April 2024

Statement of Strategy: TPR Consultation

Cardano Group response

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This response is provided on behalf of an organisation (the Cardano Group) rather than an individual. We confirm that we are happy for our response to be made publicly available.

As covenant and investment advisers and a fiduciary manager, our response is primarily with respect to those matters, leaving others to comment in more detail on specific actuarial questions in particular. Nonetheless, given the integrated nature of DB scheme funding and the considerable interdependency across these disciplines, we have provided comments on all questions where we believe feedback would be helpful.

Our response to the consultation is drafted to provide our key headline takeaways first, followed by our responses to the specific consultation questions.

Key Headlines

The latest Funding Code of Practice, Fast Track / Bespoke frameworks and associated guidance will be key information

It is difficult to respond to consultation questions on the Statement of Strategy without sight of the Funding Code of Practice or Fast Track / Bespoke frameworks, with both so inherently linked.

We understand the Statement of Strategy aims to document application of the new funding regime rules so would expect that the consultation and example Statement of Strategy provided to reflect an advanced version of the Funding Code and Fast Track / Bespoke funding frameworks. We have taken the opportunity, therefore, to comment on these, where appropriate.

We hope that these comments will be considered not only in the context of the Statement of Strategy, but also as part of the finalisation of the other regulatory frameworks to which these comments refer.

The fact that trustees will be legally required to complete the Statement of Strategy in the format prescribed by TPR brings into sharp focus the need to examine the specific items being requested. It is crucial to ensure that every piece of information is necessary and appropriate.

Trustees will need clear guidance and ongoing messaging to help them balance prudence and pragmatism, particularly given the limited scope for explanatory narrative in the Statement of Strategy and subjective nature of some of the information requested.

The Statement of Strategy is primarily a tool to provide TPR with information to help it regulate DB schemes – it is not a replacement for "best practice"

The consultation describes a key purpose of the statement of strategy as "*a useful long-term planning and risk management tool for trustees*". The consultation, however, also makes it clear that it is a tool to "e*nsure that we [TPR] have the information we need to regulate effectively*", "*without unnecessarily increasing trustee burden*".

Whilst there will naturally be overlap between these two purposes, our view is that the Statement of Strategy is predominantly a risk filter tool for TPR, rather than a risk management tool for trustees as it is primarily focused on provision of quantitative data, without overarching strategic commentary.

We believe covenant is ill-suited to a one-size-fits-all prescriptive formulaic approach. Covenant requires consideration of a wide range of qualitative and quantitative metrics, including risks and potential downside scenarios – reflecting the idiosyncratic nature of each scheme's covenant.

Covenant is also an area where data can be challenging to obtain as the support structure of a scheme can be complex, and often does not map across to corporate reporting.

It is our understanding that the need for quantitative data principally reflects TPR's desire for efficiency in their risk profiling process, rather than because this specific data will feed directly into improving member outcomes.

In some areas, the Statement of Strategy asks for more than trustees might otherwise consider (while still meeting best practice), meaning:
- an additional administrative / cost burden on trustees (potentially leading to lack of resources for other important issues); and / or
- potential for unnecessary tension between trustees and sponsors (e.g. debating metrics that do not actually move the needle, or the sharing of commercially sensitive data).

In other areas, the Statement of Strategy falls short of best practice. It is primarily focused on quantitative metrics but the reality is that meaningful covenant risk management is also focused on qualitative factors – such as key risks and downside scenarios. Neglecting factors that are not easily entered into a spreadsheet will put members' benefits at risk. For example:
- trustees may incorrectly believe they are meeting best practice when they are merely providing TPR with data; and/or
- TPR may miss impending distress (which would appear to be a failure of the risk-filter).

The legal requirement for trustees to complete the Statement of Strategy exacerbates the above risks in our views by seemingly giving the Statement of Strategy more emphasis than "best practice" as set out by guidance.

It is not clear where or how Trustees should document how covenant has influenced their funding and investment strategies

We believe that covenant should have primacy within the DB pensions risk management framework and are therefore pleased to see the role of covenant being referenced as the key driver to investment and funding risk decision-making.

The consultation is helpful in setting out TPR's expectations that it expects trustees to focus on demonstrating in the Statement of Strategy that "*the funding and investment risk is supportable by the employer covenant and in line with the maturity of the scheme*".

It is difficult, however, to understand how TPR expects to see such a demonstration – the example Statement of Strategy makes no reference to how covenant has tangibly impacted scheme funding or investment strategy. There is only one mention of covenant in Section 1 of the Statement of Strategy (the FIS) and while Section 2 references a number of covenant-specific metrics, these are not mentioned in the context of the scheme's agreed strategy.

Interestingly, in the “Trustee assessment” section, under the “Extent to which the funding and investment strategy is appropriate” heading, the only reference to covenant is a sentence to note “*We have also considered the employer’s ability to support the scheme*”. In light of the stated importance of covenant, as set out in the regulations themselves, we would expect that trustees demonstrating a best practice approach would clearly set out how their view of covenant (whether assessed by the trustees themselves or external advisers) had impacted the funding and investment decisions over the scheme’s journey plan.

Many trustees will be using the example Statement of Strategy as a base for their own draft. To not have this link between covenant and funding and investment strategy set out within the example could well lead to inadequate drafting by trustees and, potentially, risk being run that is unsupported by covenant.

A numerical or formulaic regulatory filter may introduce risks

We understand that some of the information that is being requested will be fed into a formulaic regulatory filter to drive engagement with certain schemes running excessive risk in TPR’s eyes.

If this formulaic approach is public knowledge, then it will be possible to “game” it – i.e. providing information that is less likely to result in regulatory engagement. Unnecessary risk may be run as a result, and this risk may not be spotted.

It is entirely possible that advisers will be under pressure from clients as a result, either to say something that they don’t agree with or risk being replaced by others that will (i.e. “opinion shopping”).

Covenant is de-emphasised in Fast Track

The Statement of Strategy consultation does make it clear that “all schemes” need to provide information on “*whether or not they have assessed strength of the employer covenant with reference to the maximum affordable contributions over the reliability period*” and “*any contingent assets and whether or not the employer covenant is sufficient to support the level of risk implied by the funding and investment strategy over the reliability period*”.

We note, however, that in the data list for the Statement of Strategy consultation, only schemes under the bespoke track are required to:

- Confirm the date that the trustees have assessed the employer covenant
- Confirm whether professional covenant advice was taken for the valuation
- Confirm, if no professional covenant advice was taken, what experience trustees have that enables them to assess covenant

We would recommend that all schemes should be required to confirm these points.

Furthermore, there are a number of statements made regarding the consideration of covenant under Fast Track that we consider to be unhelpful as it goes to setting the expectation regarding covenant under Fast Track. These include the following:

- “*If a scheme meets a series of Fast Track parameters, the trustee can expect to provide less information in the statement of strategy, particularly in relation to covenant*”
- “*require less information on covenant, for example no information on corporate cash flows or uses of cash, and only high level information on contingent assets*”

- "*we would expect greater detail from Bespoke schemes, but this detail will be focused on whether the funding risk is supportable by the employer covenant and in line with the maturity of the scheme*".

Whilst we do not think TPR should ask for information it will not use, we are concerned that Fast Track will become synonymous with "no need to consider covenant" and the above exacerbates this risk.

Failure to consider covenant appropriately has the following risks:

- Fast Track may not be the right funding and investment strategy for a scheme from a covenant perspective. That scheme could be running too much risk (i.e. the covenant is too weak to support the Fast Track approach) or not enough risk (e.g. where more risk is supported by covenant and could be taken to get the scheme to full funding on a buy-out basis sooner) and
- Trustees / TPR may miss impending distress / detrimental transactions if covenant is not adequately considered for Fast Track schemes

This could this all be made clearer by re-framing the sequencing of trustee consideration (and this may be made clear in the final Funding Code), with the recommended approach for trustees to consider covenant as part setting their journey plan / funding and investment strategy, following which they will know, from a covenant perspective, which valuation route (i.e. Fast Track or Bespoke) to go down, based on the right level of analysis to avoid risks/pitfalls.

More information is needed on the new covenant concepts of "reliability" and "longevity"

It is not clear from the consultation and associated documents, how TPR expects the concepts of "reliability" and "longevity" to impact trustee decision-making regarding scheme strategy.

Initial drafts of the Funding Code (including the maximum affordable risk chart) suggested that trustees would be required to de-risk linearly at the end of the period of reliability and reach full funding on an LTFT basis before the end of the longevity period. This, however, doesn't appear to be the case within the example Statement of Strategy, where the scheme has chosen its target date to reach full funding on its LTFT as the relevant date, which, in this case, is 2038. This is 10 years after the end of the reliability period has ended and 6 years after the end of the longevity period. Without having visibility of the updated maximum risk methodology, including definitions and expected approach for reliability and longevity, it is not clear what these concepts mean, how trustees should consider them and what they should be influencing (if anything at all – or whether it's purely information for regulatory risk profiling purposes).

We remain of the view that putting a timeframe on covenant reliability or longevity is likely to be arbitrary in many cases (covenant rarely has a cliff-edge, instead just becoming increasingly uncertain with time). A pragmatic approach may be to back-solve to the necessary time frames but this may also lead to gaming of the system or opinion shopping to pass the regulatory filter.

The maximum affordable contributions calculation lacks context

The maximum affordable contributions calculation seeks to apply a one-size-fits-all approach but the maximum affordable will be different in different circumstances (e.g. willingness to contribute in response to adverse scheme funding may be different based on maturity, and different sponsors have different perspectives on dividends depending on ownership).

It is not made clear in the consultation or the example Statement of Strategy how this figure feeds into the level of funding and investment risk. In any case, the level of risk being run should not consider forecast cash flow in isolation, but in the context of potential future risks and their impact.

It will be important to provide guidance as well as scope for narrative where information is not readily available in the form set out by TPR (e.g. sponsor forecasts that factor in the impact of stripping out growth investment will likely not be available).

More detail should be provided on this assessment to avoid it becoming a purely box-ticking exercise focused on a central scenario carried out by trustees for regulatory purposes. This should include thoughtful consideration of risk tolerance based on future trading prospects and associated risks.

It would be helpful to reference where/how to integrate ESG risks into Statement of Strategy, particularly alongside other risk management frameworks

ESG risks can have an impact on covenant, funding and investment. TCFD and TNFD are frameworks that require (or will require) schemes to report on climate change and nature risks in an integrated way going forward. We would expect the Statement of Strategy to link into these frameworks, to avoid trustees working off a series of different frameworks when setting their strategy. Either within the Statement of Strategy guidance, the example Statement of Strategy or the data to be submitted, it would be helpful to see some explicit mention of this interaction. As a minimum, this could ask trustees if they have undertaken TCFD and TNFD reporting (recognising that trustees may voluntarily do so as best practice).

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Responses to specific questions

Our approach to the statement of strategy

1. To what extent do you agree that our proposal to adjust the information required of smaller schemes as outlined in the document is pragmatic and proportionate?

   In the context of proportionality and desire to avoid placing an unnecessary burden and level of cost on trustees, we would agree that it is important to adjust information requirements for smaller schemes.

   It is not clear whether there are any adjustments in covenant information requirements for those that classify as a "smaller scheme". If there are no adjustments then this should be made clear.

   While we believe that covenant is important regardless of scheme size, the full list of information is likely not proportionate for very small schemes. It might be more pragmatic to limit covenant information requirements for very small schemes to confirm that covenant has been considered and that it supports the investment and funding decisions being taken. This would be aimed at schemes with very low member or liability numbers – noting that many small schemes still require significant levels of independent covenant advice.

2. To what extent do you agree with the two definitions proposed for smaller schemes depending on whether we are requesting actuarial or investment information?

   We do not have strong feelings on these definitions from an actuarial or investment information perspective.

3. To what extent do you agree with our proposal to have pre-defined templates for the statement of strategy to help trustees provide information that is proportionate, relevant and specific to the circumstances of their schemes?

   As a starting point, we agree with the proposal to have pre-defined templates – we agree that it will help provide a level of consistency in terms of information provision, particularly with respect to smaller schemes, which in turn helps with cost efficiency and TPR review / comparison across the DB universe.

   However, we believe that the extent to which these templates allow for scheme-specific circumstances is highly uncertain. The restrictions on the use of free text boxes will limit the amount of scheme-specific information to drop down options or numerical inputs. From a covenant perspective, relevant information can often not be distilled into one option out of four drop downs, for example; nor can it be quantified (e.g. the likelihood and impact of future risks on cash generation). This goes against the desire to help trustee "provide information that is proportionate, relevant and specific to the circumstances of their schemes". More free text boxes for certain covenant information or explanations would be useful in our view.

4. To what extent do you agree with the benefits we expect to see by providing a pre-determined statement of strategy?

   We agree with the benefits listed.

   It is worth noting that, by providing templates you are providing a view on “what good looks like” in terms of approach and, as is intended, trustees will use that approach as a starting point. This places extra emphasis on the templates / pre-determined statement of strategy and the need for it to be appropriate from a risk management perspective. At this stage, we have some concerns on that point – please see our key headlines above – particularly that much of the information being requested appears more to be for the purpose of regulatory risk profiling, rather than for meaningful trustee strategic and risk management analysis.

5. To what extent do you agree with the key differences in the information we ask for between the four proposed templates?

   We agree that there should be differences in information that is asked for – in particular from an actuarial and investment perspective. Please see our key headlines above for our comment regarding covenant under Fast Track – on the basis that covenant is not a condition for entry into Fast Track, there is a risk that covenant risks are inadvertently missed or minimised if no covenant information is provided by trustees.

   It is not entirely clear what the difference between the Fast Track template should be before and after the relevant date – assuming that the Fast Track regime will ensure that a scheme past its relevant date will be fully funded on a LTFT basis.

6. Are there any scenarios that the proposed four templates are not suitable for?

   It is not clear which template trustees should use if their scheme hasn’t reached full funding on a low risk basis but they are past the relevant date – the template for bespoke schemes post-relevant date would not allow them to insert a journey plan, even though one might still be required.

   TPR should consider whether it would be appropriate to have additional templates for schemes that are extremely well funded (e.g. 100% funded on a buyout basis) on the basis that the current information requirements may be disproportionate.

7. To what extent is the example Bespoke template a clear tool that supports trustees’ long-term planning and risk management and facilitates engagement between trustees, their employer and TPR?

   In our view, it is not clear how the covenant elements within the Statement of Strategy should be used by trustees to tangibly impact a scheme’s investment and funding strategy. If it is the case that covenant considerations should be impacting the investment and funding strategy decisions being made by trustees (as the regulations and, we assume, the final Funding Code will set out), then the statement of strategy would appear to be the clear place to set out this dynamic. The example statement of strategy doesn’t include this information, however. Please see our key headline entitled "*It is not clear where or how Trustees should document how covenant has influenced their funding and investment strategies*".

8. Do you have any further comments on our general approach to the statement of strategy template?

   Please see our key headlines regarding general approach.

Part 1: funding and investment strategy

1. To what extent do you agree that the long-term objective options (buy-out, run-off, move to a superfund or alternative consolidator) capture most long-term objectives for a scheme?

   We agree.

2. To what extent do you agree that the three broad categories of growth, matching and hybrid assets gives sufficient breakdown of the low dependency investment allocation?

   We agree that most low dependency investment allocations could be grouped into these categories without difficulty.

   However the definition of Hybrid assets could be improved. It currently describes a set of assets that includes some Growth assets and some Matching assets. We would have expected it to describe asset types which contain typical characteristics of both Growth and Matching assets. Examples of Hybrid asset could be provided to help clarify this.

3. To what extent do you agree that it is sensible to include all three funding bases (low dependency funding, technical provisions and buy-out)?

   It should not be a problem to request all three bases as the information should be readily available.

4. To what extent do you agree that the standard wording in the proposed statement of strategy template is adequate to outline the funding journey plan?

   We do not feel best placed to comment on this, if the preference is for extensive reference to the Technical Provisions basis, as per the current template.

5. To what extent do you agree that the discount rate approach options (horizon method, different rates pre-retirement and post-retirement, constant addition) include the majority of options available?

   We do not feel best placed to comment on this, given it relates to the valuation of scheme liabilities.

6. To what extent do you agree that the selections of gilts, swaps, inflation or other cover the main underlying yield curves used when setting technical provisions and low dependency funding basis?

   We agree.

7. In respect of the underlying yield curves, indicate the extent to which you agree with the approach proposed of providing the forward discount rate curve, or for small schemes the appropriate single rate?

   We do not feel best placed to comment on this, given it relates to the valuation of scheme liabilities.

8. In respect of the addition/premium to the yield curve, indicate the extent to which you agree with the approach proposed to provide the forward discount rates?

   We do not feel best placed to comment on this, given it relates to the valuation of scheme liabilities.

9. In respect to the addition/premium to the yield curve for schemes that use a pre- and post-retirement discount rate methodology, indicate the extent to which you agree with the approach proposed of providing the appropriate single rate?

   We do not feel best placed to comment on this, given it relates to the valuation of scheme liabilities.

10. To what extent do you agree with the proposed approach to capture information on inflation and pay increase data?

    We do not feel best placed to comment on this, given it relates to the valuation of scheme liabilities.

11. To what extent do you agree that it would be useful to provide further information on the mortality tables adopted for the mortality assumptions?

    We do not feel best placed to comment on this, given it relates to the valuation of scheme liabilities.

12. On allowances for commutation, to what extent do you agree that the options provided capture the majority of approaches used?

    We do not feel best placed to comment on this, given it relates to the valuation of scheme liabilities.

13. To what extent do you agree with the proposed approach of asking about how the key assumptions differ between the technical provisions and low dependency liabilities?

We do not feel best placed to comment on this, given it relates to the valuation of scheme liabilities.

14. Do you have any further views or considerations on the information required for Part 1 of the statement of strategy, including any views on alternative approaches or missing data to support Part 1?

Part 1 of the statement contains extensive details about the TP basis plus a concluding question about how the TP basis differs from the Low Dependency basis. This is not a problem *per se* but we would have expected the opposite emphasis.

In other words, , as the purpose of the FIS is to specify the plan to reach Low Dependency, the key information is how and whether the combination of sponsor contributions and excess investment returns enables the scheme to reach *that* basis.

In contrast, the TP basis is a stepping stone towards the Low Dependency position point and hence is relevant context but less central to the FIS.

Hence it feels to us that the details being requested of the TP basis should instead be collected on the Low Dependency basis to give more direct information about the key aspects of the journey plan.

Part 2: actuarial information

N/A – We have not responded to the questions related to actuarial information.

Part 2: recovery plan

1. To provide details about post valuation experience, we expect providing an updated estimated deficit would be best. To what extent do you agree that providing an estimated deficit is the appropriate approach?

   We consider this to be an appropriate approach.

2. If providing an updated deficit, to what extent do you agree it would be straightforward to also provide the updated estimates for assets and liabilities, if we require that detail?

   This should be relatively straightforward if an updated estimated deficit is being provided.

3. Share your views on our proposed approach to collecting information on investment outperformance and post-valuation experience, including any alternative questions that should be considered.

   We do not feel best placed to comment on this, given it relates to the actuarial calculations in the recovery plan.

Part 2: investment information

1. We do not envisage schemes will incur significantly more costs in providing journey plan investment risk data. To what extent do you agree with this assessment?

   We agree.

Part 2: covenant information

1. To what extent do you agree that the proposed approach to submitting covenant information will work in practice for different types of multi-employer schemes?

   We agree that a proportionate and pragmatic approach needs to be implemented. It is important, however, to highlight the risk of oversimplifying potentially complex covenant structures, leading to understatement or overestimation of covenant strength. For example:

   - Strong employers liable for a small percentage of liabilities may provide helpful covenant support, but this should be considered in the context of their ability to eliminate their obligation by paying the buyout deficit and consequent impact on overall covenant support for the remaining liabilities.

   - Aggregating financial data across employers assumes full joint and several support is provided by employers, which is rarely the case even in a last man standing scheme.

   - Aggregating information may lead to double counting, if consolidation adjustments are not considered.

   This point, and the example above, should be made clear to trustees. The Statement of Strategy would benefit from a free text box to allow trustees to comment on their covenant support structure and risks associated with any simplification for the purposes of the strategy documentation.

2. To what extent do you agree with the proposal that aggregated covenant information should cover employers that account for at least 80% of scheme liabilities?

   In theory, the higher the percentage of scheme liabilities that is covered, the better. However, this is subject to proportionality and the points noted in question 1 above.

3. We expect employers to work with trustees and provide the appropriate information. To what extent do you agree that information required will be obtainable to understand the level of risk supportable by the covenant?

   In terms of information from the employer, there are some very likely scenarios whereby information isn't provided. For example:

   - because the employer is too small and therefore information isn't prepared or available; or

   - where the employer is large or part of a wider international group that won't provide

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relevant information (e.g. confidentiality / insider trading concerns); or

- where legal entity reporting lines make analysis difficult at the right level.

In those cases where the information is available, covenant structures such as those above will likely add on time and costs to the valuation process.

In terms of the additional subjective information being requested (of which there are numerous examples – e.g. covenant reliability / longevity and maximum affordable contributions), expert advice will perhaps be required, which would add additional costs (which makes it difficult for smaller schemes).

For those smaller schemes without a covenant adviser, they may send the template to the employer to fill in and then send back to TPR, without much scrutiny.

4. To what extent do you agree that the covenant information we propose to request for Bespoke and Fast Track valuation submissions is reasonable and proportionate?

We do not agree that the covenant information that you propose to request for Bespoke and Fast Track valuation submissions is reasonable and proportionate on the basis that:

- It appears to prioritise aiding regulatory risk profiling, as opposed to being focussed on being a key risk management tool for trustees;

- It is not easily tailorable depending on scheme specific circumstance, including specific funding circumstances or complex covenant structures; and

- It is not clear how it relates to funding and investment strategy decision making.

As drafted, the proposed approach could lead to a number of unintended consequences, such as:

- An increase in costs incurred by schemes without an associated equivalent benefit to trustees;

- The trustees' misplaced self-assurance regarding risks (covenant risks in particular) having "done what the regulator asked within the Statement of Strategy"; and

- The potential strain on trustee-sponsor relationships, for example as a result of asking for unnecessary information.

Please see our Key Headlines for more information.

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Cardano | 9th Floor, 6 Bevis Marks, London EC3A 7BA
T: +44 (0)20 3170 5916 | E: info@cardano.com | W: cardano.com