October 2022

Public consultation on draft Occupational Pension Schemes Regulations 2023

Cardano Group response

cardano

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.

Overview

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 actuarial and legal matters. 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.

As a starting point, we believe that covenant should have primacy within the Defined Benefit ("DB") pensions risk management framework, as was set out in the response of Cardano Advisory (previously Lincoln Pensions) to TPR's Funding Code Consultation 2020. We are therefore pleased to see the role of covenant as the key driver to investment and funding risk decision-making being formalised in the draft Occupational Pension Schemes Regulations 2023 (the "Regulations"). Furthermore, on that basis, in any and all scenarios, decision-making that ignores the ability of the covenant to support the level of risk being taken represents a significant threat to the security of members' benefits. It is right, therefore, that this should be within the Regulations (rather than the Code of Practice), as it represents a fundamental point of principle.

We are also broadly supportive of the direction of travel that the Regulations are travelling in. In particular, we agree with the formal shift of risk management focus from the shorter term (i.e. technical provisions and recovery plans) to the longer-term, in the form of a long-term funding target; with the journey to this long-term funding target being informed by covenant analysis and scheme maturity.

Interaction with the draft Funding Code of Practice

As a starting point, we want to highlight the difficulty of responding to consultation questions on the draft Regulations without also having sight of the draft Funding Code of Practice, with both so inherently linked. We would, therefore, suggest allowing respondents to provide further comments on the draft Regulations once the draft Funding Code of Practice has been published (or for certain questions, for example).

It is our view that the Regulations should be used to set out the overarching framework for schemes, as represented by key principles. We have some concerns over certain instances where we feel that the Regulations, as drafted, stray from principles into a level of detail that could prove restrictive in the future.

A significant example of this is the reference within the Regulations to three specific "*matters to be considered*" as part of an assessment of covenant strength ("*cash flow*", "*the likelihood of an insolvency event*" and "*other factors which are likely to affect the performance or development of the employer's business*"). By exclusively referencing these matters, the Regulations ignore other key areas that should form part of covenant analysis. Furthermore, the extent to which proportionality and scheme-specific considerations should be considered is absent. In our view, it is not necessary (or helpful) to specify detail on matters to consider in a covenant assessment in the Regulations, which could instead sensibly refer to more comprehensive guidance "*set out in a Code*", as 7(4a) and 7(4c) do in any case. This would allow the Code (and associated

guidance) to highlight the complexities involved in assessing scheme-specific covenants and provide flexibility for trustees to be proportionate in their approach to assessing covenant.

Conversely, as currently drafted, the decision has been made to exclude the specific date at which a scheme would reach “significant maturity” from the Regulations. While we expect there to be industry concerns as to whether duration represents the most appropriate measure (particularly given its sensitivity to movements in interest rates), we agree with an approach that keeps the specific target on the relevant basis (whether duration or another) out of the Regulations. This aligns with our general view that the Regulations should focus on principles, and the Code of Practice or other regulatory publication should reflect the fact that the requirements may need to change in the future, as prevailing conditions change, particularly in times of increasingly volatility such as those being experienced now.

Potential unintended consequences

There are over 5,000 UK DB schemes, of different sizes with different covenants and different maturities. A one-size fits all approach is naturally going to struggle to be applicable to all. Accordingly, there needs to be a careful balance of flexibility but with clear overall objectives.

There is further a challenging balance between providing too much detail in the draft Regulations (leading to a lack of flexibility) and providing not enough (leading to ambiguity). This is particularly acute given we do not yet have sight of the draft Funding Code of Practice, which would be expected to provide the necessary detail and scope for flexibility.

This leads to a risk of potential unintended consequences, many of which may be addressed by ensuring the Regulations focus on the principles, and the Funding Code provides the practical detail. Clarity is needed on the implications if schemes are not able to meet the requirements of the draft Regulations: either confirming (or setting out any intention to change) the current approach (i.e. TPR is responsible for engagement and enforcement, initially via a “comply or explain” approach).

Flexibility is particularly important during periods of significant volatility, which can push even a well-managed scheme with a sensible strategy off-track. We consider it important that the Regulations (and Funding Code) remain fit for purpose regardless of what economic instability we face.

Below we set out potential unintended consequences linked to the lack of flexibility / ambiguity:

1) **Formalising an overly-simplistic definition of covenant** – The Regulations have re-drafted the definition of covenant (as compared to the current TPR definition) in a way which removes a number of elements (including legal obligation; relativity compared to scheme funding obligations and ongoing level of scheme risk; and time, being both now and in the future) that are key to carrying out robust and meaningful covenant analysis. In doing so, alongside referencing some, but not all, items to be considered, the Regulations run the risk of overly simplifying the covenant assessment analysis that Trustees should carry out or be asking advisors to complete; and in doing so, potentially putting members’ benefits at risk by running an unsupportable level of risk.

2) **Pushing employers into stress or distress through unaffordable contributions** – By requiring all schemes to reach a state of low dependency by the time they are "significantly mature", and (crucially) without making clear what the implications of not doing so would be, there is the risk that some employers will feel they have no option but to pay potentially unaffordable contributions, which could lead to significant pressure on businesses, reducing investment in sustainable growth, and possibly leading to insolvency. This contradicts with the expectation that contributions will be "reasonably affordable", which is why we consider it to be an "unintended" consequence.

3) **Schemes reducing prudence or extending covenant reliance** – There will be many schemes that are currently working towards a prudent, low dependency target that is ahead of the consultation's expected "significant maturity" date. The Regulations may "change the goal posts" re-opening discussions with sponsors as to whether previously agreed investment and funding strategies were appropriate. It would be helpful to have further commentary as to expectations of trustees and sponsors where schemes are surpassing the requirements in the draft Regulations.

4) **Low-dependency at significant maturity as the end point** – Mandating a prescribed low-risk position at the point of significant maturity might force schemes to de-risk even if they have sufficient covenant support to continue with a journey plan towards an appropriate end game. It is worth reiterating that the long-term funding target should not be considered an end point; rather, it is another step on the journey to an appropriate end game, with covenant important right up until that end point. Schemes should not be discouraged from reaching that end point more quickly, should they have sufficient and appropriate covenant support to seek to do so.

Meaningful assessment of covenant

A key point we would like to draw to your attention is the importance of thinking about covenant in the context of a scheme's journey plan, rather than as a single rating score (as is currently too often the case) – this is fundamental to actually being able to integrate covenant with investment and funding strategies. An obvious example is that a simple covenant score could be the same for a profitable, cash-generative business in an industry in structural decline, versus a business with limited current cash flows but in a growing industry; however, a covenant-driven journey plan could be very different for these cases.

We achieve this in our own covenant assessments by considering the following elements, which we expect to see more of within the Funding Code of Practice and Covenant guidance:

- **Affordability**: the ability of the employer to meet the funding needs of the scheme and to support its risks, with this measure likely focusing on the nearer future, to full funding on a Technical Provisions basis (driven in part by information availability and clarity, on both liquidity and risks);

- **Visibility**: the extent to which the affordability position is expected to persist (or otherwise) over the period to the scheme's existing long-term funding target. This is a relative assessment across employers, noting that all covenants will experience greater uncertainty further into the future and taking into account the needs of the scheme; and

cardano

- **Reliability**: the extent to which the sponsor is expected to be able to provide longer-term support for ongoing but well-funded schemes both for the residual funding, investment, legal and regulatory risks on the journey to buy out (if that is the target) and/or to remain solvent to avoid the issues that would arise from an insolvent sponsor even for a well-funded scheme. Given the timeframe under consideration may be upwards of 30 years, this factor will need to focus on a sponsors' industry/industries and its position within them.

Linking to the above observations about the importance of the Regulations focusing on principles, with the Funding Code covering practical detail, we do not consider it necessary or appropriate for the Regulations to go into this level of detail. We are merely including it to demonstrate our feedback is practical and consistent with existing best practice. A principles-based reference to the importance of the time component could be achieved in the Regulations by saying "trustees should assess covenant in a manner so as to be informative when setting investment and funding strategy, taking into account how covenant may change over that period".

In conclusion

We hope that the key points highlighted within this cover note and the detailed responses to the consultation questions prove useful. We trust that the enclosed responses to the individual consultation questions are clear but would be more than happy to discuss any aspect of it with you in more detail.

We look forward to the upcoming consultations on the DB Funding Code of Practice, which we hope will provide the appropriate level of detail to flesh out the principles within the Regulations, and the Guidance for Assessing and Monitoring the Employer Covenant.

Yours faithfully,

Kerrin Rosenberg
CEO, Investments Cardano UK

Darren Redmayne
CEO, Cardano Advisory

Responses to Consultation questions

Scheme Maturity

Question 1: Draft regulation 4(1)(b) provides that a scheme reaches significant maturity on the date it reaches the duration of liabilities in years specified by the Pensions Regulator's revised Defined Benefit Funding Code of Practice.

i) Do you think that it would be better for the duration of liabilities at which the scheme reaches significant maturity to be set out in the Regulations rather than the Code of Practice?

We note this question is specifically about the definition of significant maturity rather than the requirements associated with reaching this point. Our commentary on the requirements is included in Q8. Nonetheless, these potential requirements will be significant for many schemes, so we consider it important to reflect carefully on each element of the framework

As a general point of principle, the extent to which both the concept of significant maturity and the specific liability duration are included in the Regulations, Code of Practice or other regulatory publication should reflect the fact that the requirements may need to change in the future, as prevailing conditions change

On that basis, referencing the specific liability duration of "significant maturity" within the Regulations (as opposed to the Code of Practice) would appear to make it harder to change in the future, if appropriate/required. In light of uncertainty and volatility (e.g. impact of interest rates on maturity dates) and impact on funding levels, this might be needed in the future

Our understanding is that the duration of schemes has been relatively volatile in the recent market turmoil. Whist funding levels have generally improved for schemes as their duration has shortened, it may not be the case for all. It would be helpful to consider whether it is appropriate for a volatile metric to be a keystone in the new Regulations, and what can be done to help schemes avoid a sudden shift leaving them exposed to breaching the Regulations as they get closer to significant maturity

It would also be helpful to consider whether there are schemes where maturity is not easily represented by a single duration figure due to their membership profile (for example small schemes where individual members may represent a material share of projected cash flows, increasing the risk that duration suddenly changes)

ii) If you think that the point of significant maturity should be specified in Regulations, do you agree that a duration of 12 years is an appropriate duration at which schemes reach significant maturity?

We do not agree that the specific point of significant maturity should be specified in the

Regulations; however, we think that, wherever the specific point is referenced (e.g. Code of Practice), it needs to be flexible to be appropriate for the conditions at the relevant time

When thinking about 12-14 range already guided in TPR guidance (e.g. AFS), 12 years allows more time for schemes to get to LTFT than 14 years.

This is helpful from a corporate perspective, on the basis that it would allow an additional four years (for a typical scheme) for contributions to reach the relevant low-risk basis. In light of the impact of macro-economic circumstances on employers, it might be reasonable to land on the more company-friendly end of that 12-14 range; but this does again point towards retaining the flexibility to change the target date (for example, by keeping it within Funding Code, rather than Regulations) to adjust based on changes to macroeconomic conditions.

Conversely, defining significant maturity by reference to a 12-year duration could extend the period of covenant reliance for those schemes that may previously have been aiming for LTFT earlier than that point

This represents a greater risk in light of the macroeconomic factors over the last 12 to 18 months that have resulted in improved scheme funding levels, to such an extent that many schemes will be in a position to reach a long-term funding target significantly in advance of the 12-year duration (the other side of the risk referenced earlier where some scheme may have found their duration reduced and funding not sufficiently improved). The appropriate framing of the target by TPR in its communications, as well as retaining an element of flexibility in terms of the duration date, will be essential to avoid this consequence

Low dependency investment allocation

Question 2: Do you think that the definition of low dependency investment allocation provided by draft regulation 5 is appropriate and will it be effective?

Yes, the definition is reasonable in principle. But we note that the concepts of “broadly matched” cashflows and being “highly resilient to short-term adverse changes in market conditions” are open to interpretation. Hence guidance and clarification will be needed at some point around what this means in practice.

Low dependency funding basis

Question 3: Do you think that the definition of low dependency funding basis provided by draft regulation 6 is appropriate and will it be effective?

Yes, this is appropriate, subject to the requirement mentioned above for clarifications/guidance on the qualitative terms used to describe a low dependency investment allocation

We do stress the need for sufficient clarification that “low-dependency” should not be portrayed

(even inadvertently) as the point at which trustees no longer need to consider covenant. There may be both i) still risk at low-dependency that will need to be supported by the covenant; and ii) a subsequent journey to an appropriate end-game position that will, in the normal course, require a solvent sponsoring employer.

Strength of the employer covenant

Question 4:

i) Do you agree with the way that the strength of employer covenant is defined?

We support the decision to include a definition of covenant in the draft Regulations, particularly given the extent to which the draft Regulations set out how covenant considerations should underpin trustees' investment and funding decision making processes.

However, we do not see the need to change the definition of employer covenant from that currently set out by TPR - "*The covenant is the employer's legal obligation and financial ability to support their defined benefit (DB) scheme now and in the future". There does not appear to be anything within the draft Regulations or proposed Code of Practice (based on the consultation and subsequent updates) that requires a change to this pre-existing definition.

By contrast, in the draft Regulations, the strength of the employer covenant has been broadly defined with reference to some of the key areas that should form the basis of a covenant assessment, i.e. the financial ability of the employer in relation to the scheme to support the scheme (considering cash flow, insolvency risk and "other factors" which are likely to impact the performance or development of the employer's business); and support from contingent assets (depending on enforceability and value at the point required).

The draft Regulations do not elaborate on other key elements of covenant (which will be scheme specific), notably:

- *Legal obligation* – reflecting not only which employers are responsible (and the degree to which they are responsible) but also structure of the scheme etc. This is a key starting point of any robust covenant assessment and often an area poorly understood by trustees. This does not appear to be addressed in the draft Regulations
- *Relativity* – covenant strength is a measure of employer/contingent asset strength relative to the scheme funding obligations and ongoing level of scheme risk. It is unclear to us whether this is included within the elements considered by the draft Regulations;
- *Now and in the future* – there is no concept of timeframe in the current definition, but the extent to which covenant is important extends all the way to the point at which the scheme is closed, run-off or bought-out (or equivalent removal of covenant link).

Given the above, it is our view that the areas that form the basis of a covenant assessment should not be set out in the Regulations, but within the Funding Code of Practice and associated covenant guidance; not least because there are a significant number of areas that need to be

considered as part of a covenant assessment, to potentially differing levels of detail depending on the scheme-specific situation and noting an existing expectation of proportionality in the approach. It would be very difficult to include all areas of covenant consideration within the Regulations (or the definition of covenant).

It would be similarly difficult to set out the extent to which proportionality and scheme-specific considerations should be taken into account; or explain what the implications (or "so what") of the conclusions of this assessment should be. We also note the inflexibility of Regulations should key areas of focus change in the future relative to regulatory guidance.

Please see Question 4ii) below for further comments on methodology.

We do not agree with the statement in paragraph 3.18 of the consultation document that "*At its simplest level, the employer covenant is the employer's obligation to support the scheme*". Employer covenant does not only incorporate obligation, but also ability. It is the ability of those entities with a legal obligation (plus any contingent assets) to support the scheme in the context of the potential needs of the scheme (a function of scheme size, funding level and risk) over the period for which the scheme is reliant on covenant (i.e. until buyout or other such severance of the covenant linkage).

ii) Are the matters which trustees or managers must take into account when assessing it, as provided by draft regulation 7, the right ones?

Please see the answer to question 4 i) above, which makes clear that the areas that form the basis of a covenant assessment should not be set out in the Regulations, but within the Funding Code of Practice and associated covenant guidance.

If covenant assessment areas must be referenced in the Regulations, these should:
- Not just be limited to a list of areas to consider, but set out, in broad terms, how the impact of the assessment of covenant strength should be considered by trustees – i.e. the "so what" as well as the rating.
- Link in with the associated TPR guidance and be as consistent as possible (including terminology) as any inconsistencies would cause unnecessary confusion.
- Allow for flexibility and proportionality in the analysis undertaken.

A key focus of the draft Regulations is the setting of a funding and investment strategy by reference first to covenant, and then to maturity. Given the importance of both time and covenant in this requirement, the expected evolution of covenant over the period of covenant reliance should be properly considered. Often the "time" component is lost in a simplistic rating (e.g. by providing a "prospects" score which is then diluted amongst other covenant characteristics to provide a simple rating score at a moment in time). For reference, we have provided further detail on our approach to considering the evolution of covenant over time in question 17 and our covering letter.

We note that, as currently drafted, only 7(4a) and 7(4c) refer to additional information being

provided in the Code of Practice. 7(4b) refers to the assessment of the likelihood of insolvency, but does not reference additional guidance being provided elsewhere, despite being a complicated and potentially subjective assessment that often focusses on short term risk, rather than risk over the remaining period of covenant reliance (noting this becomes extremely challenging to evaluate over longer timeframes). 7(4b) would, therefore, benefit from additional information regarding expectations and we would recommend including a reference to additional guidance.

It is essential to make clear in the Regulations that covenant is a relative measure (i.e. financial ability relative to obligations to the scheme); we, therefore, agree with the reference to the scheme's funding deficit and, more specifically, the low dependency and solvency deficits, both of which are "covenant agnostic" (from an assumptions point of view). However, we note that there is no specific reference to funding volatility (e.g. as a result of investment risk) in this section and the need for this to be considered as part of covenant assessment analysis. While this point is inferred, on the basis that the Regulations are setting out that investment and funding strategies must be set with reference to covenant, it would benefit from being set out in this section also.

iii) Does draft regulation 7(4)(c) effectively capture the employer's broader business prospects?

The draft regulation 7(4c) is effective in capturing "all other factors" as it is clearly drafted as a "catch-all" referring to "other factors which are likely to affect the performance or development of the employer's business". We do not think a "catch-all" is helpful as it arguably creates an obligation to consider everything, which is unlikely to be proportionate. As noted previously, we believe the draft Regulations should focus on principles with practical detail covered by the Funding Code. See points set out in the answers to questions 4i) and 4ii) above.

Relevant date

Question 5: Does it work in practice to set a minimum requirement for the relevant date to be no later than the end of the scheme year that the scheme is estimated to reach significant maturity?

We do not see any issue with this subject to our commentary provided elsewhere in this response regarding the definition of significant maturity and the associated requirements.

Question 6: Does your scheme already have a long-term date and how is it calculated?

Not applicable, as we are not responding in respect of a specific scheme.

Question 7: Where the funding and investment strategy is being reviewed out of cycle with the actuarial valuation, would it be more helpful to require it to align with the most recent actuarial report?

The process of setting the funding and investment strategy would presumably benefit from the most up to date information and analysis, to the extent practically possible and proportionate. However, while we do not see any issue with this, we defer to the pensions actuarial community.

Minimum requirements on and after the relevant date

Question 8: Do you think that these minimum requirements are sensible and will provide additional protection for the accrued pension rights of scheme members?

The principles are sensible but the question is what flexibility there is around this? For example: what if a scheme is 99% funded on the Low dependency basis? What if a scheme has a small portion of assets in non-cashflow investments (e.g., running off an illiquid portfolio)?

The intention of being well funded, on a low-risk basis by the time a scheme is significantly mature makes sense to us as an approach to trying to ensure members receive their accrued benefits in full and on time

However, as currently drafted there appears to be no flexibility in the requirements associated with reaching significant maturity. There are two areas where this could be problematic:

- This might have unforeseen negative consequences of forcing schemes to de-risk when they actually have enough covenant support to continue with a journey plan towards an appropriate end game (see Q9)
- There are schemes which are poorly funded and do not have the covenant support to justify a high growth investment strategy or provide material contributions. Essentially, they cannot be certain that they achieve the requirements of the Regulations – this doesn't necessarily mean they will not be able to pay members as they fall due but there is considerably less certainty. There is the risk that some employers will feel they have no option but to pay potentially unaffordable contributions, which could lead to significant pressure on businesses, reducing investment in sustainable growth, and possibly leading to insolvency. This contradicts with the expectation that contributions will be "reasonably affordable" but it is unclear as to how these aspects will be balanced in practice

In the absence of detail regarding the consequences of not reaching the minimum requirements on and after the relevant date, we also note the potential for ambiguity regarding the trustees' need and/or ability to unilaterally de-risk to meet the minimum requirements, irrespective of requirements set out in the scheme's trust deed and rules.

Question 9:
i. Should such limited additional risk at and after significant maturity be permitted, if supported by contingent assets? If so, to what percentage of total liabilities should this be limited?

Absolutely, it is crucial that additional risk should be permitted after significant maturity where the

covenant can support this. For example, this would allow a scheme to adopt a higher returning investment strategy to continue to improve the funding position through investment returns with the aim of reaching buy-out (or some other form of risk settlement). Restricting this might result in schemes taking longer to reach buy-out or perhaps force schemes into run-off.

But any requirement to link risk taking to specific contingent assets would be unduly restrictive and unnecessary. Currently sponsors support schemes without necessarily setting contingent assets aside and that would continue to be appropriate, provided it's in the context of an appropriate journey plan and associated risk management is in place.

Limiting the ability to continue taking risk to the provision of contingent assets arguably suggests that contingent assets are more valuable than direct sponsor covenant support to a scheme (which is not consistent with regulatory guidance and could separately have unintended. consequences of erosion of direct covenant).

ii. What additional risks to members' benefits might be posed as a result, and what safeguards should apply to protect members?

The risks would be the same as those that exist with pensions schemes now. The question is specifically focused on schemes continuing to take investment and funding risk beyond the point of significant maturity, so whilst there would be no "new" risks, we note that schemes are less resilient to downside funding and investment risk as they become more mature.

The best safeguard is appropriate covenant support and ongoing formal risk management, taking into account the dynamics of mature schemes (e.g., the limited time to recover from a downside shock and likely negative cash flow profile of the scheme).

Investment risks on journey plan

Question 10: Do you think that the provisions of paragraph 4 of Schedule 1 will allow appropriate open schemes to continue to invest in growth assets as long as that risk is appropriately supported?

Yes, we do.

Risk in relation to calculation of liabilities on journey plan

Question 11: Do you think that the principles in paragraphs 4 and 5 of Schedule 1, requiring funding risks and investment risks to be linked primarily to the strength of the employer covenant, are sensible?

We believe that trustees need to be comfortable that the level of risk that they're taking is, first and foremost, supported by the covenant; and that this should be the case regardless of whether they submit a FT or a Bespoke valuation. We, therefore, agree with the principles set out in

paragraphs 4 and 5 of Schedule 1. However, the detail as to how this should be measured would be better set out in the Funding Code or associated guidance to appropriately capture the detail and complexity.

It could be made clearer that the risk associated with the funding and investment strategy does not have to be in line with covenant strength but it cannot be greater than covenant strength – i.e. a more prudent investment strategy would be possible.

Liquidity

Question 12: Do you think that the new liquidity principle set out in paragraph 6 of Schedule 1 is a sensible addition to the existing liquidity requirement of regulation 4(3) of the Occupational Pension Schemes (Investment) Regulations 2005?

Yes, we agree this is a sensible addition.

Question 13: Will the matters and principles set out in Schedule 1 enable the scheme specific funding regime to continue to apply flexibly to the circumstances of different schemes and employers, including those schemes that remain open to new members?

We believe that the draft Regulations should be focussed on the principles, rather than the detail. However, at this stage there is not enough information to answer this question; in particular, it is not clear what would happen to schemes, trustees or employers if the criteria are not met. On that basis, as drafted, we do not believe the scheme specific funding regime would continue to apply flexibly, with potentially significant unintended consequences as a result (e.g., sponsors paying unnecessary contributions with negative covenant implications, schemes de-risking or even re-risking unnecessarily). However, an element of flexibility would be restored were these points clarified.

This question may benefit from remaining open for comments as part of the consultation on Funding Code of Practice, on the basis respondents would have a more complete understanding of the funding regime at that point.

Funding and investment strategy – level of detail

Question 14: Is the level of detail required for the funding and investment strategy by draft regulation 12 reasonable and proportionate?

Yes, we believe that these are reasonable things to ask for. We note, however, that the drafting of the consultation introduces an element of ambiguity regarding who is responsible for and required to agree investment strategy decisions across the trustee and the employer. More detail on this should be provided, for example within the Funding Code of Practice.

Question 15: Do you think the requirement for high level information on expected

categories of investments will impact trustees' independence in making investment decisions in the interests of scheme members?

No response provided.

Determination, review and revision of funding and investment strategy

Question 16: Are the requirements and timescales for determining, reviewing and revising the funding and investment strategy in draft regulation 13 realistic?

We do not see any issue with this but defer to the pensions actuarial community

Statement of strategy

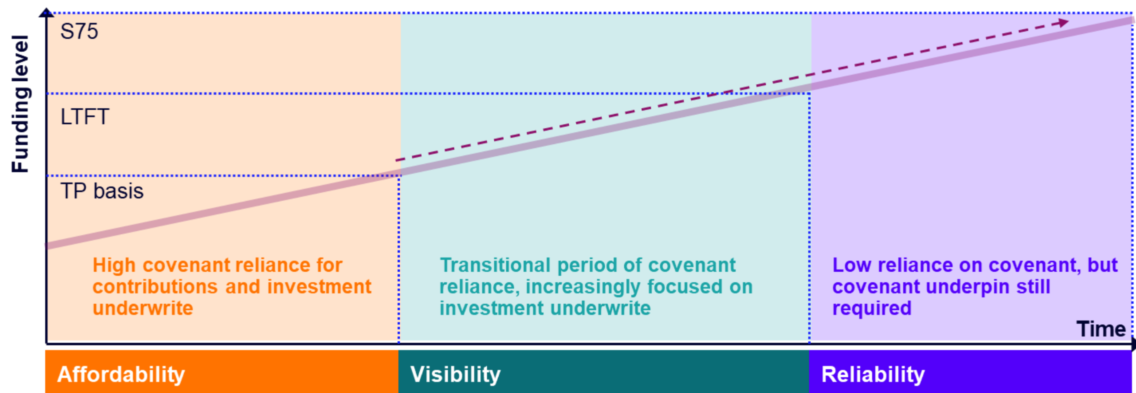
Question 17: Are there any other assessments or explanations that trustees should evidence in Part 2 of the statement of strategy?

The assessment of the strength of the covenant should consider the strength of the sponsor over the period of reliance on covenant (and other factors as set out in the Funding Code of Practice or covenant guidance, in the context of proportionality) in a way which is meaningful in the context of funding and investment strategy, rather than a simplistic RAG/number rating at a moment in time. For example, whilst there is uncertainty the further out into the future we look, there is a difference between generic ambiguity and an anticipated reduction in sponsor support (e.g. for an industry in structural decline). Time is such an important factor in a scheme's journey plan, the expected evolution of the covenant over time should not be "present-valued" back to a single data point at a moment in time – it should be considered alongside the evolution of the funding and investment strategy (and maturity) of the scheme.

This is not difficult to achieve – for example, in all of our covenant assessments, we provide commentary on covenant characteristics to show the evolution of covenant over time and help trustees integrate covenant into their journey plans. The nature of a scheme's reliance on covenant changes through its journey and this can be considered through the lenses of affordability, visibility and reliability, as follows:

- **Affordability**: capturing the ability of the employer to meet the funding needs of the scheme and to support its risks, with this measure likely focusing on the nearer future, to full funding on a Technical Provisions basis (driven in part by information availability and clarity, on both liquidity and risks);
- **Visibility**: capturing the extent to which the affordability position is expected to persist (or otherwise) over the period to the scheme's existing long-term funding target. This is a relative assessment across employers, noting that all covenants will experience greater uncertainty further into the future and taking into account the needs of the scheme; and
- **Reliability**: capturing the extent to which the sponsor is expected to be able to provide longer-term support for ongoing but well-funded schemes both for the residual funding,

investment, legal and regulatory risks on the journey to buy out (if that is the target) and/or to remain solvent to avoid the issues that would arise from an insolvent sponsor even for a well-funded scheme. Given the timeframe under consideration may be upwards of 30 years, this factor will need to focus on a sponsors' industry/industries and its position within them.



Finally, the focus appears to be wholly on achieving a low-dependency position. This is not the same as "no dependency". As noted on our response to Q3, there may be both i) still risk at low-dependency that will need to be supported by the covenant; and ii) a subsequent journey to an appropriate end-game position that will, in the normal course, require a solvent sponsoring employer. Excessive focus on the low-dependency target risks schemes extending reliance on covenant for the final part of their journey, and putting members' accrued benefits at risk.

Requirements for chair of trustees

Question 18: Do you agree that these are the appropriate requirements for the scheme trustee board when appointing a chair? Are there any other conditions that should be applied?

We defer to the pensions legal profession.

Actuarial valuations and reports

Question 19: We would like to know if you think these requirements will work in practice?

While we defer to the pensions actuarial profession for this question, it would seem sensible for scheme actuaries to regularly consider scheme maturity and the low dependency funding basis on the basis that these two concepts represent the basis for much of the Regulations.

Recovery plan

Question 20: Do you consider that the matters prescribed by regulation 8(2) of the Occupational Pension Schemes (Scheme Funding) Regulations 2005 remain relevant for trustees or managers to take account of when determining or revising recovery plans? If

so, why and how are they relevant to the setting of appropriate recovery plans?

Recovery plans must be considered in the context of scheme and sponsor elements individually, but also taking into account the interplay between the two. We believe that all the points included in regulation 8(2) remain relevant to the first aspect of assessing what would be an appropriate recovery plan from the perspective of the scheme.
We note that regulation 8(2) doesn't reference any sponsor elements, with this introduced through the new affordability principle at draft regulation 20(8).

Question 21: Do you consider that the new affordability principle at draft regulation 20(8) should have primacy over the existing matters, if they do remain relevant?

Sponsor dynamics need to be considered as part of setting an appropriate recovery plan and the concept of a sponsor's "reasonable affordability" is the right one. Guidance regarding the approach to considering "reasonable affordability", which can be a complex assessment in some cases, should be set out in the Funding Code of Practice and associated covenant guidance. Such guidance would benefit from further detail on the consequences of not reaching full funding on a low dependency basis by the point of significant maturity, on the basis that the approach to considering affordability (and implications on sponsors paying unnecessarily high contributions) or appetite for investment risk might change considerably.

In addition, actuarial estimates of a scheme's funding needs can change quickly with surplus funding generally being very hard for a sponsor to recover.

As noted above, a balance will need to be struck, with sponsor and scheme elements considered together in the round, on a scheme-specific basis. Therefore, we do not agree that the affordability principle should have primacy over other matters in these regulations. Investment in sustainable growth may be covenant enhancing, and is also one of TPR's statutory objectives – all elements of an appropriate recovery plan should be balanced on a holistic basis.

Multi-employer schemes

Question 22: Will the requirements in draft regulations 20(9) work in practice for all multi-employer pension schemes?

Our understanding is that this requires those sections of multi-employer schemes that already report separately for scheme funding purposes to also meet the requirements of the Regulations separately too. On the whole, this seems sensible and consistent. There will be cases where there is considerable overlap which could lead to duplication of reporting, but this can be efficiently managed.

Our further understanding is that this will not make a difference to multi-employer schemes that are not already required to report separately for different sections. Covenant assessment for such schemes is typically complex and we would expect the complexities in the covenant assessment to be considered and appropriately reflected in the funding and investment strategy

for such multi-employer schemes (within the existing proposed Regulations, subject to our feedback more generally).

Business burdens and regulatory impacts

Question 23: Do you agree with the information presented in the impact assessment for the funding and investment strategy?

We note that the picture is incomplete as the full impacts and costs won't be known until the Funding Code of Practice is published, which makes it hard to consider the analysis in full. As part of the consultation on the Funding Code of Practice, we suggest comments could be provided on the impact assessment across both Regulations and Code.

We note that, while many big schemes will have the expertise and resources to carry out any additional work (if not being carried out as a matter of course already), this will, undoubtedly, be a burden for the significant number of smaller schemes – which may be mitigated with further guidance on proportionality throughout.

Based on our reading of the impact assessment, we believe that there is no intention to cause the insolvency of any sponsors as a result of non-ability to comply (on the basis that insolvency is not mentioned). However, we await further details set out in the impact assessment for the Funding Code of Practice (that we hope covers both the impact of the Funding Code of Practice and the Regulations).

Question 24: Do you expect the level of detail required for the funding and investment strategy to increase administrative burdens significantly?

In theory, much of this is what trustees should already be doing. The impact is likely, therefore, to be on the smaller end of the scheme size spectrum, where robust governance and decision-making processes are less likely to be in place.

Question 25: Do you agree with information presented in the impact assessment for the statement of strategy, referenced in paragraph 6.1?

Our reading of the impact assessment is focussed on the need for trustees to set out a funding strategy and explain it to TPR; and, as noted, we are supportive of that approach and believe it will lead to better decision-making, particularly for those small schemes that are not particularly well advised.

We note the risk that, by adding to the already significant reporting responsibilities of trustees, there may be undue focus on due process at the expense of actual risk management and the protection of members' benefits. We would suggest ensuring that, where possible, guidance regarding proportionality is provided.

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

Cardano Holding Limited is part of The Cardano Group.
Cardano Holding Limited is registered in England and Wales number 09740394.
Authorised and regulated by the Financial Conduct Authority.