Options for DB schemes consultation: our perspective

On 23 February 2024, the government published a consultation on new options for Defined Benefit (DB) pension schemes. Our response (see link below) set out our view that we welcome the measures that are being considered as Options for DB schemes.

The measures that the Department for Work & Pensions (DWP) is proposing would "open up" the DB market and make other options more achievable. These more flexible options should be thought of as:

1. Within the current DB operating environment
2. Under a commercial consolidator
3. Under a public sector consolidator

This consultation seeks to address the first and third on the list (with the second arguably already addressed as part of previous reviews of consolidator operating parameters).

The DWP's proposals could improve scheme member outcomes as well as have a positive impact on the UK economy. However, we remain to be convinced that they will achieve the main stated objective of ensuring DB scheme assets work harder for the UK economy. More specifically, we note that:

1. While buyout is appropriate for many schemes, it should not be the default. We believe that there are viable alternative endgame options that can also deliver a safe outcome for members as well as deliver a good outcome for corporates and the economy as a whole.
2. Surplus extraction could be a win-win for sponsors and members, with the right safeguards in place.
3. The 100% PPF underpin proposal, as set out in the consultation, appeared expensive and therefore likely impractical.
4. We can see a Public Sector Consolidator (PSC) being useful for small schemes and, to minimise potential distortion of the superfund and insurance buyout market, it should be subject to similar regulatory parameters as the commercial consolidators.

Although the results of the consultation remain to be seen, an understanding of the options under consideration will be useful context for trustees considering their longer-term strategy.

The DB market can read into the Government's view that alternative endgame options are valid options for DB pension schemes. Regardless of whether the PSC is constituted and / or extracting DB surpluses from schemes is made easier, there are alternative risk transfer / management solutions available in the commercial market that both trustees and sponsors of DB schemes should consider in the appropriate circumstances.

Covenant will remain a key factor when considering the appropriateness of surplus extraction and / or alternative risk transfer / management solutions.

Please follow this link for our detailed response or this link for the perspective of Kerrin Rosenberg, CEO Cardano Investments.

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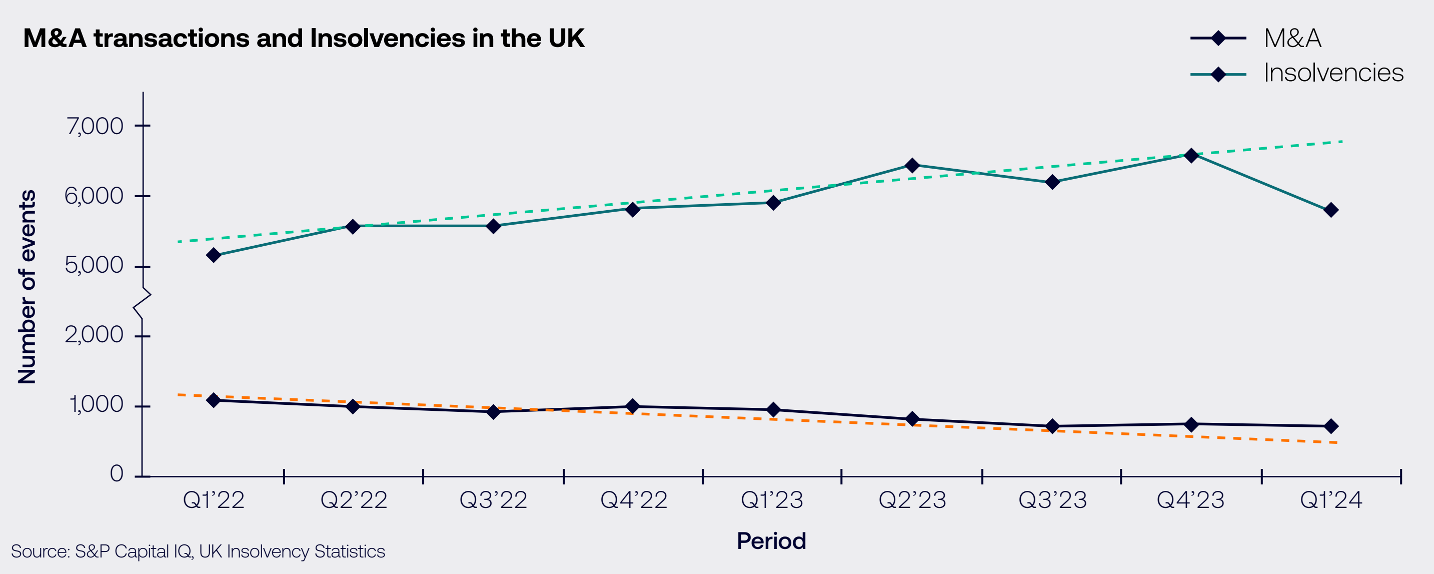
DataWatch:
Navigating M&A and Insolvency Trends: Insights for Trustees



In recent months, the landscape of mergers and acquisitions (M&A) and insolvencies has presented a mixed picture for trustees. Despite a perceived downward trend in M&A activity and a concurrent rise in insolvencies, both segments remain active and relatively stable. Interestingly, Q1 2024 saw a significant decline in insolvency rates (see chart above), offering a momentary reprieve in an otherwise challenging environment.

For investors, these market conditions present opportunities. However, trustees must exercise caution and maintain a robust understanding of covenant and where negotiating leverage may lie. Being well-versed in value routes, support mechanisms, and contingency planning is crucial for navigating potential future events effectively.

Economic Outlook and Policy Implications
We anticipate increased market activity as investors and boardrooms gain a bit more certainty post General Election. However, geopolitical and macro-political risks are likely to continue to introduce elements of uncertainty.

Current market expectations align with our view at Cardano that monetary easing will not begin until August, projecting only a shallow recovery from the recent technical recession. For more information, refer to our latest insight article on the upcoming General Election (Link here).

Continued Activity in M&A and Insolvencies
M&A activity is expected to persist, driven by corporates that have optimised their operations over recent years and those seeking strategic opportunities. Conversely, insolvency activity will remain prevalent among companies struggling with operational challenges and rising finance costs amid higher interest rates (and, in many cases, increased debt taken on during COVID).

What does this mean for trustees?
Trustees should be prepared for both M&A and restructuring scenarios given the relative market activity. While insolvency rates only highlight worst case outcomes, successful restructurings often result from prolonged stakeholder discussions, which are not reflected in these statistics. Trustees should, therefore, navigate corporate events through proactive engagement with sponsors, assessing covenant impacts, and negotiating mitigations.

Optimising investment strategies and setting clear end-game strategies are also essential steps. Understanding the true position of DB schemes can unlock value during M&A or restructuring processes. Improved funding levels mean pension schemes are less likely to be dealbreakers, and viable solutions are easier to achieve.

The current economic climate necessitates vigilant and informed trustees. By maintaining a thorough understanding of market dynamics, covenant implications, and strategic engagement practices, trustees can effectively manage their responsibilities and maximise desired outcomes for members.

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Ask the Analyst: Statement of Strategy

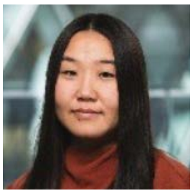
Under TPR's new regulatory framework, schemes will be required to produce a Statement of Strategy at each triennial valuation, detailing the scheme's Funding and Investment Strategy and key risks faced in its implementation. TPR's recent consultation provided insight into this process and we have set out some of our thoughts below.

It is positive to see covenant being referenced as the key driver of investment and funding risk, however, the example Statement of Strategy makes little reference to how covenant has impacted funding or investment strategy. This could lead to inadequate drafting by trustees and risk being run that is unsupported by the covenant.

From the consultation drafting, it appears that the Statement of Strategy will primarily serve as a risk filter tool for TPR, focussing on quantitative data, without overarching strategic commentary. We believe covenant is ill-suited to a formulaic approach, instead requiring consideration of a range of metrics, risks, and potential downside scenarios. Further, the exclusion of covenant metrics from TPR's 'Fast Track' parameters poses a risk that covenant is not appropriately considered by trustees.

The consultation also raises questions around how the new covenant concepts of "reliability" and "longevity" should tangibly impact strategy, the context of maximum affordable contributions, and how to integrate ESG risks into scheme strategy. Sight of the revised Funding Code and covenant guidance later this year, depending on General Election delays, will be key to understand the full regulatory framework.

Please read our full response to TPR's Statement of Strategy Consultation here.



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Regulatory developments: TPR guidance on TCFD reporting

On 11 April, TPR published its second review of Task Force on Climate-Related Financial Disclosures (TCFD) reports, and we summarise below our key takeaways:

- Quality over quantity! Reports don't need to be long and should be tailored to the audience – i.e. your members.
- Be specific on policies and risk management procedures in place.
- Where you're re-using previous analysis, you should still comment on developments. Climate policy is anything but static so it's unlikely nothing has changed over the year.
- Covenant risk is a mandatory consideration, but this should be proportionate by taking account of covenant reliance and journey plan. Whilst trustees can leverage sponsor information, they should form their own conclusions on covenant risk.
- Many scenarios used commonly across the industry are believed to significantly understate climate risk. Trustees should ensure their advisors are well-versed in the scenarios they are using and consider tailoring scenarios to ensure they are fit for purpose.
- Qualitative, rather than quantitative, analysis based on clear narratives may be more useful for risk management.

How can trustees incorporate covenant into TCFD reporting?

1. Undertake a thorough (but proportionate) piece of analysis to lay the groundwork and establish a view on sponsor risk that can be built upon in future years.
2. Make sure time horizons under consideration are relevant to the scheme's journey plan.
3. Adopt a qualitative approach to near-term scenarios and walk-through impact and response to climate-related events. E.g. what would happen to the funding position and covenant if there is a climate tipping point?
4. Ensure covenant risk is factored into your views on funding resilience across each scenario. Integrated risk management is key to understanding of climate risks.

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