S151 officer where this is not the same person as the senior LGPS officer.

5. Each Administering Authority has a duty to ensure that its pensions function is staffed such as to enable it to deliver an effective pensions service to the all fund employers and members. It is therefore important that the recruitment and retention practices applied to the pensions function facilitate this. For example, the use of market supplements may be necessary to recruit/retain both investment and pensions administration staff. Further, given that the pension fund budget is set and managed separately from the expenditure of the host authority, the impact of general council staffing policies such as recruitment freezes should not be applied to the pension fund by default.

E.1	Each administering authority must document key roles and responsibilities relating to its LGPS fund and publish a roles and responsibilities matrix setting out how key decisions are reached. The matrix should reflect the host authority's scheme of delegation and constitution and be consistent with role descriptions and business processes.
E.2	Each administering authority must publish an administration strategy.
E.3	Each administering authority must report the fund's performance against an agreed set of indicators designed to measure standards of service.
E.4	Each administering authority must ensure their committee is included in the business planning process. Both the committee and LGPS senior officer must be satisfied with the resource and budget allocated to deliver the LGPS service over the next financial year.
E.5	Each Administering Authority must give proper consideration to the utilisation of pay and recruitment policies, including as appropriate market supplements, relevant to the needs of their pension function. Administering Authorities should not simply apply general council staffing policies such as recruitment freezes to the pensions function.

Workstream 2: Compliance and improvement

F. Compliance and improvement

One of the key features of the original Good Governance Review was the view that in order to ensure required standards are adhered to consistently there needs to be regular independent review of administering authorities governance arrangements.

1. The new MHCLG guidance should set out a process for an Independent Governance Review, to include the features set out below.

a. It will be mandatory for each Fund to commission an Independent Governance Review ("IGR") which will audit the fund's Governance Compliance Statement and review compliance with the requirement of the new statutory guidance.

b. There should be a standardised framework and process for IGRs which covers all areas set out in new MHCLG guidance.

c. It is critical that the IGR should be conducted by appropriate persons who:

- properly understand the LGPS;
- are sufficiently at arm's length from the administering authority's pensions function, that is, they do not have an existing contractual relationship with the administering authority which conflicts with their ability to carry out a properly independent and objective assessment of governance standards and compliance with new statutory requirements; and
- are in some way "accredited" to ensure consistent standards of review.

d. To ensure consistent standards from those conducting IGRs, a procurement framework should be put in place which sets out the standard requirements, standard reporting and standard fee for an LGPS IGR. Ideally this should be in place for 2020/21.

e. Suppliers who can demonstrate they are suitably qualified and knowledgeable may be appointed to the framework, from which any LGPS Funds may appoint an external supplier.

f. Alternatively, administering authorities may choose to have their IGR review carried out by their own internal audit or another appropriate party to the same standards as the framework.

g. Each administering authority should have an IGR completed biennially, by a date which will be notified by the SAB.

h. The SAB may direct, as a result of concerns about the governance of a fund (or for another reason), that an administering authority must have an IGR completed outside of the two-year cycle.

i. The IGR will report findings to the body and/or individual with delegated responsibility for delivery of the LGPS as set out in the roles and responsibilities matrix and to the local pension board.

j. The administering authority must develop an improvement plan to address any issues raised in the IGR.

k. The report from the IGR and improvement plan must be published and also be submitted to SAB and relevant SAB sub-committees.

l. SAB will put in place a panel of independent experts to scrutinise the IGR reports, looking for outliers and areas of concern. The panel of experts will be drawn from LGPS stakeholders to include the s151 community and other parties as appropriate.

m. The SAB panel may enter into discussions with funds where the panel find the IGR report or agreed improvement plan or progress against a previous improvement plan are considered to be unsatisfactory. Additionally, they may refer the unsatisfactory IGR to TPR or further escalate to MHCLG.

n. Failure to submit an IGR report by the required date will result in automatic referral.

o. A dry run is recommended in parallel with the timeline for drafting the required Guidance.

p. Nothing in this process overrides an individual's responsibility to report breaches of the law under the Pensions Act 2004 or any other professional or legal whistleblowing obligations.

F. Compliance and improvement (continued)

2. LGA run a peer challenge process for some areas of local government. It is a process commissioned by a council and involves a small team of local government officers and councillors spending time at the council as peers to provide challenge and share learning. It is suggested that a similar peer challenge process is established for the LGPS.

F.1	Each administering authority must undergo a biennial Independent Governance Review and, if applicable, produce the required improvement plan to address any issues identified. IGR reports to be assessed by a SAB panel of experts.
F.2	LGA to consider establishing a peer review process for LGPS Funds.

Summary of the compliance and improvement process

Annually, each administering authority to produce a governance compliance statement signed by the senior LGPS officer and S151 which demonstrates compliance with LGPS requirements.

Biennially, each administering authority to commission an Independent Governance Review (IGR).

IGR reports to senior LGPS officer, pensions committee and pensions board.

IGR report goes to a SAB panel of experts for assessment. Panel could request further details of improvement plans, make recommendations or report to TPR & MHCLG

Next steps

The Working Group recommends that SAB and MHCLG accept the recommendations in this report and initiate phase III of the project.

Phase III should contain the following elements:

1. MHCLG to draft the required changes to the Guidance.
2. SAB to ask the National Framework to begin work on establishing Independent Governance Review provider framework.
3. SAB to establish the 10-15 KPIs referred to within proposal E.3.
4. It is envisaged that the governance compliance statement will act as a summary, evidencing the Fund's position on all areas of governance and compliance. Where a fund is non-compliant in a certain area the statement should provide information within and accompanying improvement plan about the steps being taken in order to address non-compliance. SAB to consider drawing up a complete list of the topics that should be included within the governance compliance statement.

Appendix A

Summary of recommendations

Area		Proposal
A. General	**A.1**	MHCLG will produce statutory guidance to establish new governance requirements for funds to effectively implement the proposals below. ("the Guidance").
	A.2	Each administering authority must have a single named officer who is responsible for the delivery of all LGPS related activity for that fund. ("the LGPS senior officer").
	A.3	Each administering authority must publish an annual governance compliance statement that sets out how they comply with the governance requirements for LGPS funds as set out in the Guidance. This statement must be signed by the LGPS senior officer and, where different, co-signed by the S151 officer.
B. Conflicts of interest	**B.1**	Each fund must produce and publish a conflicts of interest policy which includes details of how actual, potential and perceived conflicts are addressed within the governance of the fund, including reference to key conflicts identified in the Guidance.
	B.2	The Guidance should refer all those involved in the management of the LGPS, and in particular those on decision making committees, to the guide on statutory and fiduciary duty which will be produced by the SAB.
C. Representation	**C.1**	Each fund must produce and publish a policy on the representation of scheme members and non-administering authority employers on its committees, explaining its approach to representation and voting rights for each party.
D. Knowledge and understanding	**D.1**	Introduce a requirement in the Guidance for key individuals within the LGPS, including LGPS officers and pensions committee members, to have the appropriate level of knowledge and understanding to carry out their duties effectively.
	D.2	Introduce a requirement for s151 officers to carry out LGPS relevant training as part of their CPD requirements to ensure good levels of knowledge and understanding.
	D.3	Administering authorities must publish a policy setting out their approach to the delivery, assessment and recording of training plans to meet these requirements.
	D.4	CIPFA and other relevant professional bodies should be asked to produce appropriate guidance and training modules for s151 officers and to consider including LGPS training within their training qualification syllabus.
E. Service delivery for the LGPS function	**E.1**	Each administering authority must document key roles and responsibilities relating to its LGPS fund and publish a roles and responsibilities matrix setting out how key decisions are reached. The matrix should reflect the host authority's scheme of delegation and constitution and be consistent with role descriptions and business processes.
	E.2	Each administering authority must publish an administration strategy.
	E.3	Each administering authority must report the fund's performance against an agreed set of indicators designed to measure standards of service.
	E.4	Each administering authority must ensure their committee is included in the business planning process. Both the committee and LGPS senior officer must be satisfied with the resource and budget allocated to deliver the LGPS service over the next financial year.
	E.5	Each Administering Authority must give proper consideration to the utilisation of pay and recruitment policies, including as appropriate market supplements, relevant to the needs of their pension function. Administering Authorities should not simply apply general council staffing policies such as recruitment freezes to the pensions function.
F. Compliance and improvement	**F.1**	Each administering authority must undergo a biennial Independent Governance Review and, if applicable, produce the required improvement plan to address any issues identified. IGR reports to be assessed by a SAB panel of experts.
	F.2	LGA to consider establishing a peer review process for LGPS Funds.

Area	
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	E.4
E. Service Delivery for the LGPS Function	E.5
F. Compliance and Improvement	F.1
	F.2

Proposal
MHCLG will produce statutory guidance to establish new governance requirements for funds to effectivley implement the proposals below. ("The Guidance")
Each administering authority must have a single named officer who is responsible for the delivery of all LGPS related activity for that fund. ("the LGPS senior officer")
Each administering authority must publish an annual governance compliance statement that sets out how they comply with governance requirements for LGPS Funds set out in "The Guidance". This statement must be signed by the LGPS Senior Officer and, where different, co-signed by the S151 officer.
Each Fund must produce and publish a conflicts of interest policy which includes details of how actual, potential and perceived conflicts are addressed within the governance of the fund, including reference to key conflicts identified in the Guidance.
The Guidance should refer to all those involved in the management of LGPS, and in particular those on decision making committees, to guide the statutory and fiduciary duty which will be produced by the SAB.
Each Fund must produce and publish a policy on the representation of scheme members and non-adminstering authority employers on its committees, explaining its approach to representation and voting rights for each party.
Introduce a requirement in the Guidance for key individuals within the LGPS, including LGPS Officers and Pensions committee members, to have an appropriate level of knowledge and understanding to carry out their duties effectivley.
Introduce a requirement for S151 Officers to carry out LGPS relevant training as part of their CPD requirements to ensure good levels of knowledge and understanding.
Administering authorities must publish a policy setting out their approach to the delivery, assessment and recording of training plans to meet these requirements.
CIPFA and other relevant professional bodies should be asked to produce guidance and training modules for S151 Officers and to consider LGPS training within the qualification of their syllabus.
Each adminstering authority must document key roles and responsibilities relating to its LGPS Fund and publish a roles and responsibilities matrix setting out how key decisions are reached. The matrix should reflect the host authority's scheme of delegation and constitution and be consistent with role descriptions and business processes.
Each administering authority must produce an administration strategy.
Each administering authority must report the Fund's performance against an agreed set of indicators designed to measure standards of service.

Each administering authority must ensure their committee is included in the business planning process. Both the committee and LGPS Senior Officer must be satisfied with the resource and budget allocated to deliver the LGPS Service over the next year.
Each administering authority must give proper consideration to the utilisation of pay and recruitment policies, including appropriate market supplements, relevant to the needs of their pension function. Administering authorities should not simply apply general staffing policies such as recruitment freezes to the pensions function.
Each adminstering authority must undergo a bilenial Independent Governance Review and, if applicable, produce the required improvement plan to address any issues identified. IGR Reports to be assessed by SAB panel of experts.
LGA to consider establishing a peer review process for LGPS Funds.

Brent Pension Fund Comments
N/A
Compliant
Brent Pension Fund produces an annual governance compliance statement as part of its annual report. However, following approval of this proposal, Brent Pension Fund officers will use the guidance set to be produced by MHCLG in order to refine its annual governance compliance statement.
Compliant. Following production of the guidance by MHCLG, Brent Pension Fund officers will use this to review the existing conflicts of interest policy.
N/A
Compliant. Brent Pension Fund produces details on representation and voting rights as part of its annual report.
MHCLG are to introduce this requirement. Nonetheless, Brent Pension Fund introduces training at each Sub Committee and Board meeting to ensure that all relevant stakeholders have an appropriate level of knowledge and understanding to carry out their duties effectivley.
Brent Pension Fund will review training courses provided by CIPFA and other professional bodies as outlined in D4 in order to ensure that requirements are met.
Following approval of this proposal, Brent Pension Fund officers will look to introduce and implement a training plan setting out key details such as its delivery, assessment and recording.
N/A
Brent Pension Fund officers are to review requirement E.1 and carry out initial work with a view to producing a roles and responsibilities matrix setting out how key decisions are reached.
Compliant
Compliant

Brent Pension Fund officers are to review requirement E.4 in order to ensure full compliance.
Currently, Brent Pension Fund are applying a staffing policy aligned to Brent Council as a whole. However, officers will undertake initial work to produce a policy specific to the pension fund in order to ensure full compliance.
Brent Pension Fund to co-operate with the Independent Review and looks forward to receieving further details on implemenation of this proposal.
N/A

HYMANS ROBERTSON

Sixty second summary

UK Stewardship Code and the LGPS

Key messages

- The FRC has published the updated UK Stewardship Code which takes effect from 1 January 2020. The Code represents a new best practice standard for both asset owners and asset managers alike.
- Funds who want to remain or become signatories must publish a Stewardship Report, demonstrating compliance with the 12 principles of the Code by 31 March 2021.
- LGPS Funds should use the Code in conjunction with forthcoming SAB guidance as a basis for reviewing and strengthening their approach to responsible investment activity.

Background

The FRC last week launched its updated UK Stewardship Code. The Code aims to improve stewardship practices, setting a substantially higher standard which reflects the changing expectations of investors since the Code's last revision in 2012. The requirements of the revised Code for asset owners and managers extend to establishing clear stewardship objectives, integrating stewardship in investment strategies, and adhering to clearer and more elaborate reporting requirements.

The Code comprises a set of 12 'apply and explain' Principles for asset managers and asset owners, and six Principles for service providers, including investment consultants.

Key changes in the Code

- An **extended focus** that includes asset owners such as pension funds, and service providers including investment consultants and asset managers. The aim is to align the approach of the whole investment community with the interest of end-investors and beneficiaries.
- Annual reporting on stewardship activity and outcomes. Signatories' reports should demonstrate
  - what has been done in the previous year; and
  - what the outcome was;
  - the signatory's engagement with the assets they invest in;
  - the signatory's voting records;
  - how they have protected and enhanced the value of their investments.

  This **greater transparency** will allow clients to see how their interests are being served.
- Signatories are expected to take **ESG factors, including climate change**, into account and to ensure their investment decisions are **aligned with the needs of their clients**. Signatories are expected to disclose the issues they prioritise for assessing investments prior to holding, and to monitor through holding and exiting. This should include the ESG issues of importance to them. This update parallels the recent changes to the Investment Regulations for Occupational Pension Schemes.

- Signatories are expected to **explain how stewardship has been exercised across asset classes** beyond listed equity such as fixed income, private equity and infrastructure, and in investments outside the UK.

- Signatories are required to **explain their organisation's purpose, investment beliefs, strategy and culture**, and how these enable them to practice stewardship. They are also expected to show how they are demonstrating this commitment through appropriate governance, resourcing and staff incentives.

- There is also an expectation within the new Code for signatories to work in a **collaborative** fashion with regulators and industry bodies to identify and respond to the risk of market and systemic failure. Signatories are expected to show how they have worked with other stakeholders to promote continued improvement of the functioning of financial markets and outline the role they played in any relevant industry initiatives in which they participated.

- Signatories are expected to explain how they **escalate stewardship activities** where necessary.

Next steps for signatories

The new Code takes effect from 1 January 2020. Organisations will remain signatories to the UK Stewardship Code until the first list of signatories to the 2020 Code is published. Existing signatories to the Code will be required to submit a Stewardship Report that meets the FRC's reporting expectations in the 2020 Code by 31 March 2021 to continue to be listed as signatories to the UK Stewardship Code. Reports must be signed off at a Board level, by Chair, Chief Executive or Chief Investment Officer.

Our view

Responsible investment is an area of continually growing importance across our client base and we recognise that minimum standards together with best practice are being driven higher and the changes to the Code certainly achieve this. We believe that best practice in stewardship begins with strong governance structures and clearly defined objectives which are linked to the purpose of the organisation and reinforced through the culture and values of that organisation. The new Code promotes this, particularly in requiring Board level sign-off of reporting.

Current guidance for LGPS funds suggests that Funds should become signatories to the Stewardship Code. The strengthening of the Code will require Funds to increase both their responsible investment activity, but also to focus more clearly on how they report on this activity. Whilst there is currently no compulsion for Funds to act, Funds may want to use the framework of the new Code in conjunction with forthcoming SAB guidance as a basis for reviewing and updating their responsible investment policies.

Please contact your Hymans consultant for more information on how we can help.

Local Government Pensions Committee
Secretary, Lorraine Bennett

LGPC Bulletin 191 – November 2019

Foreword

This bulletin contains a number of important updates for LGPS administering authorities, scheme employers and software providers; whilst also providing a general update for all stakeholders.

Of particular importance are the following articles which require action by certain stakeholders:

- CEPs – all payments must cease
- TPR Guidance on transfers and conversions updated
- FCA publish video to help consumers understand pension transfer advice
- LGPC subscriptions 2019/20
- Teachers' pension employer contribution grant

If you have any comments on the contents of this bulletin or wish to suggest items that might be included in future bulletins, please contact query.lgps@local.gov.uk.

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LGPS England & Wales

Aggregation guide – version 1.9

On 6 November 2019 Rachel Abbey notified administering authorities that version 1.9 of the Aggregation technical guide has been published.

We have:

- made significant changes to the format of the guide, with the aim of making it more user-friendly. This means that that a 'tracked changes' version would not be useful so only a 'clean' version is available.
- replaced the summary previously provided in Part 1 with a table summarising the aggregation rules for each scenario and added a definitions section.
- removed the 'Outstanding issues' section that set out proposals to move back to an 'aggregation by election'.
- included the latest position concerning the regulation changes recommended to MHCLG by the national Technical Group, via the Scheme Advisory Board'.

The guide can be found on the 'Guides and sample documents' page of www.lgpsregs.org.

Good governance project - update

Further to the articles in bulletins 185, 187 and 188 the Scheme Advisory Board (SAB) have published Phase II of the Good Governance report. The report makes recommendations (see appendix A of the report for a summary of these) for new standards of governance and administration and proposes how they can be measured and assessed independently. The recommendations cover the areas below:

- general governance
- conflicts of interest
- representation
- skills and training
- service delivery for the LGPS function
- compliance and improvement

Comments on the phase II report should be sent to Robert.Holloway@local.gov.uk .

At their meeting of 6 November 2019, SAB agreed that phase III of the project, including draft statutory guidance on governance compliance statements and establishing a set of key performance indicators should now be developed. Final proposals for phase III of the project will be considered by SAB when it next meets on the 3 February 2020.

McCloud – latest position

The Scheme Advisory Board has updated the McCloud page of www.lgpsboard.org with its understanding of the latest position. This update is in addition to the background information and Q&A for administering authorities that has already been published.

McCloud – pension tax data request

In bulletin 190 we confirmed that MHCLG and HM Treasury had requested data from administering authorities to help with policy planning in relation to McCloud and wider pension tax issues affecting the public sector.

We understand that a number of administering authorities experienced difficulty in obtaining accurate data in relation to the underpin. Consequently, MHCLG paused the underpin element of the data request, though this may be reinstated in the future.

The information requested in questions 3 to 5 (relating to HM Treasury's ongoing tax project) is still required. If you have not already done so please can you send your completed spreadsheets to lgpensions@communities.gov.uk as a matter of urgency.

Pensions Made Simple - member videos

We are pleased to announce that the 'Pensions Made Simple' member videos are now available to view on both the desktop and mobile versions of www.lgpsmember.org.

There are seven videos in total with English and Welsh versions available for all. The videos are hosted on Vimeo. If you want to embed the videos on your fund's website the code to do this is available at http://www.lgpsregs.org/resources/calccode.php

We would like to thank Andy Hemming (WMPF), Steve Jones (Merseyside), Cheryl Platts (Buckinghamshire), and Leah Swane (Shropshire) for their input on the project. We would also like to thank Meirion Jones and Gwennan Williams from Gwynedd for their invaluable help with the Welsh translation.

Action for administering authorities
Please let your employers know about the videos so that they can publicise them to their employees.

Pension fund annual reports 2019

Regulation 57 of the LGPS Regulations 2013 requires administering authorities to publish their pension fund annual report, in relation to the Scheme year ending on the 31 March, on or before the following 1 December.

However, since the Local Government Accounts and Audit Regulations 2015 brought forward the deadline, from 2018, to 31st July; from 2018 onwards, we understand that many local authorities have brought forward publication of their Pension Fund Annual Report and Accounts accordingly. Please email a copy of your annual report (or hyperlink) to liam.robson@local.gov.uk when it is available (by Friday 29 November 2019 at the latest). These reports will be uploaded to the Scheme Advisory Board's website Fund Annual Report 2019 page.

Responsible Investment Guidance Consultation

On 22 November 2019 Bob Holloway emailed stakeholders with part 1 of the Responsible Investment Guidance consultation. The consultation can be found on the Scheme Advisory Board (SAB) website. Comments on the draft guidance and details of case studies should be sent to Robert.holloway@local.gov.uk by the 11

January 2020. When responding, can consultees please restrict comments to the scope and content of the part 1 guidance, bearing in mind that other relevant issues will feature in part 2 of the guidance.

A Responsible Investment workshop will be held on the 15 January 2020 at 18 Smith Square. This is arranged in conjunction with DG Publications, details of the event can be found at https://www.dgpublishing.com/responsible-investment-forum/registration/.

SAB meeting of 6 November 2019 – update

On the 14 November 2019 the Scheme Advisory Board (SAB) published a summary of its meeting held on 6 November 2019. Topics discussed include the McCloud judgment, the good governance project, responsible investment guidance, cost transparency and the CMI data request. Full details of the meeting and agenda papers can be found at www.lgpsboard.org. The next SAB meeting will take place on 3 February 2020.

Survivor membership guide – version 2.0

On 4 November 2019 Jayne Wiberg notified administering authorities that version 2.0 of the Survivor membership guide has been published. Updates are largely clarifying amendments together with a minor technical change. Clean and track changes versions can be found on the 'Guides and sample documents' page of www.lgpsregs.org.

TPR Scheme Return – standard conditional data extract report

In bulletin 187 we confirmed that on 4 July 2019 pension managers and software suppliers were emailed with a standard conditional data extract report, to be scored in the Pension Regulator's (tPR) 2018/19 annual scheme return.

Due to an oversight, the water mark "Draft" remained on the data extract report which has led to some confusion regarding the status of the document. It is now to be made clear that the data extract circulated in July was the final version agreed by the working group as a basis for ongoing discussions between administering authorities and their software provider.

Since July, it has become apparent that a number of administering authorities have, for a variety of reasons, chosen not to adopt the standard extract for conditional data. Although adoption of the standard extract is not mandatory, administering authorities and their software providers should be aware that tPR will be checking the 2018/19 returns early in the New Year for consistency and accuracy. We cannot rule out the possibility that we may come under pressure to establish a mandatory data extract should there be shortcomings against tPR expectations. The stakeholders working group will be re-convened to discuss the next steps and to assist their consideration it would be helpful if administering authorities could email Robert.holloway@local.gov.uk with details of how they have either scored their conditional data or are intending to do so.

The Local Government Pension Scheme (Amendment) Regulations 2019 [SI 2019/1449]

The above regulations were laid before Parliament on 5 November 2019 and are effective from 31 December 2019. They amend the LGPS (Transitional Provisions, Savings and Amendment) Regulations 2014 by introducing survivor benefits payable under the earlier regulations for opposite-sex civil partnerships. A person who is the surviving opposite-sex civil partner of a deceased member will be provided with a survivor pension calculated on the basis that the survivor is a widow or widower, depending on their gender.

For background information see the article later in this bulletin on the Civil Partnership (Opposite-sex Couples) Regulations 2019 [SI 2019/1458]. The Survivor benefits guide will be updated in due course to reflect these changes.

DWP

Consultation on simpler ABS for workplace pensions

Defined benefit schemes and public sector schemes are not currently in the scope of this consultation. However, there will be the opportunity to learn lessons about the potential applicability to these schemes in the future and, the consultation asks (question 3) whether these schemes should be included this time around?

In 2017, the Government undertook a review looking at how to build on the success of automatic enrolment. The review identified annual benefit statements (ABS) as being often ineffective and a lost opportunity because they are too long and complex, meaning that some savers do not understand or engage with the information they receive. At the PLSA conference in October 2018, a simpler annual benefit statement was launched for providers to voluntarily use with the support of the Minister of Pensions and Financial inclusion (bulletin 177).

On 1 November 2019, DWP published a consultation titled ‘Simpler annual benefit statements for workplace pensions’ that closes at 11.45pm on 20 December 2019. The consultation looks at how to deliver better ABS that are shorter, simpler and have information that is easy to understand and will help members plan for the retirement they want. In particular it considers whether or not this can be achieved voluntarily or by mandating through legislation.

HMRC

CEPs – all payments must cease

In bulletin 185 we confirmed that you must notify HMRC of all outstanding unpaid contribution equivalent premiums (CEPs) by 4 June 2019 (this date was later extended to 19 July 2019 for certain parties). HMRC would then complete the Scheme Financial Reconciliation exercise as set out in Countdown Bulletins 45 to 49.

In bulletin 190 we mentioned that HMRC had informed the LGA that some LGPS administering authorities are still sending CEP notifications and payments. Unfortunately despite the article in bulletin 190, some administering authorities are continuing to make CEP notifications and payments. These actions must cease with immediate effect as it is no longer possible to pay CEPs.

Urgent action for administering authorities
Please review your processes and update them where necessary to ensure that you do not send any further CEP payments or notifications to HMRC.

Pension schemes newsletters 114 and 115

On 30 October 2019 and 26 November 2019, HMRC published Pension Schemes Newsletter (PSN) 114 and 115. Of particular interest in both newsletters are the articles on annual allowance (AA) scheme pays.

HMRC have published a new guide about paying the AA tax charge for pension scheme members. The guide titled 'who must pay the pensions annual allowance tax charge' has information about 'mandatory' and 'voluntary' scheme pays and provides links for members on declaring their AA charge on their self-assessment return. Administering authorities are asked to remind those members who have exceeded their annual allowance for 2018/19 and who do not have sufficient unused annual allowance to carry forward to cover the excess, that they must declare this on their Self-Assessment tax return, even if the administering authority is paying the tax charge.

TPO

Ombudsman's Determination – PO 17634 – Ill Health

This complaint is about an ill health application from deferred status. It covers:

- administrative delays between 2011 and 2016,
- a request for the member to pay for the cost of a specialist report, and
- the fact that once the pension was awarded in 2016, it was only backdated to 2015 and not 2011, the date of the original request for payment.

The Ombudsman upheld the member's complaint and to put matters right instructed the Council to consider backdating the ill health pension to May 2011. The Council was also instructed to pay £1000 to the member for causing serious distress and inconvenience.

TPR

News roundup and messages

On 14 November 2019 TPR published its news roundup and messages webpage. This page covers the latest news, recent publications, communication campaigns, upcoming events, speeches and news from TPR partners.

The Public Service Governance and Administration Survey 2019

TPR sent out their Public Service Governance and Administration Survey 2019 to administering authorities on 6 November 2019. The survey deadline is 29 November 2019. As with previous years, if necessary, TPR will allow a limited period extension, please contact TPR directly if this is the case.

Guidance on transfers and conversions updated
TPR has updated its guidance on DB to DC transfers and conversions. This guidance is aimed primarily at addressing statutory transfers of DB benefits made in accordance with Part 4ZA of the Pension Schemes Act 1993.

Paragraphs 37 to 39 and footnote 24 have been updated to reflect changes to the Financial Conduct Authority's (FCA) financial register. On 9 December 2019, the FCA is replacing its Approved Persons Regime with the Senior Managers and Certification Regime (SM&CR). Only senior managers and selected other roles will now need to be approved. Other individuals, for example those carrying out customer-facing roles, will be subject to a certification regime carried out by their firm and most will not appear on the FCA register going forward. A new directory containing data on certified individuals will be released in 2020. Find out more in the FCA's policy statement.

Action for administering authorities
You should continue to check the Register for firm details. However, you will then need to contact firms directly to confirm that the relevant individual works for that firm or check an appropriate third-party directory.

Other news and updates

LGA Pensions Adviser vacancy
The LGA is recruiting for a pensions adviser to lead on the development and implementation of an extended service to LGPS Scotland. It is a full-time role that can be either office (London) or home based. The salary scale ranges from £41,675 to £47,736 (plus London weighting where appropriate).

The closing date for applications is 3 January 2020; interviews will be held on 13/14 January 2020. For more information or to discuss this opportunity please contact Jeff Houston (07786 681 936) or Lorraine Bennett (07766 252847).

LGPC subscriptions 2019/20
The 2019/20 LGPC subscription invoices were issued on 11 November 2019. If you have not received an invoice please contact Elaine English as soon as possible.

Action for administering authorities
Please arrange for your invoice to be paid promptly.

Teachers' pension employer contribution grant
The Department for Education (DfE) is funding the increase in employer contributions in the form of a teachers' pension employer contribution grant for schools and local authorities. Detailed guidance about the grant for September 2019 to March 2020 can be found on the DfE website. For ease, we have provided a note highlighting the key points with links to further guidance on the DfE website.

Action for administering authorities
Please pass information about the grant on to your schools, including any academies to which you provide services.

FCA publish video to help consumers understand pension transfer advice
In August 2019 the Financial Conduct Authority (FCA) published a 17 minute video explaining the transfer process. The video will be helpful to those who:

- have transferred out their defined benefit pension and are unclear whether they received good quality advice, and
- are considering transferring out their defined benefit pension and want to understand what the process should look like before they start.

A link to this video will also be available on the member website at www.lgpsmember.org.

Action for administering authorities
Please review your transfer communications to make sure that your members are aware of this video before making an election to transfer benefits out of the scheme.

The Civil Partnership (Opposite-sex Couples) Regulations 2019 [SI 2019/1458]
On 5 November 2019 the Government made the Civil Partnership (Opposite-sex Couples) Regulations 2019 [SI 2019/1458] which are effective from 2 December 2019. This means that an opposite-sex couple can give notice of a proposed civil partnership on 2 December 2019 after which the 28 day waiting period will commence (section 11 of The Civil Partnership Act 2004). This means an opposite sex civil partnership registration can take place from 31 December 2019.

These regulations were made in response to the Government consultation published on 10 July 2019, which proposed changing the law to allow opposite-sex couples to form civil partnerships (section 2 of the Civil Partnerships, Marriages and Deaths (Registration etc) Act 2019).

Also amended is section 37 of the Marriage (Same Sex Couples) Act 2013. This limits the conversion of a civil partnership into a marriage, to couples in same sex civil partnerships only. The Government has not made provisions to allow a marriage to be converted into a civil partnership.

The Local Government Pension Scheme (Amendment) Regulations (Northern Ireland) 2019 [NISR 2019/206]
The above regulations were made on 23 October 2019 and come into operation on 18 November 2019, with some amendments having an earlier effect. They amend the LGPS (Northern Ireland) 2014, the 2014 Transitional Regulations (NI) together with a number of earlier regulations.

The regulations make various technical changes / clarifying amendments, and they also:

- remove the requirement for a nomination form to be completed to qualify for a cohabiting partner's benefit,

- provide that, from 18 November 2019, an eligible cohabiting partner must be able to marry or enter into a civil partnership with the member at the date of death only, rather than for a continuous period of two years before the date of death,
- allow payment of death benefits after two years, and
- introduce gender neutral factors for the payment of additional pension contributions.

Training

Annual governance conference update – Circular 315

Our annual Governance Conference is taking place in York on 23/24 January 2020 and is open for booking. The theme for the conference is 'Public service pension reform – life after Hutton'. We are pleased to confirm our key-note speakers are Anthony Arter - the Pensions Ombudsman and Lord Hutton of Furness.

For more information, including the conference programme and a full list of confirmed speakers see circular 315 and the conference flyer.

Wider landscape

Independent Schools Phased Withdrawal Proposal - LGA response

In bulletin 189 we reported that the Department for Education (DfE) had opened a consultation to gather views on a proposal to change the Teachers' Pension Scheme (England and Wales) rules to allow independent schools to opt out of the scheme more flexibly. The LGA responded on 1 November 2019.

NHS Pension Scheme: increased flexibility consultation

In bulletin 189 we reported that the Department for Health and Social Care had opened a consultation on a new set of proposals to offer senior clinicians more control over their pensions growth, so they can continue to provide the services that patients need. The LGPS Scheme Advisory Board England & Wales informally responded on 1 November 2019.

Temporary solutions to avoid pension tax bills in the NHS

The NHS in:

- England have signed off on plans to pay the pensions tax bills of doctors for the 2019/20 pension input period, and
- Scotland have agreed to give experienced staff the option of receiving their employer pension contributions as part of their basic pay (for the period from 1 December 2019 to 31 March 2020).

Both of these interim solutions are an attempt to avoid those affected reducing their hours or retiring early. It is hoped that this will ensure crucial services are maintained as demand on both health services continues to increase.

Pension Schemes Bill – second reading delayed

In bulletin 190 we reported that that a new Pension Schemes Bill would be introduced to strengthen TPR's powers, provide a framework to support pensions dashboards and introduce regulations covering the right to a pension transfer.

The first reading of the Bill took place on 15 October 2019 and the second reading of the Bill was scheduled to take place on 30 October 2019. However this was delayed with no replacement date set, as the UK moves towards a general election on 12 December 2019.

Legislation

United Kingdom

SI	Reference Title
2019/1425	The Finance Act 2004 (Specified Pension Schemes) Order 2019
2019/1433	The Occupational Pensions (Revaluation) Order 2019
2019/1449	The Local Government Pension Scheme (Amendment) Regulations 2019
2019/1458	The Civil Partnership (Opposite-sex Couples) Regulations 2019

Northern Ireland

NISR	Reference Title
2019/206	The Local Government Pension Scheme (Amendment) Regulations (Northern Ireland) 2019

Useful links

LGA Pensions page

LGPS member website (England and Wales)

LGPS 2015 member website (Scotland)

LGPS Advisory Board website (England and Wales)

LGPS Advisory Board website (Scotland)

LGPS Regulations and Guidance website (England and Wales)

LGPS Regulations and Guidance website (Scotland)

Public Sector Transfer Club

Recognised Overseas Pension Schemes that have told HMRC that they meet the conditions to be a ROPS and have asked to be included on the list.

LGPS pensions section contact details

If you have a technical query, please email query.lgps@local.gov.uk and one of the team's LGPS pension advisers will get back to you.

Jeff Houston (Head of Pensions)
Telephone: 0207 187 7346
Email: jeff.houston@local.gov.uk

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Distribution sheet
Pension managers (internal) of administering authorities
Pension managers (outsourced) and administering authority client managers
Local Government Pensions Committee
Trade unions
CLG
COSLA
SPPA
Regional Directors
Private clients
The Pensions Regulator
The Pensions Ombudsman

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Local Government Pensions Committee
Secretary, Lorraine Bennett

LGPC Bulletin 192 – December 2019

Foreword

This bulletin contains a number of important updates for LGPS administering authorities, scheme employers and software providers; whilst also providing a general update for all stakeholders.

Of particular importance is the article on the updated transfer out declaration forms – this requires action by administering authorities.

If you have any comments on the contents of this bulletin or wish to suggest items that might be included in future bulletins, please contact query.lgps@local.gov.uk.

Contents

LGPS England & Wales

Supplementary Pensions Increase (PI) guide updated

The technical guide called 'When and how to apply supplementary pensions increase to lump sums' has been updated with a minor technical correction in relation the application of supplementary PI to a Defined Benefit Lump Sum Death Benefit (DBLSDB).

Clean and tracked versions of the guide (version 2.0) are available on the guides and sample documents page of www.lgpsregs.org.

Opt out form and notes updated

We have published an updated version of the opt out form and notes (version 2.1). We have made minor technical changes to reflect the ending of contracting out and to make reference to the upper age limit that applies when transferring out of the LGPS. We have made significant changes to the format of the form and notes for ease of use.

You can find clean and tracked versions of the opt out form and notes on the guides and sample documents page of www.lgpsregs.org.

Member guide to AVCs updated

We have published an updated version of the member guide to AVCs. The new version includes royalty-free images that each have an 'Alt text' description to aid visually impaired readers.

We have published clean and tracked versions of the guide on the guides and sample documents page of www.lgpsregs.org.

LGPS Scotland

The LGPS (Increased Pension Entitlement) (Miscellaneous Amendments) (Scotland) Regulations 2019

In 2008/2009 GMP related overpayments across public service pension schemes were identified and Scottish Ministers chose to allow the pension in payment to remain unadjusted for affected pensioners in the Police, Firefighter and Local Government Pension schemes.

Scottish Ministers have decided that a similar approach should be taken for GMP related overpayments that arise from the GMP reconciliation exercise, which concluded in December 2018. This means that pensions currently in payment will remain unadjusted going forward, for affected pensioners in the LGPS.

These regulations [SSI 2019/438] provide for a new scheme award known as an Increased Pension Entitlement (IPE), which reflects the GMP-related overpayment.

The regulations were laid in the Scottish Parliament on Monday 23 December and will come into force on 1 March 2020.

Section 13 report published

The Government Actuary's Department (GAD) has published a review of the actuarial valuations of the 15 funds in LGPS (Scotland) as at 31 March 2017, in accordance with section 13 of the Public Service Pensions Act 2013.

The review found that LGPS (Scotland) is in a strong financial position, with the aggregate funding level on prudent local bases having improved from 94% in 2014 to 102% in 2017. Six of the eleven open funds are fully funded on their prudent local bases.

The report states that to improve transparency and comparability further, it would be helpful for administering authorities and other stakeholders to be able to make meaningful comparisons between the actuarial valuations. Consequently, the report makes recommendations on consistency affecting all funds.

Other news and updates

LGA Pensions Adviser vacancy

The LGA is recruiting for a pensions adviser to lead on the development and implementation of an extended service to LGPS Scotland. It is a full-time role that can be either office (London) or home based. The salary scale ranges from £41,675 to £47,736 (plus London weighting where appropriate).

The closing date for applications is **3 January 2020**; interviews will be held on 13/14 January 2020. For more information or to discuss this opportunity please contact Jeff Houston (07786 681 936) or Lorraine Bennett (07766 252847).

Transfer out declaration forms updated

Version 8.0 of the transfer out declaration forms is available to view on the guides and sample documents pages of www.lgpsregs.org and www.scotlgpsregs.org.

The forms have been updated in light of the Pensions Ombudsman determination PO-21489 reported in bulletin 190. Both the member and receiving scheme declarations now include questions about whether the member is an ‘earner’, where the transfer is buying transfer credits in an occupational pension scheme.

The forms now also make reference to opposite sex civil partnerships and same sex marriages in the current partnership status sections.

Action for administering authorities
Update local versions of the transfer out declaration forms.

National LGPS Frameworks – December news bulletin

The December news bulletin contains the latest news and updates from National LGPS Frameworks.

Equitable Life transfers to Utmost Life and Pensions

Following the High Court hearings on 22 and 25 November 2019, court approval to transfer the business of Equitable Life to Utmost Life and Pensions was received on 4 December 2019. The proposed changes (see bulletin 188) will be implemented with effect from 1 January 2020.

Scheme policy holders and 'eligible members' voted overwhelmingly in favour of the proposed changes.

Next steps

- the 'uplift' will be applied to with-profits policies as soon as practicable after 1 January 2020
- most with-profits policies will be converted to unit-linked policies from 1 January 2020
- policy holders are encouraged to decide which funds they wish to invest in.

The next communication to policyholders will be from Utmost Life and Pensions in the New Year; this will confirm the exact amount of 'uplift' and their investment choice.

For more information see Equitable Life's website.

National technical group minutes published

Minutes from the meeting held on 10 December are now available to view. Topics of discussion include the LGPS Knowledge System, the inclusion of key performance data in CIPFA's annual report guidance, the use of AVCs to buy additional pension and the data items for inclusion in the LGA's ABS guidance.

LGPC minutes published

Draft minutes from the meeting held on 6 November are now available to view. Updates from the three LGPS schemes and the national technical group are included. The minutes will be confirmed at the next meeting on 3 February 2020.

Royal London and Eversheds Sutherland publish financial advice policy paper

Royal London and Eversheds Sutherland have published a policy paper that seeks to provide guidance to trustees and employers about facilitating financial advice for members on whether or not to transfer.

Whilst the report does not advocate a single course of action, it stresses that "doing nothing" is not a risk-free option.

Training

Annual Governance Conference – fully booked

The conference is now fully booked. We are maintaining a waiting list should more spaces become available. Please email elaine.english@local.gov.uk if you wish to add your name to the list.

Wider landscape

Fire Pension Scheme: Transitional protections case update

An update on the remedy proceedings in the Fire Pension Scheme transitional protections case is available in the National Employer's circular. The case primarily concerns the transitional protections given to older members on the introduction of the 2015 Fire Pension Scheme, which in December 2018 were found by the Court of Appeal to discriminate on grounds of age. The case has therefore returned to the employment tribunal for it to determine remedy and the Circular covers the interim order on remedy made at a hearing on 18 December 2019.

Supreme Court rules in case concerning pensions for part-time judges

The Supreme Court has decided an appeal concerning the issue of when time starts to run for a claim by a part-time judge to a pension under the Part-time Workers' Directive. In the case of Miller and others v Ministry of Justice, the Supreme Court ruled in favour of four judges who had been denied pensions for part-time work.

The Supreme Court unanimously found that the point of unequal treatment occurs at the time the pension falls to be paid. As a result, the time limit for bringing claims is three months from this date, rather than three months from the end of the period of service to which the unequal treatment relates.

This judgment only applies to part-time, fee paid judges; however, if the principle of the ruling is applied more widely there could be potential implications for other pension schemes.

NHS Clinician Pension Tax Scheme - statement from the Secretary of State

The statement confirms that the commitments being entered into to make payments to clinicians affected by annual allowance pension tax will be honoured when clinicians retire.

Pension Schemes Bill reintroduced

On 19 December, in the Queen's Speech, it was announced that the Pension Schemes Bill will be reintroduced. The Bill will create a legislative framework for the introduction of pensions dashboards, to strengthen the Pensions Regulator's powers to take action against employers and introduce regulations covering the right to a pension transfer.

Guy Opperman re-appointed as pensions minister

Following the General Election on 12 December, the Department for Work and Pensions has confirmed that Guy Opperman has been re-appointed as pensions minister.

Legislation

Scotland

SSI	Reference Title
2019/438	The LGPS (Increased Pension Entitlement) (Miscellaneous Amendments) (Scotland) Regulations 2019

Useful links

LGA Pensions page

LGPS member website (England and Wales)

LGPS 2015 member website (Scotland)

LGPS Advisory Board website (England and Wales)

LGPS Advisory Board website (Scotland)

LGPS Regulations and Guidance website (England and Wales)

LGPS Regulations and Guidance website (Scotland)

Public Sector Transfer Club

Recognised Overseas Pension Schemes that have told HMRC that they meet the conditions to be a ROPS and have asked to be included on the list.

LGPS pensions section contact details

If you have a technical query, please email query.lgps@local.gov.uk

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Elaine English (LGPS Executive Officer)
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Distribution sheet

Pension managers (internal) of administering authorities
Pension managers (outsourced) and administering authority client managers
Local Government Pensions Committee
Trade unions
CLG
COSLA
SPPA
Regional Directors
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The Pensions Regulator
The Pensions Ombudsman

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Local Government Pensions Committee
Secretary, Lorraine Bennett

LGPC Bulletin 193 – January 2020

Foreword

This bulletin contains important updates for LGPS administering authorities, scheme employers and software suppliers. It also provides a general update for all LGPS stakeholders.

Of particular importance are the articles on:

- the deadline for completing the National LGPS frameworks survey on pension administration is 3 February 2020
- The NHS Pensions tax solution for clinicians, which may apply to NHS scheme members employed by local authorities.

If you have any comments on the contents of this bulletin or wish to suggest items that might be included in future bulletins, please contact query.lgps@local.gov.uk.

Contents

LGPS England & Wales

Retirement planning guide published

On 28 January 2020, we published a new guide for members planning their retirement. You can find this employee guide on the guides and sample documents page of www.lgpsregs.org. We produced the guide jointly with the Communications Working Group (CWG) and we would like to extend our thanks to the subgroup for their work on this project.

The purpose of the guide is to help members approaching retirement understand their options, the process and the timescales involved. We anticipate that administering authorities will want to include information specific to their processes. We have included red text in the template where administering authorities may want to include fund-specific information. We understand that administering authorities intend to use the guide for different audiences and will choose to publish those sections that are relevant to their audience.

We have written the guide to be made available in electronic form. If you produce a printed version, you will need to replace the links with full web addresses.

Annual benefit statement technical guide updated

On 28 January 2020, we published version 2.0 of the Annual benefit statement technical guide. The guide has been completely re-written, and therefore we have not made a tracked changes version available. You can find a clean version on the guides and sample documents page of www.lgpsregs.org.

We recommend that any reduction due to a pension sharing order or scheme pays debit should be reflected in the figures in statements from 2020 onwards.

The guide also includes the recommendation to include the actuarially reduced benefits that would be payable to active members who were over age 55 on 31 March. Please note that these should be provided as well as the figures at 31 March before actuarial adjustment, not instead of them. We would like to thank members of the CWG for the customer surveys and research they undertook which formed the basis of this recommendation.

We do not expect this change to be in place for 2020 annual benefit statements. Any funds that want to adopt this change in their 2021 statements should raise this with their pension administration software supplier.

LGPS Scotland

Consultation on changes to the local fund valuation cycle and exit payments

On 21 January 2020, Roddy MacLeod (SPPA) contacted Scottish administering authorities to let them know about the launch of this consultation.

The consultation seeks the views of stakeholders about possible changes to the local fund valuation cycle. SPPA is also seeking views on the changes introduced in 2018 to Regulation 61. The changes provide administering authorities with the option of suspending an employer's liability to pay an exit payment when managing the process of an employer exiting the scheme.

The consultation is available to view on the SPPA website and on the Scheme consultations page of www.scotlgpsregs.org, and closes on 9 March 2020.

DWP

DWP updates guidance on pensions after Brexit

The DWP has updated the guidance explaining the rights of UK nationals in the European Economic Area (EEA) or Switzerland to benefits and pensions after the UK has left the EU.

HMRC

Countdown bulletins 50 and 51 published

HMRC published Countdown bulletin 50 and Countdown bulletin 51 on 9 January and 16 January 2020 respectively. If a scheme has made a part payment, HMRC cannot currently identify which members that payment was made for. These bulletins introduce a process that will allow schemes to tell HMRC which members any part payment has been made in respect of. HMRC have provided a spreadsheet for schemes to use to give them this information with Countdown bulletin 51.

Any administering authorities that have made a part payment, make a part payment in the future, or change a full payment into a part payment must complete the spreadsheet to tell HMRC the individual members that the payment is being made for.

If you have fully paid, and do not intend to change this to a partial payment, then you should still contact HMRC to confirm this position. An early response will enable HMRC to move on to the next stage of allocating the payment you have made to individual members.

The deadline for responses is **13 March 2020**.

Manage Pension Schemes service newsletter

HMRC published a Managing Pension Schemes newsletter on 14 January 2020. The newsletter confirms that HMRC has started Phase 2 of the process to develop the Managing Pension Schemes service. The newsletter includes an outline of the development plan. Schemes using the service will be able to submit Accounting for Tax returns on the Managing Pension Schemes service from the quarter beginning 1 April 2020. Future developments relevant to the LGPS include:

- changes to practitioner registration
- introducing the Pension Schemes Return on the Managing Pension Schemes service
- Event reporting on the Managing Pension Schemes service.

You can find out about registering for the Managing Pension Schemes service in the newsletter, and how you can submit feedback to HMRC about the system.

The Pension Schemes Online service will be decommissioned once Phase 2 is complete. All schemes must register for the Managing Pension Schemes service before this, but the deadline date has not yet been confirmed.

Pension Schemes Newsletter 116

On 28 January 2020, HMRC published Pension Schemes Newsletter 116. The newsletter provides information about what to do if you have received error messages when using the Pension Schemes Online service. HMRC are still looking for administrators to take part in research and to provide feedback on the Managing Pension Schemes service development. The updated ROPS notifications list will be published later than usual, on 5 February.

Managing Pension Schemes workshops

Lorraine Bennett contacted all funds on 30 January 2020 with an update on the Managing Pension Schemes service from David Roper, Pensions Compliance Manager at HMRC.

HMRC will be holding workshops on Phase 2 of the Managing Pension Schemes Service. The workshops will be held on 16 and 17 March 2020 at the offices of the Association of British Insurers in London.

If you are interested in attending, please contact sarah.l.mee@hmrc.gov.uk and georgia.oreilly@hmrc.gov.uk **by 7 February 2020.** Let them know your preferred date and the number of spaces you would like. Attendance is limited to three per organisation.

Event report and voluntary scheme pays deadline

The deadline for submitting an Event report for reportable events in that occurred in the year ending 5 April 2019 is 31 January 2020. Events that you will commonly need to report are:

- You have made an unauthorised payment
- A member's benefits were tested against the lifetime allowance, their benefits were more than the lifetime allowance and they relied on protection to reduce or eliminate the tax charge. The Event report has not been updated to include Fixed Protection 2016, Individual Protection 2016 or Individual Protection 2014 (if applied for online). You will need to report any cases involving these types of protection by secure email
- You have automatically issued a 'standard' pension savings statement. Note that you may choose to submit this information using a secure email, rather than using the online service.

There are 23 reportable events. HMRC guidance on sending pension scheme reports provides more information on all events that you must report.

An administering authority may have decided to pay a member's annual allowance tax charge on a voluntary basis (voluntary scheme pays) if the conditions for mandatory scheme pays were not met. If you have done so, the deadline for paying that tax for a charge that arose in the year ending 5 April 2019 is 31 January 2020. The member may have to pay interest and late payment charges if this deadline is missed. You can read more about the annual allowance, tax charges and event reporting in Bulletin 181.

Other news and updates

Update from the Annual Governance Conference

Our Annual Governance Conference took place in York on 23 and 24 January 2020. The event was sold out and feedback was very positive.

Highlights included Antony Arter, the Pensions Ombudsman (TPO), who explained the role of TPO. He praised the LGPS for the low number of complaints relative to the size of the scheme but noted that the proportion of complaints related to ill health was significantly higher than the national average. He explained the early resolution process and its success in resolving 90% of cases informally.

Councillor Roger Phillips, Chair of the LGPS England and Wales Scheme Advisory Board (SAB), summarised the SAB's achievements and emphasised the importance of the LGPS for low paid workers providing vital pubic services.

Gerard Moore, Local Pension Board Chair – Northumberland, Powys and Bedfordshire, examined the role of local pension boards. He set out what should be on the agenda of board meetings and highlighted the importance of strong relationships between the board, the Pension Committee and the pension administration manager. He suggested that honoraria could be used to get better outcomes by helping to recruit experienced and well-educated people to serve on boards.

Jon Richards from Unison delivered a review of the Hutton reforms from the perspective of members. He noted the importance of member representation on local pension boards, and the need to get member representation on pools. He welcomed the Fair Deal proposals that would allow members whose jobs are outsourced to remain in the Scheme but noted that employees at HE and FE establishments could lose access to the LGPS in the future.

Jeff Houston, Head of Pensions at the LGA and representatives from actuarial firms discussed McCloud and the cost cap mechanism. The panel recognised the huge burden that the McCloud remedy will cause for LGPS administration teams. The cost of paying increased member benefits as a result of the McCloud remedy was much harder to estimate. More information about the scope and form of the remedy is required.

Lord Hutton of Furness looked back over the period since his report was published, and considered what changes are on the horizon. He reminded delegates that in the Independent Public Service Pensions Commission: final report, he concluded that:

"special protections for members over a certain age should not be necessary. Age discrimination legislation also means that it is not possible in practice to provide protection from change for members who are already above a certain age."

Lord Hutton also acknowledged the pace of change would not reduce, and that climate change will have a significant impact.

Nick Gannon, Policy Lead from the Pensions Regulator (TPR), introduced the role and powers of TPR and gave an update on the revised, single code of practice. The annual survey results for 2018 show that the LGPS is well run but there are areas for improvement. Some funds do not document their processes well and some need to develop their risk registers further. He also recognised over-reliance on local authority controls as an area of weakness.

Kirsty Bartlett, partner at Squire Patton Boggs gave a legal update. The Pension Schemes Bill will strengthen TPR powers, introduce a framework for the pensions dashboards and tighten up pension transfer rules.

Caroline Escott, lead on ESG and corporate governance at the PLSA, considered the hot topic of why responsible investment matters. PLSA will launch responsible investment guidance at their conference in May.

Deirdre Cooper, portfolio manager from Investec Asset Management, looked at the potential impact of climate change on investment. She highlighted the need for a method of measuring a company's carbon footprint that takes into account direct and indirect carbon emissions.

Booking for next year's conference, which will be held at the Marriott Hotel in Bournemouth on 21 and 22 January 2021 will open shortly. This year's conference sold out and so we recommend early booking.

Pensions Schemes Bill reintroduced

In the Queen's Speech on 19 December 2019 it was announced that the Government will reintroduce the Pension Schemes Bill. The Bill will strengthen the Pension Regulator's powers, create a legislative framework to support pension dashboards and introduce regulations covering the right to a transfer.

The Bill has been introduced in the House of Lords and the second reading was on 28 January 2020. The Bill will now move to committee stage. The Parliament website includes the latest versions of documents related to the Pension Schemes Bill, including draft legislation and Explanatory Notes.

FBU announces new legal challenge

The Fire Brigades Union (FBU) published a FBU Circular on 23 December 2019. In the circular they announced plans to launch a legal challenge for members of the 2015 Firefighters' Pension Scheme and members of the LGPS who will not be protected by the McCloud remedy. They argue that the cost control mechanism must be put into effect immediately. As the cost of the career average schemes is cheaper than expected, they believe that the cost cap process will lead to benefit improvements or contribution reductions for members of the career average schemes.

National LGPS Frameworks survey

Lorraine Bennett contacted pension managers on 17 January 2020 to forward a request from Pippa Bestwick, the Programme Director of the National LGPS Frameworks. The National LGPS Frameworks team has been working with 11 founding authorities to develop a pensions administration software framework. They are working towards a launch date in April or May 2020.

The National LGPS Frameworks team has launched a survey to help them understand the requirements of LGPS administration in general and the specific requirements of individual funds. Each fund should complete the survey once by **Monday 3 February**. Responses will be used only to inform the Framework team's understanding of the LGPS pension administration landscape and will be treated in the strictest confidence.

If you have any questions about the survey, please contact the National LGPS Frameworks team by phoning 01603 495922 or email nationallgpsframeworks@norfolk.gov.uk.

Technical queries

The LGPC team responded to 153 technical queries in the three months to December 2019. The table below provides a summary of the topics covered by those responses.

% of queries	Topics and additional information
20.3%	Transfers and aggregation. We are preparing a technical guide covering transfers out that we aim to publish in the first quarter of 2020.
10.5%	Retirement, including trivial commutation and abatement
10.5%	Annual allowance and Lifetime allowance
7.8%	Types of employer, TUPE transfers, MATs, employer responsibilities and discretions
7.8%	Ill health
6.5%	Survivor benefits
5.2%	Paying and refunding contributions
4.6%	AVCs
4.6%	Pensionable pay, final pay and salary sacrifice
2.6%	APP and unpaid absences
2.6%	Pension sharing on divorce and pension credit members

The remaining 17% of queries concerned topics that administering authorities raised only once or twice in the quarter.

Wider landscape

RPI consultation to launch on Budget day

In bulletin 189 we let you know that the Government was planning to consult on proposed changes to RPI. In a letter to the House of Lords Economic Affairs Committee on 13 January 2020, the Chancellor announced that the consultation will be launched at the Budget on 11 March 2020. You can read the Chancellor's letter on the Government website.

The Government Actuary's Department (GAD) has published a technical bulletin on the proposed changes and their potential impact.

NHS Pensions tax solution for clinicians

We reported in bulletin 191 that NHS England had signed off on plans to pay the pension tax bills of clinicians if the tax charge arises in the 2019/20 year. More details of these plans were set out in the statement made by Matt Hancock (Secretary of State for Health and Social Care) on 7 December 2019. More information and resources from NHS England are now available and include letter templates and FAQs for staff and employers.

Clinicians working for non-NHS organisations (such as local government employers) are also eligible for this scheme, provided they are delivering NHS services and meet the eligibility criteria. They must be employed or engaged in a role that requires registration with an appropriate healthcare regulatory body and be a member of the NHS pension scheme to qualify.

Action for administering authorities
Please bring this article to the attention of employers who employ staff who are members of the NHS Pension Scheme.

Vacancy for Chair of the Firefighters' Pension Scheme SAB

Recruitment is now underway for the next Chair of the Firefighters' Pensions (England) Scheme Advisory Board. You can apply for this vacancy online. The closing date is 16 February 2020.

If you have any queries about this role, please contact Philip Perry on 0207 035 3447 or email philip.perry@homeoffice.gov.uk.

Money and Pension Service announces permanent Chief Executive

The Money and Pensions Service (MaPS) has announced the appointment of Caroline Siarkiewicz as Chief Executive. Ms Siarkiewicz has been acting Chief Executive since June 2019.

Useful links

LGA Pensions page

LGPS member website (England and Wales)

LGPS 2015 member website (Scotland)

LGPS Advisory Board website (England and Wales)

LGPS Advisory Board website (Scotland)

LGPS Regulations and Guidance website (England and Wales)

LGPS Regulations and Guidance website (Scotland)

Public Sector Transfer Club

Recognised Overseas Pension Schemes that have told HMRC that they meet the conditions to be a ROPS and have asked to be included on the list.

LGPS pensions team contact details

If you have a technical query, please email query.lgps@local.gov.uk and one of the team's LGPS pension advisers will get back to you.

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Further information

Distribution sheet

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Local Government Pensions Committee
Secretary, Lorraine Bennett

LGPC Bulletin 194 – February 2020

Foreword

This bulletin contains important updates for administering authorities, scheme employers and software suppliers. It also provides a general update for all LGPS stakeholders.

This bulletin contains important articles on:

- 2020/21 Draft employee contribution bands
- Ill Health retirement and IDRP guidance
- LGPS National Knowledge Assessment
- The Teachers' Pension Scheme grant

which need action by certain stakeholders.

If you have any comments or articles for future bulletins, please contact query.lgps@local.gov.uk.

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LGPS England & Wales Scheme Advisory Board (SAB)

Scheme Advisory Board - latest meeting

SAB met on 3 February 2020. You can read an update from the February SAB meeting on the board website. A summary of the ongoing projects follows.

Good Governance project

SAB approved resources for Phase three of the Good Governance project. This phase will determine:

- the outcome measures it will use
- the format of this work, and
- a timetable for implementation.

McCloud

At the SAB meeting in February, the Board agreed to create two working groups to help implement the outcome of the McCloud judgment for the LGPS. These will be:

- a small policy group to help MHCLG consider areas of policy not determined by HMT.
- a larger implementation group made up of practitioners, member representatives, actuaries, software providers, employers and representatives from the Scottish and Northern Irish schemes. It will consider the challenges of implementing and communicating the scheme changes.

We expect a consultation on the LGPS regulation changes in the spring; however, there might be a long delay before new regulations come into force. This will depend on the level of changes to primary legislation. This waiting period could lead to uncertainty for members which might make legal claims against the LGPS and employers more likely. SAB will be issuing communications for employers and scheme members in this period.

Practitioner Representative

Rachel Brothwood (West Midlands Pension Fund) is the new practitioner representative on the SAB. Rachel replaces Nicola Mark (Norfolk Pension Fund) and was elected to the role following a vote by LGPS administering authorities.

Commenting on Rachel's appointment, Councillor Roger Phillips said "Stepping into Nicola's shoes was never going to be an easy task, but Rachel joins the board with a wealth of knowledge and experience of the scheme. I know that she will continue to represent scheme practitioners to the same high standard enjoyed by the Board in recent years."

Responsible Investment guidance

On 24 February 2020 SAB published a statement on the draft responsible investment guidance.

Responses to the earlier consultation were generally positive with some helpful drafting points. Some respondents raised concerns about fiduciary duty in the context of the LGPS.

The issue of fiduciary duty was discussed in the Supreme Court hearing involving the Palestine Solidarity Campaign and MHCLG. When the judgment is handed down, it might help shed some light on how the fiduciary duty test applies to investment decision makers in the LGPS.

The Government recently introduced amendments to the Pension Schemes Bill 2020. These changes could also impact how investment strategy statements are prepared in relation to issues like ESG and climate change.

For these reasons, the SAB has decided not to offer definitive advice or guidance on how the fiduciary duty test applies in the LGPS at this time. It will change direction and restructure the draft guidance to:

- explain and clarify the terminology associated with responsible investment
- provide investment decision makers with a range of information, case studies and tools to help them meet the challenges associated with responsible investment.

SAB will circulate the revised draft guidance to scheme stakeholders for comment in the normal way.

LGPS England & Wales

2020 Data collection for cost management

On 14/02/2020 Lorraine Bennett forwarded a letter to administering authorities on behalf of the Government Actuary's Department (GAD). The letter confirms that:

- GAD will provide each administering authority with a short report on their 2019 data, and
- GAD plan to request 2020 data in September 2020.

The LGPS (Amendment) Regulations 2020 – exit credits

On 27 February 2020, MHCLG published a partial response to the consultation covering changes to the local valuation cycle and the management of employer risk. The response covers the proposals on exit credits only. MHCLG will submit a further response to the other proposals covered by this consultation in due course.

The response confirms that most respondents supported the proposal to allow administering authorities to take account of an employer's exposure to risk when calculating an exit credit. MHCLG confirms in the response that they will amend the LGPS regulations so that:

- administering authorities may determine the amount of any exit credit payment due, having regard to any relevant considerations

- the period within which an exit credit must be paid is increased from three months to six months
- administering authorities will not be obliged to enquire into the precise risk sharing arrangement adopted
- any exit credits that have not been paid shall only be due if the administering authority exercises its discretion to pay them
- any exit credits that have already been paid shall be treated as if the administering authority exercised its discretion to pay that amount – an administering authority may not seek to change the amount paid
- the Pensions Ombudsman has jurisdiction to hear complaints if any dispute is not resolved using the internal dispute resolution process
- administering authorities should set out their exit credit policy in their Funding Strategy Statement.

The Local Government Pension Scheme (Amendment) Regulations 2020 giving effect to these proposals were laid in Parliament on 27 February 2020. They come into force on 20 March 2020 but have effect from 14 May 2018. We will update the Timeline regulations on www.lgpsregs.org to reflect the changes before they come into force on 20 March 2020.

2020/21 Draft employee contribution bands

Below are the draft employee contribution bands, which will be effective from 1 April 2020. They are calculated by increasing the 2019/20 employee contribution bands by the September 2019 CPI figure of 1.7% and then rounding down the result to the nearest £100.

Table 1: Contribution table England and Wales 2020/21

Band	Actual pensionable pay for an employment	Main section contribution rate for that employment	50/50 section contribution rate for that employment
1	Up to £14,600	5.50%	2.75%
2	£14,601 to £22,800	5.80%	2.90%
3	£22,801 to £37,100	6.50%	3.25%
4	£37,101 to £46,900	6.80%	3.40%
5	£46,901 to £65,600	8.50%	4.25%
6	£65,601 to £93,000	9.90%	4.95%
7	£93,001 to £109,500	10.50%	5.25%
8	£109,501 to £164,200	11.40%	5.70%
9	£164,201 or more	12.50%	6.25%

Action for administering authorities
Please pass the draft employee contribution table to Scheme employers and other relevant parties.

The LGPS (Buckinghamshire Structural Changes) (Amendment) Regulations 2020

The LGPS (Buckinghamshire Structural Changes) (Amendment) Regulations 2020 take effect on 1 April 2020. They put in place local government reorganisation in Buckinghamshire. The authorities listed below will cease to exist on 1 April 2020:

- Buckinghamshire County Council
- Aylesbury Vale District Council
- Chiltern District Council
- South Bucks District Council
- Wycombe District Council.

They will be combined into a single unitary authority known as Buckinghamshire Council from 1 April 2020.

LGPS Scotland

Ill Health Retirement and IDRP guidance

On 19 February 2020, the Scottish Public Pensions Agency (SPPA) published circular 2020/01 providing guidance for:

- persons responsible for making decisions about ill-health retirement
- the Appointed Person to assist them when making a 'First Instance Decision', when they review an employer's decision at the request of the member.

This guidance follows the Pensions Ombudsman's requirements. It applies to both active and deferred members. If a case reaches the second stage of IDRP, SPPA will return the case to the decision maker where the guidance is not followed.

Action for administering authorities
Please pass the guidance on to Scheme employers and any other relevant parties.

Purchase of additional survivor benefits (ASB) – new factors

The Government Actuary's Department (GAD) has added new ASB factors to the factor workbook. GAD have adjusted the factors to take account of the reduction in the SCAPE discount rate in October 2018. GAD has recommended that the factors become effective from 1 April 2020.

GAD is working on updated guidance notes to go with the factors. Meanwhile, GAD recommends that administrators send them sample calculations using the new factors to ensure that they have been implemented in line with current guidance.

Once you confirm that you are happy with the new factors, SPPA will load them to their website. If you spot any errors or have any questions, please contact michael.rae@gad.gov.uk. If you would prefer a meeting with GAD, please contact kimberly.linge@gov.scot.

Section 13 report

As reported in bulletin 192, GAD published a review of the actuarial valuations of the 15 funds in LGPS Scotland as at 31 March 2017. The report made two recommendations for future valuations about standardisation.

On 14 February 2020, SPPA wrote to Scottish administering authorities to ask for the views of administering authorities and actuaries about how best to:

- adopt an agreed methodology and assumptions for future valuation reports, and
- put in place a standard way of presenting relevant disclosures.

GAD will work with fund actuaries to take forward the recommendations in the report.

Scheme Advisory Board (SAB) annual report 2018/19

SAB published its 2018/19 annual report on 21 February 2020.

The report summarises the financial position of funds across Scotland. The financial position of individual funds varies. The Scheme is 100% funded and sustainable.

The SAB website contains more information about their work.

The LGPS (Miscellaneous Amendments) (Scotland) Regulations 2020

The LGPS (Miscellaneous Amendments) (Scotland) Regulations 2020 take effect on 1 and 31 March 2020. They:

- correct a drafting error in the Increased Pension Entitlement Regulations
- allow administering authorities to apply to Scottish Ministers to substitute a different fund for a Scheme employer if that fund is also maintained by the same administering authority.

HMRC

Guaranteed Minimum Pension (GMP) equalisation newsletter

On 20 February HMRC published a newsletter on GMP equalisation. The newsletter supplements the information in the Pensions Tax Manual. HMT are working with MHCLG to assess if GMP equalisation must apply to LGPS members' benefits. We will notify you of the outcome in due course.

DWP

Automatic Enrolment (AE) earnings trigger 2020/2021

The AE earnings trigger for 2020/21 will be £10,000. This is the same as 2019/20. The Government confirmed this in a written statement on automatic enrolment to Parliament on 13 February 2020. It will lay legislation following the February recess to that effect.

TPO

The Pensions Ombudsman (TPO) News

TPO issued the seventh edition of 'Pensions Ombudsman News' in January 2020. The newsletter includes:

- an introductory message from the Pensions Ombudsman, Anthony Arter
- an article covering the relationship and promotional work undertaken since June 2019
- a legal update
- dates of future events
- volunteering for the TPO.

TPR

The Pensions Regulator (TPR) seeks to extend supervision to select administrators

TPR is seeking a voluntary extension to its supervision regime. This has already been introduced for the largest schemes in the UK. It will attempt to build relationships with pensions administrators of critical importance. These are the top 75 outsourcing companies and in-house teams in the country.

Key areas of focus for interaction will include:

- trustee relationship management
- handling of client transitions
- data quality controls
- due diligence on scams
- member communications
- resourcing and training
- business continuity and cyber resilience.

TPR is hopeful that a final list could be ready by the end of 2020.

Other news and updates

2020 Public Service Pension Scheme (PSPS) Indexation and Revaluation

On 25 February 2020, the Government made a written statement on indexation and revaluation. The statement confirms that the following LGPS benefits will both increase by 1.7% In April 2020:

- pensions in payment, and
- active member career average benefits.

The statement also confirms the increases that will apply to career average benefits in other Public Service Pension Schemes:

- Police Pension Scheme: 2.95%
- Firefighters' Pension Scheme: 4%
- Civil Service Pension Scheme: 1.7%
- NHS Pension Scheme: 3.2%
- Teachers' Pension Scheme: 3.3%
- Armed Forces Pension Scheme: 4%
- Judicial Pension Scheme: 1.7%.

2020 pensions increase multiplier tables

The Government produces annual pensions increase (PI) multiplier tables. This is part of the public service pensions uprating process.

On 25 February 2020, the Government published the 2020 PI tables. SPPA and the LGA sent the 2020 PI tables to administering authorities earlier in the month. They are now available to the general public.

Communications Working Group (CWG)

The CWG met on 29 January 2020. Topics covered include:

- member videos
- web content accessibility
- digital engagement
- annual benefit statements
- standardised member letters
- employer responsibilities related to ill health retirement
- CWG workplan for 2020/21.

You can read the minutes of the meeting on the CWG page of www.lgpsregs.org.

LGPS National Knowledge Assessment (NKA)

Hymans Robertson have launched their NKA. This follows their first ever LGPS National Confidence Assessment (NCA). The assessment will look at the knowledge levels of key decision makers. Key decision makers are Pension Committee (PC) and Pension Board (PB) members.

By participating in the assessment, each administering authority will receive:

- their own results report
- Hymans Robertson analysis and suggested next steps
- their benchmarked position against other LGPS administering authorities
- a recommended training plan tailored for their PC and PB.

Following the assessment, Hymans Robertson will publish a National Report. This will contain commentary and analysis on the current LGPS PC and PB landscape. Hymans Robertson will send an invitation to all administering authorities in March 2020. Completion of the survey will take 15 to 20 minutes for each PC or PB member.

For further information please contact marketing@hymans.co.uk.

PASA launches DB Transfers Code of Good Practice Consultation

The Pensions Administration Standards Association (PASA) launched its Defined Benefit (DB) Transfers Code of Good Practice Consultation. The consultation closes on 30 April 2020, with the aim of launching the Code in September.

Tell us Once (TUO)

Users of the TUO facility will know that tokens are used to access online death notifications. These tokens are being upgraded for a new model. TUO will be in touch over the coming months to help users move across to the new tokens.

Meanwhile, administering authorities should review their current users, remove users who no longer need access and add any new users. This will help administering authorities to swap users to the new tokens.

It is important that all users access the TUO notification service at least once a month to prevent deactivation of their account. It is enough to log into the first screen to keep an account active.

Training

Insight Residential Course

From 18 to 21 May 2020 we will run the Insight Residential Course in Bournemouth. This is a foundation course covering all aspects of the LGPS in England and Wales. You can read an overview of the Insight course content. The course is for staff who:

- are relatively new to the LGPS, or
- have some experience and want to gain a broader understanding.

The cost is £815 (plus VAT at the standard rate) per delegate. This includes full board accommodation throughout the course and refreshments during the day. Delegates receive a course certificate after the event. We limit the number of delegates, so we recommend booking early. You can make a booking via the LGA's online events page or by using the link below.

18 to 21 May 2020, Insight Residential Course, Highcliffe Marriott Hotel, Bournemouth.

Understanding death and survivor benefits and Understanding the employer role

In February 2020, we announced that we will be running Understanding training events covering death and survivor benefits and the employer role. We will be delivering both courses in Birmingham, Cardiff, Leeds and London. The dates scheduled in March, April and May 2020 are fully booked.

We are maintaining a waiting list to fill any places that become available. If you would like to add a name to the waiting list, please email elaine.english@local.gov.uk. You will need to let Elaine know which course you would like to attend and your preferred location. Any spaces that become available will be allocated on a first come, first served basis. If any additional dates are arranged the people on the waiting list will be given the opportunity to book before the courses are advertised. Any extra dates may not be at your preferred location.

Please use the links below to read overviews of the course contents:

Understanding death and survivor benefits – course contents
Understanding the employer role – course contents.

Wider landscape

Teachers' Pension Scheme (TPS) Grant

Bulletin 191 contains an article about the TPS employer contribution grant. The Government have updated their TPS guidance on the employer contribution grant. The guidance covers the grant for the financial years 2019 to 2020 and 2020 to 2021.

Action for administering authorities
Please pass information about the grant on to your schools. Including any academies to which you provide services.

TPS outsourced HR and/or payroll – LGA guidance

Local authorities and their maintained schools on occasion outsource their payroll and HR functions. When this happens, both parties must fulfil their employer obligations under the TPS.

In January 2020, we published new guidance and tools on the LGA website to assist local authorities and schools understand their obligations.

Action for administering authorities
Please pass the new guidance and tools on to the relevant parties.

Legislation

Acts

European Union (Withdrawal Agreement) Act 2020

Statutory Instruments

The Local Government Pension Scheme (Buckinghamshire Structural Changes) (Amendment) Regulations 2020 [SI 2020/123]

The Local Government Pension Scheme (Amendment) Regulations 2020 [SI 2020/179]

Scottish Statutory Instruments

The Local Government Pension Scheme (Miscellaneous Amendments) (Scotland) Regulations 2020 [SSI 2020/31]

Useful links

LGA Pensions page

LGPS member website (England and Wales)

LGPS member website (Scotland 2015)

LGPS Advisory Board website (England and Wales)

LGPS Advisory Board website (Scotland)

LGPS Regulations and Guidance website (England and Wales)

LGPS Regulations and Guidance website (Scotland)

Public Sector Transfer Club

Recognised Overseas Pension Schemes that have told HMRC that they meet the conditions to be a ROPS and have asked to be included on the list.

LGPS pensions section contact details

If you have a technical query, please email query.lgps@local.gov.uk and one of the team's LGPS pension advisers will get back to you.

Jeff Houston (Head of Pensions)
Telephone: 0207 187 7346
Email: jeff.houston@local.gov.uk

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Jayne Wiberg (Pensions Adviser – LGPC Secretariat)
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Email: karl.white@local.gov.uk

Bob Holloway (Pensions Secretary – LGPS Scheme Advisory Board (E&W))
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Further information

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Government Actuary's Department

March 2020

Technical Bulletin

The Pensions Regulator (TPR) issued a consultation to seek views on principles for a new code of practice on defined benefit pension scheme funding. This technical bulletin looks at the main proposals in the consultation and what will happen next.

Consultation background

In the Department for Work and Pensions (DWP) 2018 white paper 'Protecting Defined Benefit Pension Schemes' the government noted the defined benefit (DB) pensions funding framework is working largely as intended but acknowledged the need for improvement in a number of key areas and in particular:

- The need for trustees to focus on long term strategic issues as schemes mature
- A lack of clarity about how to set prudent technical provisions (TPs) and an appropriate recovery plan (RP)
- The need for greater transparency and accountability around the risks being taken

Much of the current funding regime will remain, such as three yearly valuations and the requirement to determine TPs and maintain an RP, however the Pensions Schemes Bill introduces new requirements to help address the areas requiring improvement. The Pensions Regulator's consultation document is the first of two such consultations intended to inform a new DB funding code of practice to replace the existing code[1] and reflect the legislative changes and provide trustees and sponsors with greater clarity on what is expected.

This first consultation sets out the key principles TPR think should underpin the new framework. The second consultation, planned for later in 2020, will consider a draft code with more specific details reflecting feedback received from the first consultation.

Regulatory approach

TPR propose a two-tier approach to regulation: fast track and bespoke. Under the fast track approach TPR would set specific guidelines in the areas summarised below and if a scheme meets all the requirements it might expect minimal regulatory involvement. If the trustees choose not to follow the fast track approach, or the scheme is unable to meet the fast track requirements, then the bespoke approach offers more flexibility but will inevitably attract greater regulatory scrutiny. In this case trustees will need to document and evidence why they have opted not to comply with a fast track approach and how any additional risks have been appropriately mitigated. But both approaches should be equally valid if done correctly.

[1] https://www.thepensionsregulator.gov.uk/en/document-library/codes-of-practice/code-3-funding-defined-benefits-

Long-term objective (LTO)

The cornerstone of the proposals is that trustees should identify a scheme specific long-term objective (LTO) for funding. This would mean that by the time a scheme is *significantly mature* it would need to reach a position of *low dependency* on the employer. Additionally, it would be expected to hold an investment strategy *highly resilient* to risk with sufficient liquidity and a high average credit quality.

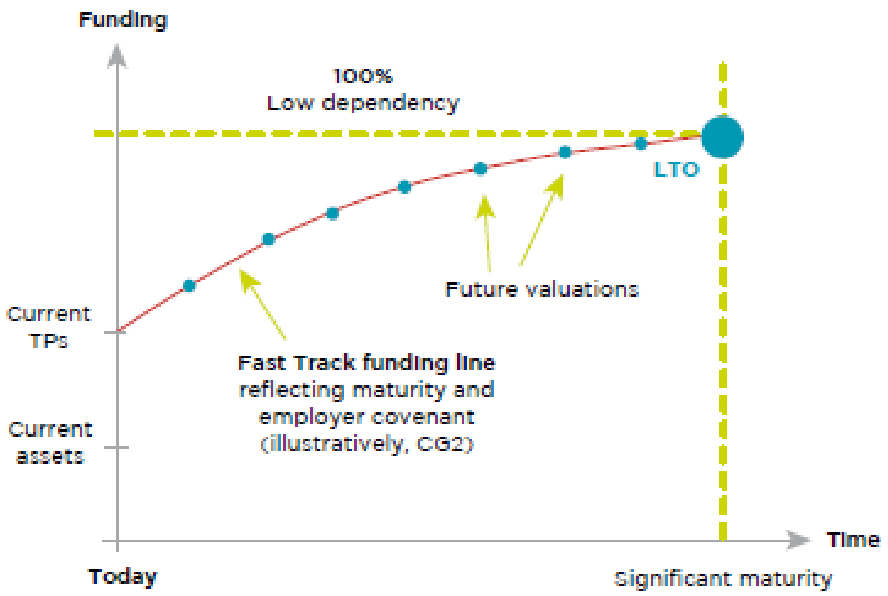
Low dependency funding means there is a low risk of requiring additional employer support and that any required support would be small in relation to the scheme. TPR consider a low dependency discount rate to be in the range of current yields on gilts plus 0.25% to 0.50%, reflecting an assumption of scheme investments primarily in high quality assets of sufficient liquidity providing a good match to a scheme's expected cashflows. Significantly mature would be in around 15-20 years for a typical closed scheme i.e. when most members will have expected to have retired.

GAD supported TPR in their development of the proposals for the LTO through technical modelling and advice. The GAD report published alongside the consultation documents illustrates the relative risk to member benefits from different levels of low dependency discount rates and definitions of significant maturity, as well as the impact of several different investment strategies.

Journey plan and technical provisions (TPs)

TPR expects trustees to set a journey plan to achieve their LTO. TPs at each future valuation would provide steps along the way to reaching the LTO. TPR were keen to dispel any misconception that TPs should always equal the LTO. Rather, TPs should reflect an appropriate funding target at a particular time, but as the scheme matures the TPs should converge towards the LTO. An example of the journey plan approach is shown below, but the way this is achieved in practice is a main area of the consultation.

Figure 1: How trustees could determine a journey plan to reach their long term objective



Source: TPR, March 2020

Investment approach

TPR propose the current and future investment strategy should be aligned with the funding strategy and LTO. In particular, the trustees should plan for reducing investment risk over time as the scheme approaches low dependency funding. The scheme would also need to maintain adequate liquidity at all times based on expected cash flows and a reasonable allowance for unexpected cash flows e.g. CETVs.

Employer support

The strength of the employer covenant has been an important consideration for TPR when reviewing the level of risk being taken in funding approaches. The consultation maintains the view that schemes with a stronger employer covenant can take more risk and assume higher investment returns. However, the consultation also questions the period over which a typical employer covenant can reasonably be assumed to remain the same and proposes that beyond the next 3-5 years it would not be appropriate for trustees to continue to rely on the same strength of covenant. There are some categories of employer where the covenant position is more complex, such as not-for-profit organisations, which TPR identify as requiring further guidance on covenant assessment.

Recovery plans (RPs)

TPR believe that affordability should still be a key driver in determining appropriate RPs. However, TPR would expect schemes with stronger covenants to have shorter RPs all things being equal. If a longer RP is required then affordability constraints would need to be clearly evidenced and documented and trustees would be expected to seek other mitigations for example realisable contingent assets or enforceable guarantees.

Next steps

The closing date for responses to the consultation is 2 June 2020. Scheme trustees and sponsors should consider the questions raised in the consultation and decide whether they wish to respond and provide views on the proposals.

TPR anticipate their new code of practice will come into force in late 2021 so it is unlikely to apply to funding valuations with an effective date in 2020. Nevertheless, trustees and sponsors should be aware of the proposals when considering their funding approach. If you would like to discuss the consultation in more detail or have any questions, then please email matt.gurden@gad.gov.uk or get in touch with your usual GAD contact.

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Consultation document

Defined benefit funding code of practice

March 2020

Contents

Executive summary

Making workplace pensions work is at the heart of what we do, but it is also the job of those who fund and manage pension schemes. It is right that our expectations of those accountable for delivering the retirement outcomes that savers expect are clear and properly enforced. This drives our clearer, quicker and tougher approach to regulating all forms of pension arrangements, including defined benefit (DB) schemes.

In its white paper published in 2018 ('Protecting Defined Benefit Pension Schemes'), the government noted that the DB funding framework is working largely as intended but also acknowledged the need for improvements in some key areas. This included greater transparency and accountability around the risks being taken on behalf of employers and members.

It recognised the need for trustees to focus on the long-term strategic issues for their scheme as the landscape matures. It also highlighted grey areas around how trustees should calculate their scheme's technical provisions (TPs) prudently and set an appropriate recovery plan (RP).

This lack of clarity has allowed a minority of trustees and employers to misuse the flexibilities in the system and has made our job of proving non-compliance and taking enforcement action more time consuming.

The government has introduced new requirements in the Pension Schemes Bill to help address these issues. We are publishing our first of two consultations on a proposed revised code of practice on DB funding to reflect the legislative changes and to provide greater clarity on what is expected from trustees and employers. Based on our experience from reviewing thousands of scheme valuations, as well as ongoing engagement with a wide range of stakeholders in the pensions industry, we have identified some key overarching principles that should stand behind all scheme valuations.

However, we need your input and views on these principles and how they can be applied in practice by schemes. It is important to get this right, as it will determine how trustees, employers and their advisers approach scheme funding and our interaction with them for years to come. We are therefore keen to understand if there are any workability issues or unintended consequences arising from what we propose.

We recognise that some of our proposals are a departure from our current approach but many of the core principles build on our recent messages (current code, guidance and Annual Funding Statements). Having a clear benchmark as a basis for discussions between trustees and employers should help speed up negotiations. Many trustees are also already applying good practice in relation to journey planning and risk management and documenting their approach to these. We therefore do not expect our proposals to be too onerous for most schemes. Greater clarity, particularly about long-term planning, also bring benefit to trustees, employers and members alike and greater transparency can help improve confidence in the system. However, there could be significant impacts for some schemes, particularly those that have been running excessive and unjustifiable levels of risk.

Our statutory objectives require us to protect member benefits and reduce risks to the PPF while minimising any adverse impacts on the sustainable growth of employers in the context of DB scheme funding. Striking the right balance between member security and employer costs is therefore important and we welcome views on whether our proposals achieve this. We will undertake a full impact assessment in our second consultation.

Twin-track approach to scheme valuations

In this consultation, we propose that the revised DB code should set a twin track approach ('Fast Track' and 'Bespoke') for trustees to demonstrate to us that their valuations are compliant with legal requirements. This will give trustees and employers greater clarity within a funding regime which remains scheme-specific.

The Pension Schemes Bill introduces a requirement for all trustees to submit to us a statement of strategy outlining their approach to funding and risk management. This is to provide greater transparency and accountability around risk-taking and trustee decision-making. It will also support twin-track compliance.

Fast Track will be relevant for trustees who can submit a scheme valuation and RP that is compliant with our guidelines. Their valuation submission will receive minimal regulatory scrutiny. Fast Track is expected to ease the process for many well-managed and well-funded schemes, as well as help the trustees of small schemes to understand what they need to do.

Bespoke will be relevant for trustees who either choose not to or cannot comply with our Fast Track guidelines (for instance they want to take more investment risk, have affordability constraints or overall have put in place arrangements which are better than Fast Track but do not meet all the guidelines). They will have to submit their valuation together with the statement of strategy and supporting evidence that explain how they meet our principles, the legislative requirements and, where relevant, how any additional risk (assessed relative to Fast Track) is supported. Bespoke arrangements may receive more scrutiny from us, but they are not 'bad' – if done properly, they are equally compliant with the legislation.

Although we are yet to finalise code guidelines and assess their impact, we do not anticipate that the practical consequences of this twin-track approach will be significant. The approach moves us from the current regime where every valuation is 'Bespoke' to a better-defined one, with a significant proportion of schemes likely to adopt the more straightforward Fast Track route, and the Bespoke approach offers more clarity on what good looks like. The submission of more information upfront through the statement of strategy should also enable us to target our resources more efficiently to schemes that require our attention.

Overarching themes

Long-term planning: The Pension Schemes Bill will introduce a requirement for trustees to set a long-term objective (LTO). A cornerstone of this consultation is our expectation that trustees should identify a scheme-specific LTO so that by the time the scheme is significantly mature (15-20 years from now for a scheme of average maturity), it is fully funded on a low dependency basis (potentially in the range of Gilts + 0.5% pa to Gilts + 0.25% pa for Fast Track compliance) and has investments highly resilient to risk. We expect trustees to set a prudent journey plan to the LTO, including an appropriate level of investment de-risking over time. To be clear, low dependency funding will not be required until significant maturity. TPs are stepping stones on the journey to the scheme's LTO.

Employer covenant: We are consulting on the extent to which the employer covenant should remain a key aspect of scheme funding, including how it should be assessed and for how long reliance can be placed on it. We are also consulting on alternative support (such as contingent assets and guarantees) and are seeking views on what reliance should be placed on this support, as well as what characteristics it should have in order to be recognised for funding purposes.

Investment risk: We expect all schemes to take only a level of investment risk that is supportable, and we set out proposals for how trustees could demonstrate whether the risk in their investment strategy is supported (for instance through a simple stress test).

Recovery plans: Where a funding shortfall arises, this should be funded by an appropriate RP. We expect (as outlined in our recent Annual Funding Statements) that RPs should have appropriate length and shape (while minimising any adverse impacts on employers). They should also ensure their scheme is treated fairly compared with other stakeholders.

Open schemes: We also consult on how the framework should apply to open schemes, including our expectation that members' accrued benefits should have the same level of security as accrued benefits in closed schemes. We are also of the view that the accrual of new benefits should not compromise the security of accrued benefits. This does <u>not</u> mean that we are advocating the closure of open schemes.

Future consultations

We will run two consultations. This first one focuses on our proposed approach, our principles and how these could be applied in practice.

We recognise that this consultation document covers a large range of topics and, by necessity, is long and detailed. We have sought to assist the reader by structuring the document into different parts, starting with high-level discussions, then focusing on application issues. We have included some worked examples (for Fast Track and Bespoke). Questions are highlighted in green at the end of each section and we welcome your views on any that you wish to answer. Details on providing feedback on this consultation can be found in Chapter 1. There is also a companion guide to this consultation which provides an abridged overview of what we are proposing: www.tpr.gov.uk/-/media/thepensionsregulator/files/import/pdf/quick-guide-db-funding-consultation.

Our second consultation, later in 2020, will focus on our draft funding code and will seek views on where regulatory guidelines should be set. The second iteration will be considerably more concise, as this consultation and your responses will have addressed many fundamental issues.

At this stage, we anticipate that the draft code will simply outline the twin-track compliance structure, proposed Fast Track parameters and the principles for those following Bespoke. We will take account of legislative change (Pension Schemes Bill and regulations), responses to the first consultation, prevailing market conditions, schemes' current funding position, and our assessment of impacts. Until this is done, the overall impact on aggregate funding levels cannot be known, but we do not intend that there should be significant increases in deficits across the board.

We currently expect the revised code to come into force in late 2021. We expect robust discussions around both consultations and we welcome a wide range of opinions to ensure that, as the DB funding regime evolves, it is fit-for-purpose for the future.

David Fairs

Executive Director, Regulatory Policy, Analysis and Advice

3 March 2020

Document layout

Part 1: Context	Part 1 sets out the context for this consultation as provided by the DB white paper and the Pension Schemes Bill, our key objectives and how to respond.
Part 2: Theory	Part 2 outlines our proposed new regulatory approach (Fast Track and Bespoke routes to compliance) and covers the theoretical questions to be addressed to develop the code, including insolvency risk and role of the covenant and the key principles we propose should underpin the code.
Part 3: Application (1) Fast Track	Part 3 sets out options for how we envisage the Fast Track route to compliance with legislative requirements could operate in relation to the LTO, TPs, the investment strategy, RPs, and setting TPs and future accruals in open schemes.
Part 4: Application (2) Bespoke	Part 4 covers the situations where trustees decide to prepare a Bespoke funding arrangement. It sets out our proposed assessment criteria using the principles outlined in Part 2, provides some worked examples of Bespoke approaches and discusses how additional support (eg contingent assets and guarantees) could be used.
Part 5: Supporting materials	Part 5 contains supporting material, including worked examples to illustrate how a valuation might work under Fast Track, the evidence and analysis that we have used to develop these consultation proposals, a glossary, and the consultation questions.

Part 1: Context

1. Introduction

TPR consultations

1. The government's white paper 'Protecting Defined Benefit schemes'[1] announced a package of measures to improve DB scheme funding. These measures will be implemented through primary and secondary legislation (the Pension Schemes Bill was introduced in Parliament in January 2020) and a revised DB funding code. The following chapter (Background) sets out the proposals outlined in the DB white paper and the key issues we are seeking to address in greater detail.
2. Our revised DB code will clarify the standards we expect trustees and employers to apply to meet legislative requirements. Greater clarity is required to ensure the flexibilities in the DB funding regime are used appropriately, to embed and drive good practice in relation to the management of long-term risks, to ensure DB schemes' efficient run-off phase, and to support more effective and efficient regulation.
3. We plan to run two consultations to ensure key stakeholders have the opportunity to input their views and to allow sufficient time to develop proposals and a revised code that are fit-for-purpose.

First TPR consultation

4. In this first consultation, we set out our initial proposals for a clearer, more readily enforceable funding framework, which implements the new requirements set out in the Pension Schemes Bill recently introduced in Parliament. We are seeking views on:
   - our proposed approach to the new code (twin-track compliance routes and our approach to prudence and risk-taking)
   - the key principles we propose should underpin the code, and
   - options for how these principles could be applied in practice through more detailed guidelines.
5. In some areas, our views are more defined. In others, we are more agnostic about what the appropriate solution could be. Whatever our views, we are very open to hearing alternative ideas, as we are looking to have as broad a consensus as possible on what 'good' looks like.
6. We welcome comments on any aspect of the proposals in this document. We have provided some specific questions throughout the document (they are also listed in Chapter 18). When thinking about these questions, please consider the following issues:
   - Whether the proposed framework delivers our aims to improve the clarity, objectivity, transparency, and enforceability of the funding regime.
   - Any other ideas on how these aims could be delivered.
   - Risks of unintended consequences and how these could be mitigated.
   - Potential implementation challenges for trustees, employers and advisers and how these could be reduced.
   - The likely impacts on employers, trustees, members and advisers. As we explain in the following chapter, we have not finalised what the code will contain and are therefore focusing on likely qualitative impacts in this first consultation. We will undertake a quantitative impact assessment in the second consultation.

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[1] https://www.gov.uk/government/publications/protecting-defined-benefit-pension-schemes.

7. We appreciate this is a lengthy consultation. We feel it is necessary to do justice to this complex subject and get sufficient input on the key issues we need to address to set clearer funding standards. We do not expect all respondents to necessarily read the whole document or answer all questions. In particular, many respondents may wish to focus primarily on Part 1 (where we set out the context for this work) and most of Part 2 (where we outline our proposed regulatory approach and the principles which we think should underpin the code). Part 3 and Part 4 (proposed application of the framework through Fast Track and Bespoke routes) address the technical detail. We have also produced a companion guide[2] to the consultation for those who do not wish to read this document in full or would like to read an overview of the key issues and proposals under consultation first. At this stage, we anticipate that the final code will be shorter and more focused, simply outlining the twin-track compliance structure, proposed Fast Track parameters and the principles for those following Bespoke.

Second TPR consultation

8. Our second consultation later in the year will be on the draft DB funding code itself and the guidelines it will contain, informed by the responses to this first consultation, our impact assessment and any changes to primary and secondary legislation. We will also cover how we intend to regulate DB funding (including enforcement using our powers) and how we propose to ensure the framework and our guidance remain up-to-date. This consultation should be more concise as our first consultation and responses will have addressed many fundamental issues. We also envisage that the code itself will be short and focused.

Engagement with industry

9. Both formal consultations have been and will be supplemented by extensive stakeholder engagement. We have also liaised with actuarial, covenant and investment practitioners to challenge the technical advice provided by our own in-house professionals in developing the consultation.

Timetable

10. The revised DB funding code is being developed in parallel to primary and secondary legislation to ensure a coherent and consistent package. The timing of our consultations and drafting of the code is therefore intrinsically linked to the legislative timetable.

11. Following our first consultation, DWP intends to draft regulations on the detailed requirements set out in the Bill (relating to the funding and investment strategy, statement of strategy and clarifications of terms (eg prudent and appropriate)). This will inform our second consultation on the draft code. We anticipate the new code and associated legislation will come into force at the end of 2021. Our codes of practice are subject to the approval of the Secretary of State for Work and Pensions and are laid in Parliament.

Who this consultation is for

12. We would like to hear from any interested party, in particular trustees, employers, advisers and members of DB pension schemes and their representative organisations.

Closing date

13. This consultation document was published on 3 March 2020. The closing date for responses is **2 June 2020**.

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[2] www.tpr.gov.uk/-/media/thepensionsregulator/files/import/pdf/quick-guide-db-funding-consultation

Responding to the consultation

14. We would encourage you to respond to the consultation by completing the online response form (www.tpr.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-funding-code-of-practice-consultation-questions)available alongside this document on our website. You can also send responses to us by email at DB.Consultation@tpr.gov.uk.

15. Our preference is for responses in electronic format but alternatively, you can post your response form to: Sarah Harvey, Regulatory Policy, Advice and Analysis Directorate, The Pensions Regulator, Napier House, Trafalgar Place, Brighton BN1 4DW

16. If you wish to submit supplementary materials, please note they will be subject to a 20mb limit (any larger documents will therefore have to be sent in batches). If you have any queries about this consultation, please call Sarah Harvey on 01273 349355.

17. We may need to share the feedback you send us within our own organisation or with other government bodies. We may publish this feedback as part of our consultation response. If you want your comments to remain anonymous or confidential, please state this explicitly in your response and we will take the necessary steps to meet your request.

18. However, please be aware that, should we receive a formal request under the Freedom of Information Act, we may be required to make your response available. When responding, please advise whether you are responding as an individual or on behalf of an organisation (and, if the latter, which organisation).

Government consultation principles

19. For the purposes of this consultation paper, we are following the government's consultation principles[3]. The key principles state that consultations should:

- be clear and concise
- have a purpose
- be informative
- be only part of a process of engagement
- last for a proportionate amount of time
- be targeted
- take account of the groups being consulted
- be agreed before publication
- facilitate scrutiny.

[3] http://bit.ly/ContPrin.

2. Background

DB white paper and our remit

20. In 2017-2018, the government consulted in a green paper[4] on a range of measures to help ensure the security and sustainability of DB pension schemes and published its conclusions in March 2018 in the DB white paper.

21. The white paper[5] concluded that the DB pensions system is not in crisis and most members are likely to get their benefits in full. However, changes were needed to improve its security and sustainability, particularly in recognition that the DB landscape is maturing, with most schemes closed or closing to future accrual. The white paper also stressed that the regime is "designed to respond flexibly to ever-changing conditions, and to provide employers and trustees with a wide range of options in how they manage their pension liability". However, it also recognised that there were examples of sponsoring employers misusing this flexibility and this needed to be addressed.

22. The white paper identified a range of issues relating to scheme funding (we elaborate on these further in the section below):

- Trustee decision-making and risk management does not always reflect good practice and our code of practice.
- Some trustees do not focus sufficiently on the long-term strategy for their schemes and do not anticipate and manage their risks with these long-term goals in mind.
- There can be a lack of accountability and transparency for trustee actions which can result in poor decision-making and investment outcomes.
- The lack of clear definition as to terms such as 'prudent' (TPs) and 'appropriate' (RPs) makes our job of proving non-compliance and taking enforcement action more difficult.

23. To help address these issues, the government announced a range of measures including:

- TPR to provide greater clarity on the funding standards through a revised code of practice on DB funding, focusing on:
  - "how prudence is demonstrated when assessing scheme liabilities
  - what factors are appropriate when considering RPs, and
  - ensuring a long-term view is considered when setting the statutory funding objective."
- Legislative change to introduce new requirements such as a LTO and a DB chair's statement. Trustees would be required to submit the statement to us and explain "their approach to managing risks to the scheme, including information on how the trustee is meeting the clearer funding standards and how the statutory funding objective (SFO) is being set in line with a long-term funding objective".

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[4] https://www.gov.uk/government/consultations/defined-benefit-pension-schemes-security-and-sustainability.

[5] See pp 19-28 of https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/693655/protecting-defined-benefit-pension-schemes.pdf.

- Legislative change to “supplement and strengthen” the proposed new DB funding code of practice and to ensure “the Regulator can enforce [the clearer funding standards] or take action in the event of non-compliance (eg through sanctions or fines and improved funding powers putting beyond doubt that it is the responsibility of scheme trustees and sponsoring employers to demonstrate compliance with funding standards or any statutory code)”.

24. The government introduced the Pension Schemes Bill[6] to Parliament on 7 January to implement the proposals outlined in the DB white paper. The Bill proposes amendments to Part 3 of the Act, including the following:

- A requirement for trustees to determine, review and, if necessary, revise a ‘funding and investment strategy’ to ensure pension and other benefits can be provided over the long term. The strategy must specify the funding level to be achieved and investments to be held. As explained in the Explanatory Notes7 to the Pension Schemes Bill, ‘funding and investment strategy’ was referred to as the ‘long-term objective’ or ‘LTO’ in the DB white paper. In this document, we continue to use the term ‘LTO’ as it is commonly used and understood in the pensions industry.
- A requirement for TPs to be calculated in a way that is consistent with the “funding and investment strategy” (ie the LTO).
- A requirement for trustees to prepare and submit to TPR a written statement of strategy (referred to as DB chair’s statement in DB white paper) setting out the scheme’s “funding and investment strategy” (LTO) and supplementary matters. These include the extent to which the LTO strategy is being successfully implemented and remedial steps, main risks to the strategy and how these will be managed/mitigated, and reflections on past decisions and lessons learned.
- A requirement for trustees of all DB schemes that are subject to Part 3 of the Act to send their actuarial valuations to us (the previous requirement was that only schemes with a RP, ie those in deficit, had to do so).
- Amendments to s231 (funding power) to enable us to direct trustees to revise their funding and investment strategy if not compliant.
- Regulation-making powers to allow DWP to make provision in secondary legislation on various matters, including the following:
  - What matters trustees must take into account (including prescribed actuarial methods and assumptions) and principles they must follow when setting their funding and investment strategy, preparing/revising their statement of strategy or determining whether the RP is appropriate.
  - The timings and circumstances for these requirements.
  - The level of detail and form of the statement of strategy.

25. The proposals in this consultation document set out our interpretation of how existing and new Part 3 legislative requirements can be complied with and have therefore been informed by the content of the Bill (see in particular Chapter 5 on General principles). Any amendments to the Bill as it passes through Parliament will be considered in our second consultation on the draft code and in light of any regulations laid by DWP. We are also aware that other possible legislative or policy developments may arise following the Bauer case and Brexit.

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[6] https://services.parliament.uk/bills/2019-20/pensionschemes.html.

[7] https://publications.parliament.uk/pa/bills/lbill/58-01/004/5801004en.pdf.

26. Our approach to reviewing our code of practice on DB funding is informed by the policy intent set out in the DB white paper and the new requirements introduced in the Pension Schemes Bill. However, the proposed changes are also in line with our evolving approach and our messages of the last few years. Our current code of practice on DB funding, which came into force in 2014, subsequent supporting guidance (such as Integrated Risk Management (IRM)[8]) and our Annual Funding Statements[9]), already set out our expectations that trustees should take a long-term view and manage risks in an integrated way when planning their approach to scheme funding and investments. Many schemes already apply good practice in these areas (for instance by setting a long-term funding target). Our revised DB code will provide further clarity on what good looks like in relation to these issues, building on our messages of the last few years and existing good practice.

Key issues

27. In this section, we set out the key issues the DB white paper touched on and we are looking to address through our revised DB funding code. Chapter 16 covers in greater detail the evidence and analysis we have used to develop our proposals.

Maturing DB landscape

28. There has been a significant trend over the last decade in DB scheme closures (both to new members and/or to future accrual). Currently, only 11% of schemes are still open to new members and a further 44% of schemes are closed to new members but not to future accrual. Most DB schemes are therefore becoming more mature.

29. As a scheme matures, the growth of pensions that must be paid out increases, which in turn increases the scheme's exposure to becoming 'cash flow negative' and will therefore be more vulnerable to investment underperformance and have shorter horizons to make good any shortfall in funding levels.

30. Many schemes will continue to mature over the next few years, exacerbating the risks associated with poor funding levels and shorter investment horizons. Our key aim is therefore to ensure that trustees of maturing DB schemes can manage their run-off phase effectively and efficiently so that the probability of member benefits being paid in full is increased without unduly affecting the employer's ability to manage and grow its business.

31. The DB white paper considered a range of suitable LTOs for DB schemes, such as:

- running on with employer support (for open schemes)
- reaching self-sufficiency with low-risk investment strategy and run-off with minimal call on the employer
- buy-out by a set time, or
- entering a consolidator vehicle within an agreed timeframe.

32. In line with this thinking, our view is that to improve the resilience of maturing DB schemes and facilitate an efficient and well-managed 'end game' phase for DB schemes, they should progressively reduce their reliance on sponsoring employers as they mature. They should have clear journey plans for how to get to a fully funded, low risk position by the time they have reached a level of maturity such that continuing to remain in deficit could impose additional and unnecessary risks on employers and members. We set out our thinking on this, including considerations around open schemes, in greater detail in Chapter 5 on General principles.

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[8] https://www.gov.uk/government/consultations/defined-benefit-pension-schemes-security-and-sustainability.

[9] See our latest Annual Funding Statement at https://www.thepensionsregulator.gov.uk/en/document-library/statements.

Inappropriate use of the flexibilities

33. As the DB white paper recognised, most schemes are well-run and already apply good practice in relation to managing their funding, investment and covenant risks in the context of a LTO beyond the short-term level of funding on a TPs basis. The standards we are looking to formalise more clearly in our revised funding code should therefore broadly be in line with what these schemes already do.

34. However, as a regulator we also see a range of bad practice from poor risk management to inappropriate use of the flexible scheme-specific regime, such as:

- imprudent TPs, ie weak funding targets which assume a level of risk that cannot be supported and result in artificially low deficits
- double-counting of the covenant: TPs are weak (resulting in lower deficits) because the strong covenant can support more risk while the RP is also long because it is claimed the strong covenant can give trustees more comfort about the affordability of future deficit repair contributions (DRCs)
- reasonable TP assumptions but an inappropriately risky investment strategy
- reasonable TPs with RPs overly-reliant on investment outperformance (therefore unwinding some of the prudence from the TPs in the overall funding strategy)
- unfair treatment compared to other stakeholders such as the trustees being asked to accept a very long RP while significant dividends are being paid out
- significantly back-ended loaded RPs, which may be pushed out again at the next valuation
- short-term focus, with closed schemes setting the discount rates based on the current investment strategy with no allowance for any likely future changes in that strategy
- short-term focus on DRCs over the next three years and lack of contingency planning (banking on higher DRCs being negotiated at the next valuation)
- reliance on additional support that doesn't provide the comfort it claims to offer (eg a guarantee from a strong company being assumed to provide a strong covenant indefinitely, or reliance on a contingent asset that does not have real value when needed), and
- trustees unable to justify how the risks the scheme is taking are being managed.

35. We consider that a flexible regime that allows for scheme-specific solutions is important. However, the examples above show that without clear boundaries, it can be misused. In this consultation, we set out proposals for how we could define clearer parameters, which would enable trustees and employers to agree appropriate funding and investment solutions.

36. Equally, many schemes apply good practice (such as setting a long-term funding target and prudent journey plans to reach it – see Chapter 16 on Evidence and analysis) and we would be looking to embed this good practice in the new code.

Lack of accountability and transparency around risk-taking

37. Risk is intrinsic to the DB funding regime and our intention is not to eliminate all risks but to ensure that they are appropriately identified, understood (including how they change over time), and managed. We think greater transparency on trustees' approach to risk-taking, particularly through the statement of strategy proposed in the Bill, could have significant benefits for the following:

- The trustees and members: On the basis that what gets reported gets managed, greater transparency and accountability could help improve risk management practices. This will in turn support better and clearer communications to members.
- The sponsoring employer(s): Having a clear understanding of the support which the scheme may need helps them better plan for their business without too many surprises.

- TPR: As a risk-based regulator, we aim to be targeted in our interventions and focus on the greatest risks and where we can have the most impact. Greater clarity upfront on the decisions being made by trustees and employers and the level of risk being carried by schemes will support a more effective assessment of the landscape. It will also support more efficient regulation and engagement with trustees and employers.

38. In this consultation (see Chapter 3 on our proposed regulatory approach), we set out our proposals for how trustees could assess risk in a more structured and objective way and for trustees to articulate this assessment in the information they provide to us through the statement of strategy.

Lack of clear standards compromises efficient enforcement

39. The current legislation and regulatory guidance refer to but only provide principles on the concepts of 'prudent' TPs and an 'appropriate' RP. This makes it difficult to take swift, efficient regulatory action where we consider the flexibilities in the funding regime are being misused. There are no clearly understood and agreed standards for prudence and appropriateness, which makes it unnecessarily difficult and time-consuming for us to demonstrate, firstly, that a scheme is not compliant with Part 3 funding and, secondly, what the compliant scheme funding outcome should be.

40. While it is important for there to be a sufficiently 'high bar' to ensure our s231 funding powers[10] are used appropriately and fairly, the lack of clear agreed parameters around what good looks like makes enforcement action around funding unduly inefficient and risks undermining compliance with the law and confidence in the regime.

41. Providing greater clarity on the funding standards in our code (as part of a comprehensive consultation process) and putting the onus on trustees to demonstrate that they comply with their legal obligations and providing this information upfront should help improve the effectiveness and efficiency of DB regulation.

42. Greater clarity will help all schemes better understand how to comply with legislative requirements but will be particularly helpful to the 2,000 or so schemes with fewer than 100 members (representing 36% of schemes but covering only 1% of total membership, assets and liabilities). Typically, these schemes have fewer resources to spend on advice and appear to be less well-governed than larger schemes (see Chapter 16).

We are also evolving the way we regulate so we can be more effective and efficient, more proactive in identifying and mitigating risks, and improve our regulatory oversight. A revised DB funding code will support our objective to be 'clearer, quicker, tougher', as set out in our TPR Future programme[11].

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[10] Section 231 of the Act gives us the power to set a scheme's TPs, impose an RP and/or schedule of contributions, or modify the rate of the members' future benefit accrual. This power can be used when there has been a failure to comply with the statutory funding requirements, for example when the scheme has put in place imprudent TPs or an inappropriate RP.

[11] https://www.thepensionsregulator.gov.uk/en/about-us/making-workplace-pensions-work

Part 2: Theory

3. Proposed regulatory approach

Introducing clarity

43. As discussed in the previous chapters, the current wholly principle-based approach has limitations and we think more clarity is needed. Introducing greater clarity presents several challenges that we have considered carefully.

Maintaining the scheme-specific regime

44. The existing regime is ‘scheme-specific’ as it does not prescribe a single funding standard that must be adopted by all schemes. Instead, it permits trustees to design funding arrangements that are unique to and appropriate for their scheme. The ability of trustees to determine their own funding arrangements is not changing and therefore our revised code will need to strike a balance between clarity and maintaining the scheme-specific regime.

Risk and subjectivity

45. Funding plans are essentially plans for an uncertain future and, therefore, judgement must be exercised, and risks must be taken and managed. The word ‘risk’ is often used as shorthand to refer to a range of (usually negative or detrimental) potential events.

46. For the purposes of DB funding, we think that the high-level risks can be broadly categorised as the likelihood of the employer weakening or becoming insolvent, investments failing to perform as expected, changes in economic conditions leading material movements in financial assumptions, and scheme demographics changing materially. Please note that there are a multitude of additional risks and sub-categories of risks and, rather than attempt to describe each risk in detail, we may at times throughout this document refer simply to ‘risks’.

47. However, we recognise that the aggregated level of ‘risk’ being run in a scheme will be variable and dependent on all the above factors. Further, the assessment of those risks can vary from person to person, ie the assessment of a risk is subjective.

48. Some of the events above can be managed in different ways. The exposure to a risk can be:

- quantified as having minimal or minor financial impact
- contained or reduced, for example by investing less in growth seeking assets
- underwritten, for example by hedging against interest rate or inflation changes or securing a contingent asset, or
- assessed as sufficiently remote not to require further management, for example, the risk of a s75 debt not being paid on the failure of very strong employer when coupled with a well-funded scheme.

49. For the purposes of this document, we expect all trustees to ‘manage’ their risks, ie to identify, assess and understand the various risks facing the scheme and then deal with the risks in one or more of the following ways:

- Obtain additional support for one or more risks.
- Mitigate a risk by taking some action to reduce its severity if it were to materialise.
- Take no further action if the risk is assessed as remote or of minimal impact, apart from keeping the position under review.

50. We are aware that different boards of trustees could reach different conclusions as to the likelihood or impact of the same event occurring and then manage it different ways and to a different extent. There are therefore a range of reasonable or likely outcomes that a rational trustee board could arrive at.

Our view

51. We conclude that 'clarity' cannot occur without introducing an objective funding standard. For example, if the concepts of prudent TPs and appropriate RPs were to remain entirely subjective, then it is difficult to understand how we and the regulated community could quickly and easily assess whether a funding arrangement is truly compliant with the legislation.

52. Therefore, an 'objective' standard needs to be developed. A scheme's subjective funding arrangement can then be compared to the objective standard and assessed against it. We recognise that pension schemes cannot eliminate risks, but we want to introduce a consistent way of measuring the risks and determining to what extent, and how, they should be managed.

53. As discussed in paragraph 51, there is likely to be a range of acceptable or reasonable outcomes, but we think that, for 'clarity', there needs to be a single reference point for the objective standard. If a range is introduced, then although we will be able to identify and determine which outcomes lie outside the range, it is more difficult to determine where in the range the scheme should be placed for enforcement purposes. Therefore, we think it should be set as a considered single point from the outset.

54. The purpose of this consultation is to work with stakeholders to determine what that objective standard should be, and how we should regulate against it. We have therefore developed an approach that maintains scheme specificity while introducing the necessary objective standard.

Our role

55. The Act expressly obliges us to publish a code of practice on the discharge of duties imposed on trustees of occupational pension schemes by or by virtue of Part 3 of the Act[12]. In addition, we have very significant powers under s231 of the Act to correct funding arrangements in certain circumstances. We consider that the combination of these powers means we have an important role to play in setting the 'objective standard'.

Our proposal: Twin-track compliance

56. We propose that trustees can choose to either follow the **Fast Track** approach that will be detailed in the new code or a **Bespoke** route, which would involve the provision of additional evidence by them and further scrutiny by us.

57. It is important to stress that either approach is acceptable and, if done correctly, will be considered by us to be compliant with legislative requirements. Merely following one route or the other does not automatically equate to compliance. The legislation and principles will need to be followed and, if we believe that valuations are not compliant, we will consider taking action. Our intention is not to introduce a 'Minimum Funding Requirement' type regime and we think that what we propose should guard against that.

58. We consider that this approach allows us to introduce some objective clarity by defining what we would consider an acceptable funding solution, while leaving trustees with the ability to reach their own arrangements if they are more appropriate for their circumstances.

Fast Track

59. For Fast Track, we would set out a series of explicit guidelines, which trustees can use to assess whether we would consider their valuation to be compliant with the legislation.

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[12] Under s90 of the Pensions Act 2004 (the Act), we must issue a code of practice relating to the discharge of duties imposed on trustees or managers of occupational pension schemes by, or by virtue of, Part 3 (scheme funding). We may revise our codes of practice from time to time and must consult on a draft code (s91).

60. It is important to understand that the Fast Track solution is not trying to be perfect. It is not a risk-free position, nor does it guarantee that the scheme will be able to pay all benefits as they fall due. The reality is that pension schemes are expected to take some risks, but we consider that the Fast Track position would represent a position of ‘tolerated’ risk for different scheme-specific factors such as maturity and employer covenant. We would like to develop a Fast Track that represents a justifiable, prudent position that most stakeholders would recognise as within the range of reasonable outcomes.

How would it work?

61. The Fast Track model would cover key aspects of funding and investment arrangements, including the funding level and timing of the LTO, TPs (discount rates and possibly other assumptions), RP length and structure, investment risk, and future service contribution rates (open schemes).

62. Most of the guidelines would be objective and quantitative. They could incorporate some scheme-specific factors such as maturity and covenant strength (if reliance on employer covenant is to be included in Fast Track). Certain aspects such as covenant would need to be checked to some extent by us.

63. We would expect trustees to provide their statement of strategy to us with supporting information, but we would seek to make this proportionate and straightforward. Subject to a few basic checks, trustees should not expect any extensive engagement with us on funding unless we had identified potential non-compliance.

64. To be considered Fast Track compliant, a scheme would have to satisfy all aspects individually, as when looked at in aggregate, it would represent our view of what constitutes an acceptable funding and investment outcome or tolerated risk for schemes of different characteristics.

65. However, as stated in paragraph 61, this would not be a risk-free position and trustees would still be expected to exercise judgement, assess and manage their own scheme- and covenant-specific risks, and plan for adverse conditions. We would refer trustees to our current guidance on how trustees can manage the risks associated with scheme funding.

66. Trustees should also note that new requirements for pension scheme governance came into force on 13 January 2019[13], including the requirement for trustees to have an effective system of governance proportionate to the size, nature, scale and complexity of their scheme. Among other things, trustees (of schemes with 100 members of more) will need to carry out and document an own risk assessment of their scheme. Our forthcoming single modular code, soon to be published for consultation[14], will reflect our expectations in relations to these new requirements.

What proportion of schemes will follow Fast Track?

67. We do not know at this stage how many schemes are likely to choose Fast Track (based on schemes’ current funding and investment strategies) as we have not finalised the Fast Track quantitative compliance formulation. This will be done once we have settled on the principles and approaches we are consulting on in this document.

68. We will finalise the Fast Track framework based on our view of appropriate outcomes and considering the Pension Schemes Bill amendments and any changes to the regulations, responses to this consultation, where the landscape is in relation to Fast Track guidelines, and our impact assessment (eg the appropriate balance between member security and costs to employers). We will then consult on our proposed guidelines and parameters in our second consultation.

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[13] Occupational Pension Schemes (Governance) (Amendment) Regulations 2018.

[14] See https://www.thepensionsregulator.gov.uk/en/document-library/statements/single-code-of-practice-statement for further information. The code content arising from our two DB funding consultations will form new and amended modules to be added to the single modular code as part of its first update.

69. Chapters 7-12 in Part 3 set out our proposals for how we could develop Fast Track compliance guidelines.

How would it be updated?

70. We are aware that such a detailed framework would need to keep track with market, economic and demographic events. Therefore, we propose that it would be developed in view of prevailing market conditions and would be regularly reviewed and updated as necessary by us (eg if material changes have occurred).

71. We consider that we should review the framework every three years or sooner if there are any material changes to the economic environment. We would not seek to review or amend the fundamental structure of the Fast Track framework but ensure that the Fast Track outputs do not become out-of-date. We will consult on our proposed review process in our second consultation.

Bespoke

72. This option provides trustees and employers with more flexibility to take account of scheme-specific circumstances. Reasons for choosing the Bespoke route could include the following:

- Trustees consider it appropriate to take additional, managed risk relative to the tolerated level of risk accepted in Fast Track. This could be in relation to investment risk, the LTO, the prudence in the TPs, or RP length or structure.
- Schemes that simply cannot meet some or all Fast Track aspects. This might include those schemes with very weak employers that can only support very long RPs due to significant affordability constraints.
- Where an aspect of the Bespoke arrangement is different from the Fast Track equivalent but despite the differences, (i) in aggregate the Bespoke arrangement represents an outcome at least as good as the Fast Track outcome overall and/or (ii) the trustees can evidence that there is no additional risk being run in the Bespoke arrangement.
- Schemes with unusual or complex circumstances or arrangements (eg atypical covenant, contingent support, investment strategy), which we have not been able to accommodate under simple Fast Track guidelines.

How would it work?

73. Although we see Bespoke as providing an alternative for trustees dealing with circumstances that do not easily fit into Fast Track or who wish to approach funding differently, we do not consider that it should be an 'opt-out' from the new regime. We think Bespoke should complement Fast Track and that both should apply a consistent methodology for legislative compliance. Therefore, we would expect trustees following the Bespoke route to adhere to the same principles that underpin Fast Track and the guidance that will be laid out in the new code.

74. Trustees who follow this route would be expected not only to fully articulate their position and decisions to us, but also provide tangible evidence to support their position or, where appropriate, demonstrate the support or mitigation obtained to underpin the additional risks. For example, in the case of a long RP, the explanation needs to be supported by detailed evidence of the affordability constraints or (where affordability is not constrained) evidence of what additional support has been provided to underpin the longer RP.

75. Trustees and employers can also expect some engagement with us after submitting their funding documents (statement of strategy and valuation)[15], although we anticipate that some arrangements will be straightforward to assess and won't require much interaction with trustees. As a risk-based regulator, we may decide not to engage with all trustees who have submitted Bespoke arrangements.

76. In the final code, we intend to provide examples of scenarios we would consider compliant and potentially non-compliant with the legislation to help trustees, employers and advisers. We have outlined some scenarios in Part 4 to give a flavour of how we intend the Bespoke framework to operate.

Objective risk-taking and demonstrating compliance

77. In paragraph 52, we said that we will need to assess scheme-specific funding arrangements against an objective standard. We think that Fast Track position is the appropriate objective standard as it will:

- have been developed following two extensive consultations with our regulated community, approved by the Secretary of State for Pensions and laid before Parliament
- be easily assessed and known to the trustees and employer in advance of negotiating a scheme-specific arrangement, and
- be scheme-specific, as it is determined by reference to the scheme's maturity and, potentially (subject to consultation), its employer's covenant support.

78. Arrangements that fully adhere to the Fast Track framework (ie the objective standard) would require little further assessment from us, other than to check compliance with the Fast Track framework. However, fully Bespoke funding arrangements will need to be assessed against the equivalent Fast Track position.

79. We propose to assess a Bespoke valuation using the following criteria:

- How the funding arrangements comply with the legislation and any relevant DB code principles.
- The extent the funding arrangements diverge from Fast Track as a reference point.
- How additional risk (if any) is being managed (eg additional support or appropriate mitigations).
- The quality of the supporting evidence provided by the trustees.

80. As set out in Chapter 2, one of our key aims is to improve the transparency of trustee decision-making and risk-taking, and to support more efficient regulation. We propose to achieve this by asking trustees to evidence objectively a) how and why they have moved away from our level of tolerated risk as defined by Fast Track and b) how they believe any additional risks have been managed (ie supported, mitigated or assessed as remote). The trustees will provide their evidence via the statement of strategy and supporting documents submitted to us.

81. If we think the Bespoke arrangements do not comply with Part 3 of the Act, we would consider whether to take action, using our powers under s.231 of the Act.

82. A fuller description of our proposals in respect of the Bespoke compliance route can be found in Part 4, Chapter 13.

Subsequent valuations

83. It is important to note that we do not anticipate trustees being obliged to always remain within either Fast Track or Bespoke. We expect that trustees will be able to move between the methods of compliance from valuation to valuation depending on the scheme and employer circumstances.

[15] The Pension Schemes Bill as currently drafted requires trustees of all schemes, whether in deficit or surplus, to submit their funding documents to us. Funding documents include the valuation, the statement of strategy and any other documents that may be required by regulations.

Benefits of this approach and increased objectivity

84. We hope the proposed approach will increase the transparency of our regulation. In turn, this should benefit everyone involved:

- Trustees and employers will be able to assess from the outset whether the expected funding arrangements would be compliant with legislative requirements. We anticipate that this will speed up employer/trustee negotiations and focus discussions on the genuine areas of concern for that scheme and employer.
- Trustees and employers will know when and why we may have concerns about their funding arrangements for the scheme, and what can be done to mitigate these concerns (which in turn would reduce the likelihood of regulatory scrutiny).
- Advisers will be able to provide advice to their clients with more certainty and will be able to guide their clients in the preparation of the information to be submitted to us when their client does not wish (or is unable) to follow the Fast Track option in the code.
- Members of schemes can be confident that all parties involved in the custodianship of their pensions have acted appropriately and with full accountability to us.
- We will be able to identify schemes we do not consider to be compliant with Part 3 of the Act more quickly and effectively and will then be able to communicate those concerns more clearly, with a view to early resolution.
- If we consider enforcement action is necessary, we will be able to act more quickly and efficiently as the level of subjectivity associated with the various issues will have been reduced.

Engagement and enforcement

85. We propose to consult further and in more detail on our enforcement policy and approach to DB regulation during our second consultation. This section outlines our initial proposal regarding the practical operation of the new funding approach.

Submission of documents

86. Once the valuation documents have been submitted to us (including those schemes which are in surplus, following a new provision introduced in the Bill), we will undertake a high-level review of these valuations (as we do now).

87. This exercise will serve two purposes:

- Verification that schemes following Fast Track meet all its guidelines.
- Inform our engagement strategy for trustees that have followed Bespoke compliance or in respect of any schemes that have not correctly followed Fast Track but have submitted on that basis.

Bespoke compliance route

88. If a scheme's valuation is selected for further scrutiny, then it will proceed through our 'initial intervention gateway'[16] to decide the level of follow-up activity required.

[16] As part of our TPR Future programme, we have designed and implemented a new operating model, which is described on page 10 of https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/tpr-future-making-workplace-pensions-work.ashx.

89. We anticipate that most of our queries will be resolved through 'low' to 'medium' intensity engagement. Particularly complex arrangements or those where the outcome is considerably different than the Fast Track standard are more likely to proceed to 'high' intensity engagement.

90. Initially, we expect that much of our engagement will involve strengthening our understanding of the trustees' approach and eliciting more detailed explanations than those originally provided in the scheme's statement of strategy. However, once trustees become more familiar with the statement and our expectations, we expect this level of engagement to diminish. We will publish guidance about how we expect trustees to complete the statement and examples of good and bad practice.

Enforcement

91. We envisage that a small number of cases will proceed, following initial engagement, to enforcement. We will endeavour to issue a Warning Notice[17] as quickly as possible after it becomes apparent that we do not consider the scheme's funding arrangements to be compliant with legislative requirements.

92. The employer and trustees would be provided with an opportunity to make representations against this position and to provide any additional evidence that had not been provided with the statement of strategy or during initial engagement with us.

93. If, following representations received, we still believe that the Warning Notice establishes grounds to act under s231(1) of the Act, we would seek a decision from our Determinations Panel to use our power under s231(2) ie to set the scheme's TPs or LTO (subject to the Bill) or both as for Fast Track and for any RP to be set over a period that is comparable to the relevant Fast Track length or reasonably affordable for the employer(s).

► Question

Q1 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?

[17] Our case team procedure can be found at https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/case-team-procedure-may-2014.ashx.

4. Employer covenant

94. The employer covenant is the extent of the employer's legal obligation and financial ability to support a DB scheme now and in the future. The legislation does not expressly refer to the role of the employer covenant, but it is a relevant factor for trustee decisions, in particular to determine the appropriate funding and investment risks to take. The covenant is therefore an important scheme-specific security mechanism and has, over time, become a key feature of the regime.

95. It is fundamental to this consultation to have a debate about the role of the employer covenant in the regime and the extent to which trustees should place reliance on it. In this chapter, we discuss the following issues:

- How much reliance should be placed on the employer covenant and the degree to which it is reasonable for DB scheme members to be subject to employer insolvency risk.
- If some reliance should be placed on the covenant, how this should be factored into a scheme's funding plan.
- The best way to assess the level of employer support.

Role of the covenant and insolvency risk

96. The current system does not insulate the scheme from the impact of an employer's insolvency. If the employer suffers an insolvency event, then the scheme may not recover the full s75 debt due to it. Therefore, if a scheme is underfunded on a buy-out basis and the employer becomes insolvent, there is a risk that members could lose some of their benefits[18].

97. Those who do not work in the industry, and even some trustees, are often surprised when an employer becomes insolvent and there is a cut in member benefits or a call on the PPF. We have also come across the misconceptions that if a scheme is fully funded on its TPs, then members will get their benefits in full or that a scheme funded at 'self-sufficiency' is fully protected in the event of the employer's insolvency. Given recent high-profile corporate failures, it is important to discuss and be clear about how much residual risk is in the system and to what extent it should be supported or mitigated.

98. At one end of the spectrum, to fully mitigate against the risk of insolvency, all schemes would have to be funded so that all member benefits could be bought out immediately from a reputable insurer. This would make the regime more transparent and objective and reduce almost all risk to member benefits and the PPF. However, this is not the intent behind the scheme-specific funding regime (which is designed to have a degree of residual risk mitigated by the PPF) and it would also cause a substantial, often unaffordable, increase in contributions required from most employers. Analysis of our data shows that the estimated total buy-out deficit across the DB universe at 31 March 2019 was £920bn, compared to £180bn for the estimated aggregate deficit on a TPs basis – a difference of £740bn. This compares to total TPs at 31 March 2019 of £1,900bn, so the difference is significant.

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[18] We note that developments in relation to the CJEU judgment in the PSV v. Bauer case may affect this position.

99. Table 1 below sets out the pros and cons of funding on a near risk-free basis:

Pros	Cons
☑ Security to members' benefits maximised once full funding is achieved. Benefits would be much less intertwined with employer performance, minimising the risk of losing some pension benefits and one's job at the same time. ☑ Significant reduction to PPF risk. ☑ Simpler, more objective valuations less open to subjective interpretation.	☒ It would have a material financial impact on most employers and could threaten the viability of the system. ☒ A funding standard that excludes the employer covenant would compromise the scheme-specific nature of Part 3 of the Act. ☒ It would be a radical change, and contrary to market expectations and our guidance for over a decade. ☒ It would drive investments towards low risk/return assets at a much earlier stage, which could have adverse impacts on capital markets.

100. There are other options that still ignore the concept of covenant but don't target such a low risk basis. These take the form of either of the following:

- Requiring schemes to be fully funded at all times on a low dependency basis. Being funded on this basis would mean a scheme could expect to provide member benefits with very limited future support from the employer and, if such support is required, it would be expected to be small relative to the size of the scheme.
- Having no explicit allowance for covenant but still allowing for investment risk to reflect the maturity of the scheme, ie schemes which are immature can afford to take higher levels of investment risk and allow for that in their discount rates used to calculate the TPs. Mature schemes would still need to be fully funded on a low dependency basis as time is not on their side. We consider the issue of maturity in greater detail in Chapter 5 (General principles) and Chapter 8 (Setting the LTO).

101. Both approaches would make the funding regime more transparent and objective than it is currently, as factoring in the employer covenant introduces a degree of additional risk. They would also reduce, but not eliminate, the risk to member benefits and the PPF. They might also cause a substantial increase in contributions required from many employers, particularly if requiring immediate full funding on a low dependency basis. Most of the other pros and cons listed in Table 1 would also apply to some degree. We would like to hear views on the merit of the approaches above.

102. In this consultation, our proposal is to allow trustees to imbed some reliance on the covenant and to allow more immature schemes to assume and take more investment risk on their way to low dependency funding (see Chapter 5 on General Principles for further discussion of these ideas). Although this approach will not eliminate the insolvency risk and some members may still lose some of their benefits (eg it does not remove the risk that benefits are reduced in an insolvency situation), it will:

- improve transparency around and management of the risks being taken by trustees (on behalf of members) and the employer, as trustees will have to make an explicit evaluation of the covenant and other risks the scheme is exposed to
- reduce the impact of employer insolvency on member benefits over time as maturing DB schemes reduce reliance on the covenant and progress towards low dependency funding, and
- improve our ability to act where inappropriate risk is being taken through the provision of better information upfront and having a clearer benchmark against which to assess schemes.

► **Question**

Q2 **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?

Integrating the covenant into scheme funding

103. If we assume that some reliance should be placed on the employer covenant, the next questions are:

- Whether it should be factored into both Fast Track and Bespoke approaches or just Bespoke?
- If it should be factored into Fast Track, then into which element of the funding and investment arrangements?

104. We have identified the options below as to how covenant could be integrated into Fast Track (beyond the default assumption that covenant is taken into account when considering whether a RP is affordable). Note that the differences between Option 1 and 2 outlined below are largely presentational. They should be broadly similar in relation to overall cash funding and investment risk.

Option 1 – Covenant integrated into Fast Track TPs via discount rate

105. The employer covenant could feature explicitly in the funding framework and be recognised as a key security mechanism to support assumed/actual investment risk. This is in line with current Integrated Risk Management (IRM) practice. Covenant would therefore be integrated into the TPs via the discount rate. However, we would seek to introduce further clarifications, including:

- a clearer and more formally defined link between covenant strength and TPs (see Chapter 9)
- additional 'checks and balances' regarding RP length and structure, in particular whether the covenant should feature both in TPs (enabling lower TPs and deficits) and the RP through investment outperformance (enabling lower DRCs) (see Chapter 11), and
- the appropriate level of risk in the investment strategy, which may also include a defined link to covenant strength (see Chapter 10).

106. Adjusting the discount rate to reflect employer covenant would introduce a greater element of risk into Fast Track TPs and undermine our aim of keeping Fast Track relatively clear and simple. An alternative would be to allow reliance on the covenant in the TPs discount rates but only as part of the Bespoke approach. Under this alternative approach, the employer covenant would not feature explicitly in the Fast Track framework but instead TPs would be set at a 'covenant-independent level', with the discount rates allowing only for assumed investment risk and associated returns to reflect the maturity of each scheme. Trustees could factor in covenant through Bespoke to justify additional risk.

Option 2 – Covenant reflected in investment outperformance in the RP

107. Instead of a covenant adjustment in Fast Track TP discount rates, covenant could be included as part of the RP in the form of investment outperformance. For Fast Track purposes, a scheme would not be allowed to factor additional investment returns into its TPs, so the TPs would be set at a covenant-independent level such as low dependency. However, we would define levels of asset outperformance that we consider acceptable with reference to employer covenant strength (reflecting the employer's ability to support investment risk). In other words, we would allow for a higher level of outperformance where employer covenant is stronger, than for a weaker covenant.

108. Any resultant deficit would need to be funded within an appropriate period. We consider that the stronger the covenant, the shorter the RP should be, and we would expect to define guidelines for RP length with reference to covenant strength (see Chapter 11).

Option 3 – Covenant reflected as a scheme resource

109. The options above correspond more closely to current practice. A different approach would be to reflect the value of the sponsoring employer as a resource[19] and integrate it explicitly as a credit to the scheme's asset base:

- The scheme's liabilities would be calculated as the present value of future cash flows using a covenant independent discount rate (such as on a low dependency basis) and would be increased by an investment stress (see Chapter 10).
- The scheme's assets would be calculated as the sum of existing scheme assets plus the present value of committed DRCs, contingent assets secured in the scheme's favour, some allowance for investment returns based on scheme maturity, and the estimated value of residual (eg uncommitted) employer support.

110. The approach to valuing employer support would require further consideration but could be assessed as:

- the present value of its unencumbered asset base
- the discounted present value of forecast cashflows, or
- another measure of employer value where evidenced (for instance, the market value of the shares in the employer).

Comparison of covenant options

111. Table 2 below sets out the pros and cons of these three broad approaches to integrating the employer covenant into Fast Track:

Option	Pros	Cons
Option 1 Covenant integrated into Fast Track TPs via discount rate	☑ Consistency with current practice in how covenant feeds into valuations. ☑ Increases the likelihood of schemes opting for Fast Track. ☑ Improved consistency in funding position and member security for schemes with similar covenants (clearer links between covenant, assumed risk and TPs). ☑ Easier to identify where a scheme is taking a higher, excessive amount of risk in Bespoke (absent appropriate mitigation). ☑ Explicitly recognises covenant as a key security mechanism and therefore allows some schemes to aim for higher	☒ Covenant idiosyncrasies: Although we would expect to update and clarify our view on how employer covenant should be assessed (see below), there remains a risk that different parties could reach different conclusions on the same covenant. ☒ Covenant 'buckets' could be overly simple: Allocating employers to a finite number of covenant grades (eg CG1-4) may be a very simple way to express a complex issue (how affordability matches across to scheme risks – a discount rate by covenant grade does not fully reflect this assessment). ☒ Integrating covenant into TPs makes them less transparent and more complex.

[19] This concept is similar to the Holistic Balance Sheet developed by the European Insurance and Occupational Pensions Authority (EIOPA) as part of their review of the IORP Directive. However, this framework would be based on a different funding requirement/basis than what was proposed by EIOPA and we would not necessarily use any of the EIOPA specifications for how to calculate the value of the employer – much further work would be required to develop this concept.

	investment returns (and so require lower employer contributions).	
Option 2 Covenant reflected in the RP investment outperformance	☑ Could avoid the complexity of integrating covenant in TPs (including how to reflect covenant visibility, as discussed in Chapter 9) and make the balance between funding and investment more transparent. This could be better for long-term risk management planning.	☒ Significant change in approach. ☒ Would move subjectivity from the TPs to the RP side (in terms of having to define the relationship between covenant strength and investment outperformance for Fast Track).
Option 3 Covenant reflected as a scheme resource	☑ Assets and liabilities are consistently valued for all schemes. ☑ All elements are explicitly valued, enabling a fully transparent and risk-based framework. Risks to members/PPF are more explicit. ☑ Easier to assess compliance as more objective. ☑ Is in line with best practice in financial services regulation.	☒ Employer support would need to be valued consistently across schemes. This could be complex and expensive. ☒ Cash flow based valuations may place undue reliance on future business cash flows where an employer's long-term viability is uncertain. An additional complication could be the complex and varied nature of the employer's other future financial commitments. ☒ Vulnerable to gaming. ☒ Significant change in approach.

112. We think that option 2 (same Fast Track TPs for all schemes, with covenant reflected in investment outperformance in the RP) has significant benefits as it would simplify TPs and provide greater transparency on the balance between cash funding and investment risk. However, this option is very different from current practice, unlike option 1 (covenant integrated into TPs via discount rate), which is most compatible with what schemes already do. For this consultation, and to enable us to develop options for Fast Track, we have therefore assumed Option 1 as the starting point. However, we would like to hear views on the best way to factor in the employer covenant into funding arrangements.

► Questions

Q3 Integrating covenant into funding

a. Do you think it is better to keep the Fast Track route simpler by only factoring covenant into Bespoke (TPs and/or RP)?
b. If you think covenant should only feature in Bespoke, how do you think it should be done?
c. If we were to integrate covenant into Fast Track guidelines, do you prefer option 1, 2 or 3 or some other approach for reflecting the employer in scheme valuations, and why? If another approach is appropriate, what do you think this should be?

Assessing the covenant

113. So we can set out clear options, the remainder of this consultation operates on the assumption that the employer covenant is likely to remain an integral part of scheme funding, and therefore we need to consider how it should be assessed.

114. One of the cornerstones of this consultation is to understand whether we can make the funding regime more objective, while still maintaining its flexibility. It is important that trustees can assess the strength of employer covenant clearly, objectively, proportionately and in accordance with a set of consistent standards. This section of our consultation focuses on how this could be done.

Options for assessing covenant

115. We have previously set out in guidance[20] our view of how the employer covenant should be assessed, as well as providing examples[21] of the characteristics that schemes with different strengths of covenant display.

116. Our guidance is mainly qualitative as it requires trustees to use their specific knowledge of the company (or companies) supporting their scheme to reach a conclusion rather than basing an assessment on any prescribed and clearly-defined financial metrics. However, it highlights areas that trustees should consider to a greater degree (for example, cash affordability) or lesser degree (such as limiting reliance on companies with no legal obligation to support the scheme) in assessing employer covenant strength.

117. To support our goal of improving the transparency and the objectivity around risks being taken, we have considered two main approaches to assessing employer covenant:

- **Option 1: Formulaic approach** – Simplifying employer covenant to a formal calculation or metric (for example: based on affordability or other ratios, or a measure of covenant 'value').
- **Option 2: Holistic approach** – Retaining the current approach to assessing employer covenant, which allows trustees and their advisers flexibility in weighing up scheme and employer-specific factors. However, we would consider providing new (and potentially more specific) guidance to assessing covenant holistically as part of the revised code and supporting guidance.

118. Under either approach we would guide trustees to continue to focus on the affordability of contributions, the level of available security in the absence of cash affordability, and the implications of stress testing (both at a scheme and employer level).

Option 1: Formulaic approach

119. One approach could be to compare the employer's affordability with a measure of the scheme's reliance on the covenant. For the latter, we suggest that a measure of deficit which is 'covenant-independent' (such as on a low dependency funding basis – see Chapter 8 for further details on the LTO) would be an appropriate benchmark. Not because an employer should be required to fund this deficit (unless the scheme is significantly mature), but to provide an objective and consistent picture of the extent to which schemes rely on the covenant. By comparison, basing covenant strength on an employer's ability to fund a TP deficit (which already pre-assumes a degree of covenant strength) would double-count the covenant and we consider this to be inappropriate.

120. Under this suggested approach, trustees would assess the period over which the low dependency deficit might be affordable from, for example, the employer's forecast reasonably affordable cash flows

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[20] https://www.thepensionsregulator.gov.uk/en/document-library/regulatory-guidance/assessing-and-monitoring-the-employer-covenant.

[21] https://www.tpr.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-funding-regulatory-enforcement-policy.ashx.

(RACF)[22]. Stronger employers should be able to support their schemes' low dependency deficit within a shorter period than weaker employers.

121. This method could also factor in the impact of downside scenarios – on both the employer (eg in terms of underperformance against trading forecasts) and the scheme (eg in the event of asset values falling). For instance, how readily could an employer support the scheme's low dependency deficit when grossed up by a (TPR-defined) measure of scheme risk? And how could this be impacted by a downturn in the financial strength of the employer?

122. We would seek to define thresholds for each covenant grade rating. The strength of an employer would depend on the number of years it would take to fund the scheme's aggregate low dependency deficit from RACF.

123. Alternatively, this method could be based on other financial metrics (such as a measure of profitability or an estimated covenant 'value') as compared to the 'covenant independent' deficit.

[22] Potentially defined as the employer cash flows after all reasonable business costs – including reinvestment in the business (for example, capex for sustainable business growth) and potentially some equitable level of 'value leakage' (eg value leaving the covenant by way of eg dividends, intercompany loans that won't be repaid, material management bonuses).

Value leakage is in recognition of some employers claiming a need to pay shareholder dividends – which leaves them unable to support short RPs. If such value outflow is indeed viewed as necessary for sustainable growth, then this should be factored into the assessment of employer affordability and thus covenant. This is particularly relevant as schemes are typically unsecured creditors and rank ahead of ordinary shareholders and, also, they are not 'willing' investors (as opposed to shareholders who may have invested in a business with the expectation of future returns).

124. The pros and cons of this approach include those highlighted in Table 3 below:

Pros	Cons
☑ Greater objectivity and accuracy: ensures TPs are set at a level that is directly and demonstrably commensurate with the covenant strength. ☑ Greater consistency and comparability across schemes (for example, the ratio of RACF-to-deficit could be directly compared for two different schemes). ☑ Clearer supportability of risk being taken, given the more direct link with employer's affordability. ☑ More clearly defined link between cash flows and deficit size could enable a greater number of covenant grade categories (or even a continuum).	☒ Difficult for trustees to reach a view on RACF if employers do not generate sufficiently detailed or medium-term cash flow forecasts (ie a one-year cash flow forecast may be insufficient for trustees to form a reliable view on RACF levels over the period their scheme needs funding). ☒ More detailed forecasts could potentially be generated by the employer. Although there could be an associated cost, this may be appropriate given the employer could benefit from this work if it resulted in a stronger level of covenant and a lower funding deficit. However, if these forecasts were only generated for valuation purposes, they could be insufficiently robust (eg could be tailored to obtain the desired result in terms of scheme funding and may not truly represent the likely performance of the business). ☒ Difficult to clearly define a reasonable or appropriate level of affordability in a way that could be used readily and consistently by trustees. ☒ The vast differences between business sectors means that necessary capital expenditure for one business may be unnecessary for another. Determining whether expenditure is essential can be extremely challenging and potentially beyond trustee capabilities, therefore requiring professional advice (at a cost) which may not be otherwise needed. ☒ We would have no way to readily assess the level of RACF without seeking recourse to the information used by trustees and the employer. This would potentially be very time-consuming and not a proportionate use of our resources in respect of most schemes.

Option 2: Holistic approach

125. In most cases, if trustees have followed our guidance, we are likely to agree with their assessment of covenant. However, the current principle-based approach can sometimes result in inaccurate assessments and, in rare cases, misuse. Our more contentious funding cases often involve challenging trustees' (and/or the employer's) assessment of covenant strength, particularly where our guidance has not been followed. Therefore, if we retain the existing approach, we would seek to tighten and clarify our guidance in the following areas:

Cash affordability

126. We would continue to set an expectation that trustees place a strong focus on the cash affordability of their employer, and that where affordability is constrained, reliance on balance sheet strength should be limited to what the scheme can reasonably expect to access (either by security or another method). This is discussed further in Chapter 14, which covers additional support in Bespoke arrangements.

Consideration of the covenant-independent funding position

127. We would set an explicit expectation that trustees consider (and base their assessment of employer covenant on) the scheme's low dependency funding level, both on a 'business as usual' basis and in a stressed situation (eg by considering the level of investment risk being run by the scheme).

Reliance on indirect covenant

128. Current practice is that trustees can consider wider group support (or ‘indirect’ covenant) when assessing the covenant of the statutory employer. Our current code acknowledges this position[23].

129. However, we have seen cases where trustees have placed too much reliance on the wider group. We consider that over-reliance on support that is not legally binding, and/or which provides no commensurate improvement in financial support, exposes a scheme to increased and potentially unsupportable risks.

130. We acknowledge current practice and suggest that wider group support should continue to be integrated into the covenant assessment of the statutory employer. However, trustees should recognise that indirect employer support is not in the control of the trustees and can be removed without notice. Reliance upon this should therefore be limited to the short term (for example: one or two years or, at most, the period to the next valuation). This is in line with our most recent guidance on assessing employer covenant.

131. In developing Fast Track, we propose to recognise that trustees’ covenant assessment may have considered short-term reliance on wider group support.

132. We would expect any reliance on other entities beyond this time to be underpinned by some form of legal recourse that is directly enforceable by the trustees such as a guarantee or security over assets. These arrangements may vary in nature and scope and we propose that they are reflected in a Bespoke funding arrangement (see Part 4 for how this could work in practice).

133. Furthermore, we consider that where reliance is placed on indirect covenant, there should be a corresponding clear and tangible benefit to the scheme, such as increased DRCs and a shortened RP, over and above what could be achieved solely from the employer’s own resources. In our view, if there is no tangible benefit to a scheme from the indirect covenant, then trustees should not factor this into their assessment.

Covenant visibility

134. We propose to place more focus on covenant visibility. As discussed in Chapters 5 (General principles) and 9 (TPs), we consider that in most cases, a sensible trustee should place a reducing level of reliance on the direct employer covenant beyond the period for which there is good visibility (subject to a new assessment at each valuation).

135. For most schemes, practical considerations may limit covenant visibility to the medium term (which we typically consider to be three to five years). In Fast Track, we propose to integrate medium-term covenant visibility into TPs. To the extent that trustees want to place full reliance on employer covenant beyond this typical period, we would expect such reliance to be justified under the Bespoke framework with trustees’ analysis.

- This may be with reference to an employer having legally underpinned cash flows or income for a longer period (eg long-term contracts or a rolling government licence giving greater certainty until the end of a regulatory period). However, trustees should also consider the counter-party risk associated with any such cash flows, and how this could increase over time.
- Alternatively, trustees may suggest (with evidence) that their scheme has such a small low dependency deficit (as compared with the current size of their employer) that even if their employer suffered significant trading stress, it would remain well able to support the relatively small scheme (even if its deficit were to increase significantly) and so assume a strong covenant beyond the medium term.

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[23] Paragraphs 72-74 of Code of Practice Funding Defined Benefits.

Deficit to financial strength

136. We could provide guidance on the level of financial strength that indicates differing covenant grades. We could issue guidance on the ratio of employer cash flows to the scheme's low dependency deficit, which might indicate a particular covenant grade rating. This is like the formulaic approach suggested above but would be guidance only, as opposed to an explicit 'hurdle' to be passed for a certain covenant grade rating to be attributed. Trustees would still be expected to take account of all other factors relevant to their covenant.

Stress testing

137. We would reiterate our expectation that trustees consider stress testing (both on the employer and the scheme) to ensure that they understand how support for their scheme could be affected in downside scenarios. This would include considering the covenant strength in the event that both employer and scheme became stressed, as well as assessing how such events may be correlated (for instance, how likely it is that employer trade could deteriorate at the same time as scheme funding declines).

Worked examples

138. We are often told that worked examples are helpful. We would therefore review and add to the examples of what we see as acceptable and unacceptable of covenant assessments in our current guidance.

Unusual employers

139. We would build on our existing guidance about how covenant assessments (and valuations in general) should be carried out for differing types of schemes or employers. This could include multi-employer schemes (both associated and non-associated) and schemes sponsored by not-for-profit employers.

Comparison of covenant assessment methods

140. The pros and cons of retaining a more holistic approach to assessing covenant include those highlighted in Table 4 below:

Pros	**Cons**
☑ Avoids the difficulties of applying a one-size-fits-all approach and instead allows flexibility for the trustees (and advisers) to consider all factors and characteristics of the employer and scheme in reaching a more balanced conclusion. ☑ Close to current practices (and our historical guidance) and therefore easily adopted by trustees.	☒ Open to inaccurate or inconsistent assessments or (in certain cases) gaming, leading to inaccurate assessment of TPs and inappropriate risk taking. However, the enhancements proposed above (as well as those around RP structure discussed in Chapter 11) should mitigate these risks to some extent.

Independent covenant advice

141. As stated in our existing guidance, we do not expect trustees to seek independent covenant advice in all situations. We recognise that, in many cases, trustees can and do assess covenant strength themselves and this is often appropriate, provided they take account of all relevant guidance in doing so.

142. There are situations where trustees choose not to assess employer covenant, since they set strong TPs which place no reliance on covenant. This too can be appropriate, although we would still expect those trustees to have considered the affordability of any resultant funding deficit, and the implicit fairness of how the scheme is treated compared to other stakeholders (eg equitability).

► Questions

Q4 Covenant assessment

a. Should a holistic approach to assessing employer covenant be retained (but with further guidance to assist trustees), or should we seek to define a more prescribed, formulaic approach?

b. If the former (holistic approach), what amendments/clarifications to our existing guidance on covenant do you consider may be necessary? Do you agree with the ones suggested above? Is the structure and content of our existing employer covenant guidance helpful and accessible to trustees? If not, what would make it better?

c. If the latter (formulaic approach), what do you think of the proposed RACF approach? How would you propose that covenant could be explicitly defined in a clear, consistent and measurable manner? What other metric(s) may be appropriate?

d. Alternatively, would it be appropriate to require employer covenant to be assessed in a prescribed (formulaic) way for Fast Track purposes, and only allow for a more holistic approach under the Bespoke framework?

Q5 Reliance on indirect covenant – Do you think that the strength of the wider commercial group should be factored into the sponsoring employer's assessment? If so, how, and to what degree?

Grading the covenant

143. Whatever method we use to assess the covenant, we need to be able to segment the landscape (for instance to set Fast Track guidelines in the code, which vary by covenant strength) or to assess whether valuations submitted to us are compliant.

144. We currently use four covenant grade ratings (CG1-4), which we think we should retain. However, we recognise there could be valid reasons for a greater number of ratings, for instance to provide greater differentiation between schemes that fall within the same (but perhaps fairly broad) covenant grade.

145. We are also mindful that there are a handful of schemes that do not have a sponsoring employer with any business assets (and who could potentially be referred to as 'CG5'). These are sometimes also referred to as SWOSSs (schemes without a substantive sponsor). Other emerging structures include DB superfunds. We will address how SWOSSs and DB superfunds should be covered in the funding code during our second consultation.

146. Regardless of how many covenant grade ratings we use in the code and regulatory approach, this does not prevent advisers and trustees from using a different scale when assessing the covenant, although we would expect any such assessment to be converted to our scale to report to us. We anticipate this would be reasonably straightforward.

147. However many covenant grade ratings we use (eg four or more), it is important to clarify the intended use and inherent limitations of these bands. We think covenant grade ratings provide a useful benchmark for schemes and act as a broad guide to the level of risk they can take. However, the allocation of a covenant grade rating does not provide all the answers for a scheme, particularly in terms of the trustees' approach to investment and funding strategies. There are many scheme-specific factors that trustees should take into account when considering how to manage their scheme, including employer covenant specifics (visibility, employer investment plans), scheme maturity and potentially many others.

► Questions

Q6 Covenant grades

a. Should we use a greater range of covenant grades to set guidelines in the code and assess schemes and, if so, what would be an appropriate number of grades?

b. Would there be sufficiently different characteristics between a greater number of grades, such that a set of trustees could reasonably and reliably assess covenant strength without requiring professional advice?

Understanding the rest of this document

148. This chapter has raised several fundamental concepts on which we welcome feedback. However, in order to draft the rest of this document, we have made the following assumptions:

- Employer insolvency risk will remain to some degree.
- The employer covenant will be reflected in scheme funding.
- In Fast Track, we propose that covenant strength should underpin the assumed level of risk in the TPs.
- We will retain a holistic approach to assessing the covenant (with further clarifications as set out above. These expectations would feature both in the Fast Track and Bespoke approaches.
- In setting guidelines in the code, we will retain our four covenant grades.

149. These assumptions will be reviewed in light of consultation responses.

5. General principles

150. We have developed some core principles, which we propose should underpin the DB funding code. These principles will supplement primary and secondary legislative requirements and describe how we consider the legislative framework should work in practice.

151. We will develop the Fast Track framework (see Part 3 for proposals) in accordance with these principles, with the expectation that they will also guide the scheme funding work undertaken by trustees, employers and professional advisers under the Bespoke approach (see Part 4). The principles will also underpin any potential enforcement action we take.

152. In this chapter, we discuss the rationale for each proposed principle. There is an element of repetition, but this is deliberate as we have attempted to develop a set of principles that work together and are consistent with each other.

153. For each principle, we have highlighted the most relevant existing and prospective legislative requirements as currently known[24]. The final legislative package is yet to be finalised as the Pension Schemes Bill is subject to Parliamentary scrutiny and DWP also intends to amend regulations. Some of the principles under consultation may be formalised in regulations. For these reasons, this set of principles may be framed differently in the draft funding code, which will be the subject of our second consultation.

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[24] Schedule 10 of the Pension Schemes Bill contains amendments to the existing provisions of Part 3 of the Act. The (as at 3 March 2019) are highlighted in italics.

Demonstrating compliance and objective risk- taking

PRINCIPLE	**Legislative requirements** ★ Trustees must prepare a written statement of strategy of the scheme's funding and investment strategy (described in this document as the LTO) and supplementary matters. ★ These include the extent to which the strategy is being successfully implemented and steps to remedy the position, and the main risks in implementing the strategy and how trustees intend to mitigate or manage them. ★ The Pension Schemes Bill also includes provisions allowing the Secretary of State to prescribe the matters trustees should take into account and the principles they should follow when preparing/revising the supplementary matters in the statement of strategy, the level of detail required, the form of the statement of strategy, and submission to us[25]. **TPR code principle** ★ We expect 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 (ie 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.

Rationale

154. The Pension Schemes Bill introduces a requirement for trustees to prepare a statement of strategy setting out their funding and investment strategy (LTO) and how they propose to manage/mitigate risks to achieving it.

155. DWP intends to make provisions in regulations on the level of detail the statement should contain, what form it should take, and requirements regarding submission to us. The intention, as set out in the DB white paper, is to improve transparency and accountability around how trustees manage risks to their scheme's funding and investments, and place greater onus on them to articulate their position and demonstrate compliance. The proposed principle builds on this aim. It is also consistent with our proposal in Chapter 3 (Proposed regulatory approach) to provide greater regulatory clarity on what 'good looks like' in the context of the scheme-specific funding regime created by Part 3 of the Act by establishing a twin-track approach to demonstrating compliance (Fast Track versus Bespoke approach).

Proposal

156. In practice, we expect the following:

- The statement of strategy would be a straightforward submission from trustees if they follow Fast Track and would include some basic information on their valuation and approach to risk management,

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[25] As set out in the Pension Schemes Bill's Explanatory Notes (https://publications.parliament.uk/pa/bills/lbill/58-01/004/5801004en.pdf) and Delegated Powers Memorandum (https://publications.parliament.uk/pa/bills/lbill/58-01/004/5801004-DPM.pdf), this power can be used to ensure the statement contains information that is relevant to support our enforcement functions.

including how they assessed the employer covenant (see Chapter 4) and investment risk (see Chapter 10).

- If adopting a Bespoke approach, the statement of strategy would fully articulate their funding arrangements with an explanation to evidence objectively how and why the trustees have moved away from Fast Track guidelines that represent a position of tolerated risk, and how they believe the additional risks are managed, ie supported, mitigated or assessed as remote or having a minimal impact.

Long-term objective (LTO)

PRINCIPLE	**Legislative requirements** ★ Trustees must determine a funding and investment strategy (described as LTO in this document) for ensuring that pension and other benefits can be provided over the long term. ★ The strategy must specify the funding level the trustees intend the scheme to have achieved and the investments the trustees intend the scheme to hold on the relevant date(s).[26] ★ The Pension Schemes Bill also includes provisions[27] which will allow the Secretary of State to prescribe the matters trustees should take into account and the principles they should follow when determining the scheme's funding and investment strategy. This includes requiring trustees to adopt prescribed actuarial methods or assumptions when specifying a funding level. **TPR code principle** ★ By the time they are (i) significantly mature, we expect schemes to (ii) have a low level of dependency on the employer and (iii) be invested with high resilience to risk[28].

Rationale

157. The Pension Schemes Bill introduces a requirement for trustees to determine a funding and investment strategy (referred to as LTO in this consultation document) which is specific in terms of its funding basis, investment profile and timing. As outlined in the DB white paper, setting a clear LTO for their scheme should help trustees better manage the covenant, funding and investment risks to the delivery of full benefits to members. It also provides a meaningful framework for trustees' long-term decision-making.

158. Journey planning towards a long-term destination is particularly important as most DB pension schemes are maturing and reaching their 'end game' as a result (ie nearing a time in the future when the scheme's assets are rapidly reducing due to the benefits being paid out). This drift towards the end game has accelerated with the significant trend in DB scheme closures in recent years. Our data shows that 89% of DB schemes are closed to new members and, in around half of those schemes, there are no longer any active members accruing new DB benefits (see Chapter 16 on Evidence and Analysis).

159. A scheme's ability to close a funding gap from investment outperformance reduces with increasing maturity and, therefore, trustees should aim for the scheme to be fully funded on a strong target by the time it becomes significantly mature.

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[26] Schedule 10 of the Bill introduces a new section 221A to the Act

[27] As set out in the Explanatory Notes and Delegated Powers Memorandum, this may, for instance, include information about the maturity of the scheme, whether it is open or closed, or the strength of the employer.

[28] All these terms (low dependency, significant maturity and high resilience to risk) are explained in the subsections below.

160. As schemes mature, more pensioners receive benefits and it becomes likely that schemes will pay out more money in benefits and expenses than they will receive from investments and contributions ('cash flow negative'). If a scheme is underfunded at this stage and its asset base reduces at a proportionately higher rate than its liabilities, the remaining assets must produce increased returns to close what is now a proportionately bigger deficit. However, because the scheme is mature, there is less time to capture the long-term outperformance from growth assets.

161. Investment volatility becomes a material risk if trustees continue to invest in growth assets when the scheme is cash flow negative This is because they run an increased risk of having to sell assets in falling markets to meet their benefit payments. This could in turn create significant contribution requests on the sponsoring employer to return to full funding. For a scheme of typical maturity, the time at which they are significantly mature is many years in the future when the ability of the employer to fund the scheme is much less certain. It is therefore prudent for the trustees to plan to have reduced dependency on the employer over the long term.

162. Schemes could be smaller and more manageable (relative to a stable employer) by the time they are significantly mature. However, this depends on whether the employer covenant and ability to support the scheme has remained as strong. It is unlikely that trustees can predict the covenant strength long into the future, and it would be imprudent to rely on the covenant remaining the same.

Proposal

163. There are various suitable LTOs that maturing schemes could aim to achieve, as seen in the examples given in the DB white paper (see paragraph 31). Broadly, these fall into two categories:

- Funding-based LTOs where the scheme reaches a 'low dependency' funding basis and pays out benefits while continuing to be sponsored by its employer(s). Low dependency means that funding and investment strategies are such that there is a low chance of requiring further employer support and, to the extent that such support is required, it is low relative to the size of the scheme.
- Transaction-based LTOs where the scheme effectively severs the link to its sponsoring employer(s). This includes buy-out and entry into a consolidation vehicle (DB superfund).

164. We propose that, by the time they are significantly mature, schemes should reach a funding-based LTO at least consistent with achieving low dependency from the employer and an investment strategy highly resilient to risk from that point. This principle should apply to all schemes, including those still open to new members and/or future accrual. In practice these schemes will take a long time to reach significant maturity or are not expected to mature at all. As long as they remain immature, they will continue to run on with employer support and will be able to assume and take more investment risk like all immature schemes. The principle further below considers in more detail how open schemes fit into the framework and we set out our proposals regarding Fast Track guidelines for open schemes in Chapter 11.

Why do we propose low dependency funding at the LTO?

165. Our view is that we should not require schemes to fund on the assumption that they will buy out or enter a consolidation vehicle, as these are trustee/employer decisions and these LTO outcomes may require a higher funding level than low dependency. In addition, the cost of buying out scheme liabilities or entering a consolidation vehicle will be driven by market forces and, particularly, the level of supply and demand in the market.

166. Getting DB schemes to reach a low dependency LTO as they become significantly mature would provide DB schemes with a good platform from which to pursue specific end-game strategies of trustees' or the employer's choice. For example, buying out or buying in benefits, entering a consolidator, or continuing to run on a low-risk basis.

167. We prefer the term 'low dependency' to the frequently-used 'self-sufficiency'. We think this better reflects the fact that, even at a strong level of funding, consistent with a low discount rate, a scheme is still exposed to a small amount of risk and is therefore not entirely self-sufficient. To achieve true self-sufficiency, a scheme arguably needs to hold significant additional reserves on top of being fully funded on a low dependency basis and, even then, is subject to the insolvency risk of the employer, which will usually cause the scheme to wind up.

Why do we think scheme funding should reach low dependency by significant maturity?

168. There are other possible timescales for reaching the LTO (as set out below). We do not think that setting an arbitrary, fixed timeframe for all schemes regardless of their maturity is appropriate in a scheme-specific funding regime and to do so could be disproportionately unfair for very immature schemes. We also consider that a covenant-based timeframe would be too short-term because of the limited period of covenant visibility for most sponsoring employers.

169. We consider that linking low dependency with scheme maturity fits with the goal of improving the resilience of schemes entering the final phase of their life cycle. This resilience is to the risks of future downside market events and/or potential future deterioration of the support provided by the sponsoring employer at a time where schemes are least likely to be able to cope with these events.

170. Table 5 below sets out the pros and cons of the different options for the timing of the LTO:

Arbitrary timeframe	Based on covenant horizon	Based on scheme maturity
☑ If the period is relatively short, provides better protection for members' accrued benefits.	☑ Would ensure a scheme achieves full funding on a low dependency basis before reasonable covenant visibility reduces materially.	☑ Clear and objective (difficult to game).
☑ Easier to regulate and take action.	☒ Differences in employer covenants could make it less easy to regulate and take action.	☑ Scheme-specific and links to when schemes should have reduced volatility risk.
☒ Not scheme-specific.	☒ Could place considerable financial demands on employers and, for many schemes, may be overly prudent.	☑ Easier to regulate and take action.
☒ If the period is relatively short, potential immediate and large impact on whole landscape (costly to employers).	☒ Fluctuations in covenant horizon (an increase or decrease in longer term visibility driven by, eg gain or loss of committed contracts, regulatory changes, technological developments) could undermine the desire for a steady journey plan to low dependency.	☒ May allow too much time compared to the de-risking plans many schemes already have in place, leading to a levelling down of current plans. ☒ Increased covenant risk driven by extended period of reliance on employer support (beyond the covenant horizon).

Why do we expect a high resilience to investment risk by significant maturity?

171. By a 'high resilience to investment risk' we mean adopting an investment strategy that ensures only a small funding deficit emerges (on a low dependency basis) if market conditions change materially. Such a strategy is likely to include a significant proportion of assets which broadly match the liabilities and a low proportion of growth-seeking assets that have a high level of short-term volatility in their value.

172. By having a high resilience to investment risk, the trustees will ensure they are limiting their reliance on the employer to fund any future emerging deficits. This is consistent with the principle of low dependency on the employer in the period after reaching a funding position in line with the LTO.

173. Chapter 8 on the LTO sets out in more detail our Fast Track proposals for a low dependency long-term funding target (level and timing) and also considers what expectations the code should set out in relation to other actuarial assumptions and what trustees should do once they have reached their proposed LTO. Chapter 10 considers the Fast Track investment strategy associated with the LTO and along the journey in greater detail.

► Questions

Q7 **Low dependency 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?

Q8 **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?

Q9 **High resilience to risk at the LTO** – Do you think that the investment portfolio should be highly resilient to risk when schemes reach their LTO? If not, what do you suggest?

Journey plan and technical provisions (TPs)

PRINCIPLE	**Legislative requirements** ★ Every scheme must have sufficient and appropriate assets to cover its TPs (SFO)[29]. ★ When calculating TPs, trustees must choose economic, actuarial and demographic assumptions prudently[30]. ★ TPs must be calculated in a way that is consistent with the scheme's funding and investment strategy (LTO)[31]. **TPR code principle** ★ We expect trustees to develop a journey plan to achieve their LTO. ★ We expect 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 to converge to the LTO as evidenced by the journey plan.

Rationale

Why a journey plan?

174. Legislation currently requires schemes to be fully funded on an ongoing basis (SFO) and will require TPs to be consistent with the LTO (Bill). Trustees will also be required to have a written statement of strategy containing their assessment of whether the LTO is being successfully implemented, any remedial action to get back on course and how key risks to implementation would be managed.

175. In line with this, we consider that once the trustees have set a LTO for the scheme, the next step is to develop a journey plan to get there. They can do this by identifying the gap between the scheme's current level of funding and that implicit in the LTO, and setting a plan, over a suitable period, to close the gap

[29] Section 221(1) of the Act.

[30] Regulation 5(4) of the Occupational Pension Schemes (scheme Funding) Regulations 2005 (3377).

[31] Schedule 10 of the Bill introduces a new section 222(2A) to the Act.

through timely and affordable contributions and appropriate risk-taking. They should use TPs at successive valuations as staging posts or steps on this journey towards achieving the LTO.

176. Setting a journey plan also requires trustees to be aware of the risks that may throw the journey plan off-course and prevent the scheme from achieving its LTO. Trustees should therefore identify, evaluate and put plans in place to manage those risks. Each scheme will have its own set of risks to manage along its journey to the LTO, but they should fall into two broad categories:

- Scheme risks – including the risk that investments do not provide the returns expected, inflation is higher than expected, mortality rates are materially lower than anticipated, scheme experience is materially different to that assumed, and the scheme's expenses are materially higher than expected.
- Employer risks – including the risk that the strength of covenant afforded to the scheme deteriorates over time (or, in extreme scenarios, disappears due to the employer becoming insolvent at some point on the journey). As a result, the employer cannot provide the cash or other support to the scheme when it is needed.

177. Trustees should have in place processes and systems to regularly monitor these risks and take corrective action to put them back on course as necessary. In the interest of good governance, and for their own risk management purposes, they should record why they consider any actions taken (or not taken) as being consistent with having put the scheme back on course to achieve its LTO.

178. We consider that a journey plan set in this manner, and monitored regularly against evolving experience, will substantially improve the chances of the scheme achieving its LTO. It should help the trustees evidence that their TPs have been set properly, that their funding and investment strategies are aligned for successful delivery of the LTO and that the key risks along the way are being managed.

Why plan to de-risk investments as a scheme approaches significant maturity?

179. We expect low dependency funding and an investment strategy with a high resilience to risk when a scheme is significantly mature. So, it would be sensible for trustees to plan for the assumed level of investment risks to decrease over time as the scheme matures. This would ensure the scheme moves towards low dependency funding and an investment strategy with an appropriate level of risk at significant maturity. Trustees could choose to de-risk sooner.

How should the TPs be consistent with the LTO?

180. TPs define the level of funding a scheme needs to achieve at each point in its lifespan. To achieve a low dependency level of funding by the time a scheme reaches significant maturity, TPs should tend towards low dependency as the scheme matures. The TPs will in effect become milestones along the journey to the LTO. If there is no link between TPs and the LTO, there is no journey plan to reach the LTO.

Proposal

181. We would expect trustees to set TPs that follow their journey plan to low dependency funding. By doing so, the TPs become milestones along the journey to achieving the LTO. If, during the journey to the LTO, there is a deficit measured against TPs, a RP should be put in place to return the scheme to the journey plan path.

182. In Chapter 9 on Fast Track journey planning and TPs, we will set out options for the shape and key drivers of the journey plan and de-risking approach and outline our proposals for the parameters we could define in Fast Track. We will also set out examples in the Bespoke framework of how trustees could take additional risk on the journey to the LTO, provided it is managed appropriately.

► Questions

Q10 **Risk-taking for immature schemes** – Is it reasonable for less mature schemes, which would have more time to reach low dependency funding, to assume and take relatively more investment risk than a mature scheme?

Q11 Journey planning – What are your views of the rationale above for the journey plan? Do you think there is a better way for trustees to evidence that their TPs have been set consistently with the LTO?

Scheme investments

PRINCIPLE	**Legislative requirements** ★ The powers of investment, or the discretion, must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole. ★ Assets held to cover the scheme's TPs must also be invested in a manner appropriate to the nature and duration of the expected future retirement benefits payable under the scheme.[32] **TPR code principle** ★ The actual investment strategy and asset allocation over time should be broadly aligned with the scheme's funding strategy (TPs and RP). ★ 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. ★ We expect the asset allocation at significant maturity to have high resilience to risk, a high level of liquidity and a high average credit quality.

Rationale

183. To fund future member benefits, a DB scheme typically relies on a combination of contributions and expected future investment returns on the existing level of assets. Achieving a sensible balance between these two is critical if a funding strategy is to be robust.

184. We have outlined approaches for setting the LTO and TPs based on key factors such as maturity and covenant. However, these depend on the *assumed* level of current and future investment strategy and not trustees' actual asset allocation.

185. We also need to consider the *actual* investment strategy. We have seen instances of trustees submitting funding solutions based on prudent TPs and with an appropriate RP, but where the scheme is carrying a high level of investment risk which clearly cannot be supported. We do not think that this is consistent with the legislative requirement to invest in a manner appropriate to the nature and duration of the expected future retirement benefits. Correspondingly, if trustees were to reflect the actual level of investment risk in the TPs, the employer would be required to support it if there was an ongoing deficit.

186. The assets' primary function is to pay the benefits when they fall due. Therefore, the ability of an investment strategy to deliver this depends on its security, quality and liquidity.

Proposal

187. We do not consider that our role is to direct how trustees should choose to invest in terms of different asset classes. But we do think that actual investment risk and assumed risk underlying the TPs should be broadly aligned and that any excess actual investment risk should be measured and supported. To the extent that the actual investment risk is not supported, we would expect the trustees to take steps to reduce the level of risk.

188. It is important that a scheme's assets are sufficiently liquid to meet predictable cash flows (for example, pensions in payments) as well as unpredictable cash flows (for example, transfers out). A scheme with a

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[32] Regulations 4(3) and 4(4) of the Occupational Pension Schemes (Investment) Regulations 2005.

high level of growth assets may be forced to sell assets at depressed prices if cash flow demands coincide with a downside investment event. Therefore, we consider that a sufficiently high level of liquidity is important, especially when a scheme is mature.

189. Many pension schemes have increased their allocation to bonds over the last decade to reduce the volatility of their funding level. However, not all bonds are of the same level of quality. Pension schemes' bond investment typically consists of a combination of government bonds (fixed and inflation linked) as well as corporate bonds. The price of both types of bonds will be affected by a change in the general level of government bond yields in the market. The price of a corporate bond will also be affected by any change in the assessment of the likelihood of receiving future coupons/principal payments, as well as any recovery in the event of default. A lower quality bond will typically have greater volatility and lower liquidity than high quality bonds of similar duration. Therefore, we consider that the underlying quality of the assets is important, and scheme's portfolios should carry a high average credit quality.

190. In Chapter 11 on Fast Track investment guidelines, we will consider how trustees can assess and demonstrate whether the level of investment risk they are taking is appropriate and their investment allocation is of sufficient liquidity and quality, particularly in relation the maturity of their scheme.

► Questions

Q12 **Relevance of investments for funding** – Do you agree that the actual investments and investment strategy are a relevant factor for scheme funding?

Q13 **Broad consistency between investment and funding strategy**

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 TPs), should trustees have to demonstrate that the investment risk taken can be managed appropriately? If not, why not and what would you suggest?

Q14 **Liquidity and quality at maturity** – Do you think that security, quality, and liquidity become more important as a scheme becomes significantly mature? In particular, do you think that the scheme's asset allocation at significant maturity should have a high level of liquidity and a high average credit quality?

Reliance on the employer covenant and covenant visibility

PRINCIPLE	★ 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.

Rationale

191. In Chapter 4, we asked for views on the role of the covenant and where and how it should feature in the funding framework, particularly in Fast Track. We said there was a good argument to retain the current approach (covenant underwriting risk in the TPs and qualitative assessment of covenant). The Fast Track options set out in subsequent chapters have been developed on that basis to illustrate how Fast Track could work.

Proposal

192. We do not contest that trustees of schemes with stronger employer covenants can afford to take more risk and so assume higher investment returns. However, we think it is inappropriate to assume indefinite reliance on the covenant and we propose that this should be limited to the period over which there is good covenant visibility. For most schemes, practical considerations will limit visibility to three to five years (and sometimes less).

193. We consider that a prudent trustee should not assume that the employer covenant remains undiminished beyond the period over which they (and employer management) have reasonable visibility. We would therefore expect trustees to place a reducing level of reliance on the employer covenant (and its ability to support investment risk) in the longer term, ie they should assume a lower level of investment risk after the initial period of visibility which is reflected in the calculation of TPs.

194. We are not suggesting that the employer covenant will weaken in the longer term but, given the scheme's trustees have no certainty that it will not, it would be prudent to reduce reliance in the longer term. This is particularly relevant given employer covenant strength can reduce relatively quickly (or, in extreme examples, can rapidly disappear).

195. By the time of the next valuation, trustees would have a renewed visibility over their employer's future strength (ie potentially covering three to five years from the point of that valuation) and could reflect this updated horizon in the funding calculations at that time. In practice this would mean either of the following:

- The covenant is of a similar strength as at the previous valuation. This means that, all other things being equal, the TPs at this valuation can be set at a lower level than expected and lower DRCs will be required in future.
- The strength of the covenant has deteriorated. However, because the trustees planned (to some degree) for such a covenant deterioration at the original valuation, the scheme received higher DRCs during the period when these were affordable, therefore reducing the deficit which now needs to be funded by an employer which is now less able to do so.

196. If an employer is likely to continue to exist in the longer term, this does not mean the covenant strength will remain undiminished over the same period. This could only be assumed if the trustees could evidence they are certain the current level of financial strength (relative to the scheme's funding level) would also remain undiminished over such an extended period.

197. To the extent that this principle around covenant visibility is appropriate, we consider how this should be reflected within a scheme's Fast Track TPs in Chapter 9. In Part 4, we provide examples of Bespoke scenarios where the trustees have assumed covenant visibility which goes beyond what we would have

198. assumed in our Fast Track guidelines and parameters.

► Questions

Q15 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?

Reliance on additional support

PRINCIPLE	★ 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 (iii) is legally enforceable and realisable at its necessary value when required.

Rationale

199. Although we consider cash funding of the scheme to be the primary form of support for the scheme, additional support (such as contingent assets or group guarantees) can be an important tool for trustees and employers to navigate funding challenges, and we recognise the value these can provide to underpin risks being borne by schemes.

200. We are keen that these remain a central part of funding solutions, for instance to support long RPs (particularly where shorter ones are unaffordable) or risk-taking in the investments or TPs – particularly if the employer covenant is not otherwise able to support these risks.

Proposal

201. It is important that additional support can be converted into tangible support when needed, without otherwise causing detriment to the employer covenant supporting the scheme. In Chapter 14, we consult on our proposals for how additional support can be used by schemes in Bespoke, and what trustees should consider in respect of this support.

► Question

Q16 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 valued when required?

Appropriate recovery plan

PRINCIPLE	**Legislative requirements** ★ RPs must comply with any prescribed requirements and must be appropriate having regard to the nature and circumstances of the scheme[33]. ★ The Pension Schemes Bill also includes provisions allowing the Secretary of State to prescribe the matters to be taken into account or the principles to be followed in determining whether a RP is appropriate[34]. **TPR code principle** ★ TP deficits should be recovered as soon as affordability allows while minimising any adverse impact on the sustainable growth of the employer.

Rationale

202. The requirement to be fully funded on a TPs basis (the SFO) is a fundamental principle of the Act[35]. Our view is that it is reasonable to ensure that the employer agrees to a RP that returns the scheme to the SFO as soon as affordability allows. This includes considerations about minimising adverse impacts on the sustainable growth of the employer. Pensions are deferred pay[36] and we do not consider it is appropriate for members' benefits to be used as credit for the employer.

203. RPs should be a temporary measure to get the scheme back to full funding if and when a deficit emerges. However, over time this simple view of the RP has been eroded to include behaviours which we consider could place inappropriate risk on the scheme, particularly when considered cumulatively, and which need to be addressed. These include:

[33] Section 226(3) of the Act.

[34] As set out in the Explanatory Notes and Delegated Powers Memorandum, this is to clarify what is meant by 'appropriate'. This may include matters such as the length of time taken by trustees to meet the SFO, taking into account whether the employer can afford to pay more into the scheme.

[35] Section 221(1) of the Act.

[36] Pensions are considered pay as per the Barber judgment in May 1990 - https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1581004151103&uri=CELEX:61988CJ0262.

- Certain trustees and/or sponsoring employers asserting that because the employer covenant has been assessed as strong, they are exempt from targeting compliance with the SFO.
- RPs being structured in a way that minimises contributions being paid by the sponsoring employer by placing additional reliance on the assumptions regarding investment returns. This can manifest itself as one or both of the following:
  (a) Removing some of the prudence assumed in the TPs by allowing asset outperformance in the RP. The longer the RP, the more this has an effect.
  (b) Back-end loading the RP, and in doing so pushing the bulk of the contributions beyond the date of the next valuation.
- Some trustees of schemes with strong employer covenants have agreed very long RPs, where the employer could easily support a much shorter (and therefore less risky) RP. This results in the covenant being effectively double-counted, from the assumption of less prudent TPs and the payment of lower DRCs for a longer period.
- Some employers often claim to provide a strong covenant but also claim a need to divert cash flows to other stakeholders (in the form of shareholder dividends, for example). In such a case, we would expect the trustees' view on covenant strength to reflect the lower level of residual cash flows after payments to other stakeholders.

Proposal

204. To mitigate these observed behaviours, we aim to provide greater clarity on what we consider to be appropriate RPs in the revised code. We propose, as a key principle, that deficits should be recovered as soon as affordability allows, while minimising any adverse impact on the sustainable growth of the employer.

205. In practice, this does not mean that we necessarily expect deficits to be recovered immediately (for example via a single lump-sum payment) even if this is affordable. As we explain in Chapter 11 on RPs, we consider that where affordable, RPs should be broadly limited to the period for which there is good visibility over employer covenant strength. Our proposal is to set out some limits on RP length for Fast Track compliance accordingly. This is in recognition that, for practical reasons, it is reasonable to allow a short period (eg between one or two valuation cycles) over which deficits can be rectified by strong employers with good affordability. This is to:

- allow investment returns time to come through and avoid unnecessary funding upfront which would prove not to be required
- allow (to some degree) for short-term volatility in funding levels which could be expected if the scheme is invested in growth-seeking assets, and
- give the employer some breathing space and scope to plan repayments in an efficient way in view of the competing demands on its cash.

206. When affordability is genuinely constrained, RPs may need to be longer, but constraints would need to be clearly justified and, where possible, supported. For instance, a longer RP could be supported with an appropriate contingent asset to underpin the additional risk being run by the scheme). Any such requirement should also be aligned with requirements to minimise unnecessary value leakage to other stakeholders in preference to the scheme.

207. This principle is consistent with the first principle above (and discussed in Chapter 3) of starting with the lowest or tolerated risk position, of restoring the scheme to full funding immediately at all times, and evidencing any deviation from this position (affordability, sustainable growth).

208. Chapter 11 sets out our proposals for Fast Track guidelines for appropriate RPs, including length and structure.

► Questions

Q17 Appropriateness of RPs and affordability as key factor

a. Should employer affordability be the key factor to determine the appropriateness of a RP? 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 TPs and size of deficits) to have a commensurately shorter RP?

Open schemes

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

Rationale

209. There are many types of different open schemes. For example, there are schemes that closed to new members many years ago and now have a very small proportion of active members still accruing new benefits. These schemes have similar characteristics to those that are closed to new benefit accrual. At the other end of the spectrum, there are schemes still open to new members, who are joining at a sufficient rate such that the scheme is not maturing or only maturing very slowly.

210. We think it is important to ensure that members' accrued benefits are protected to the same degree as in closed schemes. We consider that trustees' focus should be to ensure the security of members' accrued benefits rather than to ensure the provision of future benefits.

Proposal

211. We would expect that in normal circumstances the funding strategy (the level of TPs and the RP) for accrued benefits in an open scheme should be set consistently with that in a closed scheme of the same maturity. Trustees who use different assumptions or a different approach to funding because the scheme is open to future accrual or new members would need to explain why this is appropriate in terms of the employer's plans for staying open and the future covenant strength.

212. Chapter 12 on open schemes sets out our proposals for how the Fast Track approach would apply to open schemes (in relation to past service and future accruals) and Part 4 provides some examples of Bespoke approaches open schemes could take.

213. As time passes, future accrual becomes accrued benefits. So, the contribution rate for future accruals should be sufficient to maintain the funding level of accrued benefits over time, especially if the scheme is not fully funded on a TPs basis. While not a strict legal requirement, we would be concerned if contributions in respect of future accrual were so low that future deficits are expected to emerge. We have therefore developed proposals for dealing with future accrual contributions in Fast Track.

214. We think that it is important for trustees value their cost realistically, although this must be balanced with the need to make sure that the proposed framework does not cause disproportionate and unnecessary cost increases.

► Questions

Q18 **Open schemes, past service** – Should past service have the same level of security, irrespective of whether the scheme is open or closed?

Q19 **Open schemes, future accruals** – Do you think it would be good practice for trustees to ensure that the provision of future accruals does not compromise the security of accrued benefits?

6. Other issues

Scope of the DB code

215. This consultation covers all DB occupational pensions schemes subject to Part 3 funding. We note the following:

Transactions, material detriment and avoidance regime

216. The scope of this consultation is to inform a revised DB funding code, which will set out our view on acceptable funding. Compliance with the funding guidance set out in this code will not override the need for trustees and employers to consider (and take advice on) transactions and their impact on the scheme's funding position separately and put mitigations in place where necessary. For instance, references in this code to value leakage and dividends relate to 'normal' dividends, not material special dividends (see Chapter 11 on RPs for further details).

SWOSSs/DB superfunds

217. A handful of schemes do not have a sponsoring employer with any business assets. These are sometimes also referred to as SWOSSs (schemes without a substantive sponsor). Other emerging models include DB superfunds. We will address how SWOSSs and DB superfunds should be covered in the funding code during our second consultation.

Schemes with unusual employers/benefit structures

218. The Fast Track and Bespoke frameworks set out in this consultation document have been designed to apply to all DB pension schemes in the UK. Every scheme will have individual nuances that make them differ from other schemes, but we consider that the flexibility in the framework should ensure that trustees of most schemes will be able to submit either Fast Track or Bespoke valuations.

219. However, we recognise that some schemes have potentially 'atypical' employer covenants, are supported by employers with atypical business models, or have unusual benefit designs such as:

- multi-employer schemes – both associated and non-associated
- schemes supported by not-for-profit organisations, including charities and public sector
- schemes supported by regulated employers
- schemes with particular legal structures (eg partnerships), and
- schemes with 'unusual' benefit designs (eg automatic annuitisation schemes, cash balance schemes, in-scheme pension purchase schemes).

220. We think all these schemes should be able to fit within our proposed principles and possibly in Fast Track (but if not, in Bespoke). This will, however, require further thinking subject to the more detailed framework being finalised. We will seek views in our second consultation.

Balance of risks and impacts

221. Our statutory objectives remain unchanged. When regulating DB funding, we are required to protect members' benefits and reduce risks to the PPF while minimising any adverse impact on the sustainable growth of employers. This is because a strong, ongoing employer alongside an appropriate funding plan is the best support for a well-governed scheme. The flexibilities in the system, if used properly, greatly increase the likelihood of reaching an appropriate scheme funding outcome that reflects a reasonable balance between the need to pay promised benefits and minimising impacts on employers. This in turn helps the trustees to achieve their key funding objective. We remain of the view that affordability-driven RPs and the use of contingent security are key flexibilities for trustees and employers, and we intend to embed those into the funding framework under consultation.

222. In this document, we are consulting on various options for how we could go about setting clearer guidelines, so we are not yet able to outline what final guidelines will be included in the code. We have sought to illustrate the trade-offs at play for some key elements of the proposed framework (eg LTO) and are seeking views on the merit of the various options being proposed and their possible impacts. The final Fast Track guidelines which will form part of the draft revised code for consultation will be informed by responses to this first consultation. They will also be informed your view of appropriate outcomes, prevailing market conditions, schemes' current positions (there will be a certain degree of 'calibration' to ensure impacts are reasonable) and a full impact assessment. We are looking to embed existing good practice in the revised code and therefore do not envisage that trustees of well-run, well-funded schemes will have to alter significantly what they are already doing.

223. We are also particularly mindful to ensure the proposed framework is practicable and risks of unintended consequences are minimised. A key aim is also to ensure that the proposed framework broadly fits with current practices and does not discourage innovation and creative solutions.

Trapped/ongoing surplus

224. It is important to distinguish between trapped surpluses (on a wind-up basis) and a surplus or overfunding on an ongoing (TPs) basis.

225. There is a potential trapped surplus if a scheme is in surplus on a buy-out basis when wound up. Whether this is an actual trapped surplus and the excess can be returned to the employer depends on scheme rules. Our view is that the risk of trapped surplus is remote and manageable. There are mitigations available that can be used individually or in combination. For example:

- Contingent asset arrangements (such as escrow accounts) can be put in place to provide funding for the scheme to precisely the required s75 level on wind-up.
- Rule amendments: Employers and trustees could agree that it is in the interests of members to ensure that the ongoing funding level is as high as possible. Therefore, they could agree to amend their scheme rules to ensure there is a return of surplus to the employer on wind-up.

226. The risk of overfunding on an ongoing basis may occur if investment performance is better than prudently assumed. While it is important that trustees make prudent provision for their future liabilities, too much upfront funding may be undesirable if excessive or prolonged. However, we think there are sufficient flexibility in the regime to achieve the right balance between member security and the ability of the employer to manage competing demands on their cash flows effectively and efficiently:

- The Bespoke framework would allow for flexibility in how the funding and investments arrangements are constructed, including the use of additional support, eg to underpin longer RPs than allowed in Fast Track.
- We are looking to take a pragmatic approach to prescribing maximum RP length and back-end loading guidelines under Fast Track (ie no requirement for full funding to be restored immediately and some limited back-end loading allowed).
- Trustees can call a new valuation or revise DRCs based on annual updates.
- Trustees can revise the Schedule of Contributions.
- A surplus can be used to fund future accrual in open schemes.

Market impacts

227. In this consultation, we propose that schemes should be de-risked as they mature and should be invested with a high resilience to risk at significant maturity. We also propose to set some investment limits in Fast Track, with trustees assessing the level of investment risk in their strategy through a stress test or other method (see Chapter 10). This may result in a higher allocation to bonds for many schemes and raises the question of whether there is sufficient market capacity to accommodate these changes.

228. As explained below, our view is that there is already a clear trend towards significant bond allocation and under the current trends, we expect the average scheme to be able to comply with the most severe stress

test (at significant maturity) in six to eight years. As a typical scheme has 15-20 years to reach significant maturity, we don't expect a significant impact from de-risking from the new DB code for the average scheme. Some outliers (for example a mature scheme invested in 100% equities) would have to make some changes but we consider these changes are necessary.

- The average allocation to bonds from all pension schemes (weighted) is currently 63% (see table on average asset allocation in Chapter 16) and has been steadily increasing by around 3-4% a year for the last five years. The allocation to government bonds (UK gilts and UK inflation-linked bonds) as a proportion of total bonds is over 70%. Currently 41% of DB scheme assets (weighted) are in UK government bonds.
- Assuming this trend continues, we could expect the average weighted allocation to bonds to increase from 63% currently to around 80% in bonds within the next five years. This is based on the existing code that is currently in place and makes no allowance for any change in behaviour as a result of the introduction of this code or any other policy changes. Note that 63% is the weighted average and includes immature and mature schemes. If one includes annuities (currently 4%), as effectively bond-like in their nature, then the allocation is currently even higher at 67%.
- An allocation of 80% bonds (assuming over 70% of these bonds were government bonds as the current data shows) would be appropriate under our proposals on investment risk at the LTO (subject to consultation) for all scheme maturities and covenants assuming a scheme hedges its interest rate exposures fully using LDI (Liability Driven Investments) or alternative products.
- We expect the DB stress test we propose in Chapter 10 to incentivise schemes, particularly mature ones, to invest more in bonds but there are a number of alternative actions that may be used which may reduce the impact:
  - Schemes may choose to increase their level of interest hedging without changing their total bond allocation by using longer dated bonds or by taking advantage of LDI and other leverage/ derivative strategies. This would provide a better protection to against a fall in interest rates and a lower level of downside investment risk relative to the liabilities.
  - Some schemes may use additional support such as contingent assets under the Bespoke approach to support the investment risk and therefore avoid the need to de-risk.
- Although government bonds will be an important part of any long-term asset allocation, schemes may choose to make use of corporate bonds or other bond like investments to a greater extent. Therefore, an increase in a scheme's bond allocation does not necessarily mean an increase in the allocation to government bonds.

► Question

Q20 Other issues – Do you agree with our assessment of the issues above and do you have any further comments?

Part 3: Application (1) ‘Fast Track’

7. Introduction to Fast Track

229. In this section, we set out our proposals for how our proposed core principles could be applied in practice under Fast Track across the many variables that make up scheme funding arrangements:

- Setting the LTO (Chapter 8).
- Defining the shape of the journey plan and setting TPs (Chapter 9).
- Selecting the investment strategy (Chapter 10).
- Determining the RP when there is a deficit relative to the TPs (Chapter 11).
- Setting TPs and future accrual rates for open schemes (Chapter 12).

230. We address each of these factors in turn, examining a range of options, and their advantages and disadvantages. Our review of the consultation responses, as well as our assessment of impacts will inform how we develop the Fast Track parameters and what we propose to codify (this will be the subject of our second consultation). The Fast Track framework will set the benchmark for what we consider to be an acceptable/tolerated level of risk for a particular scheme and its supporting employer.

231. Chapter 15 in Part 5 provides a few simple worked examples to illustrate how Fast Track could work.

8. Setting the long-term objective

PRINCIPLES	★ By the time they are (i) significantly mature, we expect schemes to (ii) have a low level of dependency on their employer and (iii) be invested with a high resilience to risk.

Introduction

232. In this chapter, we set out our proposals for the following elements of a Fast Track LTO:

- Setting a funding target that takes account of
  - discount rates
  - other assumptions (relating to members' benefits and choices)
  - expense reserve, and
  - an investment strategy that is consistent with low dependency (ie highly resilient to risk).
- The timing for reaching that funding target, ie what measure of maturity we should use and how we should define 'significantly mature'.
- Whether we should set out ranges or a particular point for the LTO timing and low dependency funding basis.

233. We propose that all schemes, including open schemes, should aim for low dependency at significant maturity as a minimum. We explain in Chapter 12 our rationale for this. In practice, schemes that remain open may take a long time to reach significant maturity, if at all.

Low dependency funding target

234. There are several elements that make up a low dependency funding basis with high resilience to investment risk. The key elements are:

- discount rates
- other assumptions (relating to members' benefits)
- a reserve for future expenses, and
- the assumed investment strategy.

235. It should be noted that some of the Fast Track journey plan and investment options set out in Chapters 9 and 10 would require all schemes to calculate 'low dependency' liabilities. This means that immature schemes would need to be able to make this calculation, as well as mature schemes.

Discount rates

236. We consider that assumed discount rates should be consistent with the expected returns from an investment portfolio of assets that provide a reasonably good match for the scheme's liabilities. We would expect that prudent assumed returns would allow for risks in the asset portfolio that might reduce the return provided to the scheme, for example:

- the short-term volatility of the underlying asset allocation relative to liabilities (this relates to all assets but in particular growth assets (eg equities and low-quality corporate bonds)), and
- any defaults relating to the holding of corporate bonds.

237. Furthermore, the funding target should be such that there is a high chance of the scheme running off without requiring any further employer support and, to the extent such support is required, the level of that support should be low compared to the size of the scheme.

238. We consider that an appropriate funding basis for **Fast Track low dependency could be a discount rate in the range of Gilts +0.5% to Gilts +0.25%**[37], for the following reasons (see Chapter 16 for supporting evidence and analysis on the points below):

- Based on modelling carried out by the Government Actuary's Department (GAD), this is likely to represent a level of funding consistent with our definition of low dependency, ie there is a low chance of requiring further employer support and, to the extent that such report is required, the amount of support is low relative to the size of the scheme.
- A lower funding target (ie discount rate of Gilts + over 0.5%) would be unlikely to provide the level of independence from the covenant that we are expecting schemes to achieve.
- A higher funding target (ie discount of Gilts + less than 0.25%) would be close to the cost of buying out on current market pricing for significantly mature schemes and so, arguably, result in unnecessary cost for employers.
- This is broadly in line with existing good market practices for long-term funding targets.
- Most schemes that would fit the definition of significantly mature (ie have already reached a duration of 14 years or equivalent – see below) already fund to around this level so it is not out of line with current market practice.

239. We consider that expressing the discount rate relative to gilts is appropriate for a low dependency basis consistent with a relatively low risk investment strategy and that a discount rate in the range of Gilts +0.5% to Gilts +0.25% is appropriate in current market conditions. However, if market conditions change in the future, it may be appropriate to change the discount rate. We will cover how we propose to review and update the framework and communicate changes in our second consultation.

240. In this chapter, we seek views on whether we should be setting ranges or fixed points for the Fast Track LTO funding basis and timing to allow for some smoothing. We are also seeking views on the appropriate level for the LTO low dependency funding basis.

► Question

Q21 Fast Track low dependency discount rate – What are your views on our proposal that the appropriate low dependency funding basis for Fast Track should be with a discount rate somewhere in the range of Gilts +0.5% to Gilts +0.25%? Where in the range do you think it should be and why? If you disagree, what do you think would be a more appropriate basis and why (please provide evidence)?

Other assumptions (relating to members' benefits)

Options for Fast Track

241. There are numerous other assumptions required to calculate liabilities (eg inflation, pension increases, mortality, other demographic assumptions – see the table below for a list of main ones), and they can have a significant impact. In particular, as schemes mature, and a higher proportion of the liabilities relate to pensioners, the impact of assumptions for mortality not being borne out in practice becomes significant and can be very material to the scheme funding level.

242. A key question is to what extent we should define assumptions other than the discount rate in Fast Track to ensure an appropriate low dependency funding basis, balancing considerations around proportionality, scheme-specificity, the frequency of changes in the assumptions and risk of gaming or misuse.

243. We have considered the following options for defining assumptions other than the low dependency discount rate under Fast Track:

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[37] Gilt yield curve or gilt yield with duration appropriate to the scheme's liabilities.

1. **No requirements other than the principle that these assumptions, when taken together, should be no weaker than 'best estimate'.**
2. **We define some of these other assumptions, in particular, where it could be argued that they are not scheme-specific**, eg price inflation (RPI and CPI) or future improvements in longevity. The remaining assumptions, when taken together, should be no weaker than 'best estimate'.
3. **We define all these other assumptions.**

244. We discuss how and at what level we should set these other assumptions (under the options where we would do so) further below.

245. Table 6 below sets out the pros and cons of each of these options:

Option	Pros	Cons
1. Overall 'best estimate'	☑ The trustees and employers of individual schemes are in a much better position to determine the assumptions appropriate to their scheme than we are. Any prescription would lead to less appropriate assumptions being used.	☒ 'Best estimate' isn't a well-defined term for setting actuarial assumptions. It would be difficult for trustees and employers to verify that they had met this requirement. ☒ These assumptions can have a significant effect on the calculated level of a scheme's liabilities. Without prescription, these assumptions could be 'gamed' to produce an inappropriately low funding target inconsistent with low dependency. ☒ Where assumptions are not defined under Fast Track, more work will need to be done by schemes to determine appropriate assumptions. However, schemes currently do something similar under the current regime, so any extra work should be limited.
2. We define assumptions which are not scheme-specific, with other assumptions no weaker than best estimate overall	☑ Less open to 'gaming' than the no prescription option. ☑ The assumptions specified under Fast Track are likely to be those which are most significant to the value of the liabilities, eg inflation and mortality.	☒ We would need to choose which assumptions to specify and which assumptions to leave as scheme-specific. It is not clear how this should be done. Mortality assumptions are particularly difficult to specify across all schemes. ☒ Some defined assumptions may be inappropriate for a scheme's circumstances. This approach might drive these schemes out of the Fast Track regime unnecessarily.
3. We define all assumptions	☑ The option least open to 'gaming'.	☒ Some assumptions (eg mortality, pension increase caps and collars) are scheme-specific. It would be impossible to define these assumptions so that they remain appropriate to all schemes. ☒ We would need to keep these assumptions under review and change them from time to time. Schemes would need to revise their low dependency assumptions accordingly. This would be unnecessarily burdensome for us and pension schemes.

► **Question**

Q22 Options for defining other assumptions for Fast Track low dependency funding basis – Which of these options should be used to set assumptions for low dependency funding under Fast Track? Are there any other options we should consider? Are there any other pros and cons we should consider?

246. Depending on which of the above options is chosen, we will need to determine the following:

- Where we define some/all other assumptions in Fast Track, which ones should these be and how should this be done?
- For assumptions not defined by us, how we can verify that assumptions, when taken together, are no weaker than 'best estimate'?

247. We discuss each of these issues below.

TPR specifying some/all assumptions for Fast Track: which ones and how could this be done?

248. If we defined some or all of the assumptions (in the second and third options above), we would need to determine how to do this.

249. There are numerous assumptions, other than discount rates, that form part of an actuarial basis. The main assumptions are shown in Table 7 below, along with some suggestions for how they could be benchmarked under Fast Track:

Assumption	Notes	Example benchmarking factors
Inflation	Many pensions are linked to RPI.	Market implied RPI inflation based on fixed interest and index-linked gilt yields.
		Allowance for an inflation risk premium (IRP) to the appropriate extent, subject to taking expert evidence.
Differential between RPI and CPI	Most deferred revaluations are linked to CPI and some pensions are linked to CPI.	No more than best estimate for the difference, subject to taking expert evidence.
Pension increases	Depends on expectations and volatility of inflation plus model applied.	Difficult to benchmark because of the different models that exist and the lack of data on pension increase assumptions.
Mortality	Base table could be more scheme-specific, future improvements based on population trends.	Base table often based on socioeconomic factors (eg postcode analysis or medically underwritten mortality study) or an experience analysis if there are a sufficient number of pensioner members.
		Most recent Self-Administered Pension Schemes (SAPS) tables and Continuous Mortality Investigation (CMI) improvements and other available evidence,
Cash Commutation	Effect on liabilities depends on assumptions regarding commutation factors.	Expect to be set at less than 100% of maximum possible. Typically benchmarked against actual scheme experience.
Real salary increases (general and promotional)	Significant for many open schemes, and for cost of new benefit accrual.	For general increases no less than the level of deferred revaluation over the long term (as otherwise creates a strain on withdrawal).

CETVs (Cash Equivalent Transfer Values)	Schemes starting to allow for this in projected cash flows. Could significantly affect the duration of the liabilities.	Difficult to benchmark because of limited historic data and historic data may not be a guide to the future.
Other demographics	Includes allowance for ill-health, proportion married, withdrawals, early retirements.	Benchmarking is typically scheme-specific where there are sufficient members to assess experience and/or the terms on which members can take their benefits. For example, if a member can take some of their benefits unreduced from age 60 and some unreduced from age 65, this is likely to drive the assumptions for when members take early retirement.

250. We think that many of the assumptions in the table above are so scheme-specific in nature that it would not make sense for us to define them. If we are to determine any of these assumptions, we consider these should be restricted to financial assumptions that can be derived from market data (eg RPI and CPI inflation) and mortality assumptions.

► Questions

Q23 Defining assumptions for Fast Track low dependency funding basis

a. What are the most significant assumptions (other than discount rates) for the calculation of the Fast Track low dependency liabilities?

b. If we were to specify some or all of the assumptions to calculate the level of Fast Track low dependency liabilities, which assumptions should we specify and how should we do this? Do you have views on the suggested benchmarking factors in the table above?

c. If we determined mortality assumptions, how could we balance the scheme-specific nature of mortality with the desire to ensure a level of consistency in the assumptions used by different schemes?

Verification that assumptions meet the 'best estimate principle'

251. In the options where we do not specify some or all of the assumptions under Fast Track (in the first and second options in above), we would need some mechanism to verify that the assumptions, when taken together, are no weaker than 'best estimate'.

252. We have considered the following options as to how this could be done:

1. **No additional requirement**, ie we would use current information disclosures from schemes to do the verification.
2. **Additional disclosure requirements** (through information provided to us) to make it easier for us to understand the assumptions schemes have used.
3. A requirement that the **assumptions should be no weaker than another set of 'best estimate' assumptions** – eg compared to those used which represent 'best estimate' for the scheme – such as assumptions used in the employer's pension cost accounting, or assumptions used to set CETVs.
4. The **scheme actuary provides a certificate** stating that the assumptions used (other than the discount rate) are, when taken together, no weaker than best estimate.

253. Table 8 below sets out the pros and cons of each of these options:

Option	Pros	Cons
1. No additional requirement	☑ Least burdensome option.	☒ Option most open to 'gaming' as information currently submitted is limited, ie inflation and salary increase assumptions and some life expectancies for members of different ages.
2. Additional disclosure requirements	☑ Could be implemented with quite limited additional requirements so as not to be too burdensome for schemes to comply with. Yet the option could also allow us to scrutinise a scheme's assumptions in reasonable depth (and avoid the need to open new investigations unnecessarily).	☒ Still somewhat open to 'gaming' as we would not be able to assess whether the scheme-specific assumptions are appropriate to a scheme unless the additional disclosure requirements are substantial (ie including full experience analysis).
3. Comparison with other sets of 'best estimate' assumption	☑ Provides an independent comparator.	☒ Some employers may not have pension cost accounts to make the relevant comparison. ☒ This option may be circular as some schemes and employers base their pension cost accounting and CETV on the funding assumptions rather than the other way around. ☒ CETV assumptions may not allow for options which members are likely to take, eg early retirement, cash at retirement.
4. Scheme actuary's certificate	☑ Would provide strong verification that the assumptions are set appropriately.	☒ Assumptions for setting the low dependency basis would need to be agreed by the scheme actuary. This would change the balance of power in the scheme funding regime, particularly as the scheme actuary advises the trustees (and not the employer). ☒ Would add costs as scheme actuaries would need to do additional work to provide such a certificate.

254. Our preferred option is the second option – additional disclosure requirements. We would need to determine what these should be, and in doing so, balance the potential cost to schemes of making additional disclosures against the need to have sufficient information to make the required assessment.

► Questions

Q24 Low dependency basis – verification that other assumptions meet the best estimate principle

a. Which of these options do you prefer to verify that other assumptions used for low dependency liabilities under Fast Track meet the 'best estimate' principle and why? Are there any other pros and cons we should consider? Are there any other options we should consider?

b. If we decided to require schemes to provide additional information about their assumptions, what information should we require schemes to provide compared to the current requirements?

Other assumptions: should some of the assumptions be set prudently?

255. We have put forward some options for setting the other 'assumptions' which imply it is reasonable for all assumptions other than the discount rate to be set at 'best estimate'. However, you could argue that liabilities calculated in this way would not meet the objective of achieving low dependency, because the likelihood of the 'best estimate' assumptions not being borne out in practice would be too high. For example, it could be argued that long-term future improvements in mortality are so uncertain that this assumption should be set prudently.

► Questions

Q25 Other assumptions for Fast Track low dependency basis – prudence

a. If we specified certain assumptions, should we aim for those to be best estimate or to be chosen prudently?

b. Given the uncertainty around assumptions such as future improvements in mortality should we i) define these assumptions in Fast Track and ii) set the assumptions prudently?

Reserve for future ongoing expenses

256. To achieve low dependency, we consider a reserve for future ongoing expenses would ideally be included in the low dependency liabilities used for Fast Track. However, this may not be necessary if the scheme's trust deed and rules provides for the employer to reimburse a scheme's ongoing expenses on an arising basis. For schemes that do not have this provision, we would expect that an explicit reserve should include all future expected ongoing expenses, including PPF levies. We recognise that there are practical difficulties in calculating an appropriate ongoing expense reserve based on assumptions about future expense levels many years into the future. This particularly affects smaller schemes.

257. In the paragraph above, we refer only to ongoing expenses as we have assumed that the low dependency funding basis applies when an employer is solvent with a continuing scheme. A scheme will not be able to 'run on' in the normal course of events if the employer suffers an insolvency event. We have therefore not considered the possibility of an express reserve for winding up expenses.

► Questions

Q26 Low dependency liabilities – reserve for future ongoing expenses

a. Should the low dependency liabilities carry an expenses reserve? If so, should this only be a requirement for schemes that self-fund their expenses?

b. To what extent should we define the reserve for future expenses under Fast Track? Should we just provide guidance on how to calculate an appropriate reserve? As part of that, what level of ongoing expenses is it reasonable to allow the employer to pay directly without any reserve?

c. If we defined guidelines on expenses for Fast Track, how should we reflect the proportionally different level of expenses incurred by schemes of different sizes? Could we adopt a sliding scale of percentages of liabilities based on the size of the scheme or a fixed element and proportionate element of expenses?

Assumed Investment strategy

258. We do not propose to specify which asset allocation trustees should invest in at significant maturity – our focus is on investment risk. There are many different types of investment strategies which have a high resilience to investment risk. However, on reaching significant maturity, we would expect schemes to adopt a strategy broadly consistent with a low dependency funding basis, or to otherwise explain why they have adopted a different strategy through the Bespoke route.

259. Some examples of appropriate strategies include the following:

- **"Barbell" strategy** – The majority of the assets are invested in gilts and LDI, which provide a very good match for the scheme's cash flows, with the remaining small proportion of assets invested in a diversified growth portfolio. The growth portfolio is expected to provide the small amount of additional return required to achieve returns above those assumed for the discount rate in the low dependency basis.
- **Credit-based strategy** – Wholly invested in bonds, the majority of which are high-quality and liquid. This strategy is not aiming for a precise cash flow match nor to remove the re-investment risk. Instead, the strategy is aiming for some addition return over the discount rate to provide a buffer against adverse future experience. This strategy might include a mixture of gilts and corporate bonds, including some illiquid and multi-asset credit.
- **"Cash flow-driven-investment" strategy** – An extension to the credit-based approach to invest in a portfolio that is expected to deliver cash flows which very closely match the liabilities. Such an approach is likely to include a higher proportion of less risky assets, ie more gilts and high-quality corporate bonds with a low chance of default.

260. In Chapter 10 on the investment strategy, we set out options for measuring the actual level of investment risk associated with any strategy. For example, at the simplest level, we could look at the percentage invested in growth assets. An alternative would be to require schemes to apply a stress test.

261. We also set out proposals for setting a limit on the percentage in growth assets or increase in the deficit as a result of the stress test, which applies when schemes are significantly mature. We consider that having a high resilience would be consistent with having a relatively low percentage of growth assets or a proportionately small increase in the deficit following the application of a stress. As part of our second consultation on the DB code, we will propose some numerical limits.

Scheme maturity

Measures of maturity

262. As set out in Chapter 5 on General principles, we expect schemes to reach low dependency funding when they are significantly mature. Therefore, we need to decide how to measure maturity. There are many different measures of maturity, each having advantages and disadvantages. We consider the four main measures are as follows:

- **Duration of the liabilities**[38]: This is the mean term of the liabilities weighted by the value of the scheme's future cash flows. It is measured in years and can be calculated directly using the scheme's cash flows. Mature schemes have a shorter liability tail and, hence, a shorter duration while immature schemes have a longer duration. An alternative measure, producing a similar answer (where benefit cash flows from year to year are reasonably smooth) is based on the sensitivity of the scheme's liability to small changes in the discount rate: the more mature the scheme, the lower its sensitivity to changes in the discount rate. The two approaches require different calculations, the former based on

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[38] Note that this is a technical value derived from the cashflows and not a simple measure of time.

cash flows and the latter based on liabilities, but both produce similar answers when expressed as a number of years.

- **Proportion of remaining cash flows relating to pensioner members**: Future benefit cash flows are calculated based on actuarial assumptions underlying the scheme's liabilities. Cash flows are calculated separately for current pensioners and current non-pensioners. This measure of maturity is calculated by dividing the total amount of future cash flows relating to current pensioners by the total amount of future cash flows for all members.
- **Proportion of scheme assets (or liabilities) paid as benefits**: The amount of benefits expected to be paid out over the next year divided by the current value of the scheme's assets (or liabilities).
- **Proportion of liabilities that relate to pensioner members**: The amount of liabilities relating to current pensioners is divided by the amount of liabilities relating to all members' past service benefits.

263. Whatever measure of maturity is adopted for Fast Track, it needs to be appropriate not only for defining the point at which a scheme is significantly mature but also to measure maturity at different points in a scheme's life, and it should be capable of being measured in a consistent and objective way. An assessment of the different measures of maturity is provided in Table 9 in the appendix to this chapter.

264. The above measures of maturity are sensitive to the assumptions used to project cash flows and calculate liability values. This means that the maturity calculation could be used to game the Fast Track regime or could be done inconsistently across schemes. This might be mitigated in part by using the low dependency basis assumptions under Fast Track. This would not remove sensitivity to changes in assumptions but would, at least, bring an element of consistency to the calculations over time and some consistency between different schemes.

265. We think that a high percentage of assets being paid out as cash flows is the most important reason why schemes need to be properly funded on a low dependency basis at significant maturity and to manage volatility of their asset values. If a scheme is not adequately funded at this stage, then the remaining assets have to provide higher returns to close what is now a proportionately bigger deficit. However, because the scheme is mature, there is less time to capture the long-term outperformance from growth assets. In addition, if the investment strategy does not have a high resilience to risk, then the resulting investment volatility means there is an increased risk of having to sell assets in falling markets to meet benefit payments.

266. Hence, the proportion of scheme assets paid as benefits annually appears to be the most appropriate measure of maturity to use to define when a scheme is significantly mature. However, in practice different schemes will have different funding levels at the time they reach significant maturity. To ensure consistent measurement across all these different schemes, we may want to express the ratio of benefits to a standard liability measure, eg low dependency.

267. There are some disadvantages with using this measure across all schemes, including the following:

- Variability in cash flows year-to-year for smaller schemes, where a few members represent a high proportion of the total liabilities and the timing of retirement and other member options is significant relative to the total cash flows of the scheme.
- The incidence of CETV payments and retirement lump sums (in small schemes) can distort the measure significantly.
- Although it has the advantage of being straightforward to calculate at a valuation date, it is just as complicated to determine how this measure is expected to develop over time.

268. On balance, we think the duration of the liabilities would be a more suitable measure to define the point of significant maturity because of the following:

- It avoids the disadvantages (see paragraph above) associated with variability and incidence. of cash flows which the measure 'Proportion of scheme assets/ liabilities paid as benefits' has.
- Many scheme actuaries will already calculate duration as part of their actuarial valuation.
- It is relatively straightforward to calculate how a scheme's maturity is expected to develop in the future.

- Although potentially more difficult for non-actuaries to understand, it can be translated into an equivalent 'ordinary' timeframe (eg a scheme can estimate how many years into the future it is expected to reach significant maturity by).

► Questions

Q27 Definitions of maturity

a. Should maturity be defined as duration for the purpose of prescribing significant maturity under Fast Track? If not, which measure would you favour and why? Note that whatever measure we use, it needs to be applicable not only to the time at which we would expect a scheme to reach significant maturity but also at all earlier times in the scheme's life.

b. Whichever method is used to determine maturity, we need to use actuarial assumptions to make the calculation. Should we require that the Fast Track low dependency assumptions are used for this purpose? What other assumptions could be used?

Time to reach significant maturity

269. As a scheme matures, it becomes susceptible to an investment spiral risk if it remains underfunded. This means by an increasingly higher proportion of assets begin to be paid out in the form of benefits each year, and because the scheme is not fully funded, the deficit begins to grow in relation to its liabilities. This may be aggravated further by an investment downside event forcing trustees to sell assets in an unplanned manner (see more details in Chapter 16).

270. To stop this risk spiralling out of control trustees would need to either:

- seek higher investment returns by investing in a strategy which would be inconsistent with having a high resilience to risk, and/or
- seek substantial additional funding from the employer, which would inconsistent with low dependency on the employer.

271. It is important to note that this risk is a direct consequence of the scheme being underfunded, with increasing levels of benefit outflow for mature schemes simply serving to accentuate it. We therefore consider it prudent for trustees to manage this risk by planning to reach full funding on the low dependency basis before the scheme reaches a particular level of maturity, which we define as significant maturity, when the risk may otherwise become unmanageable.

272. In the previous section, we discuss in more detail the precise definition of a low dependency funding target, and in Chapter 16 we present evidence to support our preference.

273. On the timeframe for reaching full funding on the low dependency basis, we propose that **'significant maturity' should be defined somewhere in the range of duration 14 years to 12 years (or another maturity measure which results in a similar timeframe)**. Duration 14 years to 12 years is broadly equivalent to a point at which the scheme will be paying out 5% or 6% of its liabilities each year as benefits. Anecdotal evidence from some practitioners in the pensions industry suggests that it would be prudent to have the investment spiral risk under control by the time the scheme's annual benefit payments have reached this level. Furthermore, the evidence shows that leaving the scheme underfunded for much longer may have a significant effect on risk by the time the annual benefits have reached about 7-8% of liabilities.

274. Analysis we have commissioned from GAD[39] shows that whether we require schemes to reach low dependency at a duration of 12 years or 14 years has little effect on the assessed security of members' benefits and likelihood of requiring future funding from the sponsoring employers after that point. This is

[39] See Chapter 16 on Evidence and Analysis.

because, once the scheme has reached full funding on the low dependency basis and has an investment strategy broadly aligned with this basis, the risk of the investment spiral has been largely eliminated.

275. However, whether a scheme reaches low dependency at duration 12 years or 14 years (or earlier) does affect the period over which the scheme remains reliant on the employer covenant before reaching low dependency and also the rate at which the employer needs to contribute to get there. For an indication of the typical timescales involved, the average scheme may currently have maturity duration of around 21 years and it may take a little over 15 years for it to reach maturity duration 14 and around another five years to reach maturity duration 12. Chapter 16 (Evidence and Analysis) includes a figure showing the current maturity profile across DB schemes.

276. We intend to test the potential impact of setting significant maturity at a range of duration 14 to12 years on the journey plans and employer contribution rates of DB pension schemes as part of the modelling work we will undertake to inform our second consultation. We do not wish to place an unnecessary financial burden on employers of DB pension schemes by requiring them to fund their schemes to a low dependency level too quickly. Nor do we wish to allow schemes to aim for low dependency too late and run the investment spiral risk described above. The impact assessment will help us determine whether setting significant maturity at a range of duration 14 to12 years appropriately balances these risks.

► Question

Q28 Defining the timing point for significant maturity – What are your views on our proposal to set significant maturity (used to define the timeframe for reaching the LTO) for Fast Track to be in the range of a scheme duration of 14 to 12 years (or equivalent on a different maturity measure)? If you disagree, what would be a more appropriate timeframe and why? Please provide evidence.

Points or ranges for low dependency funding basis and timing

277. **Low dependency funding could be set at a particular level** (ie Gilts +0.25%) **to be reached at a particular point in time** (ie when a scheme reaches a duration of 14 years) in Fast Track. Alternatively, we could set a range of funding levels and timings (eg Gilts +0.5% to Gilts +0.25% and duration of 14 to12 years).

278. Setting a particular funding level and timing has the advantage of providing clear targets for trustees and employers and our regulatory activities. However, this could create volatility in contribution levels as a scheme approaches significant maturity if, for example, a deficit emerges on the fixed low dependency funding basis at a time close to the fixed point for reaching significant maturity.

279. An alternative would be to allow ranges, eg reaching low dependency funding within [x to y] years (with reference to scheme maturity) and/or calculated using a discount rate of [a to b]. This has the advantage of giving schemes some scope to adapt their journey plan (to a limited degree) to help deal with short-term volatility of investment markets and smooth the level of contributions which employers are required to pay.

280. To help balance the need for a clear, distinct target and allow some smoothing, we propose to set the low dependency funding basis at a particular level (we propose somewhere between Gilts +0.5% to 0.25%) but the timing point as a range (duration 14 to 12 years or equivalent measure).

► Question

Q29 Points or ranges for low dependency funding basis and timing point – Do you think our proposal to set a particular level for the low dependency funding basis and/or a range for the significant maturity timing associated with the LTO would be helpful to schemes to manage volatility and allow some smoothing? If not, what would you suggest?

Period after significant maturity

281. However a scheme's LTO is defined, once it reaches significant maturity we expect the scheme to have reached its LTO. This means it should be fully funded on a basis consistent with a low level of dependency on its employer and with an investment strategy that is highly resilient to risk. After this point, we expect the scheme to at least maintain low dependency funding and continue to invest with a high resilience to risk. Fast Track TPs should be set at least equal to low dependency liabilities once a scheme has reached significant maturity. Trustees and their sponsoring employers may also wish to set a further objective to buy out (or buy-in) the liabilities at some point after reaching significant maturity.

282. Trustees should also continue to monitor and manage the remaining investment risks and the other risks their scheme is exposed to, such as longevity risk and administration expenses, which will assume greater importance. Risk management continues to be an important trustee task over this period. Trustees may seek to mitigate some of the longevity risks through, for example, longevity swaps or partial 'buy-ins'.

Appendix – Different measures of maturity

283. Table 9 sets out an assessment of the different measures of maturity.

Measure → **Criteria ↓**	**Duration of the liabilities**	**Proportion of remaining cashflows relating to pensioner members**	**Proportion of scheme assets (or liabilities) paid as benefits**	**Proportion of liabilities that relate to pensioner members**
How easily can this be calculated and understood?	This is widely used by scheme actuaries as part of their valuation calculations. It is relatively easy to calculate for all schemes. It may be hard for trustees and sponsoring employers to understand that there is not a 1:1 link between time and duration. Typically, for a closed scheme, each year of time will result in the duration of the liabilities falling by 0.3 to 0.5 years. The calculation of duration varies with different discount rates, ie if the discount rate is high, this results in a lower value for the duration and vice versa. (However, for the purposes for which we want to use this measure, we can fix the discount rate across the board at, say, the Fast Track low dependency discount rate.)	This measure is easily understood and already used by some consultancies. To calculate this measure, trustees need access to cash flows for all future years. These cash flows may not be readily available to smaller schemes or may only be available at additional cost, material relative to the size of the scheme's assets.	This measure is easily understood and already used by some consultancies, particularly in the context of considering future investment strategies and cash flow matching. To calculate this measure at future dates, trustees need access to cash flows for all future years, split between pensioners and non-pensioners. These cash flows may not be readily available to smaller schemes or may only be available at additional cost, material relative to the size of the scheme's assets. But to calculate the scheme's current maturity, trustees don't need any new calculations – the relevant information is available in the most recent scheme accounts.	This measure is simple to calculate and is widely used a rule of thumb for a scheme's current maturity. Less simple if you want to calculate projected maturity levels at future dates.

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How easy is it to estimate how a scheme will mature under each measure?	If the measure is based on estimated future cash flows, it is straightforward to calculate duration at all future dates once these cash flows have been calculated. If an alternative measure is used, to estimate duration at future dates maybe more difficult. For a scheme open to new entrants, it would be necessary to make an assumption about the rate of new entrants in future years.	To calculate this measure at future dates, it would be necessary to track how the balance between non-pensioner and pensioner cash flows change as members retire. This would be a very complex calculation. For a scheme open to new entrants, it would be necessary to make an assumption about the rate of new entrants in future years.	As for duration but would also require a projection of the scheme's asset or liability value. For a scheme open to new entrants, it would be necessary to make an assumption about the rate of new entrants in future years as well as the level of contributions paid to meet these new benefits.	To calculate this measure at future dates, pensioner and non-pensioner liabilities would need to be calculated at those future dates. Such calculations would need to take account of the changing balance of pensioner and non-pensioner liability over time. For a scheme open to new entrants, it would be necessary to make an assumption about the rate of new entrants in future years.
How significantly is this measure affected by market conditions?	Duration depends on the assumption used for the calculation of the liabilities, particularly discount rates. As a result, duration may be very sensitive to changes in market conditions. For example, if there was a significant increase in the discount rate, this could result in a material reduction in the calculated duration of the liabilities.	Still affected by market conditions to some degree, particularly changes in future expected inflation. However, less affected than other measures.	Benefits payments are still affected by market conditions to some degree, particularly changes in future expected inflation. However, less affected than other measures. If liabilities are used as the denominator, these could also be affected by changes in the discount rates similarly to the proportion of liabilities that relate to pensioner members. If assets are used as the denominator, there is potentially a big exposure to market conditions. Furthermore, a scheme's funding level will affect this measure of maturity, eg a poorly funded scheme will be rated as more mature, all other things being equal.	Because it's a liability measure, it depends on the assumption used for the calculation of the liabilities, particularly discount rates. As a result, the ratio of pensioner and non-pensioner liabilities may be too sensitive to changes in market conditions. For example, if there was a significant increase in the returns expected on the scheme's assets, this could result in a material increase in the ratio of the pensioner liabilities to the overall liabilities.

What is the risk that this measure can be 'gamed'?	In theory, the calculation of duration could be gamed by changing particular assumptions. For example, by assuming no cash commutation at retirement, the duration of the liabilities could increase significantly. However, we consider this to be a relatively low risk as we would expect trustees, as advised by scheme actuaries, to seek to use realistic assumptions to calculate cash flows and benefits.	Difficult to 'game' although still affected by assumptions to some degree (eg inflation, mortality).	Difficult to 'game' although still affected by assumptions to some degree (eg inflation, mortality).	Relatively difficult to 'game' although still affected by assumptions to some degree (eg inflation, mortality). In addition, the ratio can be materially different depending on the discount rate structure used. For example, if a scheme uses a pre- and post-retirement discount rate approach, this will result in a higher ratio than a single discount rate approach.
How volatile is this measure to membership movements?	Less volatile than other measures, as the overnight change in the duration in respect of the liabilities of members retiring is not normally significant. However, will still be affected by other changes to the scheme membership, eg a member's transfer exercise (for non-pensioners) could significantly decrease the duration of the liabilities.	For smaller schemes, the timing of retirement of individual members with big benefits creates large and sudden changes to the ratio.	Smaller schemes may have volatile cash flows year-by-year, eg one or two members with high proportion of the liabilities retiring and taking a cash lump sum or choosing to take a CETV.	For smaller schemes, the timing of retirement of individual members with big benefits creates large and sudden changes to the ratio. The measure may be too simple as it doesn't reflect that some schemes have lower Normal Retirement Ages (NRAs) (eg age 60) and/or a young pensioner population. Such schemes will still have a long time until the last benefit is paid and therefore may not need to de-risk to the same extent as another scheme which has a higher NRA (eg age 65) and an older pension population. This could be case even when both schemes have the same proportion of liabilities that relate to pensioners.

9. Technical provisions (TPs)

PRINCIPLES	
	★ We expect trustees to develop a journey plan to achieve their LTO. ★ We expect 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.

Introduction

284. In Chapter 5, we proposed key principles for schemes achieving their LTO based on the assumption that schemes would set a journey plan, with TPs acting as key milestones on the journey, and reduce the levels of investment risk as they mature.

285. In this chapter, we outline our proposals for guidelines on suitable journey plans for achieving an LTO and how TPs could be set in the Fast Track framework. This focuses on an acceptable level of risk that could be *assumed* in the TPs. Chapter 10 on the investment strategy considers the actual level of risk taken by schemes (and what to do if it differs significantly from risk assumed in the TPs).

286. As we explained In Chapter 12, we propose that Fast Track TPs for open schemes should be set consistently with closed schemes of the same maturity.

287. We are seeking views on the following:

- What key factors should determine an appropriate journey plan to achieving low dependency funding, particularly regarding the shape of the de-risking journey and the scheme-specific factors which should be taken into account (eg maturity, covenant).
- Having decided what journey plans should broadly look like, what parameters we should define with regards to setting TPs in Fast Track (eg discount rates or funding ratios).
- How we could derive these guidelines and parameters in practice.

Journey plan

288. There are three key factors which will determine what appropriate journey plans should look like:

- The underlying shape of the journey plan, including scheme-specific factors such as maturity and investment risk.
- The level of covenant support provided by the sponsoring employer.
- How reliance on covenant may change over the longer term (covenant visibility).

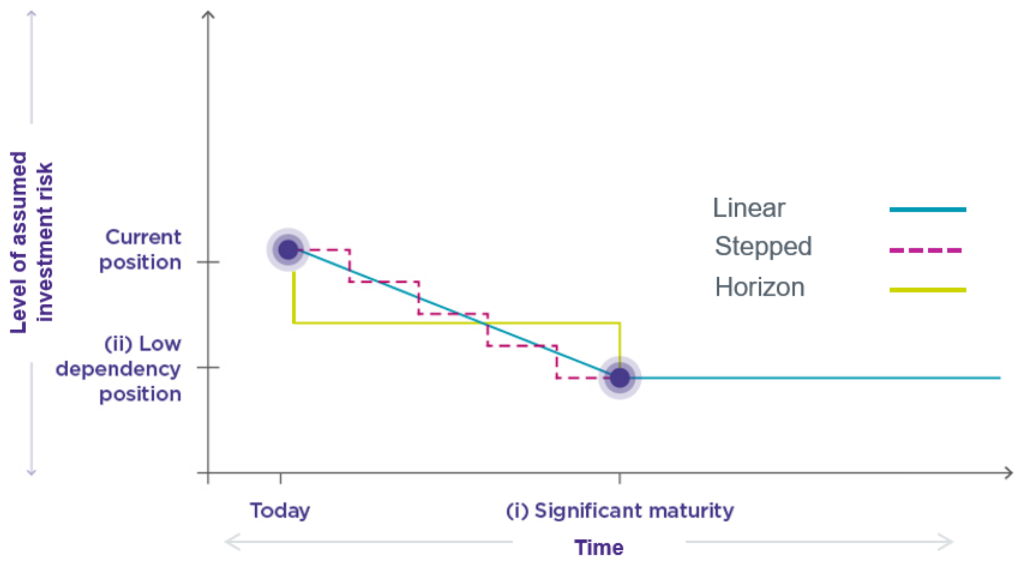
Shape of the journey plan

289. A journey plan to the LTO could take several different shapes. These reflect different approaches to risk-taking and de-risking on the journey to reaching low dependency funding. However, they share a common principle that more immature schemes can assume a higher level of investment return, which can be reflected in the discount rates used to calculate the TPs (see Chapter 5 on General principles). An immature scheme has a longer investment time horizon and therefore, in general, can place more reliance on growth assets out-performing matching assets over the long term and ride out short-term volatility in asset values.

290. Our objective is to provide Fast Track guidelines on acceptable risk-taking on the journey to low dependency funding, while providing some flexibility to reflect the fact that trustees have different investment strategies appropriate for their scheme. This section focuses on assumed investment risk. Actual investment risk is addressed in Chapter 10 (including a consideration of the impact of different journey plan shapes on the investment strategy).

291. Figure 1 below shows three types of journey plan shapes schemes can and do adopt. We need to adopt one approach in order to determine Fast Track TPs:

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



292. Each journey plan shape represents a different balance over time between assumed investment risk and member security and so affects the structure of the term-dependent discount rates used to value scheme liabilities (ie they are not 'flat' discount rates that reduce at each valuation).

293. All these journey plans imply that the required Fast Track TPs expressed as a proportion of the low dependency funding basis will increase as a scheme matures. For example:

- Under the horizon approach, the pre-horizon period (before the step down in the discount rate at significant maturity) will become shorter at each valuation. This means the overall single equivalent discount rate is moving close to that used in the low dependency basis.
- Under the stepped and linear approaches, the term-dependent discount rates will reduce over time and so, as the discount rates unwind, the single equivalent discount rate moves closer to the low dependency rate.
- The choice of method only affects the pace at which TPs approach the low dependency funding level.

294. Other actuarial assumptions which make up valuations are considered in Chapter 8. Our approach to setting these assumptions under Fast Track for TPs would be consistent with the approach we are consulting on for low dependency.

Linear de-risking

295. Under this approach, the assumed level of investment risk and return reduces progressively over time, eg each year or each quarter, as the scheme becomes more mature. The rate of reduction could be linked to:

- a maturity measure, eg years of duration of the liabilities, or
- linearly from a starting point appropriate to the initial maturity of the scheme moving to a level of investment risk and return consistent with low dependency funding by the time at which the scheme is expected to be significantly mature.

296. Once the scheme reaches significant maturity, the assumed level of risk and return become constant and consistent with the risk implicit in the low dependency basis. Table 10 below sets out the pros and cons of this approach:

Pros	**Cons**
☑ Implicitly presupposes the assumed level of investment risk will converge to the level of risk the scheme will run after it has reached significant maturity. Therefore, it creates a smooth path towards low dependency. ☑ Assumes the higher level of investment risk at the point at which the visibility of the covenant is greatest and therefore the potential for the employer to provide additional funding following a downside event is the highest. ☑ Relatively simple to understand. ☑ Results in a broadly similar pattern for term-dependent discount rates as a pre and post retirement discount rate approach, which is the one most commonly used under the current framework. However, the post-retirement discount rate typically needs to be lower than the low dependency discount rate for these methods to be equivalent (see paragraph 306).	☒ Where scheme size is expected to reduce in the near future (as is the case for many closed schemes), this approach assumes that the highest amount of risk (in £ terms) will be taken now rather than later. As a result, if a downside event happens at this time, it will have the largest effect on the schemes funding in £ terms. ☒ Schemes are expected to broadly align their investment strategy with the level of risk assumed in the TPs (see Chapter 10 on investment strategy). Having a progressive reduction in the level of assumed investment risk and return means the investment strategy will need to be reviewed and changed frequently, requiring appropriate governance from the trustees. For small schemes, this may have resource implications.

Horizon (or ‘lower for longer’) approach

297. Under this approach, there is one level of assumed investment risk and return in the period before the scheme reaches its LTO and a lower level of assumed investment risk consistent with low dependency funding thereafter. The time at which the scheme is expected to achieve low dependency funding could be linked to the scheme’s maturity or another measure (see Chapter 8 on LTO). This approach is sometimes referred to as the ‘lower for longer’ approach, ie the scheme starts by assuming that it will take lower risk than under a linear approach but maintains that level of risk over a longer period.

298. Table 11 sets out the pros and cons of this approach:

Pros	Cons
☑ Where scheme size is expected to reduce in the near future (as is the case for many closed schemes), this approach assumes that a lower amount of risk (in £ terms) will be taken now rather than later. As a result, if a downside event happens at this time, it will have a smaller effect on the scheme's funding in £ terms, which may increase the security of members' benefits in the long run, relative to a linear de-risking approach. ☑ Over time, the value of the liabilities of a closed scheme is expected to reduce in £ terms. As a result, although the relative level of assumed investment risk remains the same over the pre-horizon period, the £ amount of risk will reduce. To the extent that the strength and value of the covenant remains the same over time, this means the level of investment risk will become more easily supportable over time. ☑ It may be easier for schemes to plan their future investment strategies based on this approach of having two distinct periods, compared to a linear de-risking approach with regular de-risking.	☒ Unlike the linear approach, there is not a smooth de-risking path towards low dependency funding. In theory, the scheme could continue to assume to take significant amounts of investment risk until just before it reaches significant maturity, when the scheme's assets are potentially less able to recover from a downside event. ☒ Results in a very different pattern for term-dependent discount rates to a pre- and post-retirement discount approach, which is the one most commonly used under the current framework. This may therefore represent a significant change from current practice. However, the initial level of TPs may not be that different.

Stepped approach

299. The time before the scheme reaches its LTO is split into a number of periods. During each period, there is a fixed level of assumed investment risk and return allowed for in the discount rates. As the scheme transitions from one period to the next, the level of assumed investment risk and return reduces. For the purposes of the Fast Track approach, these would be fixed time periods (not necessarily of the same length). Many schemes may choose to step up their actual de-risking based on pre-defined triggers such as funding level, which are expected to broadly match the assumed periods.

300. This approach sits somewhere between the linear approach and horizon approach. If there are many short periods, then the approach will be similar to linear de-risking. If there is a small number of long periods, then the approach will be similar to the horizon method. Table 12 sets out the pros and cons of this approach:

Pros	Cons
☑ Potentially, this could represent the best of the linear and horizon method as there is some implicit de-risking in the journey but, by having set periods, it will be easier to plan the scheme's future investment strategy.	☒ More complicated to understand than the linear or horizon method.

Other approaches

301. There are numerous other approaches to de-risking, which could be built into the discount rates based on a combination of the three approaches set out above. For example, we could have a mixture of the horizon and linear approach where there is a fixed level of assumed investment risk and return over an initial period, followed by period of de-risking along a straight line down to a low dependency level.

302. Alternative approaches could be used which implicitly build in de-risking without explicitly linking it to a particular time period. For example, a common approach is the 'pre- and post-retirement' method where a higher discount rate is used prior to a member's pension age and a lower rate thereafter, the overall rate being a function of the scheme's membership distribution.

303. We would be interested to hear about the other approaches schemes currently adopt and what alternatives people would recommend we consider.

► Questions:

Q30 Journey plan shape for Fast Track TPs

a. Which shape of journey plan is most appropriate to define for calculating the Fast Track TPs and why? Does this vary depending on the circumstances of the scheme?

b. Are there any other journey plan shapes we should consider?

c. What unintended consequences might arise from adopting the linear de-risking or horizon method journey plans for Fast Track?

Comparison of the proposed approaches with those commonly in use.

304. To promote effective compliance and to minimise sudden changes across the DB funding landscape, we want to ensure that most schemes can choose to take the Fast Track compliance route without making material changes to their approach to journey planning and setting TPs.

305. Table 13 summaries how four valuation approaches used to calculate TPs compare to the proposed journey plans set out in the previous section:

Valuation approach	Description	How commonly used currently	Comparison to proposed journey plans
Pre- and post-retirement discount rate	Post-retirement discount rate applies to current and future benefits paid to pensioners. Typically, the rate is in line with returns expected on a lower risk investment strategy which broadly match liabilities. Pre-retirement discount rate applies for period up to each member's retirement. Typically, the rate is in line with the higher expected returns from a portfolio which includes a proportion of growth assets.	Very common.	Broadly aligns with the linear de-risking journey plan.
Single discount rate	A single fixed discount rate, or single fixed addition to a risk-free rate (eg gilts or swaps), which applies over all periods.	Quite common.	Diverges from all the journey plans over time.

Horizon method	One discount rate which applies over an initial period followed by a different discount rate which applies for all period thereafter.	Small proportion of schemes.	Most closely aligns with the horizon journey plan.
Term-dependent discount rates	Discount rates that vary each year based on some assumptions for the scheme's investment strategy in the future. Normally allows for some de-risking in the investment strategy.	Small proportion of schemes.	Normally aligns with our proposed principles so can comply without significant adjustment.

306. We have provided a more detailed explanation of how the different approaches compare below:

- **Pre- and post-retirement discount rate**: If the post-retirement discount rate is set at the low dependency basis discount rate, then the effective discount rate in each year is likely to follow a pattern similar to the linear de-risking approach. As a result, the TPs under the two approaches are likely to be similar at most maturities and so many schemes using pre and post discount rates will be able to comply with Fast Track without adjusting their approach.
- When the level of TPs may differ is when the scheme reaches significant maturity. At this point, the TPs under a pre- and post-retirement discount rates approach are likely to be somewhat lower than the linear de-risking approach because a proportion of the members will not have retired. This could be managed in practice by reducing the post-retirement discount rate to a level slightly below the low dependency discount rate.
- **Single discount rate:** Using a single discount rate (at a higher rate than the low dependency discount rate), which does not change over time, is likely to diverge significantly from the proposed methods as the scheme gets closer to significant maturity. There is no explicit de-risking in a single discount rate approach and consequently, when the scheme is significantly mature, the discount rate could be significantly higher (and the TPs significantly lower) than under our three proposed journey plan approaches.
- Many schemes that currently calculate their TPs using a single discount rate appear to be planning to reduce the discount rate at future valuations as the scheme becomes more mature. If they do reduce the discount rate as planned, this approach may resemble one of the approaches above, depending on how the reduction is applied in practice.
- **Horizon method:** There are a few different horizon methods currently in use. Some of these are more like a pre- and post-retirement discount rate approach (and therefore produce similar results to the linear de-risking approach). Others are more like the horizon method we are suggesting under the new framework, eg a higher discount rate over an initial period of, say, 15 years and a lower discount rate thereafter. For most schemes, it would be a relatively easy change conceptually to ensure the TPs comply with our Fast Track if it was based on the horizon method journey plan set out above.
- **Term-dependent discount rates:** Schemes are increasingly adopting term-dependent discount rates, which allow for assumed de-risking year by year. Schemes are using several different shapes for their de-risking plan. However, such a journey plan should conceptually align with our proposed principles, so that trustees of such schemes should be able to comply with Fast Track without significantly adjusting their approach.

Employer covenant and TPs

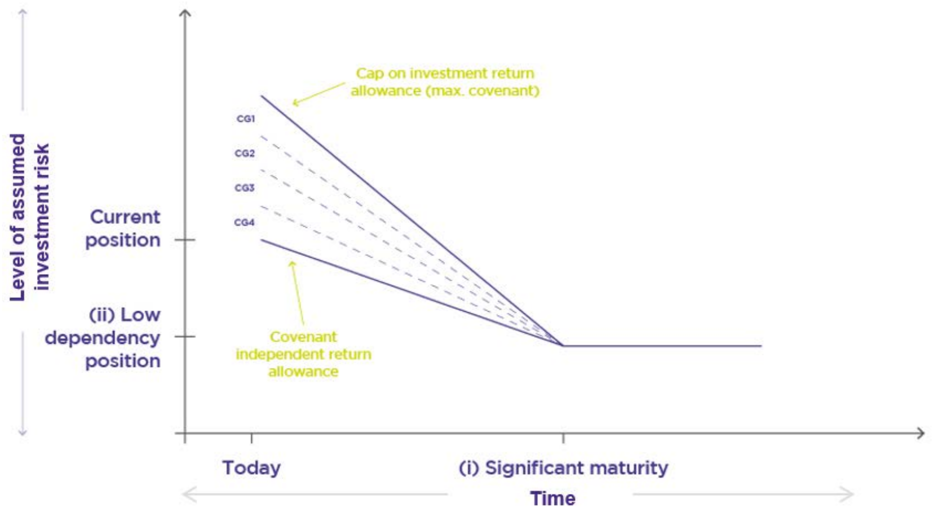
307. In addition to the broad shape of the journey plan, we need to consider which factors should affect the shape of the discount rates/TPs in the Fast Track framework. The employer covenant is a key scheme-specific factor which could determine the appropriate assumed level of risk and return to assume in TPs.

308. In Chapter 4 on the role of the employer covenant, we are seeking views on whether reliance should be placed on the employer covenant in the funding regime and, if so, how the covenant should be factored in.

309. Our starting point for the purpose of this consultation is that we should assume schemes can rely on the covenant to underpin additional levels of investment risk assumed in setting discount rates and TPs (in line with current market practice) – albeit subject to our defined limits.

310. Figure 2 below illustrates Fast Track discount rates assuming (illustratively) a linear de-risking shape for the journey plan. We would set baseline TPs which are independent of covenant and define additional lines allowing for higher assumed investment risk in the TPs for different covenant strength up to a maximum assumed investment return allowance (for CG1).

311. While we could envisage schemes assuming additional investment risk under this approach, where evidenced by stronger employer covenant, we would (for the reasons above) expect these lines to converge to the LTO. This would mean there is low dependence on the covenant at the point of significant maturity (unless, for example, underwritten by additional support such as a contingent asset, as discussed in Part 4 (Bespoke framework)).



► Questions:

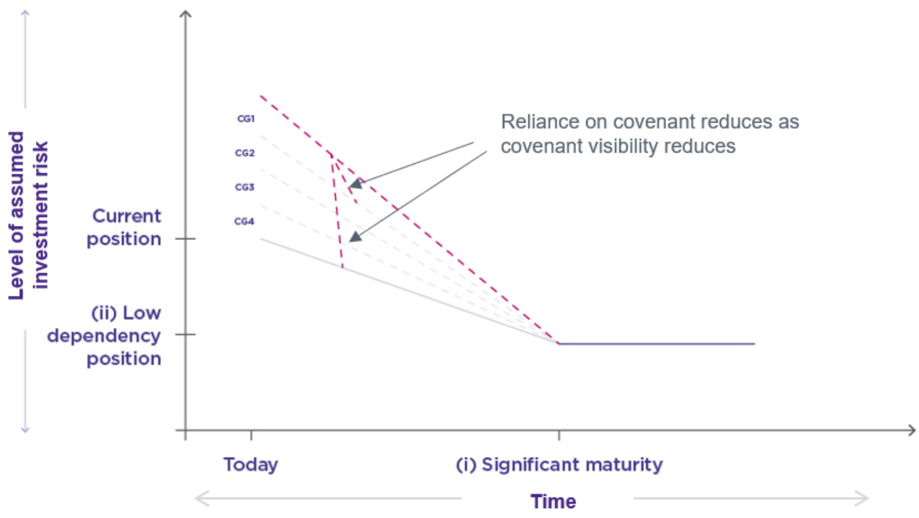
Q31 **Key factors for Fast Track TPs** – Should other scheme-specific factors other than covenant and maturity be considered to define the journey plan and TPs in Fast Track?

Covenant visibility

312. In Chapter 5 on the General principles, we discussed how long covenant should be relied upon. That is, whether *full* reliance on covenant strength should be time-limited to the period over which there is good covenant visibility. Should the concept of a ‘covenant horizon’ be appropriate, we also need to consider, in practical terms, how this should be reflected within a scheme’s TP calculations under the Fast Track regime.

313. Figure 3 below provides a simplified illustration of how the covenant visibility might be allowed for in the discount rate assuming a linear shape for the journey plan. In this example there is assumed to be full reliance on the strong (CG1) covenant for the short-to-medium period (eg three to five years), with a range of options for what might be appropriate for reducing reliance on the (unknown) covenant beyond that time.

314. We are seeking views on the extent to which covenant visibility should be embedded in the journey plan (ie how much reliance should be placed on the covenant beyond the short and medium term), as detailed in Figure 3 and the questions below.



► Questions

Q32 Extent of reliance on covenant in Fast Track TPs

a. Should we define a maximum period of acceptable full covenant reliance for Fast Track TPs? For example, a general guideline of five years? Or should covenant reliance be assumed to decline in the much shorter term (or immediately)?

b. What level of covenant support should subsequently be assumed? Should there be an assumption of a single covenant grade reduction (eg CG1 to CG2), a reduction to assumed returns in line with a weak covenant, or something else?

c. Over what period should any reduction in reliance take place? Should this be immediate (eg a reduction to a lower covenant reliance in the sixth year) or more gradual (for example, over the subsequent five years)?

d. Does the need for a covenant visibility overlay depend on the approach taken for the journey plan to low dependency? For example, is this a more relevant consideration where the horizon journey plan shape is used?

Defining Fast Track TPs

How should Fast Track TPs be expressed

315. The concepts and principles discussed above will inform what parameters we put around acceptable journey plans and TPs under Fast Track.

316. We envisage setting acceptable TPs for Fast Track as a **maturity and covenant-linked matrix of ranges** expressed as either of the following:

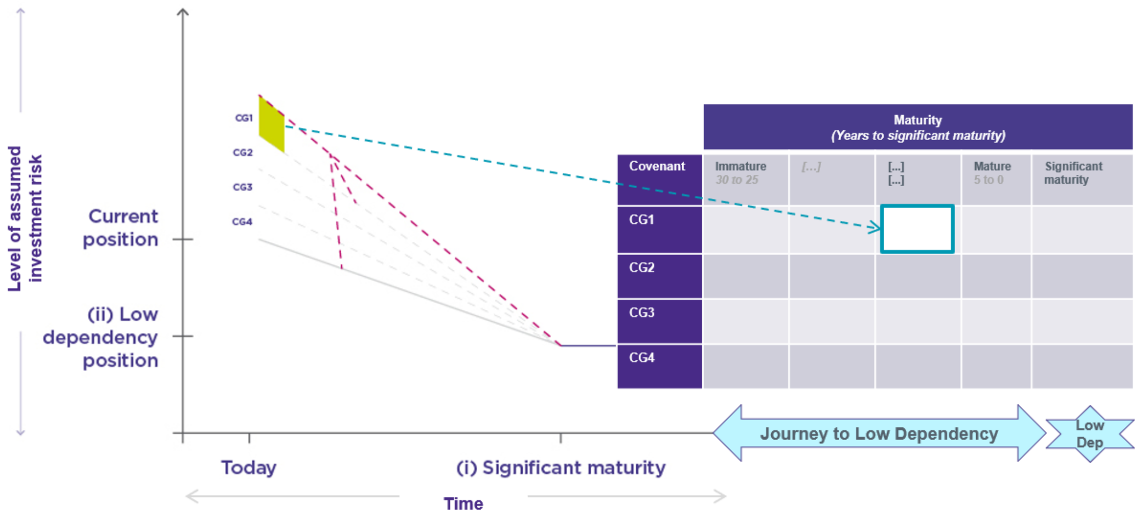
- **Discount rates** (maximum acceptable):

– **Single equivalent discount rates**, which could be expressed as nominal rates or a premium above the yield on gilts (eg 3.0% to 3.15% pa or Gilts +1.2% to 1.35%). To a large degree this is simply a presentational point, although it would affect how schemes would monitor their funding position and manage their risks. The approach of adding a premium above the yield on gilts is not the same as having a pre-determined fixed margin over gilts, which applies at each valuation. The premium would still be expected to vary in different market conditions.

– **Term/maturity dependent discount rates**, ie a full discount rate structure in line with our preferred journey plan shape. These could be defined as premiums over the gilts curve or year-by-year nominal rates.

- **Target TPs** (minimum acceptable under Fast Track) expressed as a percentage of the TPR-defined Fast Track minimum funding low dependency basis (eg 85% to 88% of low dependency) along the journey plan.

317. Figure 4 below illustrates how it could work:



318. Trustees would set their funding strategy in much the same way as they currently do, in collaboration with the employer and using an IRM framework:

- They would assess the strength of covenant (eg with reference to the new guidance as proposed in Chapter 4).
- They would assess the maturity of their scheme (to an agreed definition on which their scheme actuary will be able to advise).
- Using the table above, they should be able to read off the range of discount rates or TPs as a percentage of low dependency funding and compare with their actual parameters to determine consistency with the Fast Track approach.

319. The greater the reliance on employer covenant, or the more immature the scheme, the more risk can be assumed in the TPs (ie the lower the TPs compared to low dependency) up to the threshold we defined under Fast Track. Depending on the outcome of this consultation on the principle that trustees should assume a reducing level of reliance on the employer covenant over time (depending on its visibility), we may have to make a further assumption about how this will apply in practice. This may affect the construction and presentation of discount rates or target TPs. If necessary, we would provide an additional guideline on its application. We would also specify additional guidelines to ensure consistency between risk implicit in TPs and risk in actual investment strategy (see Chapter 10 on the investment strategy).

320. The pros and cons of each option are set out in Table 14 below:

Option	Pros	Cons
Discount rate – single equivalent rate	☑ Those we regulate are used to thinking about discount rates as a measure of TP strength. ☑ Compared to a full discount rate structure, provides greater scope for schemes to set an underlying discount rate structure that better reflects the trustees' preferred journey plan for the scheme (while still meeting the Fast Track requirements).	☒ In practice, it could look more like a Minimum Funding Requirement than TPs as a percentage of low dependency, although in practice, the difference may be presentational. ☒ Would need additional guidelines for some of the other key assumptions, where they are defined by us.
Discount rate – full structure	☑ Allows a connection to be then made to the actual investment risk being taken and planned for the future. This is more consistent with an IRM approach.	☒ This approach is more restrictive than the other approaches. ☒ Would need additional guidelines for some of the other key assumptions, where they are TPR-defined.
TPs as % of low dependency	☑ LTO and low dependency funding is a new requirement – a journey plan target line as a % of this new number may be a natural direction of travel for us to set. And it might be easier to understand and explain. ☑ It seems a less restrictive constraint on the design of TPs and the investment strategy. It may also remove some of the unhealthy focus on discount rates. ☑ It could solve some of the potential issues around prescribing other actuarial assumptions used to calculate TPs.	☒ The difference with discount rate approaches might just be presentational – depending on how we set it (eg using discount rates).

► Questions

Q33 How Fast Track TPs should be expressed – Which option do you think is preferable for defining TPs/journey plans under Fast Track and why? What are the practical issues associated with each option? If you disagree with these options, what would you suggest and why?

Deriving parameters

321. There are different methods we could use to determine the acceptable TPs (or maximum discount rates) for the Fast Track approach. We have described three such methods below, each of which is capable of further adaptation to incorporate decisions relating to the relevant consultation questions (such as shape of journey plan, allowance for covenant and the manner in which such allowance is made, whether we would set discount rates or TPs, and limits on investment risk).

322. These methods are not mutually exclusive, and in practice, they are most likely to be used in a complementary way, for example to sense-check results or provide an alternative interpretation of results for a more informed debate on the key factors.

Data driven approach

323. This approach would use our extensive data, and therefore be based on the actual behaviour of schemes, to inform possible lines (or some parameters) that define 'acceptable' practice for the level of TPs or discount rates under Fast Track.

324. For example, our data set of discount rates, reported by schemes, could be used to inform us on the structure and range of discount rates used by the universe of schemes. A baseline could be established by focusing initially on, for instance, the median discount rates for all DB schemes adjusted for consistency with the desired shape of the journey plan. The resulting rates could be maintained as term-dependent rates or converted for simplicity to single equivalent discount rates (SEDRs) or used to calculate TPs.

325. The baseline would then be adjusted further to allow for differential risk-taking, if appropriate, according to covenant support available to the scheme. For the purpose of distinguishing by covenant, we have little by way of practice to draw upon, because our data has consistently shown a distinct lack of correlation between covenant strength and risk embedded in the TPs (except, to a limited degree, for CG4 schemes). Any overlay for covenant-based risk in the TPs would have to be decided through other means. We are therefore interested in learning from respondents how schemes decide in practice the level of assumed investment risk considered appropriate based on their assessed covenant strength.

326. Table 15 sets out the pros and cons of this approach:

Pros	Cons
☑ Evidence-based approach: uses existing data (subject to limitations) to guide where the majority of the landscape sits. ☑ Data includes a variety of journey plan shapes and other behaviours encountered in practice. ☑ Can be used to control the scope and size of the Fast Track framework to take account of potential impacts.	☒ Pre-supposes that the selected schemes within the chosen subset are following the right behaviours and are on the right path to deliver. ☒ Data may not be entirely reliable – plus we must make further assumptions for translating to SEDRs and expressing them as premiums above the yield on gilts. ☒ This approach quickly becomes circular as schemes' current behaviour is used to anchor their future behaviour.

TP target: Stochastic modelling

327. In the period before the scheme reaches significant maturity, and consistent with the principle that TPs should reflect the LTO and the level of all risks over time, there should be an explicit link between the TPs and this long-term target. A mapping of the target level of TPs consistent with this could be determined by a stochastic modelling approach aimed at answering the question "What level of assets does the scheme need now so that, with an allowance for reasonable investment returns in the future but no further employer contributions, it is likely to reach low dependency funding at its point of significant maturity with an acceptable degree of confidence?"

328. This approach would require two key assumptions:

- The acceptable level of confidence for the success measure, on which we are inviting views from respondents.
- How investment strategies may change during the scheme's journey to low dependency, which would be informed by the other aspects of the consultation earlier in this chapter.

329. In addition, there would be numerous other assumptions which would be used in any stochastic model. If we target this approach to setting TPs for Fast Track~~,~~ we will consult on how best to set those assumptions (they would also be informed by the outcome of the consultation on 'other assumptions' in Chapter 8).

330. The resulting target TPs would be specific to the scheme's current level of maturity and the regulatory requirement for Fast Track would be better expressed as a target percentage of the low dependency funding (rather than a discount rate).

331. The pros and cons of this approach are set out in Table 16 below:

Pros	**Cons**
☑ Provides deeper insights to the key moving parts and appropriate balance. ☑ Reflects how schemes may be approaching the problem. ☑ Allows more robust testing under different economic scenarios. ☑ May allow us to be less prescriptive on the shape of the journey plan.	☒ Requires a pre-determined success criterion. ☒ Size of expected Fast Track segment more difficult to control. ☒ Back-solving to a discount rates guideline is complex. ☒ Subject to model risk and assumptions, which would be difficult to regulate without some form of model approval regime which would be resource-intensive.

TP target: Deterministic modelling

332. This approach would seek to answer the same question as in the previous approach, but instead of a stochastic model to generate a range of future economic and investment scenarios, a set of deterministic assumptions would be used. This approach would once again reflect a preferred journey plan shape based on the outcome of the consultation in the earlier part of this chapter, making assumptions about expected prudent returns from the appropriate investments.

333. The pros and cons of this approach are set out in Table 17 below:

Pros	**Cons**
☑ Simpler to apply than the stochastic approach. ☑ Allows particular scenarios to be modelled – more conducive to engagement by trustees.	☒ Results are sensitive to judgements made about prudent investment returns. In practice risks could be minimised by agreeing assumptions with an expert industry group.

► Questions

Q34 Method to derive Fast Track TPs

a. Do you prefer a particular approach? If so, why? Is there another approach that would be suitable?

b. Do you have ideas as how to best approach each option?

c. How do trustees incorporate considerations about covenant strength into their TP assumptions/discount rates?

d. If a stochastic approach is adopted, what would you consider to be an appropriate confidence level against which to mark the results?

e. Do you have any data or modelling results which you think would provide useful evidence for the baseline TPs or covenant overlay? Please provide full details of methodology/data limitations.

10. Investments

PRINCIPLES	
	★ The actual investment strategy and asset allocation over time should be broadly aligned with the scheme's funding strategy (TPs and RP). ★ Trustees must 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. ★ We expect the asset allocation at significant maturity to have high resilience to risk, a high level of liquidity and a high average credit quality.

Introduction

334. Future investment returns are one of the most important factors in meeting future cash flow obligations when they fall due. Schemes with a longer time horizon and ones with strong employers can afford to take more investment risk and potentially benefit from the greater returns.

335. We do, however, see many schemes rely heavily on investment returns to meet future cash flows but with limited or no support from the sponsoring employer if an adverse investment outcome occurs.

336. We consider it is very important to set out clear expectations on investment as part of the revised DB funding code. For example, we do not think that two virtually identical schemes with exactly the same benefit cash flows and level of funding should be treated the same if the level of investment risk is very different (eg one is invested in 100% equities and the other is invested in 100% long-dated government bonds).

Defining investments and risk

337. Investment risk depends on a number of factors, including, but not limited to, the following:

- diversification
- allocation to growth (return seeking) assets, and
- Amount of interest rate/ inflation/ currency hedging.

338. Throughout this document, we use the terms 'growth' and 'matching' assets (see Glossary in Chapter 17). We realise that many schemes use a variety of methodologies to allocate their assets, but we think this is a useful distinction, although we acknowledge its limitations. There are also a wide range of views as to what should be included in the 'growth' and 'matching' categories and how assets with characteristics of both (eg property) might be treated. However, for simplicity we have used equities as an example of a growth asset and UK gilts as an example of a matching asset.

Application in Fast Track

339. Our aim is to consult on the appropriate *level of investment risk* that a scheme should take. For the avoidance of doubt, we are not proposing setting guidelines that promote or prohibit any category or type of investment. Our proposals are underpinned by the principles set out above and discussed in Chapter 5 (note that they would apply to both Fast Track and Bespoke approaches).

340. In order to develop Fast Track investment compliance guidelines, we need to address the questions below and welcome views on our proposals:

A. The reference point from where to measure investment risk.

B. How to measure investment risk.

C. The appropriate maximum level of risk (for a significantly mature scheme as well as other maturities) in Fast Track.

D. What we would expect if a scheme exceeded the maximum allowable risk under Fast Track.

E. Additional requirements around liquidity and quality.

341. All quantitative examples are *indicative/illustrative* at this stage and are subject to change following the outcome of this consultation, developments in other elements of the framework and our impact assessment.

Reference point from which to measure investment risk

Liabilities versus assets as a reference point

342. Typically, schemes are concerned about a deterioration in funding caused by an adverse investment scenario and, therefore, it makes sense to include the **liabilities** as a reference point to measure risk. A reference point only based on assets (for example cash) would ignore the sensitivity of liabilities to a change in interest rates and/or inflation. Therefore, we consider that the appropriate reference point is either:

- a **scheme-specific measure of the liabilities**, or
- a **reference investment portfolio that represents the interest rate and inflation sensitivity of the liabilities of an average scheme.**

343. Pension schemes have different inflation sensitivities depending on their individual pension increases and the sensitivity of their liabilities to inflation will therefore vary. Some schemes will have many tranches of their pensions that have different level of sensitivities to inflation (for example, if pension increases are inflation-capped at a certain level) or indeed different types of inflation (for example RPI or CPI). We therefore think that a scheme-specific measure of liabilities is more appropriate to measure risk from.

344. However, we note that including a stress of the liabilities (should we opt for a stress test to quantify the risk – see sections below) may be more burdensome for smaller schemes. We therefore consider below whether the second option (reference investment portfolio) would be an appropriate one for smaller schemes.

Which measure of the liabilities?

345. Focusing on the first option, there are a number of possible measures of the liabilities that could be used as a reference point under Fast Track:

- **Fast Track TPs basis**
- **Fast Track low dependency basis** (eg somewhere in the range of Gilts +0.5% to Gilts +0.25% – see Chapter 8), or
- **Gilts 'flat' basis** (ie fully in line with the return on Gilts).

346. We consider the pros and cons of each option in Table 18 below:

Option	Pros	Cons
Fast Track TPs basis	☑ Same measure as is used for funding.	☒ Not a low risk position as it allows for a higher level of investment returns as the scheme is more immature. ☒ Unlikely to be used as a measure of liabilities if a scheme was trying to remove all its interest rate/ inflation risk through hedging. ☒ Scheme-specific measure so doesn't enable easy comparisons across different schemes.
Fast Track low dependency basis (eg somewhere in the range of Gilts +0.5% to 0.25%)	☑ Consistent with the long-term funding basis under Fast Track. ☑ Consistent measure across all schemes. ☑ Allows a scheme to think about risk as a deterioration of the low dependency funding level or an increase in deficit.	☒ Although a low risk measure, it still allows a small degree of return/ risk and is consistent with a portfolio with a small allocation to equities or one which has corporate bonds, both of which have a degree of risk. ☒ A scheme trying to reduce as much risk as possible vs its liabilities is unlikely to use a Gilts +0.5%-0.25% to value the liabilities for hedging purposes.
Gilts 'flat' basis	☑ A lower risk, more conservative measure. ☑ Consistent with a matching portfolio of UK gilts and UK inflation-linked gilts with little or no risk of default. ☑ Closer to buy-out pricing for a typical scheme with a mix of active, deferred and pensioner members. ☑ Consistent measure across all schemes.	☒ A new basis/ new calculation of liabilities in addition to the TPs and the low dependency basis used for the LTO.

347. Both the TPs and low dependency basis have a discount rate that implicitly assumes a level of investment risk in the form of a portfolio with equities or corporate bonds or both. Some equity investments have future cash flows (dividends) but these are not guaranteed and, as such, are a poor match to the liability cash flows. Corporate bonds do have a set of expected future cash flows, but they are subject to risk of default. Both asset classes are key components of many investment portfolios and we encourage their use. However, we consider, from a theoretical perspective, that the lowest risk position from which to measure risk is a pure gilts measure which provides an investment with predictable cash flows with minimal default risk. On the other hand, there are some advantages of using a low risk alternative (Fast Track low dependency) from a practical perspective.

348. After careful consideration, we do not think that Option 1 (TPs) is appropriate as a reference point to measure investment risk from as this measure already assume a degree of investment risk. We prefer either Option 2 (Fast Track low dependency basis) or Option 3 (Gilts flat basis).

Simpler approach to measuring risk for small schemes

349. Using any of these two measures of liabilities (Fast Track low dependency or Gilts flat basis) may carry the cost of extra calculations by the scheme actuary as the liabilities would need to be re-calculated with the stress (should we go down the option of a stress test to quantify the risk – see below). We therefore propose a simpler approach to address the cost issue for smaller schemes. For the avoidance of doubt, this applies only to the liabilities.

Using a reference portfolio as a proxy for liabilities

350. For the purpose of developing Fast Track compliance guidelines for investment risk, we propose allowing smaller schemes to use a simple reference portfolio to represent their liabilities if they wish. This portfolio would consist of fixed-interest gilts and inflation-linked gilts represented by market indices of an appropriate duration. This would be for the purpose of measuring the investment risk of the liabilities with a standard assumption as to the proportion of liabilities that are sensitive to inflation.

351. We expect larger schemes to calculate scheme-specific sensitivity of their liabilities to interest rates and inflation. This would typically be done by the scheme actuary. This approach would also be available for smaller schemes that may choose to use a scheme-specific approach.

352. Small schemes for this purpose could be defined as follows:

- The **number of members** (for example, fewer than 100).
- The **size of assets** (for example, less than £20m).
- The **size of liabilities measured on Fast Track TP basis** (for example, less than £20m).

How could we construct a reference portfolio to represent the liabilities?

353. According to our data, the average inflation sensitivity for schemes is approximately 70% and we would therefore propose using a reference portfolio consisting of fixed-interest gilts and inflation-linked gilts that has around 70% sensitivity to inflation. For a significantly mature scheme, a reference portfolio as a proxy to liabilities could have the following characteristics:

- 100% invested in government bonds (fixed and inflation-linked),
- 70% inflation sensitivity, and
- duration of 14-12 years.

354. For more immature schemes, a portfolio with longer dated fixed-interest government bonds and longer dated inflation-linked government bonds would be appropriate. One approach would be to allow schemes to use a mix of the significantly mature liability reference portfolio and an immature liability reference portfolio, with a higher duration, depending on their level of maturity. A more mature plan will have a higher weight to the significant maturity reference portfolio and vice versa.

355. The above Fast Track guideline is clearly a simplification and makes no allowance for the specific types of inflation increase or indeed the profile of the liabilities. For small schemes with a fairly typical benefit structure, this approach should work well. If a small scheme has a very different profile or has an inflation sensitivity materially different from 70%, then they should seriously consider asking their scheme actuary to perform the sensitivity analysis on the liabilities, as is the case for larger schemes.

► Questions

Q35 Which reference point from which to measure investment risk in Fast Track

a. Would a measure of the liabilities be an appropriate position to measure investment risk from? If not, why not?

b. Do you prefer a liability measure on the low dependency basis (Gilts +0.5% to +0.25%) or a Gilts flat basis? Why? Are there any other liability measures that would be suitable?

c. Would a liability reference portfolio approach (as a proxy for liabilities) for smaller schemes be more proportionate and practical? If so, how should a small scheme be defined for this purpose (number of members, assets or liabilities)? What would be an appropriate threshold?

d. Would a reference portfolio consisting of gilts and inflation-linked gilts with a duration similar to the liabilities be appropriate as a proxy for the liabilities for smaller schemes? If not, how would you go about constructing a reference portfolio as a reference point from which to measure risk for smaller schemes?

Methodology for measuring investment risk

Two options to quantify investment risk

356. We see schemes using various methods to measure investment risk but, for Fast Track, we would like to specify a methodology that is:

- not overly complex
- easy to apply (acknowledging the limitations of a simpler approach), and
- is consistent across schemes.

357. Moreover, we want to avoid the situation where two identical schemes have a different measure of investment risk because of the specific model they have used to calculate the investment risk.
We see two possible approaches to measuring the investment risk:

- **Defining a percentage of growth assets**, or
- **using a simple stress test**.

358. We set out a worked example (with illustrative numbers) in Chapter 15 to illustrate how a stress test would work.

Percentage growth assets

359. Under this approach, we express the current asset allocation as a percentage in growth assets and a percentage in matching (or non-growth) assets. Growth assets are typically return-seeking and do not have a high correlation to the liabilities. Conversely, matching assets are correlated to the liabilities but have low return expectations. The percentage allocation to growth assets is then compared to a maximum permitted threshold that varies by maturity.

360. As mentioned before, some asset classes do not fall neatly into growth or matching and have characteristics of both. To use this approach, we would need to be clear on the allocation between growth and matching assets. An example allocation is set out in Table 19 below:

Asset Class	% Growth	% Matching
Equities	100	0
Hedge funds	80	20

Insurance funds	60	40
Property	75	25
Corporate bonds	25	75
Government bonds	0	100
Cash	0	100
Deferred or immediate fully insured annuities	0	100
Other asset classes	100	0

Simple stress test

361. This approach stresses the assets and the liabilities (or liability reference portfolio for smaller schemes) by a set of factors, typically a fall in long-term bond yields combined with a fall in level of growth assets. Under such a stress, growth (return-seeking) assets fall and matching assets (for example, bonds) increase as they generally have an inverse relationship with bond yields. The value of liabilities is not affected by a stress in growth assets but is affected by a fall in interest rates/ bond yields which typically increases their value.

362. Our preferred approach is to use a simple stress test to measure investment risk, as it captures not only the investment risk associated with growth assets (equities, etc) but also the degree of interest rate and inflation risk relative to the liabilities. Moreover, a scheme that hedges all or part of its exposure to interest rates and inflation will report a lower stress in funding level than one that does not hedge. We consider such a distinction is appropriate and would not be possible under the first option (% growth / matching) as it just looks at the allocation to growth assets in isolation.

Defining a pensions stress test

Key characteristics

363. There is not one universally accepted stress test. Several countries in Europe use their own stress test to measure investment risk within the pension framework. Although all different, stress tests within the pensions regime typically take the form of an instantaneous fall in the market value of growth assets (which typically impacts the value of the assets), combined with a fall in level of bond yields, which typically increases the value of the liabilities as well as the value of the bonds held as part of the assets.

364. Table 20 below summarises what we see as essential requirements for an appropriate pensions stress test to measure investment risk. It is important for any stress test to capture the risk of growth assets and interest rate risk relative to the liabilities.

Characteristics of a good pensions stress test	
Risk level	Should represent a downside investment scenario with an associated probability (1 in x years).
Standardised and Objective	A test should be objective so that two identical pension schemes with exactly the same asset allocation show the same numbers.
Flexible	We should have a degree of control of how the test is designed to change the stresses if required.

Growth assets	Fall in value.
Matching assets	Increase in value as the market value of bonds increases as interest rates/ bond yields fall.
Liabilities	Increase significantly in value as the value of liabilities increases as interest rates/bond yields fall.

Which stress test?

365. A number of stress tests (described in Table 21 below) are currently in use in the UK and other European countries. Some of these are specifically related to pension schemes and others relate to other areas of finance.

Brief description of existing stress tests	
PPF	Used by the PPF as part of the levy calculation and familiar to many UK schemes.
PRA	Not a pensions stress test but one that is used for the banking and insurance sectors in the UK. Fairly complex with multiple stresses applied to many different sub-asset classes.
EIOPA	A standard test used in Europe to measure the risk of pension schemes on the same basis. Fairly complex with multiple stresses applied to many different sub-asset classes.

366. In addition, we could design our own stress test for the purpose of measuring investment risk in Fast Track. We have set out below the pros and cons for all these options in Table 22 below.

Option	**Pros**	**Cons**
PPF stress test	☑ Already familiar to the UK pensions industry as it is used for the levy calculation. ☑ Fairly simply to apply to assets as there are a limited number of high level categories. ☑ Guidance already available in terms of how to apply the test in more complex situations, for example, when using derivatives. ☑ Potential to amend the stress test and the sub-asset classes that are stressed by working with the PPF in the future.	☒ Relies heavily on the existing categories of the current scheme return. ☒ Not designed for the purposes of measuring the risk in relation to long-term funding. ☒ PPF liabilities are different from those of an ongoing DB scheme so the stresses will need to be applied to a new liability measure.

PRA stress test	☑ Consistency with other sectors (banks, insurers).	☒ Complicated and costly to implement. ☒ Currently aimed at UK banks, building societies and insurers and therefore does not take account of specific risks relating to the funding of pension schemes.
EIOPA stress test	☑ Consistency across Europe.	☒ Reasonably complex to implement. ☒ Unfamiliar to many small and medium UK pension schemes. ☒ Launched recently so industry still getting used to the test. ☒ Bond yields increase in the stress test. Pension schemes are typically concerned with a fall in bond yields.
Separate TPR stress test	☑ Full flexibility to focus on risks from a funding perspective. ☑ Can be set at any risk tolerance (currently the PPF test is based on a one in six-year downside event).	☒ Scheme would need to understand two separate tests to measure investment risk, one for the PPF and one for us. ☒ Schemes may question why they were assessing investment risk twice even though the objectives are different. ☒ New methodology and guidance required on how to apply the test.

367. Our preference is to use a TPR-defined stress test for the purpose of measuring investment risk so that we can specify it in a way that meet our needs and review and potentially revise it from time to time to ensure it remains appropriate. However, we are also conscious that DB schemes already use the PPF stress test for levy purposes and that there would be advantages, from a burden point of view, to use one single stress test for DB pensions. This approach allows us the flexibility to depart from the PPF stress test in the future if it is deemed necessary.

368. We therefore think that the stresses and methodology adopted by the PPF would provide a good starting point to develop an appropriate stress test for funding. The PPF stress tests has the following broad stresses (as at the time of writing):

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

369. For schemes with PPF (section 179 valuation) liabilities greater than £1.5b, it is mandatory to use a PPF Bespoke test which takes into account the maturity of assets to a greater extent, as well as any use of derivatives. The PPF Bespoke option is also available for schemes under £1.5bn of PPF liabilities if they

wish to use it. For the purpose of the DB funding stress test, we propose using the same approach and the same threshold to allow for consistency, and to avoid schemes having to carry out two tests for the purposes of stressing their assets.

370. We are aware that the PPF will review its stress test in the coming months. The levels of stress for individual sub-asset classes and the actual sub-asset classes that might be used are typically reviewed during this process. We do not expect this review to change significantly our view that using the PPF stresses would provide a good starting point. We will also discuss with the PPF how we could develop a common stress test that works for both our purposes.

371. We are working with the PPF on revising the existing asset class information that we will require schemes to submit. We are keen to ensure that schemes should only need to submit one set of asset class data and we recognise that there is merit in expanding/amending the asset classes used to provide a better insight into the level of investment risk. This objective is shared by both the PPF and TPR and, with this in mind, we plan to issue a joint consultation on amending the scheme asset class information.

Limitations of any stress test

372. It is important that any stress test used is relatively simple to perform and easy to understand. This inevitably leads to some simplifications, which are stated below:

- Most stress tests assume a parallel change in bond yields across the yield curve. This does not capture the risk associated with a flattening or steepening of the yield curve but captures the key duration risk of the assets/liabilities.
- The stresses are assumed to occur instantaneously, which in reality is unlikely. However, if one builds in a change occurring over a period of time, then an important additional assumption is the return of each asset class. This makes the calculation more complicated. On balance, an instantaneous stress strikes the right balance between capturing the key aspects of volatility whilst maintaining simplicity.

How should the result of the stress test be expressed?

373. The stress test will typically lead to a change in the assets and the liabilities, with an increase in the deficit (or decrease in the surplus) after the stress compared to before.

374. There are three main options as to how to express the impact of the stress test (all ratios):

1 **Change in surplus or deficit */ starting liabilities* (preferred)**

2 **Assets at start / liabilities at start/(assets after stress / liabilities after stress) -1**

3 **Change in deficit / starting assets**

**Surplus/deficit = assets – liabilities defined below (low dependency/Gilts flat)*

***Note that for the stress test purposes, liabilities = low dependency liabilities or Gilts flat liabilities*

375. Although these options are similar when a scheme has assets similar to the low dependency or Gilts flat liabilities, they differ significantly when a scheme has assets materially lower than these liabilities. This is particularly the case with immature schemes (when the TPs are much less than low dependency) and/or when a scheme is significantly underfunded.

376. In general, when assets are lower than low dependency/Gilts flat liabilities, Option 1 will give the lowest result and Option 3 the highest. If Option 3 is chosen, then an underfunded or immature scheme will face a tougher test than a well-funded or mature one.

377. We consider Option 1 is preferable and is consistent with the concept of liabilities being the appropriate place to measure risk from.

► Questions

Q36 Methodology to measure investment risk in Fast Track

a. Would a simple stress test to measure investment risk in Fast Track be the most preferable option? If not, why not? Are there other measures of investment risk that are more suitable, taking account of the desire for a relatively simple and objective measure?

b. Do you agree with the proposed principles for an appropriate pensions stress test, namely a fall in growth assets and a fall in interest rates? If not, what do you suggest?

c. What are your views on which stress test we should use? Do you think the PPF stress test (Bespoke and simple approach) would be a good starting point?

d. Which of the ways to measure the impact of the stress would you prefer and why? Is there an alternative method not listed that would work better? If so, please describe it.

The appropriate level of maximum investment risk in Fast Track

378. Having determined which reference point to measure risk from and which measure of risk to use, we would need to specify a threshold for the maximum acceptable level of investment risk under Fast Track.

379. In the sections below, we focus and seek views on the following:

- What considerations and principles should we follow in defining an acceptable maximum risk level for a significantly mature scheme at low dependency under Fast Track?
- Based on these considerations, what would these investment limits for a significantly mature scheme look like?
- What considerations and principles should we follow in defining an acceptable maximum risk level for an immature scheme under Fast Track?

Considerations for defining a maximum level of investment risk for a significantly mature scheme

380. In establishing an appropriate maximum threshold for investment risk under Fast Track, we think it is logical to start at the point at which a scheme reaches significant maturity. When a scheme is significantly mature, it should have low reliance on the sponsoring employer, ie low dependency funding. From an investment risk perspective, this means a scheme should have an investment portfolio with a high resilience to investment risk.

381. To set an appropriate maximum risk for a significantly mature scheme, we think it is helpful to consider the following:

- The downside risk of possible low investment risk portfolios.
- The expected return of possible low investment risk portfolios to ensure they are consistent with the discount rate used in the Fast Track calculation of the low dependency liabilities.

(a) Downside risk of low investment risk portfolios

382. Focusing on the key investment risks of (i) a fall in growth assets and (ii) a fall in bond yields, it follows that a low risk investment portfolio should have low risk (relative to the liabilities) in each of these areas.

383. We consider that acceptable investment portfolios consistent with low dependency should protect the funding level of the scheme and, in an adverse investment scenario (growth assets falling and bond yields falling), suffer only a small deterioration in funding level.

384. For growth assets, the allocation to these asset classes should be low to avoid a fall in market value. For interest rate risk, the asset portfolio should have a duration similar to that of the liabilities. If we consider modelling we commissioned from GAD (see Chapter 16), which looks over a longer time period, we can see the impact of the level of growth assets on low dependency funding level. The 10% growth portfolio has low risk in the short term but leads to a significant deterioration in probability of a fall in funding over the long term. The portfolios of 20% and 25% growth assets show a better trade-off between the medium term and long term. This is illustrated in Table 23 below.

Probability of funding level falling below 95%	Short term (3 years)	Medium term (5 years)	Longer term (12 years)
10% growth	4%	12%	37%
20% growth	12%	17%	22%
25% growth	14%	18%	20%

(b) Expected return of low investment risk portfolios (consistency with assumptions for LTO)

385. In addition, according to the investment principle set out in Chapter 5, the expected returns of the actual asset allocation for a mature scheme should be broadly consistent with the assumptions used to value the liabilities of a mature scheme. Under Fast Track, this is the low dependency basis. With this in mind, a prudent expected return on **actual** asset allocation should be broadly consistent with the discount rate used for the low dependency basis (which we propose could be somewhere in the range of Gilts +0.5% and Gilts +0.25% (subject to consultation).

386. We have taken the approach throughout the document of looking at the discount rate first and considering the impact of this on associated asset allocations afterwards. This logic flows from the legislative approach, which places the focus on funding and the assumptions associated with discount rate.

387. Mapping a discount rate to a set of asset allocations may appear straightforward but is complicated by two factors. Firstly, the best estimate assumptions of asset classes vary significantly between investment managers and consultancies. Secondly, the allowance for prudence has historically been applied in a variety of ways by different trustees and consultancies, leading to a large variation in the allowance from scheme to scheme.

388. In our experience, long-term best estimate expected returns of growth assets used by trustees, investment consultants and fund managers vary, but typically fall in the range Gilts +3% to Gilts +5% net of fees. For example, this would mean a portfolio with 20% growth assets would have an expected return of between Gilts +0.6% to Gilts +1.0% (assuming the rest of the portfolio is invested in Gilts). Clearly, there needs to be a small reduction for prudence, but any adjustment should be relatively small as we are considering a low risk funding and investment strategy. In our view, an investment portfolio with a higher level of growth assets than 20% is unlikely to have a prudent expected return consistent with the low dependency funding basis at significant maturity.

Maximum level of investment risk for a significantly mature scheme under fast track

389. In view of the above, we consider an appropriate maximum level of investment risk in Fast Track for a significantly mature scheme that has reached low dependency funding to be consistent with a portfolio of 20% growth assets. As noted in Chapter 16 (Evidence and analysis), the GAD modelling of higher risk investment strategies suggests that the trade-off between higher expected returns in the long term and the associated higher short-term risk becomes important. For example, increasing the proportion of growth assets in the investment strategy increases the expected returns and therefore the chance of reaching buy-out funding. But it also brings increased volatility to the funding level, and thus increases the likelihood of the trustees having to resort to the employer for additional funding. Other higher risk strategies repeat this pattern.

390. Under the PPF stress test (one in six years), this equates to around 4% deterioration in funding level assuming the bonds held mean that the portfolio, as a whole, has a similar interest rate and inflation sensitivity to that of the liabilities. A '1 in 20 event' would lead to a significantly higher deterioration than 4%. In our view, a portfolio with a higher level of growth than 20% would not be consistent with a portfolio with a high resilience to risk.

391. A 20% growth allocation also provides an appropriate balance of short, medium and long-term risks as measured by the probability of falling below a 95% funding level (see GAD modelling) and is broadly consistent with the LTO discount rate after making a small deduction for prudence.

392. Assuming that schemes continue the trend of the last ten years of increasing their allocation to bonds, then the average scheme allocation to non-bonds is likely to be less than 20% by 2028, at which point a scheme of average maturity now will be approaching significant maturity as defined by a duration of 14-12 years (see Chapter 8). The maximum at significant maturity is therefore unlikely to impact a scheme of typical maturity now.

Considerations for defining a maximum level of investment risk for an immature scheme under Fast Track

393. We currently see DB schemes that are of average maturity or are immature, investing a significant proportion of their assets in growth assets. This is generally appropriate as they are benefiting from a longer-term horizon and do not have the negative cash flow constraints of mature schemes that can crystallise losses after an adverse investment event. There are, however, risks associated with a portfolio that has higher volatility versus the liabilities. In particular, employer insolvency can crystalize any deficit and may occur after an adverse investment market event. Getting the appropriate balance between the expected return and the medium and long-term risks are therefore important.

394. We discuss below the following factors below, which we think we should consider in setting investment limits for immature schemes under Fast Track:

- The shape of the de-risking journey plan.
- Downside risk in the medium and long term.
- Whether covenant should be factored in and how.

Shape of the de-risking journey plan

395. As discussed in Chapter 9 on TPs, there are two main approaches to journey planning, namely the linear de-risking method and the horizon method (the stepped approach being a mixture of these two).

396. When setting an appropriate level of investment risk for a more immature scheme not close to significant maturity, it is important to make sure it is consistent with the assumed journey plan. In Chapter 9, we are consulting on which journey plan shape might be appropriate for setting TPs in Fast Track. Each shape will have different pros and cons from a purely investment perspective, as set out in Table 24 below:

Journey plan shape	Pros	Cons
Linear de-risking	☑ Gradual reduction in investment risk over time, no cliff edges ☑ Allows very immature and open schemes	☒ An immature plan now may de-risk significantly over time even if the size of the plan relative to the employer is gradually decreasing over time. ☒ Schemes which are very immature may

	to continue to take higher levels of investment risk. ☑ Would require schemes that are currently very mature (close to significant maturity that are potentially negative cash flow) to reduce their level of investment risk.	take very high levels of risk with associated large downsides at a time when the scheme is its largest in real terms.
Horizon	☑ Allows a scheme that is current immature to factor in the decreasing size of the scheme relative to the company in the future and hence in £ terms a lower level of risk in the future for the same asset allocation. ☑ Simpler approach and no need to have different investment risk for different maturities.	☒ For schemes that are currently mature and close to significant maturity, Fast Track will allow a high level of risk. ☒ Would require an immediate reduction in risk for many current immature schemes? ☒ Without smoothing there would be a cliff edge in acceptable risk when a scheme moves from mature to fully mature ie as it reaches significant maturity.

397. Different journey plan shapes will have different implications for the level of investment risk for different maturity segments as shown in Table 25 below:

Investment risk	**Very immature**	**Average mature**	**Mature**	**Significantly mature**
Linear de-risking	**HIGH** High level of risk assuming a strong covenant – likely to be set with reference to maximising return.	**HIGH/MEDIUM** Likely to allow a typical scheme to maintain the average asset allocation of 60% bonds.	**MEDIUM/LOW** Likely to allow a lower level of investment risk than horizon as this gradually reduces with linear de-risking.	**LOW** Same under both approaches.
Horizon	**MEDIUM** Likely to result in a material reduction in allowable investment risk for a typical scheme in this segment.	**MEDIUM** Likely to result in a modest decrease in allowable investment risk for the typical scheme.	**MEDIUM** Likely to allow a higher level of investment risk with a cliff-edge when scheme reaches significant maturity.	**LOW** Same under both approaches.

Downside risk in the medium and long term

398. Once the shape of the journey plan has been decided, the level of acceptable risk should be determined by considering the downside risk of the investment portfolio over both the medium and long-term horizon. We intend to use further modelling from GAD to inform our decision.

399. Expected return of the investment portfolio should be consistent with the discount rate used for the calculation of TPs. We note from a range of long-term forecasts provided by investment managers and advisers that the risk premium of growth vs matching assets (best estimate) is in the range of 3-5% pa. To ensure consistency, we consider that acceptable investment portfolios should have a best estimate return slightly higher than the discount rate with an allowance for prudence that increases as the investment strategy becomes riskier.

Consideration of the covenant

400. Regardless of the journey plan assumed above (linear de-risking or horizon or another approach in between), one should consider if allowance should also be made for the strength of covenant in determining an acceptable maximum level of investment risk.

401. In general, we consider that schemes with a stronger covenant are able to support a higher level of downside investment risk than schemes with a poorer covenant although, the degree of support is likely to be scheme-specific.

402. We have set out in Table 26 below the pros and cons of including an allowance for the covenant in the Fast Track investment test:

Option	Pros	Cons
Setting levels of maximum investment risk with reference to covenant and maturity	☑ Consistent with the principle of schemes with strong covenants being able to take more investment risk. ☑ Allows high levels of investment risk only when supported by a strong covenant. ☑ Schemes with a CG1 covenant get the benefit of additional investment risk as well as lower TPs.	☒ Heavy reliance on covenant assessment. ☒ Small schemes may feel they need to pay for a covenant assessment to justify a strong covenant and hence take more investment risk.
Setting levels of maximum investment risk with reference to maturity only	☑ Simple to apply. ☑ Avoids the cost/time required for covenant assessment to determine the maximum level of acceptable investment risk.	☒ Is not consistent with the principle that, in general, a stronger covenant is in a better position to support downside investment risk than a weaker covenant.

► Questions

Q37 Approach to defining maximum levels of investment risk for schemes of different maturities in Fast Track

a. What are your views on the proposed methodology for setting maximum thresholds for investment risk for significantly mature schemes in Fast Track? If you disagree, what would you suggest?

b. In relation to acceptable portfolios and consistency with discount rates, is it reasonable to use a best estimate return premium for growth assets over long-term gilts in the range of 3-5% pa?

c. Should the allowance for prudence be higher for an investment portfolio with a higher level of risk?

d. What are your views on the considerations we have set out to determine investment limits for immature schemes (journey plan shape, downside risk and covenant)? In particular, should the maximum level of investment risk for immature schemes vary by covenant under Fast Track?

Trustee options – scheme's investment risk is higher than the Fast Track threshold

403. We propose a simple 'Pass or fail' test to assess whether a scheme complies with the investment risk in Fast Track (as measured by the stress test or other method, which will be outlined in Fast Track subject to this consultation). We expect trustees' investment advisers to assess the scheme's assets as part of their ongoing risk management. If a scheme has investment risk in excess of the tolerated risk set out in Fast Track, the trustees can do one of the following:

- Reduce their level of investment risk to within the acceptable threshold (if they wish to comply with Fast Track).
- Demonstrate through the Bespoke route how they intend to support excess risk in accordance with the principles and approach set out in Bespoke (see Chapters 13 and 14).

Other requirements relating to liquidity and quality

404. In the Fast Track approach above, we have focused on setting a test for the level of investment risk, in particular, the reference point to measure risk from, the methodology to measure risk and an acceptable level of risk by maturity. We think there are additional considerations that should be set out as part of the Fast Track and Bespoke frameworks, namely in the areas of quality and liquidity of the portfolio.

Liquidity

405. For all schemes, but in particular for mature schemes, it is important that a scheme's assets are sufficiently liquid to meet predictable cash flows (for example, pensions in payments) as well as unpredictable cash flows (for example, transfers out). Also, a scheme with a high level of growth assets can be forced to sell assets at depressed prices if cash flow demands coincide with a downside investment event. For all the above reasons, a high level of liquidity is important, especially when a scheme is mature.

406. Typically, the liquidity of an investment is determined by two factors:

- The liquidity of the underlying investment (equities, bonds, property, etc).
- For pooled funds, the frequency of the dealing date (daily, monthly, etc).

Quality

407. As explained in Chapter 5 (General Principles), many pension schemes have increased their allocation to bonds over the last ten years to reduce the volatility of their funding level. It is therefore important to consider bonds in a little more detail. Pension schemes' bond investment typically consists of a combination of government bonds (fixed and inflation-linked) as well as corporate bonds. The price of both types of bonds will be affected by a change in the general level of government bond yields in the market. The price of a corporate bond will also be affected by any change in the assessment of the likelihood of receiving future coupons or principal payments as well as any recovery in the event of default.

408. We saw in 2007 and 2008 when concerns regarding corporate bonds were significant, that many corporates bonds returned large negative returns compared to government bonds that posted modest positive returns. This divergence was most acute for lower quality bonds and, in particular, high yield. It is therefore important to ensure that any methodology to measure risk takes account of the quality of the bonds a pension scheme holds.

409. As it currently stands, the PPF stress test makes a distinction between investment grade and sub-investment grade (under its bespoke test) but all investment grade qualities (AAA to BBB) are treated the same.

410. Finally, government bonds typically offer a greater level of liquidity than corporate bonds and the liquidity of corporate bonds tends to decrease as the quality of the bonds decreases with high yield bonds having a much lower liquidity than investment grade corporate bonds. This illiquidity issue become more profound at times of market stress with corporates offering very poor liquidity during the financial crisis.

411. In summary, quality impacts the level of investment risk (that is partially captured by the stress test) as well as liquidity. Low quality bonds typically suffer a negative impact from both factors during times of market stress.

Possible approaches (in addition to the measuring investment risk) in order to ensure the level of illiquidity/credit risk is not excessive

412. In view of the above considerations around liquidity and quality, we have outlined below a number of possible approaches to setting out appropriate constraints of the investment portfolio under Fast Track for a significantly mature scheme:

Option 1: Principle-based approach

413. We would provide some general guidelines rather than quantitative approach as set out in Options 2-6.

Option 2: Minimum allocation to high-quality bonds (investment grade and above) and/or cash

414. There is clearly some overlap with the stress test here, but we are looking at this from a liquidity perspective rather than a risk perspective. For example, a minimum of 80% of the portfolio in high-quality bonds and/or cash might be reasonable.

Option 3: Minimum allocation to assets that can be realised within a specified period of time (one day, one week, etc)

415. This is similar to Option 2 but is making a more subtle distinction between various asset classes. This allows greater flexibility but requires a more complicated calculation with a degree of subjectivity as some investments have good liquidity in normal times but have poor liquidity under stress (for example Corporate bonds). One could set the threshold by maturity. For example, 20% of the portfolio within three months for significantly mature schemes with a lower proportion for more immature plans.

Option 4: Minimum level of liquidity to meet expected (and unexpected) cash flows

416. This looks at liquidity in the context of meeting the expected cash flows for a certain period, along with a reasonable allowance for unexpected cash flows from, for example, transfer value activity and is therefore scheme-specific. This is a more complex test to apply as one needs to know the individual cash flows to perform the analysis. The advantage is a more customised liquidity test. For example, sufficient liquidity within three months to meet expected cash flows but an additional 10% of liabilities for unexpected cash flows.

Option 5: Setting an overall maximum expected return on the assets (versus gilts)

417. Under this approach, one places a limit on the maximum expected return for a scheme at maturity to ensure the illiquidity and quality premium and associated risk is not too high. The rationale is that expected return is typically due to a combination of the following:

- A higher level of market risk (captured with the stress test).
- A lower level of credit quality (partially captured with the stress test).
- A lower level of liquidity (not captured under the stress test).

418. In our experience, a long-term best estimate return of greater than 1.0% is typically a concern in that the scheme is likely to be taking too much of the combined risks above and is therefore unlikely to have a low resilience to risk.

419. A long-term best estimate expected return maximum of around Gilts +1% pa for a significantly mature scheme would be broadly consistent with acceptable portfolios that meet the stress test and the discount rate of Gilts +0.5% to +0.25% pa.

Option 6: Average credit quality

420. This option would require a scheme that is significantly mature to calculate its average credit quality. This can be done with reference to a credit rating agency using a scoring system. For securities that are not rated (this would be include mainly non- fixed income asset classes) they should be treated as 'other'.

421. This is potentially complex if one looks at each individual security, but one can reduce burden significantly by allowing an average asset class to be used per investment manager rather than having to go down to the individual security. This should retain the robustness of the test but make it simpler and quicker to calculate and apply.

422. Once the methodology of the test is established, one needs to decide on the appropriate minimum average credit quality. We consider that a sensible minimum credit quality is A and allows reasonable flexibility for a portfolio to combine UK government bonds (currently rated AA) with range of UK corporate bonds.

423. Table 27 below provides an example of a scoring system:

AAA	4
AA	3
A	2
BBB	1
Other	0

424. For example, a portfolio of 20% equities, 80% gilts would give a score of 80% x 3 + 20%*0 = 2.4 which is higher than the score of 2 associated with A.

425. We have set out in Table 28 below the pros and cons of each approach. These need not be mutually exclusive: several of the tests could apply in combination. We do not have a single preferred option, although we think that Options 3 and 4 are likely to be more appropriate as explanations for Bespoke arrangements.

Option	Pros	Cons
Qualitative	☑ Simple to understand.	☒ Open to interpretation.

		☒ Difficult for a qualitative approach to work in Fast Track.
Minimum allocation to Cash and high-quality bonds	☑ Easy to apply. ☑ Simple guideline would work well with a Fast Track regime.	☒ Not scheme-specific.
Minimum allocation to assets that can be realised within a certain period	☑ A more customised approach taking into account the specifics of the asset allocation.	☒ More complex. ☒ Requires an analysis by asset class that may vary significantly depending on individual product and structures. ☒ Difficult to apply easily to Fast Track.
Sufficient liquidity to meet expected (and unexpected) cash flows	☑ Scheme and liability specific.	☒ More complex to apply. ☒ Open to different interpretation, for example, how liquid are Corporates in a market stressed scenario.
Maximum expected return	☑ Simple to understand. ☑ Limits the combination of credit quality and illiquidity. ☑ Simple enough to be applied to Fast Track.	☒ Expected returns for the same asset class may vary between advisers and schemes.
Average credit quality	☑ Treats the portfolio as a whole and is more aligned with the principle we have set out. ☑ Guidance exists under PPF test of how to categorise credit quality.	☒ An additional calculation to perform but reasonably simple if one allows this to be applied to asset mandates and not the individual security level.

► Questions

Q38 Defining guidelines for liquidity and quality of the investment portfolio in Fast Track

a. Do you think we should define some guidelines around liquidity and quality in Fast Track?

b. If so, what are your views on the options outlined above? Are there other approaches you favour?

c. What limits would you set on the above criteria and why?

d. How would the above change for a more immature plan?

11. Recovery plan (RP)

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

Introduction

426. A deficit on a TPs basis can emerge when:

- scheme experience (eg investment returns, membership experience) has not turned out as planned, or
- trustees have had to modify their assumptions about the future (for example, where their view of the covenant, their expectations for future investment returns, or their expectations for mortality rates have changed).

427. Under current practice, the funding deficit will typically be addressed through a RP that comprises a balance of employer contributions and investment returns.

428. This chapter addresses expectations for how RPs should be constructed under Fast Track. To be clear, we are not expecting RPs to fund a scheme's entire deficit on a low dependency funding basis (unless the scheme is significantly mature). Instead, and in line with current practice, it is the scheme's TPs deficit which is to be funded (the TPs having been set taking the scheme's LTO, maturity and employer covenant strength into account).

429. As discussed in Chapter 5 on General principles, we propose that trustees should seek to agree a RP as short as employer affordability allows, provided doing so does not impede the employer's sustainable growth. We think this is particularly important given the decreasing visibility of covenant strength beyond the short to medium term and the inherent risk that the covenant could weaken in the future, meaning that trustees cannot be sure that DRCs will be paid in the longer term (ie credit risk).

430. We are seeking views on the key elements which would make up an appropriate RP for Fast Track compliance:

- RP length.
- RP structure (eg back-end loading).
- Allowance for investment outperformance.
- Changes to RPs at subsequent valuations.
- Equitability of treatment.

431. Our objective is to ensure employers have sufficient flexibility in how they manage DRCs without unduly increasing risks to the scheme.

Recovery plan length

432. Under Fast Track, we propose to set clear limits on the maximum length of an RP. There are two broad options: 1) Different RP lengths by covenant grade or 2) Same RP length for all schemes regardless of covenant grade.

433. However, where a scheme is very mature or there are pressing concerns about the ongoing viability of the employer (eg a need to fund the TPs deficit sooner than any TPR-defined limits), we would expect this to be the most relevant factor in agreeing a RP.

Different RP lengths by covenant grade

434. In this option, RP length would vary by covenant grade, with a requirement for RPs to be shorter for schemes for stronger covenants.

435. We propose that schemes relying on stronger covenants should seek to agree RPs that are no longer than six years from the valuation submission, particularly considering the following:

- A period of two valuation cycles (six years) is broadly consistent with the maximum period of covenant visibility, which we consider is unlikely to be longer than three to five years for most employers (and in many cases could be much shorter).
- Six years is broadly in line with industry averages. The average RP length[40] is currently around seven years[41] for all schemes in deficit, five and a half years for 'Strong' (CG1) schemes and seven years for 'Tending to strong' (CG2) schemes.
- Many strong (CG1) employers could recover TP deficits much faster than this (often immediately or within a year). However, providing some flexibility to spread contributions over a longer timeframe reduces the risk of overfunding and smoothing of contributions can also help employers manage their cash flows and business planning. At the same time, a relatively short RP would avoid the risks associated with longer RPs (namely the inherent and increasing uncertainty about the ability of employers to pay DRCs in the longer term).

436. We recognise that many schemes with weaker covenants (CG3 and CG4) may not be able to support a six-year RP, particularly as their TP deficit is likely to be comparatively larger than for schemes with stronger covenants. They may therefore need a longer period than schemes with stronger covenants to get back to full funding (even though this would typically go beyond the visibility of the covenant). Under Fast Track we could allow longer RPs for these schemes, subject to trustees and employers taking account of our guidance on equitability (as discussed below).

437. Table 29 below illustrates what RP length limits could look like for Fast Track purposes. It is important to note that these numbers are **illustrative** at this stage to promote a discussion on the concept of varying RP length. We will consult on the final limits on RP lengths in our second consultation, informed by the extent to which other RP flexibilities should be allowed under Fast Track (see below), our modelling of impacts (including the level at which we set low dependency funding and the timing for significant maturity), and responses to this first consultation.

For covenant to be assessed as (and for TPs to be set in line with this)	(Illustratively) RP length must be shorter than
CG1 (Strong)	6 years (or shorter?)
CG2 (Tending to strong)	6 years
CG3 (Tending to weak)	9 years
CG4 (Weak)	12 years

[40] See https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/scheme-funding-analysis-2019, Table 3.3 Average RP length by scheme characteristics (schemes in deficit only).

[41] See Figure 17 on Distribution of RP lengths by covenant grades in Chapter 16 (Evidence and analysis).

438. We are seeking views on whether a much shorter RP for strong (CG1) covenants, eg three years, may be reasonable. This would be more consistent with the higher affordability we expect such employers to have but it may not provide sufficient flexibility to allow the scheme a reasonable window to manage investment volatility. It could therefore increase the risk of overfunding (although this risk could be manageable for some schemes, for instance via the payment of some DRCs into an escrow account secured in the scheme's favour).

439. Another key principle is that there should be consistency between (i) the strength of covenant assumed in the TPs and (ii) the length and structure of the RP. If a scheme's deficit cannot be funded within an appropriately short period (and with an appropriate structure, as discussed below), then we would query whether the covenant used to calculate the TPs is truly as strong as claimed.

440. In this case, we would typically not recognise the RP as being compliant with Fast Track and we would expect the trustees to submit a Bespoke valuation with supporting evidence as to why the RP needs to be longer. We would also expect trustees to demonstrate that they have secured appropriate alternative support to underpin the additional level of risk that the scheme is being asked to bear (see Chapter 11).

441. This is particularly relevant in scenarios where covenant strength is based on an employer having a strong balance sheet, but weak cash flows. This is because there is a real risk that these assets will not be available to the scheme at the point it needs to rely on them, for example because they:

- have been pledged as security for bank debt
- have been utilised or sold to enable the employer to continue trading, or
- no longer have material value because they are inextricably linked to a business which is in decline.

442. This also includes 'stressed' schemes (in the weak, CG4 category), ie whose employers may have significant affordability constraints to the extent that they cannot comply with the maximum RP length (illustratively, 12 years). We consider these schemes in Part 4 (Bespoke).

443. To the extent that there are covenant visibility issues (for example, significant concerns regarding the longer-term viability or strength of the employer), we would expect any such horizons to override our RP length guidance and for a shorter RP to be agreed.

444. In Part 4 (Bespoke approach), we outline how contingent assets and parental guarantees could support longer RPs or enhance the covenant underpin assumed in TPs.

Same RP length for all

445. An alternative to this approach could be to set an expectation that trustees of all schemes should seek to agree a RP that is no longer than, say, six years, and for a longer RP to be acceptable only where:

- the underlying covenant strength relied upon is demonstrably weaker (eg CG3 or CG4)
- where it can be evidenced that a compliant RP is not affordable (such assertions would need to be demonstrated via the Bespoke approach), and
- the scheme is being treated equitably.

446. Table 30 below outlines the pros and cons of both approaches:

Different RP length by different covenant grade	Same RP length for all schemes
☑ Better reflects different affordability constraints and allow more schemes to opt for Fast Track. ☒ More complex and somewhat arbitrary as there is no straight-forward relationship between covenant grades, affordability and RP length.	☑ Simpler to understand. ☑ More objective, less arbitrary difference between different covenant grades. ☒ Does not reflect different affordability of

☒ May incentivise some trustees and employers to agree funding strategies based on weaker TPs (reflecting potentially spurious assessments of weaker covenant strength) and to benefit from longer RPs that still meet the Fast Track guidelines. However, there are mitigations to this, such as clearly defined expectations around equitable treatment, and the fact that we will perform an independent assessment of covenant strength as part of our ongoing assessment of valuations.	different covenant strengths, potentially limiting the number of weaker schemes that could submit Fast Track valuations.

RP length near or at significant maturity

447. Another key consideration is how long a RP should be under Fast Track when a scheme is significantly mature. We consider that **RP lengths**, particularly for weaker covenant schemes with longer RPs, **should get shorter as the scheme gets closer to being significantly mature** and achieving low dependency funding. This is consistent with our principle for schemes' LTOs and to ensure they have sufficient funds to meet all benefit payments and mitigate the risk of disinvesting assets at depressed prices.

448. If we assume that RPs should be shorter, another key question is whether and how maximum RP lengths under Fast Track should taper as the scheme approaches significant maturity.

Recovery plan structure

449. The structure of RPs and the relative level of DRCs in different years of the plan also need to be appropriate. Excessive back-end loading within the RP (eg with a greater proportion of DRCs committed in the latter years) may be of concern to us. We currently see a number of schemes with back-ended loaded RPs which are not achievable based on the employer's forecasts. These are potentially being agreed as a way of either:

- minimising contributions paid into the scheme until the next valuation (at which time the hope may be that the scheme's funding shortfall will have reduced and contribution levels can be renegotiated), or
- artificially shortening the RP length (and in doing so, to be less of an outlier compared with other schemes and less likely to attract regulatory scrutiny).

450. Bullet payments are an extreme form of back-end loading, which we also see. In such cases, the early years of the RP typically have extremely low (or even nil) DRCs, with the majority of DRCs committed in the last year(s).

451. However, we recognise that it may be reasonable for DRCs to increase by small amounts annually, where employer performance is expected to improve in line with market factors (eg inflation-linked increases).

452. Another consideration is the potential for over-funding on a TPs basis, particularly for shorter RPs. If an employer is required to pay a high level of contributions in the first three years of the RP, this means it is more likely that the next valuation following the original plan will reveal a surplus, which the employer may not easily be able to use.

453. A balance therefore needs to be struck between inappropriate back-end loading and the potential for over-funding. We would like to seek views as to whether, for Fast Track purposes, we should do any of the following:

- **Prohibit back-end loading or payments in later years apart from increases linked to a suitable inflation measure** (such as CPI).
- **Have guidelines which define the shape of a RP.** For example, in Fast Track we could require a minimum proportion of DRCs to be committed to the first half of the RP and/or broadly consistent amounts each year over the initial period. For instance, at least 50% of total DRCs would have to be

paid in the first three years of a six-year RP. Different thresholds would have to be devised for different RP lengths and covenant strengths. This would allow more flexibility but would be more complex.

Investment outperformance

454. Some trustees make allowance for investment outperformance in the RP, ie they assume higher investment returns over the recovery period than what has been assumed (prudently) in the TPs. This has the effect of reducing the level of DRCs needed in the RP. However, if the scheme's assets fail to achieve the higher return assumed, the deficit will not reduce as expected and additional DRCs will be required at the next funding valuation. Allowance for asset outperformance in the RP therefore increases the overall risk that the funding strategy does not result in full funding. Investment outperformance also has more of an effect the longer the RP is.

455. We consider allowance for investment outperformance removes some (and sometimes most) of the prudence in the discount rates used to calculate TPs. This is because by allowing for higher investment returns over the recovery period, the scheme's funding strategy is relying on higher assumed investment returns than the discount rates. This reduces transparency around the overall risks being taken.

456. We therefore propose that for the Fast Track framework, **asset outperformance (above that assumed in the TPs) should not be used when calculating the RP**. Allowance for investment outperformance could be deemed acceptable with appropriate justification, eg using contingent security, in Bespoke.

457. The effect of removing asset outperformance in the RP on the level of DRCs required would depend on how the scheme's funding strategy is currently structured. For example, some schemes may currently set TPs with a significant margin for prudence (more than usually required given the covenant strength) and then make a material allowance for asset outperformance in the RP. For Fast Track purposes, this strategy could be reshaped so the margin for prudence in the TPs is reduced and asset outperformance in the RP removed. This could result in the same average assumption for asset returns over the lifetime of the scheme and DRCs, which are at broadly the same levels. Alternatively, trustees could submit a Bespoke valuation and evidence how any asset outperformance assumed in the RP is appropriately underwritten, for instance by additional support such as a contingent asset, or is offset by very prudent TPs to the extent that the outcome is at least as good as Fast Track overall.

Future recovery plans

458. For Fast Track purposes, we would like to seek views on various options as to how much 'rolling forward' or 're-spreading' could be allowed, ie where the agreed RP end date is extended at the next valuation (so DRCs are effectively re-spread). Main options include:

- **RPs should not be 'rolled forward'** unless there has been a material worsening in a scheme's funding position and/or a weakening in the employer's affordability.
- **RPs could be 'rolled forward' at future valuations** as long as they meet the requirement for the maximum RP lengths in line with the Fast Track guidelines and provided the trustees have assessed and are comfortable with the covenant visibility.
- **More nuanced guidelines** could be defined, such as:
  - if the deficit has reduced in line with expectations, we would expect the same end date to be maintained
  - if the deficit has reduced more quickly than expected, we would expect the same end date to be maintained, resulting in lower annual DRCs
  - if the deficit is a little higher than expected, we would accept the same level of DRCs resulting in a new RP, as long as the new end date was not more than three years after the current one

- if the deficit has grown significantly, we would expect at least the same level of annual DRCs and the guidelines on RP length to apply from the new valuation date.

Equitability

459. We also propose to set clear expectations on scheme equitability for both Fast Track and Bespoke approaches. Equitability relates to the treatment of the scheme compared with historical and expected payments to other stakeholders, particularly where these payments represent 'value leakage', such as value leaving the covenant through dividends, intercompany loans that are unlikely to be repaid or material management bonuses.

460. To be clear, references to 'value leakage' (particularly dividends) relate to 'normal' or 'business as usual' payments that are affordable from the employer's ongoing trade. Exceptional distributions (for example, a large one-off dividend equivalent to a significant proportion of business value) are deemed to be 'transactions' and we expect trustees to consider these in line with our guidance on corporate transactions.

461. In other words, a Fast Track compliant valuation (with due consideration given to equitability) would not give an employer licence to make large distributions without consideration of its pension scheme and appropriate consultation with the trustees.

462. We recognise that 'equitability' is very difficult to reduce to a specific ratio or quantum (given scheme and employer specificity) and we expect that guidance on equitability (in the context of scheme funding) will be qualitative and with reference to scheme-specific circumstances, particularly employer covenant strength. For example:

- For stronger employers (CG1 or CG2), provided RPs are appropriately short and in line with our proposed thresholds (not longer than, for example, six years, as well as meeting our expectations in other areas, including back-end loading), we would not expect to be concerned by a proportionately high level of covenant leakage as long as:
  - the employer remains strong after the covenant leakage, and
  - the leakage does not cause a need for the RP to be subsequently extended (eg at the next valuation).
- For weaker employers (CG3 or CG4), we would expect DRCs to be maximised or, often, prioritised over all forms of covenant leakage, other than where such leakage can be demonstrated to trustees and us to be absolutely necessary for the sustainable growth of the employer. However, we are likely to remain sceptical about arguments that there is any 'necessary' level of value leakage that is in the long-term interest of the sustainability of weaker employers and the schemes they support.
- Where trustees consider value leakage is justified, particularly in the instance of weaker covenants and longer RPs, we expect them to seek suitable protections to compensate their scheme for the resultant deterioration in covenant. This includes, for example, security over employer assets, or 'upside sharing mechanisms' so that, in the event employer performance improves in future, the scheme can receive increased DRCs. We consider that such contingent arrangements represent good practice for trustees' integrated risk management.

463. Broadly speaking, we will be less concerned with equitable treatment provided the RP is within our Fast Track limits for CG1 and CG2 covenants (illustratively, six years). Our focus would be on schemes with longer RPs and/or weaker covenants.

464. In some cases, the level of DRCs needed for a valuation to be Fast Track compliant may require a business to reduce payments elsewhere. This may drive a reduction in the payment of dividends (or other methods of 'value leakage'). For the avoidance of doubt, we do not automatically recognise dividends as an essential business cost and consider that the payment of these in preference to paying an appropriate level of DRCs is likely to be detrimental to the covenant.

465. Trustees will be able to explain, through the Bespoke approach (see Part 4), why the agreed RP is different to the requirements set out in Fast Track. However, in the absence of detailed evidence, we are unlikely to recognise a need to pay dividends as reasonable justification for an overly long RP, particularly where additional support such as a contingent asset has not been provided to underpin the additional risk associated with this longer RP.

466. For the avoidance of doubt, the approach to equitability outlined above relates to valuations under Part 3 and our approach to our powers under s231(2) of the Act. We may adopt a different view when considering whether to pursue a Contribution Notice or Financial Support Direction as these are different regulatory functions based on different legislation.

► Questions

Q39 Fast Track guidelines on RP length

a. What are your views on the principles set out above in relation to RP length under Fast Track? In particular, do you have views on what may be appropriate RP length thresholds for different covenant strengths? Is it helpful to frame these in terms of the typical multiple of valuation cycles (ie three years)?

b. Do you consider it would be more appropriate to have a single maximum guidance RP length and to expect trustees (under the Bespoke framework) to justify any plans that are longer than this?

c. Do you think Fast Track RP lengths should be shorter for schemes nearing and/or at significant maturity? If so, to what extent?

Q40 Fast Track guidelines on RP structure – Should the extent of back-end loading be limited to increases which are in line with inflation (in the absence of appropriate additional support such as a contingent asset being provided)? Or should there be more flexibility subject to a significant proportion of DRCs being committed in the early years of the plan? If inflation-linked increases are acceptable, what measure of inflation do you consider would be an appropriate benchmark?

Q41 Fast Track guidelines on investment outperformance – Should investment outperformance not be allowed in Fast Track RPs? What do you think the impacts may be?

Q42 Fast Track guidelines on future RPs – In what circumstances should/could outstanding RP payments be re-spread at subsequent valuations? In particular:

a. If a scheme's funding deficit has reduced (at least) in line with the expectations at the previous valuation, would it be appropriate to maintain the same end date? Or would it be pragmatic to re-spread the remaining deficit over a renewed period?

b. If a scheme's funding deficit is higher than expected, what guidelines should apply for the appropriate length of the new RP?

c. Would the idea of 're-spreading' be more acceptable where a scheme has a long period before it becomes significantly mature?

Q43 Equitability – What are your views on the concept of 'equitability' in respect of how a scheme is treated compared with other stakeholders? Should any requirements be qualitative (in line with the commentary above) or should trustees also be expected to consider a specific metric? If so, what might be an appropriate measure of equitability (for example, comparing the ratio of DRCs to dividends, or the size of scheme deficit to the 'stake' of other stakeholders) and how could this reflect a scheme's superior creditor status over shareholders?

12. Open schemes

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

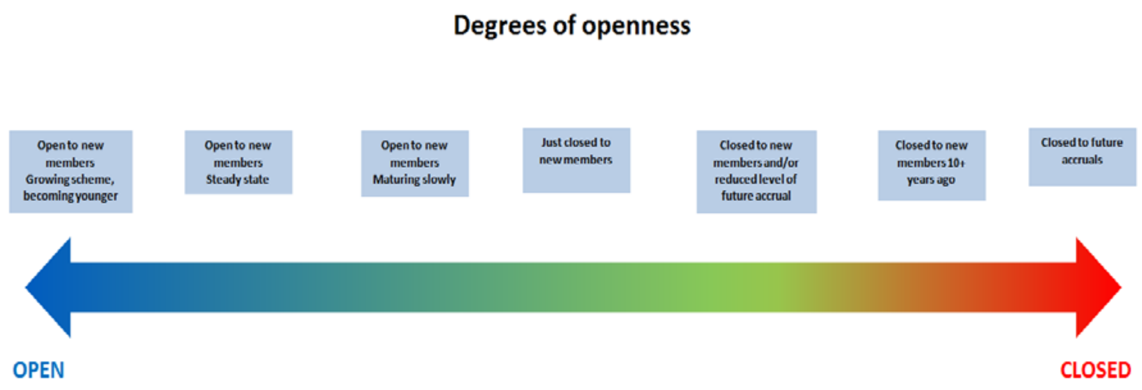
Introduction

467. Although a sizeable minority of schemes are closed to future accrual, the majority of schemes are still open to future accrual and, of those, an important proportion of members and assets under management are in schemes open to new members[42]. It is therefore important that the DB funding code addresses open schemes. In Chapter 5 on General principles, we discussed the concept of ensuring that members' accrued benefits in open schemes are protected to the same degree as in closed schemes while making sure the funding framework does not unduly increase the cost of future accruals, which could lead to scheme closures.

468. In this chapter, we will cover:

- our proposal to treat past service liabilities (TPs) and future accruals separately and for all schemes to have the same LTO of low dependency funding at significant maturity
- options for the calculation of TPs under Fast Track, and
- options for how trustees of open schemes should calculate the cost of future service and the contribution rate required under Fast Track.

469. There is a wide range of open schemes, from schemes which closed to new members some time ago, where future accrual is small compared to past service liabilities, to schemes which remain open to new entrants, where future accrual is significant and anticipated to remain so. In developing the proposals below, we have kept these differences in mind to make sure the new DB code will cater for all types of open schemes. This is illustrated in Figure 5 below:



470. Open schemes are typically less mature than closed schemes, reflecting the fact that new benefits continue to accrue for active members. Some open schemes, particularly those open to new entrants, are considerably less mature than closed schemes and, at least in theory, are expected to remain immature indefinitely. We have kept this feature of open schemes in mind when developing our proposals.

[42] In 2019, 89% of DB schemes were closed to new members and half of these were still providing new accruals but to a closed and declining group of employees (see Chapter 16 (Evidence and analysis)).

Past service vs future service

471. Typically, open schemes treat past and future service liabilities separately. Legislation requires schemes to set TPs in respect of their past service liabilities. Future service liabilities are typically measured over the period covered by the schedule of contributions which is five years or the RP period if longer. Typically, future service liabilities are expressed as a percentage of active member payroll. In this consultation document, we use this approach – we outline below proposed Fast Track guidelines for past service (TPs and future service).

► **QUESTION**

Q44 Treating past service and future service liabilities separately in Fast Track – What are your views on our proposed approach to outlining code guidelines for open schemes. Should any other approach to calculating future service liabilities be considered?

Long-term objective (LTO) for open schemes

472. We expect all schemes to achieve low dependency on their sponsoring employer by the time they are significantly mature to ensure an orderly run-off phase.

473. Many schemes are open to new accrual but closed to new entrants. These schemes are typically less mature than closed schemes. All other things being equal, the only difference between a scheme open to new accrual (but not new entrants) and a closed scheme is that the open scheme will take longer to become significantly mature. Therefore, when such a scheme becomes significantly mature, we expect it to have low dependency on its sponsoring employer and an investment strategy with a high resilience to risk in the same way as a closed scheme.

474. Some schemes are open to new entrants as well as new accrual. Many of these schemes are not expected to mature (or only expected to mature slowly) as the addition of new entrants will broadly maintain the balance of active members and pensioners. However, we consider that these schemes should also have a LTO defined in the same way as closed schemes, as:

- having such a LTO (and journey plan to it) will help trustees plan for the possibility of closure to new entrants
- this would avoid funding and investment cliff-edges on closure to new entrants – the LTO would be unaltered by closure, and
- as much as possible, we want the funding regime to apply consistently to all schemes.

475. We acknowledge that if such schemes do continue to admit new entrants and do not mature then the scheme will not actually reach significant maturity. We are content that such a scheme retains the same flexibility in its funding and investment strategies that all immature schemes have, as described in Chapters 9 (TPs) and 10 (Investments).

476. In practice this means that to follow Fast Track, trustees of all open schemes will also have to set a low dependency funding target of Gilts +0.5% to Gilts +0.25% pa at duration 14-12 (subject to consultation) with an investment strategy which has a high resilience to risk.

► **Question**

Q45 Fast Track LTO for open schemes – Should the LTO (low dependency at significant maturity) for an open scheme be the same for a closed scheme? If not, how should they differ?

Technical provisions/Journey plan (past service liabilities)

477. We have considered various options for the calculation of TPs (past service liabilities) for open schemes under Fast Track:

Option A: Open schemes must set TPs consistently with closed schemes.

478. In order to comply with Fast Track, TPs would be set using a discount rate no higher than that which would apply to a closed scheme of the same maturity (in relation to past service benefits) and covenant strength. Other assumptions would be set based on the current membership of the scheme (ignoring future new joiners) including an assumption for salary increases when applicable.

Option B: Open schemes may set lower TPs than closed schemes.

479. This is on the basis that open schemes have a longer time until they become significantly mature than closed schemes (some are not expected to mature at all) and longer investment horizons. Because of this extra flexibility, they can expect higher investment returns over the long-term which can be reflected in their discount rate assumptions. Some may argue that requiring open schemes to set their TPs at the same level as a closed scheme would be unnecessarily cautious. The higher expected returns may even generate trapped surpluses.

480. Table 31 below sets out the pros and cons of each option:

Option	Pros	Cons
Same approach as closed schemes	☑ All schemes (open and closed) are treated consistently. ☑ If an open scheme were to close to new entrants or close to future accrual in the future, its TPs would be unchanged. Therefore, there would be no 'cliff-edge' effects in liabilities/deficits associated with scheme closure.	☒ Potential for over-funding/ trapped surpluses (if scheme remains open).
Lower TPs as longer investment horizon	☑ Reflects the longer investment time horizon an open scheme has compared to a closed scheme.	☒ Inconsistent treatment of open and closed schemes. ☒ Causes a 'cliff edge' whenever a scheme closes to new entrants and/or future accrual.

481. Our preferred approach is Option A, ie trustees of open schemes should set TPs in the same way as closed schemes. This would have the following consequences:

- Consistency of approach for all schemes, open or closed. Open schemes that close to new entrants or future accrual will not need to materially change their TPs assumptions. Although there is likely to be some changes to the technical provision due to the removal of the link to salary increases on active member's benefits (which typically reduces the TPs).

- Open schemes arguing that longer investments time horizons give them the flexibility to have lower TPs than closed schemes would not comply with Fast Track, so would have to use the Bespoke approach (see Chapter 13 for examples of Bespoke scenarios).
- Schemes open to new entrants that do not mature will, in theory, never become significantly mature and reach low dependency funding. Their TPs calculated at each valuation will continue to be based on discount rate assumptions consistent with their (unchanging) maturity.

► **Question**

Q46 Fast Track TPs for open schemes – What option do you favour and why? Are there other options we should consider?

Future service liabilities and contribution rate

482. As well as having an LTO and setting TPs in relation to past service benefits, open schemes need to calculate the cost of future service benefits and the contribution rate required to meet those costs.

483. Various methods are used to calculate these costs based on the scheme's expected membership profile (such as Projected Unit Method and Attained Age Method). Therefore, we do not think it is appropriate to determine which method ought to be used in Fast Track. Trustees should continue to use a method appropriate to their circumstances. We are more concerned about the assumptions being used to calculate the cost of future accrual. This is addressed in the sections below.

Actuarial certification

484. Legislation[43] requires the scheme actuary to certify a scheme's schedule of contributions such that the scheme is expected to be 100% funded on its TPs assumptions by the end of the period covered by the schedule of contributions. This is by the end of the RP or after five years, whichever is later.

485. Trustees do not necessarily have to use the same assumptions to calculate future service costs as they use to calculate TPs (past service liabilities). However, as benefits accrue, they form part of a scheme's TPs at future valuation dates. This means that any difference between the assumptions used to calculate future service costs and TPs has to be accounted for somewhere for the purpose of the scheme actuary's certification of the schedule of contributions. Any difference is usually accounted for by either of the following:

   - Making an adjustment to DRCs (ie increasing them to reflect the new deficit that is expected to emerge from future service benefits).
   - Making a further assumption for the purpose of the scheme's RP, often by assuming that the scheme's assets will produce higher returns than the discount rate used to calculate the TPs. In Chapter 10, we consider whether allowance for investment outperformance should feature in Fast Track RPs.

Assumptions for future service costs

486. We recognise that Part 3 of the Act does not expressly impose any obligations in respect of future service costs, however that does not eliminate the need for trustees to address the issue, therefore Fast Track

[43] s227(5) & (6) of the Act. Regulation 10 and Schedule 1 of The Occupational Pension Schemes (Scheme Funding) Regulations 2005.

needs to provide some guidance on the best practice. We have considered various options for the calculation of future service costs for open schemes under Fast Track, as follows:

Option A: same discount rates

The same discount rate assumptions must be used to calculate future service costs as are used to calculate TPs.

Option B: discount rate reflects future service maturity

As Option A, except the discount rate may reflect the fact that future service benefits will (almost certainly) be more immature than the maturity of past service benefits.

Option C: best estimate

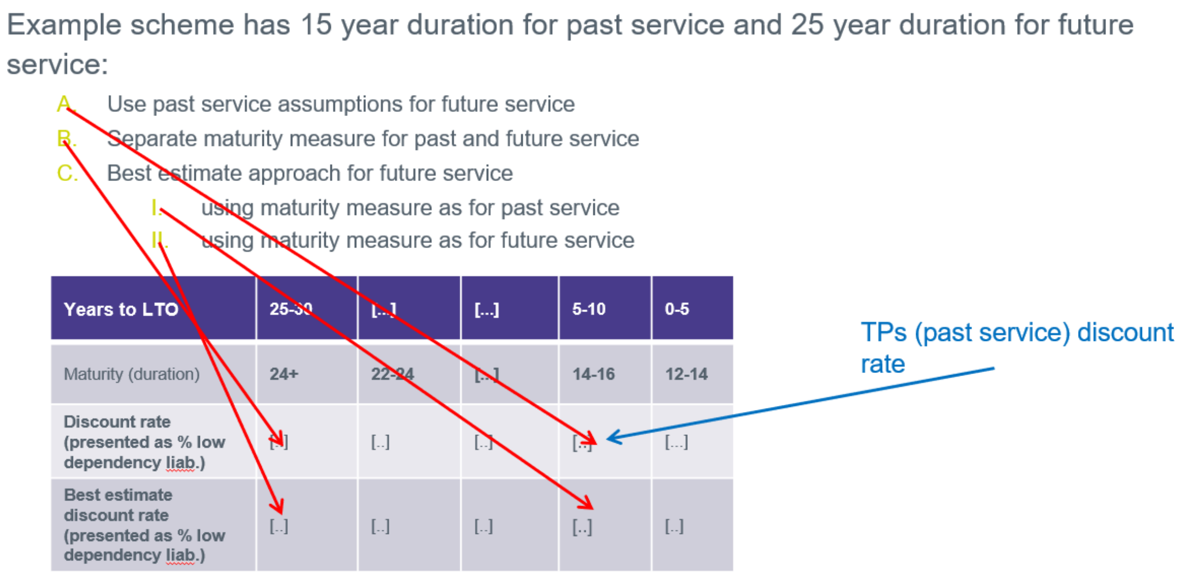
Best estimate discount rates may be used to calculate future service costs.

Option D: no requirements

No requirements will be placed on future service cost calculations.

487. We recognise that there are other methods to set discount rates for future service contribution rates. One example is to use different pre- and post-retirement discount rates. This has implications for how the three options above would play out.

488. The example set out in Figure 6 below illustrates how these options for calculating the cost of future service benefits under the Fast Track would work. A scheme calculates the minimum TPs allowed under Fast Track using the percentage of low dependency liabilities figure from the box indicated by the blue arrow. The options for calculating minimum future service costs allowed under the Fast Track approach are indicated by the red arrows.



Best estimate assumptions

489. Option C above allows future service costs to be determined based on the same assumptions as TPs, except schemes can set the discount rate for these costs equal to best estimate investment return assumptions on the scheme's investments. The best estimate return for this purpose could be set as either of the following:

- The **trustees' best estimate** of their scheme's investment return on assets expected to fund the future service costs.
- A **rate set by TPR** to be consistent with the Fast Track compliant discount rates used to calculate TPs. We would need to set compliant best estimate return assumptions. We could do this based on the reference asset portfolios used to determine the investment stress test or the proportion of allowable growth-seeking assets under Fast Track (see Chapter 10).

490. Table 32 below sets out the pros and cons of each of the options for setting future service costs:

Option	Pros	Cons
A: Same assumptions as TPs	☑ Most straightforward option – a single set of assumptions is used throughout. This makes it clear how schemes can comply with Fast Track. ☑ Most straightforward option when it comes to the scheme actuary's certification of the schedule of contributions.	☒ Does not reflect the fact that future service liabilities are very likely to be more immature (and have a longer duration) than past service liabilities.
B: Same assumptions as TPs (but reflecting maturity of future service benefits)	☑ Would provide trustees with some flexibility to determine future service costs and contributions rates, which reflect the different maturities of future service liabilities and past service liabilities. ☑ Compared to the above approach, might also help to avoid schemes developing trapped surpluses. ☑ Compared to approaches based on best estimate assumptions, there is little risk of deficits being created at future valuations. This is because the contributions paid should broadly equal the value of past service benefits accrued over the inter-valuation period.	☒ Inflexible (although not as inflexible as above option). There is a greater risk of trapped surplus than the approaches below but less than the option above. ☒ Might make it more difficult for the scheme actuary to certify the schedule of contributions than the approach above. This is because the contributions paid in respect of future service may not be worth exactly the same as the value of the past service benefits which will accrue over the period of the schedule. ☒ Potentially more complex than Option A as, depending on the structure of the discount rates, past and future service liabilities may be calculated using different assumptions.
C: Best estimate assumptions	☑ This would provide trustees with flexibility to determine future service costs and contributions rates which reflect the circumstances of their scheme. ☑ Could be used to set contribution rates to avoid unnecessary over-funding/ trapped surplus.	☒ Flexibility for trustees to use their own best estimate investment return assumptions is out of line with the concept of Fast Track. ☒ Under the option that we determine best estimate assumptions, we would need to set best estimate returns for all asset classes. This would be more complex and difficult to tailor to all the circumstances of all schemes. ☒ Future service contribution rates might be

		set at such a low level that deficits would be expected to emerge as inter-valuation accruals become past service.
D: No requirements on future service cost calculations	☑ This would provide trustees with flexibility to determine future service costs and contributions rates which reflect the circumstances of their scheme. ☑ Could be used to set contribution rates to avoid unnecessary over-funding.	☒ Flexibility that is more in line with Bespoke. ☒ Future service contribution rates might be set at such a low level that deficits would be expected to emerge as inter-valuation accruals become past service.

491. Our preferred approach is Option B, ie the same assumptions must be used to calculate future service costs as are used to calculate TPs, except the discount rate used may reflect greater immaturity (represented, for example, by a higher duration of the liabilities) of future service benefits. We consider this provides the best balance between:

- ensuring the provision of future accruals should not compromise the security of accrued benefits, and
- having a consistent approach which applies across all Fast Track schemes,
- whilst not systematically over-funding the scheme.

► Questions

Q47 Fast Track guidelines for calculating future service costs

a. Which options do you favour and why? Are there any other options for calculating future service costs which should be considered, for example pre-and post- retirement discount rates?

b. If Option C (best estimate) were adopted, how should the best estimate return assumption be determined? Are there any options other than those described above that we should consider?

c. Would our preferred approach (Option B) make it difficult for scheme actuaries to certify schedules of contributions?

Schemes in surplus and future service contributions test

492. Open schemes that have a surplus measured against TPs sometimes reduce their future service contribution rate below the future service cost for a period, effectively using the surplus to make up the difference.

493. We consider it a prudent approach to pay for new benefits as they accrue based on TP assumptions. A surplus (measured against TPs) can be used to offset contributions only if and when it emerges. We prefer this approach to one that which decreases the future service cost by relying on future returns, which may or may not be realised.

494. We propose to continue to allow these approaches under the Fast Track framework, as long as a scheme has a surplus (or, at least, not have a deficit) measured against its TPs and the scheme is expected to have a surplus by the end of the schedule of contributions where the reduced rates are set out.

► Question

Q48 Funding future service using past service surplus – Do you think that this approach to funding future service using past service surplus is reasonable? If not, why not? What else would you suggest?

Part 4: Application (2) ‘Bespoke’

13. Bespoke framework key features

495. In Chapter 5 (Proposed regulatory approach), we outlined our proposal to introduce a twin-track compliance regime and described Fast Track and Bespoke compliance at a high level.

496. This chapter and the next cover our more detailed proposals for how the Bespoke framework could operate in practice. We discuss:

- our proposed assessment criteria for Bespoke arrangements (paragraphs 497 to 501)
- some anticipated circumstances where trustees might opt for a Bespoke arrangement, including illustrative examples (paragraphs 502 onwards), and
- the use of additional support (eg contingent assets or guarantees) in Bespoke arrangements (Chapter 14).

Assessment criteria

497. We currently assess all valuations submitted to us (from trustees of schemes in deficit) and will continue to do so. We also note that the Bill includes a provision to require all schemes, including those in surplus, to submit their valuations. Fast Track valuations will be checked against Fast Track criteria (as set out in preceding sections) while we propose to assess a Bespoke valuation by reference to the following criteria:

A. Consider how the Bespoke arrangement complies with legislation and any relevant DB code principles

498. We would consider how the submitted arrangements comply with relevant legislation and we propose that the principles in Chapter 5 should also apply where trustees have followed a Bespoke route.

B. Assess the Bespoke arrangement using Fast Track as a reference point

499. We would consider the extent to which (and why) the Bespoke arrangement deviates from Fast Track assumptions and parameters. We would examine whether the difference from the ‘Fast Track equivalent’ (in this chapter we refer to this as the FTE) position results in a weaker outcome overall or means that the scheme is running additional risks (such as lower TPs, longer RP etc).

C. Assess how additional risk (if any) is being managed

500. We would expect trustees to clearly articulate and demonstrate how any additional risk they are taking (and which has not been assessed as remote or minimal) is being managed through a combination of appropriate mitigations and/or additional support. We would expect those trustees unable to comply with Fast Track to provide additional support, or, failing that, to take some action to mitigate the risk (ie reduce its severity) if it were to materialise.

D. The quality of the supporting evidence provided by the trustees

501. The explanations provided by trustees must be supported by robust evidence provided in their statement of strategy. We would need to be comfortable that the funding solution has been developed by reference to an accurate assessment of the scheme-specific factors, additional risks and, if appropriate, any support provided by the employer and/or the wider group or mitigation actions. In the case of stressed schemes, we would expect robust and evidence explanation of why the approach taken is the only outcome available to the trustees.

► **Question**

Q49 Criteria for assessing Bespoke arrangements – What are your views on the criteria we propose to use to assess Bespoke arrangements? If you disagree, what would you change and why? What else should we consider?

Common Bespoke features and illustrative examples

502. We envisage three main reasons why trustees might choose to submit a Bespoke arrangement:

- An aspect of the Bespoke arrangement is different from the Fast Track equivalent (FTE) but despite the differences, (i) in aggregate the Bespoke arrangement represents an outcome that is at least as good as the Fast Track outcome overall and/or (ii) the trustees can evidence that there is no additional risk being run in the Bespoke arrangement.
- Where trustees consider it appropriate to take additional, managed risk relative to the tolerated level of risk set out in Fast Track.
- Where trustees are unable to meet some or all standards expected in Fast Track (eg stressed schemes).

503. We initially considered whether these scenarios could be integrated into Fast Track. However, we found that adapting the framework to accommodate all of these features and their variables overly complicated Fast Track and undermined our aim of simplicity. However, we do not want to discourage trustees and employers from using flexibilities available to them, nor to undermine trustees who simply cannot submit Fast Track compliant valuations.

504. In this chapter, we describe these Bespoke categories in greater detail and consider some examples that illustrate how we would assess these funding arrangements and how we would expect trustees to evidence their position in the statement of strategy.

505. These examples are illustrative (eg based on specific options for Fast Track which are subject to consultation and therefore are not final). They have been deliberately simplified to illustrate different aspects and principles and to help consultees understand how the Bespoke framework is intended to work. The illustrations are not exhaustive, and we recognise that for most schemes, reality will be more complex.

A. Same or better outcome than Fast Track

506. To comply with Fast Track, a scheme would have to meet *all* key Fast Track aspects (ie quantitative parameters and guidelines) separately. In summary, these would cover:

- setting an appropriate LTO based (as a minimum) on low dependency funding, high resilience to investment risk and a target date that represents significant maturity
- setting TPs that are at least as strong as defined for the scheme's maturity and covenant strength
- agreeing a RP that does not exceed TPR-defined lengths (for the covenant relied upon) and which meets other RP guidelines (eg on back end loading, investment outperformance, etc)
- taking investment risk within Fast Track limits, and
- setting future service contribution rates according to Fast Track levels.

507. However, we anticipate situations where the trustees' funding arrangement does not meet one or more of these individual Fast Track aspects but, overall, the outcome is the same or better than Fast Track. We would expect trustees to demonstrate that this is the case.

508. We provide some possible examples of these situations below:

Example 1: LTO – Bespoke assumptions
• In setting their long-term low dependency funding basis, the trustees have adopted mortality rates significantly higher than the standard mortality table. They have assumed a long-term rate of improvement slightly lower than the assumption recommended by us under Fast Track. This means targeting a lower funding basis than the LTO we recommended for Fast Track. • They based their decision on analysis they commissioned on the scheme's mortality rates and historic improvements in mortality. This analysis showed the scheme-specific mortality rates have been worse than the UK population average and are not improving as quickly. **TPR assessment: Compliant – no additional risk** • Although the trustees have chosen a lower funding target for their LTO than the FTE, this change does not result in additional risk because the assumptions reflect the real nature of the scheme's demographic profile and liabilities. • The trustees can provide the relevant demographic data that was assessed by the scheme actuary to evidence why their assumptions are appropriate and scheme-specific.
Example 2: LTO – CDI strategy
• A significantly mature scheme is invested 100% in Cash Driven Investment (CDI) backed by a combination of UK inflation-linked bonds, UK fixed interest gilts and UK investment grade corporate bonds. • The arrangement fails the Fast Track investment stress threshold but the scheme is using the Fast Track equivalent TPs which are equal to low dependency. The trustees' statement of strategy explains that the failure is caused by the level of corporate exposure and that the stress test is only applied to specified asset maturity categories. • They provide evidence of the expected pattern of cash flows from the CDI product matching the expected cash flows from liabilities. • They demonstrate there is sufficient liquidity to deal with unexpected cash flows (for example, transfers out). The expected return overall and the average credit quality is consistent with what we would expect from a portfolio with a high resilience to risk. **TPR assessment: Compliant – no additional risk** • The trustees have adequately demonstrated that because of the quality of the assets, their investment strategy runs no additional risk as compared to a scheme investment strategy that passed the stress test. • **NOTE**: We would have been concerned if the scheme had been invested 100% in CDI backed by a high level of private debt, high yield bonds, emerging market bonds. Central / best estimate forecasts may show this type of CDI portfolio providing the expected cash flows to match the liabilities but there are significant risks: – The level of corporate fund defaults increases in a time of market stress leading to expected cash-flows from corporate bonds being lower than expected and insufficient to meet expected liability cash flows. – Due to the lower quality of bonds held, they are likely to have greater market volatility, particularly in times of market stress, which may lead to forced selling at depressed values if liability cash flows are different from expected. – Liquidity for these asset classes is typically lower than for high quality investment grade bonds and government bonds and can deteriorate dramatically in times of market stress, this could make it difficult to sell any of these assets if liability cash flows are different than expected. In summary, the scheme may therefore experience the impact of a perfect storm of impaired

market value/higher level of corporate bond defaults at a time of vanishing liquidity. Such a combination of factors played out over a prolonged period of time during and immediately after the 2007-2008 financial crisis.

Example 3: Longer-term reliance on covenant

- A closed scheme is sponsored by an employer that primarily operates under a rolling 15-year contract to provide services to the UK government. The employer is profitable and has free cash flow which is reasonably high relative to the size of the scheme. The trustees assess the covenant as tending to strong (CG2) with reference to our guidance.
- The trustees consider that this gives them longer-term visibility of the strength of covenant than implied under the Fast Track guidelines (illustratively, three to five years) and they are confident that their covenant will remain CG2 for at least eg 10 years.
- They adopt discount rates in their TPs which assume moderately higher investment returns (with associated higher risk) over the initial eg 10-year period. TPs are therefore weaker than Fast Track.

TPR assessment: Compliant – no additional risk

- Although we would ordinarily consider that additional risk arises from the longer-term view of the employer's strength in this case, the trustees have undertaken full due diligence on the legal and financial aspects and have taken appropriate professional advice. They have provided evidence that:
  - their employer has legally underpinned cash flows/income, for instance by reference to a long and committed order book, which provides comfort over the employer's longer-term viability,
  - they have assessed there to be minimal *counter*-party risk (such as the risk that the contract could be removed, and/or a competitor come into this market, and
  - they have received advice on the legal certainty regarding cash flows and are confident that the terms could not be *easily* varied.
- We therefore conclude that the detailed evidence provided justifies the longer reliance on employer covenant, and the assumption that it can underpin investment risk for a longer period.
- **NOTE**: We would have concerns if:
  - the trustees had assumed that the contract would be renewed on the same terms and, therefore, they could rely on the same level of support indefinitely, or
  - the terms of the contract could be varied, as the trustees would be unable to demonstrate there will be a legally certain income stream over the 10 years, and
  - the resultant TP deficit were not funded in an appropriate period (e.g. if the RP was longer than, illustratively, six years).

B. Additional risk relative to Fast Track

509. In other situations, trustees may decide to diverge from Fast Track and their Bespoke arrangement will represent additional risk over and above the tolerated level of risk assumed in Fast Track. We would expect trustees to demonstrate in their statement of strategy how this additional risk is being managed and supported (unless they face significant affordability constraints and the scheme is stressed – see section C below).

510. In this context, we use the word 'risk' to represent the additional risks run by the trustees as a result of targeting a lower or weaker position than in Fast Track. For example, an LTO that targets less than low dependency funding, is premised on higher investment risk or a date for achieving the objective after significant maturity.

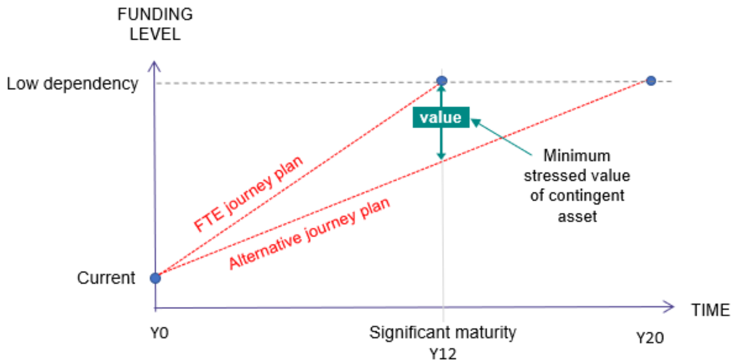
511. We consider that there are two broad categories types of additional support:

- Contingent assets: The additional risk is underwritten by contingent security which is of sufficient value (based on an appropriate valuation) and is realisable when required. We discuss in greater detail our expectations around the use of contingent support in Chapter 14.
- Guarantee support: eg from the employer or the wider group.

512. We provide a few examples below:

Example 4: Low dependency targeted later than significant maturity

- The scheme's actuary calculated that the scheme would reach 'significant maturity' (as defined in Fast Track) in 12 years. However, the trustees have selected a target date of 20 years from the effective date of their valuation to reach low dependency funding.
- The trustees secured a contingent asset of sufficient stressed value that would be released in an insolvency event.
- Figure 7 below illustrates this:



NB An alternative approach could involve the trustees setting the current TPs to be lower than the FTE. In that case the value of the minimum stressed value of the contingent asset would still be calculated in the same way.

TPR assessment: Compliant – additional risk is managed (by additional support)

- Although the scheme is carrying more risk than the FTE position, the trustees have properly managed the risk by securing support.
- This security has been valued properly and is available when needed so the trustees have evidenced that this supports the additional risks associated with running a significantly mature scheme.

Example 5: Back-end loaded RP

- For valid business reasons, a CG3 employer needs to materially reduce the scheme's DRCs for the next three years but is prepared to commit to DRCs over the subsequent six years which are sufficient to fund the TP deficit (eg the nine-year RP is consistent with the FTE but is back-end loaded).
- The employer shares its detailed business plan with the trustees who take independent covenant advice. The covenant advice recommends that, on balance, the employer's plan is reasonable and likely to result in a stronger covenant in the medium to long term. The trustees are comfortable that this strategy is necessary and reasonable.
- The proposal includes a hiatus on dividends and other forms of value leakage until (at least) the scheme has received the level of DRCs that it would have received under an FTE RP (eg at least 3

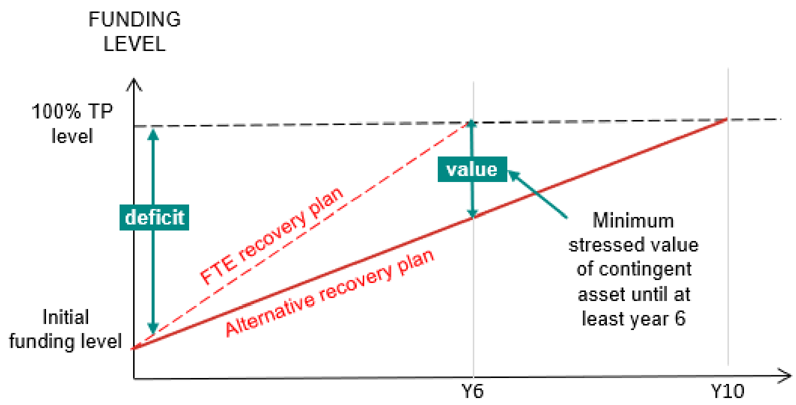
years) and the trustees/management consider that alternatives (eg raising new debt to fund the investment plans) would be detrimental to the covenant.

TPR assessment: Compliant – additional risk is managed (mitigated)

- The trustees have provided good evidence on the need to delay DRCs and this is properly detailed in their statement of strategy.
- They have assessed the risk of short-term insolvency as remote and have further mitigated the additional exposure to employer covenant deterioration by ensuring no dividends or any other value leakage occurs in years one to three. The dividend suspension is supported by a legally binding agreement.
- **NOTE**: We would be concerned if:
  - The trustees and employers could not evidence there was a genuine financial need for DRCs to be postponed.
  - The employer looked vulnerable to *insolvency* in the short to medium term.
  - The scheme was not being treated equitably with the employer's other stakeholders. For example, there was no 'risk-share' in place (such as the legally binding agreement not to pay *dividends* in the period of employer re-investment).

Example 6: Long RP

- A scheme closed to future accrual is sponsored by an employer that the trustees have assessed as strong (CG2) and so they have set TPs consistent with Fast Track for that covenant grade.
- However, the trustees have agreed a 10-year RP on the basis that the scheme's sponsoring employer cannot afford more as it is cash poor but asset rich. This is much longer than the appropriate RP length under Fast Track for CG2.
- In mitigation, the trustees have secured a contingent asset of sufficient stressed value to cover scheme's exposure to being underfunded for a longer period. The asset will be automatically released at the end of the RP if the scheme has not reached the SFO.
- Figure 8 below illustrates this:



TPR assessment: Compliant – additional risk is managed (supported)

- The trustees have security that underwrites the risk of a longer RP. It has been properly valued and can be accessed when and if it is needed.
- **NOTE**: We would call into question the trustees' covenant assessment of CG2 if the employer could not support a relatively short RP and was not willing or able to provide adequate contingent security.

Example 7: Stronger TPs but longer RP

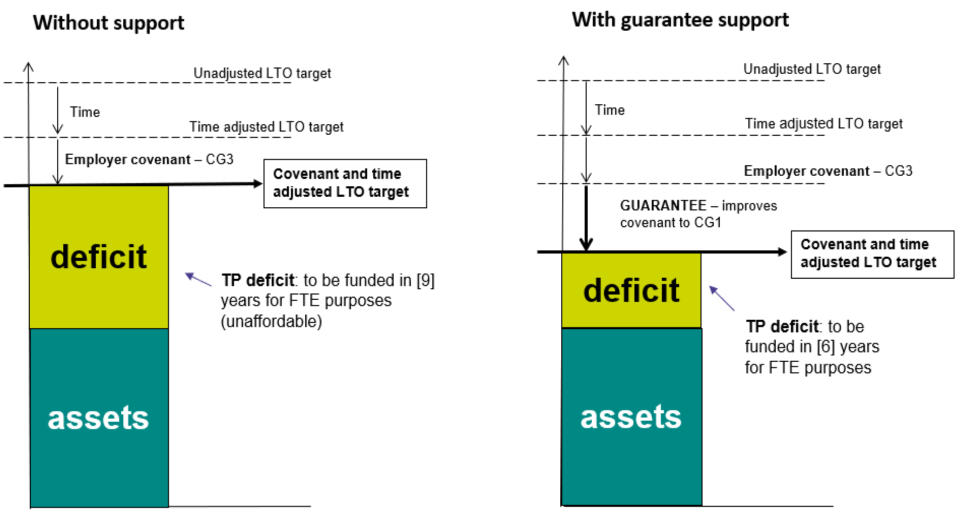
- The trustees of a closed scheme have set a LTO in accordance with the Fast Track guidelines. They have also set TPs using the same low dependency assumptions. This means the TPs are significantly higher than the Fast Track minimum, resulting in a larger TP deficit.
- To fund this deficit, they have agreed a RP of 10 years, which is longer than Fast Track length for their CG2 employer covenant.
- The scheme's investment strategy passes the Fast Track investment stress test.
- The trustees were concerned about the longer reliance on the employer for DRCs and they have agreed with the employer an information-sharing protocol and a conditional payment in the schedule of contributions if there is any change to the employer covenant strength.

TPR assessment: Compliant – (i) better than FTE and also (ii) managed risk

- The trustees demonstrated that higher contributions are being paid than if the Fast Track TPs and RP had been adopted. This 'equivalence test' would be done by comparing aggregate DRCs that would be payable under the Fast Track approach with the sum of total actual planned contributions over the Fast Track RP period. The other guidelines about back-end loading, investment outperformance and equitability were met.

Example 8: Underpinning covenant with a guarantee

- The Fast Track guideline for a CG3-sponsored scheme is a recovery plan of no more than nine years (note that this is subject to consultation). However, the corresponding DRCs are not affordable by the employer.
- The employer's parent company, which is capable of providing a CG1 level of employer covenant, grants the scheme a guarantee that (i) covers its low dependency deficit at the outset but will increase if the low dependency deficit increases, (ii) is not time-limited, and (iii) guarantees the payment of DRCs if the employer cannot.
- The trustees therefore assume that the scheme's covenant has improved to CG1 and agree TPs and an RP that meet the Fast Track guidelines for a CG1-sponsored scheme.
- Figure 9 below illustrates this:



TPR assessment: Compliant – additional risk is managed (supported)

- The trustees have secured a legally enforceable guarantee for an appropriate value and time period and from a sufficiently robust counterparty. This justifies assuming (for funding purposes) that the covenant of the direct employer is that of the parent. The resulting lower deficit is to be funded over a period commensurate with the improved covenant.

- **NOTE**: If the guarantee had expired after the six-year RP period then we would consider that it only supported the RP, not that it provided a full covenant equivalence. We would therefore consider that even if the scheme was fully funded on a TPs basis, the TPs were too low for the employer covenant.
- We discuss our proposals regarding the use of guarantees in greater detail in Chapter 14.

Example 9: Weaker TPs – based on strong long-term covenant

- A closed scheme is sponsored by an employer the trustees have assessed as strong (CG1). The employer has suggested, and the trustees have agreed, that investment de-risking is unnecessary and that the current covenant strength should be fully reflected in TPs discount rates over the 20-year period before reaching low dependency (ie with the assumed investment returns and risk being maintained for this period at a level commensurate with a CG1 covenant).
- This approach means that the discount rates assumed allow for significantly higher investment returns (with associated high risk) over the medium term to long term than the Fast Track approach, resulting in the TPs being substantially lower for 20 years. The trustees have obtained contingent support to underwrite the additional risk.
- The legally enforceable contingent support obtained by the trustee is of sufficient stressed value to underwrite additional investment and insolvency risk over the 20-year period and realisable when needed (for example cash, or property not occupied by the employer, which can be readily converted to cash by the trustees without harming the employer).

TPR assessment: Compliant – additional risk is managed (supported)

- The mitigation obtained appropriately underwrites the additional risk created by diverging from the Fast Track position, it is consistent with the principles, and the trustees' statement of strategy and supporting documentation explain this clearly.
- **NOTE**: We would have concerns if the trustees had simply assumed that the covenant would remain strong over the entire period and failed to seek additional support or otherwise manage the additional risk.

Example 10: Lack of journey planning so TPs inconsistent with LTO

- The trustees of a closed scheme have an LTO to buy-out out in 25 years' time when the scheme is expected to be significantly mature. The trustees have adopted a single discount rate to calculate the TPs.
- The single discount rate is based on prudent expected returns on the current investment strategy which can be supported by the current covenant. The trustees plan to maintain the current investment strategy indefinitely. This approach means the TPs are substantially lower than in Fast Track.

TPR assessment: Potentially not compliant – failure to adequately manage additional risks

- This approach is not consistent with the principles as there is:
  - no link between TPs and the LTO (journey planning) which means that the trustees cannot *demonstrate* that their TPs will reach the LTO and are therefore prudent
  - no plan *for* the level of scheme-based or investment risks to decrease over time, and;
  - an *assumption* that the reliance on the covenant can be maintained at a similar level over a very long period.

- The trustees have provided no evidence to support their approach and merely confirm their personal views that they have a strong employer who can support all the risks indefinitely.

Example 11: High allocation of growth assets

- The trustees of an open scheme have assessed their employer covenant as CG2 and are heavily invested in equities. The scheme's investment profile fails the stress test.
- The trustees have secured a contingent asset to support the excess investment risk being run as compared to a Fast Track compliant investment strategy. The contingent asset is of sufficient liquidity to be converted to cash by the scheme in an adverse investment event (without adverse impact on the employer covenant). The trustees' lawyers have confirmed that the asset will be released in appropriate amounts if the investment returns are below the anticipated level at subsequent valuations.

TPR assessment: Compliant – additional risk is managed (supported)

- The additional investment risk is adequately supported, the funding arrangement is consistent with the principles, and the trustees' statement of strategy and supporting documentation explain this clearly.
- **NOTE**: We would not consider that investing only in growth-seeking assets on the grounds that the scheme is open to new members would be a sufficient justification.

Example 12: High allocation to growth assets, strong covenant

- The trustees of a small immature closed scheme are heavily invested in growth assets. The scheme's sponsoring employer is very large and has been assessed as strong (CG1) and the RP agreed is in line with FTE for this covenant grade (for example, less than six years). The scheme's investments have failed the Fast Track stress test.
- The trustees confirm in their statement of strategy that they have properly managed the increased risk because of the following:
  - The downside risk of the potential investment underperformance can be supported in the short term by their employer. The employer has cash flows and assets considerably more than the amount quantified by the trustees as 'at risk' and has provided a commitment to make good any downside event within the very short term, ie six months.
  - The trustees have a unilateral power to set contributions under the trust deed and rules.
  - The trustees have a contingency plan detailing the lower risk asset allocation they would move to in the event of a deterioration in the covenant (which is consistently monitored by the trustees).

TPR assessment: Compliant – additional risk is managed (supported and mitigated)

- Additional investment risk is being taken but is supported by the employer and the trustees have demonstrated that possible downside deficits can be comfortably met by the employer's cash assets. Further, the additional risk has been mitigated by the contingency plan and the trustees' ability to unilaterally call for additional contributions.
- **NOTE**: This is a situation where the covenant is significantly strong in relation to the size of the scheme. Less strong CG1 covenants (for example, those which are not able to underwrite investment risk in the very short term) might not get through Bespoke without a contingent asset to underpin the additional risk.

Example 13: Open scheme with weaker TPs

- The trustees of a scheme open to both future accrual and new entrants have set TPs with a discount rate significantly higher than the FTE for an initial period of three years then de-risking gradually down to a low dependency level by significant maturity assuming no future accrual after the initial period.
- The trustees justify this approach by demonstrating:
  - the employer covenant is strong with good visibility over this initial period and therefore could rectify any downside scenarios at the valuation after this three-year period;
  - that the employer has provided contingent support of sufficient (and realisable) value to underwrite the additional investment risk this strategy incurs, and
  - an appropriately evidenced commitment from the employer to keep the scheme open to new entrants and accrual over this initial three-year period (meaning the scheme will not mature).
- They have agreed to review this approach at each valuation, it is temporary.

TPR assessment: Compliant – additional risk is managed (supported and mitigated)

- The arrangement is consistent with the principles, the additional investment risk is supported and the closure risk has been mitigated. Further it is a temporary arrangement that can be unwound at the next valuation (which would mitigate long-term risks).
- **NOTE**: We would be concerned if the trustees only put forward *unsupported and unevidenced* explanations such as that the scheme is open and therefore it:
  - has a much *longer* investment time horizon than a closed scheme
  - is not under *pressure* to dis-invest to meet pension payments as contributions and investment income cover current pension payments many times over
  - can invest in a wider pool of investments than a closed scheme, or
  - can achieve a higher level of return with the same level of risk as a closed scheme.
- Of course, if the trustees could provide good evidence and demonstrate appropriate risk management, then the above explanations could be acceptable.

C. Inability to meet the Bespoke criteria

513. We expect in some circumstances that there will be genuine reasons why the trustees and employer cannot agree a funding arrangement that meets the Bespoke criteria (ie following the code principles and managing additional risk).

514. For example, 'stressed schemes', which are poorly funded and whose sponsor is too weak to adequately fund the scheme, often have very long RPs or take unsupported investment risk. To be clear, we would only regard a scheme as fitting into this 'stressed' category if it was not possible for it to access sufficient contingent support, for example security over an asset or a parent company guarantee. We expect trustees to exhaust all avenues of potential support before concluding that their scheme is 'stressed'. The reality is that, other than the status quo, there are very few alternatives for these stressed schemes (including being able to afford entry into a Superfund). Generally, the options are as follows:

- Winding up the scheme (whether the decision is made by the trustees or us): This would trigger the s75 debt, which would probably make the employer insolvent and cause job losses, so this will not be an attractive solution in all but the rarest situations.
- Regulated Apportionment Agreements (RAAs): These are only available in very specific circumstances and under tight controls.

515. Trustees of these stressed schemes may often wish to take more investment risk than we would expect for a CG4 employer and doing so will run the risk of investment losses which cannot be made good by increased employer contributions (ie the investment risk is unsupported). This would be inconsistent with the principle regarding unsupported risks. However, it is not clear what alternative should be adopted, as if employer affordability is genuinely constrained, then we would not be able to use our powers, for instance to increase contributions.

516. We set out below two broad approaches in respect of these stressed schemes that we might expect trustees to take and to explain to us under the Bespoke framework:

- Trustees take an acceptable level of investment risk but agree a very long RP.
- Trustees set a short RP but take higher levels of investment risk.

517. The pros and cons of each approach are set out in the table below:

Option	Pros	Cons
Trustees take an acceptable level of investment risk, but have to accept a longer RP (eg > CG4 thresholds as set out by TPR)	☑ It could limit PPF's potential losses if the investments fail to perform as expected. ☑ Approach would be compatible with our principles (trustees should not take unsupported risks; deficits should be recovered as soon as possible based on affordability).	☒ It could restrict the trustees' ability to invest in a way that delivers members benefits in full. ☒ RPs could potentially be extremely long (eg +30 years) or some schemes may not be able to come up with a viable RP.
Trustees agree a shorter RP (eg compliant with our Fast Track guidelines for a CG4 scheme) but seek an increased investment risk	☑ If the investment strategy delivers it could in theory remove any future PPF liability and allow trustees to deliver PPF⁺ or full benefits (but that very argument undermines the principles – see last point in the 'Cons' column).	☒ May not actually deliver the investment returns anticipated and the potential loss to the PPF would increase. ☒ The constraint on RP length could drive significantly higher investment risk. ☒ Undermines the principle that trustees should not take risk that is not supported.

518. Our view is that 'stressed schemes' should not run additional risk over and above the tolerated FTE level (with reference to, for example, scheme maturity) and, therefore, that these schemes' trustees should not seek to increase investment risk just to be able to submit a FTE RP. This is because the employer is unlikely to be able to make good significant reductions in funding level due to investment losses or, by doing so, risks damaging the covenant. Therefore, we would expect trustees to meet the TPs and investment Fast Track guidelines for a CG4 employer and report a long RP under the Bespoke regime supported by evidence demonstrating how affordability has been assessed.

519. In addition to taking managed investment risk, we would expect trustees to take other steps to limit the risk of the scheme's position deteriorating, such as ensuring a robust risk management framework is in place, considering whether future accrual should stop and whether it is appropriate to wind up the scheme. We would also expect trustees to maximise the support available to the scheme by taking steps to ensure that the employer:

- limits the flow of value away from the employer (for example, through dividend restrictions)
- prevents detriment to the scheme's claim on the covenant, for example as a result of the employer's debt financing, and
- improves the scheme's security through a contingent asset from the employer or formal group support if available (even if this security does not fully mitigate the excess risk being run).

520. The example below illustrates the proposed approach:

Example 14: Stressed scheme with a long RP
• The trustees of a closed scheme determine the scheme's LTO and define a de-risking journey plan to reach this target by the time it reaches significant maturity in 20 years. The trustees, on advice, conclude that the covenant is weak (CG4). They therefore set TPs based on the appropriate Fast Track basis. The scheme's investment strategy passes the Fast Track investment stress test. The trustees have a robust risk management plan in place. • The trustees and the employer acknowledge the employer's limited ability to fund the resulting TPs deficit and agree that a 15-year RP is the shortest affordable plan. • This lack of affordability, coupled with the employer having no unencumbered assets that could be secured in the scheme's favour, and there being no associated company that could provide support, leads the trustees to conclude that their scheme is 'stressed'. • Employer management provides binding commitments that no dividends will be paid without trustee approval and that the scheme will receive a committed share of profitability above current forecast levels, eg a negative pledge and a contingent payment mechanism, respectively. **TPR assessment: Compliant – additional risk is managed (mitigated)** • There is additional risk as the RP is longer than the FTE. However, it complies with the principle of affordability as the trustees have agreed as short an RP as is affordable and have provided evidence on the employer's limited affordability. They have also evidenced that there are no potential areas of additional support. • They have also mitigated the risk of value leakage from the employer with the legally binding protections regarding the scheme's treatment and the contingent payment mechanism provides a potential upside for the scheme (albeit the current likelihood of extra payments is low).

521. We would consider these schemes compliant with Part 3 of the Act (through the Bespoke route), even though the RP may be significantly long.

Non-viable funding arrangements

522. In some situations, a scheme may be so 'stressed' that the actuary is unable to certify the schedule of contributions as they must confirm that, in their opinion, the SFO will be met by the end of the RP period.

523. Our view is that schemes with non-viable RPs would not be compliant with the code and with Part 3 legislation, but we acknowledge that if there are no additional funds available, then the use of s231 powers would not be appropriate. There are currently few other regulatory tools we could use to improve the outcome for those schemes. It may be appropriate in certain circumstances to wind the scheme up, but although this would protect the PPF from further exposure, by crystallising the s75 debt, it will almost certainly result in the employer's insolvency and possible job losses.

524. The DB green paper considered some options to help address schemes with significant affordability constraints such benefit reductions, but these measures were not taken forward in the DB white paper. However, the greater clarity around funding standards in the new code should help provide a better picture of the extent of these issues. We hope that the transparency of the new regime will shine a spotlight on these situations and we can start to gather data in order to assess the extent of the problem in the future and work with DWP and stakeholders to develop possible solutions

► Questions

Q50 Bespoke examples

a. Do you have any comments on the assessments we have made in the examples above?

b. Could you provide other examples (relevant to your own scheme experience or that of schemes you advise) of arrangements which you think will follow the Bespoke route? Why do you think these arrangements would be compliant?

c. In example 2 (LTO – CDI strategy), could it be appropriate, in your view, to be able to use a higher discount rate / lower value of TPs (low dependency basis) than in Fast Track? If so, in what circumstances and by how much?

Q51 Stressed schemes

a. Assuming that affordability is genuinely constrained, are very long RPs 'appropriate' and therefore compliant with the Act?

b. Alternatively, should we make an exception to the principles and allow the trustees of stressed schemes to take unsupported investment risk, or more risk investment risk than other CG4 schemes (schemes with weak employers)? What checks and balances should we put in place in addition to those mentioned above (equitable treatment, risk management)?

c. For schemes with unviable RPs, should an exception be made for them in terms of the level of acceptable investment risk?

d. Are you aware of situations other than stressed schemes where the trustees and employer would have difficulties meeting the Bespoke compliance principles?

14. Additional support

PRINCIPLE	★ 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 (iii) is legally enforceable and realisable at its necessary value when required.

Introduction

525. Additional support may represent a source of real value to schemes as it can provide support that is not otherwise available from their statutory employer or can enhance a scheme's existing claim. Furthermore, the existence of such support can give trustees a stronger negotiating position in future discussions with their employer/group.

526. We envisage that the assets of the sponsoring employer and the assets or support of its wider group will play a leading role in Bespoke funding solutions, as illustrated in the examples in the preceding chapter - particularly to support and underwrite additional risks being taken.

527. To be clear, formal and legally binding reliance on additional support differs from reliance on 'indirect employer covenant' (as discussed earlier in Chapter 4) which is non-legally binding, and should ideally not be relied upon beyond the short term.

528. In this chapter, we discuss the types of additional support available to schemes and our expectations around how they should be assessed and accounted for. We envisage providing some guidance on this in the DB funding code to help trustees and employers. Broadly speaking, there are two main types of additional support provided to schemes and throughout this section we refer to them as follows:

- Contingent asset support – Where a scheme can place increased reliance on an asset owned by its employer, its wider group or another entity (such as cash, property, business assets, intellectual property or securities).
- Guarantee support – Where a scheme is provided with legal recourse to a party other than its employer in pre-defined situations or is given improved recourse to its employers (for example: in a multi-employer scheme, the ability to claim up to the entire s75 deficit on all employers).

Trustee's risk assessment

529. In line with the principle we set out in Chapter 5, we would expect trustees who are considering using additional support to address the following:

A. **Assess:** identify the additional risks arising from the Bespoke arrangements.

B. **Access**: when or in what circumstances will those risks crystallise and therefore when the additional support will be needed.

C. **Quantum**: assess how much support will be needed in those circumstances.

D. **Quality**: assess whether the additional support (asset or guarantee) will have the necessary value at that time and that it will be legally accessible/enforceable.

530. The types of risks that the trustees may need to assess could include, relative to the tolerated level of risk in Fast Track:

- an LTO that targets a lower funding basis than low dependency
- an LTO that targets a timeframe longer than significant maturity
- weaker TPs
- longer RP

- RP with significant back-end loading
- RP with significant investment outperformance
- significant RP re-spreading
- a high level of investment risk, and
- increased exposure to employer insolvency (for example, by placing reliance on the employer covenant beyond a period of reasonable visibility).

When will the support be needed?

531. It is important that the trustees can access the additional support when the scheme needs it, so they need to think carefully about the situations where they might call it.

532. Every scheme and employer's circumstances are different, and the Bespoke arrangements will also be unique as they will be tailored to fit those conditions. We cannot therefore define exactly the situations where a particular risk will be crystallised and the support should be accessible. However, we expect trustees to approach this in a logical and consistent manner and be able to clearly explain why they are satisfied that the support provided is acceptable.

533. We would expect a scheme not to release its claim over the support while the additional risk still exists. However, we recognise it may be appropriate for the size of the scheme's claim to reduce as the level of incremental risk reduces.

534. In many situations, we expect the additional support to be available on the employer's insolvency in addition to on the crystallisation of other risks.

535. Example – Part 1:

A scheme's FTE RP length would be nine years; however, the trustees agree to a 15-year RP, subject to contingent asset support from the employer.
STEP A: Assess the risk The trustees determine that the scheme will be underfunded for a longer period with reliance on the employer covenant far beyond the period it can reasonably be forecast. Therefore, there is a risk that the scheme could be exposed to a weakening employer, with the potential for DRCs to be delayed/missed or even an employer insolvency, as well as the risk of investment underperformance. **STEP B: Access to support** We would expect, at the very least, the security to be accessible in the event of the employer's insolvency before the end of the RP and at the end of the RP period if the scheme's funding has failed to reach the SFO.

How much support is needed?

536. As a minimum, we would expect trustees to determine whether the additional support is of sufficient value to underpin the additional risk by reference to the difference between FTE and Bespoke. This is consistent with the sections in Chapter 3 and 13 **where we talk about the FTE and measuring against Fast Track**. However, the support that is appropriate for their scheme may be more than the minimum required when benchmarked against Fast Track and the trustees should be mindful that Fast Track is a regulatory tool, it carries its own risks and is not the 'perfect' funding solution.

537. Trustees should ask themselves whether the support would be able to put the scheme's funding back in the position it would have been in had Fast Track been followed. For instance, in the case of additional support for an RP longer than that recommended in Fast Track, we would expect its recoverable value to be all times at least equivalent to the level of 'delayed DRCs' (ie the difference in a Fast Track compliant RP and the proposed 'alternative' RP).

538. Example (Part 2)

A scheme's FTE RP length would be nine years; however, the trustees agree to a 15-year RP, subject to contingent asset support from the employer.
STEP C: Quantum – how much? The trustees instruct their advisers to ensure that the recoverable value at least equals (i) any deficit that may exist at the end of the RP, and ideally, (ii) on insolvency the difference between the amount received and the amount that would have been received had the trustees followed Fast Track.

Quality of the support

539. Trustees need to be confident not just of the value of the support when they enter into the arrangement but that it will be of sufficient value to support the downside events at the time they will need to access the support.

540. In relation to additional support for a scheme's ongoing risks, such as investment underperformance, we expect trustees to be able to demonstrate and evidence how the scheme would be able to access the additional support in a way that would not cause damage to the employer covenant or the sustainable growth of the employer. This would include, for instance, considering whether an asset could readily be converted to cash without impeding employer trading, or if a guarantee could be called upon without adversely affecting company reserves.

541. The legal structure of the additional support is as important as the underlying quality of the asset or strength of guarantor. If the support cannot be accessed by the trustees easily and when it is required, then we would not consider that it appropriately mitigates the risks.

542. Given the very scheme-specific nature of the risks that will be supported, we don't think that creating new TPR standard documentation is appropriate, but we would expect trustees to obtain their own legal advice on when and how the support can be accessed. However, we would welcome suggestions for how we could implement a more standardised framework.

543. Example (Part 3)

A scheme's FTE RP length would be nine years. However, the trustees agree to a 15-year RP, subject to contingent asset support from the employer.
STEP D: Quality of the support? The trustees have determined that the scheme needs a contingent asset worth at least £x to support the risks during the 15-year RP. The employer suggests security over a tangible asset (property). The asset can used to generate cash at the end of the RP or on the employer's insolvency (if it occurs sooner), eg by selling the property or borrowing against it. The trustees obtain an independent valuation confirming the property's current value comfortably exceeds the level of cover they require. The trustees decide there is no reason for the asset's value to fall, but that they will keep it under frequent review (with an independent valuation at least every three years and with more frequent reviews for market indicators that the asset could have declined in value). The trustees' lawyers confirm that the release criteria are acceptable.

Contingent assets

544. Our view is that longer-term risks being run by schemes are typically better underpinned by contingent asset support (particularly where of sufficient quality and value) than guarantee support which could have reducing value beyond the guarantor's 'covenant visibility'.

545. We recognise that there are various types of assets, both tangible and intangible, over which schemes could be provided legal security. Some assets have clear, demonstrable and readily recoverable market value – such as cash, gilts, and properties that are not occupied by the scheme's employer or its wider group.

546. Other contingent assets have a commercial value that may be closely linked to the ongoing strength of the employer, such as properties that are in use by the employer, trade debtors, stock, and brands or other intellectual property that may have less value to other parties. Their value to a scheme may be more complex to assess given this could significantly decline at the same time as the employer covenant deteriorates, which is the time when the contingent asset may be needed by a scheme. These types of contingent asset may still be acceptable for Bespoke purposes but would be less clear-cut and therefore require further evidence from trustees and potentially greater scrutiny by us.

547. Regardless of the type of asset, trustees should be focussing on the recoverable value of the contingent asset when it will be needed. Because this could include a scenario where the employer is insolvent, we would always expect trustees to assess the 'stressed value' of any contingent assets.

548. While we do not want to dissuade trustees and employers from taking advantage of contingent asset support, there may be situations where trustees should consider procuring expert valuation advice. Although the value provided by contingent assets shouldn't be outweighed by the cost of valuing, implementing and monitoring them, a contingent asset may represent such a material proportion of future scheme support that valuation advice becomes imperative.

549. Regardless of the materiality of a contingent asset to a scheme, we do not consider it appropriate for trustees to ascribe a higher value to a contingent asset than the value listed in the employer's audited accounts unless they obtain an independent valuation.

550. We will set out some broad guidance on valuing contingent assets in the new code but welcome views on the issues discussed and the extent to which we should set out some detailed requirements or whether such details should be left entirely to trustee discretion.

Guarantees

551. If another entity is prepared to stand in the place of the statutory employer and to underpin a scheme's liabilities, then that can be a very valuable form of additional support and can represent an enhancement to a scheme's employer covenant.

552. However, as noted above, we would be concerned if a guarantee is being used as justification for a longer RP given there will typically be reduced visibility about a guarantor's financial strength in the longer term (much as there would be for the employer).

553. Instead, we consider guarantee support is more appropriate as an underpin for higher investment risk in the shorter term, provided the (smaller) TP deficit is funded in an appropriate short timeframe (see example 8 in the preceding chapter).

554. Guarantees can vary in value - from providing schemes with a fixed (and potentially small) level of support, up to unlimited support covering all scenarios (including s75 debt cover on wind up). The greater the value of the guarantee, the more likely it is that the Bespoke arrangement will be assessed as compliant (subject to it coming from a sufficiently robust counterparty).

555. In particular, we consider that the employer covenant can be said to have been fully provided by the guarantor (for the purposes of assessing the funding arrangements) if the guarantee provided the following:

- Guarantees at least the scheme's entire low dependency funding deficit at the time required. For example, the guarantee is for a floating amount at least equal to the full low dependency deficit at any point in time, as opposed to being capped at the low dependency deficit at the point where the guarantee is provided.

- Guarantees the payment of all the DRCs.
- Is not time limited.
- Funds any deficit in an appropriate period – that is, the resultant TPs deficit from any assumed improvement to the covenant should be funded within the period that is commensurate with our Fast Track guidelines for RPs. For instance, if the covenant improves to a 'CG2' level because of the guarantee support provided, the resulting deficit should be funded within no more than, illustratively, six years.

556. We recognise that full guarantees (in the terms set out above) may not be available to some schemes, and we do not wish to dissuade trustees from agreeing lower levels of guarantee support.

557. For example, a guarantee that provides for only the TP deficit or a capped amount may still have real value to a scheme but should not be seen as providing full covenant replacement. In this case, trustees may wish to consider the 'blended' support that such a 'partial guarantee' could provide.

► Questions

Q52 **Trustees' assessment of additional support in Bespoke arrangements** – Do you have any views on the framework we have set out for trustees to assess the appropriateness of additional support in Bespoke arrangements? If you disagree, what do you suggest?

Q53 **Accessing additional support** – When do you think trustees should be able to access the additional support? Does it depend on the Bespoke arrangement and the type of risk that it supports?

Q54 **Assessing the value of additional support** – Should trustees be required to assess the stressed value of any contingent asset? What other guidance do you think we should set out on the recoverable value of contingent asset support?

Q55 **Independent valuation** – Should trustees always be expected to seek an independent valuation of continent assets, or should it depend on asset value and/or type? If this should be based on value thresholds, how should these be defined? How frequently should we expect trustees to seek an independent valuation? Should trustees be expected to regularly monitor contingent asset value in the intervening period?

Q56 **Guarantees**

a. Should we treat guarantee support differently to asset backed support?

b. Should trustees rely on guarantee support to change the covenant grade assessment or do you think in these circumstances the supporting entity should become a statutory employer instead?

Alignment with PPF regime

558. We recognise that there may be crossover between the documentation and support used for PPF-levy reduction purposes, and those used for scheme funding purposes. The PPF standard documentation is normally calculated with reference to the PPF's exposure (typically lower than the deficit on a TP or LTO basis) and we expect that contingent security arrangements supporting scheme funding are likely to cover a greater financial level and potentially a broader range of circumstances. The differences in the level of cover and the release terms of PPF levy support means the standard legal documentation used by the PPF may not be adequate for scheme funding arrangements under Bespoke.

559. Trustees should not automatically assume that a PPF-compliant asset would be appropriate for funding purposes and it may be necessary for trustees to take additional advice on this. This does not mean that a PPF levy compliant contingent support arrangement should not be given any credit, but trustees should consider the support arrangement in the context of the framework outlined above and be prepared to explain any reliance on the arrangement as part of their statement of strategy.

Other possible mitigations

560. In this chapter, we have so far focused entirely on contingent asset and guarantee support. We recognise there are other types of arrangements that help trustees minimise risk, including the following:

- **Negative pledges** – Trustees might take some limited comfort that negative pledges protect the employer covenant, for example those which prevent the leakage of value from the employer covenant (such as via dividends) or which prohibit security being granted over employer assets in favour of other creditors.
- **Contingent contributions (scheme funding-linked)** – Some schemes have contingent contribution mechanisms: whereby additional payments are made by the employer in the event of the scheme's funding deficit being greater than expected (or sitting outside of an acceptable range). We recognise that these may be of value to the scheme, provided trustees are comfortable that necessary payments can be afforded by the employer.
- **Contingent contributions (employer performance-linked)** – We recognise that performance-linked contributions (for example 'profit sharing' mechanisms) can be of significant value to schemes and we encourage trustees to seek such arrangements. This is particularly relevant where RPs are long (as incremental future payments can reduce the duration of contributions) and can provide valuable upside for a scheme if set at appropriate levels. They can also be an effective way of ensuring that schemes are treated equitably as compared with payments made to other creditors (including, but not limited to, shareholder dividends). However, we note that these do not provide downside support for a scheme (in the way that other mechanisms discussed in this section do), and we would expect trustees to place limited comfort on such arrangements in agreeing funding levels and RPs.
- **Blended support** – Contingent support arrangements that have characteristics of guarantees and security over assets. For example, a scheme may have first ranking security over an intercompany balance. Such an arrangement may be valuable to a scheme, but we would expect trustees to consider the value of the underlying asset and explain the reliance placed on this in their statement of strategy.

561. To the extent that trustees place reliance on these types of arrangements, we would expect this to be explained to us under the Bespoke framework.

► Question

Q57 Other mitigations – Can you think of any other types or arrangements which can help trustees mitigate risks?

Reporting additional support to TPR

562. We propose that trustees should be required to confirm the following in the statement of strategy:

- their assessment of the additional risks presented by their 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 (eg the anticipated value after an event has occurred in which the trustee is able to enforce its security up to and including a hypothetical employer insolvency)
- whether they received an independent valuation of the asset or if not, why not

- 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 RP
  - any steps taken by the trustees to ensure that the value of any contingent support is being protected

563. Trustees would also be expected to be able to provide evidence that supports their valuation and the explanations made in their statement if requested to do so but we don't anticipate that this supporting evidence should be submitted unless requested.

► Question

Q58 Reporting information on additional support – Is there any reason why it would be unreasonable to expect trustees to undertake the analysis and provide the information outlined above? Is there additional information that should also be provided to us?

Part 5: Supporting materials

15. Worked examples

564. The purpose of this chapter is to provide two worked examples (one for a closed scheme and one for an open scheme) to illustrate how a valuation under Fast Track might work and help respondents understand the proposals set out in Part 3 (Fast Track approach).

Illustrative Fast Track requirements

565. Many aspects of the Fast Track funding requirements are yet to be determined and are subject to this consultation and further analytical work. When developing these worked examples, we have assumed the following purely illustrative Fast Track guidelines:

566. **LTO** definitions:

- Low dependency funding calculated using a discount rate of 0.5% pa in excess of gilt yields appropriate to the duration of the scheme.
- Price inflation assumption used is defined by us. All other actuarial assumptions are determined by agreement between trustees and employer and are required to be overall no weaker than best estimate.
- Low dependency funding must be reached when the scheme reaches a duration of 14 years.
- An investment strategy which results in a stress test of less than 5%.

567. **TPs** must be greater than or equal to an amount calculated as follows:

- Calculate the value of past service liabilities using low dependency assumptions.
- Calculate the duration of these liabilities using low dependency assumptions.
- Multiply the value of past service liabilities using low dependency assumptions by the ratio set out in Guidelines Table A below. This ratio is set by us from time to time and varies by scheme duration and covenant grading.

568. **RP:**

- Maximum length of RP is set by us from time to time and varies by covenant grading. See Guidelines Table B below.
- No back-end loading or deficit re-spreading is permitted and assumptions used to calculate DRCs must be the same as used to calculate TPs. In particular, investment returns over the RP must be equal to the TPs discount rate.

569. **Investment strategy:**

- A stress test is carried out, which includes a maximum permissible stress. See Guidelines Table C below.
- The maximum permissible stress is set by us from time to time and varies by duration and covenant grading.
- The stress test involves a fall in growth assets, combined with a fall in interest rates and a slight fall in inflation. It is the same as the PPF levy stress test. Full details of the stress are shown on the PPF website (https://www.ppf.co.uk/sites/default/files/file-2018-10/1819_investment_risk_appendix_0.pdf).
- Stresses for different asset classes are as follows:
- Global equities: 16%
- UK equities: 19%
- Property: 5%
- Long corporates: +5%

- Long gilts: +15%, and
- Long inflation-linked gilts: +18%.

570. Future service costs: All assumptions used to calculate future service cost must be the same as those used to calculate TPs, except that the longer duration of future service liabilities can be reflected in the discount rate used to calculate future service costs.

Guidelines Table A: Fast Track minimum TPs ratio by covenant and maturity[44]

Duration (years)	CG1	CG2	CG3	CG4
14 or less	100%	100%	100%	100%
…				
19 - 20		92%		
…				
21 - 22		89%		
22 - 23		86%		
…				
Over 28		74%		

Guidelines Table B: Fast Track maximum RP lengths

	CG1	CG2	CG3	CG4
RP (years)		6 years		

Guidelines Table C: Fast Track maximum investment stress (measured as deterioration in the ratio of assets to liabilities on low dependency basis)

Duration (years)	CG1	CG2	CG3	CG4
14 or less	5%	5%	5%	5%
…				
19 - 20		10%		

[44] The data in Guidelines Tables A-C has been deliberately edited to highlight only the relevant information for the following examples.

…				
21 - 22		**12%**		
22 - 23		**13%**		
…				
Over 28				

Example 1: Closed scheme

571. Table 34 below summarises the key facts relating to this scheme.

Facts: Scheme assets = £550m. Covenant grade rating = CG2. Scheme duration = 21.3 years.		
Fast Track feature	**Details**	**Pass/ Fail**
LTO	Set using Fast Track assumptions. Low dependency liabilities = £670m.	☑
TPs	TPs agreed by trustees and employer = £600M. Greater than the Fast Track minimum (=£670m x 89% = £596m).	☑
RP	Deficit = £50m. RP is equal to maximum Fast Track RP length of six years with DRCs of £9m pa.	☑
Investment stress	Investment stress is 9.5%. This is less than the maximum Fast Track stress of 12%.	☑
Overall	**Complies with Fast Track.**	☑

Detail

572. The trustees and employer agree they wish to follow the Fast Track approach. They adopt the Fast Track LTO (as defined above). Therefore, the scheme has a low dependency funding basis calculated using a discount rate of 0.5% pa in excess of gilt yields appropriate to the duration of the scheme. The price inflation assumption is set by us and the other low dependency basis assumptions are set by the trustees so that, overall, they are no weaker than best estimate. So, the scheme passes the LTO assessment under Fast track. ☑

573. The scheme actuary calculates that the scheme's liabilities measured on these assumptions are £670m. This is a measure of the scheme's long-term target. The scheme's TPs will approach this figure as the scheme matures and moves closer to significant maturity.

574. The trustees decide, having taken independent covenant advice, that the employer covenant has a covenant grade of CG2 (Tending to strong) and that they don't have longer than typical visibility about how the employer covenant will develop in future, ie they only have good visibility over around three to five years.

575. The scheme actuary calculates that the scheme has a duration of 21.3 years, using the low dependency assumptions. The ratio used to calculate minimum TPs is 89%, taken from the entry in Guidelines Table A

for covenant rating CG2 and duration of between 21 and 22 years. Therefore, in order to meet Fast Track requirements, the scheme needs to have TPs equal to or greater than £670m x 89% = £596m.

576. The trustees and employer agree the TPs assumptions and the scheme actuary calculates the value of the TPs as shown in Table 35 below:

Valuation balance sheet	**£m**
Value of assets	550
TPs	600
Surplus/ (deficit)	(50)

577. The scheme's TPs (£600m) are greater than the Fast Track minimum TPs (£596m). So, the scheme passes the TPs guidelines under Fast Track.☑

578. The scheme has a deficit of £50m.

579. The Fast track RP has a maximum of six years, taken from the entry in Guidelines Table B for covenant grade rating CG2. The trustees and employer agree a six-year RP with annual contributions of £9m. Assumptions used to calculate the DRCs are the same as those used to calculate the scheme's TPs. So, the scheme passes the RP assessment under Fast Track. ☑

580. The scheme actuary certifies the schedule of contributions based on the above TPs, deficit and RP.

581. The trustees carry out the Fast Track investment stress test, as set out below. The scheme is invested in the following way:

- Global equities 25%
- UK equities 5%
- Property 10%
- Long gilts 30%
- Long inflation-linked gilts 30%

582. As shown in Table 36 below, the stress test is applied to both the assets (in the proportions stated above) and also to the liabilities (measured on the low dependency assumptions described above).

	Before stress	**After stress**
Global equities (25%)	137.5	115.5
UK equities (5%)	27.5	22.3
Property (10%)	55	52.3
Long gilts (30%)	165	189.8
Long inflation-linked gilts (30%)	165	194.7
Total assets	**550**	**574.5**
Liabilities on low dependency basis	**670**	**763**
Assets to liabilities (low dependency)	**-120**	**-188.5**

583. The assets to liabilities (low dependency basis) deficit has deteriorated by £68.5m. This change, expressed as proportion of the liabilities on low dependency basis is 10.2%[45], which is less than the maximum of 12% as set out in Guidelines Table C, so this passes the investment stress test under Fast Track. ☑

584. The trustees submit the valuation to us. In their statement of strategy, the trustees declare that the valuation complies with Fast Track and provide relevant evidence.

585. We review the trustees' submission and confirm that no further action is necessary. ☑

Example 2: Open scheme

586. Table 37 below summarises the key facts relating to this scheme.

Facts: Scheme assets = £220m. Covenant grade rating = CG2. Past service duration = 22.6 years. Future service duration = 28 years.		
Fast Track feature	**Details**	**Pass/ Fail**
LTO	Set using Fast Track assumptions. Low dependency liabilities = £300m. Future service rate on LTO assumptions = 40% of pay.	☑
TPs	TPs agreed by trustees and employer = £260m. Greater than the Fast Track minimum (=£300m x 86% = £258m)	☑
RP	Deficit = £40m. RP is equal to maximum Fast Track RP length of six years with DRCs of £7m pa.	☑
Future service	Future service rate = 30% of pay. Greater than the Fast Track minimum (=40% x 74% = 29.6% of pay)	☑
Investment stress	Investment stress is 10.4%. This is less than the maximum Fast Track stress of 13%.	☑
Overall	**Complies with Fast Track.**	☑

Detail

587. As in the first example, the trustees adopt the Fast Track LTO. The scheme actuary calculates that the scheme's liabilities measured on the low dependency assumptions are £300m. The scheme actuary calculates a future service cost of 40% of pay using the low dependency assumptions.

588. The scheme actuary calculates that the scheme has a duration of 22.6 years in respect of accrued benefits, using low dependency basis assumptions. The ratio to use to calculate the minimum TPs is 86% appropriate to the scheme's duration, taken from the entry in Guidelines Table A for covenant grade CG2 and duration of between 22 and 23 years. In order to meet Fast Track requirements, the scheme needs to have TPs equal to or greater than £300m x 86% = £258m.

589. The ratio to use to calculate the minimum future service contribution rate is 74% appropriate to the scheme's duration, taken from the entry in Guidelines Table A for covenant grade CG2 and duration of 28

[45] = 68.5 / 670.

years and above. In order to meet Fast Track requirements, the scheme needs to have a future service contribution rate of equal to or greater than 40% x 74% = 29.6% of pay.

590. The trustees and employer agree the scheme's TPs assumptions and the scheme actuary calculates the value of the TPs as shown in Table 38 follows:

Valuation balance sheet	£m
Value of assets	220
TPs	260
Surplus/ (deficit)	(40)

591. The scheme's TPs (£260m) are greater than the Fast Track minimum TPs (£258m). So, the scheme passes the TPs assessment under Fast Track. ☑

592. The scheme has a deficit of £40m.

593. The scheme actuary calculates a future service cost of 30% of pay. This is greater than the Fast Track minimum (29.6%). So, the scheme passes the future service assessment under Fast Track. ☑

594. As in example 1, the trustees and employer agree a six-year RP. Annual contributions of £7m are agreed. The scheme passes the RP assessment under Fast Track. ☑

595. The investment stress test is also passed. The scheme is invested as follows:

- Global equities 25%
- UK equities 10%
- Property 5%
- Long gilts 25%
- Long inflation-linked gilts 35%

596. As shown in Table 39 below, the stress test is applied to both the assets (in the proportions stated above) and also to the liabilities (measured on the assumptions in low dependency).

	Before stress	After stress
Global equities (25%)	55	46.2
UK equities (10%)	22	17.8
Property (5%)	11	10.5
Long gilts (25%)	55	63.3
Long inflation-linked gilts (35%)	77	90.9
Total assets	**220**	**228.6**
Liabilities on low dependency basis	**300**	**344.2**
Assets to liabilities	**-80**	**-115.6**

597. The assets to liabilities (low dependency basis deficit) has deteriorated by £35.6m. This change, expressed as proportion of the liabilities (low dependency) is 11.9%[46]. This is less than the maximum of 13% as set out in Guidelines Table C so this passes the investment test under Fast Track. ☑

598. The trustees submit the valuation to us. In their statement of strategy, the trustees declare that the valuation complies with Fast Track and provide relevant evidence.

599. We review the trustees' submission and confirm no further action is necessary. ☑

[46] 35.6/300 = 12%.

16. Evidence and analysis

600. The main purpose of this chapter is to provide some additional background information to put into context the proposals we are consulting on. This chapter also sets out the following:

- Describes certain features of the DB landscape, observable from our data and research[47] as well as from our casework and publications of external commentators. These have informed the design of the proposed funding framework.
- Explains why we consider scheme maturity to be an important influence on funding decisions over the future, at least for closed schemes, and why it should be a key aspect of the new framework.
- Summarises the results of research commissioned from GAD on how we might set the more detailed parameters to define low dependency for Fast Track.
- Reviews evidence from external commentators on the extent to which pension schemes already incorporate, as a matter of good practice, long-term objectives and associated journey plans to deliver them.
- Emphasises that fair treatment for the pension scheme remains a key issue for us, and re-iterates, using previously published evidence, that while most schemes remain affordable for their employers, there is a mixed picture for some.
- Sets out our views on the challenges faced by some small schemes.

The current DB landscape

601. The Purple Book 2019[48] dataset showed that there were 5,422 private sector DB pension schemes in the UK, with combined assets of just over £1.6 trillion and covering 10.1 million members as at March 2019. 42% of members were already drawing their pensions.

602. Deeper analysis (see below) shows that the underlying DB landscape is wide and diverse. One of our challenges has therefore been to design the new funding framework in a way that is applicable across this diverse range of schemes.

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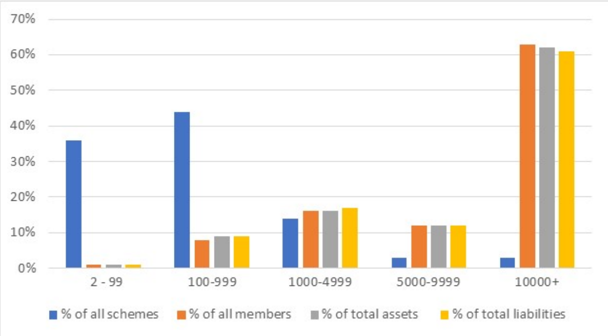
[47] Various charts in this chapter are based on our own analysis. The underlying data for assets and liabilities is sourced from information supplied by each scheme in its latest Scheme Return, rolled forward to a common date for all schemes (31 March 2019 unless otherwise stated) using methods, assumptions and limitations explained in https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-analysis-tranche-fourteen-review-2019.ashx.

[48] https://www.ppf.co.uk/purple-book

DB schemes are highly skewed by size

603. 75% of members belong to 354 of the largest schemes (7% of all schemes), each with more than 5,000 members. Between them, they cover 75% of the total assets and liabilities. A little under 2,000 schemes (36% of all schemes by number) have fewer than 100 members each. Together they account for just 1% or less of total scheme memberships, assets or liabilities.

Figure 10: Distributions by scheme size



Source: Purple Book 2019

The DB landscape is largely comprised of members who are not accruing new benefits

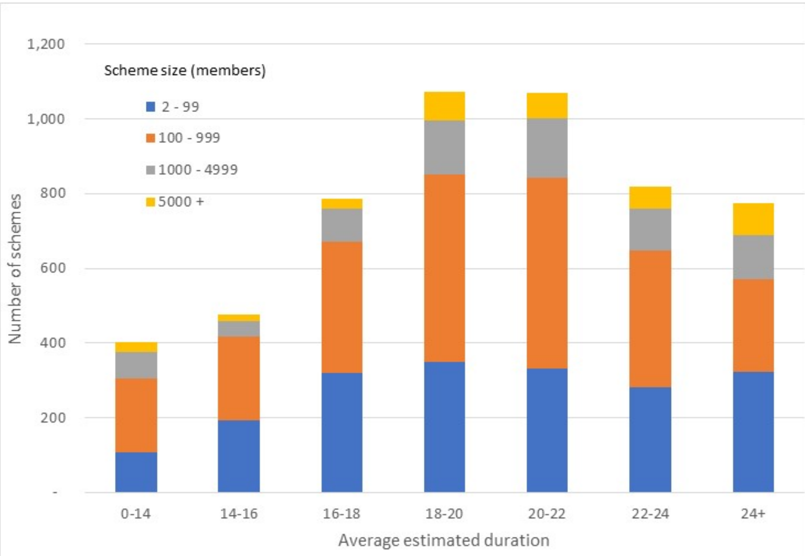
604. The Purple Book also reports that 89% of DB pension schemes are now closed to new members. Among these, half are still providing new accruals, but only to a closed and declining group of existing employees, while the other half are closed to new accruals altogether. Consequently, both groups are maturing, the former less rapidly than the latter.

605. Overall, the trend showing the decline in provision of new DB accruals has continued, with the number of private sector employees still accruing new DB benefits having reduced from 3.5 million in 2006 to 1.1 million in 2019.

606. Although 70% of members are currently in schemes that are open to new benefit accrual, only 11% of members are actually accruing new benefits.

About 15% of DB schemes are already quite mature

Figure 11: DB landscape by number of schemes, size and maturity



Source: TPR calculations at March 2019 based on scheme return data

Table 39: Estimated benefit outgo (as % of Broadly Hedged liabilities) by duration

Average estimated duration[49]	0-14	14-16	16-18	18-20	20-22	22-24	24+
% of schemes	7%	9%	15%	20%	20%	15%	14%
Approximate benefit outgo (% of liability)[50]	5% or more	4%-5%	3%-4%	2.5%-3%	2%-2.5%	1.5%-2%	1.5% or less

Source: TPR calculations at March 2019 based on model generated benefit outflows using scheme return data

607. Fewer than 10% of schemes have reached a high level of maturity whereby the amount of benefits being paid out each year may be 5% or more of liabilities.

608. A significant proportion of schemes (over 40%) are currently paying out benefits each year in the region of 2.5%-5% of liabilities. Most of these schemes are expected to reach a high level of maturity in the next decade.

609. The remaining schemes (about 50%) are at a more modest level of maturity where the benefits being paid out each year may be less than 2.5% of liabilities. The majority of these are expected to reach a high level of maturity in the following decade, and those who continue to grant future accruals or remain open to new members may mature at a slower rate or not at all.

The trend in risk reduction continues

Figure 12: Weighted asset allocation

Year	Equities	Bonds	Other
2007	60%	30%	10%
2010	42%	40%	18%
2013	35%	45%	20%
2016	30%	51%	19%
2019	24%	63%	13%

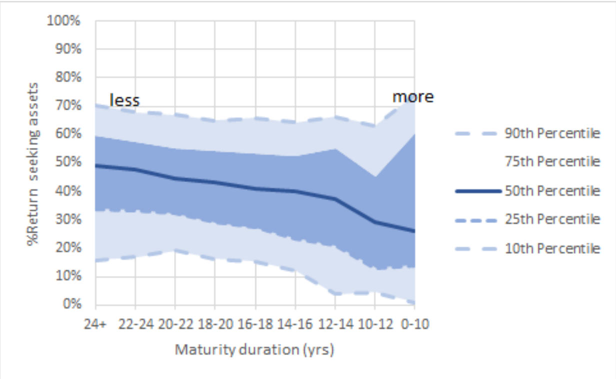
Source: Purple Book 2019

The average allocation to equities in investment strategies, currently at 24%, has reduced by more than half in the last decade. During the same period, the allocation to bonds has increased substantially to almost 63%. This excludes the impact of the use of leverage and/or derivatives to improve the matching characteristics of the bonds held.

[49] We are consulting on the appropriate measure of scheme maturity, but for the purpose of this analysis, and for consistency with the maturity-related modelling presented elsewhere in this chapter, we have defined scheme maturity as the mean term of accrued liabilities weighted by the value of future cashflows discounted at Gilts +0.5%.

[50] This is an approximate mapping, recognising that while there is a strong correlation between the maturity duration and the benefits paid (as a percentage of liability), there is no strict one-to-one relationship between them. Liabilities have been measured using a discount rate of Gilts +0.5%. Benefit cashflows have been estimated using limited data points from scheme return data which may not be as accurate and up-to-date as the information held by each scheme.

Figure 13: Return-seeking asset allocations by scheme maturity



Source: TPR calculations at March 2019 based on TPR-assessed covenants

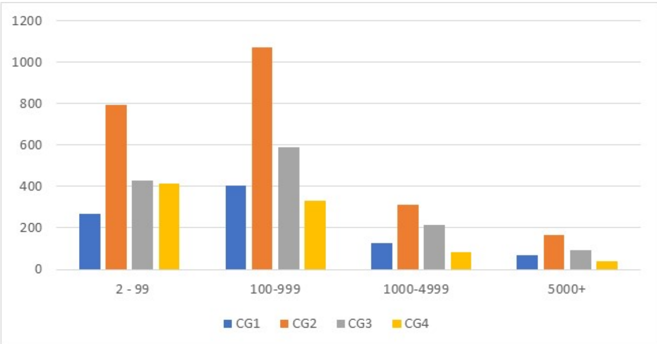
Additionally, the allocation to annuities has increased from 2% in 2016 to 4% now. This may be due to increased risk transfer exercises known as buy-ins.

We believe this de-risking is a consequence of schemes becoming better funded and more mature. Indeed, our data also shows a tendency towards a reduction in return-seeking assets[51] as schemes mature. This is consistent with de-risking plans we come across in practice.

We expect this trend to continue as a greater proportion of the landscape becomes more mature.

Most DB schemes are sponsored by stronger employers

Figure 14: Number of schemes by size and covenant



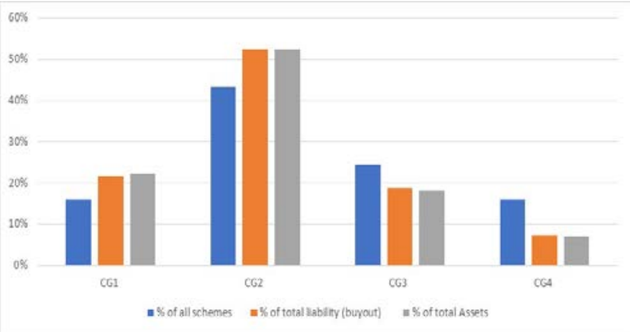
Source: TPR calculations at March 2019 based on TPR-assessed covenants

The majority of schemes are sponsored by Strong and Tending to strong (CG1 and CG2) employers across the size range.

Small schemes are not necessarily confined to the weaker employers (CG3 and CG4), nor are large schemes confined to the stronger employers.

[51] For this purpose, return-seeking assets are defined to include the following weightings: 100% equities, 75% property, 100% commodities, 60% insurance policies, 80% hedge funds, 25% corporate bonds, 100% 'other'.

Figure 15: Percentage of schemes, assets and liabilities by covenant



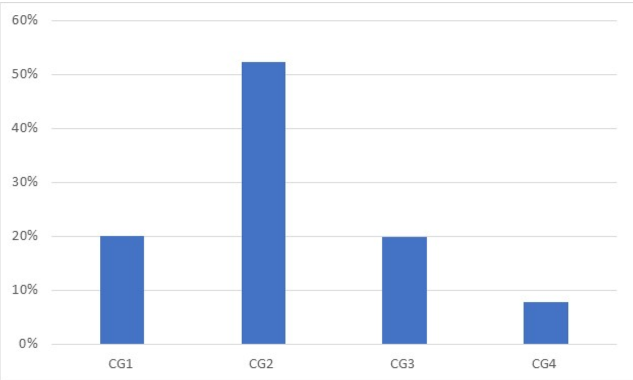
The stronger employers account for almost 60% of all schemes, and between them 70% to 75% of all assets and liabilities.

The weaker employers (also sponsor a significant proportion (about 40%) of all DB schemes. However, they account for a much smaller proportion of total liabilities (between 25% and 30%).

Source: TPR calculations at March 2019 based on TPR-assessed covenants

Most deficits are in schemes with the stronger employers

Figure 16: Percentage of total buy-out deficits by covenant



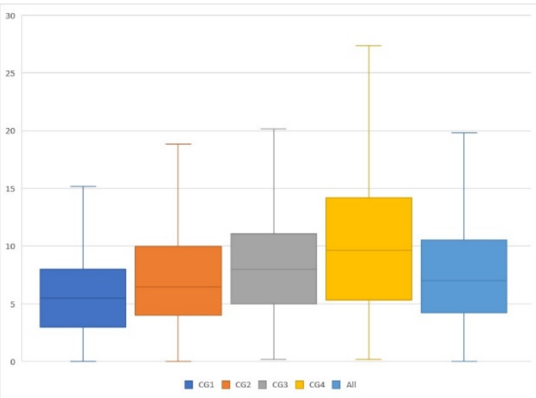
Schemes with stronger employers account for 70% of total deficits on the buy-out basis.

The weakest employers (CG4) account for less than 10% of total deficits.

Source: TPR calculations at March 2019 based on TPR-assessed covenants

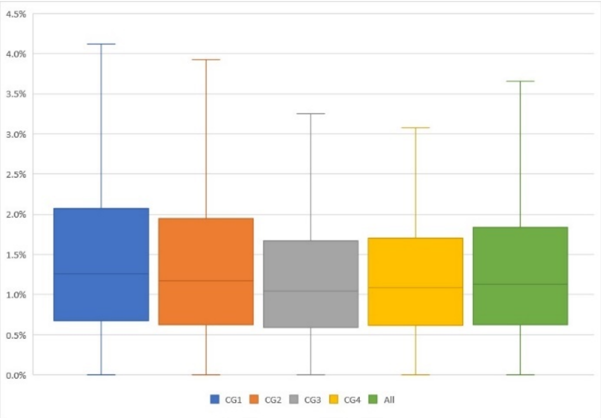
Deficits are being recovered on average over seven years by payment of DRCs at about 1.25% of buy-out liability

Figure 17: Recovery plan lengths (years)



Source: TPR calculations at March 2019 based on TPR-assessed covenants

Figure 18: DRCs as a percentage of buy-out liabilities



Source: TPR calculations at March 2019 based on TPR-assessed covenants

610. The rate at which deficits are recovered should depend on a number of scheme-specific factors including the size of the TPs deficit, the strength of the employer, and the resources available to apply towards reducing deficits.

611. Our data shows (see charts[52] above) that deficits were typically being recovered on average over seven years. 50% of all schemes are recovering their deficits over periods between 4 and 11 years but there is a wider range for the others. The median RP periods for strong employers are nearer five years, while those for weak employers are nearer 10 years.

612. 50% of all schemes in deficit are paying DRCs which are between 0.6% and 1.8% of the scheme's buy-out liability, with a much wider range for others. The median DRCs are nearer 1.25% of liability for the stronger employers and nearer 1% of liability for the weaker ones.

DB landscape will continue to mature over the next few years

613. We expect the next two decades to mark a fundamentally different shift in the management of DB schemes. Our analysis (see chart below[53]) suggests that benefit outflows from most DB pension schemes may be close to their peak already[54] and are expected to fall gradually over the following three decades as the impact of scheme maturity takes hold.

614. Looking at this in another way, we estimate that almost one quarter of the accrued benefits of DB schemes will need to be settled by the end of the next decade due to the effect of ageing alone (that is as members reach pension age and draw their pensions). Similar proportions are expected to have been settled in each of the following two decades. The impact of future accruals will have the effect of delaying

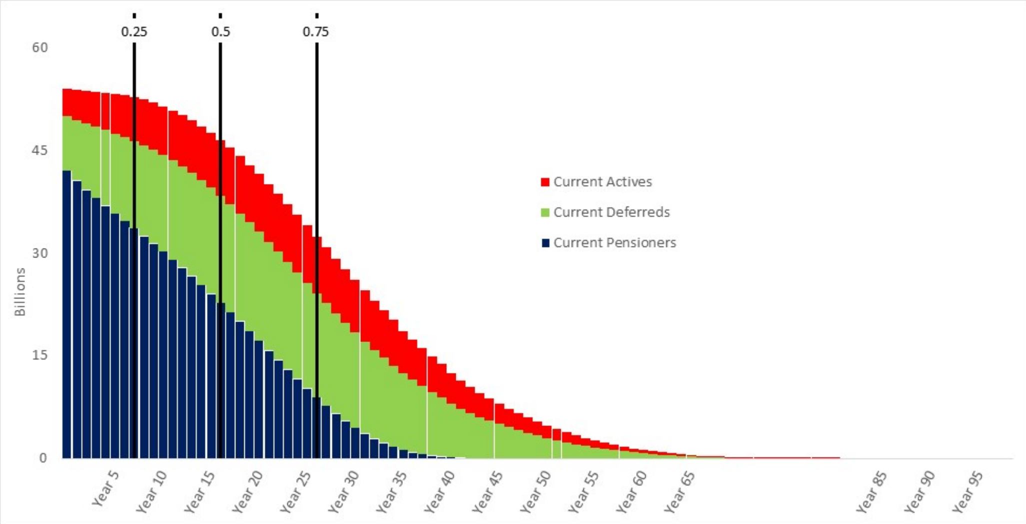
[52] In both these charts, the coloured boxes show the range of data for 50% of the schemes in each covenant category. The horizontal line in each box shows the median position – half of the schemes are above this line and the other half below it.

[53] TPR estimates for illustration only, based on data reported by UK pension schemes, and a number of assumptions. Assumes all schemes closed to future accruals and all members commute 20% pension at retirement. No allowance for any large-scale transfers or for the effect of any risk transfer/buy-out activity.

[54] On a constant price basis.

this process somewhat, while that of transfers out of DB schemes, either individually or due to buy-out and risk transfer activity, will have the opposite effect.

Figure 19: Expected cash flow payments from DB schemes (constant money)



Source: TPR calculations at March 2019 based on scheme return data

615. During this period, we expect most schemes to become cash flow negative, meaning benefit outflows to pensioners will exceed the sum of investment income from the scheme's assets and contributions from employers and members[55]. In other words, schemes will have to start using their accumulated scheme assets more and more to meet their growing benefit outflows. Consequently, the overall DB landscape will begin to downsize (in terms of assets and liabilities, but not necessarily at the same rate unless schemes are fully funded).

616. Individual schemes will, however, be affected differently depending on how their maturity profiles develop over the future to interact with other scheme-specific features. Among closed schemes, the more mature ones will run-off more rapidly than the less mature ones. Schemes remaining open to accruals of new benefits for existing members will continue to grow in real terms for a few years until the existing members retire or leave, while those that remain open to new members may continue to grow for much longer.

Why scheme maturity matters to individual schemes

617. There are no commonly accepted definitions of scheme maturity, but for individual schemes, maturity may be characterised by the amount of benefits being paid out each year as a percentage of the scheme's liability (preferably an objective measure of liability for comparability across schemes). Our research suggests that the range may be from 1% or less of liability on a low-risk measure (Gilts +0.5%) for very immature schemes, through to 7% or more for the very mature schemes. Around half of the DB schemes

[55] Some independent surveys show that many schemes are already cash-flow negative, although definitions may vary, and some of the more recent analysis may be unduly influenced by large scale transfers out which may not persist at the same level in future. See for example Mercer's European Asset Allocation Survey 2019 (large schemes), Buck's Mid-market Pensions Review 2019 (schemes with assets between £10m-£1bn), and LCP's publication 'Chart your own course - Navigating the pensions journey', all of which show a significant proportion of schemes surveyed being already cash-flow negative (but on different definitions).

might currently be regarded as immature (maturity durations of 20 or more) and, for them, benefit outgo may currently be around 2% or less of liability, while for a minority of the more mature schemes (durations of less than 14) it may be nearer 5% or more. Cash flow negativity may typically set in anywhere in-between, depending on the level of contributions into the scheme. We are of the view that by the time benefit outflow reaches around 5% of liability, the risks due to scheme maturity are beginning to take hold and need to be managed carefully.

618. The reason for this is that mature schemes have limited timeframes to recover from a sustained period of underperformance by the scheme's investments, or from investment shocks[56]. These are risks we have been raising in recent Annual Funding Statements. The impact on funding and investment decisions can be two-fold. First, liquidity management and cash flow matching become far more important in order to avoid the risk of having to sell assets in depressed market conditions to meet the benefit outgoings. Additionally, where such schemes are still underfunded, trustees and employers need to be aware that the scheme's assets may be depleting rapidly and if they are still relying on asset outperformance to close the funding gap, then either additional strain will be placed on the investment strategy and/or more reliance placed on employer contributions, which could also become more volatile.

619. A working party of the Institute and Faculty of Actuaries[57] described this effect on the scheme's funding as 'running faster to keep up'. This means that as an underfunded scheme gets more mature and its benefit outflow increases, the level of contributions required (as a percentage of the scheme's liabilities) to keep the funding level from falling also increases. Additionally, the amount by which the contributions increase is linked directly (among other things) to the level of benefit outflow. Some simple examples[58] below illustrate this:

Table 20: Contributions required to maintain funding level by funding level and maturity

		FUNDING LEVEL			
		70%	**80%**	**90%**	**100%**
Contribution required to maintain funding level (% of liability)	**Immature**	0.6%	0.4%	0.2%	0.0%
	Mature	1.5%	1.0%	0.5%	0.0%

Note: In these examples, the immature scheme is assumed to have an annual benefit outflow equal to 2% of liability, while that of the mature scheme is assumed to be 5%.

620. Given that for most schemes, the pension deficit contributions are less than 2% of their liability, the above figures illustrate the additional strain on the scheme's funding due to its maturity if it remains underfunded by the time it has reached a high level of maturity.

[56] See, for example, the illustration in our 2016 Annual Funding Statement: https://webarchive.nationalarchives.gov.uk/20160701134008/http://www.thepensionsregulator.gov.uk/docs/db-annual-funding-statement-2016.pdf

[57] Institute and Faculty of Actuaries: Mature Pension Schemes – onwards and forwards: Analysis by the Running Off Mature Schemes Working Party, May 2018. Available at https://www.actuaries.org.uk/system/files/field/document/Running%20Off%20Mature%20Schemes%20Working%20Party%20slide%20pack%20vFINAL%20FINAL%2020180614.pdf

[58] The working party provided examples for schemes with 80% funding level, we have extended them for other funding levels. For simplicity these examples assume no investment outperformance. The working party shows other examples with such allowance but notes that as maturity increase the potential credit from this source should diminish anyway.

621. This observation is consistent with research from others. For example, Redington[59] has likened the drag on the scheme's funding to the wind-chill factor, caused by what they refer to as the sequencing risk associated with a negative cash flow profile. This means that the sequence of returns matters when the scheme is paying out from its accumulated assets. For example, a heavy setback early on which causes the scheme to sell assets in a depressed market to pay benefits may put the scheme in a position from which it is hard to recover. Redington go on to suggest that this effect is not captured by standard risk measures such as VaR or volatility, and consequently risk management for mature schemes requires a different set of risk lenses in order to properly evaluate the risk in the scheme.

622. These findings are consistent with our own research as well as observations from our case teams in some mature schemes. We consider them to be an important aspect of the design of the long-term funding objective.

Defining the long-term objective (LTO)

623. The analysis above shows why it is important for schemes to plan ahead and build up their funding levels such that, after they have reached a high level of maturity, they are not relying on excessive risk-taking, which places an unnecessary (even unaffordable) burden on the employer. This concept needs a more precise definition for practical application. We asked GAD to provide financial analysis to help inform the key considerations around the design of an LTO, which would be consistent with the requirement that a DB pension scheme should have low dependency on its employer for additional funding once it has reached significant maturity.

624. More specifically, we asked them to examine whether it was possible for a significantly mature scheme (say one at duration 14 – see below for reasons why) which had already reached 100% funding on a low dependency target to deliver its remaining benefit payments in due course with a high degree of certainty and with minimal recourse to the sponsoring employer. What might be the reasonable combinations of low dependency funding bases and practical low-risk investment strategies which could deliver such outcomes?

625. GAD provided analysis[60] to assess the implications on expected member outcomes of setting the low dependency funding target at different levels (assuming discount rates of up to 1% in excess of gilt yields) and stochastically modelling the progress of a model scheme, in the absence of any further support from the employer using a number of investment strategies as follows[61]:

[59] Walking uphill: How to manage negative cash flows, Redington, 2017 https://www.redington.co.uk/article/walking-uphill-manage-negative-cashflows/

[60] 'Modelling the long-term funding objective: likely outcomes of different approaches', 14 February 2020. Available at: www.tpr.gov.uk/-/media/thepensionsregulator/files/import/pdf/modelling-long-term-funding-objective.

[61] These are illustrative. In practice, low dependency does not mean zero dependency. Also, investment strategies may be more complex than those modelled and the impact of the economic scenarios will vary according to the risk exposure in each.

Table 40: Investment strategies used in GAD modelling

Investment strategy	Asset allocation percentages				Level of interest rate and inflation hedging	Target long-term return %pa
	Growth assets	Matching gilts	3x leveraged LDI	Corporate bonds		
Core hedged	20	70	10	0	100%	Gilts +1%
Corporate bond	10	25	10	55	55%	Gilts +1%
More cautious	10	85	5	0	100%	Gilts +0.5%
More adventurous	25	62.5	12.5	0	100%	Gilts +1.3%
Core hedged variant	33.3	50	16.7	0	100%	Gilts +1.6%
Corporate bond variant	37.5	15	7.5	40	37.5%	Gilts +1.6%

Base case

626. GAD's base case analysis assumed a low dependency funding target based on a discount rate of Gilts +0.5% (approximating to 93% of buy-out cost before expenses). They assumed that schemes will reach full funding on this target by the time they are "significantly mature", which for this purpose was assumed to be at maturity duration 14.

627. The 'core hedged' and 'corporate bond' strategies were considered suitable illustrative investment strategies targeting a long-term return of 1% in excess of gilts.

628. The base case results (see table below) showed that in 72%-82% of scenarios, the scheme reached buy-out funding levels within the next 25 years. In the remaining scenarios, there was a risk of at least some of the benefits not being paid, but the overall member losses could be contained to within 2% (before any allowance for PPF protection)[62].

[62] It should also be noted that, while the success measures presented above appear reasonable, the range of possible outcomes remains relatively wide and, in some scenarios of market conditions considered, support would be required from the employer or the PPF.

Table 41: GAD base case results

Indicative low dependency target	Long-term investment strategy	Target long-term return	Likelihood of achieving buy-out funding within 25 years	Member losses
Gilts +0.5%	Core hedged	Gilts +1%	72%	2%
Gilts +0.5%	Corporate bond	Gilts +1%	82%	1%

629. When tested against alternative investment strategies, it was clear that the 'more cautious' investment strategy (targeting Gilts +0.5%) would not generate sufficient long-term returns to deliver full benefits with a high probability. On the other hand, for higher risk investment strategies the trade-off between better expectations in the long term and the associated higher short-term risk became important. For example, increasing the proportion of growth assets in the 'corporate bond' strategy increases the expected returns and, therefore, the chance of reaching buy-out funding. But it also brings increased volatility to the asset value, and thus increases the likelihood of the scheme falling into the investment spiral and the trustees having to resort to the employer for additional funding. Other higher risk strategies repeated this pattern[63].

630. The 25-year projection period was considered to be adequate for the bulk (about 75%) of the remaining liability to have run-off by the end of it. Extending the projection period to 40 years had minimal impact on the likelihood of buy-out or on member losses.

Alternative low dependency strategies

631. The implications of setting low dependency 'strength' at different levels were also modelled by GAD, with the results compared against the base case below:

Table 42: Comparison of different low dependency targets and investment strategies against base case used in GAD modelling

Indicative low dependency target	Long-term investment strategy	Target long-term return	Likelihood of achieving buy-out funding within 25 years	Member losses
Gilts +0.25%	Core hedged	Gilts +1%	89%	1%
Gilts +0.25%	Corporate	Gilts +1%	93%	0%
Gilts +0.5%	Core hedged	Gilts +1%	72%	2%
Gilts +0.5%	Corporate	Gilts +1%	82%	1%
Gilts +0.75%	Core hedged	Gilts +1%	54%	4%
Gilts +0.75%	Corporate	Gilts +1%	64%	2%
Gilts +1.0%	Core hedged	Gilts	66%	5%
Gilts +1.0%	Corporate	Gilts	72%	4%

[63] See GAD's report: www.tpr.gov.uk/-/media/thepensionsregulator/files/import/pdf/modelling-long-term-funding-objective.

632. It can be seen that strengthening the low dependency funding target to Gilts+0.25% is beneficial to member security by providing greater resilience to future risks and significantly improving the chances of reaching buy-out. However, it has an associated cost on employers in the pre-LTO period when they would need to provide additional funding to reach the higher target.

633. On the other hand, weakening the low dependency funding target to Gilts +0.75% or Gilts +1.0% appears detrimental to member security as it reduces the chances of reaching buy-out significantly and thus leaving members exposed to higher risk for longer.

634. A further consequence of weakening the low dependency target is that investment risk needs to be increased through a heavier allocation to more volatile assets, in search of the additional return required. This increases the short-term risk, with similar consequences to those discussed above.

Time to significant maturity

635. Our starting point was to set significant maturity at duration 14. This is because we consider that around this time in a scheme life, the impact of maturity could begin to have a material effect on scheme's funding if it is still underfunded. So, it seems prudent to expect schemes to reach a position of low dependency before this happens. Anecdotal evidence from various practitioners suggests a suitable 'tipping point' for this purpose to be when a scheme's benefit outgo is of the order of 5% of liabilities, and our data suggests that this may be happening broadly when the scheme has reached maturity duration of 14-12. A scheme of average maturity, may take a little over 15 years to reach maturity duration 14 and around another five years to reach maturity duration 12.

636. The impact of bringing forward or delaying the time when a scheme reaches full funding on the low dependency basis was investigated by GAD and found to have a minor effect on the chances of achieving buy-out in the subsequent years. In other words, whether the base case is run from duration 17 or 12 instead of 14 makes little difference as long as the scheme is fully funded on the low dependency basis and the investment strategy is broadly aligned with it.

637. However, there are other implications. The quicker schemes are required to reach the low dependency funding target, the higher the necessary contributions for employers (especially for schemes who are already very mature and underfunded). On the other hand, the longer schemes have to reach low dependency, the longer the scheme funding is exposed to risks from employer insolvency. This is a trade-off we will be examining in greater detail in our second consultation, once some of the conceptual matters in this consultation have been settled.

Our preliminary conclusions

638. While the GAD modelling has its limitations, it nevertheless shows that an LTO can be set so that there is a high likelihood of a typical mature closed scheme funded at a low dependency level and invested on a low risk basis being able to survive on its own with minimal reliance on employer support. It also shows that, in the design of the LTO, there is clearly a balance to be struck between the cost to employers and risk to members from having a stronger or weaker low dependency target, a longer or shorter period until significant maturity and the acceptable balance between short- and long-term investment risk in the period after significant maturity.

639. In particular, the analysis shows that setting a discount rate of between 0.25% pa and 0.5% pa in excess of gilt yields for a scheme with a duration of 14 years would appear to fit the definition of low dependency. This is because there is a low chance of requiring any further support from the employer and a very low chance of that support being significant relative to the original size of the scheme. It also shows that, to protect member benefits, it is important to maintain an investment strategy that is highly resilient to risk.

How are trustees currently planning to deliver benefits?

640. Since most DB schemes are now closed to new members (and, to a lesser extent, closed to future accrual), we expect scheme maturity issues to assume greater significance for setting funding and investment strategies in the future. In the context of scheme funding, the important consideration is the interaction between (a) the level of assets, the degree of underfunding and the amount of benefits paid out, and (b) the scheme's ability to close the funding gap from investments and new contributions in a reasonable timeframe given the scheme's maturity. The above analysis shows that funding to a level where these risks are minimised will become increasingly important as schemes approach high levels of maturity.

641. Anecdotal evidence suggests that many schemes already claim to do this by setting a LTO, often expressed as a secondary funding objective, and a plan for delivering it. For example, Aon's Pension Risk Survey 2019[64] shows that

- 92% of schemes surveyed claim to have a LTO.
- The majority (78%) are targeting either buy-out or 'strong' forms of "self-sufficiency"/low-risk positions.
- Two out of three schemes are planning to reach their long-term target within 10 years.
- Methods for delivering the LTO vary. While most schemes have factored an element of asset performance as well as additional contributions beyond the agreed funding plan to reach the long-term target, the larger schemes are more likely to be relying on asset performance.

642. Another survey by Willis Towers Watson (WTW)[65] shows the following:

- 33% of schemes surveyed are targeting buy-out.
- 37% are planning to run-off the scheme over time with minimal reliance on the employer.
- 27% envisaged managing investment risk over the long term. Our understanding of this is that they would seek higher levels of investment risk underpinned by the employer stepping in to provide further support if necessary.
- Only 3% of schemes said their plan did not fall into any of these categories.

643. Delivery of the LTO requires a suitable journey plan to get there. Information from external surveys reveals mixed practice among schemes.

644. In the WTW survey, 86% of schemes surveyed said a long-term journey plan was either in place or under development.

645. The Aon survey probed deeper into the quality of the journey plans and uncovered the following:

- 23% of the smaller schemes (under £100m) and 70% of the larger schemes had a robust journey plan. We interpret this as one that has been stress-tested and modelled so it is known how it will evolve in different scenarios.

[64] Covering 170 UK schemes with individual schemes ranging from fewer than 500 members (15% of schemes) to more than 10,000 members (28% of schemes) and asset sizes ranging from less than £100m to more than £1bn: https://retirement-investment-insights.aon.com/u-k/aon-global-pension-risk-survey-2019-uk-findings-chapter-1-long-term-targets-report?_ga=2.14436020.204533150.1571675519-1637887178.1562850956.

[65] What next for DB? 2018 Defined Benefit Survey, covering 159 large schemes with typical (median) scheme having assets of around £800m and 6,000 members.

- 36% of the smaller schemes and 19% of the larger schemes had a basic journey plan which we believe was expected to take the scheme to its LTO but had not been subject to rigorous challenge or testing.
- 40% of the smaller schemes and 10% of the larger ones considered an aspirational plan to be adequate. This is one where the LTO has been set higher than the TPs, but there are no formal plans on how to deliver this objective.

646. Survey information also shows schemes having taken steps in recent years to reduce the time they allocate to reach their LTO. In the most recent Aon survey, 63% of schemes said they expect to reach their chosen LTO within 10 years, compared with 43% two years previously. 32% of schemes said they are now expecting to take between 10 and 20 years compared with 50% two years ago.

647. The conclusion we draw is that the concept of a LTO is not new to the majority of schemes. However, there is a variable picture regarding the extent to which schemes link this objective to their funding and investment strategies. Where journey plans do exist, their quality seems to vary, from those that are robust and more likely to deliver the LTO, to others which are less likely to deliver because they have not taken full account of the risks they are likely to face along the way.

Fair treatment for the pension scheme

648. Deficit contributions should reflect the size of the scheme's deficit (on varying bases) and the employer's ability to reduce the funding deficit as soon as possible without endangering its sustainable growth.

649. In the analysis accompanying our most recent Annual Funding Statement[66], we presented data showing a consistent and growing disparity between dividend growth and stable DRCs across companies of all sizes. We view this as an indication that over recent years, successively smaller proportions of corporate cash flows have been used by many companies to pay down pension deficits as compared with payments to the shareholders.

650. Similar studies by other organisations confirm the general picture of dividend payments considerably exceeding contributions to pension schemes. For example:

- An analysis by Lane Clarke and Peacock[67] of the accounting disclosures by FTSE100 companies during 2018 shows that pension contributions among the FTSE 100 companies remained at a similar level to the previous year, at around £13bn, while dividend payments increased from £80bn to £90bn.
- Another analysis by Hymans Robertson[68] of the accounting disclosures, up to 31 March 2018, of FTSE350 companies sponsoring DB schemes showed that actual spending on DB pensions fell 5% to £19bn over the previous year at a time when company earnings increased by 26%.

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[66] Annual Funding Statement analysis 2019, https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-analysis-tranche-fourteen-review-2019.ashx.

[67] LCP Accounting for pensions 2019. Analysis based on FTSE 100 companies reporting during 2018.

[68] Putting pensions in context: FTSE350 Pensions Analysis 2018. Analysis based on information reported in year-end accounts up to 31 March 2018.

651. We have made clear in recent years that equitable treatment is a key concern in scheme funding discussions. More recently, our Annual Funding Statement 2019[69] has provided greater clarity on this, including setting out expectations that schemes with stronger employer covenants should have shorter RPs, and where schemes have weaker covenants, we expect DRCs to be prioritised over other forms of 'value leakage'.

652. To the extent that inappropriate RPs (including inappropriate splits of corporate cash) are agreed, we have powers (under s231(2) of the Act) to impose an alternative RP. This is a powerful tool in requiring employers to provide a fairer level of cash to their DB schemes. A notable example is our recent intervention in relation to the Southern Water Pension Scheme[70].

Affordability of pension deficits

653. The Hymans report also provides more detailed insight at the individual company level. It shows that 93% of the FTSE350 companies have IAS19 deficits which are less than 10% of their market cap, and that 90% of companies are able to pay off their IAS19 deficit with less than six months earnings. Our interpretation is that the same analysis, if repeated on a more prudent TPs basis, would show a similar message (albeit with less stark metrics).

654. Analysis we provided in the government's DB green paper in 2017[71], covering all companies who sponsor DB schemes (not just FTSE350), explored the burden of existing DRCs on the employers' business. This showed that, where profit before tax (PBT) [72] data was available (for 84% of employers), around half were paying less than 20% of their reported profits as pension contributions. At the other end, 20% of employers were either loss making or paying pension contributions that were in excess of 100% of their reported profits (although this takes no account of any additional support from the employer's wider corporate group).

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[69] https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-annual-funding-statement-2019.ashx.

[70] https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/regulatory-intervention-section-89-southern-water.ashx

[71] Security and Sustainability in Defined Benefit Pension Schemes, Cm 9412, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/595105/security-and-sustainability-in-defined-benefit-pension-schemes-print.pdf.

[72] There is no single measure of affordability that gives definitive conclusions. However, we consider that at the aggregate level DRC to PBT ratios give a reasonably prudent illustration of the affordability situation. PBT data was not available for 16% of employers (for example, because income statement information is not included in their small company accounts).

655. We also provided analysis in the green paper looking at affordability through an IRM lens. This considered potential outcomes in the round, based on risk embedded in current funding and investment strategies and the covenant support available for both. The assessments were based on a range of information including our internal risk indicators[73].

656. This analysis showed that the overwhelming majority (89%) of members were in schemes which were either in surplus or, if there was a deficit, then either the covenant was deemed sufficient to provide adequate support to the scheme as and when needed[74], or the funding and investment strategies employed were deemed adequate in the prevailing circumstances. Among the remaining minority, some were thought to be in schemes with the potential to benefit from wider group support, leaving a smaller minority (about 5%) of DB members in schemes where the prospect of additional support appeared uncertain.

657. The DB green paper noted that, while it is hard to find evidence of pension deficits driving companies into insolvency, there are clearly some employers for whom the pension deficits are a significant call on their resources.

658. Therefore, an important consideration for us in the design of the proposed framework has been to recognise that, while most schemes look to be affordable for their employers, there is nevertheless a minority for whom affordability is an issue. Accordingly, some of the detailed parameters of the proposed new funding framework will be informed by a full impact assessment which will form part of our second consultation.

Covenant visibility

659. This consultation considers whether scheme trustees should be allowed to place reliance on employer covenant, particularly in Fast Track, and, if so, whether any such reliance should be reduced beyond the period for which it can be realistically forecast.

660. Analysis carried out internally highlights that the covenant grade rating has (in recent years) typically changed for approximately one in four schemes between triennial valuations. Considered over two valuation cycles, this ratio increases to approximately one in three. The ratio does not vary significantly for different covenant grade bands (eg a CG2 scheme is just as subject to change as a CG3 scheme).

661. While this analysis reflects covenants which are improving or worsening between valuations, it highlights that a significant proportion of schemes' covenant grade ratings are likely to change during subsequent valuation cycles. Furthermore, this does not take account of the number of schemes whose covenant has weakened, but not sufficiently to warrant a covenant downgrade.

662. This analysis also highlights a smaller proportion (around 5-10%) of schemes whose covenant grade declines by more than one covenant grade rating over the same six-year period.

663. Given the above, we consider it reasonable to allow credit for employer covenant only to the extent that trustees have visibility over it and can evidence it.

[73] See sections 122-128 and Annex 2 of DB green paper for a description of the methodology applied, assumptions made and limitations of the results.

[74] Based on TPR's own assessments using publicly available employer data.

Small schemes

664. Our data suggests a very heavily skewed landscape by size of scheme. There are about 2,000 small schemes (fewer than 100 members) which account for 35% of all schemes by number but less than 1% by membership, and in aggregate, small schemes account for only 1% of assets or liabilities in the DB universe.

665. We have no evidence that smaller schemes exhibit higher financial/economic risk than the rest of the universe. While there are differences between individual schemes, in general small schemes have a slightly lower proportion of active memberships, are on average a little better funded and have shorter RPs. They have similar headline asset allocations to the larger schemes but perhaps less hedging. While the covenant of the employers backing small schemes is on average marginally weaker, but not significantly so, their deficit contributions as a percent of profits are significantly higher than for larger schemes. History has shown higher insolvencies among smaller schemes, as borne out by the PPF experience and its capacity to absorb them.

666. However, smaller DB schemes do tend to display poorer governance standards, with trustees placing less emphasis on assessing fitness and propriety of new trustee board members and their arrangements for managing conflicts of interest. Research[75] carried out on our behalf showed that fewer than half of the trustees of small schemes (48%) had a documented process to assess the fitness and propriety of new trustees, compared with those of large schemes (62% and 82% respectively), and that a third of all trustees had no documented conflicts policy and no register of interests for the trustee board.

667. From a funding perspective, the same research also showed some weakness generally among trustees of smaller schemes to adhere to the guidance in our DB code, particularly around taking and managing risk. Specific areas of concern to us based on these surveys, as well as learnings from an initiative to engage directly with a sample of small schemes, include the following:

- A failure by some trustees to include appropriate contingency planning within their risk management frameworks.
- A reluctance by some trustees to properly assess the employer covenant or robustly assess business investment plans put forward by employers.
- An increase in the percentage of trustees reporting that they take no actions to ensure their scheme is treated fairly among competing demands on the employer.
- Affordability constraints limiting the ability of trustees to pay for substantive independent advice (where those trustees do not feel they have sufficient technical knowledge and/or capacity to perform their own analysis).

668. We conclude from this evidence that the issues for small DB schemes revolve around governance, proportionality and cost efficiency. We consider the proposed framework, with its greater clarity and its clear Fast Track path, should help trustees and employers of small schemes to develop more robust and cost-efficient funding and investment strategies.

[75] Summarised in DB Research Response, Sept 2018 available on TPR website at https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-research-response-2018.ashx.

17. Glossary

Act	The Pensions Act 2004.
Actuarial valuation	Required by s224 of the Act, it is a comparison by the actuary of the value placed on scheme assets with the TPs and an assessment of any future contribution requirement. Calculation of the TPs is usually based on full member-by-member data.
Asset allocation	The way in which a scheme's investments are apportioned between different asset classes, ie equities, property, bonds, cash etc. A scheme's asset allocation is a key feature of its investment strategy and would be expected to reflect its overall objectives, attitude to risk, need for liquidity etc.
Buy-out	Securing scheme liabilities with annuities, written in names of individual members, purchased from a regulated insurance company.
Buy-out liabilities	Also referred to as 's75 liabilities' or 'solvency liabilities'. A measure of scheme liabilities based on the cost of securing scheme benefits with annuities purchased from a regulated insurance company. It can also refer to the scheme actuary's estimate of these liabilities.
Closed scheme	A scheme where no members are accruing future service benefits. Note that other publications, such as the Purple Book, may use a slightly different definition.
Covenant (or employer covenant)	The level of financial support available to a pension scheme from its employers and, if applicable, any guarantors or other contingent support. We assess covenant strength using a four-point rating scale ranging from CG1 (Strong) to CG4 (Weak).
Covenant assessment	An assessment of employer covenant strength. The covenant is typically assessed at each scheme valuation, taking account of the employer's financial strength and the scheme's funding needs. It should be regularly monitored for change between valuations.
DB Superfund	An occupational pension scheme set up for the purpose of effecting consolidation of DB pension schemes' liabilities.
Defined Benefit (DB)	A type of pension benefit where there is a promise to pay a particular level of benefits on retirement or death (if earlier). The pensions are worked out using a formula, defined in the scheme's rules, that is usually related to the members' pensionable earnings and length of service.
DB funding code ('the code')	TPR's code of practice relating to the funding of DB schemes. The current version came into force on July 2014 (GB) and July 2015 (NI) and can be found at:

	https://www.thepensionsregulator.gov.uk/en/document-library/codes-of-practice/code-3-funding-defined-benefits-.
Deficit	In general terms, this refers to the shortfall arising when a DB scheme's assets are insufficient to fund scheme liabilities. It can be measured in different ways depending on the way the liabilities are calculated (eg liabilities on a buy-out basis, on a TPs basis, PPF basis etc).
Deficit repair contributions (DRCs)	Contributions made by employers to a scheme in order to address a TPs deficit, in line with the Schedule of Contributions and the recovery plan.
Discount rate	This is a rate of compound interest used to calculate the present value of a sum due at a later time. This action discounts the sum due to its value today. It inherently assumes that the present value is invested and must earn the chosen discount rate to achieve the sum due at the later time.
Dividends	A dividend is a distribution of a portion of a company's earnings or reserves, decided by the board or directors, to a class of its shareholders. Dividends are typically issued as cash payments.
Downside scenario	A negative event that could adversely impact the position of a scheme. This includes (but is not limited to) a downturn in the financial strength of the employer or a change in economic markets causing a negative impact on the funding level of the scheme.
Duration	A measure of scheme maturity expressed as a number of years. It represents the mean term of the liabilities weighted by the value of the scheme's future cash flows or, alternatively, it is based on the sensitivity of the scheme's liability to small changes in the discount rate. In this consultation and supporting analysis, where duration is used as a measure of scheme maturity, we have made the calculation using a discount rate of Gilts +0.5% at the effective date for consistency and comparability between schemes.
Effective date or valuation date	An actuarial valuation or an actuarial report considers the funding of a scheme as at a particular date, known as the effective date. The effective date will be earlier than the date on which calculations are done.
Enforcement action (TPR)	The use of the range of powers available to us in the event of non-compliance or breach of statutory duties (such as fines, appointing Independent Trustees, s.231 orders). This potential use follows a risk-based approach which considers the threat posed and available mitigation and is informed by gathering and analysing information.
End game	The stage of life for a closed DB scheme when it is paying out a high level of benefits relative to the size of the scheme. By this time, the trustees' focus would most likely be to manage the scheme using low risk strategies to discharge their remaining

	liabilities (which may include awaiting opportunities for buy-out or entering a superfund).
Fully funded	A pension scheme that has sufficient assets to provide for all the accrued benefits it owes and therefore can meet its future obligations. As with 'deficit' and 'surplus' it is not an absolute measure in itself but depends on the way that the liabilities are measured. For example, a scheme can be fully funded on a TPs basis but still have a deficit on a buy-out basis.
Funding basis	The set of assumptions used to calculate the value of a scheme's liabilities. For example, it will include assumptions about future investment returns on the scheme's assets and members' life expectancies.
Gilts	Sterling-denominated bonds issued by the British government and listed on the London Stock Exchange. Gilts whose proceeds (ie coupons and redemption amount) are fixed are known as fixed-interest, conventional, or nominal, gilts. By contrast, gilts whose proceeds are linked to the Retail Prices Index are known as index-linked gilts.
Gilts +x% pa	This formulation is used throughout the document to refer to annual interest rate(s) or discount rate(s) calculated as a fixed annual amount, x%, in excess of the yield(s) on gilts. The gilts yield(s) could be expressed as a single spot yield, appropriate to the duration of a scheme's liabilities, or a yield curve (which includes a spot rate for each future year).
Growth assets (also referred to as return seeking assets)	Pension schemes hold growth assets, also known as 'return seeking investments', because they want a positive return over time to grow the scheme assets. Investment in growth assets involves taking risks to target the desired return. Many different types of growth asset are available to pension schemes and involve taking different types of risk to seek that return.
Investment spiral risk	In a mature scheme which is not fully funded, the assets may be depleting at a faster rate than its liabilities because a high proportion of assets have to be paid as benefits (in full). If the scheme is looking to close the funding gap using investment returns alone, then the required return from its investments increases because of its limited timeframe and reducing assets. As a higher proportion of the assets are paid out as benefits, there is a ratchet effect, and the scheme enters an investment spiral of ever increasing required rates of return to discharge its remaining liabilities. This may be aggravated further by an investment downside event forcing trustees to sell assets in an unplanned manner.
Investment strategy	The strategy undertaken by trustees (after consulting with the employer) about how to invest pension assets with the appropriate level of risk and governance considerations.

Investment outperformance	The extent to which investments perform compared to an agreed measure of the liabilities (TPs) over a specific time period.
Journey plan	A scheme's trustees' plan to reach their long-term objective (LTO). This will include a description of how the scheme's TPs and investment strategy will evolve over time to those underlying the LTO.
Key principles	The eight key principles explained in the consultation consider the following: • Demonstrating compliance and objective risk taking • Long-term objective • Journey plan and TPs • Scheme investments • Reliance on the employer covenant and covenant visibility • Reliance on additional support • Appropriate RP • Open schemes
Long-term objective (LTO)	Introduced by the Pension Schemes Bill where it is described as a 'funding and investment strategy', a new requirement for trustees to set a long-term objective for their scheme with regards to the desired funding target, the time taken to get there and the investments that will be held.
Low dependency	Where a scheme's funding and investment strategies are such that there is a low chance of requiring further employer support and, to the extent that such support is required, the amount of support is low relative to the size of the scheme.
Matching assets	Trustees are legally required to invest assets backing DB liabilities in a way that's appropriate to the nature, timing and duration of the expected future retirement benefits payable under their scheme. To help achieve this, many schemes hold 'matching assets' in order to manage investment risk relative to the liabilities. Different types of matching asset match the liabilities in different ways, with varying degrees of accuracy and with different levels of expected return. A scheme's matching asset portfolio may comprise only physical (ie non-derivative) assets, eg fixed or index-linked gilts, corporate bonds, long-lease property and some forms of infrastructure. However, it is common practice for matching asset portfolios to use derivatives as well, to increase the level of matching achieved. This type of approach is known as liability driven investment (LDI).
Maturity	A measure of how far a scheme is through its lifetime. A scheme whose membership is predominantly made up of active members and which is open to new entrants is immature. A scheme whose membership is predominantly made up of pensioners and which is closed to new entrants is mature.

Open scheme	A scheme where some or all members are accruing future service benefits. Such a scheme may or may not be open to new entrants.
Part 3 valuation, or scheme funding valuation	An actuarial valuation meeting the requirements of Part 3 of the Pensions Act 2004 concerning the funding of DB pension liabilities, which apply to any actuarial valuation received by trustees (on or after 30 December 2005) that is based on an effective date of 22 September 2005 or later.
Pension Schemes Bill (2019-2020)	The bill laid before parliament on 7 January 2020 which includes provisions on DB scheme funding to implement commitments made in the DB white paper.
Pension Protection Fund (PPF)	This is a corporate body established under the Act. The PPF was set up to provide compensation to members of eligible DB pension schemes when there is a qualifying failure event in relation to the employer and where there are insufficient assets in the pension scheme to cover the PPF level of compensation.
Recovery plan (RP)	A recovery plan is defined in s226 of the Act. Where there is a funding deficit at the effective date of the actuarial valuation, the trustees must prepare a plan to achieve full funding in relation to the TPs (the SFO). The plan to address the deficit is known as a recovery plan. The RP length is the time that it is assumed it will take for a scheme to eliminate any deficit at the effective date of the actuarial valuation, so that by the end of the RP it will be fully funded in relation to the TPs.
Rolling forward or re-spreading	Where an RP is extended in circumstances where no additional deficit has arisen. The deficit is taken at a point of time and rolled forward with a number of years of interest.
s75 debt	Section 75 of the Pensions Act 1995 provides for the calculation of a debt due from the employer on the buy-out basis if a scheme winds up or if an employer becomes insolvent or ceases to participate in a multi-employer scheme.
s75 liabilities	See Buy-out liabilities.
Schedule of Contributions (SoC)	A requirement of s227 of the Act for trustees to prepare a "Schedule of Contributions" ie a statement showing (a) the rates of contributions payable towards the scheme by or on behalf of the employer and the active members of the scheme, and (b) the dates on or before which such contributions are to be paid.
Scheme assets	The assets owned by and/or available to a scheme.
Scheme liabilities	The amount equivalent to the present value of the future benefit payments, which can then be compared to the market value of the assets. The liabilities can be calculated used different funding bases (eg buy-out basis, TPs basis, PPF basis etc).

Scheme funding position	The funding position of a scheme is how its current market value of assets compares with its liabilities. It can be expressed as a ratio of the scheme's assets and liabilities (known as the funding level) or as the difference between the assets and liabilities (referred to as a surplus or deficit).
Significantly mature	When a scheme is very mature, its membership is predominantly made up of pensioners and it is cash flow negative, paying out a significant proportion of its assets out as benefits every year.
Single effective discount rate (SEDR)	A single composite rate made up of constituents of the different rates reported, allowing for the maturity of scheme liabilities. The value of scheme liabilities calculated using the SEDR will equal the value of the scheme liabilities calculated using the discount rates reported.
Statement of strategy	The Pension Schemes Bill introduces a requirement for trustees to prepare and submit to TPR a written statement of strategy setting out the scheme's "funding and investment strategy" (LTO) and approach to risk management.
Surplus	In general terms, this refers to the excess arising when a DB scheme's assets are more than sufficient to fund scheme liabilities. It can be measured in different ways depending on the way the liabilities are calculated (eg liabilities on a buy-out basis, on a TPs basis, PPF basis etc).
Statutory employer	The statutory employer refers to an employer who has a legal obligation under statute to the scheme. A scheme may have more than one statutory employer.
Statutory funding objective (SFO)	Section 222(1) of the Act requires every scheme to have sufficient and appropriate assets to cover its TPs (ie it must be fully funded on an TPs basis).
Stress test	Subjecting the scheme to a hypothetical scenario in which its liabilities, assets and/or employer covenant become stressed. This is to help trustees to understand how support for their scheme could be affected by such scenarios.
SWOSS	Scheme without a substantive sponsoring employer, for example where a scheme's sponsoring employer is a shell or special purpose vehicle without any (substantial) ongoing trade.
TPR Future programme	A programme of work we have undertaken to become a stronger and more effective regulator.
Technical provisions (TPs)	TPs are defined in s223 of the Act as the funding measure used for the purposes of Part 3 valuations. The TPs are a calculation undertaken by the actuary of the assets needed at any particular time to make provision for benefits already considered accrued under the scheme using assumptions prudently chosen by the trustees. In other words, what is required for the scheme to meet

	the SFO. These include pensions in payment (including those payable to survivors of former members) and benefits accrued by other members and beneficiaries, which will become payable in the future.
Twin-track compliance route	Fast Track and Bespoke funding arrangements. Fast Track: A set of clear and quantitative compliance guidelines that will be defined in our code. Trustees (and employers) will be able to use these to assess whether we would consider their valuation to be compliant with the legislation. As long as all aspects are satisfied, there will be minimum regulatory involvement. Bespoke: An option providing trustees and employers more flexibility for scheme-specific circumstances or where, for certain reasons, they are otherwise unable to comply with the guidelines in Fast Track. Decisions in this route will need to be fully articulated and may mean higher regulatory involvement.
White paper (DB)	The DB white paper published by DWP in March 2018: https://www.gov.uk/government/publications/protecting-defined-benefit-pension-schemes.

18. Consultation questions

Chapter 3: Proposed regulatory approach

Q1 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?

Chapter 4: Employer covenant

Q2 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?

Q3 Integrating covenant into funding

a. Do you think it is better to keep the Fast Track route simpler by only factoring covenant into Bespoke (TPs and/or RP)?

b. If you think covenant should only feature in Bespoke, how do you think it should be done?

c. If we were to integrate covenant into Fast Track guidelines, do you prefer option 1, 2 or 3 or some other approach for reflecting the employer in scheme valuations, and why? If another approach is appropriate, what do you think this should be

Q4 Covenant assessment

a. Should a holistic approach to assessing employer covenant be retained (but with further guidance to assist trustees), or should we seek to define a more prescribed, formulaic approach?

b. If the former (holistic approach), what amendments/clarifications to our existing guidance on covenant do you consider may be necessary? Do you agree with the ones suggested above? Is the structure and content of our existing employer covenant guidance helpful and accessible to trustees? If not, what would make it better?

c. If the latter (formulaic approach), what do you think of the proposed RACF approach? How would you propose that covenant could be explicitly defined in a clear, consistent and measurable manner? What other metric(s) may be appropriate?

d. Alternatively, would it be appropriate to require employer covenant to be assessed in a prescribed (formulaic) way for Fast Track purposes, and only allow for a more holistic approach under the Bespoke framework?

Q5 Reliance on indirect covenant

Do you think that the strength of the wider commercial group should be factored into the sponsoring employer's assessment? If so, how, and to what degree?

Q6 Covenant grades

a. Should we use a greater range of covenant grades to set guidelines in the code and assess schemes and, if so, what would be an appropriate number of grades?

b. Would there be sufficiently different characteristics between a greater number of grades, such that a set of trustees could reasonably and reliably assess covenant strength without requiring professional advice?

Chapter 5: General principles

Q7 Low dependency 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?

Q8 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?

Q9 High resilience to risk at the LTO

Do you think that the investment portfolio should be highly resilient to risk when schemes reach their LTO? If not, what do you suggest?

Q10 Risk-taking for immature schemes

Is it reasonable for less mature schemes, which would have more time to reach low dependency funding, to assume and take relatively more investment risk than a mature scheme?

Q11 Journey planning

What are your views of the rationale above for the journey plan? Do you think there is there a better way for trustees to evidence that their TPs have been set consistently with the LTO?

Q12 Relevance of investments for funding

Do you agree that the actual investments and investment strategy are a relevant factor for scheme funding?

Q13 Broad consistency between investment and funding strategy

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 TPs), should trustees have to demonstrate that the investment risk taken can be managed appropriately? If not, why not and what would you suggest?

Q14 Liquidity and quality at maturity

Do you think that security, quality, and liquidity become more important as a scheme becomes significantly mature? In particular, do you think that the scheme's asset allocation at significant maturity should have a high level of liquidity and a high average credit quality?

Q15 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?

Q16 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 valued when required?

Q17 Appropriateness of RPs and affordability as key factor

a. Should employer affordability be the key factor to determine the appropriateness of a RP? 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 TPs and size of deficits) to have a commensurately shorter RP?

Q18 Open schemes, past service

Should past service have the same level of security, irrespective of whether the scheme is open or closed?

Q19 Open schemes, future accruals

Do you think it would be good practice for trustees to ensure that the provision of future accruals does not compromise the security of accrued benefits?

Chapter 6: Other issues

Q20 Other issues

Do you agree with our assessment of the issues above and do you have any further comments?

Chapter 8: Setting the long-term objective (LTO)

Q21 Fast Track low dependency discount rate

What are your views on our proposal that the appropriate low dependency funding basis for Fast Track should be with a discount rate somewhere in the range of Gilts +0.5% to Gilts +0.25%? Where in the range do you think it should be and why? If you disagree, what do you think would be a more appropriate basis and why (please provide evidence)?

Q22 Options for defining other assumptions for Fast Track low dependency funding basis

Which of these options should be used to set assumptions for low dependency funding under Fast Track? Are there any other options we should consider? Are there any other pros and cons we should consider?

Q23 Defining assumptions for Fast Track low dependency funding basis

a. What are the most significant assumptions (other than discount rates) for the calculation of the Fast Track low dependency liabilities?

b. If we were to specify some or all of the assumptions to calculate the level of Fast Track low dependency liabilities, which assumptions should we specify and how should we do this? Do you have views on the suggested benchmarking factors in the table above?

c. If we determined mortality assumptions, how could we balance the scheme-specific nature of mortality with the desire to ensure a level of consistency in the assumptions used by different schemes?

Q24 Low dependency basis – verification that other assumptions meet the best estimate principle

a. Which of these options do you prefer to verify that other assumptions used for low dependency liabilities under Fast Track meet the ‘best estimate’ principle and why? Are there any other pros and cons we should consider? Are there any other options we should consider?

b. If we decided to require schemes to provide additional information about their assumptions, what information should we require schemes to provide compared to the current requirements?

Q25 Other assumptions for Fast track low dependency basis – prudence

a. If we specified certain assumptions, should we aim for those to be best estimate or to be chosen prudently?

b. Given the uncertainty around assumptions such as future improvements in mortality should we i) define these assumptions in Fast Track and ii) set the assumptions prudently?

Q26 Low dependency liabilities – reserve for future ongoing expenses

a. Should the low dependency liabilities carry an expenses reserve? If so, should this only be a requirement for schemes that self-fund their expenses?

b. To what extent should we define the reserve for future expenses under Fast Track? Should we just provide guidance on how to calculate an appropriate reserve? As part of that, what level of ongoing expenses is it reasonable to allow the employer to pay directly without any reserve?

c. If we defined guidelines on expenses for Fast Track, how should we reflect the proportionally different level of expenses incurred by schemes of different sizes? Could we adopt a sliding scale of percentages of liabilities based on the size of the scheme or a fixed element and proportionate element of expenses?

Q27 Definitions of maturity

a. Should maturity be defined as duration for the purpose of prescribing significant maturity under Fast Track? If not, which measure would you favour and why? Note that whatever measure we use, it needs to be applicable not only to the time at which we would expect a scheme to reach significant maturity but also at all earlier times in the scheme's life.

b. Whichever method is used to determine maturity, we need to use actuarial assumptions to make the calculation. Should we require that the Fast Track low dependency assumptions are used for this purpose? What other assumptions could be used?

Q28 Defining the timing point for significant maturity

What are your views on our proposal to set significant maturity (used to define the timeframe for reaching the LTO) for Fast Track to be in the range of a scheme duration of 14 to 12 years (or equivalent on a different maturity measure)? If you disagree, what would be a more appropriate timeframe and why? Please provide evidence.

Q29 Points or ranges for low dependency funding basis and timing point

Do you think our proposal to set a particular level for the low dependency funding basis and/or a range for the significant maturity timing associated with the LTO would be helpful to schemes to manage volatility and allow some smoothing? If not, what would you suggest?

Chapter 9: Technical provisions (TPs)

Q30 Journey plan shape for Fast Track TPs

a. Which shape of journey plan is most appropriate to define for calculating the Fast Track TPs and why? Does this vary depending on the circumstances of the scheme?

b. Are there any other journey plan shapes we should consider?

c. What unintended consequences might arise from adopting the linear de-risking or horizon method journey plans for Fast Track?

Q31 Key factors for Fast Track TPs

Should other scheme-specific factors other than covenant and maturity be considered to define the journey plan and TPs in Fast Track?

Q32 Extent of reliance on covenant in Fast Track TPs

a. Should we define a maximum period of acceptable full covenant reliance for Fast Track TPs? For example, a general guideline of five years? Or should covenant reliance be assumed to decline in the much shorter term (or immediately)?

b. What level of covenant support should subsequently be assumed? Should there be an assumption of a single covenant grade reduction (eg CG1 to CG2), a reduction to assumed returns in line with a weak covenant, or something else?

c. Over what period should any reduction in reliance take place? Should this be immediate (eg a reduction to a lower covenant reliance in the sixth year) or more gradual (for example, over the subsequent five years)?

d. Does the need for a covenant visibility overlay depend on the approach taken for the journey plan to low dependency? For example, is this a more relevant consideration where the horizon journey plan shape is used?

Q33 How Fast Track TPs should be expressed

Which option do you think is preferable for defining TPs/journey plans under Fast Track and why? What are the practical issues associated with each option? If you disagree with these options, what would you suggest and why?

Q34 Method to derive Fast Track TPs

a. Do you prefer a particular approach? If so, why? Is there another approach that would be suitable?

b. Do you have ideas as how to best approach each option?

c. How do trustees incorporate considerations about covenant strength into their TP assumptions/discount rates?

d. If a stochastic approach is adopted, what would you consider to be an appropriate confidence level against which to mark the results?

e. Do you have any data or modelling results which you think would provide useful evidence for the baseline TPs or covenant overlay? Please provide full details of methodology/data limitations.

Chapter 10: Investments

Q35 Which reference point from which to measure investment risk in Fast Track

a. Would a measure of the liabilities be an appropriate position to measure investment risk from? If not, why not?

b. Do you prefer a liability measure on the low dependency basis (Gilts +0.5% to +0.25%) or a Gilts flat basis? Why? Are there any other liability measures that would be suitable?

c. Would a liability reference portfolio approach (as a proxy for liabilities) for smaller schemes be more proportionate and practical? If so, how should a small scheme be defined for this purpose (number of members, assets or liabilities)? What would be an appropriate threshold?

d. Would a reference portfolio consisting of gilts and inflation-linked gilts with a duration similar to the liabilities be appropriate as a proxy for the liabilities for smaller schemes? If not, how would you go about constructing a reference portfolio as a reference point from which to measure risk for smaller schemes?

Q36 Methodology to measure investment risk in Fast Track

a. Would a simple stress test to measure investment risk in Fast Track be the most preferable option? If not, why not? Are there other measures of investment risk that are more suitable, taking account of the desire for a relatively simple and objective measure?

b. Do you agree with the proposed principles for an appropriate pensions stress test, namely a fall in growth assets and a fall in interest rates? If not, what do you suggest?

c. What are your views on which stress test we should use? Do you think the PPF stress test (Bespoke and simple approach) would be a good starting point?

d. Which of the ways to measure the impact of the stress would you prefer and why? Is there an alternative method not listed that would work better? If so, please describe it.

Q37 Approach to defining maximum levels of investment risk for schemes of different maturities in Fast Track

a. What are your views on the proposed methodology for setting maximum thresholds for investment risk for significantly mature schemes in Fast Track? If you disagree, what would you suggest?

b. In relation to acceptable portfolios and consistency with discount rates, is it reasonable to use a best estimate return premium for growth assets over long-term gilts in the range of 3-5% pa?

c. Should the allowance for prudence be higher for an investment portfolio with a higher level of risk?

d. What are your views on the considerations we have set out to determine investment limits for immature schemes (journey plan shape, downside risk and covenant)? In particular, should the maximum level of investment risk for immature schemes vary by covenant under Fast Track?

Q38 Defining guidelines for liquidity and quality of the investment portfolio in Fast Track

a. Do you think we should define some guidelines around liquidity and quality in Fast Track?

b. If so, what are your views on the options outlined above? Are there other approaches you favour?

c. What limits would you set on the above criteria and why?

d. How would the above change for a more immature plan?

Chapter 11: Recovery plan (RP)

Q39 Fast Track guidelines on RP length

a. What are your views on the principles set out above in relation to RP length under Fast Track? In particular, do you have views on what may be appropriate RP length thresholds for different covenant strengths? Is it helpful to frame these in terms of the typical multiple of valuation cycles (ie three years)?

b. Do you consider it would be more appropriate to have a single maximum guidance RP length and to expect trustees (under the Bespoke framework) to justify any plans that are longer than this?

c. Do you think Fast Track RP lengths should be shorter for schemes nearing and/or at significant maturity? If so, to what extent?

Q40 Fast Track guidelines on RP structure

Should the extent of back-end loading be limited to increases which are in line with inflation (in the absence of appropriate additional support such as a contingent asset being provided)? Or should there be more flexibility subject to a significant proportion of DRCs being committed in the early years of the plan? If inflation-linked increases are acceptable, what measure of inflation do you consider would be an appropriate benchmark?

Q41 Fast Track guidelines on investment outperformance

Should investment outperformance not be allowed in Fast Track RPs? What do you think the impacts may be?

Q42 Fast Track guidelines on future RPs

In what circumstances should/could outstanding RP payments be re-spread at subsequent valuations? In particular:

a. If a scheme's funding deficit has reduced (at least) in line with the expectations at the previous valuation, would it be appropriate to maintain the same end date? Or would it be pragmatic to re-spread the remaining deficit over a renewed period?

b. If a scheme's funding deficit is higher than expected, what guidelines should apply for the appropriate length of the new RP?

c. Would the idea of 're-spreading' be more acceptable where a scheme has a long period before it becomes significantly mature?

Q43 Equitability

What are your views on the concept of 'equitability' in respect of how a scheme is treated compared with other stakeholders? Should any requirements be qualitative (in line with the commentary above) or should trustees also be expected to consider a specific metric? If so, what might be an appropriate measure of equitability (for example, comparing the ratio of DRCs to dividends, or the size of scheme deficit to the 'stake' of other stakeholders) and how could this reflect a scheme's superior creditor status over shareholders?

Chapter 12: Open schemes

Q44 Treating past service and future service liabilities separately in Fast Track

What are your views on our proposed approach to outlining code guidelines for open schemes. Should any other approach to calculating future service liabilities be considered?

Q45 Fast Track LTO for open schemes

Should the LTO (low dependency at significant maturity) for an open scheme be the same for a closed scheme? If not, how should they differ?

Q46 Fast Track TPs for open schemes

What option do you favour and why? Are there other options we should consider?

Q47 Fast Track guidelines for calculating future service costs

a. Which options do you favour and why? Are there any other options for calculating future service costs which should be considered, for example pre-and post- retirement discount rates?

b. If Option C (best estimate) were adopted, how should the best estimate return assumption be determined? Are there any options other than those described above that we should consider?

c. Would our preferred approach (Option B) make it difficult for scheme actuaries to certify schedules of contributions?

Q48 Funding future service using past service surplus

Do you think that this approach to funding future service using past service surplus is reasonable? If not, why not? What else would you suggest?

Q49 Criteria for assessing Bespoke arrangements

What are your views on the criteria we propose to use to assess Bespoke arrangements? If you disagree, what would you change and why? What else should we consider?

Chapter 13: Bespoke framework key features

Q50 Bespoke examples

a. Do you have any comments on the assessments we have made in the examples above?

b. Could you provide other examples (relevant to your own scheme experience or that of schemes you advise) of arrangements which you think will follow the Bespoke route? Why do you think these arrangements would be compliant?

c. In example 2 (LTO – CDI strategy), could it be appropriate, in your view, to be able to use a higher discount rate/lower value of TPs (low dependency basis) than in Fast Track? If so, in what circumstances and by how much?

Q51 Stressed schemes

a. Assuming that affordability is genuinely constrained, are very long RPs 'appropriate' and therefore compliant with the Act?

b. Alternatively, should we make an exception to the principles and allow the trustees of stressed schemes to take unsupported investment risk, or more risk investment risk than other CG4 schemes (schemes with weak employers)? What checks and balances should we put in place in addition to those mentioned above (equitable treatment, risk management)?

c. For schemes with unviable RPs, should an exception be made for them in terms of the level of acceptable investment risk?

d. Are you aware of situations other than stressed schemes where the trustees and employer would have difficulties meeting the Bespoke compliance principles?

Chapter 14: Additional support

Q52 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?

Q53 Accessing additional support

When do you think trustees should be able to access the additional support? Does it depend on the Bespoke arrangement and the type of risk that it supports?

Q54 Assessing the value of additional support

Should trustees be required to assess the stressed value of any contingent asset? What other guidance do you think we should set out on the recoverable value of contingent asset support?

Q55 Independent valuation

Should trustees always be expected to seek an independent valuation of continent assets, or should it depend on asset value and/or type? If this should be based on value thresholds, how should these be defined? How frequently should we expect trustees to seek an independent valuation? Should trustees be expected to regularly monitor contingent asset value in the intervening period?

Q56 Guarantees

a. Should we treat guarantee support differently to asset backed support?

b. Should trustees rely on guarantee support to change the covenant grade assessment or do you think in these circumstances the supporting entity should become a statutory employer instead?

c. Other mitigations – Can you think of any other types or arrangements which can help trustees mitigate risks?

Q57 Other mitigations

Can you think of any other types of arrangements which can help trustees mitigate risks?

Q58 Reporting information on additional support

Is there any reason why it would be unreasonable to expect trustees to undertake the analysis and provide the information outlined above? Is there additional information that should also be provided to us?

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Consultation overview

Quick guide to our defined benefit funding consultation

March 2020

Contents

Foreword

In its 2018 white paper 'Protecting Defined Benefit Pension Schemes', the government noted that the defined benefit (DB) funding framework is working largely as intended. However, it also acknowledged that there was room for improvement in some key areas, for example the need for greater transparency and accountability around the risks being taken on behalf of members and employers, and for trustees to focus on the long-term strategic issues for their scheme as the landscape matures.

It also highlighted some grey areas in the existing framework relating to how DB trustees should set their scheme's technical provisions (TPs) prudently and an appropriate recovery plan (RP). This lack of clarity has enabled a minority of schemes and employers to misuse the flexibility in the system and made it more difficult for us to regulate DB schemes efficiently.

We are consulting on a revised DB funding code to address these concerns and to implement the new measures introduced in the Pension Schemes Bill[1] laid in Parliament in January 2020.

If you wish to learn more about the background to and purpose of this consultation, you can refer to Chapters 1 and 2 of the consultation document.

1 https://services.parliament.uk/Bills/2019-20/pensionschemes.html

Introduction

We are consulting on a revised DB funding code of practice in two parts.

The first consultation considers our new proposed regulatory approach, the principles we think should underpin the new framework, and how they could be applied in practice to provide clearer guidelines.

The second consultation, planned for later in 2020, will focus on the draft code itself and what final guidelines might look like, informed by industry feedback to this current consultation, our impact assessment, and changes to legislation (Pension Schemes Bill and regulations). It is important to get things right and we are keen to involve the pensions industry as much as possible in helping us define 'what good looks like'. In particular, we are keen to understand if there are any practical issues or unintended consequences arising from our proposals.

We are seeking to create a sustainable framework, which provides the right balance between the security of member benefits and the costs to employers of running their DB schemes. Although the proposed framework may be a departure from our current DB code[2], many of the core principles are consistent with our messages over the last few years (integrated risk management and the importance of long-term planning) and the good practice that many schemes already apply.

We therefore don't expect our new proposed approach to be too onerous for most schemes to implement, but we appreciate there could be significant impact for some schemes, particularly those that have been running excessive and unjustifiable levels of risk.

This stand-alone document provides an overview of the first consultation document. The consultation document is long because we raise complex issues and need sufficient input to ensure the framework is fit-for-purpose. We do not expect all respondents to read everything and answer all the questions, but to focus on their areas of interest and expertise. In particular, our non-technical audience may wish to focus on our proposed regulatory approach (Chapter 3), key principles (Chapter 4) and Bespoke approach (Chapters 13 and 14).

2 https://www.tpr.gov.uk/en/document-library/codes-of-practice/code-3-funding-defined-benefits-

Key principles

We have identified a number of overarching principles that we believe should stand behind all scheme valuations. These are based on our experience from reviewing thousands of scheme valuations, ongoing engagement with a wide range of our stakeholders, and current and forthcoming legislation. The proposed principles are as follows:

Compliance and evidence
• We expect 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 (ie 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.
Long-term objective (LTO)
• By the time they are significantly mature, we expect schemes to have a low level of dependency on the employer and be invested with high resilience to risk.
Journey plans and technical provisions (TP)
• We expect trustees to develop a journey plan to achieve their LTO. • We expect 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.
Scheme investments
• The actual investment strategy and asset allocation over time should be broadly aligned with the scheme's funding strategy (TPs and RP). • Trustees must 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. • We expect the asset allocation at significant maturity to have high resilience to risk, a high level of liquidity and a high average credit quality.

Proposed principles continued...

Reliance on the employer covenant
• 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.
Reliance on additional support
• Schemes can account for additional support when carrying out their valuations provided that it: – provides sufficient support for the risk(s) being run – is appropriately valued, and – is legally enforceable and realisable at its necessary value when required.
Appropriate recovery plan (RP)
• TP deficits should be recovered as soon as affordability allows, while minimising any adverse impact on the sustainable growth of the employer
Open schemes
• Members' accrued benefits in open schemes should have the same level of security as members' accrued benefits in closed schemes.

If you wish to learn more about why we are proposing these principles and what they mean, you can refer to Chapter 5 of the consultation document.

A new regulatory approach: Fast Track and Bespoke

The government's white paper highlighted the need for greater clarity around what we expect of trustees, for greater accountability around their decision-making, and clearer parameters around the use of the flexibilities in the regime. However, we do not intend to re-introduce a one-size-fits-all funding standard. Instead, we have sought to reconcile the need for greater direction with the scheme-specific funding regime by proposing a twin-track compliance route to carrying out valuations (referred to as 'Fast Track' and 'Bespoke'). We expect all the principles above to apply to both approaches.

Twin-track approach

Fast Track

- We set straightforward quantitative compliance guidelines for trustees to assess whether we would consider their valuation compliant with the legislation.
- If all aspects are satisfied, trustees can expect minimum regulatory involvement on DB funding.

Bespoke

- This option provides trustees and employers with more flexibility to account for scheme and employer-specific circumstances.
- Decisions in this route will need to be fully articulated and evidenced, and may mean higher regulatory involvement.

We anticipate the twin-track approach will introduce greater clarity for trustees and employers, so they can understand whether and why we may have concerns about their funding arrangements and what can be done to lessen those concerns. In addition, advisers will be able to provide advice to their clients with more certainty, and savers can be confident that those responsible for their pensions have acted appropriately and with more accountability.

Trustees opting for either route will have to submit evidence to us (to a greater degree in Bespoke) demonstrating their approach to managing their funding and investment risks as part of the new statement of strategy introduced in the Pension Schemes Bill. Receiving this information at the outset will help us assess valuations against our guidelines and avoid unnecessary engagement with trustees who have provided clear explanations and evidence.

Trustees would not be expected to maintain the previous approach (eg Fast Track or Bespoke) at future valuations. Funding arrangements understandably may have to change with employer and scheme circumstances.

Overview of Fast Track

- Relevant for trustees who can submit a valuation that is compliant with our code guidelines.
- Trustees can expect to have to provide less evidence and for their valuation submission to receive much less regulatory scrutiny.
- Expected to ease the process for well-funded and well-managed schemes.
- Will set clearer expectations and provide an easier route to compliance for trustees of smaller schemes.

We propose to set a series of objective and quantitative compliance guidelines and parameters which cover key aspects of funding and investment arrangements, such as:

- funding target (long-term objective or 'LTO') and timing to reach this
- TPs including discount rates and (possibly) other assumptions
- RP length and structure
- investment risk
- future service contribution rates (open schemes).

These would include some scheme-specific factors such as maturity and employer covenant strength. Schemes would have to satisfy all requirements individually to be Fast Track compliant.

The parameters would be developed in line with prevailing market conditions and we would regularly review and update them as necessary. Some parts of the Fast Track framework may be predicated on a covenant grade assessment, which may be subject to some checks by us (as is the case now).

The Fast Track framework would represent a baseline of 'tolerated risk' for schemes in different circumstances. We use 'tolerated risk' as an umbrella term that covers the multitude of risks, both scheme- and employer-related. We do not suggest that Fast Track would be a risk-free framework, so trustees would still be expected to exercise judgement and assess and manage their own scheme- and covenant-specific risks.

If you wish to learn more about our proposals for Fast Track guidelines, you can refer to Part 3 of the consultation document.

Overview of Bespoke

- Relevant for trustees who cannot or choose not to comply with Fast Track. They will submit their valuation, along with supporting evidence, explaining how and why they have differed from the Fast Track position and how any additional risk is being managed.
- Bespoke arrangements may receive more regulatory scrutiny, but it is not a 'bad' or second-best option.
- Bespoke and Fast Track approaches, if done correctly, are equally compliant with the legislation.

There may be many reasons why trustees choose to opt for the Bespoke route. Some may want to take additional, managed risk relative to the tolerated level of risk set out in Fast Track. Others may agree funding solutions that represent an outcome at least as good as Fast Track overall but do not satisfy all individual Fast Track guidelines. And finally, some trustees may not be able to meet some or all Fast Track guidelines, for instance those with employers facing significant affordability constraints.

We propose that Bespoke arrangements should meet the key principles and be assessed against the Fast Track standard. Our consultation considers how additional flexibilities can be integrated. For instance, if trustees take more risk in their funding arrangement and this risk has not been assessed as minimal or remote, they would have to provide evidence showing how that additional risk is managed. Good risk management can include additional support, such as contingent assets and guarantees. We would expect additional support to be assessed robustly, be of sufficient value to cover the risk(s) and be legally enforceable and accessible by trustees when needed. Employers with affordability constraints may not be able to provide additional support, so we would expect the trustees to mitigate the additional risk by taking action to reduce its severity if it were to materialise.

We do not know yet how many schemes might adopt Fast Track or Bespoke – this will depend on the final Fast Track guidelines, which we will consult on in our second consultation. This will also be informed by your responses to the first consultation on principles and concepts, prevailing market conditions and our assessment of impacts.

We recognise that the Fast Track framework may not be suitable for all schemes' funding arrangements. However, if Fast Track were to be extended to reflect a wider group of scheme funding arrangements, it would over-complicate what is intended to be a straightforward option. Therefore, we have tried to ensure that scheme-specific flexibility remains through the Bespoke option.

To find out more about how the Bespoke approach might work, including how Bespoke arrangements would be assessed, example scenarios and how we propose additional support should be integrated, you can refer to Part 4 of the consultation document.

A closer look at some key principles and options for Fast Track guidelines

Employer covenant

We ask in the consultation whether (and if so, how much) reliance should be placed on the employer covenant and the degree to which it is reasonable for DB scheme members to be subject to employer insolvency risk.

We conclude that fully insulating schemes from the impact of employer insolvency by requiring funding on a risk-free basis would be too costly and inconsistent with Part 3 funding. However, we think our proposal to allow trustees to embed some reliance on the covenant and more immature schemes to assume and take more investment risk on their way to low dependency funding, strikes an appropriate balance between the security of member benefits and costs to employers. Where exactly that balance lies will be the focus of our second consultation.

We also consult on options for how we should integrate covenant support, particularly in Fast Track guidelines. For the purpose of developing consultation proposals, we explain that assumed reliance could be placed on the covenant in Fast Track TPs via the discount rate (similar to current practice).

However, we propose some limits should be placed on that reliance based on covenant visibility, which we think does not typically extend beyond the short to medium term (three to five years).

Finally, we consider how the covenant can be assessed with as much clarity, objectivity and proportionality as possible and consult on two main options: retaining the current 'holistic' approach (but with further clarifications) or simplifying employer covenant to a formal calculation or metric.

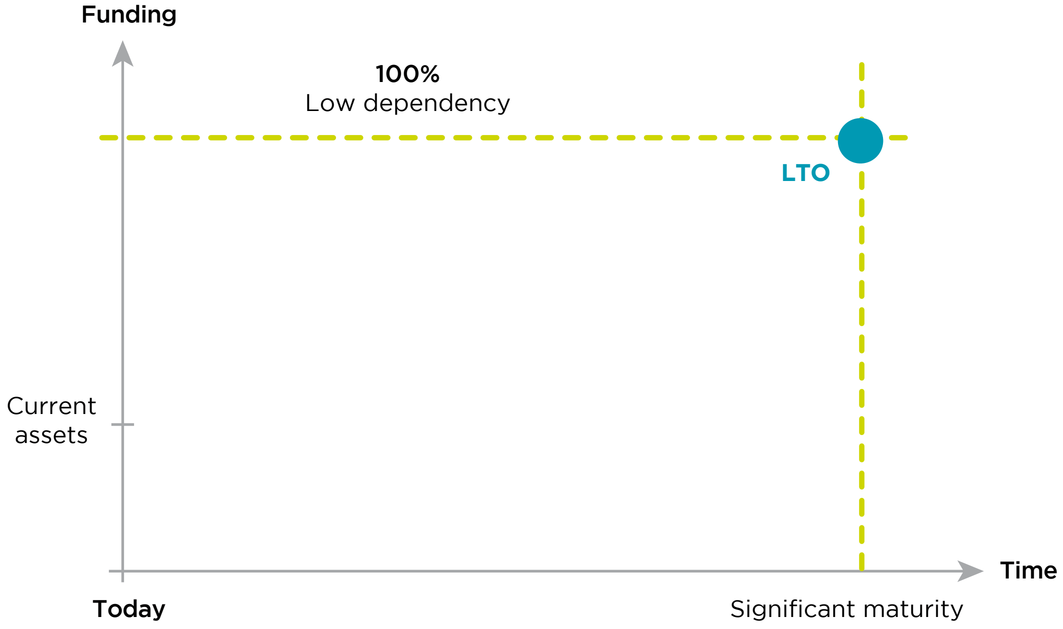
We propose retaining our current covenant grading system (CG1-4) for the purpose of setting Fast Track guidelines but recognise that there are arguments for increasing the number of ratings, and we welcome views on this as well.

To find out more about what we propose on the role and assessment of the covenant, you can refer to Chapter 4 of the consultation document.

Long-term objective (LTO)

An important part of the Pension Schemes Bill and our consultation is the requirement that trustees set a LTO (described as 'funding and investment strategy' in the Bill). We propose that schemes should seek to progressively reduce their reliance on the employer covenant over time to reach a position of low dependency[3] funding combined with investments that are highly resilient to risk by the time they are significantly mature.

Figure 1: How trustees could determine the scheme-specific long-term objective



Targeting an LTO should improve the resilience of the growing number of mature schemes at a time where they are increasingly vulnerable to investment underperformance and have shorter horizons to make good any shortfall in funding levels. By reaching this position, trustees and employers should have a good platform to pursue 'end game' strategies suitable for their circumstances, whether it is buying out, entering a consolidator or running off on a low-risk basis.

In this consultation we are seeking views on an appropriate LTO for Fast Track. While many of the Fast Track parameters are yet to be defined, we have set out our views on potential definitions of low dependency funding basis and significant maturity. We consider the low dependency discount rate to be somewhere in the range of Gilts +0.5% pa to Gilts +0.25% pa, and significant maturity to be 15-20 years from now for a scheme of average maturity[4].

3 Low dependency is where a scheme's funding and investment strategies are such that there is a low chance of requiring further employer support and, to the extent that such report is required, the amount of support is low relative to the size of the scheme.
4 In order to help form this view, we commissioned analysis from the Government Actuary's Department (GAD). See also Chapter 16 of the consultation document and the GAD report published alongside the consultation.

Long-term objective (LTO) continued...

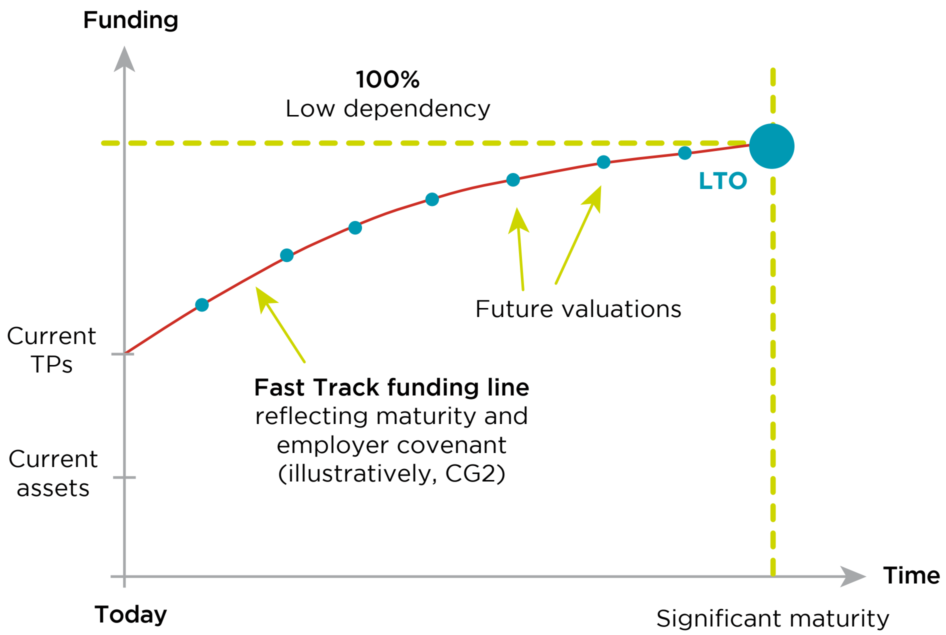
We are also consulting on other aspects of low dependency funding, such as whether we should define other assumptions relating to members' benefits and choices and set expectations around expense reserves. Additionally, we debate what measure of maturity we should use for Fast Track.

To find out more about what we propose on the LTO for Fast Track, you can refer to Chapter 8 of the consultation document.

Journey planning and technical provisions (TPs)

The Pension Schemes Bill will also require TPs to be set consistently with the LTO. Having a journey plan will help trustees demonstrate how they intend to achieve their LTO and to assess and manage key risks along the way.

Figure 2: How trustees could determine a journey plan to reach their long term objective (reflecting scheme maturity and reliance on employer covenant).



During initial stakeholder engagement, we have found there is a misconception that TPs should equate to the LTO for all schemes and that the LTO needs to be achieved within a short timeframe. This is not the case.

TPs are a way of measuring progress towards the LTO and intended to be a smooth path based on the agreed journey plan. The TPs will therefore reflect the discount rates during the journey and how the investment strategy is incorporated.

Journey planning and technical provisions (TPs) continued…

In terms of cash funding, we are not expecting employers to have to pay more once the scheme is fully funded on a TPs basis. However, once the scheme funding objective has been reached and the scheme is fully funded on a TPs basis, we would expect trustees to invest broadly in line with the journey plan and use investment returns to take them to a low dependency position, with employer contributions only necessary if a deficit arises on a TPs basis. In other words, the LTO is the destination, the TPs are the journey milestones, and the RP is the corrective measure to get back on track.

There are many different journey plans trustees can adopt. These reflect different approaches to risk-taking and de-risking on the journey to reaching the LTO. We are consulting on what shape of the journey plan we should assume to set Fast Track TPs and how much covenant reliance (and visibility) we should embed into the TPs. We also discuss how we should express Fast Track TPs (as discount rates or funding ratios by maturity and covenant grade) and how we should go about deriving these guidelines.

To find out more about what we propose on Fast Track TPs, you can refer to Chapter 9 of the consultation document.

Scheme investments

The investment strategy is an important factor in terms of the risk to member benefits. We are not seeking to direct how trustees should invest but would like to ensure that investment risk is appropriate and supported.

We are consulting on the principle that a scheme's investment strategy and asset allocation over time should be broadly aligned with the funding strategy, including consideration of the TPs and journey plan. At the point of significant maturity, the asset allocation should have a high resilience to risk along with sufficient liquidity and a high average credit quality.

We discuss how trustees need to ensure the investment strategy has sufficient security and quality, as well as being able to satisfy liquidity requirements.

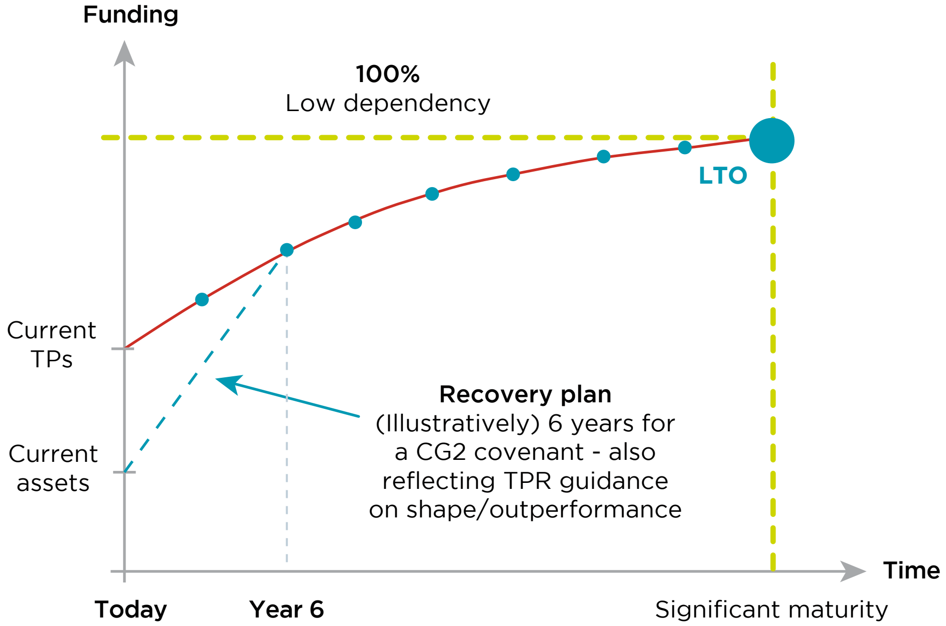
We set out proposals for how trustees could demonstrate whether the risk in their investment strategy is supported. In particular, we outline a few options for the reference point from which investment risk should be measured (eg liabilities or a reference portfolio), how to measure risk (for instance through a simple stress test, which we could seek to align to the PPF's own test), and how we would define an acceptable level of investment risk suitable for different maturities and covenant strengths. We also look at how we could define some Fast Track guidelines for credit quality and liquidity.

To find out more about what we propose on the investment strategy for Fast Track, you can refer to Chapter 10 of the consultation document.

Appropriate recovery plans (RPs)

We intend to be clearer about what constitutes an appropriate RP. Our view is that affordability should remain a key driver and that TP deficits should be recovered as soon as affordability allows, while minimising adverse impacts on the sustainable growth of employers. This means that, all other things being equal, we expect schemes with stronger employers to have shorter RPs. If an appropriately short RP cannot be agreed, we would expect affordability constraints to be evidenced, and for trustees to seek suitable and realisable mitigations.

Figure 3: How trustees could approach agreeing an appropriate recovery plan in line with their journey plan and long term objective.



We are consulting on options for Fast Track guidelines for RP lengths. For instance, should the trustees of all schemes aim for RPs of a standard length (eg broadly limited to the period over which there is good covenant visibility), or should different thresholds be set for different covenant grades?

We also consult on the appropriate mix of other flexibilities in RPs. Our aim is to achieve the right balance between managing scheme risks and employers having the flexibility to manage their cash flows efficiently and avoid unnecessary over-funding.

To find out more about what we propose on Fast Track RPs, you can refer to Chapter 11 of the consultation document.

Open schemes

It's good practice for open schemes to plan for the long term, but we recognise that they typically mature more slowly (or indeed not at all) compared to closed schemes.

We are consulting on a range of solutions for open schemes which take these factors into consideration and reflect the wide range of open schemes in the DB universe. However, we think it is right to expect that members' accrued benefits should have the same level of security as accrued benefits in closed schemes.

In our consultation, we propose to treat past service liabilities (TPs) and future accruals separately and for all schemes to have the same LTO of low dependency funding at significant maturity. For Fast Track, we consult on various options for how the TPs and the cost of future service benefits should be calculated for open schemes.

> **To find out more about what we propose on open schemes for Fast Track, you can refer to Chapter 12 of the consultation document.**

Next steps

We welcome your responses on any aspect of the consultation by 2 June 2020.

We would like to hear from any interested party, particularly trustees, employers, advisers, and members of DB pension schemes and their representative organisations. You can provide feedback in the online response form published alongside the main consultation document or by emailing: **DB.Consultation@tpr.gov.uk**.

How to contact us

Napier House
Trafalgar Place
Brighton
BN1 4DW

www.tpr.gov.uk

www.trusteetoolkit.com
Free online learning for trustees

The Pensions Regulator

Consultation overview
DB funding code of practice

Defined benefit funding code of practice

Consultation questions

March 2020

Contents

Responding to the consultation

We would encourage you to respond to the consultation by completing this online response form. You can also send responses to us by email at: **DB.Consultation@tpr.gov.uk**.

Our preference is for responses in electronic format but alternatively, you can post your response form to:

Sarah Harvey
Regulatory Policy, Advice and Analysis Directorate
The Pensions Regulator
Napier House
Trafalgar Place
Brighton BN1 4DW

If you wish to submit supplementary materials electronically, please note they will be subject to a 20mb limit (any larger documents will therefore have to be sent in batches). If you have any queries about this consultation, please call Sarah Harvey on 01273 349355.

We may need to share the feedback you send us within our own organisation or with other government bodies. We may publish this feedback as part of our consultation response. If you want your comments to remain anonymous or confidential, please state this explicitly in your response and we will take the necessary steps to meet your request.

However, please be aware that, should we receive a formal request under the Freedom of Information Act, we may be required to make your response available. When responding, please advise whether you are responding as an individual or on behalf of an organisation (and, if the latter, which organisation).

Defined benefit funding code of practice: Consultation questions

This form is interactive. Please save the whole consultation pdf to your computer, fill in your response to the questions as appropriate and return it to the following email address: **DB.Consultation@tpr.gov.uk**

Your details

Your name:

Organisation (if applicable):

Job title (if applicable):

Postal address:

Telephone:

Email:

Which category best describes you or your organisation?

Select one:

Please select one category from the scrollable list above.

Confidentiality

Please confirm whether you would like us to list your organisation on our list of respondents to this consultation:

☐ Yes, I wish my organisation to be included on the list of respondents.

We may need to share the feedback you send us within our own organisation or with other government bodies. We may also publish this feedback as part of our response to the consultation. If you wish your response, in whole or in part, to remain confidential, please tick the box below:

☐ Yes, I wish my response to remain confidential.

If so, please specify which part of your response you wish to remain confidential and why:

Consultation questions and response form: Chapter 3: Proposed regulatory approach

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?

Chapter 4: Employer covenant

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?

3. Integrating covenant into funding

a. Do you think it is better to keep the Fast Track route simpler by only factoring covenant into Bespoke (TPs and/or RP)?

b. If you think covenant should only feature in Bespoke, how do you think it should be done?

c. If we were to integrate covenant into Fast Track guidelines, do you prefer option 1, 2 or 3 or some other approach for reflecting the employer in scheme valuations, and why? If another approach is appropriate, what do you think this should be?

4. Covenant assessment

a. Should a holistic approach to assessing employer covenant be retained (but with further guidance to assist trustees), or should we seek to define a more prescribed, formulaic approach?

b. If the former (holistic approach), what amendments/clarifications to our existing guidance on covenant do you consider may be necessary? Do you agree with the ones suggested above? Is the structure and content of our existing employer covenant guidance helpful and accessible to trustees? If not, what would make it better?

4. Covenent assessment continued...

c. If the latter (formulaic approach), what do you think of the proposed RACF approach? How would you propose that covenant could be explicitly defined in a clear, consistent and measurable manner? What other metric(s) may be appropriate?

d. Alternatively, would it be appropriate to require employer covenant to be assessed in a prescribed (formulaic) way for Fast Track purposes, and only allow for a more holistic approach under the Bespoke framework?

5. Reliance on indirect covenant
Do you think that the strength of the wider commercial group should be factored into the sponsoring employer's assessment? If so, how, and to what degree?

6. Covenant grades

a. Should we use a greater range of covenant grades to set guidelines in the code and assess schemes and, if so, what would be an appropriate number of grades?

b. Would there be sufficiently different characteristics between a greater number of grades, such that a set of trustees could reasonably and reliably assess covenant strength without requiring professional advice?

Chapter 5: General principles

7. **Low dependency 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?

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?

9. High resilience to risk at the LTO
Do you think that the investment portfolio should be highly resilient to risk when schemes reach their LTO? If not, what do you suggest?

10. Risk-taking for immature schemes
Is it reasonable for less mature schemes, which would have more time to reach low dependency funding, to assume and take relatively more investment risk than a mature scheme?

11. Journey planning
What are your views of the rationale above for the journey plan? Do you think there is there a better way for trustees to evidence that their TPs have been set consistently with the LTO?

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

13. Broad consistency between investment and funding strategy

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 TPs), should trustees have to demonstrate that the investment risk taken can be managed appropriately? If not, why not and what would you suggest?

14. Liquidity and quality at maturity

Do you think that security, quality, and liquidity become more important as a scheme becomes significantly mature? In particular, do you think that the scheme's asset allocation at significant maturity should have a high level of liquidity and a high average credit quality?

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?

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 valued when required?

17. Appropriateness of RPs and affordability as key factor

a. Should employer affordability be the key factor to determine the appropriateness of a RP? 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 TPs and size of deficits) to have a commensurately shorter RP?

18. Open schemes, past service
Should past service have the same level of security, irrespective of whether the scheme is open or closed?

19. Open schemes, future accruals
Do you think it would be good practice for trustees to ensure that the provision of future accruals does not compromise the security of accrued benefits?

Chapter 6: Other issues

20. Other issues

Do you agree with our assessment of the issues above and do you have any further comments?

Chapter 8: Setting the long-term objective (LTO)

21. Fast Track low dependency discount rate
What are your views on our proposal that the appropriate low dependency funding basis for Fast Track should be with a discount rate somewhere in the range of Gilts +0.5% to Gilts +0.25%? Where in the range do you think it should be and why? If you disagree, what do you think would be a more appropriate basis and why (please provide evidence)?

22. Options for defining other assumptions for Fast Track low dependency funding basis
Which of these options should be used to set assumptions for low dependency funding under Fast Track? Are there any other options we should consider? Are there any other pros and cons we should consider?

23. Defining assumptions for Fast Track low dependency funding basis

a. What are the most significant assumptions (other than discount rates) for the calculation of the Fast Track low dependency liabilities?

b. If we were to specify some or all of the assumptions to calculate the level of Fast Track low dependency liabilities, which assumptions should we specify and how should we do this? Do you have views on the suggested benchmarking factors in the table above?

c. If we determined mortality assumptions, how could we balance the scheme-specific nature of mortality with the desire to ensure a level of consistency in the assumptions used by different schemes?

24. Low dependency basis – verification that other assumptions meet the best estimate principle

a. Which of these options do you prefer to verify that other assumptions used for low dependency liabilities under Fast Track meet the 'best estimate' principle and why? Are there any other pros and cons we should consider? Are there any other options we should consider?

b. If we decided to require schemes to provide additional information about their assumptions, what information should we require schemes to provide compared to the current requirements?

25. Other assumptions for Fast track low dependency basis – prudence

a. If we specified certain assumptions, should we aim for those to be best estimate or to be chosen prudently?

b. Given the uncertainty around assumptions such as future improvements in mortality should we: i) define these assumptions in Fast Track and ii) set the assumptions prudently?

26. Low dependency liabilities – reserve for future ongoing expenses

a. Should the low dependency liabilities carry an expenses reserve? If so, should this only be a requirement for schemes that self-fund their expenses?

b. To what extent should we define the reserve for future expenses under Fast Track? Should we just provide guidance on how to calculate an appropriate reserve? As part of that, what level of ongoing expenses is it reasonable to allow the employer to pay directly without any reserve?

c. If we defined guidelines on expenses for Fast Track, how should we reflect the proportionally different level of expenses incurred by schemes of different sizes? Could we adopt a sliding scale of percentages of liabilities based on the size of the scheme or a fixed element and proportionate element of expenses?

27. Definitions of maturity

a. Should maturity be defined as duration for the purpose of prescribing significant maturity under Fast Track? If not, which measure would you favour and why? Note that whatever measure we use, it needs to be applicable not only to the time at which we would expect a scheme to reach significant maturity but also at all earlier times in the scheme's life.

b. Whichever method is used to determine maturity, we need to use actuarial assumptions to make the calculation. Should we require that the Fast Track low dependency assumptions are used for this purpose? What other assumptions could be used?

28. Defining the timing point for significant maturity
What are your views on our proposal to set significant maturity (used to define the timeframe for reaching the LTO) for Fast Track to be in the range of a scheme duration of 14 to 12 years (or equivalent on a different maturity measure)? If you disagree, what would be a more appropriate timeframe and why? Please provide evidence.

29. Points or ranges for low dependency funding basis and timing point
Do you think our proposal to set a particular level for the low dependency funding basis and/or a range for the significant maturity timing associated with the LTO would be helpful to schemes to manage volatility and allow some smoothing? If not, what would you suggest?

Chapter 9: Technical Provisions (TPs)

30. Journey plan shape for Fast Track TPs

a. Which shape of journey plan is most appropriate to define for calculating the Fast Track TPs and why? Does this vary depending on the circumstances of the scheme?

b. Are there any other journey plan shapes we should consider?

c. What unintended consequences might arise from adopting the linear de-risking or horizon method journey plans for Fast Track?

31. Key factors for Fast Track TPs
Should other scheme-specific factors other than covenant and maturity be considered to define the journey plan and TPs in Fast Track?

32. Extent of reliance on covenant in Fast Track TPs

a. Should we define a maximum period of acceptable full covenant reliance for Fast Track TPs? For example, a general guideline of five years? Or should covenant reliance be assumed to decline in the much shorter term (or immediately)?

b. What level of covenant support should subsequently be assumed? Should there be an assumption of a single covenant grade reduction (eg CG1 to CG2), a reduction to assumed returns in line with a weak covenant, or something else?

c. Over what period should any reduction in reliance take place? Should this be immediate (eg a reduction to a lower covenant reliance in the sixth year) or more gradual (eg over the subsequent five years)?

d. Does the need for a covenant visibility overlay depend on the approach taken for the journey plan to low dependency? For example, is this a more relevant consideration where the horizon journey plan shape is used?

33. How Fast Track TPs should be expressed

Which option do you think is preferable for defining TPs/journey plans under Fast Track and why? What are the practical issues associated with each option? If you disagree with these options, what would you suggest and why?

34. Method to derive Fast Track TPs

a. Do you prefer a particular approach? If so, why? Is there another approach that would be suitable?

b. Do you have ideas as how to best approach each option?

34. Method to derive Fast Track TPs continued...

c. How do trustees incorporate considerations about covenant strength into their TP assumptions/discount rates?

d. If a stochastic approach is adopted, what would you consider to be an appropriate confidence level against which to mark the results?

e. Do you have any data or modelling results which you think would provide useful evidence for the baseline TPs or covenant overlay? Please provide full details of methodology/data limitations.

Chapter 10: Investments

35. Which reference point from which to measure investment risk in Fast Track

a. Would a measure of the liabilities be an appropriate position to measure investment risk from? If not, why not?

b. Do you prefer a liability measure on the low dependency basis (Gilts +0.5% to +0.25%) or a Gilts flat basis? Why? Are there any other liability measures that would be suitable?

35. Which reference point from which to measure invetment risk in Fast Track continued...

c. Would a liability reference portfolio approach (as a proxy for liabilities) for smaller schemes be more proportionate and practical? If so, how should a small scheme be defined for this purpose (number of members, assets or liabilities)? What would be an appropriate threshold?

d. Would a reference portfolio consisting of gilts and inflation-linked gilts with a duration similar to the liabilities be appropriate as a proxy for the liabilities for smaller schemes? If not, how would you go about constructing a reference portfolio as a reference point from which to measure risk for smaller schemes?

36. Methodology to measure investment risk in Fast Track

a. Would a simple stress test to measure investment risk in Fast Track be the most preferable option? If not, why not? Are there other measures of investment risk that are more suitable, taking account of the desire for a relatively simple and objective measure?

b. Do you agree with the proposed principles for an appropriate pensions stress test, namely a fall in growth assets and a fall in interest rates? If not, what do you suggest?

36. Methodology to measure investment risk in Fast Track continued...

c. What are your views on which stress test we should use? Do you think the PPF stress test (Bespoke and simple approach) would be a good starting point?

d. Which of the ways to measure the impact of the stress would you prefer and why? Is there an alternative method not listed that would work better? If so, please describe it.

37. Approach to defining maximum levels of investment risk for schemes of different maturities in Fast Track

a. What are your views on the proposed methodology for setting maximum thresholds for investment risk for significantly mature schemes in Fast Track? If you disagree, what would you suggest?

b. In relation to acceptable portfolios and consistency with discount rates, is it reasonable to use a best estimate return premium for growth assets over long-term gilts in the range of 3-5% pa?

37. Approach to defining maximum levels of investment risk for schemes of different maturities in Fast Track continued...

c. Should the allowance for prudence be higher for an investment portfolio with a higher level of risk?

d. What are your views on the considerations we have set out to determine investment limits for immature schemes (journey plan shape, downside risk and covenant)? In particular, should the maximum level of investment risk for immature schemes vary by covenant under Fast Track?

38. Defining guidelines for liquidity and quality of the investment portfolio in Fast Track

a. Do you think we should define some guidelines around liquidity and quality in Fast Track?

b. If so, what are your views on the options outlined above? Are there other approaches you favour?

38. Defining guidelines for liquidity and quality of the investment portfolio in Fast Track continued...

c. What limits would you set on the above criteria and why?

d. How would the above change for a more immature plan?

Chapter 11: Recovery plan (RP)

39. Fast Track guidelines on RP length

a. What are your views on the principles set out above in relation to RP length under Fast Track? In particular, do you have views on what may be appropriate RP length thresholds for different covenant strengths? Is it helpful to frame these in terms of the typical multiple of valuation cycles (ie three years)?

39. Fast Track guidelines on RP length continued...

b. Do you consider it would be more appropriate to have a single maximum guidance RP length and to expect trustees (under the Bespoke framework) to justify any plans that are longer than this?

c. Do you think Fast Track RP lengths should be shorter for schemes nearing and/or at significant maturity? If so, to what extent?

40. Fast Track guidelines on RP structure

Should the extent of back-end loading be limited to increases which are in line with inflation (in the absence of appropriate additional support such as a contingent asset being provided)? Or should there be more flexibility subject to a significant proportion of DRCs being committed in the early years of the plan? If inflation-linked increases are acceptable, what measure of inflation do you consider would be an appropriate benchmark?

41. Fast Track guidelines on investment outperformance

Should investment outperformance not be allowed in Fast Track RPs? What do you think the impacts may be?

42. Fast Track guidelines on future RPs

In what circumstances should/could outstanding RP payments be re-spread at subsequent valuations? In particular:

a. If a scheme's funding deficit has reduced (at least) in line with the expectations at the previous valuation, would it be appropriate to maintain the same end date? Or would it be pragmatic to re-spread the remaining deficit over a renewed period?

b. If a scheme's funding deficit is higher than expected, what guidelines should apply for the appropriate length of the new RP?

c. Would the idea of 're-spreading' be more acceptable where a scheme has a long period before it becomes significantly mature?

43. Equitability

What are your views on the concept of 'equitability' in respect of how a scheme is treated compared with other stakeholders? Should any requirements be qualitative (in line with the commentary above) or should trustees also be expected to consider a specific metric? If so, what might be an appropriate measure of equitability (for example, comparing the ratio of DRCs to dividends, or the size of scheme deficit to the 'stake' of other stakeholders) and how could this reflect a scheme's superior creditor status over shareholders?

Chapter 12: Open schemes

44. Treating past service and future service liabilities separately in Fast Track
What are your views on our proposed approach to outlining code guidelines for open schemes. Should any other approach to calculating future service liabilities be considered?

45. Fast Track LTO for open schemes
Should the LTO (low dependency at significant maturity) for an open scheme be the same for a closed scheme? If not, how should they differ?

46. Fast Track TPs for open schemes
What option do you favour and why? Are there other options we should consider?

47. Fast Track guidelines for calculating future service costs

a. Which options do you favour and why? Are there any other options for calculating future service costs which should be considered, for example pre-and post-retirement discount rates?

47. Fast Track guidelines for calculating future service costs continued...

b. If Option C (best estimate) were adopted, how should the best estimate return assumption be determined? Are there any options other than those described above that we should consider?

c. Would our preferred approach (Option B) make it difficult for scheme actuaries to certify schedules of contributions?

48. Funding future service using past service surplus
Do you think that this approach to funding future service using past service surplus is reasonable? If not, why not? What else would you suggest?

49. Criteria for assessing Bespoke arrangements
What are your views on the criteria we propose to use to assess Bespoke arrangements? If you disagree, what would you change and why? What else should we consider?

Chapter 13: Bespoke framework key features

50. Bespoke examples

a. Do you have any comments on the assessments we have made in the examples above?

50. Bespoke examples continued…

b. Could you provide other examples (relevant to your own scheme experience or that of schemes you advise) of arrangements which you think will follow the Bespoke route? Why do you think these arrangements would be compliant?

c. In example 2 (LTO–CDI strategy), could it be appropriate, in your view, to be able to use a higher discount rate/lower value of TPs (low dependency basis) than in Fast Track? If so, in what circumstances and by how much?

51. Stressed schemes

a. Assuming that affordability is genuinely constrained, are very long RPs 'appropriate' and therefore compliant with the Act?

b. Alternatively, should we make an exception to the principles and allow the trustees of stressed schemes to take unsupported investment risk, or more risk investment risk than other CG4 schemes (schemes with weak employers)? What checks and balances should we put in place in addition to those mentioned above (equitable treatment, risk management)?

51. Stressed schemes continued…

c. For schemes with unviable RPs, should an exception be made for them in terms of the level of acceptable investment risk?

d. Are you aware of situations other than stressed schemes where the trustees and employer would have difficulties meeting the Bespoke compliance principles?

Chapter 14: Additional support

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?

53. Accessing additional support

When do you think trustees should be able to access the additional support? Does it depend on the Bespoke arrangement and the type of risk that it supports?

54. Assessing the value of additional support

Should trustees be required to assess the stressed value of any contingent asset? What other guidance do you think we should set out on the recoverable value of contingent asset support?

55. Independent valuation

Should trustees always be expected to seek an independent valuation of continient assets, or should it depend on asset value and/or type? If this should be based on value thresholds, how should these be defined? How frequently should we expect trustees to seek an independent valuation? Should trustees be expected to regularly monitor contingent asset value in the intervening period?

56. Guarantees

a. Should we treat guarantee support differently to asset backed support?

b. Should trustees rely on guarantee support to change the covenant grade assessment or do you think in these circumstances the supporting entity should become a statutory employer instead?

57. Other mitigations
Can you think of any other types of arrangements which can help trustees mitigate risks?

58. Reporting information on additional support

Is there any reason why it would be unreasonable to expect trustees to undertake the analysis and provide the information outlined above? Is there additional information that should also be provided to us?

How to contact us

Napier House
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Brighton
BN1 4DW

www.tpr.gov.uk

www.trusteetoolkit.com
Free online learning for trustees

Consultation questions
Defined benefit funding code of practice

Brent	**Pension Board** 25 March 2020
	Report from the Director of Finance
2019 Triennial Valuation Results and Funding Strategy Statement	

Wards Affected:	ALL
Key or Non-Key Decision:	Non-Key
Open or Part/Fully Exempt: (If exempt, please highlight relevant paragraph of Part 1, Schedule 12A of 1972 Local Government Act)	PART EXEMPT - as it contains the following category of exempt information as specified in Paragraph 3, Schedule 12A of the Local Government Act 1972, namely: "Information relating to the financial or business affairs of any particular person (including the authority holding that information)"
No. of Appendices:	Four 1. Draft valuation report (Exempt) 2. Contribution Rate Modelling (Exempt) 3. Brent Council - Contribution Options (Exempt) 4. Funding Strategy Statement (FSS) (Open)
Background Papers:	▪ N/A
Contact Officer(s): (Name, Title, Contact Details)	Minesh Patel, Director of Finance Ravinder Jassar, Head of Finance Sawan Shah, Senior Finance Analyst

1.0 Purpose of the Report

1.1 This report sets out the results of 2019 triennial actuarial valuation and the Funding Strategy Statement (FSS) to the Committee for consideration and approval.

2.0 Recommendation(s)

2.1 To note, comment and agree the draft valuation report and that members of the committee delegate authority to the Director of Finance to finalise the report before 31 March 2020.

2.2 To approve the contribution rate for the next three financial years for Brent Council, as 35.0% for 2020/21, 2021/22 and 2022/23 as set out in section 3.8 of this report and Appendix 2.

2.3 To delegate authority to the Director of Finance to finalise details of the advance payment of Brent Council's employer contributions and the subsequent impact on the rates and adjustment certificate, as set out in section 3.9 of this report and Appendix 3.

2.4 To approve the Funding Strategy Statement (FSS) as set out in section 3.13 of this report and Appendix 4.

3.0 Detail

3.1 Members of the committee will be aware from previous reports presented to the committee and training sessions that the Fund is required by law to undertake and actuarial every three years. All funds in the England and Wales are required to carry out a valuation as at 31 March 2019.

3.2 The purpose of the valuation is to value the assets and liabilities of each individual employer and the pension fund as a whole, with a view to setting employer contribution rates which will result in each employer's liabilities becoming as close to fully funded as possible over the agreed recovery period outlined in the Funding Strategy Statement (FSS).

3.3 Hymans Robertson, the Fund actuary, attended the October 2019 meeting outlining the valuation process, the assumptions used and the initial results.

3.4 At the meeting, the committee heard why the assumptions were being used, a presentation of the whole fund results including the funding level, assets, liabilities and the overall deficit level. It was also explained that different employers within the Fund will have different funding levels due to the profile of their members and contribution rates in the past.

3.5 Since that meeting draft valuation results schedules, which set the contribution rate for each employer for the next three financial years, have been produced for the Council and for most employers within the Fund. These have been communicated to employers. For a small number of employers where results have not yet been issued, these will be sent out as soon as possible.

3.6 The draft valuation report, attached in restricted Appendix 1, summarises the process that has taken place and presents the valuation results, funding position and employer contribution rates for 2020/21 to 2022/23. This report recommends the committee to note, comment and agree the draft valuation report and delegate authority to the Director of Finance to finalise the report.

3.7 In line with the valuation process, the council commissioned a contribution rate modelling exercise to allow the officers to consider a long term funding strategy for the stabilised employers within the Fund, that is, Brent Council, academies and local authority schools.

3.8 Based on the results of this modelling work and discussions with the fund actuary, officers propose to freeze contribution rate at 35% of pay for next 3 years and stabilised thereafter at +/- 1% per annum because there is an acceptable likelihood of success and downside risk on the 16 or 19 year time horizon. This proposal has been agreed by the Fund actuary. The full contribution rate modelling report is attached in restricted Appendix 2. This report recommends to approve the contribution rate for the next three financial years for Brent Council, as 35.0% for 2020/21, 2021/22 and 2022/23.

3.9 As part of the valuation, the council is considering paying a large part of its employer contributions upfront as a lump sum. A report was commissioned by the Fund actuary to model a number of options, set out further in Appendix 3, which concluded that there is an economic benefit to the Council in considering this and there is no negative impact on the pension fund.

3.10 This proposal, which is now quite common across a number of LGPS funds, is still under consideration as it requires advance clearance with the Council's auditor and is subject to independent advice. It is envisaged that a decision on the pre-payment will be taken in early March 2020, in order to be reflected in the formal valuation.

3.11 The Funding Strategy Statement (FSS) is a document detailing how employer contributions to the Pension Fund are calculated. It is normally updated in line with the triennial valuation to ensure consistency.

3.12 The fund needs an FSS because:

- It is a legal requirement under the LGPS Regulations, and also to revise this at each formal valuation;
- It shows employers how their cash contributions are calculated, and how these might change if the employer's circumstances change.
- It acts as a valuable policy/reference document for the Fund to help deal with employers who raise issues between valuations.

3.13 At the October 2019 committee meeting, the committee agreed the draft FSS for consultation with employers. The consultation has now been completed by officers and the final FSS is provided in Appendix 4 for committee approval.

4.0 Financial Implications

4.1 These are discussed throughout the report.

5.0 Legal Implications

5.1 The triennial valuation is a statutory process conducted every three years that ensures the Pension Fund is both compliant with LGPS regulations and has a viable long-term funding strategy. The latter is achieved by ensuring it has a robust Funding Strategy Statement (FSS) and Investment Strategy Statement.

6.0 Equality Implications

6.1 Not applicable.

7.0 Consultation with Ward Members and Stakeholders

7.1 Not applicable.

8.0 Human Resources

8.1 Not applicable.

<u>Report sign off:</u>

Minesh Patel
Director of Finance
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London Borough of Brent Pension Fund

Funding Strategy Statement

February 2020

Contents

Funding Strategy Statement PAGE

Appendices

1. Introduction

1.1 What is this document?

This is the Funding Strategy Statement (FSS) of the London Borough of Brent Pension Fund ("the Fund"), which is administered by the London Borough of Brent, ("the Administering Authority").

It has been prepared by the Administering Authority in collaboration with the Fund's actuary, Hymans Robertson LLP, and after consultation with the Fund's employers and investment adviser. It is effective from 25th February 2020.

1.2 What is the London Borough of Brent Pension Fund?

The Fund is part of the national Local Government Pension Scheme (LGPS). The LGPS was set up by the UK Government to provide retirement and death benefits for local government employees, and those employed in similar or related bodies, across the whole of the UK. The Administering Authority runs the London Borough of Brent Fund, in effect the LGPS for the Brent area, to make sure it:

- receives the proper amount of contributions from employees and employers, and any transfer payments;
- invests the contributions appropriately, with the aim that the Fund's assets grow over time with investment income and capital growth; and
- uses the assets to pay Fund benefits to the members (as and when they retire, for the rest of their lives), and to their dependants (as and when members die), as defined in the LGPS Regulations. Assets are also used to pay transfer values and administration costs.

The roles and responsibilities of the key parties involved in the management of the Fund are summarised in Appendix B.

1.3 Why does the Fund need a Funding Strategy Statement?

Employees' benefits are guaranteed by the LGPS Regulations, and do not change with market values or employer contributions. Investment returns will help pay for some of the benefits, but probably not all, and certainly with no guarantee. Employees' contributions are fixed in those Regulations also, at a level which covers only part of the cost of the benefits.

Therefore, employers need to pay the balance of the cost of delivering the benefits to members and their dependants.

The FSS focuses on how employer liabilities are measured, the pace at which these liabilities are funded, and how employers or pools of employers pay for their own liabilities. This statement sets out how the Administering Authority has balanced the conflicting aims of:

- affordability of employer contributions,
- transparency of processes,
- stability of employers' contributions, and
- prudence in the funding basis.

There are also regulatory requirements for an FSS, as given in Appendix A.

The FSS is a summary of the Fund's approach to funding its liabilities, and this includes reference to the Fund's other policies; it is not an exhaustive statement of policy on all issues. The FSS forms part of a framework which includes:

- the LGPS Regulations;
- the Rates and Adjustments Certificate (confirming employer contribution rates for the next three years) which can be found in an appendix to the formal valuation report;
- the Fund's policies on admissions, cessations and bulk transfers;
- actuarial factors for valuing individual transfers, early retirement costs and the costs of buying added service; and
- the Fund's Statement of Investment Principles / Investment Strategy Statement (see Section 4)

1.4 How does the Fund and this FSS affect me?

This depends who you are:

- a member of the Fund, i.e. a current or former employee, or a dependant: the Fund needs to be sure it is collecting and holding enough money so that your benefits are always paid in full;
- an employer in the Fund (or which is considering joining the Fund): you will want to know how your contributions are calculated from time to time, that these are fair by comparison to other employers in the Fund, in what circumstances you might need to pay more and what happens if you cease to be an employer in the Fund. Note that the FSS applies to all employers participating in the Fund;
- an Elected Member of the London Borough of Brent: you will want to be sure that the council balances the need to hold prudent reserves for members' retirement and death benefits, with the other competing demands for council money;
- a Council Tax payer: your council seeks to strike the balance above, and also to minimise cross-subsidies between different generations of taxpayers.

1.5 What does the FSS aim to do?

The FSS sets out the objectives of the Fund's funding strategy, such as:

- to ensure the long-term solvency of the Fund, using a prudent long term view. This will ensure that sufficient funds are available to meet all members'/dependants' benefits as they fall due for payment;
- to ensure that employer contribution rates are reasonably stable where appropriate;
- to minimise the long-term cash contributions which employers need to pay to the Fund, by recognising the link between assets and liabilities and adopting an investment strategy which balances risk and return (**NB** this will also minimise the costs to be borne by Council Tax payers);
- to reflect the different characteristics of different employers in determining contribution rates. This involves the Fund having a clear and transparent funding strategy to demonstrate how each employer can best meet its own liabilities over future years; and

- to use reasonable measures to reduce the risk to other employers and ultimately to the Council Tax payer from an employer defaulting on its pension obligations.

1.6 How do I find my way around this document?

In Section 2 there is a brief introduction to some of the main principles behind funding, i.e. deciding how much an employer should contribute to the Fund from time to time.

In Section 3 we outline how the Fund calculates the contributions payable by different employers in different situations.

In Section 4 we show how the funding strategy is linked with the Fund's investment strategy.

In the Appendices we cover various issues in more detail if you are interested:

A. the regulatory background, including how and when the FSS is reviewed,

B. who is responsible for what,

C. what issues the Fund needs to monitor, and how it manages its risks,

D. some more details about the actuarial calculations required,

E. the assumptions which the Fund actuary currently makes about the future,

F. a glossary explaining the technical terms occasionally used here.

If you have any other queries please contact Ravinder Jassar in the first instance at e-mail address Ravinder.jassar@brent.gov.uk or on telephone number 0208 937 1487.

2. Basic Funding issues

(More detailed and extensive descriptions are given in Appendix D).

2.1 How does the actuary calculate the required contribution rate?

In essence this is a three-step process:

1. Calculate the funding target for that employer, i.e. the estimated amount of assets it should hold in order to be able to pay all its members' benefits. See Appendix E for more details of what assumptions we make to determine that funding target;

2. Determine the time horizon over which the employer should aim to achieve that funding target. See the table in 3.3 and Note (c) for more details;

3. Calculate the employer contribution rate such that it has at least a given likelihood of achieving that funding target over that time horizon, allowing for various possible economic outcomes over that time horizon. See 2.3 below, and the table in 3.3 Note (e) for more details.

2.2 What is each employer's contribution rate?

This is described in more detail in Appendix D. Employer contributions are normally made up of two elements:

a) the estimated cost of benefits being built up each year, after deducting the members' own contributions and including an allowance for administration expenses. This is referred to as the "*Primary rate*", and is expressed as a percentage of members' pensionable pay; plus

b) an adjustment for the difference between the Primary rate above, and the actual contribution the employer needs to pay, referred to as the "*Secondary rate*". In broad terms, payment of the Secondary rate is in respect of benefits already accrued at the valuation date. The Secondary rate may be expressed as a percentage of pay and/or a monetary amount in each year.

The rates for all employers are shown in the Fund's Rates and Adjustments Certificate, which forms part of the formal Actuarial Valuation Report. Employers' contributions are expressed as minima, with employers able to pay contributions at a higher rate. Account of any higher rate will be taken by the Fund actuary at subsequent valuations, i.e. will be reflected as a credit when next calculating the employer's contributions.

2.3 What different types of employer participate in the Fund?

Historically the LGPS was intended for local authority employees only. However over the years, with the diversification and changes to delivery of local services, many more types and numbers of employers now participate. There are currently more employers in the Fund than ever before, a significant part of this being due to new academies.

In essence, participation in the LGPS is open to public sector employers providing some form of service to the local community. Whilst the majority of members will be local authority employees (and ex-employees), the majority of participating employers are those providing services in place of (or alongside) local authority services: academy schools, contractors, housing associations, charities, etc.

The LGPS Regulations define various types of employer as follows:

Scheduled bodies - councils, and other specified employers such as academies and further education establishments. These must provide access to the LGPS in respect of their employees who are not eligible to join another public sector scheme (such as the Teachers Scheme). These employers are so-called because they are specified in a schedule to the LGPS Regulations.

It is now possible for Local Education Authority schools to convert to academy status, and for other forms of school (such as Free Schools) to be established under the academies legislation. All such **academies (or Multi Academy Trusts)**, as employers of non-teaching staff, become separate new employers in the Fund. As academies are defined in the LGPS Regulations as "Scheduled Bodies", the Administering Authority has no discretion over whether to admit them to the Fund, and the academy has no discretion whether to continue to allow its non-teaching staff to join the Fund. There has also been guidance issued by the MHCLG regarding the terms of academies' membership in LGPS Funds.

Designating employers – some employers are able to participate in the LGPS via a resolution (and the Fund cannot refuse them entry where the resolution is passed). These employers can designate which of their employees are eligible to join the scheme.

Other employers are able to participate in the Fund via an admission agreement, and are referred to as 'admission bodies'. These employers are generally those with a "community of interest" with another scheme employer – **community admission bodies** ("CAB") or those providing a service on behalf of a scheme employer – **transferee admission bodies** ("TAB"). CABs will include housing associations and charities, TABs will generally be contractors. The Fund is able to set its criteria for participation by these employers and can refuse entry if the requirements as set out in the Fund's admissions policy are not met. (NB The terminology CAB and TAB has been dropped from recent LGPS Regulations, which instead combine both under the single term 'admission bodies'; however, we have retained the old terminology here as we consider it to be helpful in setting funding strategies for these different employers.

2.4 How does the calculated contribution rate vary for different employers?

All three steps above are considered when setting contributions (more details are given in Section 3 and Appendix D).

1. The **funding target** is based on a set of assumptions about the future, (e.g. investment returns, inflation, pensioners' life expectancies). If an employer is approaching the end of its participation in the Fund then its funding target may be set on a more prudent basis, so that its liabilities are less likely to be spread among other employers after its cessation;

2. The **time horizon** required is the period over which the funding target is achieved. Employers may be given a lower time horizon if they have a less permanent anticipated membership, or do not have tax-raising powers to increase contributions if investment returns under-perform; and

3. The **likelihood of achieving** the funding target over that time horizon will be dependent on the Fund's view of the strength of employer covenant and its funding profile. Where an employer is considered to be weaker, then the required likelihood will be set higher, which in turn will increase the required contributions (and vice versa).

For some employers it may be agreed to pool contributions, see 3.4.

Any costs of non ill-health early retirements must be paid by the employer, see 3.6.

Costs of ill-health early retirements are covered in 3.7 and 3.8.

2.5 How is a funding level calculated?

An employer's "funding level" is defined as the ratio of:

- the market value of the employer's share of assets (see Appendix D, section D5, for further details of how this is calculated), to
- the value placed by the actuary on the benefits built up to date for the employer's employees and ex-employees (the "liabilities"). The Fund actuary agrees with the Administering Authority the assumptions to be used in calculating this value.

If this is less than 100% then it means the employer has a shortfall, which is the employer's deficit; if it is more than 100% then the employer is said to be in surplus. The amount of deficit or shortfall is the difference between the asset value and the liabilities value.

It is important to note that the funding level and deficit/surplus are only measurements at a particular point in time, on a particular set of assumptions about the future. Whilst we recognise that various parties will take an interest in these measures, for most employers the key issue is how likely it is that their contributions will be sufficient to pay for their members' benefits (when added to their existing asset share and anticipated investment returns).

In short, funding levels and deficits are short term high level risk measures, whereas contribution-setting is a longer term issue.

2.6 How does the Fund recognise that contribution levels can affect council and employer service provision, and council tax?

The Administering Authority and the Fund actuary are acutely aware that, all other things being equal, a higher contribution required to be paid to the Fund will mean less cash available for the employer to spend on the provision of services. For instance:

- Higher Pension Fund contributions may result in reduced council spending, which in turn could affect the resources available for council services, and/or greater pressure on council tax levels;
- Contributions which Academies pay to the Fund will therefore not be available to pay for providing education; and
- Other employers will provide various services to the local community, perhaps through housing associations, charitable work, or contracting council services. If they are required to pay more in pension contributions to the LGPS then this may affect their ability to provide the local services at a reasonable cost.

Whilst all this is true, it should also be borne in mind that:

- The Fund provides invaluable financial security to local families, whether to those who formerly worked in the service of the local community who have now retired, or to their families after their death;

- The Fund must have the assets available to meet these retirement and death benefits, which in turn means that the various employers must each pay their own way. Lower contributions today will mean higher contributions tomorrow: deferring payments does not alter the employer's ultimate obligation to the Fund in respect of its current and former employees;
- Each employer will generally only pay for its own employees and ex-employees (and their dependants), not for those of other employers in the Fund;
- The Fund strives to maintain reasonably stable employer contribution rates where appropriate and possible. However, a recent shift in regulatory focus means that solvency within each generation is considered by the Government to be a higher priority than stability of contribution rates;
- The Fund wishes to avoid the situation where an employer falls so far behind in managing its funding shortfall that its deficit becomes unmanageable in practice: such a situation may lead to employer insolvency and the resulting deficit falling on the other Fund employers. In that situation, those employers' services would in turn suffer as a result;
- Council contributions to the Fund should be at a suitable level, to protect the interests of different generations of council tax payers. For instance, underpayment of contributions for some years will need to be balanced by overpayment in other years; the council will wish to minimise the extent to which council tax payers in one period are in effect benefitting at the expense of those paying in a different period.

Overall, therefore, there is clearly a balance to be struck between the Fund's need for maintaining prudent funding levels, and the employers' need to allocate their resources appropriately. The Fund achieves this through various techniques which affect contribution increases to various degrees (see 3.1). In deciding which of these techniques to apply to any given employer, the Administering Authority takes a view on the financial standing of the employer, i.e. its ability to meet its funding commitments and the relevant time horizon.

The Administering Authority will consider a risk assessment of that employer using a knowledge base which is regularly monitored and kept up-to-date. This database will include such information as the type of employer, its membership profile and funding position, any guarantors or security provision, material changes anticipated, etc.

For instance, where the Administering Authority has reasonable confidence that an employer will be able to meet its funding commitments, then the Fund will permit options such as stabilisation (see 3.3 Note (b)), a longer time horizon relative to other employers, and/or a lower likelihood of achieving their funding target. Such options will temporarily produce lower contribution levels than would otherwise have applied. This is permitted in the expectation that the employer will still be able to meet its obligations for many years to come.

On the other hand, where there is doubt that an employer will be able to meet its funding commitments or withstand a significant change in its commitments, then a higher funding target, and/or a shorter time horizon relative to other employers, and/or a higher likelihood of achieving the target may be required.

The Fund actively seeks employer input, including to its funding arrangements, through various means: see Appendix A.

2.7 What approach has the Fund taken to dealing with uncertainty arising from the McCloud court case and its potential impact on the LGPS benefit structure?

The LGPS benefit structure from 1 April 2014 is currently under review following the Government's loss of the right to appeal the McCloud and other similar court cases. The courts have ruled that the 'transitional protections' awarded to some members of public service pension schemes when the schemes were reformed (on 1 April 2014 in the case of the LGPS) were unlawful on the grounds of age discrimination. At the time of writing, the Ministry of Housing, Communities and Local Government (MHCLG) has not provided any details of changes as a result of the case. However it is expected that benefits changes will be required and they will likely increase the value of liabilities. At present, the scale and nature of any increase in liabilities are unknown, which limits the ability of the Fund to make an accurate allowance.

The LGPS Scheme Advisory Board (SAB) issued advice to LGPS funds in May 2019. As there was no finalised outcome of the McCloud case by 31 August 2019, the Fund Actuary has acted in line with SAB's advice and valued all member benefits in line with the current LGPS Regulations.

The Fund, in line with the advice in the SAB's note, has considered how to allow for this risk in the setting of employer contribution rates. As the benefit structure changes that will arise from the McCloud judgement are uncertain, the Fund has elected to make an approximate allowance for the potential impact in the assessment of employer contribution rates at the 2019 valuation: this will be achieved by building in a slightly higher required likelihood of reaching funding target, all other things being equal.

The fund will reassess the employer contribution rates at the next formal valuation of the Fund. If the outcome of the McCloud case is then known, a more accurate allowance for the impact will be made at that time.

The Fund has also considered the McCloud judgement in its approach to cessation valuations. Please see note (j) to table 3.3 for further information.

2.8 When will the next actuarial valuation be?

On 8 May 2019 MHCLG issued a consultation seeking views on (among other things) proposals to amend the LGPS valuation cycle in England and Wales from a three year (triennial) valuation cycle to a four year (quadrennial) valuation cycle.

The Fund intends to carry out its next actuarial valuation in 2022 (3 years after the 2019 valuation date) in line with MHCLG's desired approach in the consultation. The Fund has therefore instructed the Fund Actuary to certify contribution rates for employers for the period 1 April 2020 to 31 March 2023 as part of the 2019 valuation of the Fund.

3. Calculating contributions for individual Employers

3.1 General comments

A key challenge for the Administering Authority is to balance the need for stable, affordable employer contributions with the requirement to take a prudent, longer-term view of funding and ensure the solvency of the Fund. With this in mind, the Fund's three-step process identifies the key issues:

1. What is a suitably (but not overly) prudent funding target?

2. How long should the employer be permitted to reach that target? This should be realistic but not so long that the funding target is in danger of never actually being achieved.

3. What likelihood is required to reach that funding target? This will always be less than 100% as we cannot be certain of the future. Higher likelihood "bars" can be used for employers where the Fund wishes to reduce the risk that the employer ceases leaving a deficit to be picked up by other employers.

These and associated issues are covered in this Section.

The Administering Authority recognises that there may occasionally be particular circumstances affecting individual employers that are not easily managed within the rules and policies set out in the Funding Strategy Statement. Therefore the Administering Authority reserves the right to direct the actuary to adopt alternative funding approaches on a case by case basis for specific employers.

3.2 The effect of paying lower contributions

In limited circumstances the Administering Authority may permit employers to pay contributions at a lower level than is assessed for the employer using the three step process above. At their absolute discretion the Administering Authority may:

- extend the time horizon for targeting full funding;
- adjust the required likelihood of meeting the funding target;
- permit an employer to participate in the Fund's stabilisation mechanisms;
- permit extended phasing in of contribution rises or reductions;
- pool contributions amongst employers with similar characteristics; and/or
- accept some form of security or guarantee in lieu of a higher contribution rate than would otherwise be the case.

Employers which are permitted to use one or more of the above methods will often be paying, for a time, contributions less than required to meet their funding target, over the appropriate time horizon with the required likelihood of success. Such employers should appreciate that:

- their true long term liability (i.e. the actual eventual cost of benefits payable to their employees and ex-employees) is not affected by the pace of paying contributions;
- lower contributions in the short term will result in a lower level of future investment returns on the employer's asset share. Thus, deferring a certain amount of contribution may lead to higher contributions in the long-term; and

- it may take longer to reach their funding target, all other things being equal.

Overleaf (3.3) is a summary of how the main funding policies differ for different types of employer, followed by more detailed notes where necessary.

Section 3.4 onwards deals with various other funding issues which apply to all employers.

3.3 The different approaches used for different employers

Type of employer	**Scheduled Bodies**			**Community Admission Bodies and Designating Employers**		**Transferee Admission Bodies**
Sub-type	**Local Authorities**	**Academies**	**Other**	**Open to new entrants**	**Closed to new entrants**	**(all)**
Funding Target Basis used	Ongoing participation basis, assumes long-term Fund participation (see Appendix E)			Ongoing participation basis, but may move to "gilts exit basis" - see Note (a)		Contractor exit basis, assumes fixed contract term in the Fund (see Appendix E)
Primary rate approach	(see Appendix D – D.2)					
Stabilised contribution rate?	Yes - see Note (b)	Yes - see Note (b)	No	No	No	No
Maximum time horizon – Note (c)	19 years	19 years	19 years	19 years	Future working lifetime of actives	As per letting employer
Secondary rate – Note (d)	% of payroll	% of payroll	Monetary	Monetary	Monetary	Monetary
Treatment of surplus	Covered by stabilisation arrangement		Preferred approach: contributions kept at Primary rate. However, reductions may be permitted by the Administering Authority			Reduce contributions by spreading the surplus over the remaining contract term if less than 4 years, else no reduction
Likelihood of achieving target – Note (e)	70%	75%	70%	75%	80%	70%
Phasing of contribution changes	Covered by stabilisation arrangement		3 years	3 years	3 years	None
Review of rates – Note (f)	Administering Authority reserves the right to review contribution rates and amounts, and the level of security provided, at regular intervals between valuations					Particularly reviewed in last 3 years of contract
New employer	n/a	Note (g)	n/a	Note (h)		Notes (h) & (i)
Cessation of participation: exit debt/credit payable	Cessation is assumed not to be generally possible, as Scheduled Bodies are legally obliged to participate in the LGPS. In the rare event of cessation occurring (machinery of Government changes for example), the cessation calculation principles applied would be as per Note (j).			Can be ceased subject to terms of admission agreement. Exit debt/credit will be calculated on a basis appropriate to the circumstances of cessation – see Note (j).		Participation assumed to expire at end of contract. Cessation debt/credit calculated on the contractor exit basis, unless the admission agreement is terminated early by the contractor in which case low risk basis would apply. Letting employer liable for future deficits and contributions arising. See Note (i) for further details

Note (a) (Gilts exit basis for CABs and Designating Employers closed to new entrants)

In the circumstances where:

- the employer is a Designating Employer, or an Admission Body but not a Transferee Admission Body, and
- the employer has no guarantor, and
- the admission agreement is likely to terminate, or the employer is likely to lose its last active member, within a timeframe considered appropriate by the Administering Authority to prompt a change in funding,

the Administering Authority may set a higher funding target (e.g. based on the return from long term gilt yields) by the time the agreement terminates or the last active member leaves, in order to protect other employers in the Fund. This policy will increase regular contributions and reduce, but not entirely eliminate, the possibility of a final deficit payment being required from the employer when a cessation valuation is carried out.

The Administering Authority also reserves the right to adopt the above approach in respect of those Designating Employers and Admission Bodies with no guarantor, where the strength of covenant is considered to be weak but there is no immediate expectation that the admission agreement will cease or the Designating Employer alters its designation.

Note (b) (Stabilisation)

Stabilisation is a mechanism where employer contribution rate variations from year to year are kept within a pre-determined range, thus allowing those employers' rates to be relatively stable. In the interests of stability and affordability of employer contributions, the Administering Authority, on the advice of the Fund Actuary, believes that stabilising contributions can still be viewed as a prudent longer-term approach. However, employers whose contribution rates have been "stabilised" (and may therefore be paying less than their theoretical contribution rate) should be aware of the risks of this approach and should consider making additional payments to the Fund if possible.

This stabilisation mechanism allows short term investment market volatility to be managed so as not to cause volatility in employer contribution rates, on the basis that a long term view can be taken on net cash inflow, investment returns and strength of employer covenant.

The current stabilisation mechanism applies if:

- the employer satisfies the eligibility criteria set by the Administering Authority (see below) and;
- there are no material events which cause the employer to become ineligible, e.g. significant reductions in active membership (due to outsourcing or redundancies), or changes in the nature of the employer (perhaps due to Government restructuring), or changes in the security of the employer.

Currently the only eligible Fund employer is the London Borough of Brent's Council Pool, although Academies will pay the same rate as the Council for at least the three years beginning 1 April 2020 (see Note (g)).

On the basis of extensive modelling carried out for the 2019 valuation exercise (see Section 4), the current stabilised rate for the Council Pool is a total contribution rate 35.0%, payable for the three years beginning 1 April 2020.

The stabilisation criteria and limits will be reviewed at the next formal valuation. This will take into account the Council's membership profile, whether stabilisation should continue to apply (and if so, whether this should be extended to other employers), and other relevant factors.

Note (c) (Maximum time horizon)

The maximum time horizon starts at the commencement of the revised contribution rate (1 April 2020 for the 2019 valuation). The Administering Authority would normally expect the same period to be used at successive triennial valuations, but would reserve the right to propose alternative time horizons, for example where there were no new entrants.

For employers with no (or very few) active members at this valuation, the deficit should be recovered by a fixed monetary amount over a period to be agreed with the body or its successor, typically not to exceed 3 years.

Note (d) (Secondary rate)

The Secondary contributions for each employer are typically expressed in monetary terms (as opposed to percentage of payroll). This is to avoid the situation where a stagnating or falling payroll results in insufficient secondary contributions being made over the three year period.

For certain employers, at the Administering Authority's discretion but currently including all Academies, these payments may instead be set as a percentage of salaries. However, the Administering Authority reserves the right to amend these rates between valuations and/or to require these payments in monetary terms instead, for instance where:

- the employer is relatively mature, i.e. has a large deficit recovery contribution rate (e.g. above 15% of payroll), in other words its payroll is a smaller proportion of its deficit than is the case for most other employers, or
- there has been a significant reduction in payroll due to outsourcing or redundancy exercises, or
- the employer has closed the Fund to new entrants.

Note (e) Likelihood of achieving funding target)

Each employer has its funding target calculated, and a relevant time horizon over which to reach that target. Contributions are set such that, combined with the employer's current asset share and anticipated market movements over the time horizon, the funding target is achieved with a given minimum likelihood. A higher required likelihood bar will give rise to higher required contributions, and vice versa.

The way in which contributions are set using these three steps, and relevant economic projections, is described in further detail in Appendix D.

Different likelihoods are set for different employers depending on their nature and circumstances: in broad terms, a higher likelihood will apply due to one or more of the following:

- the Fund believes the employer poses a greater funding risk than other employers,
- the employer does not have tax-raising powers;
- the employer does not have a guarantor or other sufficient security backing its funding position; and/or
- the employer is likely to cease participation in the Fund in the short or medium term.

Note (f) (Regular Reviews)

Such reviews may be triggered by significant events including but not limited to: significant reductions in payroll, altered employer circumstances, Government restructuring affecting the employer's business, or failure to pay contributions or arrange appropriate security as required by the Administering Authority.

The result of a review may be to require increased contributions (by strengthening the actuarial assumptions adopted and/or moving to monetary levels of deficit recovery contributions), and/or an increased level of security or guarantee.

Note (g) (New Academy conversions)

At the time of writing, the Fund's policies on academies' funding issues are as follows:

i. The new academy will be regarded as a separate employer in its own right and will not be pooled with other employers in the Fund. The only exception is where the academy is part of a Multi Academy Trust (MAT) in which case the academy's figures will be calculated as below but can be combined with, for the purpose of setting contribution rates, those of the other academies in the MAT;

ii. The new academy's past service liabilities on conversion will be calculated based on its active Fund members on the day before conversion. For the avoidance of doubt, these liabilities will include all past service of those members, but will exclude the liabilities relating to any ex-employees of the school who have deferred or pensioner status;

iii. The new academy will be allocated an initial asset share from the ceding council's assets in the Fund. This asset share will be calculated using the estimated funding position of the ceding council at the date of academy conversion. The share will be based on the active members' funding level, having first allocated assets in the council's share to fully fund deferred and pensioner members. The assets allocated to the academy will be limited if necessary so that its initial funding level is subject to a maximum of 100%. The asset allocation will be based on market conditions and the academy's active Fund membership on the day prior to conversion;

iv. The new academy's calculated contribution rate will be based on the time horizon and likelihood of achieving funding target outlined for Academies in the table in Section 3.3 above;

v. The new academy's actual contribution rate will be as per the Council rate, expressed purely as a percentage of pensionable pay. This applies whether or not the theoretical rate is above the Council rate. All other things being equal, this will mean some academies taking longer to pay off their deficit (where the theoretical rate is higher than the Council rate), or paying off the deficit more quickly (where the theoretical rate is below the Council rate).

The Fund's policies on academies are subject to change in the light of any amendments to MHCLGand/or DfE guidance or removal of the formal guarantee currently provided to academies by the DfE . Any changes will be notified to academies, and will be reflected in a subsequent version of this FSS. In particular, policies (iv) and (v) above will be reconsidered at each valuation.

Note (h) (New Admission Bodies)

With effect from 1 October 2012, the LGPS 2012 Miscellaneous Regulations introduced mandatory new requirements for all Admission Bodies brought into the Fund from that date. Under these Regulations, all new Admission Bodies will be required to provide some form of security, such as a guarantee from the letting employer, an indemnity or a bond. The security is required to cover some or all of the following:

- the strain cost of any redundancy early retirements resulting from the premature termination of the contract;
- allowance for the risk of asset underperformance;
- allowance for the risk of a greater than expected rise in liabilities;
- allowance for the possible non-payment of employer and member contributions to the Fund; and/or
- the current deficit.

Transferee Admission Bodies: For all TABs, the security must be to the satisfaction of the Administering Authority as well as the letting employer, and will be reassessed on an annual basis. See also Note (i) below.

Community Admission Bodies: The Administering Authority will only consider requests from CABs (or other similar bodies, such as section 75 NHS partnerships) to join the Fund if they are sponsored by a Scheduled Body with tax raising powers, guaranteeing their liabilities and also providing a form of security as above.

The above approaches reduce the risk, to other employers in the Fund, of potentially having to pick up any shortfall in respect of Admission Bodies ceasing with an unpaid deficit.

Note (i) (New Transferee Admission Bodies)

A new TAB usually joins the Fund as a result of the letting/outsourcing of some services from an existing employer (normally a Scheduled Body such as a council or academy) to another organisation (a "contractor"). This involves the TUPE transfer of some staff from the letting employer to the contractor. Consequently, for the duration of the contract, the contractor is a new participating employer in the Fund so that the transferring employees maintain their eligibility for LGPS membership. At the end of the contract the employees revert to the letting employer or to a replacement contractor.

Ordinarily, the TAB would be set up in the Fund as a new employer with responsibility for all the accrued benefits of the transferring employees; in this case, the contractor would usually be assigned an initial asset allocation equal to the past service liability value of the employees' Fund benefits. The quid pro quo is that the contractor is then expected to ensure that its share of the Fund is also fully funded at the end of the contract: see Note (j).

Employers which "outsource" have flexibility in the way that they can deal with the pension risk potentially taken on by the contractor. In particular there are three different routes that such employers may wish to adopt. Clearly as the risk ultimately resides with the employer letting the contract, it is for them to agree the appropriate route with the contractor:

i) <u>Pooling</u>

Under this option the contractor is pooled with the letting employer. In this case, the contractor pays the same rate as the letting employer, which may be under a stabilisation approach.

ii) <u>Letting employer retains pre-contract risks</u>

Under this option the letting employer would retain responsibility for assets and liabilities in respect of service accrued prior to the contract commencement date. The contractor would be responsible for the future liabilities that accrue in respect of transferred staff. The contractor's contribution rate could vary from one valuation to the next. It would be liable for any deficit (or entitled to any surplus) at the end of the contract term in respect of assets and liabilities attributable to service accrued during the contract term.

iii) <u>Fixed contribution rate agreed</u>

Under this option the contractor pays a fixed contribution rate throughout its participation in the Fund and on cessation does not pay any deficit or receive an exit credit. In other words, the pension risks "pass through" to the letting employer.

The Administering Authority is willing to administer any of the above options as long as the approach is documented in the Admission Agreement as well as the transfer agreement. Any risk sharing agreement should ensure that some element of risk transfers to the contractor where it relates to their decisions and it is unfair to burden the letting employer with that risk. For example the contractor should typically be responsible for pension costs that arise from:

- above average pay increases, including the effect in respect of service prior to contract commencement even if the letting employer takes on responsibility for the latter under (ii) above; and
- redundancy and early retirement decisions.

redundancy and early retirement decisions.

Note (j) (Admission Bodies Ceasing)

Notwithstanding the provisions of the Admission Agreement, the Administering Authority may consider any of the following as triggers for the cessation of an admission agreement with any type of body:

- Last active member ceasing participation in the Fund (NB recent LGPS Regulation changes mean that the Administering Authority has the discretion to defer taking action for up to three years, so that if the employer acquires one or more active Fund members during that period then cessation is not triggered. The current Fund policy is that this is left as a discretion and may or may not be applied in any given case);
- The insolvency, winding up or liquidation of the Admission Body;
- Any breach by the Admission Body of any of its obligations under the Agreement that they have failed to remedy to the satisfaction of the Fund;
- A failure by the Admission Body to pay any sums due to the Fund within the period required by the Fund; or
- The failure by the Admission Body to renew or adjust the level of the bond or indemnity, or to confirm an appropriate alternative guarantor, as required by the Fund.

On cessation, the Administering Authority will instruct the Fund actuary to carry out a cessation valuation to determine whether there is any deficit or surplus. Where there is a deficit, payment of this amount in full would normally be sought from the Admission Body; where there is a surplus, following the LGPS (Amendment) Regulations 2018 which came into effect on 14th May 2018, this will normally result in an exit credit payment to the Admission Body. If a risk-sharing agreement has been put in place (please see note (i) above) no cessation debt or exit credit may be payable, depending on the terms of the agreement.

As discussed in Section 2.7, the LGPS benefit structure from 1 April 2014 is currently under review following the Government's loss of the right to appeal the McCloud and other similar court cases. The Fund has considered how it will reflect the current uncertainty regarding the outcome of this judgement in its approach to cessation valuations. For cessation valuations that are carried out before any changes to the LGPS benefit structure (from 1 April 2014) are confirmed, the Fund's policy is that the actuary will apply a [x%] loading to the ceasing employer's post 2014 benefit accrual value, as an estimate of the possible impact of resulting benefit changes.

For non-Transferee Admission Bodies whose participation is voluntarily ended either by themselves or the Fund, or where a cessation event has been triggered, the Administering Authority must look to protect the interests of other ongoing employers. The actuary will therefore adopt an approach which, to the extent reasonably practicable, protects the other employers from the likelihood of any material loss emerging in future:

(a) Where a guarantor does not exist then, in order to protect other employers in the Fund, the cessation liabilities and final surplus/deficit will normally be calculated using a "gilts exit basis", which is more prudent than the ongoing participation basis. This has no allowance for potential future investment outperformance above gilt yields, and has added allowance for future improvements in life expectancy. This could give rise to significant cessation debts being required.

(b) Where there is a guarantor for future deficits and contributions, the details of the guarantee will be considered prior to the cessation valuation being carried out. In some cases the guarantor is simply guarantor of last resort and therefore the cessation valuation will be carried out consistently with the approach taken had there been no guarantor in place. Alternatively, where the guarantor is not simply guarantor of last resort, the cessation may be calculated using the ongoing participation basis or contractor exit basis as described in Appendix E;

(c) Again, depending on the nature of the guarantee, it may be possible to simply transfer the former Admission Body's liabilities and assets to the guarantor, without needing to crystallise any deficit or surplus. This approach may be adopted where the employer cannot pay the contributions due, and this is within the terms of the guarantee.

Under (a) and (b), any shortfall would usually be levied on the departing Admission Body as a single lump sum payment. If this is not possible then the Fund may spread they payment subject to there being some security in place for the employer such as a bond indemnity or guarantee.

In the event that the Fund is not able to recover the required payment in full, then the unpaid amounts fall to be shared amongst all of the other employers in the Fund. This may require an immediate revision to the Rates and Adjustments Certificate affecting other employers in the Fund, or instead be reflected in the contribution rates set at the next formal valuation following the cessation date.

As an alternative, where the ceasing Admission Body is continuing in business, the Fund at its absolute discretion reserves the right to enter into an agreement with the ceasing Admission Body. Under this agreement the Fund would accept an appropriate alternative security to be held against any deficit on the gilts exit basis, and would carry out the cessation valuation on the ongoing participation basis. Secondary contributions would be derived from this cessation debt. This approach would be monitored as part of each formal valuation and secondary contributions would be reassessed as required. The Admission Body may terminate the agreement only via payment of the outstanding debt assessed on the gilts exit basis. Furthermore,, the Fund reserves the right to revert to the "gilts exit basis" and seek immediate payment of any funding shortfall identified. The Administering Authority may need to seek legal advice in such cases, as the Admission Body would have no contributing members.

3.4 Pooled contributions

From time to time, with the advice of the Actuary, the Administering Authority may set up pools for employers with similar or complementary characteristics. This will always be in line with its broader funding strategy. The current pools in place within the Fund are as follows:

- LEA schools generally are also pooled with the Council. However there may be exceptions for specialist or independent schools.
- Academy schools may be pooled within their Multi Academy Trust (if this applies).
- Smaller Transferee Admission Bodies may be pooled with the letting employer, provided all parties (particularly the letting employer) agree.

The intention of the pool is to minimise contribution rate volatility which would otherwise occur when members join, leave, take early retirement, receive pay rises markedly different from expectations, etc. Such events can cause large changes in contribution rates for very small employers in particular, unless these are smoothed out for instance by pooling across a number of employers.

On the other hand it should be noted that the employers in the pool will still have their own individual funding positions tracked by the Actuary, so that some employers will be much better funded, and others much more poorly funded, than the pool average. This therefore means that if any given employer was funding on a stand-alone basis, as opposed to being in the pool, then its contribution rate could be much higher or lower than the pool contribution rate.

It should also be noted that, if an employer is considering ceasing from the Fund, its required contributions would be based on its own funding position (rather than the pool average), and the cessation terms would also apply: this would mean potentially very different (and in particular possibly much higher) contributions would be required from the employer in that situation.

Those employers which have been pooled are identified in the Rates and Adjustments Certificate.

Employers who are permitted to enter (or remain in) a pool at the 2019 valuation will not normally be advised of their individual contribution rate unless agreed by the Administering Authority.

Community Admission Bodies that are deemed by the Administering Authority to have closed to new entrants are not usually permitted to participate in a pool.

3.5 Additional flexibility in return for added security

The Administering Authority may permit greater flexibility to the employer's contributions if the employer provides added security to the satisfaction of the Administering Authority.

Such flexibility includes a reduced rate of contribution, an extended time horizon, or permission to join a pool with another body (e.g. the Local Authority).

Such security may include, but is not limited to, a suitable bond, a legally-binding guarantee from an appropriate third party, or security over an employer asset of sufficient value.

The degree of flexibility given may take into account factors such as:

- the extent of the employer's deficit;
- the amount and quality of the security offered;
- the employer's financial security and business plan; and
- whether the admission agreement is likely to be open or closed to new entrants.

3.6 Non ill health early retirement costs

It is assumed that members' benefits are payable from the earliest age that the employee could retire without incurring a reduction to their benefit (and without requiring their employer's consent to retire). (**NB** the relevant age may be different for different periods of service, following the benefit changes from April 2008 and April 2014). Employers are required to pay additional contributions ('strain') wherever an employee retires before attaining this age. The actuary's funding basis makes no allowance for premature retirement except on grounds of ill-health.

Employers must make these additional contributions as a one off payment to the Fund in the financial year following the award of an early retirement. In exceptional circumstances, the Administering Authority may at its absolute discretion agree to spread the payment over a period not exceeding three years. If this is agreed, interest will be charged using factors provided by the actuary.

3.7 Ill health early retirement costs

In the event of a member's early retirement on the grounds of ill-health, a funding strain will usually arise, which can be very large. Such strains are currently met by each employer, although individual employers may elect to take external insurance (see 3.8 below).

The cumulative cost of ill health retirements between actuarial valuations will in effect be reflected in the employer's results at the next valuation.

Where a different approach is adopted (eg regularly monitoring ill health experience and requesting contributions between valuations), details will be included in each that employer's Admission Agreement.

3.8 External Ill health insurance

If an employer provides satisfactory evidence to the Administering Authority of a current external insurance policy covering ill health early retirement strains, then:

- the employer's contribution to the Fund each year is reduced by the amount of that year's insurance premium, so that the total contribution is unchanged, and
- there is no need for monitoring of allowances.

The employer must keep the Administering Authority notified of any changes in the insurance policy's coverage or premium terms, or if the policy is ceased.

3.9 Employers with no remaining active members

In general an employer ceasing in the Fund, due to the departure of the last active member, will pay a cessation debt or receive an exit credit on an appropriate basis (see 3.3, Note (j)) and consequently have no further obligation to the Fund. Thereafter it is expected that one of two situations will eventually arise:

a) The employer's asset share runs out before all its ex-employees' benefits have been paid. In this situation the other Fund employers will be required to contribute to pay all remaining benefits: this will be done by the Fund actuary apportioning the remaining liabilities on a pro-rata basis at successive formal valuations;

b) The last ex-employee or dependant dies before the employer's asset share has been fully utilised. In this situation the remaining assets would be apportioned pro-rata by the Fund's actuary to the other Fund.

In exceptional circumstances the Fund may permit an employer with no remaining active members and a cessation deficit to continue contributing to the Fund. This would require the provision of a suitable security or guarantee, as well as a written ongoing commitment to fund the remainder of the employer's obligations over an appropriate period. The Fund would reserve the right to invoke the cessation requirements in the future, however. The Administering Authority may need to seek legal advice in such cases, as the employer would have no contributing members.

3.10 Policies on bulk transfers

The Fund has a separate written policy which covers bulk transfer payments into, out of and within the Fund. Each case will be treated on its own merits, but in general:

- The Fund will not pay bulk transfers greater than the lesser of (a) the asset share of the transferring employer in the Fund, and (b) the value of the past service liabilities of the transferring members;
- The Fund will not grant added benefits to members bringing in entitlements from another Fund unless the asset transfer is sufficient to meet the added liabilities; and
- The Fund may permit shortfalls to arise on bulk transfers if the Fund employer has suitable strength of covenant and commits to meeting that shortfall in an appropriate period. This may require the employer's Fund contributions to increase between valuations.
- Active members switching employment from one Fund employer to another will result in assets equal to the past service liabilities being reallocated between the employers, i.e. a "fully funded transfer". This means that the deficit at the point of transfer is retained by the ceding employer.

  However, in the case of schools converting to academy status (i.e. the members switch from Council employment to the new Academy); the process is instead as per Note (g) to section 3.3 above. This is because the guidance from the Department for Education and the Department for Communities and Local Government anticipates that the past service deficit will be inherited by the new Academy.

4. Funding strategy and links to investment strategy

4.1 What is the Fund's investment strategy?

The Fund has built up assets over the years, and continues to receive contribution and other income. All of this must be invested in a suitable manner, which is the investment strategy.

Investment strategy is set by the Administering Authority, after consultation with the employers and after taking investment advice. The precise mix, manager make up and target returns are set out in the Investment Strategy Statement, which is available to members and employers.

The investment strategy is set for the long-term, but is reviewed from time to time. Normally a full review is carried out as part of each actuarial valuation, and is kept under review annually between actuarial valuations to ensure that it remains appropriate to the Fund's liability profile.

The same investment strategy is currently followed for all employers.

4.2 What is the link between funding strategy and investment strategy?

The Fund must be able to meet all benefit payments as and when they fall due. These payments will be met by contributions (resulting from the funding strategy) or asset returns and income (resulting from the investment strategy). To the extent that investment returns or income fall short, then higher cash contributions are required from employers, and vice versa

Therefore, the funding and investment strategies are inextricably linked.

4.3 How does the funding strategy reflect the Fund's investment strategy?

In the opinion of the Fund actuary, the current funding policy is consistent with the current investment strategy of the Fund. The actuary's assumptions for future investment returns (described further in Appendix E) are based on the current benchmark investment strategy of the Fund. The future investment return assumptions underlying each of the fund's three funding bases include a margin for prudence, and are therefore also considered to be consistent with the requirement to take a "prudent longer-term view" of the funding of liabilities as required by the UK Government (see Appendix A1).

In the short term – such as the three yearly assessments at formal valuations – there is the scope for considerable volatility in asset values. However, the actuary takes a long term view when assessing employer contribution rates and the contribution rate setting methodology takes into account this potential variability.

The Fund does not hold a contingency reserve to protect it against the volatility of equity investments.

4.4 Does the Fund monitor its overall funding position?

The Administering Authority monitors the relative funding position, i.e. changes in the relationship between asset values and the liabilities value, quarterly. It reports this to the regular Pensions Committee meetings, and also to employers through newsletters and Employers Forums.

5. Statutory reporting and comparison to other LGPS Funds

5.1 Purpose

Under Section 13(4)(c) of the Public Service Pensions Act 2013 ("Section 13"), the Government Actuary's Department must, following each triennial actuarial valuation, report to MHCLG on each of the LGPS Funds in England & Wales. This report will cover whether, for each Fund, the rate of employer contributions are set at an appropriate level to ensure both the solvency and the long term cost efficiency of the Fund.

This additional MHCLG oversight may have an impact on the strategy for setting contribution rates at future valuations.

5.2 Solvency

For the purposes of Section 13, the rate of employer contributions shall be deemed to have been set at an appropriate level to ensure solvency if:

(a) the rate of employer contributions is set to target a funding level for the Fund of 100%, over an appropriate time period and using appropriate actuarial assumptions (where appropriateness is considered in both absolute and relative terms in comparison with other funds); and either

(b) employers collectively have the financial capacity to increase employer contributions, and/or the Fund is able to realise contingent assets should future circumstances require, in order to continue to target a funding level of 100%; or

(c) there is an appropriate plan in place should there be, or if there is expected in future to be, a material reduction in the capacity of fund employers to increase contributions as might be needed.

5.3 Long Term Cost Efficiency

The rate of employer contributions shall be deemed to have been set at an appropriate level to ensure long term cost efficiency if:

i. the rate of employer contributions is sufficient to make provision for the cost of current benefit accrual,

ii. with an appropriate adjustment to that rate for any surplus or deficit in the Fund.

In assessing whether the above condition is met, MHCLG may have regard to various absolute and relative considerations. A relative consideration is primarily concerned with comparing LGPS pension funds with other LGPS pension funds. An absolute consideration is primarily concerned with comparing Funds with a given objective benchmark.

Relative considerations include:

1. the implied deficit recovery period; and
2. the investment return required to achieve full funding after 20 years.

Absolute considerations include:

1. the extent to which the contributions payable are sufficient to cover the cost of current benefit accrual and the interest cost on any deficit;
2. how the required investment return under “relative considerations” above compares to the estimated future return being targeted by the Fund’s current investment strategy;
3. the extent to which contributions actually paid have been in line with the expected contributions based on the extant rates and adjustment certificate; and
4. the extent to which any new deficit recovery plan can be directly reconciled with, and can be demonstrated to be a continuation of, any previous deficit recovery plan, after allowing for actual Fund experience.

MHCLG may assess and compare these metrics on a suitable standardised market-related basis, for example where the local funds’ actuarial bases do not make comparisons straightforward.

Appendix A – Regulatory framework

A1 Why does the Fund need an FSS?

The Ministry of Housing, Communities and Local Government (MHCLG) has stated that the purpose of the FSS is:

*"to establish a **clear and transparent fund-specific strategy** which will identify how employers' pension liabilities are best met going forward;*

*to support the regulatory framework to maintain **as nearly constant employer contribution rates as possible**; and*

*to take a **prudent longer-term view** of funding those liabilities."*

These objectives are desirable individually, but may be mutually conflicting.

The requirement to maintain and publish a FSS is contained in LGPS Regulations which are updated from time to time. In publishing the FSS the Administering Authority has to have regard to any guidance published by Chartered Institute of Public Finance and Accountancy (CIPFA) (most recently in 2016) and to its Statement of Investment Principles / Investment Strategy Statement.

This is the framework within which the Fund's actuary carries out triennial valuations to set employers' contributions and provides recommendations to the Administering Authority when other funding decisions are required, such as when employers join or leave the Fund. The FSS applies to all employers participating in the Fund.

A2 Does the Administering Authority consult anyone on the FSS?

Yes. This is required by LGPS Regulations. It is covered in more detail by the most recent CIPFA guidance, which states that the FSS must first be subject to "consultation with such persons as the authority considers appropriate", and should include "a meaningful dialogue at officer and elected member level with council tax raising authorities and with corresponding representatives of other participating employers".

In practice, for the Fund, the consultation process for this FSS was as follows:

a) A draft version of the FSS was issued to all participating employers in October 2019 for comment;

b) Comments were requested to be received no later than 31st January 2020;

c) There was an Employers Forum on 13th November 2019 at which questions regarding the FSS could be raised and answered;

d) Following the end of the consultation period the FSS was updated where required and then published, in February 2020.

A3 How is the FSS published?

The FSS is made available through the following routes:

A full copy included in the annual report and accounts of the Fund;

A copy sent by email to each participating employer in the Fund;

A copy sent to employee representatives;

A summary issued to all Fund members;

Copies sent to investment managers and independent advisers;

Copies made available on request.

A4 How often is the FSS reviewed?

The FSS is reviewed in detail at least every three years as part of the triennial valuation (which may move to every four years in future – see Section 2.8). This version is expected to remain unaltered until it is consulted upon as part of the formal process for the next valuation.

It is possible that (usually slight) amendments may be needed within the three year period. These would be needed to reflect any regulatory changes, or alterations to the way the Fund operates (e.g. to accommodate a new class of employer). Any such amendments would be consulted upon as appropriate:

- trivial amendments would be simply notified at the next round of employer communications,
- amendments affecting only one class of employer would be consulted with those employers,
- other more significant amendments would be subject to full consultation.

In any event, changes to the FSS would need agreement by the Pensions Committee and would be included in the relevant Committee Meeting minutes.

A5 How does the FSS fit into other Fund documents?

The FSS is a summary of the Fund's approach to funding liabilities. It is not an exhaustive statement of policy on all issues, for example there are a number of separate statements published by the Fund including the Investment Strategy Statement, Governance Strategy and Communications Strategy. In addition, the Fund publishes an Annual Report and Accounts with up to date information on the Fund.

These documents can be found on the web at https://www.brent.gov.uk/your-council/transparency-in-brent/performance-and-spending/budgets-and-finance/pensions/

Appendix B – Responsibilities of key parties

The efficient and effective operation of the Fund needs various parties to each play their part.

B1 The Administering Authority should:-

1. operate the Fund as per the LGPS Regulations;
2. effectively manage any potential conflicts of interest arising from its dual role as Administering Authority and a Fund employer;
3. collect employer and employee contributions, and investment income and other amounts due to the Fund;
4. ensure that cash is available to meet benefit payments as and when they fall due;
5. pay from the Fund the relevant benefits and entitlements that are due;
6. invest surplus monies (i.e. contributions and other income which are not immediately needed to pay benefits) in accordance with the Fund's Investment Strategy Statement (ISS) and LGPS Regulations;
7. communicate appropriately with employers so that they fully understand their obligations to the Fund;
8. take appropriate measures to safeguard the Fund against the consequences of employer default;
9. manage the valuation process in consultation with the Fund's actuary;
10. provide data and information as required by the Government Actuary's Department to carry out their statutory obligations (see Section 5);
11. prepare and maintain a FSS and a ISS, after consultation;
12. notify the Fund's actuary of material changes which could affect funding (this is covered in a separate agreement with the actuary); and
13. monitor all aspects of the fund's performance and funding and amend the FSS and ISS as necessary and appropriate.

B2 The Individual Employer should:-

1. deduct contributions from employees' pay correctly;
2. pay all contributions, including their own as determined by the actuary, promptly by the due date;
3. have a policy and exercise discretions within the regulatory framework;
4. make additional contributions in accordance with agreed arrangements in respect of, for example, augmentation of scheme benefits, early retirement strain; and
5. notify the Administering Authority promptly of all changes to its circumstances, prospects or membership, which could affect future funding.

B3 The Fund Actuary should:-

1. prepare valuations, including the setting of employers' contribution rates. This will involve agreeing assumptions with the Administering Authority, having regard to the FSS and LGPS Regulations, and targeting each employer's solvency appropriately;
2. provide data and information as required by the Government Actuary's Department to carry out their statutory obligations (see Section 5);
3. provide advice relating to new employers in the Fund, including the level and type of bonds or other forms of security (and the monitoring of these);
4. prepare advice and calculations in connection with bulk transfers and individual benefit-related matters;
5. assist the Administering Authority in considering possible changes to employer contributions between formal valuations, where circumstances suggest this may be necessary;
6. advise on the termination of employers' participation in the Fund; and
7. fully reflect actuarial professional guidance and requirements in the advice given to the Administering Authority.

B4 Other parties:-

1. investment advisers (either internal or external) should ensure the Fund's ISS remains appropriate, and consistent with this FSS;
2. investment managers, custodians and bankers should all play their part in the effective investment (and dis-investment) of Fund assets, in line with the ISS;
3. auditors should comply with their auditing standards, ensure Fund compliance with all requirements, monitor and advise on fraud detection, and sign off annual reports and financial statements as required;
4. governance advisers may be appointed to advise the Administering Authority on efficient processes and working methods in managing the Fund;
5. legal advisers (either internal or external) should ensure the Fund's operation and management remains fully compliant with all regulations and broader local government requirements, including the Administering Authority's own procedures;
6. MHCLG (assisted by the Government Actuary's Department) and the Scheme Advisory Board, should work with LGPS Funds to meet Section 13 requirements.

Appendix C – Key risks and controls

C1 Types of risk

The Administering Authority has an active risk management programme in place. The measures that it has in place to control key risks are summarised below under the following headings:

- financial;
- demographic;
- regulatory; and
- governance.

C2 Financial risks

Risk	Summary of Control Mechanisms
Fund assets fail to deliver returns in line with the anticipated returns underpinning the valuation of liabilities and contribution rates over the long-term.	Only anticipate long-term returns on a relatively prudent basis to reduce risk of under-performing. Assets invested on the basis of specialist advice, in a suitably diversified manner across asset classes, geographies, managers, etc. Analyse progress at three yearly valuations for all employers. Inter-valuation roll-forward of liabilities between valuations at whole Fund level.
Inappropriate long-term investment strategy.	Overall investment strategy options considered as an integral part of the funding strategy. Used asset liability modelling to measure 4 key outcomes. Chosen option considered to provide the best balance.
Active investment manager under-performance relative to benchmark.	Quarterly investment monitoring analyses market performance and active managers relative to their index benchmark.
Pay and price inflation significantly more than anticipated.	The focus of the actuarial valuation process is on real returns on assets, net of price and pay increases. Inter-valuation monitoring, as above, gives early warning. Some investment in bonds also helps to mitigate this risk. Employers pay for their own salary awards and should be mindful of the geared effect on pension liabilities of

Risk	Summary of Control Mechanisms
	any bias in pensionable pay rises towards longer-serving employees.
Effect of possible increase in employer's contribution rate on service delivery and admission/scheduled bodies	An explicit stabilisation mechanism has been agreed as part of the funding strategy. Other measures are also in place to limit sudden increases in contributions.
Orphaned employers give rise to added costs for the Fund	The Fund seeks a cessation debt (or security/guarantor) to minimise the risk of this happening in the future. If it occurs, the Actuary calculates the added cost spread pro-rata among all employers – (see 3.9).
Effect of possible asset underperformance as a result of climate change	Covered in the Fund's Investment Strategy Statement

C3 Demographic risks

Risk	Summary of Control Mechanisms
Pensioners living longer, thus increasing cost to Fund.	Set mortality assumptions with some allowance for future increases in life expectancy. The Fund Actuary has direct access to the experience of over 50 LGPS funds which allows early identification of changes in life expectancy that might in turn affect the assumptions underpinning the valuation.
Maturing Fund – i.e. proportion of actively contributing employees declines relative to retired employees.	Continue to monitor at each valuation, consider seeking monetary amounts rather than % of pay and consider alternative investment strategies.
Deteriorating patterns of early retirements	Employers are charged the extra cost of non ill-health retirements following each individual decision. Employer ill health retirement experience is monitored, and insurance is an option.
Reductions in payroll causing insufficient deficit recovery payments	In many cases this may not be sufficient cause for concern, and will in effect be caught at the next formal valuation. However, there are protections where there is concern, as follows:

Risk	Summary of Control Mechanisms
	Employers in the stabilisation mechanism may be brought out of that mechanism to permit appropriate contribution increases (see Note (b) to 3.3). For other employers, review of contributions is permitted in general between valuations (see Note (f) to 3.3) and may require a move in deficit contributions from a percentage of payroll to fixed monetary amounts.

C4 Regulatory risks

Risk	Summary of Control Mechanisms
Changes to national pension requirements and/or HMRC rules e.g. changes arising from public sector pensions reform.	The Administering Authority considers all consultation papers issued by the Government and comments where appropriate. The Administering Authority is monitoring the progress on the McCloud court case and will consider an interim valuation or other appropriate action once more information is known. The government's long term preferred solution to GMP indexation and equalisation - conversion of GMPs to scheme benefits - was built into the 2019 valuation.
Time, cost and/or reputational risks associated with any MHCLG intervention triggered by the Section 13 analysis (see Section 5).	Take advice from Fund Actuary on position of Fund as at prior valuation, and consideration of proposed valuation approach relative to anticipated Section 13 analysis.
Changes by Government to particular employer participation in LGPS Funds, leading to impacts on funding and/or investment strategies.	The Administering Authority considers all consultation papers issued by the Government and comments where appropriate. Take advice from Fund Actuary on impact of changes on the Fund and amend strategy as appropriate.

C5 Governance risks

Risk	Summary of Control Mechanisms

Risk	Summary of Control Mechanisms
Administering Authority unaware of structural changes in an employer's membership (e.g. large fall in employee members, large number of retirements) or not advised of an employer closing to new entrants.	The Administering Authority has a close relationship with employing bodies and communicates required standards e.g. for submission of data. The Actuary may revise the rates and Adjustments certificate to increase an employer's contributions between triennial valuations Deficit contributions may be expressed as monetary amounts.
Actuarial or investment advice is not sought, or is not heeded, or proves to be insufficient in some way	The Administering Authority maintains close contact with its specialist advisers. Advice is delivered via formal meetings involving Elected Members, and recorded appropriately. Actuarial advice is subject to professional requirements such as peer review.
Administering Authority failing to commission the Fund Actuary to carry out a termination valuation for a departing Admission Body.	The Administering Authority requires employers with Best Value contractors to inform it of forthcoming changes. Community Admission Bodies' memberships are monitored and, if active membership decreases, steps will be taken.
An employer ceasing to exist with insufficient funding or adequacy of a bond.	The Administering Authority believes that it would normally be too late to address the position if it was left to the time of departure. The risk is mitigated by: Seeking a funding guarantee from another scheme employer, or external body, where-ever possible (see Notes (h) and (j) to 3.3). Alerting the prospective employer to its obligations and encouraging it to take independent actuarial advice. Vetting prospective employers before admission. Where permitted under the regulations requiring a bond to protect the Fund from various risks.

Risk	Summary of Control Mechanisms
	Requiring new Community Admission Bodies to have a guarantor. Reviewing bond or guarantor arrangements at regular intervals (see Note (f) to 3.3). Reviewing contributions well ahead of cessation if thought appropriate (see Note (a) to 3.3).
An employer ceasing to exist resulting in an exit credit being payable	The Administering Authority regularly monitors admission bodies coming up to cessation The Administering Authority invests in liquid assets to ensure that exit credits can be paid when required.

Appendix D – The calculation of Employer contributions

In Section 2 there was a broad description of the way in which contribution rates are calculated. This Appendix considers these calculations in much more detail.

As discussed in Section 2, the actuary calculates the required contribution rate for each employer using a three-step process:

- Calculate the funding target for that employer, i.e. the estimated amount of assets it should hold in order to be able to pay all its members' benefits. See Appendix E for more details of what assumptions we make to determine that funding target;
- Determine the time horizon over which the employer should aim to achieve that funding target. See the table in 3.3 and Note (c) for more details;
- Calculate the employer contribution rate such that it has at least a given likelihood of achieving that funding target over that time horizon, allowing for various possible economic outcomes over that time horizon. See the table in 3.3 Note (e) for more details.

The calculations involve actuarial assumptions about future experience, and these are described in detail in Appendix E.

D1 What is the difference between calculations across the whole Fund and calculations for an individual employer?

Employer contributions are normally made up of two elements:

a) the estimated cost of ongoing benefits being accrued, referred to as the "Primary contribution rate" (see D2 below); plus

b) an adjustment for the difference between the Primary rate above, and the actual contribution the employer needs to pay, referred to as the "Secondary contribution rate" (see D3 below).

The contribution rate for each employer is measured as above, appropriate for each employer's assets, liabilities and membership. The whole Fund position, including that used in reporting to MHCLG (see section 5), is calculated in effect as the sum of all the individual employer rates. MHCLG currently only regulates at whole Fund level, without monitoring individual employer positions.

D2 How is the Primary contribution rate calculated?

The Primary element of the employer contribution rate is calculated with the aim that these contributions will meet benefit payments in respect of members' **future** service in the Fund. This is based upon the cost (in excess of members' contributions) of the benefits which employee members earn from their service each year.

The Primary rate is calculated separately for all the employers, although employers within a pool will pay the contribution rate applicable to the pool as a whole. The Primary rate is calculated such that it is projected to:

1. meet the required funding target for all future years' accrual of benefits*, excluding any accrued assets,

2. within the determined time horizon (see note 3.3 Note (c) for further details),

3. with a sufficiently high likelihood, as set by the Fund's strategy for the category of employer (see 3.3 Note (e) for further details).

* The projection is for the current active membership where the employer no longer admits new entrants, or additionally allows for new entrants where this is appropriate.

The projections are carried out using an economic modeller (the "Economic Scenario Service") developed by the Fund's actuary Hymans Robertson: this allows for a wide range of outcomes as regards key factors such as asset returns (based on the Fund's investment strategy), inflation, and bond yields. Further information about this model is included in Appendix E. The measured contributions are calculated such that the proportion of outcomes meeting the employer's funding target (at the end of the time horizon) is equal to the required likelihood.

The approach includes expenses of administration to the extent that they are borne by the Fund, and includes allowances for benefits payable on death in service and on ill health retirement.

D3 How is the Secondary contribution rate calculated?

The Secondary rate is calculated as the balance over and above the Primary rate, such that the total contribution rate is projected to:

1. meet the required funding target relating to combined past and future service benefit accrual, including accrued asset share (see D5 below)

2. at the end of the determined time horizon (see 3.3 Note (c) for further details)

3. with a sufficiently high likelihood, as set by the Fund's strategy for the category of employer (see 3.3 Note (e) for further details).

The projections are carried out using an economic modeller (the "Economic Scenario Service") developed by the Fund Actuary Hymans Robertson: this allows for a wide range of outcomes as regards key factors such as asset returns (based on the Fund's investment strategy), inflation, and bond yields. Further information about this model is included in Appendix E. The measured contributions are calculated such that the proportion of outcomes meeting the employer's funding target (at the end of the time horizon) is equal to the required likelihood.

D4 What affects a given employer's valuation results?

The results of these calculations for a given individual employer will be affected by:

1. past contributions relative to the cost of accruals of benefits;

2. different liability profiles of employers (e.g. mix of members by age, gender, service vs. salary);

3. the effect of any differences in the funding target, i.e. the valuation basis used to value the employer's liabilities at the end of the time horizon;

4. any different time horizons;

5. the difference between actual and assumed rises in pensionable pay;

6. the difference between actual and assumed increases to pensions in payment and deferred pensions;
7. the difference between actual and assumed retirements on grounds of ill-health from active status;
8. the difference between actual and assumed amounts of pension ceasing on death;
9. the additional costs of any non ill-health retirements relative to any extra payments made; and/or
10. differences in the required likelihood of achieving the funding target.

D5 How is each employer's asset share calculated?

The Administering Authority does not operate separate bank accounts or investment mandates for each employer. Therefore it cannot account for each employer's assets separately. Instead, the Fund Actuary must apportion the assets of the whole Fund between the individual employers. There are broadly two ways to do this:

1) A technique known as "analysis of surplus" in which the Fund actuary estimates the surplus/deficit of an employer at the current valuation date by analysingmovements in the surplus/deficit from the previous actuarial valuation date. The estimated surplus/deficit is compared to the employer's liability value to calculate the employer's asset value. The actuary will quantify the impact of investment, membership and other experience to analyse the movement in the surplus/deficit. This technique makes a number of simplifying assumptions due to the unavailability of certain items of information. This leads to a balancing, or miscellaneous, item in the analysis of surplus, which is split between employers in proportion to their asset shares.

2) A 'cashflow approach' in which an employer's assets are tracked over time allowing for cashflows paid in (contributions, transfers in etc.), cashflows paid out (benefit payments, transfers out etc.) and investment returns on the employer's assets.

Until 31 March 2016 the Administering Authority used the 'analysis of surplus' approach to apportion the Fund's assets between individual employers.

Since then, the Fund has adopted a cashflow approach for tracking individual employer assets.

In particular, with effect from 1 April 2019, the Fund Actuary uses the Hymans Robertson's proprietary "HEAT" system to track employer assets on a monthly basis. Starting with each employer's assets from the previous month end, cashflows paid in/out and investment returns achieved on the Fund's assets over the course of the month are added to calculate an asset value at the month end.

The Fund is satisfied that this new approach provides the most accurate asset allocations between employers that is reasonably possible at present.

D6 **How does the Fund adjust employer asset shares when an individual member moves from one employer in the Fund to another?**

Under the cashflow approach for tracking employer asset shares, the Fund has allowed for any individual members transferring from one employer in the Fund to another, via the transfer of a sum from the ceding employer's asset share to the receiving employer's asset share. This sum is equal to the member's Cash Equivalent Transfer Value (CETV) as advised by the Fund's administrators.

Appendix E – Actuarial assumptions

E1 What are the actuarial assumptions used to calculate employer contribution rates?

These are expectations of future experience used to place a value on future benefit payments ("the liabilities") and future asset values. Assumptions are made about the amount of benefit payable to members (the financial assumptions) and the likelihood or timing of payments (the demographic assumptions). For example, financial assumptions include investment returns, salary growth and pension increases; demographic assumptions include life expectancy, probabilities of ill-health early retirement, and proportions of member deaths giving rise to dependants' benefits.

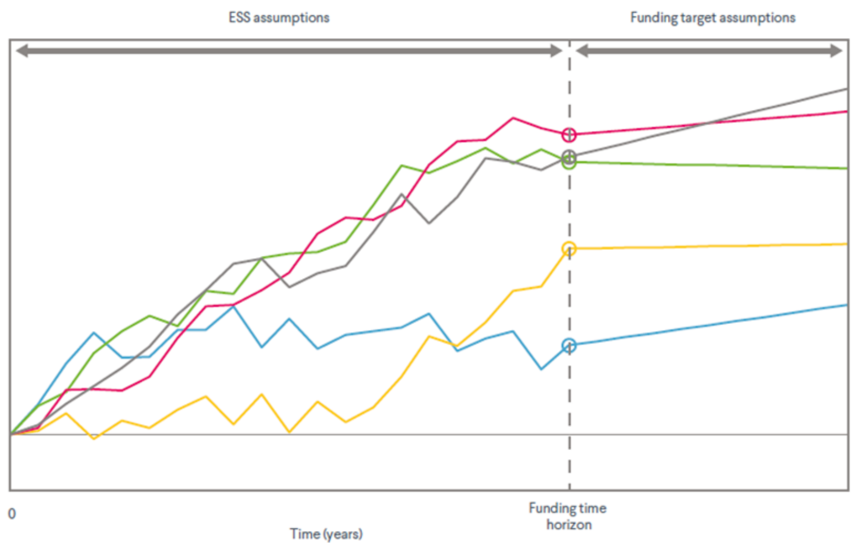
Changes in assumptions will affect the funding target and required contribution rate. However, different assumptions will not of course affect the actual benefits payable by the Fund in future.

The actuary's approach to calculating employer contribution rates involves the projection of each employer's future benefit payments, contributions and investment returns into the future under 5,000 possible economic scenarios. Future inflation (and therefore benefit payments) and investment returns for each asset class (and therefore employer asset values) are variables in the projections. By projecting the evolution of an employer's assets and benefit payments 5,000 times, a contribution rate can be set that results in a sufficient number of these future projections (determined by the employer's required likelihood) being successful at the end of the employer's time horizon. In this context, a successful contribution rate is one which results in the employer having met its funding target at the end of the time horizon.

Setting employer contribution rates therefore requires two types of assumptions to be made about the future:

1. Assumptions to project the employer's assets, benefits and cashflows to the end of the funding time horizon. For this purpose the actuary uses Hymans Robertson's proprietary stochastic economic model - the Economic Scenario Service ("ESS").

2. Assumptions to assess whether, for a given projection, the funding target is satisfied at the end of the time horizon. For this purpose, the Fund has three different funding bases.



Details on the ESS assumptions and funding target assumptions are included below (in E2 and E3 respectively).

E2 What assumptions are used in the ESS?

The actuary uses Hymans Robertson's ESS model to project a range of possible outcomes for the future behaviour of asset returns and economic variables. With this type of modelling, there is no single figure for an assumption about future inflation or investment returns. Instead, there is a range of what future inflation or returns will be which leads to likelihoods of the assumption being higher or lower than a certain value.

The ESS is a complex model to reflect the interactions and correlations between different asset classes and wider economic variables. The table below shows the calibration of the model as at 31 March 2019. All returns are shown net of fees and are the annualised total returns over 5, 10 and 20 years, except for the yields which refer to the simulated yields at that time horizon.

E3 What assumptions are used in the funding target?

At the end of an employer's funding time horizon, an assessment will be made – for each of the 5,000 projections – of how the assets held compare to the value of assets required to meet the future benefit payments (the funding target). Valuing the cost of future benefits requires the actuary to make assumptions about the following financial factors:

- Benefit increases and CARE revaluation
- Salary growth
- Investment returns (the "discount rate")

Each of the 5,000 projections represents a different prevailing economic environment at the end of the funding time horizon and so a single, fixed value for each assumption is unlikely to be appropriate for every projection. For example, a high assumed future investment return (discount rate) would not be prudent in projections with a weak outlook for economic growth. Therefore, instead of using a fixed value for each assumption, the actuary references economic indicators to ensure the assumptions remain appropriate for the prevailing economic environment in each projection. The economic indicators the actuary uses are: future inflation expectations and the prevailing risk free rate of return (the yield on long term UK government bonds is used as a proxy for this rate).

The Fund has three funding bases which will apply to different employers depending on their type. Each funding basis has a different assumption for future investment returns when determining the employer's funding target.

Funding basis	Ongoing participation basis	Contractor exit basis	Low risk exit basis
Employer type	All employers except Transferee Admission Bodies and closed Community Admission Bodies	Transferee Admission Bodies	Community Admission Bodies that are closed to new entrants
Investment return assumption underlying the employer's funding target (at the end of its time horizon)	Long term government bond yields plus an asset outperformance assumption (AOA) of 1.6% p.a.	Long term government bond yields plus 1.6% (appropriate to the basis used to allocate assets to the employer on joining the Fund)	Long term government bond yields with no allowance for outperformance on the Fund's assets

E4 What other assumptions apply?

The following assumptions are those of the most significance used in both the projection of the assets, benefits and cashflows and in the funding target.

a) Salary growth

After discussion with Fund officers, the salary increase assumption at the 2019 valuation has been set to be a blended rate combined of short term restrictions plus longer term increases linked to price inflation; the agreed blended rate is RPI less 0.7% p.a.. This is the same assumption used at the previous valuation.

b) Pension increases

Since 2011 the consumer prices index (CPI), rather than RPI, has been the basis for increases to public sector pensions in deferment and in payment. Note that the basis of such increases is set by the Government, and is not under the control of the Fund or any employers.

At this valuation, we have continued to assume that CPI is 1.0% per annum lower than RPI. (Note that the reduction is applied in a geometric, not arithmetic, basis).

c) Life expectancy

The demographic assumptions are intended to be best estimates of future experience in the Fund based on past experience of LGPS funds which participate in Club Vita, the longevity analytics service used by the Fund, and endorsed by the actuary.

The longevity assumptions that have been adopted at this valuation are a bespoke set of "VitaCurves", produced by the Club Vita's detailed analysis, which are specifically tailored to fit the membership profile of the Fund. These curves are based on the data provided by the Fund for the purposes of this valuation.

Allowance has been made in the ongoing valuation basis for future improvements in line with the 2018 version of the Continuous Mortality Investigation model published by the Actuarial Profession and a 1.25% per annum minimum underpin to future reductions in mortality rates. This updated allowance for future improvements will generally result in lower life expectancy assumptions and hence a reduced funding target (all other things being equal).

The approach taken is considered reasonable in light of the long term nature of the Fund and the assumed level of security underpinning members' benefits.

d) General

The same financial assumptions are adopted for most employers (on the ongoing participation basis identified above) in deriving the funding target underpinning the Primary and Secondary rates: as described in (3.3), these calculated figures are translated in different ways into employer contributions, depending on the employer's circumstances.

The demographic assumptions, in particular the life expectancy assumption, in effect vary by type of member and so reflect the different membership profiles of employers.

Appendix F – Glossary

Administering Authority	The council with statutory responsibility for running the Fund, in effect the Fund's "trustees".
Admission Bodies	Employers where there is an Admission Agreement setting out the employer's obligations. These can be Community Admission Bodies or Transferee Admission Bodies. For more details (see 2.3).
Covenant	The assessed financial strength of the employer. A strong covenant indicates a greater ability (and willingness) to pay for pension obligations in the long run. A weaker covenant means that it appears that the employer may have difficulties meeting its pension obligations in full over the longer term.
Designating Employer	Employers such as town and parish councils that are able to participate in the LGPS via resolution. These employers can designate which of their employees are eligible to join the Fund.
Employer	An individual participating body in the Fund, which employs (or used to employ) **members** of the Fund. Normally the assets and **funding target** values for each employer are individually tracked, together with its **Primary rate** at each **valuation**.
Funding basis	The combined set of assumptions made by the actuary, regarding the future, to calculate the value of the funding target at the end of the employer's time horizon. The main assumptions will relate to the level of future investment returns, salary growth, pension increases and longevity. More prudent assumptions will give a higher funding target, whereas more optimistic assumptions will give a lower funding target.
Gilt	A UK Government bond, ie a promise by the Government to pay interest and capital as per the terms of that particular gilt, in return for an initial payment of capital by the purchaser. Gilts can be "fixed interest", where the interest payments are level throughout the gilt's term, or "index-linked" where the interest payments vary each year in line with a specified index (usually RPI). Gilts can be bought as assets by the Fund, but are also used in funding as an objective measure of a risk-free rate of return.
Guarantee / guarantor	A formal promise by a third party (the guarantor) that it will meet any pension obligations not met by a specified employer. The presence of a guarantor will mean, for instance, that the Fund can consider the employer's **covenant** to be as strong as its guarantor's.

Letting employer	An employer which outsources or transfers a part of its services and workforce to another employer (usually a contractor). The contractor will pay towards the LGPS benefits accrued by the transferring members, but ultimately the obligation to pay for these benefits will revert to the letting employer. A letting employer will usually be a local authority, but can sometimes be another type of employer such as an Academy.
LGPS	The Local Government Pension Scheme, a public sector pension arrangement put in place via Government Regulations, for workers in local government. These Regulations also dictate eligibility (particularly for Scheduled Bodies), members' contribution rates, benefit calculations and certain governance requirements. The LGPS is divided into 100 Funds which map the UK. Each LGPS Fund is autonomous to the extent not dictated by Regulations, e.g. regarding investment strategy, employer contributions and choice of advisers.
Maturity	A general term to describe a Fund (or an employer's position within a Fund) where the members are closer to retirement (or more of them already retired) and the investment time horizon is shorter. This has implications for investment strategy and, consequently, funding strategy.
Members	The individuals who have built up (and may still be building up) entitlement in the Fund. They are divided into actives (current employee members), deferreds (ex-employees who have not yet retired) and pensioners (ex-employees who have now retired, and dependants of deceased ex-employees).
Primary contribution rate	The employer contribution rate required to pay for ongoing accrual of active members' benefits (including an allowance for administrative expenses). See Appendix D for further details.
Profile	The profile of an employer's membership or liability reflects various measurements of that employer's **members**, ie current and former employees. This includes: the proportions which are active, deferred or pensioner; the average ages of each category; the varying salary or pension levels; the lengths of service of active members vs their salary levels, etc. A membership (or liability) profile might be measured for its **maturity** also.
Rates and Adjustments Certificate	A formal document required by the LGPS Regulations, which must be updated at the conclusion of the formal **valuation**. This is completed by the actuary and confirms the contributions to be paid by each employer (or pool of employers) in the Fund for the period until the next valuation is completed.
Scheduled Bodies	Types of employer explicitly defined in the LGPS Regulations, whose employees must be offered membership of their local LGPS Fund. These include Councils, colleges, universities, academies, police and fire authorities etc, other than employees who have entitlement to a different public sector pension scheme (e.g. teachers, police and fire officers, university lecturers).

Secondary contribution rate	The difference between the employer's actual and **Primary contribution rates**. See Appendix D for further details.
Stabilisation	Any method used to smooth out changes in employer contributions from one year to the next. This is very broadly required by the LGPS Regulations, but in practice is particularly employed for large stable employers in the Fund.
Valuation	A risk management exercise to review the Primary and Secondary contribution rates, and other statutory information for a Fund, and usually individual employers too.

Brent	**Pension Board** 25 March 2020
	Report from the Director of Finance

Abatement of Local Government Pension on re-employment

Wards Affected:	ALL
Key or Non-Key Decision:	Non-Key
Open or Part/Fully Exempt: (If exempt, please highlight relevant paragraph of Part 1, Schedule 12A of 1972 Local Government Act)	Open
No. of Appendices:	1. Summary of Abatement Policies across London in 2018 2. Current policy and proposed change
Background Papers:	▪ N/A
Contact Officer(s): (Name, Title, Contact Details)	Minesh Patel, Director of Finance Ravinder Jassar, Head of Finance

1.0 Purpose of the Report

1.1 This report provides the Committee with information regarding the reduction or suspension of a Local Government Pension on account of further employment within Local Government after an individual has retired (Abatement).

1.2 The report explains the background to the "Abatement" rules and the current statutory provisions for doing so.

1.3 Information about the abatement practices of other Local Authorities is set out in Appendix 1 while further explanation of the current policy and proposed change is set out in Appendix 2.

2.0 Recommendation(s)

2.1 The Committee is asked to approve the report for consultation with employers for agreement. Any material changes arising from consultation will be reported back to the Committee.

3.0 Detail

Background

3.1 Abatement is a technical term regarding the reduction or suspension of a Local Government Pension Scheme (LGPS) pension where a pensioner has entered into further local government employment. If the annual salary in the second local government employment plus the pension in payment exceeded the annual salary at the initial retirement, then the pension would be reduced or potentially suspended for the duration of the subsequent local government employment.

3.2 When formulating an abatement policy, the pension regulations require that the Administering Authority has regard to:

- The level of potential financial gain at which it wishes abatement to apply;
- To the administrative costs which are likely to be incurred as a result of abatement in the different circumstances in which it may occur; and
- To the extent to which a policy not to apply abatement could lead to a serious loss of confidence in the public service.

3.3 Until 31 March 1998 abatement was mandatory, but from 1 April 1998 to 31 March 2014 abatement was discretionary. With effect from the introduction of the 2014 LGPS career average pension, abatement ceased to be applicable for service after 1 April 2014. Accordingly, a scheme member who only has LGPS membership from 1 April 2014 will not be subject to abatement.

3.4 Abatement cannot apply if a pension recipient obtains further local government work as an agency worker, nor if a person is engaged as a contractor or a consultant. A pension payable to the spouse or partner of a former local government employee, cannot be abated if the spouse/partner enters local government employment.

3.5 In respect of an LGPS pension recipient, a further employment in the wider public sector such as teaching or in the NHS does not require assessment for abatement.

3.6 Under the terms for ‘flexible’ retirement, a scheme member aged 55 or over may, with the agreement of the employer, reduce working hours or take a pay grade reduction and receive the LGPS pension including salary without abatement.

3.7 At present there are 7 Brent Council pension recipients whose pensions are being abated due to re-employment. Pensioners are also being contacted on a regular basis to enquire if they have commenced further local government employment, which places an administrative burden on collecting, collating and implementing abatement. Currently, there are also 17 pension recipients being assessed regularly in respect of earnings in further local government employment.

3.8 A survey of London Boroughs in 2018 has shown that 15 Councils currently do not abate pensions in payments. There are 4 Councils which offer a limited abatement and 18 currently abate pensions in payments.

3.9 The abolition of post 1998 abatement will allow for fairer treatment for all pensioners, as pensioners with only post 2014 scheme membership are not subject to abatement.

3.10 The change in pensions rationale over the last few years, seen with the introduction of "Pension Freedoms", has allowed active and deferred scheme members to access reduced pensions at a date of their choosing, but the continued use of abatement seems to be working against this shift in policy.

3.11 The proposal is that the London Borough of Brent, consults with our employees as per the regulations and if there are no major objections, then we will cease to abate pensions for staff who ceased employment after 1 April 1998 from 1 April 2020.

3.12 For those pensioners who are currently abated and their Brent employment ended after 1 April 1998, they will cease to have their pensions abated and will be reinstated to the current values from 1 April 2020.

4.0 Financial Implications

4.1 The cost of administering abatements is chargeable to the Pension Fund and places a strain on the Fund and the Council's resources.

4.2 By ceasing abatement the cost of administering the scheme will be reduced through less time and resource being spent on checking and monitoring pensioners who may be drawing a pension from the Local Government Scheme, for example the cost of reducing and increasing pensions from payroll and LPP running regular employment checks on Brent pensioners as well as the cost of auditing and handling of complaints from abated pensioners.

5.0 Legal Implications

5.1 There are no abatement provisions in the LGPS Regulations 2013. Therefore if an employee leaves on or after the 1st April 2014, draws their pension benefits and are then is subsequently re-employed in local government, the Council may not abate their post 1st April 2014 pension.

5.2 However, the abatement provisions in Regulations 70 & 71 of the LGPS (Administration) Regulations 2008 continue to have effect in relation to pensions in payment deriving from the pre 1st April 2014 pension schemes regardless of when payment of those pensions commenced, by virtue of Regulation 3(13) of the LGPS (Transitional) Regulations 2014.

5.3 Under Regulation 70, the Council, as its administering authority must keep under review its policy concerning abatement. This includes; the extent, if any, to which the amount of retirement pension payable to a member and applicable to the period prior to 1st April 2014, should be reduced (or whether it should be extinguished) where the member has entered a new employment with a scheme employer within the LGPS.

5.4 In formulating its existing policy concerning abatement, the Council would have had regard to:

- the level of potential financial gain at which it wishes abatement to apply;
- the administrative costs which are likely to be incurred as a result of abatement in the different circumstances in which it may occur; and
- the extent to which a policy not to apply abatement could lead to a serious loss of confidence in the public service.

5.5 When reviewing its existing abatement policy, the Council will need to have regard to the matters set out above. If, as a result of reviewing its policy concerning abatement, the Council decides to amend the abatement policy, it must publish a statement of the amended policy before the expiry of the period of one month beginning with the date of its determination.

6.0 Equality Implications

6.1 To be advised by Human Resources.

7.0 Consultation with Ward Members and Stakeholders

7.1 Not applicable.

8.0 Human Resources

8.1 Not applicable.

<u>Report sign off:</u>

Minesh Patel
Director of Finance
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Appendix 1

Brent

Abatements Report November 2018

The abatement policies for 33 London councils from Barking & Dagenham to Westminster have been referred to and the following breakdown produced. We have looked at what other London councils are doing on abatement and it is about 50/50 when you take into account certain criteria some council have adopted when abating pensions.

The following 15 councils have no abatement

1 Barking & Dagenham
2 Ealing
3 Hackney
4 Harrow
5 Havering
6 Islington
7 Kingston
8 Redbridge
9 Richmond upon Thames
10 Royal Borough of Kensington and Chelsea
11 Sutton
12 Tower Hamlets
13 Waltham Forest
14 Wandsworth
15 Westminster

Following 18 councils have abatement

1 Barnet
2 Bexley
3 Brent
4 Bromley
5 Camden
6 City of London
7 Croydon
8 Enfield
9 Greenwich
10 Hammersmith & Fulham
11 Haringey
12 Hillingdon
13 Hounslow
14 Lambeth
15 Lewisham
16 Merton
17 Newham
18 Southwark

The following councils apply certain criteria:

Barnet	Abatement if enhanced ill health Pension
City of London	Pension benefits of those individuals that retire after 31st March 2014 and are subsequently re-employed are not subject to abatement
Croydon	Abatement if was an early retirement with a pension strain cost
Enfield	Only abate old pre 97 additional years cases

Appendix 2

Brent Council Pension Fund

ADMINISTERING AUTHORITY DISCRETION - Abatement

Summary
Under the provisions of the Local Government Pension Scheme (LGPS) the Administering Authority is required to maintain a policy on how it will apply the various discretions given under the Scheme.

The current policy was approved by the General Purposes Committee on 16 January 2007.
It is proposed that this policy is changed in regard to the policy of re-employed pensioners

The proposed amendments are shown below, and apply to the three distinct member groups, each of which is relevant to the date of active membership, or when active membership ceased. Although the relevant regulations to each category differ, the proposed policy intention is the same.

Discretions from 01.04.14 in relation to post 31.03.14 active members and post 31.03.14 leavers
Regulation
TP3(13) & **A**70(1) & **A**71(4(c)

Description of discretion	Current Policy Decision	Proposed Amendment
Decide policy on abatement of pre April 2014 elements of pensions in payment following re-employment	Abatement has been removed from LGPS 2014 and so only pre 01/04/2014 benefits can be abated. All pensioners who retired with membership before 1 April 2014 will be subject to abatement. Abatement can be waived at the discretion of the Council up to £5000 per annum, if the pensioner notifies the Council of re-employment prior to commencement of re-employment and the pay earned in the second employment is less than £25000 per annum and the pensioner can demonstrate special circumstances such as extreme financial hardship or medical reasons.	Abatement will cease to apply in all cases.

Appendix 2

Discretions in relation to scheme members who ceased active membership on or after 01.04.08 and before 01.04.14

Regulation

TP3(13) & **A**70(1) & **A**71(4(c) & **T**12

Description of discretion	Current Policy Decision	Proposed Amendment
Decide policy on abatement of pensions following re-employment. Abatement reduces a member's pension during a period of reemployment where a pensioner has re-entered local government employment which is subject to the LGPS and whose total pension and new salary together exceed the salary at retirement.	Abatement has been removed from LGPS 2014 and so only pre 01/04/2014 benefits can be abated. All pensioners who retired with membership before 1 April 2014 will be subject to abatement. Abatement can be waived at the discretion of the Council up to £5000 per annum, if the pensioner notifies the Council of re-employment prior to commencement of re-employment and the pay earned in the second employment is less than £25000 per annum and the pensioner can demonstrate special circumstances such as extreme financial hardship or medical reasons.	Abatement will cease to apply in all cases

Discretions under the Local Government Pension Scheme Regulations for active or ceased scheme members before 01.04.08

Regulation

109 & 110(4)(b) Abatement

Description of discretion	Current Policy Decision	Proposed Amendment
Abatement of pensions following re-employment pre 1 April 2008 leavers Abatement reduces a member's pension during a period of reemployment where a pensioner has re-entered local government employment which is subject to the LGPS and whose total pension and new salary together exceed the salary at retirement	Abatement has been removed from LGPS 2014 and so only pre 01/04/2014 benefits can be abated. All pensioners who retired with membership before 1 April 2014 will be subject to abatement. Abatement can be waived at the discretion of the Council up to £5000 per annum, if the pensioner notifies the Council of re-employment prior to commencement of re-employment and the pay earned in the second employment is less than £25000 per annum and the pensioner can demonstrate special circumstances such as extreme financial hardship or medical reasons.	Abatement will cease to apply in all cases

Brent	**Pension Board** 25 March 2020
	Report from the Director of Finance

Review of Investment Strategy

Wards Affected:	ALL
Key or Non-Key Decision:	Non-Key
Open or Part/Fully Exempt: (If exempt, please highlight relevant paragraph of Part 1, Schedule 12A of 1972 Local Government Act)	OPEN
No. of Appendices:	One 1. Investment Strategy Review – February 2020
Background Papers:	▪ N/A
Contact Officer(s): (Name, Title, Contact Details)	Minesh Patel, Director of Finance Ravinder Jassar, Head of Finance Sawan Shah, Senior Finance Analyst

1.0 Purpose of the Report

1.1 This report presents the analysis and results of the investment review carried out by Hymans Robertson. This review follows on from the 2018 strategic investment review and the Fund's 2019 Actuarial Valuation. The purpose of the review was to review the current investment strategy and analyse the ability of alternative strategies to meet the Fund's strategic objectives.

2.0 Recommendation(s)

2.1 The Committee should discuss and agree the investment strategy review undertaken by the Fund's investment advisors, Hymans Robertson, available in Appendix 1. The following proposals should be taken into consideration:

- That the committee's current investment beliefs are fit for purpose but expands on its Responsible Investment beliefs in light of the increased focus on, and importance of, this area.
- The current long term strategy is fit for purpose from a returns perspective as it is expected to return in excess of the required return.

- To introduce a global low carbon mandate as part of the Fund's equity allocation and to delegate authority to the Director of Finance to agree the size and fund in question and to put into effect this investment following discussions at the committee meeting.
- The Fund's actual investment arrangements will deviate from their target over time and therefore a degree of rebalancing should take place on a regular basis to try and prevent too much deviation from the desired strategic allocation.

3.0 Detail

3.1 Following the 2019 valuation and agreed at the last committee meeting, the Fund commissioned an investment strategy review. The full report is available in Appendix 1.

4.0 Financial Implications

4.1 These are included in Appendix 1.

5.0 Legal Implications

5.1 Not applicable.

6.0 Equality Implications

6.1 Not applicable.

7.0 Consultation with Ward Members and Stakeholders

7.1 Not applicable.

8.0 Human Resources

8.1 Not applicable.

<u>Report sign off:</u>

Minesh Patel
Director of Finance
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HYMANS ROBERTSON

London Borough of Brent Pension Fund

Investment strategy review

February 2020

William Marshall, Partner
Kameel Kapitan, Associate Consultant
Dave Gilmour, Investment Analyst

For and on behalf of Hymans Robertson LLP

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Executive Summary

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This report is addressed to the Officers and Pension Fund Sub Committee (the "Committee") of the London Borough of Brent ("Brent") as administering authority to the London Borough of Brent Pension Fund (the "Fund"). In line with the agreed scope, the report sets out the results and commentary of the quantitative and qualitative analysis undertaken as part of the review of the investment strategy of the Fund and provides high-level comments on the Fund's investment structure.

Summary of report

We have summarised our findings and recommended next steps below:

- The Committee's current investment beliefs, which were formally signed off in November 2018, are still fit for purpose. We recommend that the Committee expands its Responsible Investment beliefs in light of the increased focus on, and importance of, this area.
- Inputting the current long-term target asset allocation into Hymans Robertson's Structure model gives a best estimate long term expected return of **5.40% p.a.** with a corresponding volatility of **9.77% p.a.** over 1 year.
- The current long-term strategy is therefore fit for purpose from a "returns" perspective, as it is expected to return in excess of the "required" return of **4.40% p.a.** used by the Actuary in the funding valuation.
- After assessing alternative investment strategies, we recommend a 5% increase in the allocation to equities, and a 5% allocation to private debt, both funded from "diversifiers". This change to the strategy increases the Fund's expected return to **5.52% p.a.** and only marginally increases the level of investment risk. Given the Fund's strong positive cashflow, we are comfortable with this change.
- We recommend that global low carbon mandate forms part of the Fund's equity allocation. The size of this allocation and the precise fund in question will be discussed with you further. We anticipate this being funded from a portion of the Fund's existing equities.
- The Fund's actual investment arrangements will deviate from their target over time and therefore we strongly recommend a degree of rebalancing takes place on a regular basis to try and prevent too much deviation from the desired strategic allocation. Further thoughts are set out in the final section of this report.

Prepared by:

William Marshall, Partner
Kameel Kapitan, Associate Consultant
Dave Gilmour, Investment Analyst

For and on behalf of Hymans Robertson LLP

General Risk Warning

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.

1 Introduction

Addressee

This report is addressed to the Officers and Pension Fund Sub Committee (the “Committee”) of the London Borough of Brent (“Brent”) as administering authority to the London Borough of Brent Pension Fund (the “Fund”). The report sets out the results and commentary of the quantitative and qualitative analysis undertaken as part of the review of the investment strategy of the Fund. It has not been prepared for use for any other purpose and should not be so used. We also provide some high level comment on the Fund’s investment structure.

This report has not been prepared for any other purpose. This report should not be released or otherwise disclosed to any third party except as required by law or regulatory obligation without our prior written consent. We accept no liability where this report is used by, or released or otherwise disclosed to, a third party unless we have expressly accepted such liability in writing. Where this is permitted, the report may only be released or otherwise disclosed in a complete form which fully discloses our advice and the basis on which it is given.

Background

2018

A strategic review took place in 2018, which was based on the member date from the 2016 triennial actuarial valuation. The 2018 review looked at:

- Establishing a set of Investment beliefs to support the long-term strategic approach;
- Setting the high-level allocation to growth, income (diversifiers) and protections assets; and
- The diversification opportunities available within the portfolio.

Following this review and subsequent discussions, the Fund agreed to restructure its equity exposure to take on more of a global focus, increase its allocation to income diversifiers (property and infrastructure) and restructure its protection allocation to include a 5% allocation to multi-asset credit (“MAC”).

2019/2020 review

The 2019 actuarial valuation revealed the Fund remains with a funding gap (i.e. assets falling short of the current assumed value of future benefits) on the Fund’s reported ongoing funding basis. Following on from the 31 March 2019 valuation. Hymans Robertson in our role as investment advisor to the Fund, have undertaken a review of the existing investment strategy.

Given the in-depth asset liability modelling carried out in 2018 (relatively recently), this paper focus more on the risk and return profiles of various strategies using more compact analysis, Hymans Robertson’s proprietary “Structure Lite” model. This “lighter touch” approach was agreed with Officers on the basis of the membership profile of the 2019 valuation remaining broadly consistent with that previously modelled and the funding strategy also remaining materially unchanged.

This report will:

- Provide a detailed recap of the 2018 strategy review;
- Review the existing investment beliefs with a view to expanding those focussed on responsible investment;
- Evaluate the risk/return profile of the existing investment strategy against set criteria;
- Analyse a range of alternative investment strategies to determine whether or not they more effectively meet the set criteria; and
- Assess the structures of the growth and income portions of the strategy.

2 Recap of 2018 Investment strategy review

In 2018 a review of the Fund's investment arrangements was carried out using asset liability modelling to help inform decisions about the investment strategy. The review focussed on the high-level investment strategy in terms of the allocation to higher return seeking "growth" assets such as equities, diversifying "income" focussed assets such as property and infrastructure, and lower risk "matching" assets such as bonds. As part of the strategic review, asset liability modelling was carried out using information from the 2016 valuation and market conditions as at 31 March 2017. The analysis gave us the ability to test the impact of different contribution and investment strategies on the possible outcomes for the Fund. Objective metrics were adopted during the review as a means to assess the potential impact of changes to the investment and funding strategy. The metrics were as follows:

Long term

- The strategy should have at least a 2/3rds chance of achieving full funding on the Fund's ongoing funding basis in 20 years' time.
- The probability of the Fund being less than 90% funded after 20 years should be less than 10%.

Short term

- The increase in deficit in the worst 5% of outcomes over the next 3 years must be no more than 2 times.
- The probability of being less than 70% funded after 3 years should be less than 10%.

Conclusions of review

The analysis considered the impact of restructuring the allocation to growth assets and the potential impact of introducing greater diversification within the income ("diversifier") allocation. As a reminder, the main conclusions of the review included:

- The current strategy provided a good chance of meeting long term funding objectives, but alternative strategies existed that could more efficiently deliver on these;
- Based on the contribution strategy that was in place, it was possible to reduce the growth allocation (including DGF) within the investment strategy to be 60% over the longer-term; and
- There was scope to increase diversification and maintain the ability to meet the Fund's long-term objectives through increased allocations to diversifiers. This was due to the diversification benefits and the level of expected returns for equities and certain yielding assets.

Outcomes of review

Based on the conclusions of the review we recommended the Fund seek to reduce risk and diversify the strategy in two stages. This resulted in the following interim and long-term targets being agreed. Full details of the propose mapping to these strategies is included in Appendix 2.

Table 1: Asset allocation summary - 2018

	Interim Target	Long-term Target
Growth (including DGFs)	68%	60%
Income (Diversifiers)	17%	25%
Protection	15%	15%

However, it was also noted that moving from the current allocations to these new targets will take time e.g. as the London CIV launches sub funds and as private market allocations are built up over time; and during this process a degree of pragmatism is likely to be required on the Fund's allocations e.g. holding diversified growth funds as a proxy for Income assets. We discuss this further in this paper.

3 Strategic goals, objectives and beliefs

Strategic goals and objectives

The strategic goals of the Fund are to **pay benefits as they fall due, and to have a stable (and affordable over the long-term) contribution rate.** These goals are further expanded in the strategic objectives.

- The primary objective of the Fund is to provide pension and lump sum benefits for members on their retirement and/or benefits on death, before or after retirement, for their dependants, on a DB basis.
- The investment objective is to maximise returns over the long term within specified risk tolerances.

In order to achieve these objectives, the Officers must set a clear investment strategy. The approach to setting this strategy is set depend, in part, on the Fund's investment beliefs, and therefore it is important that the investment beliefs are reviewed and adjusted as necessary.

Investment beliefs

The current investment beliefs were formally signed off in November 2018. We believe that, for the most part, they are still appropriate and relevant for the Fund. However, we understand the Officer and Committee are committed to further developing the beliefs with respect to the Responsible Investment ("RI"). Responsible investment has moved up the agenda in recent times at both a macro and micro level. The Fund's current RI beliefs are listed below, and the complete list of beliefs can be found in the Appendices.

Environmental, social and corporate governance ('ESG') issues can have a material impact on the long-term performance of its investments *– the Committee recognises that ESG issues can impact the Fund's returns. The Committee commits to an ongoing development of its ESG policy to ensure it reflects latest industry developments and regulations and ESG is integrated into strategic considerations.*

Climate change and the expected transition to a low carbon economy is a long-term financial risk to Fund outcomes – *the Committee recognises that environmental issues can impact the Fund's returns. The Committee aims to be aware of, and monitor, financially material environmental-related risks and issues through the Fund's investment managers and advisors.*

In light of the Fund's increased focus and importance of responsible investment, we believe that there is scope to add to these existing beliefs. Our proposed additional beliefs to consider are set out below.

Proposed additional beliefs

Ongoing engagement is preferable to divestment

The Committee believe that, in relation to ESG risks, ongoing engagement with investee companies is preferable to divestment. This engagement maybe via our managers or alongside other investors (e.g. LAPFF). Where, over a considered period, however, there is no evidence of a company making visible progress towards carbon reduction, we believe that divestment should be actively considered.

We must act as responsible owners

As asset owners in the 21st Century, we believe it is our responsibility to support the transition to a low carbon global economy, consistent with the aims of the Paris 2016 Climate Change agreement to limit temperature increases by 2050 to a maximum of 2ºC.

The Fund's investment managers should embed the consideration of ESG factors into their investment process and decision-making *Investment managers are responsible for implementing the Fund's strategy. In this role, the managers should reflect the Fund's desire for achieving long-term sustainable returns and improve corporate behaviour.*

4 Investment strategy

Current investment strategy

The Fund's current strategic long-term target strategy and current allocation are shown below.

Table 2: 2018 outcomes summary

Asset Class	Current Allocation[1]	Interim Target	Long-term Target
Global Equity	37%	35%	35%
UK Equity	13%	5%	5%
EM Equity	3%	5%	5%
Private Equity	5%	5%	0%
DGFs	19%	18%	15%
Infrastructure	4%[2]]	12%	15%
Property	0%	5%	10%
Multi Credit	4%	5%	5%
Gilts	9%	10%	10%
Cash	6%	0%	0%

[1] As at 31/12/19. [2] Note a further 5% of capital has been committed to the LCIV Infrastructure fund which has not yet been drawn.

As shown, the Fund's current allocation deviates from both the agreed interim and long-term targets. This partly reflects market moves, with equities having performed strongly, but also assets being held in DGF to help fund the agreed investments in property and infrastructure (LCIV infrastructure and property offerings have taken much longer to launch than anticipated). This raises the question about whether the Fund should wait for the LCIV or look to address this imbalance within the portfolio sooner. This is discussed in a later section.

Target return

As previously noted, the purpose of the investment strategy is to help deliver on the Fund's long-term objectives alongside the agreed funding strategy. The funding strategy is developed by the Fund's actuaries, also Hymans Robertson, at formal valuations, the most recent being 31 March 2019. We therefore need to ensure that the investment strategy is consistent with the assumptions adopted as part of this valuation.

As part of the 2019 formal valuation, the actuaries adopted a future investment return assumption (a "discount rate") of 4.4% when reporting the funding level for the Fund. However, when doing so the actuary is required to make a prudent assumption of future investment returns. Thus, we use this only as a guide for evaluating the investment strategy i.e. we would expect each strategy to achieve this as a minimum with a view to achieving excess return in the most efficient manner.

4.4% p.a. is therefore the minimum return the Fund should be seeking to achieve on its investment strategy and what we use as very much the lower bound to assess the current and alternative investment strategies considered in this section.

Risk and return profile – current long-term target

Inputting the long-term target asset allocation (shaded column, table 2) into Hymans Robertson's Structure model gives a best estimate long term expected return of **5.40%** p.a. with a corresponding volatility of **9.77%** p.a. over 1 year.

This is in excess of the "required" return used by the Actuary in the funding valuation i.e. continuing with the current investment strategy is consistent with the funding objectives and therefore fit for purpose from a pure return front.

The volatility measure captures risk in the form of the potential variance in expected return over a 1 year period. The 9.77% p.a. figure for the current portfolio therefore implies that over a 1 year period expected return could vary by +/- 9.77% in any two years out of three. Equity risk is the largest contributor to both return and risk when measured on an absolute basis.

The expected risk and return figures are based on projected returns from Hymans Robertson's proprietary stochastic asset model, Economic Scenario Service (ESS). The assumptions underlying this model are provided in the Appendix 3 and are as at 31 December 2019.

Alternative investment strategies

This section seeks to determine the extent to which changes to the current long-term target could take to still meet the Fund's return objectives. We have modelled potential alternative portfolios which show what effect different asset allocations have on expected risk and return. This modelling helps give an indication of the implications of changing the Fund's investment strategy, most notably in terms of taking more investment risk, or seeking more diversification.

Table 3: Modelled investment strategies

Asset Class	Current Long-term Target	Current – Restructured	Diversifier Focussed	Growth Focussed
Global Equity	*35%*	*40%*	*30%*	*45%*
UK Equity	*5%*	*5%*	*2.5%*	*7.5%*
EM Equity	*5%*	*5%*	*2.5%*	*7.5%*
Private Equity	*0%*	*0%*	*0%*	*0%*
Total equities	**45%**	**50%**	**35%**	**60%**
Multi Asset	*15%*	*5%*	*15%*	*13%*
Infrastructure	*15%*	*15%*	*15%*	*12%*
Property	*10%*	*10%*	*10%*	*0%*
Private Debt	*0%*	*5%*	*10%*	*0%*
Total diversifiers	**40%**	**35%**	**50%**	**25%**
Multi Credit	*5%*	*5%*	*5%*	*5%*
Gilts	*10%*	*10%*	*10%*	*10%*
Total protection	**15%**	**15%**	**15%**	**15%**
Return (p.a. over 20 yr)	**5.40%**	**5.52%**	**5.38%**	**5.50%**
Risk (vol, over 1 yr)	**9.77%**	**9.88%**	**9.39%**	**10.18%**

From the quantitative analysis above we can see the following points from a strategic perspective:

- Two of the alternative strategies, with the exception of the “Diversifier-Focussed” one, achieve a higher per annum expected return than the current long-term target
- Increasing the allocation to equities increases the overall risk and return levels
- Adopting a more Diversifier focussed strategy marginally reduces the expected return but reduces the risk more noticeably.

Summary and conclusions for investment strategy

The above results suggest that there is scope for the Fund to increase its long-term target exposure to equities to c50% of total assets, as it increases expected return and only marginally increases the level of investment risk (as shown by column “Current- Restructured”). Given the Fund’s strong positive cashflow, we are comfortable with this move and believe the impact of the risk change is marginal.

This represents a 5% increase in the strategic equity target, compared the 2018 targets, with this allocation funded by reducing the allocation to “diversifiers”

Asset Class	Current Long-term Target	Revised long-term target	Change
Total equities	**45%**	**50%**	**+5%**
Total diversifiers (including DGFs)	**40%**	**35%**	**-5%**
Total protection	**15%**	**15%**	**0%**
Total assets	**100%**	**100%**	**-**

In the following section we talk about the Investment structure i.e. the mandates that sit within the investment strategy and the approach to implementation.

5 Investment structure

There are number of aspects that fit within this Section.

Governance and implementation

Diversified Growth classification

The Fund has mandates with Ruffer and Baillie Gifford that invest across a range of asset classes, collectively these mandates are called Diversified Growth ("DGF") mandates. For the purpose of this paper, we define these assets in the "Diversifiers", as we believe this reflects the role these assets perform in the Fund's overall arrangements. This classification represents a different approach to the 2018 review, when the DGFs were in the "Growth" asset grouping. Please note, this is purely a presentational change, it had no impact on the 2018 or 2020 results, as the modelling is carried out on a mandate specific basis.

London CIV

The CIV continues to experience considerable turnover and change e.g. most recently the departure of the Head of Fixed Income. This ongoing change seems to be having implications on the time it is taking the CIV to launch certain sub-funds and draw money for those sub-funds that are launched e.g. the Fund has committed money to the CIV's infrastructure fund but this has not been drawn yet. We are taking the CIV's current position seriously and are meeting them on a number of occasions over the coming months, which we will keep you updated on.

In terms of this paper, this lack of sub-fund offering/time to get money invested raises questions for the Fund e.g. is there scope/willingness for the Fund to invest outside the Pool? How should money, expected to be invested with the CIV, be held in the interim e.g. the money earmarked for property and infrastructure.

Asset classes

Equities

We continue to support the Fund having a diverse allocation to equities (including global emerging markets). With the majority of this exposure accessed via index-tracking mandates.

One area that is worth further discussion is Responsible Investment. Over recent years, there has been notable evolution in the investment strategies being offered by investment managers (index-tracking and active). Given the Fund's large index-tracking exposure, we strongly recommend that you consider such mandates, at least for a proportion of the Fund's index-tracking exposure. The main index-tracking offerings tend to look to offer similar levels of investment returns than the broad market, but with a notably lower carbon exposure. We will provide further comments at the Pre-Committee training session. Following this session, we can agree next steps with you.

Protection assets

We continue to be comfortable with the Fund's current arrangements, with the gilts offering low cost exposure to nominal protection assets and the MAC mandate offering low duration exposure to credit markets.

Diversifiers

We continue to support notable allocations to property and infrastructure.

We also believe there is merit in including an allocation to Private Debt in the Fund's investment strategy. Private debt is an income focussed asset with a shorter-term focus than infrastructure, so would provide natural diversification within the "diversifier" bracket whilst adding wider diversification within the portfolio. The aim of allocating to assets in this category is to deliver an absolute return, meaningfully higher than might currently be achieved investing in cash or short-term high-quality bonds, but with a degree of reasonable predictability. To deliver the predictability in returns, a large part of the return will be derived through identifiable sources of income rather than relying on the uncertainty of capital gains.

Private Debt mandates tend to focus on sub-investment grade credit ratings, therefore a core skill of the underlying investment manager is to assess the credit worthiness of the underling debt issuer. The LCIV plans to offer a Private Debt vehicle although the development of this remains at a very early stage with no set date for launch available.

Implementation

CIV

As stated previously, the issue over getting access via the CIV is real one and affects a number of assets classes. The Fund has already committed £50m to the CIVs infrastructure offering, albeit none of this money has been called yet. No money has been committed to the CIV for Private Debt or Property (due to the lack of vehicle available).

For all the asset classes, there is scope to access these outside the pool e.g. buy secondary property units or commit further money to your existing infrastructure manager Alinda,or make other infrastructure investments e.g. JP Morgan/IFM. This is in part depends on the Committee's comfort for investing outside the Pool. We will discuss this with you at your February meeting. You may wish to raise this with the CIV and also other London Boroughs who are facing similar challenges.

Time to invest

In addition, to the above point, the nature of a number of these asset classes means that it can take considerable time to get access e.g. infrastructure you commit money, with this money then gradually drawn by the manager as they find investments. This means that you typically gradually work towards the target allocation. Given this, you may have to invest these monies elsewhere, until it is ready to be drawn. Another feature of these less liquid asset classes is the challenge of rebalancing i.e. you can't buy or sell to rebalance to target allocations. Again, this means a degree of pragmatism needs to be required in any rebalancing process.

Recommended strategy

Taking the above points into account we propose the following approach to implementation (see table below).

		Previous		Recommended	
Asset Class	**Current Allocation**	**Interim Target**	**Long-term Target**	**Interim Target**	**Long-term Target**
Global Equity ex UK	*37%*	35%	35%	40%	*40%*
UK Equity	*13%*	5%	5%	5%	*5%*
Global Low carbon	*0%*	0%	0%	To be discussed with Committee	
EM Equity	*3%*	5%	5%	5%	*5%*
Private Equity	*5%*	5%	0%	5%	*0%*
Total equities	***58%***	**50%**	**45%**	**55%**	***50%***
DGF	*19%*	18%	15%	20%	5%
Infrastructure	*4%**	12%	15%	10%	*15%*
Property	*0%*	5%	10%	0%	*10%*
Private Debt	*0%*	0%	0%	0%	5%
Total diversifiers	***23%***	**35%**	**40%**	**30%**	***35%***
Multi Credit	*4%*	5%	5%	*5%*	*5%*
Gilts	*9%*	10%	10%	*10%*	*10%*
Cash	*6%*	0%	0%	0%	0%
Total protection	***19%***	15%	15%	**15%**	**15%**
Total	***100.0***	**100.0**	**100.0**	**100.0**	**100.0**

Points to note include:

- We continue to support a phased approach to working towards the long-term target allocations, with an interim allocation in place.
- We anticipate a global low carbon mandate forming part of the Fund's equity allocation. The size of this allocation and the fund in question will be discussed with you further. We anticipate this being funded from a portion of the Fund's existing equities.
- Private equity will run off over time. However, this will take time, hence it continues to justify a place in the Fund's interim strategy.
- Until there is a decision on potential routes of investment, we do not propose any interim allocations to property and private debt. We have set the interim infrastructure allocation to 10% (reflecting the current allocation and the future commitment), albeit in reality the Fund will struggle to reach this allocation in the absence of further commitments.
- The Fund's DGF mandates provide a low governance diverse approach to investment markets. We remain comfortable with DGF, performing a role in the Fund's investment strategy at this time.
- We do not propose any changes to the Fund's protection assets at this time.

Rebalancing

For a range of reasons, the Fund's actual investment arrangements will deviate form the target over time e.g. market movements, manager performance etc. We strongly recommend a degree of rebalancing takes place on a regular basis e.g. quarterly, to try and prevent too much deviation from the desired strategic allocation (also rebalancing has proven to add value over the long-term).

For the Fund, we propose the following key principles:

- At a high level, the important rebalancing is between Equities, Diversifiers and Protection assets groupings. **We recommend rebalancing ranges of ±5% at each of these grouping levels e,g. for protection assets a range of 10%-20%.**
- Pragmatism is applied. When rebalancing, we propose it is not all the way to the target allocation, instead just moving to half way between central and outer range. This reduces the transaction costs associated with such rebalancing.
- Rebalancing between mandates within these groupings is also relevant, albeit we view its as lower priority. For the underlying equity mandates, we propose ranges of ±3% at each fund level. We note that these ranges are large for the smaller allocations, but we believe this is acceptable in terms of total Fund risk.
- For Diversifiers, the DGFs will be used to help balance the total allocation, this may mean that at times, the actual allocation deviates notably from the target. We remain supportive of both of the Fund's managers. We will discuss this with you in more detail at your February meeting.
- For Protection assets, we propose ranges of ±3% at each mandate. We also recommend any unallocated cash holdings are included in the Fund's Protection asset allocation

We look forward to discussing this paper with you in February. Once there is agreement we recommend it is turned into a formal investment policy

A summary of key points are included in the first section of this report.

Prepared by:-

William Marshall, Partner
Kameel Kapitan, Associate Consultant
Dave Gilmour, Investment Analyst

10 February 2020

For and on behalf of Hymans Robertson LLP

Appendices

Appendix 1 – Current Investment Beliefs

Clear and well-defined objectives are essential to achieve future success – the Committee is aware that there is a need to generate a sufficient level of return from the Fund's assets, while at the same time having a clear understanding of the potential risks and ensuring there is sufficient liquidity available to pay members' benefits as they fall due.

Strategic asset allocation is a key determinant of risk and return, and thus is typically more important than manager or stock selection – the Committee understands that having the appropriate strategy in place is a key driver of the Fund's future success. As a result, priority is given to more strategic investment matters. The Committee is aware that there is need to take investment risk in order to generate a sufficient level of return.

Return and risk should be considered relative to the Fund's liabilities, funding position and contribution strategy – the Committee believes that as the funding position of the Fund improves, the level of risk taken by the Fund should reduce as appropriate i.e. only take as much risk as necessary. The Committee believes that there exists a relationship between the level of investment risk taken and the rate of expected investment return. In reducing risk, the Fund's expected return would typically also reduce.

Long term investing provides opportunities for enhancing returns – As a long-term investor it is important that the Fund acts as an asset owner. As a long-term investor, the Fund may choose to gain additional compensation by investing in assets that are illiquid or may be subject to higher levels of volatility (a premium return is required for any such investments).

Environmental, social and corporate governance ('ESG') issues can have a material impact on the long-term performance of its investments – the Committee recognises that ESG issues can impact the Fund's returns. The Committee commits to an ongoing development of its ESG policy to ensure it reflects latest industry developments and regulations and ESG is integrated into strategic considerations.

Climate change and the expected transition to a low carbon economy is a long-term financial risk to Fund outcomes – the Committee recognises that environmental issues can impact the Fund's returns. The Committee aims to be aware of, and monitor, financially material environmental-related risks and issues through the Fund's investment managers and advisors.

Equities are expected to generate superior long-term returns – the Committee believes that, over the longer term, equities are expected to outperform other liquid assets, in particular government bonds. However the Committee also recognise that equities can be highly volatile over the short-term.

Diversification reduces the overall volatility of the Fund's asset returns – the Committee believes that diversification across asset classes can help reduce the volatility of the Fund's overall asset value and improve its risk-return characteristics. However, the Committee also recognise that there is scope to over diversify and that any desire to diversify needs to be aligned to the Fund's governance arrangements.

Passive management has a role to play in the Fund's structure – the Committee recognises that passive management allows the Fund to access certain asset classes (e.g. equities) on a low-cost basis and when combined with active management can help reduce the relative volatility of the Fund's performance. There is a belief that passive management is most suitable for markets that are deemed as being more efficient such as developed market equities.

Active management can add value but is not guaranteed – the Committee recognises that certain asset classes can only be accessed via active management. The Committee also recognises that active managers may be able to generate higher returns for the Fund (net of fees), or similar returns but at lower volatility, than equivalent passive exposure. There is a belief that active management is most suitable for markets that are deemed as being less efficient e.g. emerging market equities, specialist markets e.g. infrastructure or where views on the relative value of different asset classes are a targeted source of value e.g. DGF mandates.

Private markets can offer opportunities – Private markets can offer opportunities and give higher return due to higher illiquidity premia. However, it is recognised that private markets can be more expensive, less transparent (e.g. fees and drivers of return), increase the Fund's governance burden and require ongoing maintenance to achieve target exposure. Such factors must be taken into account when considering such an allocation.

Choice of benchmark index matters – the Committee recognises that, for each asset class, there is a range of benchmark indices that they could use. As a result, the Committee focus on the benchmark's underlying characteristics and consider how they may be appropriate for the Fund.

Rebalancing policies are important – the Committee recognises that rebalancing the Fund's assets towards the strategic asset allocation is important in achieving the Fund's longer-term objectives, in particular following a period of strong or weak market performance.

Fees and transaction costs matter – The Committee considers the fees and costs of its investment arrangements to ensure the Fund is getting value for money and to minimise, as far as possible, any cost leakages from its investment process. It also does not seek to move in and out of investments regularly due to the cost drag. The Committee also seek to have transparency on the fees that it is paying to its providers.

Governance "budget" matters – The Committee recognises that the resources (and time) involved in deciding upon (and implementing) an investment strategy and structure play a part in any investment decisions made. A low governance approach to accessing markets is likely to be preferred if it can offer similar risk adjusted returns to alternative approaches.

The London CIV is the Fund's preferred approach to implementation – the Committee recognises the potential benefits of LGPS pooling. There preferred route is to implement their investment strategy via the London CIV, subject to carrying out suitable due diligence on the CIV's investment offering.

Appendix 2 – 2018 Investment Strategy Review mapping

	Style	Manager	31/03/2018 Value (£m)	31/03/2018 Actual allocation (%)	Current Target Asset Allocation (%)	Interim Asset Allocation (%)	Proposed Target Asset Allocation (%)	Comment
Private Equity	Fund of Funds	Capital Dynamics	64.5	7.8	10.0	5.0	0.0	Allocation gradually being unwound. No further commitments to be made. Further work to get indication of timescale for run-off. Continue to include exposure in total equity allocation.
	Fund of Funds	Yorkshire	0.5	0.1				
Equities	UK Passive	LGIM (CIV)	108.4	13.1	45.0	45.0	45.0	Adjust the benchmark to have lower UK allocation and add a proportion of emerging markets. Redeem small cap equities and proceeds invested into passive mandate
	Overseas Passive	LGIM (CIV)	274.3	33.0				
	Small-Cap	Henderson	31.6	3.8				
Diversified Growth	Multi-asset	Baillie Gifford (CIV)	75.5	9.1	21.0	18.0	15.0	Although DGFs are part of Fund's growth exposure they also provide a degree of exposure to income and protection assets. They can act as "balancing" item for strategic allocation during the period as the income exposure is being built up.
	Multi-asset	Ruffer (CIV)	48.8	5.9				
Total growth	-	-	**603.6**	**72.8**	**76.0**	**68.0**	**60.0**	

	Style	Manager	31/03/2018 Value (£m)	31/03/2018 Actual allocation (%)	Current Target Asset Allocation (%)	Interim Asset Allocation (%)	Final Proposed Target Asset Allocation (%)	Comment
Infrastructure	Direct	Alinda	24.9	3.0	8.0	12.0	15.0	Priority is to work towards current target. Investigate scope to commit additional monies e.g. working with existing managers and CIV. Also potential use of secondary market.
	Funds+ Direct	Capital Dynamics	8.4	1.0				
Property	Europe fund-of-funds	Aviva	2.1	0.2	0.0	0.0	0.0	Being wound down. No further commitments
New income mandate	One or more	TBC	0.0	0.0	0.0	5.0	10.0	Potential to add core UK property or other additional income fund via secondary market as initial step
Total income	-	-	**35.4**	**4.2**	**8.0**	**17.0**	**25.0**	
Fixed Income	Active	Henderson – Total Return	94.1	11.3	15.0	0.0	0.0	Redeem Henderson Fund, not going to be part of CIV.
Fixed Income	Active/ Passive	Recommend LGIM/CIV	-	-	-	15.0	15.0	Recommendation is for proportion c.10% in passive longer duration bonds plus c 5% allocation to multi-asset credit
Cash	Short-dated	In-house	97.0	11.7	1.0	-	-	Remove 1% strategic allocation to cash
Protection	-	-	**191.1**	**23.0**	**16.0**	**15.0**	**15.0**	-
TOTAL	-	-	**830.2**	**100.0**	**100.0**	**100.0**	**100.0**	-

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Appendix 3 – ESS Assumptions

The distributions of outcomes depend significantly on the Economic Scenario Service (ESS), our (proprietary) stochastic asset model. This type of model is known as an economic scenario generator and uses probability distributions to project a range of possible outcomes for the future behaviour of asset returns and economic variables. Some of the parameters of the model are dependent on the current state of financial markets and are updated each month (for example, the current level of equity market volatility) while other more subjective parameters do not change with different calibrations of the model.

Key subjective assumptions are the average excess equity return over the risk free asset, the volatility of equity returns and the level and volatility of yields, credit spreads, inflation and expected (breakeven) inflation, which affect the projected liability and bond returns. The output of the model is also affected by other more subtle effects, such as the correlations between economic and financial variables.

Our expectation (i.e. the average outcome) is that long term real interest rates will gradually rise from their current low levels. Higher long-term yields in the future will mean a lower value placed on liabilities and therefore our median projection will show, all other things being equal, an improvement in the current funding position (because of the mismatch between assets and liabilities). The mean reversion in yields also affects expected bond returns. The impact of the yield reversion assumption is illustrated in the standard results charts that we produce using the model output.

While the model allows for the possibility of scenarios that would be extreme by historical standards, including very significant downturns in equity markets, large systemic and structural dislocations are not captured by the model. Such events are unknowable in effect, magnitude and nature, meaning that the most extreme possibilities are not necessarily captured within the distributions of results.

Given the context of this modelling, we have not undertaken any sensitivity analysis to assess how different the results might be with alternative calibrations of the economic scenario generator.

The returns presented here are time weighted returns over the specified period and are unaffected by the timing of any contributions received or pensions paid over that period. Such returns are, in general, a poor estimator of money weighted returns, which are sensitive to the timing of cashflows.

The probability that a specific asset return will be exceeded will not usually equate to the probability that some funding plan based on this return will be sufficient to meet all the pension payments. Complex interactions between the assets, yields and cashflow timings can mean that the two probabilities are materially different, especially for more mature schemes.

We would be happy to provide fuller information about the scenario generator, and the sensitivities of the results to some of the parameters, on request.

Brent	**Pension Board** 25 March 2020
	Report from the Director of Finance

Update on Responsible Investment, Climate Change Risk and Environmental, Social and Governance (ESG) issues

Wards Affected:	ALL
Key or Non-Key Decision:	Non-Key
Open or Part/Fully Exempt: (If exempt, please highlight relevant paragraph of Part 1, Schedule 12A of 1972 Local Government Act)	PART EXEMPT - as it contains the following category of exempt information as specified in Paragraph 3, Schedule 12A of the Local Government Act 1972, namely: "Information relating to the financial or business affairs of any particular person (including the authority holding that information)"
No. of Appendices:	Three 1. Carbon footprinting scopes 2. Climate Change Funding Analysis 3. ESG-oriented Equity funds (Exempt)
Background Papers:	▪ N/A
Contact Officer(s): (Name, Title, Contact Details)	Minesh Patel, Director of Finance Ravinder Jassar, Head of Finance Sawan Shah, Senior Finance Analyst

1.0 Purpose of the Report

1.1 This report provides an update on Environmental, Social and Governance (ESG) considerations with regards to strategic investment decisions, in particular how the fund is continuing to manage the risks of climate change.

2.0 Recommendation(s)

That the committee:

2.1 Note the overall report with regards to the position on Responsible Investment and Environmental, Social and Governance matters (ESG).

2.2 Note the work carried out in relation to scenario analysis of the impact of climate change and agree the actions arising.

2.3 Note the research carried out on low carbon (or ESG orientated) index tracking funds and delegate authority to the Director of Finance to put into effect this investment as part of the wider investment strategy review.

2.4 Agree to conduct a carbon footprint of the Fund at an estimated cost of between £10k and £20k and to delegate authority to the Director of Finance to finalise the terms of the exercise as set out in section 5.9 of this report.

2.5 Note the collaborative work being undertaken by London Boroughs and the London CIV to bring forward new ESG orientated investments.

3.0 Background

3.1 LGPS funds face increasing pressure from various stakeholders to ensure that Environmental, Social and Governance (ESG) issues are considered in the course of managing the fund and in its investment decision making. This has been driven by an increased focus in this area from lobby groups and regulators, and from greater public scrutiny.

3.2 Environmental, Social and Governance (ESG) is a term that is used to describe a set of factors within responsible investing (RI) that can be a source of financial risk within different assets. The below table shows some examples of ESG factors.

Environmental factors	Social factors	Governance Factors
Climate change	Diversity	Board Structure
Resource Scarcity	Human rights	Executive Remuneration
Water Stress	Health & Safety	Transparency
Pollution	Data Protection	Shareholders Rights
Waste Management	Community Relations	Auditing and Accounts

3.3 LGPS Guidance on Preparing and Maintaining an Investment Strategy Statement requires that responsible investment and ESG issues are considered in investment decisions:

3.4 When making investment decisions, administering authorities must take proper advice and act prudently. In the context of the local government pension scheme, a prudent approach to investment can be described as a duty to discharge statutory responsibilities with care, skill, prudence and diligence. This approach is the standard that those responsible for making investment decisions must operate.

3.5 Although administering authorities are not subject to trust law, those responsible for making investment decisions must comply with general legal principles governing the administration of scheme investments. They must also act in accordance with ordinary public law principles, in particular, the ordinary public law of reasonableness. They risk challenge if a decision they make is so unreasonable that no person acting reasonably could have made it.

3.6 The law is generally clear that schemes should consider any factors that are financially material to the performance of their investments, including social, environmental and corporate governance factors, and over the long term, dependent on the time horizon over which their liabilities arise.

3.7 Although schemes should make the pursuit of a financial return their predominant concern, they may also take purely non-financial considerations into account provided that doing so would not involve significant risk of financial detriment to the scheme and where they have good reason to think that scheme members would support their decision.

4.0 Scenario Analysis

4.1 The Brent Fund Pension Fund has engaged with its actuary to model the impact of three climate change scenarios. These are:

- **Green Revolution**: Rapid policy response from government creates the absolute necessity for change which is matched by the deployment of green technologies and ongoing investment in adaptation;

- **Challenging times**: Challenging times reflects delayed policy action. Change is likely to be intermittent at first but is assumed to become more severe in response to growing environmental feedbacks;

- **Head in the Sand**: Policy responses do not prioritise environmental change with corporates largely continuing business as usual type approaches.

4.2 This analysis isolates different market outcomes which are associated with these three climate scenarios and examines the long term funding impacts on the fund. The modelling combines the impact of markets (which generally affects asset values) and the longevity impact (which affects the Fund's liabilities). The full report is available in Appendix 2.

4.3 The results of this analysis show that, both, the head in the sand and the challenging times scenarios are likely to give poorer funding outcomes than the current funding plan anticipates. Under both of these scenarios, the reduction in longevity lead to a reduction in liabilities. All other things being equal, this would improve the funding position. Therefore, the poorer funding outcome can be attributed to reduction in GDP growth and equity returns.

4.4 The Green Revolution scenario provides the most optimistic outcomes in the medium to long term. These are similar funding outcomes to those that are anticipated in the current funding plan. However, even some of the projections in this most optimistic scenario provide negative funding outcomes in the short term.

4.5 The Fund's current investment strategy reflects that the Brent Pension is poorly funded compared to other LGPS pension funds and strikes an appropriate balance between generating a satisfactory long-term return on investments whilst taking account of market volatility and risk and the nature of the Fund's liabilities.

4.6 Nevertheless, the report proposes a set of next steps including:

- A review of investment beliefs and asset allocation,
- A review of carbon exposure of existing investments,
- Engagement programmes with fund managers and
- Improved reporting and disclosures on ESG using industry best practice guidance.

The Fund has considered many of these actions in this report.

5.0 Fund Manager Research and Measuring Climate Risk

5.1 Within ESG issues, it is clear that climate change and its effect on the planet is a key challenge. To minimise the consequences, world leaders agreed to limit global temperature rise this century to below 2 degrees Celsius above pre-industrial levels and to pursue efforts to limit the temperature increase even further to 1.5 degrees Celsius in the Paris agreement. Furthermore, the UK government has committed to bring all greenhouse gas emissions to net zero by 2050. It is clear that that Climate Change poses a significant risk to long-term investors such as the Brent Pension Fund however there remains considerable uncertainty as to what the exact impact will be.

5.2 With an increasing focus on climate risk, investment managers are also adapting to investors' concerns. Therefore, it is important to understand the Fund's current position, both, in terms of engagement and activity already carried out by investment managers, and to understand the Fund's exposure to climate change.

5.3 Officers have asked each active fund manager for further information on the extent to which they are taking account of climate risk within their portfolios and how they are managing this risk. They have also been asked on engagement activity they have conducted on assets owned.

5.4 It is also proposed to undertake a carbon footprint exercise for the Fund in order to improve its understanding of the Fund's holdings. The exercise will use the latest data on greenhouse gas emissions attributable to global companies.

5.5 An initial carbon footprinting exercise on the Fund's assets would:

- Provide base data to better understand the impact of the Fund's current investments on emissions and climate risks.
- Allow the committee to assess the impact of future investment decisions on environmental factors and to monitor progress over time.

5.6 Carbon footprinting is a measure of carbon emissions that can be attributed to the Fund's investment portfolio. This is based on the total carbon emissions data of the individual company and then calculating the ownership of the organisation by the Fund. The Fund would then receive a carbon intensity score measured in tonnes/$m invested. This is then typically compared to the footprint of the benchmark (e.g. the portfolio benchmark or FTSE All-world)

5.7 It is important to note that there are several limitations of carbon footprinting and therefore carbon footprinting can only be seen as a tool to aid analysis. However, these limitations are expected to improve over time. In summary:

5.7.1 There are caveats around data quality. The main source of information is through publically available information such as annual reports. Furthermore, the data can sometimes be quite old.

5.7.2 In many countries, carbon reporting is voluntary and is not always audited. Where data is not available carbon footprinting uses estimation techniques to fill gaps.

5.7.3 Assumptions are made as to whether emissions fall into scopes 1, 2 or 3. Carbon footprinting tools focus on scopes 1 and 2, data for scope 3 is not widely reported. Further information on scopes is available in appendix 1.

5.7.4 Data is generally not available for private equity and other private markets.

5.8 Other methods of analysis in this area include: carbon risk ratings which score companies on how susceptible they are to climate change, % portfolio invested in fossil fuel production companies and % of portfolio invested in green transport and renewable energy.

5.9 Officers will work with our investment advisors, Hymans to agree the exact terms of the exercise and to appoint a contactor to conduct a carbon footprint of the Fund. This is estimated to cost between £10k and £20k and the exact cost will depend on the fund's holdings at the measurement date. The results of this exercise will be reported to the committee later this year.

6.0 Investment Strategy

6.1 The Fund's Investment Strategy Statement (ISS) describes its overarching approach to dealing with environmental, social and governance (ESG) issues, these are reflected in its investment beliefs which were formally agreed in November 2018:

Environmental, social and corporate governance ('ESG') issues can have a material impact on the long term performance of its investments *- the*

Committee recognises that ESG issues can impact the Fund's returns. The Committee commits to an ongoing development of its ESG policy to ensure it reflects latest industry developments and regulations and ESG is integrated into strategic considerations.

***Climate change and the expected transition to a low carbon economy is a long term financial risk to Fund outcomes** - the Committee recognises that environmental issues can impact the Fund's returns. The Committee aims to be aware of, and monitor, financially material environmental-related risks and issues through the Fund's investment managers and advisors.*

6.2 Following the 2019 valuation and agreed at the last committee meeting, the Fund commissioned an investment strategy review, which is to be considered as a separate report on this agenda. This report recommends that the committee's current investment beliefs are fit for purpose but expands on its Responsible Investment beliefs in light of the increased focus on, and importance of, this area.

6.3 The Fund holds a large proportion of its equity investments in passive tracker funds, these are funds that seek to replicate the performance of a market index. This is a practice encouraged by government due to the low fees paid to investment managers. The government has also encouraged Funds to pool their assets to further benefit from fee savings.

6.4 As at 31 December 2019, 54% of the Fund's total assets were invested in listed equities with 50% of the Fund's assets in passive tracker funds. The Fund has conducted research into ESG-oriented equity tracker funds that are available for investment by the pension fund. This is shown in appendix 3.

6.5 It is important to recognise that there are costs to moving from the Fund's current passive tracker funds to more ESG focussed funds from additional management expenses. The exact cost will depend on which mandate is sold and the new investment entered into. Where the Fund achieves a lower rate of return of return due to increased investment management expenses, this will have a negative impact on the overall funding level of the Brent Pension Fund (which is already low in comparison to other funds) as well increase the employer contribution rate for the Council and other employers in the Fund.

6.6 The investment strategy review has recommended that a global low carbon mandate forms part of the Fund's equity allocation, which is to be funded by selling some of the Fund's existing equity holdings and using cash available. The size of the holding and next steps will be discussed further at the committee meeting.

6.7 The Fund's pool, London CIV (LCIV), currently does not offer sufficient products with an ESG focus however, the Fund is aware that there is now an increased focus in this area from the LCIV. It is therefore important for the Fund to collaborate with other local authorities to work to reduce the costs for investments in this area.

6.8 At the February 2019 committee meeting, the sub-committee agreed to commit £50m to the London CIV's infrastructure fund. The Fund had a successful first close of £399m in total on 31st October 2019. At least 25% of the Fund's investment will be invested in renewable projects. The initial infrastructure investment has been made into the "Macquarie GIG Renewable Energy Fund 2". This fund will be 100% focussed on renewable energy with the majority of investments being in wind and solar assets.

6.9 London CIV are also currently working on a 100% renewable infrastructure fund and an active exclusion equity fund due to demand from a number of London Boroughs. Brent will conduct the necessary due diligence on these products as further details are revealed during the year and provided they fit within the scope of the investment strategy will be brought forward to the committee for consideration.

7.0 Financial Implications

7.1 These are discussed throughout the report.

8.0 Legal Implications

8.1 Not applicable.

9.0 Equality Implications

9.1 Not applicable.

10.0 Consultation with Ward Members and Stakeholders

10.1 Not applicable.

11.0 Human Resources

11.1 Not applicable.

Report sign off:

Minesh Patel
Director of Finance
.

Appendix 1 - Carbon footprinting scopes

DEFINING THE SCOPE: DIRECT VS INDIRECT EMISSIONS

MSCI's carbon footprint calculations are based on Scope 1 + Scope 2 carbon emissions:

- **Scope 1:** All direct GHG emissions from sources owned or controlled by the company. Some examples include emissions from fossil fuels burned on site, emissions from entity-owned or leased vehicles.

  As of 21 Sept 2015, Scope 1 emissions comprised 81% of total emissions of the MSCI ACWI Index.

- **Scope 2:** Indirect GHG emissions from consumption of purchased electricity, heat, or steam, and the transmission and distribution (T&D) losses associated with some purchased utilities.

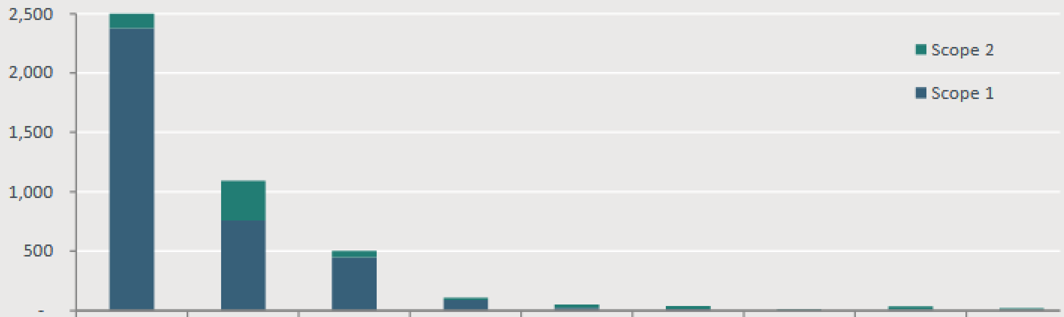
  As of 21 Sept 2015, Scope 2 emissions comprised 19% of total emissions of the MSCI ACWI Index.

- **Scope3:** Other indirect emissions that occur from sources not owned or controlled by the company. Some examples of scope 3 activities are extraction and production of purchased materials; transportation of purchased fuels; and use of sold products and services.

  Since Scope 3 emissions occur from sources not owned or controlled by the company, and the boundaries to measure scope 3 emissions are not well-defined, it is not consistently calculated or disclosed by companies.

  The inconsistency of scope 3 emissions data makes it difficult to perform any meaningful comparative analysis across companies or industries. Further, due to lack of control of the emission sources and boundaries, it is difficult to estimate such emissions comprehensively.

Figure 8 – Scope 1 vs. Scope 2 Emissions by Sector



	Utilities	Materials	Energy	Industrials	Consumer Staples	Consumer Discretionary	Financials	Telecommunication Services	Information Technology
Scope 2	124	332	53	20	26	24	9	33	15
Scope 1	2,377	758	451	90	25	15	5	5	5

Source of definitions: GHG Protocol

Source: MSCI – Carbon Footprinting 101

London Borough of Brent Pension Fund

Climate change risk analysis

Douglas Green FFA
Laura McInroy FFA

16 December 2019

HYMANS ROBERTSON

Background

- This paper is addressed to the London Borough of Brent in its capacity as Administering Authority (in effect the trustee) to the London Borough of Brent Pension Fund (“the Fund”). The Fund is part of the Local Government Pension Scheme (“LGPS”), and its assets are held separately from the Council;
- The Fund has obligations under LGPS Regulations to pay benefits to members as and when they retire, and to their dependants as and when members die, details being defined in those Regulations;
- The Fund holds assets to pay those benefits, although the benefits are not affected by market movements. The assets are derived from contributions paid in by the employers (mainly the Council) and members (set by Regulations), plus investment returns achieved;
- A shortfall in the assets available (i.e. a funding level below 100%) means that, all other things being equal, the employer will need to pay more into the Fund to ensure the Fund can pay the benefits;
- Hymans Robertson is the actuary to the Fund, and one of our Regulatory responsibilities is to advise how much employers need to pay in to the Fund to ensure there are sufficient assets available in the future to pay benefits.

Climate change: a hot topic

- Climate change has the potential to affect the benefits which the Fund needs to pay:
  - if it affects the longevity of members in retirement, then it needs to pay more if members live longer, and less if members die sooner;
  - if it affects price inflation, then members' pensions in payment will rise faster (meaning higher pay-out needed) or slower (meaning lower pay-out needed).
- Climate change also has the potential to affect the assets available to meet these benefits, if it affects:
  - economic growth and inflation,
  - shares & property values,
  - interest rates,

  then this can speed up or slow down the growth in the Fund's asset values (or even reduce the Fund's asset values).
- See slide 10 for details of some of these potential impacts, which we have modelled.
- We have measured how some of these potential impacts might affect the Fund in the short, medium and long term.

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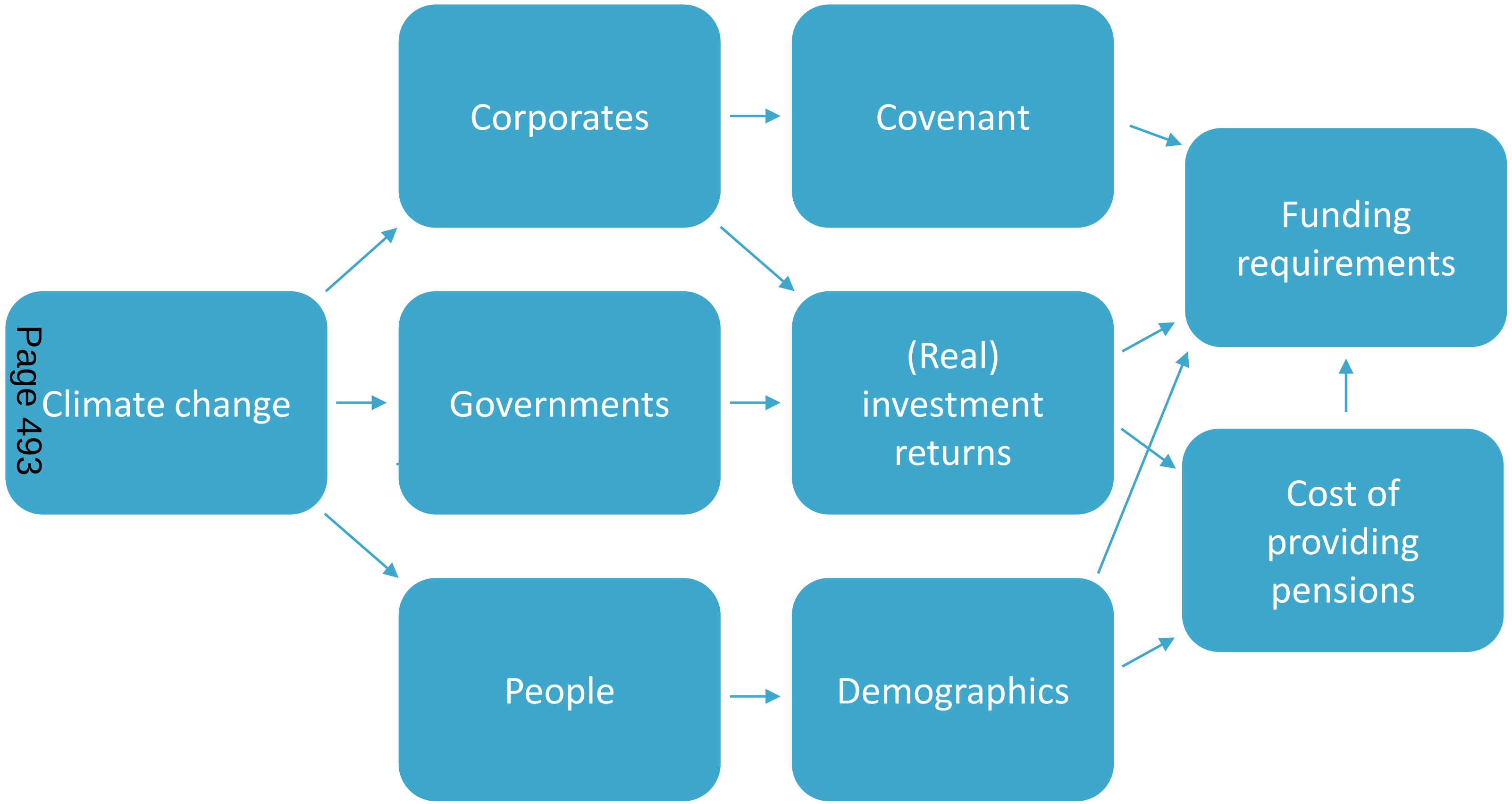
Professional notes

- This paper is addressed to, and has been requested by, the London Borough of Brent in its capacity as Administering Authority (in effect, trustee) to the Fund. The paper may be made publicly available;
- The paper is not formally addressed to, or intended to be taken as advice by, any other party such as Fund employers, members of the Fund, or Council tax-payers;
- The purpose of the paper is to identify to the Fund some of the potential long term funding impacts of different climate change scenarios. It is not intended to be part of the contribution-setting decisions in the 31 March 2019 formal funding valuation;
- Hymans Robertson does not accept responsibility for, nor can be held liable for, this paper being used by any other party than the Administering Authority or for any other purpose.

Climate, economy and pension funds are linked



Policy and market responses controlled by Corporates and Governments

Scenarios modelled

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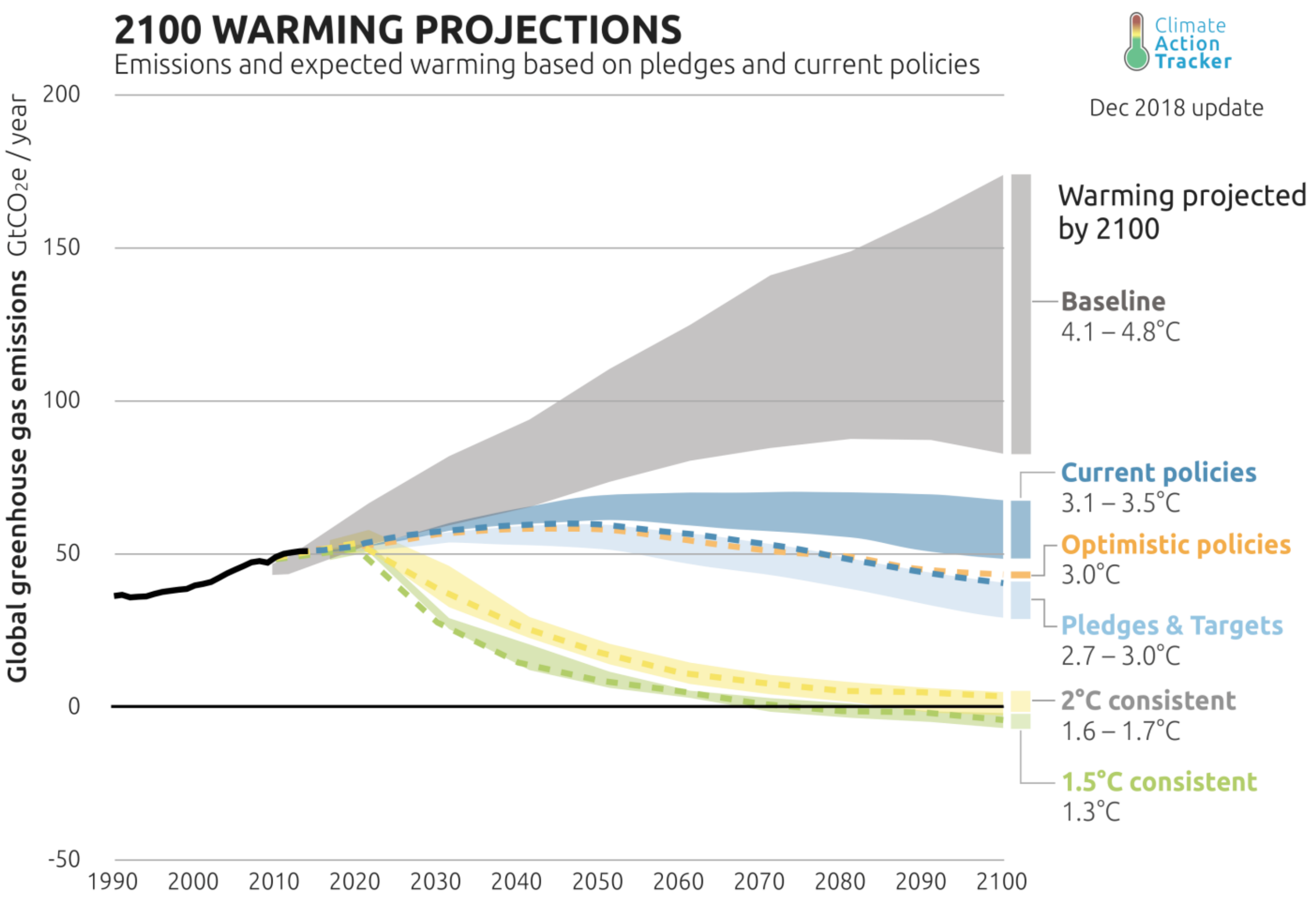
Measuring climate change risk



Pension impact will depend more on Government policy and market reactions, rather than on degree of warming

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Building on longevity impacts

Head in the sand

A range of disastrous outcomes resulting from a total lack of response to climate risk.

Global crop failures, influx of new diseases, severe temperature fluctuations resulting in harsh flu epidemics. Antibiotic resistance rises as new discoveries are limited.

Liabilities -12%

Challenging times

Some adaptation achieved. “Peak oil flow” is reached constraining economies of the future.

Increasing fuel prices, constrained government finances, difficulty obtaining access to imported foods. More/less severe for lower/higher socio-economic groups.

Liabilities -4%

Green revolution

Rapid technological advances leading to positive adaptation to climate change.

Healthier lifestyles prevail (walking, cycling etc), diets improve with less processed food consumption, homes protected against extreme temperatures.

Liabilities +5%

Club Vita analysed the impact on longevity (and hence on liability values: reduced longevity means higher liabilities and vice versa) under these three scenarios

Source: Club Vita- Hot and Bothered?: https://www.hymans.co.uk/media/uploads/ClubVita_Booklet_UpdatedStats.pdf

Economic, financial and longevity impacts

Markets impact | **Longevity impact**

Head in the sand

GDP growth & equity returns continue to rise in short term but then fall significantly.
Inflation stable in short term then rises.
Gilt yields rise short term then fall significantly.
Credit spreads widen significantly.

Liabilities -12%

Challenging times

GDP growth & equity returns flat in short term then fall (especially in medium term).
Inflation stable in short term then rises.
Gilt yields fall significantly in medium term.
Credit spreads widen significantly (especially in medium term).

Liabilities -4%

Green revolution

GDP growth & equity returns fall in short term but then improve.
Inflation continues to rise then stabilises long term.
Gilt yields rise short term then stabilise long term.
Credit spreads widen significantly then stabilise long term.

Liabilities +5%

Modelling shows **combined** impact of markets and longevity changes

Source for longevity impact:
Club Vita- Hot and Bothered?

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Modelling approach

1. 5000 scenarios projected over 20 years
2. Filter scenarios to identify those which look like the climate scenario
3. Constraints based on scenario expectations applied at different points in the projection period
4. Results presented based on filtered output

Outcomes filtered by each scenario's parameters

We have used the existing modelling data/parameters for the Council

Modelling results

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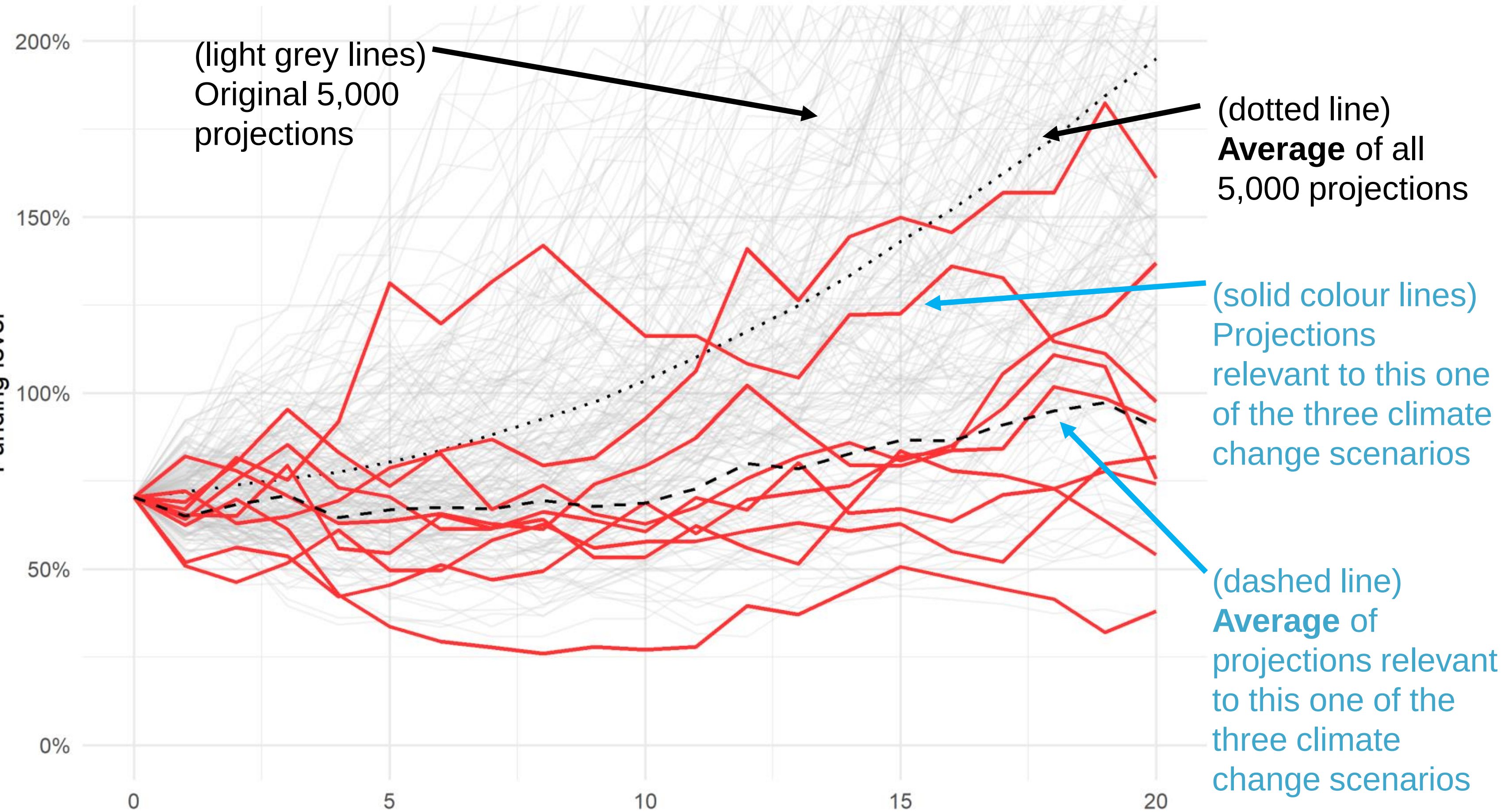
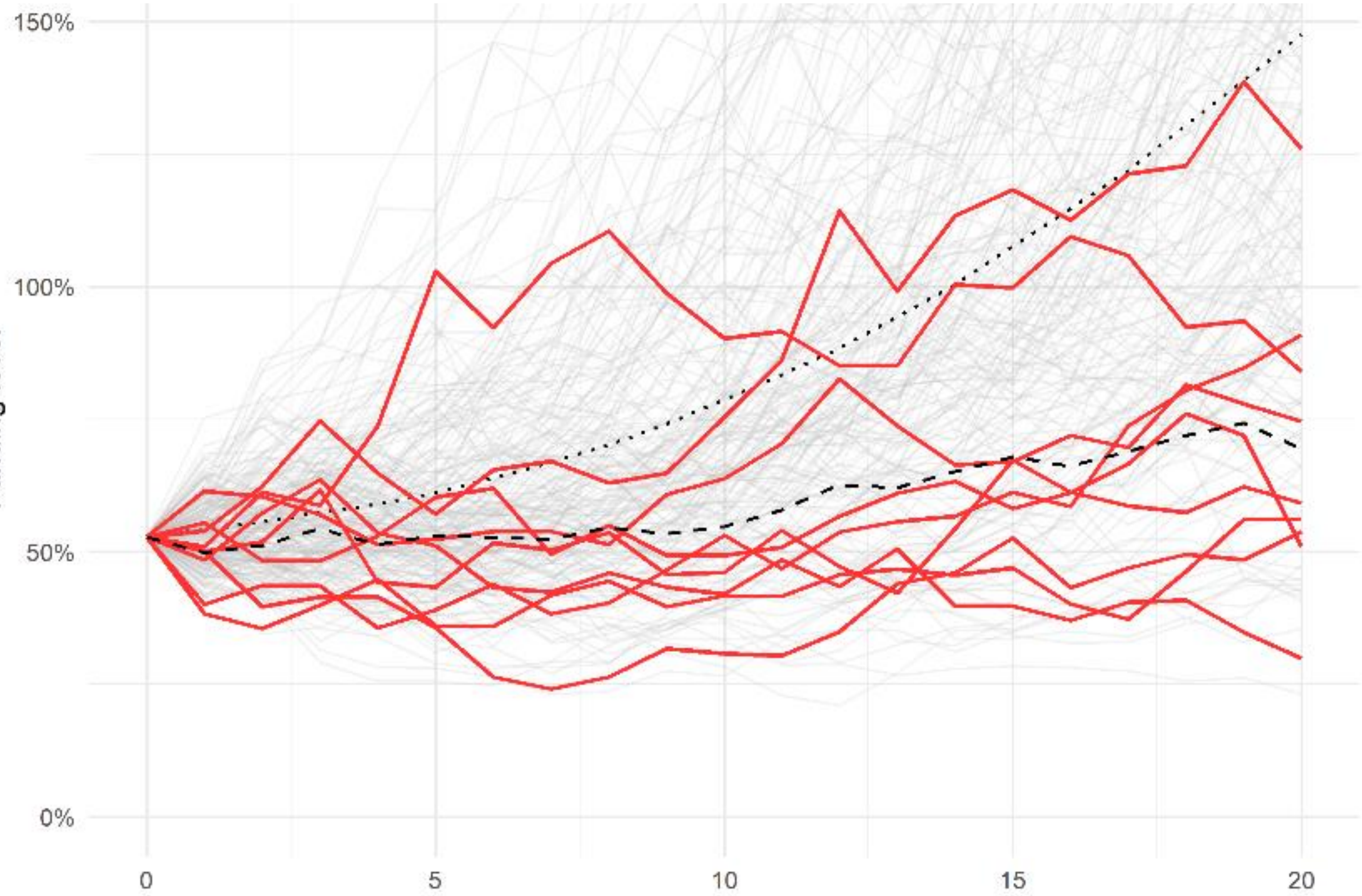
Format of results:
(shown separately per scenario on next three slides)

Page 500



All figures relate to funding level
(based on discount rate of prevailing gilt yields + 1.6%)

Results: Head in the sand



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Expected to give poorer funding outcomes than current funding plan anticipates

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Results:

Challenging times

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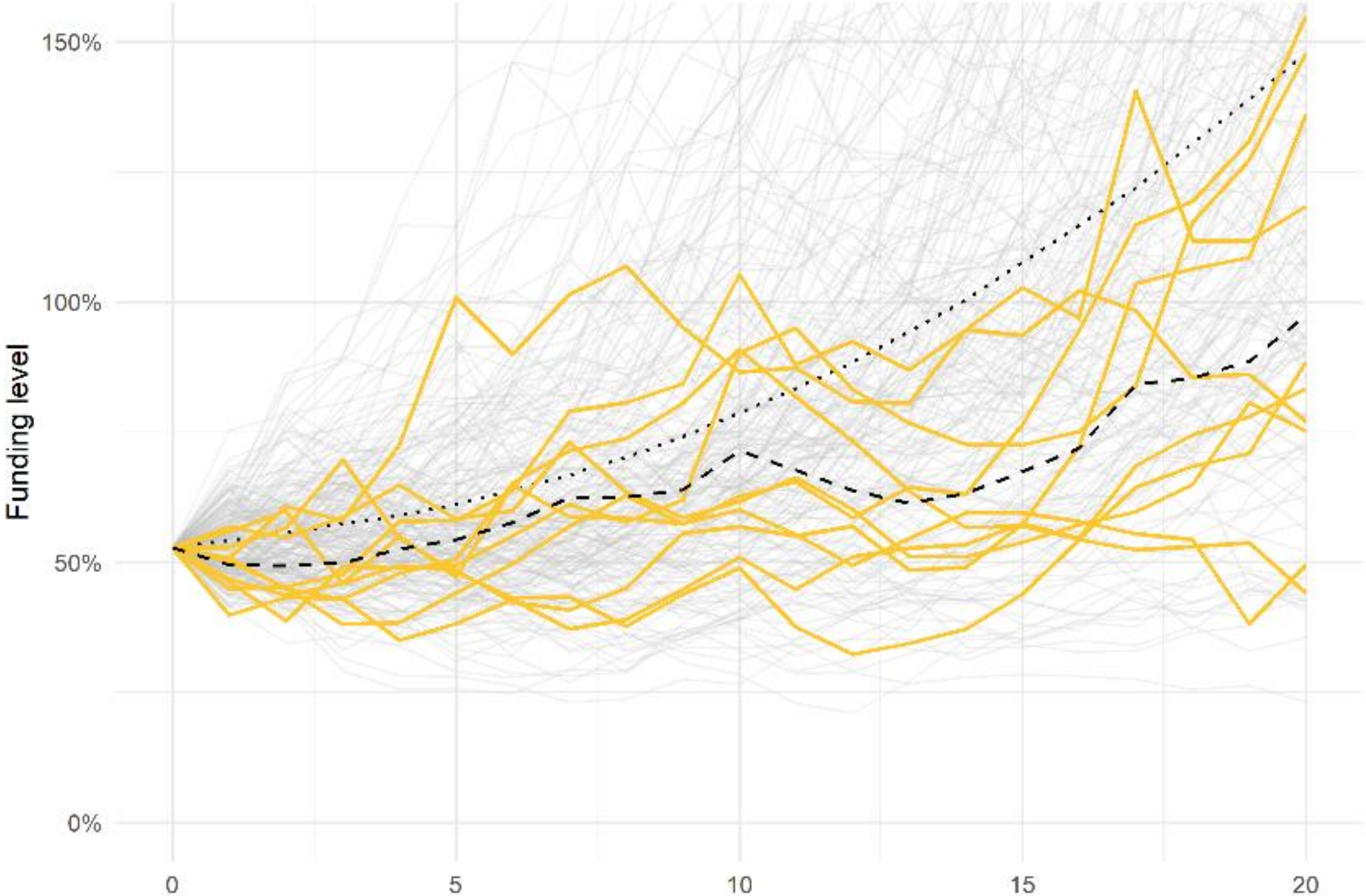

Still likely to give poorer funding outcomes than current funding plan anticipates

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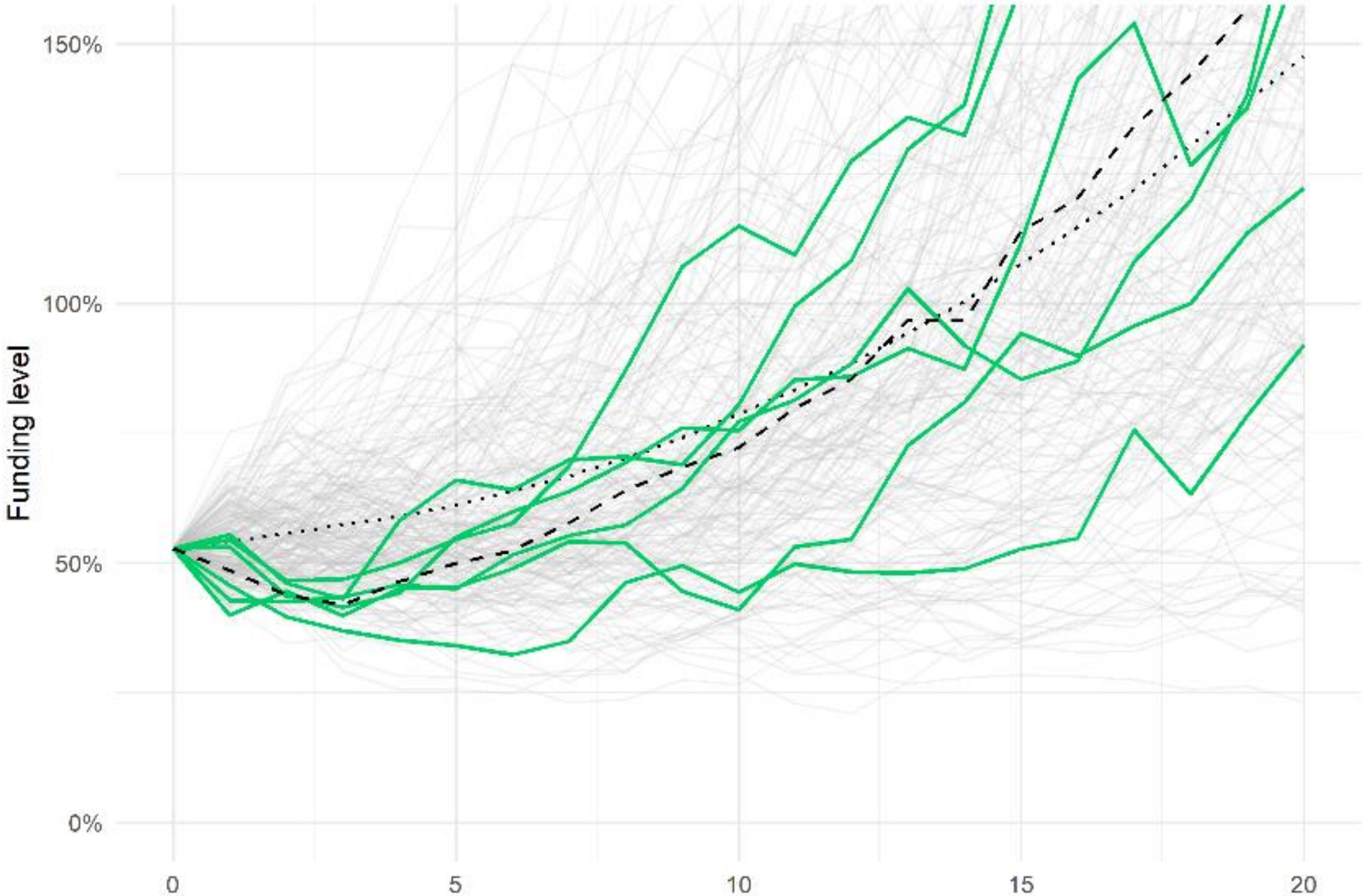
Results:

Green revolution



Expected to give similar funding outcomes as the current funding plan anticipates

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High level comments

- The Fund is exposed to climate risk on the asset and liability side
- This modelling illustrates the range of future funding outcomes we <u>might</u> see as a direct result of government/business action and inaction
- Some of these outcomes are very negative

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What could be done to reduce the impact on the Fund?

Lobby government to take action against adverse scenarios

But may not want to take credit for this in funding plans

Ask employers to pay higher contributions

But affordable increases may be not make much of a difference

Reduce exposure to investments at risk

Or invest more in assets expected to perform well in adverse climate scenarios

Next steps – becoming climate friendly

Action	Requirements
Beliefs	• Review your current investment beliefs
Governance	• Consider your climate risk policy
Asset allocation	• Can you bias towards prevailing opportunities?
Carbon risk exposure	• Review your equity portfolio and frame appropriate targets
Manager benchmarks	• Look at different types of index benchmark
Engagement programmes	• Speak to your fund manager/pool about actions they are taking to drive change
Reporting	• Think about summary reports including objectives, actions taken and results achieved

Draw up a plan of action and speak to your advisors

Appendix - Technical & Professional Notes

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Technical & professional notes (1)

Climate change scenarios – purpose

The purpose behind the modelling is to show the impact of three preconceived climate change scenarios and to promote engagement and discussion around the possible outcomes and impacts for the Fund around these scenarios. The modelling does not provide a framework for testing different courses of action by the Fund (via its funding and investment strategy) to mitigate against the risks discussed in this paper, due to the way in which the analysis has been constructed.

Climate change scenarios – method

We have used the Fund's ComPASS modelling (see paper entitled Contribution Rate Modelling, dated 5 April 2019) to explore the impact on the Fund's solvency in the event that three pre-specified climate change scenarios occur. The Reliances and Limitations that apply to the Fund's ComPASS modelling also apply here.

The climate change scenario modelling assumes that economic and financial relationships are not broken and that climate outcomes exist within the extremes of the 5000 scenarios modelled for ComPASS (as generated by our Economic Scenario Service (ESS)). Although the ESS captures a wide range of future financial conditions, it has not been calibrated to allow for climate change explicitly. **Importantly, this modelling does not place a likelihood of each of these scenarios occurring and the number of simulations captured under each scenario shouldn't be used as such.**

The longevity impact has been included approximately by scaling the liabilities linearly such that by time 20 the full impact is realised. In each year of the projection, this means that the liabilities are being adjusted to reflect updated beliefs about future longevity but the projected cashflows being paid out are not being modified away from the base ALM scenario. The longevity impacts are assumed to be the same in 20 years' time as they are today.

Technical & professional notes (2)

Data – Cashflows

In projecting forward the evolution of the Scheme, we have used estimated cash flows generated using our actuarial valuation system, based on information provided as at 31 March 2019 by the Fund.

Data – ESS

The distributions of outcomes depend significantly on the Economic Scenario Service (ESS), our (proprietary) stochastic asset model. This type of model is known as an economic scenario generator and uses probability distributions to project a range of possible outcomes for the future behaviour of asset returns and economic variables. Some of the parameters of the model are dependent on the current state of financial markets and are updated each month (for example, the current level of equity market volatility) while other more subjective parameters do not change with different calibrations of the model.

Key subjective assumptions are the average excess equity return over the risk free asset (tending to approximately 3% p.a. as the investment horizon is increased), the volatility of equity returns (approximately 18% p.a. over the long term) and the level and volatility of yields, credit spreads, inflation and expected (breakeven) inflation, which affect the projected value placed on the liabilities and bond returns. The market for CPI linked instruments is not well developed and our model for expected CPI in particular may be subject to additional model uncertainty as a consequence. The output of the model is also affected by other more subtle effects, such as the correlations between economic and financial variables.

Our expectation (i.e. the average outcome) is that long term real interest rates will gradually rise from their current low levels. Higher long-term yields in the future will mean a lower value placed on liabilities and therefore our median projection will show, all other things being equal, an improvement in the current funding position (because of the mismatch between assets and liabilities). The mean reversion in yields also affects expected bond returns.

While the model allows for the possibility of scenarios that would be extreme by historical standards, including very significant downturns in equity markets, large systemic and structural dislocations are not captured by the model. Such events are unknowable in effect, magnitude and nature, meaning that the most extreme possibilities are not necessarily captured within the distributions of results.

Technical & professional notes (3)

Assumptions

We have used the whole Fund's membership (actives, deferred and pensioner) and assets in the Pension Fund, all as at 31 March 2019, as the starting point for our modelling. We assume continued payment of the current Council contribution rate of 35% of pay indefinitely, to enable like-for-like comparison between different projections and scenarios; this is not to assume that contributions will follow that pattern in practice.

For calculation of the funding level under each of the 5,000 future projections we assume:

- Discount rate based on prevailing gilt yield plus 1.6% (i.e. this is not as per the presentation as at 31 March 2019, but is adopted consistently throughout the 20 year projection for ease of consideration);
- Other financial assumptions (e.g. salary growth, CPI inflation of benefits in payment) as per 31 March 2019 actuarial formal valuation;
- Demographic assumptions other than longevity (e.g. rates of withdrawal and ill-health early retirement) as per 31 March 2019 actuarial formal valuation;
- Longevity assumptions in retirement as per 31 March 2019 actuarial formal valuation but adjusted for the each scenario as identified earlier in this paper.

We have estimated future service benefit cash flows and projected salary roll for new entrants after the valuation date such that payroll remains constant in real terms (i.e. full replacement).

There is a distribution of new entrants introduced at ages between 25 and 65, and the average age of the new entrants is assumed to be 40 years. All new entrants are assumed to join and then leave service at State Pension Age, which is a much simplified set of assumptions compared with the modelling of existing members

A judgement always has to be made as the most appropriate assets from the ESS to model the strategy under consideration. We have agreed this with yourselves during the scoping stage and further details are in the appendices.

TAS Compliance

The models used to carry out this modelling, and this presentation, comply with Technical Actuarial Standards 100 (Principles for Technical Actuarial Work) and 300 (Pensions).

HYMANS ROBERTSON

General risk warning

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Agenda Item 15

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