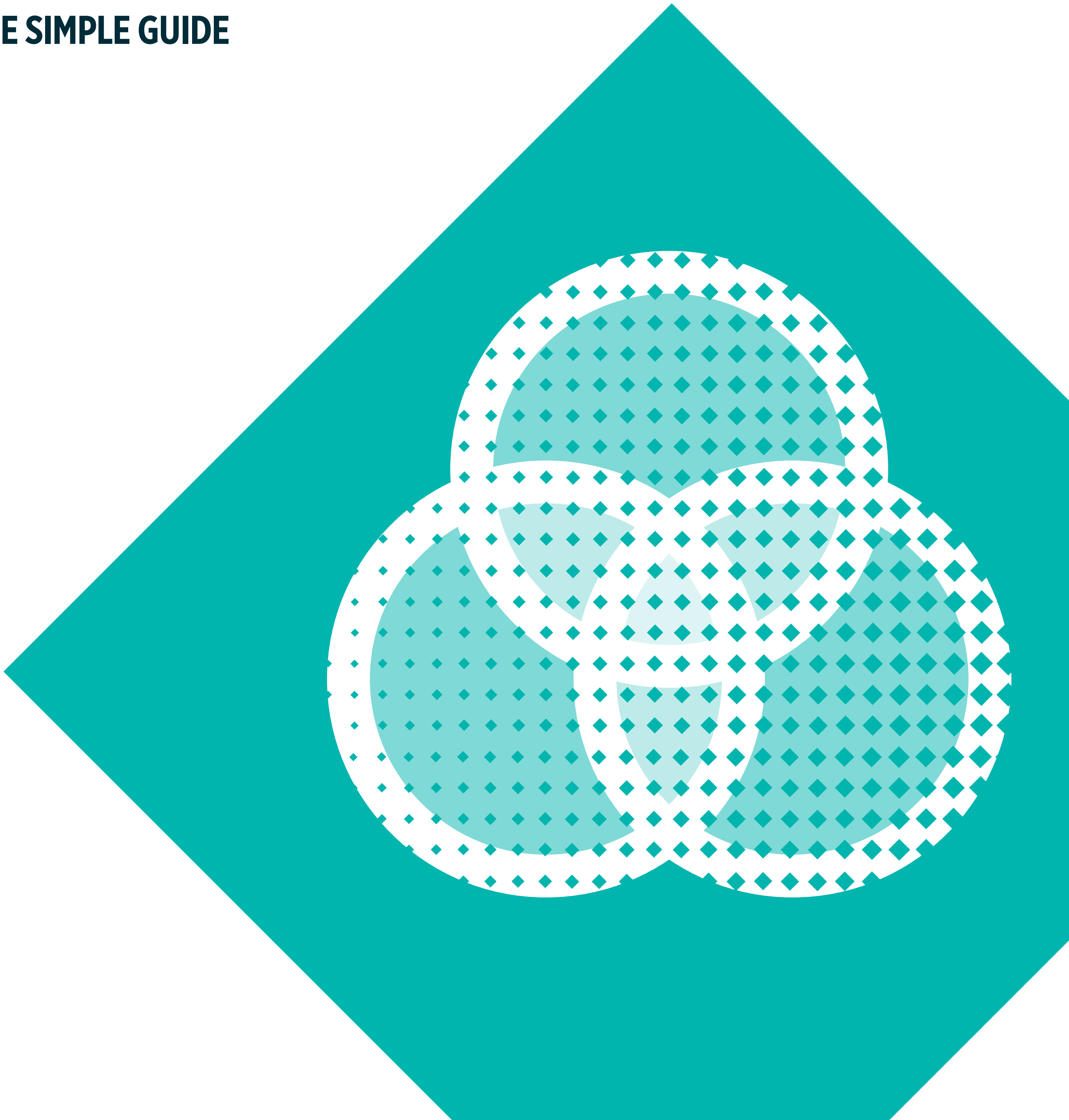
PENSIONS AND
LIFETIME SAVINGS
ASSOCIATION

October 2017

INTEGRATED RISK MANAGEMENT (IRM)

MADE SIMPLE GUIDE



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This guide is for information only. It is not investment or legal advice.

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1 FOREWORD

CARDANO, THE RISK AND INVESTMENT SPECIALIST, AND LINCOLN PENSIONS, THE SPONSOR COVENANT ADVISOR, CAME TOGETHER IN 2016 BECAUSE THEY BELIEVE AN INTEGRATED CONSIDERATION OF DIFFERENT RISKS RESULTS IN BETTER OUTCOMES FOR PENSION MEMBERS, SCHEME TRUSTEES, CORPORATE SPONSORS, AND THEIR SHAREHOLDERS.

We believe "integrated risk management" (IRM) is exceptionally important to UK defined benefit pension schemes and The Pension Regulator's focus on its implementation exemplifies the positive impact regulators can have on the industries they oversee.

At its best, IRM can be a practical framework that creates greater mutual understanding among all the pension stakeholders to help them evaluate the risk trade-offs and to make better overall decisions.

However, we think our industry has more work to do before IRM achieves its full potential. While some credit should be given to early adopters, many have marginally modified their existing approach with a "tick box" exercise of limited value; others have developed detailed quantitative models which claim spurious accuracy that are reliant on the input assumptions.

This guide is designed to explain IRM and highlight ways in which its implementation can be more effective to help trustees and sponsors achieve their objectives, together. We hope that you find the guide informative and we look forward to working together with our clients and industry peers in the near term to further develop IRM in theory and in practice.

Kerrin Rosenberg, CEO Cardano Risk Management

Darren Redmayne, CEO Lincoln Pensions

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WHAT IS IRM AND HOW DO YOU KNOW IF YOU'RE ALREADY DOING IT?

INTEGRATED RISK MANAGEMENT (IRM) WAS FIRST ARTICULATED BY THE PENSIONS REGULATOR (TPR) IN ITS 2014 CODE OF PRACTICE, WHERE IT WAS PRESENTED AS A "RISK MANAGEMENT TOOL" FOR TRUSTEES AND SPONSORS OF DEFINED BENEFIT (DB) PENSION SCHEMES.

Together with its December 2015 IRM guidance, TPR made clear that IRM is not a discrete piece of work – rather, it is a risk-centric approach to decision-making, requiring appropriate frameworks, tools and mindsets.

TPR's guidance promotes greater communication and understanding of the interrelationships between three fundamental risk areas: covenant, investment, and funding. Joined-up thinking is now expected to lie at the heart of all DB scheme governance.

As IRM is a mindset, any written description struggles to convey its dynamic and three-dimensional nature – decisions in one risk area may have important consequences for others. By adopting an IRM approach you are trying to make balanced decisions which optimise the prospect of meeting the scheme objective without collectively exceeding accepted overall risk constraints.

Integrated risk management: definition

> **IRM IS A RISK MANAGEMENT APPROACH THAT HELPS TRUSTEES IDENTIFY AND MANAGE THE RISKS THAT AFFECT THE PROSPECTS OF MEETING THE SCHEME OBJECTIVE, ESPECIALLY THOSE RISKS THAT AFFECT SCHEMES IN DIFFERENT WAYS.**

TPR, December 2015

To be clear, IRM is not about avoiding risk. Instead, it is about only taking risks intentionally based on a good understanding of the likelihood of those risks arising, the impact of those risks if they materialise and the sponsor's and scheme's ability to manage and respond to that impact.

Risk terminology

- Risk exposure is a means of expressing the impact a risk could have on a scheme. For instance, it may be defined as the expected loss, i.e. the likelihood of a risk occurring times the impact should the risk occur
- Risk capacity is the total amount of risk exposure that an entity can take while still being able to meet its objectives. For the purpose of IRM, the risk capacity of the sponsor is often a crucial consideration
- Risk appetite is the amount of risk that a scheme and its sponsor are willing to take. This may be less than the total risk capacity, building in a margin for prudence and considering, for instance, the impact of behavioural finance factors

For an IRM approach to be most effective, it is not just advisers that need to work collaboratively. Sponsors also have an active role as without knowing the sponsor's key risk exposures, pension risk capacity, and risk appetite, a scheme cannot make optimal decisions over its own risk allocations (such as between the level of funding sought and investment risks taken).

THE EVER-INCREASING PROMINENCE OF IRM

As with TPR's introduction of the concept of covenant risk over a decade ago, it will inevitably take time for the pensions industry to adapt and properly embed IRM into its approach.

This is unfortunate given that the challenges currently faced by many schemes are largely due to not fully understanding their risk exposures (in particular, to falling interest rates). Had trustees (and sponsors) been using an IRM approach for the last decade, it's likely that many schemes would be in a much better position than they find themselves in today.

Although some trustees and advisors should be commended for quickly adopting an IRM approach, they have so far mostly fallen short of implementing it effectively.

Some have characterised IRM as a "tick box" exercise, which adds little to no value whilst others have developed complex quantitative models that over-simplify IRM to a few key metrics.

So, how can you know if you have properly adopted the IRM mindset? The following test may help:

IRM TEST

- Has something changed in the way you operate and govern the scheme because of implementing IRM?
- Do you understand the key risks in the sponsor which affect affordability of contributions, and how they interact with the scheme's risks?
- Have you developed contingency plans for adverse scenarios, with clearly defined triggers for action?

Almost without exception, IRM identifies new issues which have not been thought of previously and will result in change. If nothing has changed in the way a scheme is managed, then it's a good sign that IRM is not being fully embraced.

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THE BENEFITS OF IRM

WHAT CAN IRM DO FOR YOU?

Fundamentally, IRM should allow schemes and sponsors to utilise their risk budget more efficiently than if they take decisions in isolation. Therefore, expected outcomes should improve without having to take additional risk.

- Legal and regulatory compliance obligations are fulfilled, by ensuring that trustees are exercising due skill and care in performing their role;
- From a trustees' point of view, IRM will increase the likelihood that members' benefits are paid in full; and
- From a sponsor's point of view, IRM may help to create shareholder value by reducing DB scheme volatility and the ongoing uncertainty of funding requirements.

THE CHALLENGES OF GETTING IT RIGHT

Most challenges presented by IRM stem from not implementing it correctly or proportionately:

- IRM is a more involved approach to risk management, and may require additional time and cost;
- IRM may have been treated as an isolated exercise rather than an ongoing mindset;
- Without appropriate training and education IRM may confuse more than it helps, and lead to slower or worse decision-making; and
- IRM analysis can, in its early adoption, be either insufficiently detailed to be effective or disproportionately complicated.

Whilst implementing IRM effectively will require an initial investment of time and resources, it ensures that effort is not wasted on developing an inappropriate strategy which exposes the scheme to unnecessary risk.

IRM SHOULD ALLOW SCHEMES AND SPONSORS TO UTILISE THEIR RISK BUDGET MORE EFFICIENTLY THAN IF THEY TAKE DECISIONS IN ISOLATION.

TPR, December 2015

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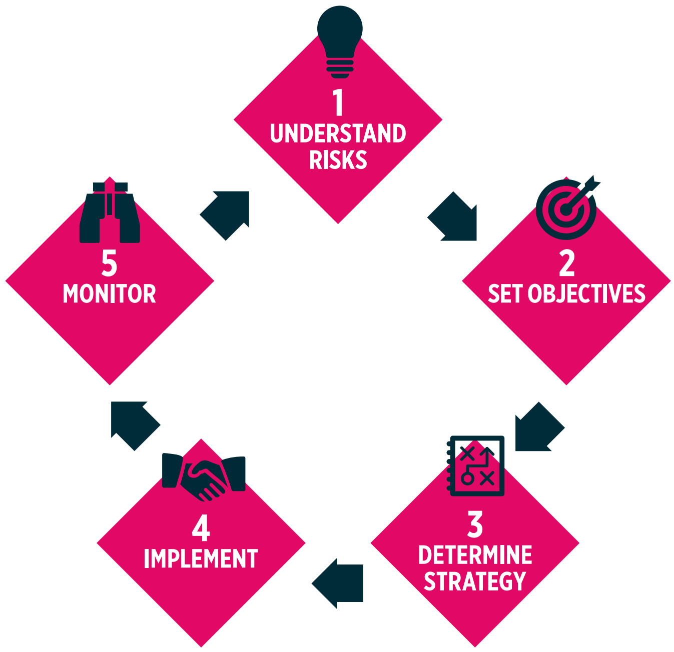
PUTTING IRM INTO PRACTICE

SUCCESSFUL INTEGRATION OF IRM INTO TRUSTEES' DECISION-MAKING CAN BE FACILITATED BY A RISK-CENTRIC GOVERNANCE APPROACH, SUCH AS THE FOLLOWING RISK CONTROL CYCLE:



1. UNDERSTAND RISKS

The trustees and sponsor should, together, set out a full understanding of all areas which may pose a material risk to the agreed objectives. This process may involve answering questions similar to those set out below, recognising that many of the questions need input from different advisers to answer.

	COVENANT	INVESTMENT	FUNDING
What risks is the sponsoring business exposed to?	◆		
How long, and to what extent, can the sponsoring business make contributions to the scheme?	◆		◆
What level of investment risk can the covenant underwrite?	◆	◆	
Are there correlations between the assets held by the scheme and the nature of the sponsor's business?	◆	◆	
What liquidity constraints may arise (e.g. transfers out)?		◆	◆
What membership risks are there (e.g. longevity, commutation, early retirements), and are they affected by sponsor actions?	◆		◆
How mature is the scheme and how does this affect investment strategy?		◆	◆

2. SET OBJECTIVES

Setting the ultimate objective for trustees may be straight forward, as the trustees' focus is predominantly on paying member's benefits in full. However, it may be beneficial for many schemes to set out both intermediate objectives to be targeted over a shorter time frame (e.g. achieving de-risking targets) and a clear plan for how the long-term objective will be met (e.g. through a buy-out at some stage). Importantly, trustees should recognise that in most cases, full funding on the technical provisions basis is not the end of the journey as their scheme will likely retain material risks and therefore still rely on their sponsor's covenant.

As part of this decision-making process, good IRM governance should involve the sponsoring employer, and the sponsor's objective should also be defined. This may not always be to reduce short term funding needs as, once the size of scheme risks is fully understood, sponsors may be willing to reduce the longer-term risks and uncertainty through increases in short-term funding.

3. DETERMINE STRATEGY

Using the information gained from the above process, the next step is to formulate an integrated strategy to achieve the agreed objectives. This part of the process can (and, to some extent, should) be iterative - this is further evidence that IRM is being implemented correctly as the strategy is refined to reflect additional considerations. Circularity can be reduced by considering covenant strength and risk capacity first, leading to selection of a suitable investment strategy (which is supportable by the covenant), and only then assessing the scheme's funding needs.

This may help schemes avoid the pitfall of anchoring to their previous actuarial valuation basis without considering whether this remains appropriate in the context of the evolving sponsor covenant and investment risks.

4. IMPLEMENT

Once a strategy is agreed in principle, it is important that a robust governance process is put in place to ensure it is correctly implemented and adhered to in the future. Whilst this can be set out in the standard scheme documentation (e.g. Statement of Investment Principles, “SIP”, and Statement of Funding Principles, “SFP”), it may be helpful to break the strategy down into smaller sub goals and additional policies which are set out in a separate document.

Milestone reviews and measurable targets should also be defined together with clearly defined actions which help to reduce the impact of behavioural biases. For instance, delegating potentially challenging investment decisions to professionals may help to ensure adherence to the strategy determined at outset. Similarly, contingency plans for the failure of milestone objectives could be agreed between trustee and sponsor together in advance, including pre-defined triggers and a timeline for action to be taken.

EXAMPLE ACTIONS FOR CONTINGENCY PLANS

- CLOSE TO ACCRUAL
- MONETISE SPONSOR ASSETS
- WIND UP SCHEME
- INCREASE CONTRIBUTIONS
- REBALANCE PORTFOLIO
- REDUCE INVESTMENT RISK

5. MONITOR

Progress should be monitored as often as required to ensure that action can be taken sufficiently quickly to limit the impact of adverse events. It is important that monitoring follows the same IRM mindset as the initial risk assessment and strategy, and doesn’t just focus on one aspect (e.g. covenant strength or funding level progression). Instead, monitoring should cover developments in covenant, investment, and funding risks, and ensure that any unintended changes in risk exposure or emerging risks are discovered and responded to in a timely manner.

5
TOOLS TO HELP YOU APPLY IRM

A RANGE OF TOOLS, BOTH QUANTITATIVE AND QUALITATIVE, IS AVAILABLE TO HELP THROUGHOUT THE IRM PROCESS OUTLINED IN THE PREVIOUS SECTION.

QUALITATIVE TOOLS

Risk register – A summary table of the key risks faced by the scheme. Visual indicators of the likelihood and magnitudes of an adverse event and assigned responsibilities are often useful additions

Workshop – An all-party discussion, covering the current situation and risk exposures of the scheme and sponsor, and developing an appropriate strategy to mitigate and (if necessary) respond to these risks. Involvement of the sponsor in some or all of such a workshop can be invaluable

Horizon scanning – The identification of emerging risks which have not been discussed previously, particularly those which align / correlate between the sponsor and the scheme. This may include an analysis of how exposure to existing risks may change further in the future

QUANTITATIVE TOOLS

Quantifying risk exposures – For example, sensitivity analysis showing the funding level impact of a fixed change in key valuation assumptions

Integrated simulators – A simulation of the stresses that can arise on a scheme and its sponsor which allows trustees and sponsors to consider how they could change their investment and funding strategies to react to shocks. This helps to inform discussions on whether the risks in a scheme can, in fact, be supported by the sponsor

Deterministic stresses – Illustrations of how certain future scenarios (e.g. a recessionary environment) may impact both the scheme and the sponsor, and whether the sponsor would be able to take sufficient corrective action to support the scheme adequately throughout the period of stress

Stochastic stresses – These are similar to deterministic stresses, but they use more complex models based on estimated probabilities of future events occurring and the magnitude of their impact. These are projected forward many times to illustrate the probability and range of outcomes and to determine metrics such as Value at Risk. The range of potential outcomes can be as important as the central projection

LIMITATIONS OF FINANCIAL PROJECTIONS

Financial models attempting to project a scheme's future experience, such as asset-liability modelling, have to be used with care. In particular, the model and assumption risk inherent in these tools has to be recognised to avoid misplaced reliance which can give the illusion of control. The output of such models is only as reliable as the assumptions that they are based on and, ultimately, it's rarely possible to accurately predict the future. With the benefit of hindsight, these projections have often been shown to be inaccurate and misleading as actual experience will invariably deviate from simplified assumptions. Users should be cautious about 'over-relying' on quantitative methods.

6
THE IMPORTANCE OF TRAINING AND EDUCATION

TO MAKE THE BEST IRM DECISIONS BASED ON THE INFORMATION DELIVERED BY THE TOOLS AND DEVELOPED THROUGH THE GOVERNANCE PROCESS IT IS ESSENTIAL THAT ALL PARTIES HAVE RECEIVED SUITABLE EDUCATION AND TRAINING. AREAS OF FOCUS COULD INCLUDE:

- Effective governance processes which can support the components of an IRM approach;
- The different IRM risk areas and their components, and how they can relate to each other;
- The limitations of financial models, and how to utilise the available tools to inform rather than make risk management decisions;
- The options available to them and how they may help to mitigate risks; and
- Example case studies and shared experiences around IRM.

The body of IRM literature is beginning to grow, and it is becoming easier for trustees and sponsors to educate themselves on the practical application of IRM. Professional trustees may also help improve the level of education across a trustee board given their professional backgrounds and experiences gained over multiple schemes.

The role of advisers in this context is also not to be forgotten. While they can't make decisions for the trustees, the knowledge and experience of advisers can be vital to help facilitate and educate along the IRM process. In addition, it is critical to have advisers who are capable of working together effectively based on a good understanding of each other's skillsets and roles in the IRM process.

THE KNOWLEDGE AND EXPERIENCE OF ADVISERS CAN BE VITAL TO HELP FACILITATE AND EDUCATE THE IRM PROCESS

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SO WHAT NEXT?

IRRESPECTIVE OF SCHEME SIZE OR FUNDING LEVEL, ALL PENSION SCHEMES SHOULD BE ADOPTING IRM, AND MAKING DECISIONS BASED ON AN UNDERSTANDING OF ALL THE MATERIAL RISKS FACED BY THEIR SCHEME AND ITS SPONSOR.

Ignoring IRM or turning it into a "tick-box" exercise increases the risk that members will not receive their promised pensions, sponsors will fail, and employees will lose their jobs.

Having a suitable governance structure in place with decision-makers who have received IRM training will help trustees determine the most proportionate tools to use based on the size and situation of a scheme. All else being equal, schemes which should be committing greater resources to IRM are those which are:

i) Larger; *and/or*

ii) Less well funded; *and/or*

iii) Contain greater investment and funding risks; *and/or*

iv) Have a weaker covenant which is less able to support the scheme's downside risks.

You can begin to implement an IRM approach at any time – it doesn't have to wait until the next triennial valuation. We live in uncertain times and delaying implementation further increases the risk that your scheme may not be well-equipped to cope with a downturn when it comes.

8 CASE STUDY: AN INTEGRATED APPROACH TO MANAGING SCHEME RISKS

A SIMPLIFIED EXAMPLE

THE CASE STUDY ON THE FOLLOWING PAGES IS A SIMPLE ILLUSTRATION OF HOW RISKS CAN BE IDENTIFIED AND ADDRESSED USING AN IRM APPROACH IN THE CONTEXT OF A TRIENNIAL VALUATION. THE ACTIONS TAKEN BY THE TRUSTEES AND SPONSOR IN THIS STUDY SHOULD NOT BE INTERPRETED AS THE "RIGHT" COURSE OF ACTION AND WE ENCOURAGE THE READER TO FOCUS ON THE APPROACH AND HOW IT CAN BE APPLIED TO THEIR SCHEME RATHER THAN THE SPECIFIC ACTIONS TAKEN.

THE SPONSOR

The scheme is sponsored by a company operating in a competitive market, which has led to reduced affordability for funding pension contributions. It owns a property which could be sold to realise material value although the property is secured by the sponsor's lender. The sponsor's debt has a variable interest rate and its sales include significant exports to Germany.

THE SCHEME

The scheme remains open to accrual and is not particularly mature. It is a medium-sized scheme (c.£200 million assets) and is 90% funded on a technical provisions basis (based on the trustees' assumption that the covenant rating is strong). The scheme is invested heavily in return-seeking assets, and levels of interest rate and inflation hedging are low.

THE SITUATION

In preparation for its upcoming valuation the trustees have engaged their covenant, investment, and actuarial advisers to provide IRM-centric training to help them identify relevant risks and to put in place a suitable governance structure to design and implement a strategy to address them.

They have created a valuation subcommittee which consists of a professional trustee, a member-nominated trustee with a financial background, and a representative of the sponsor. The subcommittee will be responsible for commissioning and reviewing expert advice, and will update the full trustee board on a monthly basis.

The future investment and funding strategy which the subcommittee recommend will still be subject to approval by the full trustee board.

Furthermore, all the trustees have ensured they are complying with the Trustee Knowledge and Understanding requirements set out by TPR, and its latest guidance on IRM.

1. UNDERSTANDING RISKS

The sponsor's view is that the property has enough value to support the scheme, and therefore the scheme should target high investment returns to reduce funding needs and allow investment in the business.

The trustees are more prudent, and would like to commission an independent covenant assessment to better understand the capacity to tolerate risk on an ongoing basis and how value might be realised from the property in a distressed scenario. Furthermore, they would like to understand the scheme's investment risk and how the sponsor's performance could also be affected in a scenario where investment risks arise.

Following this initial conversation, the trustees commission proportionate advice from their advisers to understand the key risks faced by the sponsor and the scheme:

COVENANT RISKS

- The sponsor generates stable revenues, but competitive pressures and its financing costs mean it generates only a small profit and its affordability is constrained.
- Its bank debt is secured on the property which is an illiquid asset and it may take time to sell in a distressed scenario. The bank loan would be repaid before any proceeds become available to the scheme and a forced sale may not realise best value from it.
- The sponsor has material interest rate exposure as its bank loans attract a floating interest rate. Should rates rise this would increase its finance costs and further reduce affordability.

The sponsor faces foreign exchange (FX) risk from its exports to Germany as an appreciation of Sterling could reduce the value of its overseas revenues. The sponsor does not hedge this risk.

INVESTMENT RISKS

- The scheme's current investment strategy is predominantly invested in growth assets, split mostly between UK and European equities. The FX risks on its overseas investments are not currency hedged.
- A smaller matching portfolio of fixed and index-linked gilts is expected to move together with the value of liabilities, however the overall interest and inflation hedge ratios remain low.
- The investments held by the scheme only generate a small amount of income and, since low deficit repair contributions are currently being received, the fund is therefore at risk having to disinvest to meet its cash outflow demands.
- Given the covenant is weaker than thought, the advice concludes that the investment risk posed by the current asset allocation may be too high. A lower allocation to the growth portfolio may be more appropriate, although that would likely result in reduced returns and increased short-term funding need from the sponsor.

FUNDING RISKS

- The scheme remains open to accrual for only a few employees. The sponsor has indicated that restructuring exercises are likely, which would result in an increase in liabilities as increases in deferment are expected to exceed the capped salary increases.
- While the scheme membership is currently not mature, this is expected to change rapidly over the next 5 to 10 years, leading to an increase in benefit outflows.
- The scheme has a small deficit on a technical provisions basis, although this was based on assumptions which are based on a strong covenant rating; on a solvency basis, the scheme has a material deficit.

RISK CONCENTRATIONS AND DIVERSIFICATIONS BENEFITS

Following this analysis, the trustees have identified several risks which impact both the scheme and the sponsor at the same time, namely: (i) interest rates; (ii) FX, and (iii) restructuring activities.

As the covenant was rated as fairly strong, the trustees conclude that a simple approach of estimating the size of the relative risk exposures would be sufficient, and ask both the sponsor and the trustees' advisers to do so. Depending on the outcome of this initial analysis, further investigations or work may be commissioned.

i) Interest rate risk

The trustees find that although a fall in interest rates would reduce the sponsor's finance costs, thereby increasing future affordability of contributions, the impact on the scheme's deficit was so significant that a greater increase in contributions would be required than the increase in affordability seen by the sponsor. In other words, while the risk exposures of the scheme and the sponsor somewhat offset, the scheme is still exposed to the risk of interest rates falling.

ii) FX risk

The covenant assessment has highlighted that the profitability of the sponsor is affected by the Sterling to Euro exchange rate as a Sterling appreciation would adversely affect its profitability. The scheme's overseas investments would see a reduction in their Sterling value in such a situation, meaning that the scheme would need additional funding at a time when the sponsor would be less able to afford it..

iii) Restructuring activities

The sponsor is considering a restructuring programme which would include redundancies. This could increase the scheme's liabilities as more generous indexation is provided to deferred members and it could lead to an increase in early retirements.

2. SETTING OBJECTIVES

The trustees meet with representative of the sponsor (the pensions manager and the finance director) to have an honest conversation about each side's objectives from the valuation process.

- The sponsor wishes to minimise cash deficit repair contributions in the short-term to allow it to invest in improving productivity and profitability.
- In addition to ultimately paying members' benefits in full, the trustees wish to achieve full funding to at least a technical provisions level over the medium term.
- Both the trustees and the sponsor would like to buy-out the scheme at some stage in the future.

The trustees acknowledge the sponsor's objective but stress that their first priority is to manage the schemes' risks in the long-term to avoid placing a further strain on the sponsor in the future.

3. DETERMINING STRATEGY

INVESTMENT STRATEGY

Interest rate risk

Whilst changes in interest rates have somewhat offsetting impacts on the scheme and sponsor, the impact on the scheme will be greater. Therefore, the trustees would like to reduce the scheme's exposure to interest rate risk, to protect the scheme from falls in interest rates.

The investment strategy should therefore include raising the level of interest rate hedging to at least a point where the scheme and sponsor impacts on affordability more closely offset each other. Through the introduction of leverage in the matching portfolio, the investment adviser notes that hedging levels could be raised to the desired level without having to divert a significant amount of assets from the return seeking portfolio.

FX risk

To help reduce the potentially dangerous correlation of risk in the sponsor and the scheme, the trustees agree to discuss switching a proportion of assets from European equities to UK equities with their investment adviser, noting that the risk-return characteristics of any investments need to be understood first.

Market risk

Other than the interest rate hedging and FX changes noted above, the trustees are worried that the risk run by the asset strategy is higher than could be supported by the sponsor given its affordability constraints.

The trustees appreciate that maintaining the current, comparatively high, allocation to growth assets is helpful given that the sponsor has low affordability. To investigate the level of risk of the investment strategy proposed above, the trustees commissioned scenario analysis stressing both scheme and sponsor jointly to illustrate the impact of a recession.

This analysis showed that funding the increased deficit would be affordable with only a modest increase in recovery plan length, making the trustees comfortable that the covenant available from the sponsor is sufficient to support the level of asset risk.

However, the higher-risk investment strategy will not remain appropriate as the scheme becomes more mature, as it will have high benefit outflows which will mean that it is less able to tolerate investment volatility. Therefore, the trustees and sponsor agree to gradually lower the return-seeking proportion broadly in line with the proportion of non-pensioners that remain in the scheme.

Property risk

Given that the sponsor's covenant has material reliance on the value of its property, both trustees and the sponsor agree it is appropriate to avoid allocating any funds to the property asset class. This is because there is potentially a strong correlation between investment property returns and the value of the sponsor's assets, which would otherwise mean that the scheme's funding needs could increase in the same scenario when the sponsor could realise less value from selling the property.

Divesting risk

The trustees are concerned that the scheme's liquidity needs are expected to increase in the coming years as it becomes more mature and are concerned about the risks that they may need to sell scheme assets at potentially unfavourable times to make benefit payments. To avoid this, credit instruments and other liquid assets are used to match projected outflows, including an allowance for transfers out and commutations, over the next three years.

FUNDING STRATEGY

Technical provisions

The scheme's covenant rating is weaker than originally assumed, and the trustees feel it is necessary to increase the prudence reflected in their funding assumptions. These also take account of changes in the investment strategy set out above. On this more prudent basis, the funding level deteriorates and a somewhat material funding deficit emerges.

Recovery plan

Maintaining the same recovery plan end date as at the last valuation would require contributions which would not allow the sponsor to continue with its investment programme. Given covenant advice confirming that the sponsor has significant tangible assets to fall back on, the trustees are comfortable with extending the recovery plan end date to take account of constrained affordability.

Risk management strategy and mitigations

The trustees are aware that in a worst-case scenario, the sponsor could potentially realise value by selling its property and using some of the proceeds to fund the scheme once the debt secured on the property has been repaid.

As the scheme is likely to experience a funding strain from active members becoming deferred, the trustees have made the sponsor aware that this additional cost will need to be considered as part of the restructurings and should, if possible, be pre-funded.

Mitigation options

Should the strategy set out above not be successful, the trustees and sponsor agree on a list of contingency measures which could be enacted, including:

- A sale of part of the sponsor's property to help finance additional contributions; and/or
- A closure to future accrual, with any savings being contributed to the scheme; and/or
- An agreement to stop shareholder distributions until the scheme's funding position is improved; and/or
- A change in investment strategy to reduce investment risk. Although this will increase reliance on sponsor funding this will reduce the risk that a bad situation is made worse

4. IMPLEMENTING

The trustees engage their investment adviser and scheme actuary to update the SIP and SFP to capture the high-level goals and strategy agreed with the sponsor. The SIP is amended to include de-risking triggers to provide clear points of reference for ongoing monitoring and future strategy changes, as well as exposure limits regarding interest rate, FX, and property risk. The SFP is updated for the agreed technical provisions basis and recovery plan, and the potential demographic risk from future restructurings.

Additionally, together with their legal and covenant adviser, the trustees prepare a (non-binding) Memorandum of Understanding (MoU), setting out objectives, the key risks and how they have been addressed, and the parties' intention to take the above mitigation options should the key risks materialise. While not legally binding, the MoU is intended to act as helpful supporting material should any mitigation options have to be called upon in future.

5. MONITORING

Finally, the trustees and sponsor agree a monitoring package, with the aim of identifying any material events in the scheme or sponsor which would require action, as set out in the MoU.

In particular, this includes:

- A quarterly update on investment and scheme funding progression, with automatic notifications if a de-risking trigger is met.
- Reviewing the value of the sponsor's property on an annual basis following its valuation for accounting purposes. This also includes a review of the amount of debt secured on the property and a brief update on the sponsor's financial performance.
- A notification framework is agreed with the sponsor covering any material developments with the sponsor, including the property and the sponsor's FX and interest rate exposures.
- Finally, to address concerns about the liquidity of the scheme as it matures, the trustees agree to monitor the scheme's level of liquid assets as a proportion of expected benefit outgo, expenses, and PPF levy for the next three years. This includes monitoring the scheme's experience of member actions (e.g. early retirements, commutations or transfers) and adjusting the required cash buffer as appropriate.

NOTES

DISCLAIMER

Material provided in this publication is meant as general information on matters of interest. This publication is not meant to give accounting, financial, consulting, investment, legal, or any other professional advice.

You should not take action based on this guide and you should speak to a professional adviser if you need such information or advice.

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