2 September, 2020

David Fairs
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By Email to: DB.Consultation@tpr.gov.uk

Dear Mr Fairs,

CFA UK response to The Pension Regulator's ("TPR") Consultation on the DB Funding Code

The CFA Society of the UK (CFA UK) is delighted to have the opportunity to share its views on this consultation paper from the TPR which undertakes a welcome root-and-branch review of the funding issues faced by the UK's defined benefit pension schemes covering some £2.1trn of liabilities on a buy-out basis as of 31 March 2019.

CFA UK's mission is to help build a better investor profession for the ultimate benefit of society. Ensuring that the UK's significant defined benefit pension schemes are governed well, responsibly invested and have adequate funding and liquidity resources to fully meet the needs of their members is of critical importance both to our profession and broader society.

About CFA UK & the CFA Institute

Please see Appendix 1 for a brief overview of both CFA UK and CFA Institute.

EXECUTIVE SUMMARY

CFA UK wishes to table the following principles in relation to the subject matter of this consultation paper before turning to the detail of the technical questions contained within it. CFA UK believes that the introduction of a Fast Track (FT) approach may provide a rigorous framework, particularly for smaller schemes to operate within, focus regulator resource where it is needed and overall improve pension outcomes. We also believe it to be essential that the principles do not distort pensions scheme investment strategies resulting in herding that will introduce systemic risk. We would like to make the follow points regarding the FT approach to funding:

- Defined benefit pension schemes should be funded with reference to liabilities that are valued using the yields observable in investment markets on low risk assets. We caution against either a constant rate of return over gilt yields, that may not reflect the current market conditions, or reference to a credit yield, which could cause a herding towards particular credits as the 'matching asset'. CFA UK's preference is for this approach to apply both to Technical Provisions and Long Term Objective liability bases.
- We believe it is vital that the funding regime does not distort investment decision making and that trustees remain free to pursue an investment strategy that is optimal from an

economic perspective, rather than appearing optimal on some actuarial or accounting basis. The funding regime should not limit, for example, the trustees ability to invest in a range of assets with contractual cash flows, nor their ability to access an illiquidity premium to the extent that their scheme does not need liquidity.

- Valuing pension schemes with reference to low-risk investments is consistent with how pension schemes are valued on accounting balance sheets for going concern companies and with where pension schemes rank in priority alongside debt holders under insolvency law and we believe that a Technical Provision (TP) based on an equivalent discount rate will bring transparency, consistency and comparability.
- CFA UK recommends that allowance is made for investment outperformance over liabilities in recovery plans. This enables a reasonable expectation and transparent measure of the value of investment performance that can be delivered by asset owners and investment managers.
- CFA UK strongly believe that, subject to their circumstances and suitability, pension scheme trustees should be able to take investment risk in their contribution planning and still fall within FT. To remove this would make the cost of funding DB pensions prohibitive, put an unnecessary strain on companies, particularly at this time of economic difficulty and accelerate the closure of the remaining open schemes.
- Variable levels of covenant strength across companies should not be allowed for under FT. Many DB pension schemes have not historically obtained specialist covenant advice, which would leave this metric open to a high degree of subjectivity and inaccuracy. We therefore recommend that either no reference to covenant strength be made under FT, subject to the sponsor being a going concern, or that FT simply incorporates the ability for trustees to demonstrate that they are a AA/A+ or better credit and hence get through FT with a higher investment return assumption in their recovery plan, if this is reflected in their investment strategy.
- Long Term Objective liabilities should be specified with reference to yields on diversified assets backed by contractual cashflows from strong covenants and significantly mature schemes should not be restricted solely to investing in the public sterling corporate and government bond markets. These markets currently have insufficient size and depth to cover the scheme liabilities which will eventually need to be funded on a buyout basis.
- DB pension schemes should be subject to a reasonably simple stress test to determine whether investment risk is within acceptable parameters under FT. We would like to see consistency with how the assets are stressed for FT with the PPF stress testing.

Whilst CFA UK supports Fast Track this should not in any way take away the ability of trustees to take their scheme's specific circumstances into account. A Bespoke approach must be as acceptable as a Fast Track approach.

QUESTIONS

Twin-track approach

Q1: 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?

CFA UK supports the proposal of a twin-track compliance approach on the basis that Bespoke remains a well-accepted approach to funding and that there is not undue pressure on sponsors to increase contributions to an unaffordable level. The twin-track approach should enable TPR to

focus its resource and attention where it is needed most. For the smaller and less resourced schemes, it should give clear parameters for them to work within in defining an acceptable funding basis.

We would wish to make the following additional supportive comments:

- Out of the many thousands of UK DB schemes there are a high proportion of small schemes (under £50m). Many schemes in this group do not have the time or resource to assess covenant strength in a meaningful way, which has implications for the specification of their funding and investment strategies. For small companies with correspondingly small attached pension schemes, long term covenant strength and business sustainability can in any case be harder to assess than for larger companies. Larger companies often have public accounts, credit ratings and more stable dominant positions in their sectors. A FT process, not relying on an assessment of covenant strength, is therefore preferable for the many schemes where covenant strength is harder to assess and less practical to obtain.
- It is already common for liability valuations to be linked to scheme maturity. Liabilities are commonly valued with lower risk where pensions are in payment and more risk where benefits are yet to be paid. It is practical and appropriate to continue supporting an approach where liability discount assumptions are linked to maturity under FT.
- Under the current funding approach for DB schemes it is common to value liabilities using a discount rate of gilt yields plus a spread. For most schemes, still holding equity or other risk assets, this brings funding volatility in 'risk off' markets when there is a flight to quality. Gilts and liabilities typically rise whilst risk assets fall. This can result in increased deficit contributions when a sponsor may already be under pressure. Whilst DB pensions should be funded prudently, to negate this to some extent, DB liabilities could be valued using some cyclical risk premia under FT that moves with investment markets.
- While a 'gilt plus' approach is widely accepted and common, many other assets generate contractual cashflows with a good covenant behind them, but market forces may prevent their yields being highly correlated. A discount rate that moves with market observable yields on the secure assets actually held by a scheme would improve funding stability and in turn reduce conflicts between optimal investment strategies and funding stability.
- It is CFA UK's view that a Fast Track approach should be reasonably simple for more resource constrained schemes. Investment strategies should be reflected in funding plans where scheme investment and funding level risks fall within defined market stress tests.
- For those schemes that have unhedged liabilities and inadequate asset diversification, stress tests should be designed to provide a steer towards more risk mitigating investments under a FT approach. We are comfortable that schemes wishing to take more investment risk and have this reflected in their funding plan, should follow a Bespoke approach.
- Encouraging schemes towards lower risk Long Term Objectives can stabilise schemes beyond the visibility of their covenant. However, this has implications for investment markets. On recent measurement, £2.1tn of liabilities will eventually need to be funded[1] which represents roughly 80% of today's entire value of the sterling government[2] and

[1] *Source: 2019 Purple Book (£2.1bn liabilities measured on a buyout basis as at 31 March 2019)*

[2] *Source: United Kingdom Debt Management Office Quarterly Review January to March 2020 (£2.1trn net issuance by market value as at 31 December 2019 (with £0.5trn owned by the Bank of England))*

corporate[3] bond markets combined. Not every pension scheme (along with insurers hedging annuity books) will be able to invest all of their assets in these markets and attempts to do so will drive down yields to distorted levels. CFA UK strongly suggests that the specification of a low risk Long Term Objective basis is specified with reference to a market observable yield on diversified contractual cashflow assets with strong covenants, without restricting itself to sterling corporate and government bond markets.

- We agree that pension schemes should be able to take a Bespoke funding approach where they wish to make their own assessment of their sponsor's covenant strength or wish to evidence why they are able to take more risk in their investment strategy than is permitted by a FT stress test., They may also wish to evidence why it would be appropriate that their recovery plan is outside of the bounds permitted under the Fast Track approach.
- To be FT, CFA UK would suggest that a pension scheme should have a sponsor that is seen as a going concern. An alternative would be to have a separate FT funding regime for sponsors with qualified accounts. However, pulling such schemes into Bespoke seems a better approach.

Employer Covenant

Q2: 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?

- CFA UK cannot comment on the acceptability or otherwise of member benefit reductions under insolvency law. However, CFA UK does note the distinction between setting a regulatory approach and an approach set by pension scheme trustees.
- The regulatory approach needs to consider the restraints posed by law, TPR's regulatory powers, and TPR's resource. Pragmatically, TPR is unlikely to have the ability to regulate a zero-risk regime and the current financial health of UK Plc (especially post COVID-19) does not permit scheme funding at this level. However, this does not mean that trustees should not aim to minimise the risks faced by their scheme.
- Reliance on covenant should not be implicit in funding plans. Covenant should be explicitly recognised by trustees when setting investment strategy.

Q3: a. Do you think it is better to keep the Fast Track route simpler by only factoring covenant into Bespoke (TPs and/or RP)?

- As above, CFA UK sees that FT has an important role to play in helping to ensure effective governance and regulation of the significant number of small DB schemes. These schemes are less likely to have the resources to take specialist advice (across all forms) and would benefit most from a simple pathway that steers them towards a lower risk future.
- Given that covenant is subjective and dedicated professional covenant advice is unlikely to be affordable for many schemes, we propose that FT criteria are set in a fashion which does not factor in any reliance on covenant. Whilst CFA UK recognises that this may lead to more prudent criteria being set (i.e. effectively restricting access to FT to those schemes placing

[3] *Source: Bloomberg Barclays Sterling Non-Gilt Index Market Value as at 31 December 2019 (£0.6trn issuance by market value)*

less reliance on their covenant), the Bespoke option will remain available for those schemes which to place reliance on the covenant.
- CFA UK recognises that a practical means of implementation may be to set investment risk thresholds less prudently at the beginning of a regulatory regime, but then tightening the requirements every triennial cycle.

***Q3:* b. If you think covenant should only feature in Bespoke, how do you think it should be done?**

- The nature of the Bespoke approach is that the way in which the sponsor's covenant is reflected will be scheme specific. However, the core themes should be consistent with TPR's existing guidance on assessing and monitoring the employer covenant[4] . Trustees will need to demonstrate how the covenant provided by their sponsor can support the funding needs, investment risks, demographic risks and other risks borne by their scheme. Furthermore, trustees should also evidence what plans they have in place to react if these risks crystallise and/or their covenant were to weaken.

***Q3:* 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?**

- CFA UK would not support the integration of covenant assessment into FT guidelines, aside from a requirement that the sponsor is a going concern.

***Q4:* 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?**

- As above, CFA UK propose that covenant would only be relevant to the Bespoke approach – therefore, by definition, it is appropriate for trustees to be allowed discretion in holistically considering the relevant features of their sponsor's covenant. In other words, there is no need to take a formulaic approach.

***Q4:* 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?**

- The existing guidance is clear and should allow trustees of smaller schemes with adequate skillset, time, and objectivity to prepare an assessment of the covenant. For larger schemes,

[4] *(https://www.thepensionsregulator.gov.uk/en/document-library/regulatory-guidance/assessing-and-monitoring-the-employer-covenant) and integrated risk management (https://www.thepensionsregulator.gov.uk/en/document-library/regulatory-guidance/integrated-risk-management)*

it is reasonable to expect them to take professional advice as they would do on actuarial, investment and legal matters.

Q4: 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

- As above, CFA UK does not believe a formulaic approach is necessary. More generally, we note a general trend in the DB pension landscape to excessive reliance on quantification and which can create a false sense of security founded on assumptions rather than fact. Many (including TPR) have tried and failed to build a sensible model of covenant and there is no way to meaningfully capture the many qualitative factors. Valuations are an art rather than a science and therefore building a regulatory regime on them would not be appropriate. We note that credit rating agencies similarly apply judgment alongside financial analysis when giving their ratings.

Q4: 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?

- As above, we are proposing that covenant is not included in FT.

Q5: 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?

- Whilst many sponsors do, in practice, operate in a joined-up fashion with their wider group, experience has shown that this may not form a reliable recourse for pension scheme trustees and that reliance on it may encourage schemes to greater risks than they would otherwise take. These risks may not be justified. Therefore, reliance should not be placed on the indirect covenant without appropriate codified/contractual support being in place (in line with TPR's existing guidance).
- More generally, whilst we note that parental guarantees have been a common choice to improve covenant, they do not typically provide schemes with recourse to additional funding – they simply serve to enhance the creditworthiness of existing obligations to a scheme.
- To the extent that these obligations later become insufficient, the guarantee alone does not help to address this issue. Rather, it often worsens it where guarantees have been used as justification for reduced funding for the scheme.
- TPR and trustees should focus instead on preserving the strength of their sponsor and ensuring sufficient funding can and will be accessed if required.

Q6: 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?

- Here we draw a distinction between covenant grades used for the benefit of a regulatory regime versus those used for advisory purposes and for setting the strategy used by a scheme (but TPR should recognise the risk of inadvertently connecting the two). Given that

TPR's risk tolerance towards a specific scheme should be expected to be somewhat higher than for the trustees of a scheme, it would seem to be sensible to suggest that TPR could have a less granular rating scale. However, there is no right or wrong answer here.

***Q6:* 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?**

- As above, for the Bespoke approach, it is reasonable to expect that trustees would pay for appropriate covenant advice. With regards to greater number of covenant grades under a FT approach CFA UK does not have view as it does not believe covenant strength should be relied on under a FT approach, beyond whether a sponsor is a going concern or has qualified accounts.

General Principles

Q7. 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?

- Yes. CFA UK believes that all DB schemes should have a low level of dependency on the employer by the time they are significantly mature.
- 5-year and 10-year default rates from the leading credit rating agencies evidence that even for some large companies, default rates are surprisingly high particularly in the sub-investment grade categories[5]. We note additionally that, since the launch of the consultation paper, the CV-19 pandemic has put many companies' finances in a more stressed position and led to many downgrades of large companies' ratings below sub-investment grade.
- Unfortunately, there are some large mature UK schemes which are not close to a low-level of dependency and CFA UK recognises that in many cases there are no quick fixes to remedying this situation.

Q8. What factors should influence the timing of reaching the LTO? Do you think that the timing should be linked to maturity?

- CFA UK believes that the timing of reaching the LTO should be linked to scheme maturity.
- Covenant visibility is in most cases far harder to assess than scheme maturity and CFA UK would argue that covenant strength should not play a role in determining the timing of when a scheme reaches its LTO [unless the covenant is rated at least single/double-A or better from two rating agencies - S&P's 20 year default rates are 2%/3% for these rating categories].
- Across the DB pension universe, 'peak cash-flow' (the time of greatest cash out-flows from DB schemes to members) is still approximately 20 years from today but most scheme members will have retired within the next 10 years.

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[5] S&P's 2019 default study (p4) published in April 2020 shows 5/10-year default rates of 2%/4% (BBB), 6%/12% (BB), 16%/23% (B), 45%/50% (CCC/C).

Q9. Do you think that the investment portfolio should be highly resilient to risk when schemes reach their LTO? If not, what do you suggest?

- Yes. CFA UK believes that there should be little need for additional funding from the sponsor in order for the scheme to have low financial dependency (note: including any payments to cover expenses, levies, etc).
- Where a scheme has not yet achieved a point of high resilience by the time of its LTO, then the sponsor should either be required to increase its contributions or an RP should be in place to achieve high resilience in as short a time as possible (and without the fund taking additional risk).
- Given the UK gilt and credit markets are insufficient in their size to fund all liabilities with UK DB schemes (see also our response to question 1) a variety of alternative contractual cashflow assets should be permitted (ground rents, property leases, etc.)

Q10. 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?

- Yes. CFA UK believes that all less mature schemes should be permitted to take on more investment risk. Historically, more risky assets (e.g. equities) have consistently produced greater returns than less risky assets (e.g. bonds) over the longer-term. However, these risks should be taken prudently and having the freedom to invest in return seeking assets, does not mean that liabilities should be left fully unhedged.
- However, trustees taking this approach should reasonably believe that the scheme's sponsor covenant is strong enough to be likely to be able to afford increased future contributions to make up any shortfall should the higher risk assets under-perform.

Q11. 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?

- CFA UK supports the proposed rationale for a journey plan for a scheme on its pathway to maturity. There are two possible approaches:
    - the TPs are set at a similarly prudent level to the LTO and investments are de-risked as the journey to full funding is achieved; CFA UK has a preference for this approach as described in the chapter on covenant.
    - the alternative is a journey plan, where the TPs converge to the LTO over time and the investments de-risk at a similar pace to the TP liabilities.
- Both approaches are prudent and will be helpful to promote a consistent approach.
- Discount rates should be set for the TPs and the LTO that reflect market conditions at the time of the valuation, in terms of what investment returns are available. Please see our answer to Question 21 for a further developed suggestion on how this might be achieved in practice.
- Investment and funding level based de-risking should also be encouraged. If funding levels are ahead of the projected journey plan then further de-risking can be brought forward and possibly even incentivised. Investment risk should reduce as the LTO approaches and this should also be reflected in the discount rate used for the scheme's liabilities.

Q12. Do you agree that the actual investments and investment strategy are a relevant factor for scheme funding?

- Yes. CFA UK fully agrees that a scheme's actual investment strategy and investments held should reflect the risk capacity as framed within its TPs.

Q13a. 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?

- In most cases, yes. CFA UK agrees that there should not usually be a material misalignment between a scheme's actual asset risk and the risk assumed in its TPs and its recovery plan. A funding plan must not assume a level of investment return commensurate with risk assets while not investing in risk assets. There may be cases where it is appropriate for risk taken in the investment strategy is not reflected in the funding plan, if this equates to more prudent funding.

Q13b. 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?

- Where a misalignment exists, Trustees must be able to explain why their scheme's actual asset risk does not reflect the risk assumed in its TPs or recovery plan. Sponsor covenant strength should be one such permitted rationale but this should be reserved only for the strongest sponsors [either double-A or single-A credits with two leading rating agencies].
- Investment markets are complex, and it should also be noted that under simple rules, an investment strategy may appear to carry more risk than implied by the TP, in reality this is not the case at a portfolio level. This may include, for example, quasi matching assets such as long lease property or equity option-based strategies

Q14. 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?

- Yes. The security, quality and liquidity of a scheme's asset mix are important considerations throughout a scheme's journey but as a scheme reaches maturity, and becomes cash-flow negative, this becomes even more the case.
- Whilst asset security, quality and liquidity are important it should not be necessary for all a scheme's assets to be high quality and highly liquid investments. Pensions schemes typically pay out c.3-4% pa. of their fund annually so 100% liquidity, or close to it, is not required for this. 'Liquidity' may also be unavailable on an asset now but expected long before it is required e.g. in private debt markets. Again, this will reduce the liquidity requirement at any point in time. However, it is important that liquidity requirements factor in potential demands arising when derivatives mark-to-markets move against a scheme and also for unexpected cash flows (e.g. a pick-up in transfers out).
- Holding some assets of low credit quality may also be desirous within a diversified portfolio, provided the relative risk/yield is acceptable. [High-yield bonds for example currently yield

c.7% but default rates are not expected to be at this level YoY]. The TPs should focus on right-sizing the amount of these types of risks that a scheme adopts rather than directing pension schemes' investment decisions.

Q15a. 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?

- Yes.

Q15b. 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?

- CFA UK would strongly support a re-set period of 3-5 years for all but the strongest credits. This could be gradated depending on the credit quality of the sponsor. Rating agency default and migration statistics point to a standard deviation period from original rating to default of 5.5 years for all credits[6].

Q16. 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?

- Yes. Additional support factors should be allowed, but full account needs to be taken of the reliability of their valuation, the ease with which they can be enforced against/realised as cash and the extent of any concentration risk that might arise as a result of reliance and appropriate hair-cuts should be made.
- Ultimately, schemes need cash rather than contingent assets. Such instruments can have a part to play in the journey to get to a full funding position, but the key thing is for trustees to be able to demonstrate what the benefit of these assets is (often guarantees are a lot less useful than assumed). New superfund guidance allows for contingent capital so there is equivalence here.

Q17a. Should employer affordability be the key factor to determine the appropriateness of a RP? If not, what should it be?

- Yes. However, there are commercial and governance issues which can override this:
    - In practice most trustees do not have the power to set contributions and whatever funding is agreed is a negotiation with the sponsor.
    - Many finance directors are still of the opinion that if they have a strong company they should not have to pay cash into their pension fund now; they prefer to take long-term investment risk in the pension fund.

[6] S&P's 2019 default study (p32, Table 10) published in April 2020 shows the standard deviation period from original rating to default of 5.5 years for all credits, flexing from just 2.8yrs (CCC/C), 4.1yrs (B), 5.6yrs (BB), 6.7yrs (BBB), 8.8yrs (A) to 9.2yrs (AA).

- Many trustees in their day jobs are subordinate to FDs and CFOs and can only push their view so far, whilst professional trustees risk losing their role if they force matters.
- Corporate boards may have to make a judgement over which the trustees have no say. Does the company take on additional debt leverage to fund a shorter RP, does it pull back from a major new investment or acquisition or does it reduce its dividend, for example?

Q17b. 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?

- Yes – in this case the trustees are taking additional risk and running a less prudent TP on the assumption that the employer can repair the scheme as necessary. This would be inconsistent with a long RP.
- Ultimately pension liabilities represent deferred employee pay / compensation and rank as a senior creditor in insolvency. They should not be jeopardised at the expense of dividend payments to shareholders.

Q18. Should past service have the same level of security, irrespective of whether the scheme is open or closed?

- It would be easy to agree that past service should have the same level of security, irrespective of whether a scheme is open or closed, as a pension scheme's primary obligation is to protect accrued benefits, however we believe that this is an oversimplification. Particularly against a backdrop of regulation seeking to move schemes towards self sufficient funding. While there are now relatively few defined benefit schemes that are open to accrual for all members, those that are may be offering very attractive future retirement provision, particularly to younger members, Companies may only be able to justify this benefit provision on the expectation that they can take advantage of attractive long term returns on risk assets (while being in a position to underwrite this risk). If they are forced to fund the scheme to a very high level of security for accrued benefits, then we may see the closure of such schemes to the detriment of their members, because:

    - the sponsoring employer may not be able to get a return of surplus funding under current regulation, and as a result
    - there may be little incentive to run investment risk, making the long-term costs of the provision unattractive to the company.

- We would presume that accelerating the demise of open schemes would be an unintended consequence of the funding code, and therefore do not consider the 'principle' set out in the consultation a straightforward one to adopt. Reconsideration of the rules surrounding the ease of access to surplus could be one approach to finding a solution.
- We note that the situation is complicated where a scheme has a mix of those with accrued benefits only and those accruing future benefits, and this will always be the case where a scheme has pensions in payment. It is difficult to justify a reduced level of security within the scheme to the detriment of those members whose pension is already in payment and who have nothing to gain from a reduced cost of future provision.

Q19. 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?

Trustees must ensure that they have adequate security for accrued provision and this adequate security should not come at the cost of seeking to support future provision. However, trustees have a complex job in balancing the needs of all of their scheme members and we believe it is reasonable to take future pension provision into consideration.

Other issues

Q20: Do you agree with our assessment of the issues above and do you have any further comments?:

CFA UK has no additional comment.

Setting the Long-term Objective ("LTO")

Q21: 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)?

- A FT low dependency discount rate should be set at a level that reflects market observable yields on contractual cashflow assets that match future projected liability cashflows, net of costs. It should not reflect a general mix of matching and growth assets, whose expected returns are harder to forecast over the next several years. A constant gilts + X% discount rate is less relevant as it may not reflect investment markets in years to come. Currently gilts + 0.25- 0.5% reflects market conditions for a low dependency basis but even in recent years this has not always been the case. One solution may be the introduction of a professional body that would ensure that the low dependency basis be kept under review to remain consistent with markets. We would see committee approach as preferable to determining the spread by, for example taking a corporate bond yield spread, as this formulaic approach risks defining a 'matching asset' that many schemes will then be artificially encouraged to invest in causing market distortions.

Q22: 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?

- Financial discount rates should reflect market observable yields on contractual cashflow assets. Estimating expected returns on risky growth assets is not a low risk position consistent with an LTO.
- CFA UK does not feel it is appropriate for it to comment on matters other than those associated with investment markets.

Q23-Q29:

Please refer to our response to questions 21-22; CFA UK has no additional comment.

Technical Provisions ("TPs")

***Q30:* 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?**

- Financial discount rates should be reflective of market observable yields. For the calculation of TP liabilities a market consistent approach would be to use discount rates based on current market gilt yield curves supplemented by market observable spreads on low risk contractual cashflow assets. CFA UK's preference is for TPs to be set consistently with the LTO. It is CFA UK's view that investment risk should be permitted under a FT approach up to an acceptable limit. However, this risk should be recognised relative to liabilities in a manner consistent with how liabilities are recognised on a going concern company balance sheets and under insolvency law.
- Linear or horizon-based journey planning where TPs are strengthened over time seem to be simplifications of current market economic pricing. CFA UK's preference is to reflect current market economic pricing now. For some schemes this may result in an increase in the current TPs liabilities. However, a prudent level of TPs could then be somewhat offset by allowance for investment performance in recovery plans.

Q31-34:

Please refer to our response to question 30; CFA UK has no additional comment. CFA UK's expertise is in matters associated with investment markets and practices, rather than on actuarial matters.

Investment

***Q35:* a. Would a measure of the liabilities be an appropriate position to measure investment risk from? If not, why not?**

- Yes. The purpose of a pension scheme is to meet its members' retirement payments and a pension scheme liabilities that are well defined, in contrast to (say) charities or endowments, so investment risk should always be measured relative to the projected cash flows.
- The ultimate risk for a pension scheme is that a scheme sponsor cannot make good any deficit arising. A high-risk investment strategy can accentuate this risk, particularly if the scheme is large relative to the sponsor. In these cases, the pension scheme itself may be a risk factor for sponsor insolvency. That said, even in these instances the pension scheme is only one of many possible causes of employer insolvency and the risk of employer insolvency is likely correlated strongly with investment risk (both adversely affected in most instances by economic downturn). Therefore, both the quantum of the deficit relative to the employer and the funding percentage deficit matters; the latter will impact individuals' risk of reduced benefits. The quantum of the deficit will also matter to the PPF.

***Q35:* 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?**

- CFA UK believes it is reasonable for a scheme with low dependency on its sponsor to still have its liabilities valued with a small spread over gilts; this should reflects the opportunities in, and investment freedom to access, liquid and illiquid credit markets as well as other assets with contractual cash flows offering more attractive yields than comparable gilts.
- That said, CFA UK notes that markets can be subject to significant changes. At times, gilts +0.5% may be relatively easy to achieve with high-quality investment grade credit (AA/A+) and at others, hard to achieve without a level of risk that is inconsistent with low dependency. Therefore, CFA UK believes a Gilts + 50bps or Gilts + 25bps solution is unlikely to work in all markets and at all times, whilst Gilts flat will force a strain on sponsors from unnecessary prudent funding, especially in present market conditions with gilts close to 0% pa yield. CFA UK therefore would support the establishment of some form of market-referenced forum or mechanism responsible for setting the rate say on an annual basis under a predetermined framework.
- A scheme with a significant proportion allocated to credit and an overall portfolio average credit grade of close to AA/A+ risk feels like an acceptable 'low dependency' portfolio. A good low dependency portfolio will seek diversification, rather than invest in the AA listed credit universe in isolation - including some diversified exposure to high-quality ABS, infrastructure, even long lease property as well as other low risk contractual cashflow assets.

***Q35:* 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?**

- CFA UK would caution against adoption of a liability reference portfolio approach without rigorous methodology. The liabilities of different pension schemes can differ markedly in their durations and inflation sensitivities, depending on how benefits have been defined, as well as the dates benefits accrual ceased, if it has, amongst other factors. It may not be simply the overall interest rate and inflation sensitivity, but also the shape of this exposure. CFA UK have a preference for accurately defining liabilities when assessing risk.
- However, a liability reference portfolio is required for schemes, regardless of size, if one is trying to construct the lowest risk investible portfolio for modelling risk. Pension scheme liabilities themselves are not investible - examples are the floors and caps on pension increases in retirement and deferral. The question then becomes how blunt can the liability proxy become? While inflation and interest rate DV01s are the first order risk measures, CFA UK view a proxy index or bond portfolio using only inflation and interest rate sensitivity as rather too blunt.
- Should there be a strong desire to produce a simplified liability proxy for smaller schemes, the CFA UK would be more comfortable in an approach that recognises perhaps 3 key point durations, to reflect how the long, middle and short end of yield curves can be quite disconnected. That said, given the way the industry has moved and the help and support provided by the suppliers of liability matching investment products, it is unlikely that a fund hedging a significant proportion of its liabilities would not have managed its curve risk to some extent. For a scheme not hedging its liabilities in any meaningful way, then duration risk will in any case dominate.

***Q35:* 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?**

- As explained above, CFA UK could support an approach to a reference portfolio that has a simplified approach to term exposure. A fixed weighting to a single gilt and a single inflation-linked gilt index with similar duration to the liabilities would not suffice; as well as different rates term exposures, schemes inflation sensitivity will vary with term. However, a mix of short, medium and long index-linked and short, medium and long fixed gilts or gilt indices that best represent a scheme's liability duration and inflation-linkage across the yield curve may provide an acceptable solution.

***Q36:* 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?**

- CFA UK supports the use of stress tests and would oppose use of the growth assets methodology which is overly simplistic. A stress test approach is consistent with other regulations (European pensions, insurance, banking) and can still be implemented relatively simply as per the PPF's specification. That approach would also be objective as it would not be reliant on an individual's assumptions of volatility. The specific stress test should be kept under review by a central body so that it remains consistent with market observable risk.

***Q36:* 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?**

- A classic risk-off market event, with falls in growth assets and falling rates, is the biggest risk that pension schemes need to consider and a simple stress test does the main job of simply quantifying this. However, the other significant, although potentially less likely, downside market event for a pension scheme is stagflation as seen in the 1970s - where inflation rises constrain corporate covenants and damage growth assets. This type of stress test could also be considered.

***Q36:* 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?**

- Ideally only one stress test would be used and CFA UK inherently likes the idea of bringing the TPR and PPF methodologies into line and the TPR and PPR should work together to define this methodology. However, CFA UK notes that the PPF is trying to measure risk relative to PPF benefits and TPR versus scheme-risk against scheme-specific benefits and this should be allowed for.

***Q36:* 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.**

- All three of the ratios shown are helpful. Option 1 possibly more so, closely followed by option 2. In all cases it would be useful to show the £-amount as well as the percentage.

***Q37:* 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?**

- Ideally maximum thresholds for investment risk should be set depending on a scheme's maturity and covenant strength, but because of the difficulties that many schemes face in accessing detailed covenant advice we believe that under Fast Track maximum thresholds for investment risk should just be set by maturity. Significantly mature schemes should be funded to self-sufficiency, but it must be recognised that not all significantly mature schemes are funded to this currently, and RPs will have to reflect this. We believe that covenant strength can justify higher levels of investment risk, even for significantly mature schemes, but this should be considered under Bespoke.

***Q37:* 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?**

- Rates are currently at unprecedented lows so history may not help answer this question. With gilts yielding little more than 0%, inflation subdued, a risk of deflation and dividends under pressure due to CV-19 a growth asset yield net of fees of 2-4% seems more realistic at present.
- For schemes of significant maturity, modelling using just growth and matching assumptions is too simplistic. In the UK in 1929 equities underperformed gilts for almost the next 20 years. In that scenario investing for growth would have turned out to be a short-, medium- and long-term risky investment had DB schemes of significant maturity existed. Rather than basing a discount rate on a mix of growth and matching assets, CFA UK recommends that a discount rate for a scheme of significant maturity is based on market observable yields on a replicating portfolio of contractual cashflow assets. No subjective return premia allowances should be permitted. Maximum levels of investment risk should be defined around this liability definition. If a scheme of significant maturity wishes to allocate to equities and growth assets it should not be able to take all this additional return expectation into account in its funding plan. These types of schemes should be encouraged to invest in contractual cashflow assets that replicate their liabilities. For less mature schemes, modest growth asset assumptions could also temper otherwise excessive equity allocations. A prudent growth assumption might be market observable dividend yields plus inflation with little allowance for growth. Markets should be assumed to be largely efficient for mature schemes and views around manager outperformance (alpha), or reversions in interest rates that are inconsistent with market yield curves should not be permitted.

***Q37:* c. Should the allowance for prudence be higher for an investment portfolio with a higher level of risk?**

- CFA UK presume that by ‘prudence’ the TPR means the difference between best estimate returns and the allowance for investment returns in the valuation.

- In our view, the higher the level of investment risk (and equivalent higher target return), the less one can benefit from portfolio diversification, so from that point of view we see some justification for increasing prudence in the valuation.
- However, it would be unhelpful if the net effect of this was to hurry the demise of defined benefit provision where a company is in a good position to take additional risk. From that point of view, CFA UK would be keen to see schemes that are immature, because they are still letting benefits accrue, fund assuming an allowance for expected returns, with risk managed more prudently for schemes of significant maturity.
- For most asset liability projections, including GAD's, risk is reasonably quantified based on historic observed asset volatility. However, it is harder to estimate the average return on growth assets over the next 10 years. The estimation of the optimal allocation to growth assets is subject to error in the estimation of growth asset returns. This estimation error is reduced by investing in contractual cashflow assets like investment grade credit, infrastructure debt, ground rents, etc. When investing in these types of assets their prices may change with volatility over the investment period, but their returns will tend to pull-to-par over time, tending to the known contractual yield at the point of investment, subject to default risk. Allocating to these types of assets removes the errors associated with estimating returns on growth assets (equities) and then having to adjust ALM outputs for margins of prudence.
- For immature schemes to take more investment risk, the prudent threshold risk limit can reduce with scheme maturity.

Q37: 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?

- The maturity of the schemes should dictate how much investment risk can be accounted for under FT. Generally, CFA UK's view is that the TPR simply has a going concern assumption for FT as covenants can deteriorate quickly and it is not wise to presume a seemingly strong sponsor will always remain strong.
- CFA UK notes that the specification of journey plans that de-risk pension scheme liabilities over time, whether in a linear or horizon-based shape, is a simplification of carrying out a market-related liability valuation today. If liabilities will be de-risked over time, that can be recognised today by setting a risk premia over the gilt curve that declines over time.

Q38: a. Do you think we should define some guidelines around liquidity and quality in Fast Track?

- Yes. It is not clear from the consultation paper whether the TPR is asking whether there should be separate tests on liquidity and quality – but CFA UK notes that whilst these qualities often go together it is not always the case. Private credit is often very illiquid, for example, but can be of very high quality. Listed equities are liquid but are clearly risk assets.
- As regards liquidity to meet regular pension payments, we are mindful that even with mature schemes these regular payments may represent only, say, 4% of the fund's total value in one year and this level of liquidity is not difficult to find. That said, we see benefit in rules being in place to ensure these predictable payments are covered by liquid assets (and consideration should be given to hair-cuts – perhaps those based on EU2015/61?) for at least a rolling 24-month period and there should be no reliance placed on the corporate's (regular or otherwise) contributions to make good these predictable payments.

- CFA UK notes that the significant liquidity events in pension fund schemes are more likely to occur when large cash requirements crystallise to meet derivative collateral calls (e.g. if interest rates expectations increase or inflation falls), when significant member transfers need to be funded or if assets and liabilities are bulk-transferred to insurers. For these reasons, there do need to be additional liquidity rules in place which go beyond those outlined above to meet regular payments.
- CFA UK would not like to see regulation that would limit schemes' ability to access illiquidity premia. This is one competitive advantage of pension funds in the investment markets. We would therefore encourage an approach which applies a threshold for illiquid assets based on a funds need to meet benefits (to be defined) rather than one which seeks to stipulate and quantify a liquid assets requirement for all schemes. The latter could see pension funds forced to over invest in low- and even negative-yielding short-dated assets which also serve little liability matching purpose.

Q38: b. If so, what are your views on the options outlined above? Are there other approaches you favour?

- See our response to a. above; our preference is for Option 4.
- In Option 4, the consultation paper highlights the need to meet unexpected as well as expected cashflows. Demand for unexpected liquidity could come through derivative calls particularly in an environment of rising rates and the magnitude of these will depend on a scheme's hedging strategy and maturity. We can see the case for stress-testing to determine the liquidity that needs to be held to provide for such tail-risk events.
- The meaning of illiquidity also needs to be considered. An illiquid asset may be one that cannot be expected to be easily realised as cash without a significant mark-down in value within (say) a 12 month period and yet if this asset is a contractual one maturing in 24 months it may be highly suitable for liability payments occurring at this time. This reinforced the importance of considering overall liquidity versus liabilities as they fall due.

Q38: c. What limits would you set on the above criteria and why?

- See our response to a. and b. above with regards to liquidity.
- For significantly mature schemes near their LTO, allocation towards high-quality assets should be encouraged to deliver cashflow and match liabilities in a low-risk manner. With regards to a separate limit for credit quality, we would be keen to encourage diversification and believe an average rating approach could be adopted, probably of AA/strong-A,. Internal ratings methodologies could be used to rate positions without the benefit of an external credit rating, but these methodologies should undergo regular external assessment/audit.

Q38: d. How would the above change for a more immature plan?

- For more immature schemes, more growth assets, such as equities, should be allowed for in funding. We note these are typically liquid.

Recovery Plan

Q39: 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 (i.e. three years)?

- Many schemes do not receive specialist covenant advice and covenant scores will be subjective and hence we do not see covenant strength forming an important part of the FT approach. A recovery period of 5-6 years, or two valuation cycles (factoring in times for completion), is generally consistent with most sponsors' covenant visibility and the certainty of any sponsor being a going concern beyond this could be questioned. For FT treatment CFA UK believes 6 years could form a maximum recovery plan length for a scheme of typical maturity. However, there are many moving parts to setting recovery plans and these could be recognised flexibility under a Bespoke approach.

Q39: 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?

- Yes – the Bespoke approach gives ample opportunity to explain in terms of cases of reduced affordability.

Q39: c. Do you think Fast Track RP lengths should be shorter for schemes nearing and/or at significant maturity? If so, to what extent?

- Yes. For corporates at or near significant maturity it becomes difficult to justify the payment of any dividend ahead of addressing the pension deficit. To do so puts shareholders ahead of staff which neither respects the pension scheme's ranking in insolvency, nor the lower risk level at which pension scheme liabilities should be valued on company balance sheets. Immature schemes, on the other hand, should be able to justify longer RPs.
- Where covenant is used to justify increased investment risk, e.g. under Bespoke, the length of covenant visibility should be given appropriate consideration.

Q40: 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?

- Back-end loading of contributions should be limited, noting that covenant risk increases with time. Inflation-linked increases are acceptable as any early DRCs should earn a return once paid into a scheme. Theoretically, a rate of company earnings growth could fit with an affordable measure at which to increase contributions. However, sectors and companies are different and a wide range of subjective growth estimates are likely to be provided across schemes, which would not be ideal. Given the level of subjectivity a commonly accepted measure of inflation may be a reasonable measure in practice.

Q41: Should investment outperformance not be allowed in Fast Track RPs? What do you think the impacts may be?

- As in Q30 and Q11 it is CFA UK's preference for FT TPs to be valued on a low risk basis, with reference to market observable yields on low risk assets. Allowances for investment outperformance should not be double counted but should be present in the recovery plan. We believe this provides consistency and clarity. Sponsors can benefit from potential investment outperformance in recovery plans and reduced contributions if this performance is delivered.

Q42: 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?

- If the deficit reduction is in line with expectations, and the situation of the company sponsor is unchanged, then it is entirely appropriate to retain the same end-date for the deficit recovery period.

b. If a scheme's funding deficit is higher than expected, what guidelines should apply for the appropriate length of the new RP?

- Either the end-date must stay the same and the DRCs increase; or the RP could be re-spread for a further period in line with FT RPs. Lengthening the RP should usually only occur if the corporate cannot afford the increased payments under the former approach. This is especially true for mature schemes. CFA UK notes the importance of the sponsor bearing the risk directly rather than extending recovery periods where covenant viability is uncertain.

c. Would the idea of 're-spreading' be more acceptable where a scheme has a long period before it becomes significantly mature?

- Yes. This is particularly true of schemes open to new entrants or with a significant proportion of the membership still accruing benefits.

Q43: W***hat 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?***

- Once a scheme becomes significantly mature it becomes harder to justify dividends taking precedence over pension DRCs. Theoretically, if a company went bankrupt then its administrator should regard any recent dividend payments as preferential payments and

seek to reverse them. As this is impractical in most cases, dividends should not have been paid in the first place. Particularly where FT criteria are not met for a significantly mature scheme, then dividends should only be payable by exception (and then relativity between treatment of stakeholders should be relevant). Free cashflow is one metric that can be used relative to the size of deficit contributions and if there is good coverage it is difficult to argue why DRCs cannot be paid.

Open Schemes

Q44: What are your views on our proposed approach to outlining code guidance for open schemes. Should any other approach to calculating future service liabilities be considered?

- We agree it is important to recognise the 'degrees of openness' and that at one extreme (schemes that closed to new members over 10 years ago) they differ little from schemes closed to future accruals; as their last active members retire or leave employment, they become closed schemes. For TP calculations we agree that the only difference between open and closed schemes is, instead, one of maturity (and in theory there may still be closed schemes that are less mature than some 'open' ones). However, we note that while consideration of the time to payment of accrued liabilities at any point in time could be used as the measure of maturity, the time between a particular level of maturity and our measure of significant maturity will differ depending on the extent to which a scheme is open.
- We do not have any suggestions on other ways to calculate the future service cost.

Q45: Should the LTO for an open scheme be the same for a closed scheme? If not, how should they differ?

- By definition the LTO is the objective being targeted for when the scheme is at significant maturity. The LTO is therefore relevant, and should be the same, for a closed scheme as for an open scheme. The only exception to this may be schemes that are open to new employees of a company and where that company is in steady state or expanding. Here the LTO may be irrelevant as the scheme will not be moving towards significant maturity.

Q46: What option do you favour and why? Are there other options we should consider?

- We agree with your analysis of the pros and cons in Table 3 but are significantly concerned that the funding regime should not hasten closure of schemes, as we set out in our answer to Q18 in the General Principles section. In the absence of changes that enable sponsors to gain better access to surplus funding, long term funding costs are likely to rise if Option A is adopted. While we accept that for simplicity Option A may be appropriate for FT, we agree Option B should be considered appropriate for Bespoke funding approaches.

Q46: Fast Track guidelines for calculating future service costs.

- While we would agree that Option B is the intuitive answer, given the actuarial complexities we do not believe that the CFA UK is best placed to respond to this question.

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?

- CFA UK's view is that funding for past service liabilities should be targeted using discount rates associated with low risk assets for both TPs and LTO. Discount rates to fund for future service benefits not yet accrued should reflect their longer dated maturities. The higher yields on government bonds and credit securities that are generally observable at longer durations in investment markets (usually the curve is upwards sloping) should be allowed to be used to discount these longer dated benefits as in Option B. However, an allowance for growth asset returns over these yields should also be allowed for in funding benefits that have not yet been earnt as in Option C.

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?

- Growth asset expected returns can be allowed for in future service discount rates. These are higher than the lower risk discount rates used in the calculation of past service liabilities for closed schemes. Future service discount rates can be based on a best estimate expected return, or still contain a level of prudence. It is well documented by investors that forecasting returns for equities is harder than for contractual cashflows assets with observable market yields. For instance, Ilmanen 2011[7] documents that there are issues with using dividend models to forecast equity returns. In particular one has to rely on subjective opinions of dividend growth expectations as well as future buyback yields and share dilution effects amongst other inputs. As noted in the consultation there can be large differences in subjective opinions. However, Antti Ilmanen also shows that observable market yields for equity earnings and inflation expectations can lead to more objective and reliable estimates of future long-term equity returns, leaving more subjective opinions aside. These should be considered for long-term expected returns on equities.

c. Would our preferred approach (Option B) make it difficult for scheme actuaries to certify schedules of contributions?

- The use of market observable yields on contractual cashflow assets for past service TPs and future service contributions should not make it difficult. Government bond and credit yields at longer maturities are typically (though not always) higher. As these yields "roll down" over time there is consistency in the value of future and past service benefits. However, if different mixes of assets are specified in past and future service discount rates then this can cause funding strains when future service benefits accrue into past service. This occurs if there is an allowance for growth asset returns in future service liabilities but not past service.
- Funding strain would be avoided either if there is no allowance for growth asset returns, or a consistent allowance, across both past and future service liabilities. There is justification for an allowance for growth asset returns in both if there is a genuine steady state of active and non-active liabilities due to the steady flow of new scheme members and new accrual. In these circumstances a pension scheme would not be expected to reach a point of significant

[7] *(https://www.amazon.co.uk/Expected-Returns-Investors-Harvesting-Rewards/dp/1119990726)*

maturity and therefore under these conditions growth assets can be allowed for in the funding of future service and past service liabilities.

***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?**

- There are many cross-subsidies within DB pension funds where many lives are pooled. For example, the funding of a pensioner in poor health may fund another in good health; the funding of a pensioner with no spouse may help fund a pensioner with a young spouse. Similarly, those members with well-funded accrued pensions may help fund those members currently accruing benefits. These effects come with pooling across many lives. So long as the scheme is in surplus and accrued benefits not placed at risk, CFA UK believes this is acceptable.

Bespoke Framework – key features

***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?**

- CFA UK agrees with the general criteria laid out.

Q50: ***Bespoke examples***

a. Do you have any comments on the assessments we have made in the examples above?

CFA UK would like to draw attention to two of the bespoke examples and suggest their inclusion under the FT regime:

EXAMPLE 2:

- The LTO-CDI investment strategy in example 2 is invested in assets that deliver contractual cashflows that replicate the payment of liability cashflows with a low risk of default and a high certainty of return. The returns over the lives of “buy and hold” CDI securities are closely related to the yields at which they were invested.
- When setting the financial basis on which to value LTO liabilities CFA UK therefore recommends that market yields should be used on the assets that replicate liability cashflows with a low risk of default (and suitably adjusted for the small risks of default and downgrade). This is a more reliable method to forecast the future returns on low risk assets than using mixes of “growth” and liability matching assets. For almost 20 years following 1930 equities and growth portfolios delivered negative returns. Yields on contractual cashflow assets are a more reliable way to value low risk liabilities than forecasting future growth returns that could turn out to be more negative than expected over long time-horizons.
- In this example the investment stress test seems to be being failed due to the inconsistent valuation of assets and liabilities. Credit risk is recognised in the assets but not the liabilities. For CDI strategies consistent economic valuations should be applied to both assets and

liabilities. Both can incorporate a low level of credit risk reflecting the risk of failure or impairment of issuers' assets and sponsors' liabilities.

EXAMPLE 7:

- In example 7 the TPs are set at an equivalent value to the LTO. CFA UK has a preference for this TP low risk valuation methodology as the TPs are then valued more consistently with low risk liabilities on a going concern company's balance sheet (valued using corporate bond yields) and more consistently with the ranking of pension liabilities upon company insolvency (commonly with a similar ranking to bond holders).
- This method reduces the investment risk associated with the valuation of TP liabilities. However, CFA UK recognises that sponsors should be allowed to take risk in funding DB pensions. Consequently, CFA UK believes some prudent outperformance of a low risk discount rate could be allowed for in recovery plans.

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?

- No comment

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?

- For low risk CDI strategies yields are typically observable on the invested assets. These are appropriate to be used to define both LTO and TP liability bases (with appropriate haircuts to reflect the risks of both credit downgrade/migration and default).
- It is possible to construct CDI portfolios that utilise higher risk contractual cashflow assets to generate higher yield, return and cashflow until an LTO position is achieved. Assets such as high yield debt, emerging market debt and private debt could be incorporated into such a strategy. For this type of investment strategy, the TPs can be lower in value than they would be referencing the LTO, until the LTO is reached. When the LTO is reached it is likely that only the level of risk equivalent to investment grade debt is appropriate to manage a DB pension scheme on a low dependency basis.

Q51: **Stressed schemes**

a. Assuming that affordability is genuinely constrained, are very long RPs 'appropriate' and therefore compliant with the Act?

- Yes. Forcing the sponsoring company distress is typically not in a pension scheme's interest, however companies taking such an approach should not be maintaining dividends.

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)?

- No. There is a high likelihood of making a bad situation worse. Trustees face a large moral hazard with this approach as ultimately it is the PPF that bears the risk. Trustees should work with the regulator to formulate the best solution in the specific circumstances under the Bespoke approach.

c. For schemes with unviable RPs, should an exception be made for them in terms of the level of acceptable investment risk?

- No. See our answer to Q51b above; if not carefully controlled, such action runs the risk of making a bad situation worse.

d. Are you aware of situations other than stressed schemes where the trustees and employer would have difficulties meeting the Bespoke compliance principles?

- No comment.

Additional Support

Q52: 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?

- CFA UK broadly agrees with the proposed framework. However, it also proposes that trustees should be required to explicitly consider what they are conceding in exchange for the additional support (noting that this may be the opportunity cost of an alternative funding and/or security arrangement). It should be incumbent upon trustees to explain why a solution involving the use of a contingent asset (noting that this may be used as a basis for lower funding) is a better option for members than compliance with FT.

Q53: 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?

- Access requirements will typically depend on the nature of the arrangement and the purpose for putting it in place. However, it is important that trustees should themselves be able to call on the value of the asset when the agreed conditions have been met (rather than requiring the operation of mechanics which are beyond their control).

Q54: 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?

- Trustees should be required to assess the value of an asset in the scenario in which it would be called. In many cases (but not all) this would be in a scenario when the employer is in distress. The PPF has provided equivalent guidance for certifying such assets for PPF levy purposes on an annual basis and it would seem natural to use the same guidance and approach.

***Q55:* 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?**

- Trustees should be required to seek an appropriate valuation of a contingent asset, which will typically require independent and expert assessment where the asset in question cannot be priced with reference to an active market. The approach used will necessarily depend on the type of asset but, as above, we expect there will be overlap with valuations performed for PPF purposes. The asset should be fully revalued at least as part of every triennial valuation as, if its value has changed, this may need to be reflected in the scheme's strategy. In addition, trustees should be encouraged to perform regular monitoring of the asset in question (or guarantors where appropriate) on at least an annual basis.

***Q56:* a. Should we treat guarantee support differently to asset backed support?**

- Yes. Guarantee support is different in nature to asset backed support (which in turn also encompasses a very wide range of different arrangements with varying degrees of strength and therefore cannot be viewed as a homogenous group).

***Q56:* 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?**

- The legal obligations of a guarantor are typically different to that of an employer and placing covenant reliance on it in the same way is not necessarily appropriate (even though some trustees and advisors have taken this somewhat simplistic approach). It is also our experience that TPR has concerns over whether it can exercise its statutory powers against a guarantor in the same fashion that it can for an employer. Therefore, ideally, guarantors would also be participating employers in the scheme. Note that it would still be important for the additional employer to be a guarantor to prevent situations where it could pay a de minimis exit debt and cease obligations to the scheme.
- However, we recognise that it may not be feasible to make all guarantors into employers (particularly for legal reasons) and the enforcement of UK statutory obligations overseas may be harder than for contractual obligations.
- In such situations it is essential that trustees understand the inherent limitations of a guarantee. A key concept is that where a guarantor is to be relied on, it should be recognised in the guarantee deed that the affordability of the guarantee by the guarantor should be relevant for valuation purposes (rather than just that of the employer).

***Q57:* Can you think of any other types of arrangements which can help trustees mitigate risks?**

- There are a wide range of arrangements which are Bespoke to scheme-specific circumstances. It is not practical to list them here or to develop specific requirements for trustees on how they should be reflected by trustees in their scheme's strategy. Innovation can be a positive force in helping to protect members, and therefore we encourage TPR to

focus on a principles-based (rather than rules-based) approach to considering the benefit of such assets so as not to stifle the development of new arrangements.

Q58:* *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?

- No.
- In addition, and as above, Trustees should be required to report why this arrangement is better than an approach based on FT compliance.

CONCLUSION

CFA UK welcomes the TPR's consultation paper on these matters of fundamental importance to the investment profession and appreciates this opportunity to share its views.

Should you have any questions or points of clarification regarding this letter, please contact Andrew Burton (aburton@cfauk.org) in the first instance.

Yours sincerely,

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Appendix 1: About CFA UK & the CFA Institute

CFA UK: serves nearly 12,000 leading members of the UK investment profession. Many of our members work with pension funds, either managing investment portfolios, advising on investments or as an in house employee responsible for pension investment oversight.

- The mission of CFA UK is to build a better investment profession and to do this through the promotion of the highest standards of ethics, education and professional excellence in order to serve society's best interests.
- Founded in 1955, CFA UK is one of the largest member societies of CFA Institute (see below) and provides continuing education, advocacy, information and career support on behalf of its members.
- Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation, or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

CFA Institute: is the global association for investment professionals that sets the standard for professional excellence and credentials.

- The organization is a champion of ethical behavior in investment markets and a respected source of knowledge in the global financial community. Our aim is to create an environment where investors' interests come first, markets function at their best, and economies grow.
- It awards the Chartered Financial Analyst® (CFA), and Certificate in Investment Performance Measurement® (CIPM) designations worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry.
- CFA Institute has members in 162 markets, of which more than 170,000 hold the Chartered Financial Analyst® (CFA) designation. CFA Institute has nine offices worldwide and there are 158 local member societies.
- For more information, visit www.cfainstitute.org or follow us on Twitter at @CFAInstitute and on Facebook.com/CFAInstitute.