THE MEMBER BACKING PENSIONS AND LIFETIME SAVINGS ASSOCIATION

November 2021

INTEGRATED RISK MANAGEMENT (IRM)

MADE SIMPLE GUIDE

ACKNOWLEDGEMENTS

We would like to thank Cardano for its help producing and sponsoring this guide. For further information visit www.cardano.co.uk.

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FOREWORD

CARDANO IS A PRIVATELY-OWNED PENSIONS & SUSTAINABILITY BUSINESS WITH THREE SERVICE PILLARS: ADVISORY, INVESTMENT AND DC. WE PREVIOUSLY AUTHORED THE INTEGRATED RISK MANAGEMENT (IRM) MADE SIMPLE GUIDE IN OCTOBER 2017. WE ARE RE-VISTING THIS GUIDE TO EXPLORE WHAT IRM MEANS TODAY, WITH A WIDER POOL OF BEST PRACTICE TO REFER TO, AN IMPENDING NEW CODE OF PRACTICE ON DB FUNDING AND THE PENSION SCHEMES ACT, AND WITH MANY SCHEMES FACING NEW AND UNPRECEDENTED RISKS IN THE 2020'S.

IRM remains of central importance to UK defined benefit pension schemes and The Pension Regulator's (TPR) increasing focus on its implementation exemplifies the positive impact regulators can have on the industries they oversee. COVID-19, a textbook "IRM shock", has brought this more into focus than ever before and many trustees are also increasingly concerned with longer-term ESG risks and their potential impact across covenant, investment and funding.

Whilst the concept of IRM has been used by the pensions industry for a number of years now, and TPR guidance has remained broadly the same since 2016, well publicised practical applications remain rare. IRM "solutions" often deliver single-number answers, or base important decisions on overly-simplified and abstract analysis. The reality, however, is always much more complex.

This guide has been designed to explain IRM in the context of trustee decision making along the journey to an appropriate end-game. We hope that these practical examples of how IRM can be used in practice by trustees, in the context of their journey plans, enables the long-standing theory to be brought to life.

Kerrin Rosenberg, CEO Investment, Cardano

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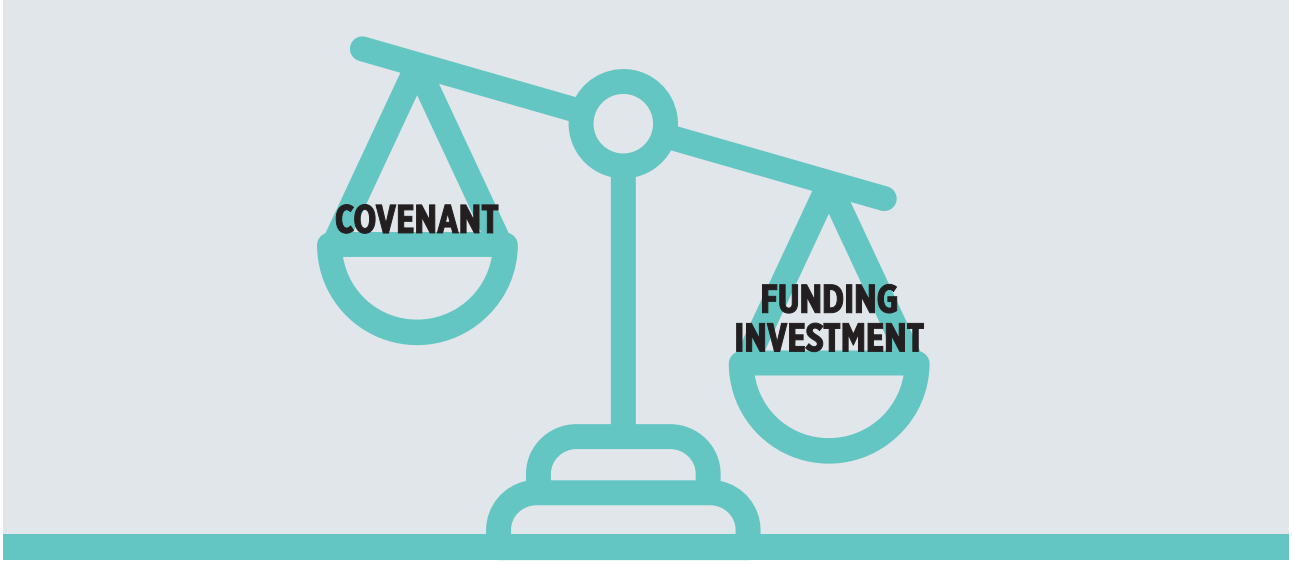
SECTION 1: INTRODUCING IRM

1. WHAT IS IRM?

> **"IRM IS A METHOD THAT BRINGS TOGETHER THE IDENTIFIED RISKS THE SCHEME AND THE EMPLOYER FACE TO SEE WHAT RELATIONSHIPS THERE ARE BETWEEN THEM. IT HELPS PRIORITISE THEM AND TO ASSESS THEIR MATERIALITY"**
>
> TPR, DECEMBER 2015

THE BASICS OF IRM

Schemes face many risks over the course of achieving their funding plans. These risks are inter-related and arise through the employer covenant, investment and funding. Ultimately, the employer covenant should support the investment and funding risks.



IRM is a holistic risk-centric risk management tool and represents an approach to decision making around covenant, investment and funding risks. It concerns how each risk interacts and influences the others, and requires appropriate frameworks, tools and mindsets.

By adopting an IRM approach, the intention is to make balanced decisions which optimise the prospect of meeting the scheme objective without collectively exceeding accepted overall risk constraints.

Since the 2014 Code of Practice which first articulated IRM, TPR has released the December 2015 IRM guidance, the December 2016 IRM "Quick Guide" and "IRM key considerations", alongside more general commentary on best practice IRM in its annual funding statements. Across these publications, the underlying principles of IRM decision making have remained broadly the same.

However, as more schemes are inevitably moving towards their "end-game" since the guidance was released in 2015, and with the economy experiencing a true "IRM shock" with COVID-19, the need for joined up thinking across covenant, funding and investment in designing an appropriate journey plan towards a long-term funding target ("LTFT") is more pronounced than ever before.

THE RATIONALE FOR IRM

The last decade has presented many challenges for trustees with falling interest rates leaving many schemes with risk exposures higher than planned, and the unexpected events of Brexit and COVID-19 creating the perfect storm of issues across covenant, investment and funding. Had more trustees (and sponsors) been using an IRM approach over this period, it's likely that many schemes would be in a much better position than they find themselves in today. This is true, in part because contingency planning is a core component of an IRM approach.

Today, TPR expects trustees to formulate a long-term view and take an IRM approach in doing so. In TPR's 2021 Annual Funding Statement, it was explicitly stated that for those schemes with a strong or tending to strong covenant, there is an expectation that a clear IRM strategy should be in place, with realistic contingency planning for key downside risks.

ARE YOU TAKING AN IRM APPROACH?

How do you know if you have properly adopted the IRM mindset? The following test may help:

- Have you set a **long-term funding target ("LTFT")** for your scheme and a plan for how to reach it?
- Do you understand the **key risks in the sponsor** which affect affordability of contributions, how they interact with the scheme's risks, and over what timescales?
- 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 changes to a scheme's approach.

IRM IS NOT ABOUT AVOIDING RISKS ALTOGETHER

To be clear, it is not possible to remove risk altogether along the journey to full funding. IRM 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. Different schemes can withstand different levels of risk, dependent on the membership profile and the strength of the employer covenant.

In coming to a conclusion on the appropriate level of risk exposure, it's helpful for trustees to understand "risk capacity" and "risk appetite".

RISK CAPACITY

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

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

RISK EXPOSURE

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

Sponsors have an active role in IRM as without understanding 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 IRM approach is iterative and requires repeated risk assessments, with sponsor and trustee involvement, at a regularity appropriate for the size and risk exposure of the scheme.

In addition, processes are most efficient where advisors are working collaboratively and understand, at least at a broad level, each others' disciplines and value add in the context of risk management.

2. WHAT CAN IRM DO FOR YOU?

> **"IRM IS AN IMPORTANT TOOL FOR MANAGING THE RISKS ASSOCIATED WITH SCHEME FUNDING. IT FORMS AN IMPORTANT PART OF GOOD GOVERNANCE"**
>
> TPR, DECEMBER 2015

BENEFITS OF IRM

Fundamentally, IRM should allow schemes and sponsors to utilise their risk budget more efficiently than if they take decisions in isolation i.e. there are synergies in taking a combined approach. The idea is that the likelihood of schemes meeting their key objectives over the journey plan is increased 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 trustee's point of view**, IRM will increase the likelihood that members' benefits are paid in full**
- A **focused and proportionate approach to risk management can create efficiencies** over the medium and long term, making the most of trustees', sponsors' and advisers' time
- From a sponsor's point of view, **IRM may help to create shareholder value** by reducing defined benefit (DB) scheme volatility and the ongoing uncertainty of funding requirements, or enable near term investment in the business by better securing future scheme risks.

WHAT ARE THE CHALLENGES TO IIMPLEMENTATION?

Most of the challenges with IRM stem from not implementing it correctly or proportionately:

- If treated as an isolated exercise rather than an ongoing mindset, **IRM may appear expensive and absent of tangible results in the short-run**
- 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.

SECTION 2: IRM IN ACTION

1. IRM JOURNEY PLANNING AND IMPLEMENTATION

SUCCESSFUL INTEGRATION OF IRM INTO TRUSTEES' JOURNEY PLANNING DECISION-MAKING CAN BE FACILITATED BY A RISK-CENTRIC GOVERNANCE APPROACH SUCH AS THE EXAMPLE BELOW.

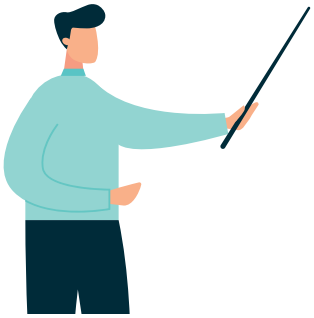
PLANNING THE JOURNEY

A. ROLES AND RESPONSIBILITIES

The approach above represents just one example of an IRM framework and there are alternatives. The "right" approach will ultimately depend on the characteristics of the scheme in question. Similarly, who does what and when is another question with answers bespoke to each situation.

Regardless of the eventual approach, IRM works best when there is collaboration between the trustees and the sponsor. This enables there to be a complete understanding of the risk capacity and approach for the trustees and sponsor, whilst there may not be complete agreement.

In working out how to organise matters, some schemes may find it helpful to ask one of their advisers to take the lead on organising an IRM framework, perhaps as part of a trustee sub-committee. A sub-committee can help to ensure advice is co-ordinated effectively whilst the trustee board, as a whole, remain responsible for the scheme's governance.



B. UNDERSTAND RISKS

Trustees need to build their knowledge and consider the key risks across covenant, investment and funding and how they interact with each other. This involves the consideration of the scheme's current position and risks need to be considered together in terms of their links, impacts and concentrations, usually through collaboration between trustees and advisers. The following questions will help:

	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?		◆	◆

A comprehensive risk assessment should closely involve sponsors, will typically perform risk assessments on a regular basis for reporting or other regulatory purposes. Once complete, the assessment will enable trustees to have a fully informed conversation with sponsors about appropriate objectives for the journey plan.

Consideration of risks should incorporate scenario analysis, in order to establish which scenarios present material risks, the likelihood and impact of such scenarios, and how they might be rectified.

C. SET OBJECTIVES

Setting the ultimate objective for trustees may be straight forward, as the trustees' focus is predominantly on paying members' benefits in full. However, it is 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 (including the LTFT) will be met** (e.g. through a buy-out at some stage).

Increasingly, TPR is urging trustees to see full funding on the technical provisions basis as a step on the journey to an appropriate "end-game". This is because many schemes retain material risks and therefore still rely on their sponsor's covenant beyond technical provisions. Soon, it may become mandatory to set a LTFT and a clear journey for how to reach it. Determining what LTFT you want to set for your scheme is best done with all your advisors in the same room, so you can agree what's realistic and achievable:

Covenant: Assess the sponsor's ability to underwrite investment risk and make contributions.

Investment: Understand viable options on the investment risk-return trade-off.

Actuarial: Model scheme maturity and recovery plan scenarios.

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. The examples below demonstrate the kind and range of questions that might be asked at the objective setting stage.

How might a global pandemic impact investments and the covenant?

Which "end-game" solutions are plausible for this scheme given its maturity profile?

What happens if members live three years longer on average?

D. 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 – and this is further evidence that IRM is being implemented correctly as the strategy is refined to reflect additional considerations.

Actuarial valuations are important pit-stops along a pension scheme's journey, providing a chance to check whether the scheme is still on course to reach its end-game. This means balancing the risk capacity and affordability of the sponsor with the scheme's investment strategy and funding needs to enable the journey to remain on track.

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.

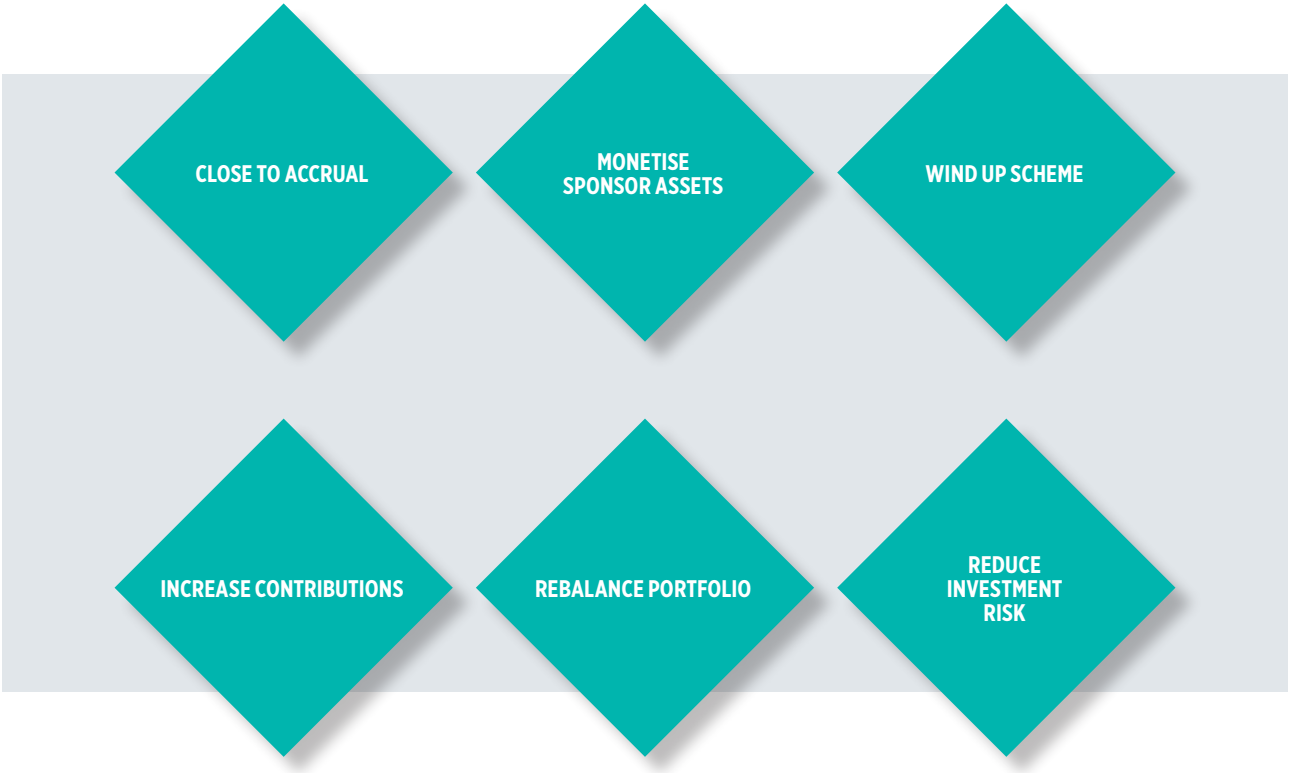
IMPLEMENTATION

A. IMPLEMENT THE STRATEGY

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, documented 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.

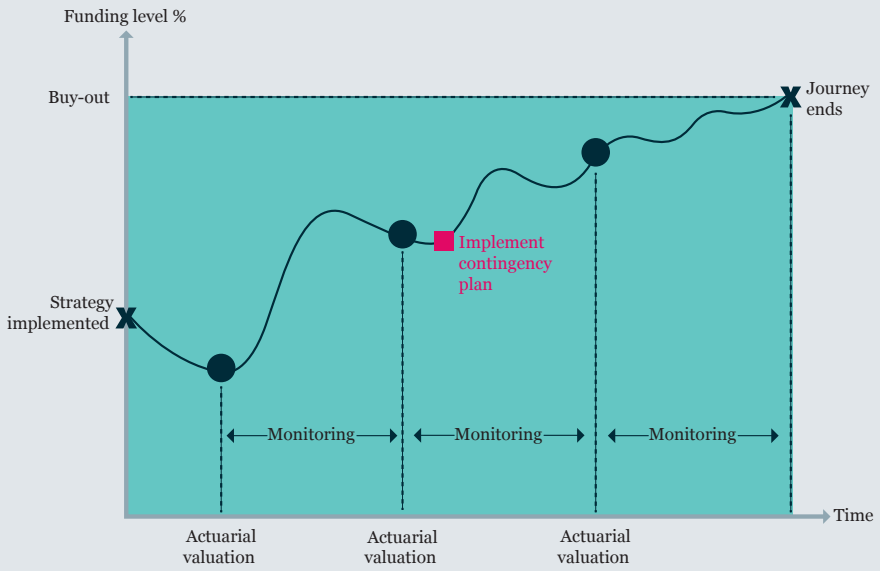
Milestone reviews and measurable targets should also be defined together with clearly defined actions which help to reduce the impact of behavioural biases. For instance, delegating potentially challenging investment decisions to professionals may help to ensure adherence to the strategy determined at outset.

Contingency plans for downside scenarios where the journey goes off track and what the trustees can do about it is an important component. Appropriate actions in the event of the failure of milestone objectives could be agreed between trustee and sponsor together in advance, including predefined triggers and a timeline for action to be taken. Contingency planning should also, as far as possible, include the consideration of unexpected events and how trustees can ensure there is an appropriate flow of information.

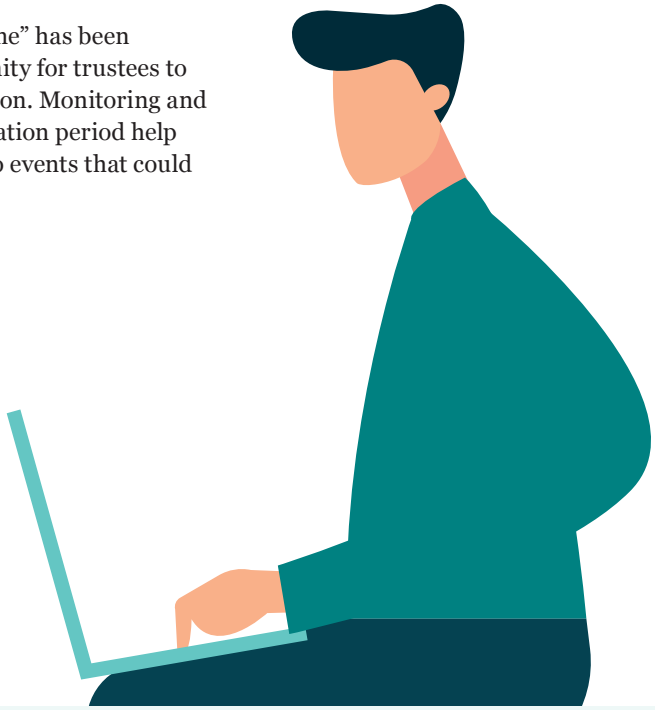


B. MONITOR

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.



The risk control cycle can continue until the "end-game" has been achieved. Each actuarial valuation provides opportunity for trustees to review assumptions in the context of the latest situation. Monitoring and the availability of contingency plans in the intra-valuation period help to ensure that trustees understand and are reactive to events that could take the scheme off course in its journey plan.



2. TOOLS TO HELP APPLY IRM

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

A. 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.

B. 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 not possible to 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.

3. THE IMPORTANCE OF TRAINING AND EDUCATION

THE CHALLENGES OF TODAY MEAN TRAINING AND EDUCATION FOR TRUSTEES AND SPONSORS IS MORE IMPORTANT THAN EVER BEFORE.

Typical focus areas for training include:

- Effective governance processes that support the IRM approach;
- The different IRM risks, their components, and how they can link together;
- The limitations of financial models, and how to utilise the available tools to inform rather than make risk management decisions;
- Contingency planning: Key risks, trustee tool-kits and how to use them to mitigate risks;
- Interactive scenario training tools; and
- Example case studies and shared experiences around successful IRM implementation.

The body of IRM literature continues to grow and it is becoming easier for trustees and sponsors to educate themselves on the practical application of IRM.

Professional trustees increasingly sit on Trustee Boards and help to improve the level of education across a trustee board given their professional backgrounds and experiences gained over multiple schemes. Advisers are ever-important too and in the context of IRM, need to be able to work collaboratively with other advisers and have a base-line knowledge of each other's skillsets and roles.

SECTION 3: IRM CASE STUDY

CASE STUDY – AN INTEGRATED APPROACH TO MANAGING SCHEME RISKS

THE CASE STUDY BELOW IS AN ILLUSTRATION OF USING AN IRM APPROACH. THE ACTIONS TAKEN BY THE TRUSTEES AND THE SPONSOR IN THIS CASE STUDY SHOULD NOT BE INTERPRETED AS THE "RIGHT" COURSE OF ACTION. WE ENCOURAGE THE READER TO FOCUS ON THE PROCESS AND HOW IT CAN BE APPLIED RATHER THAN THE SPECIFIC ACTIONS TAKEN.

BACKGROUND

SPONSOR

- The Sponsor is an entity acting as the primary UK trading entity of a large US-listed software company (together with its subsidiaries, the "Group"). Half of its customers are based in the UK, with the remainder split largely across France and Germany.
- It has a small number of core customers and long-term contracts which are periodically renewed, as well as a larger number of smaller contracts.
- The Sponsor is debt free, but its US parent is highly leveraged and while no formal cross-guarantees are in place, debt service is being paid with using dividends received from its subsidiaries (including the sponsor).
- The Sponsor has limited assets due to the nature of its business apart from a material intra-group receivable due from the US parent.

SCHEME

- The Scheme is medium sized, with c.£200m of assets and is c.95% funded on its current technical provisions basis.
- The Scheme is closed to new members but remains open to future accrual although only c.4% of members are active.
- The Scheme is relatively mature and members, aside from the small contingent of actives, are split between pensioner members and deferred members in a proportion of approximately 65:35.

THE SITUATION

- The Scheme's next triennial valuation is in one year. In light of recent TPR guidance, the expected direction of travel for the pensions industry more generally, and given some concerns about the longevity of the employer covenant, the Trustees wish to formulate a formal journey plan ahead of the valuation.

1. PLANNING THE JOURNEY

STEP 1: ROLES AND RESPONSIBILITIES

- The Trustees set up a sub-committee to run the journey planning initiative, reporting to the full board on a quarterly basis. This includes a professional trustee, a member nominated trustee with a financial background and a representative of the Sponsor.

STEP 2: UNDERSTANDING RISKS

- As a first step, the Trustees ensure that, via an all adviser training session / workshop, they are complying with the Trustee Knowledge and Understanding requirements set out by TPR and its latest guidance on IRM. This includes a scenario training exercise in order for the Trustees to experience the kind of decisions that will need to be made along the journey.
- The Trustees commission proportionate advice from their advisers to understand the key risks faced by the sponsor and the Scheme over the short, medium and longer term.

COVENANT:

- **The Sponsor operates in a competitive and innovative field, and is lagging behind the trend towards software as a servic**e ("SaaS"), which has led to eroding market share and the loss of certain long-term contracts. This has meant a step down in revenue, profit and free cash generation, reducing affordability in recent years;
- **Whilst significant in scale relative to the obligations of the Scheme, the listed US parent faces similar challenges globally**, and has generated decreasing revenue, profit and free cash over the last ten years. If it is unable to adapt to the changing market, there is a risk that it withdraws from overseas markets, including the UK;
- **The Sponsor's free cash flows are used to pay regular dividends to the US parent company**. The Trustees are concerned that the Sponsor's intra-group receivable from the US parent may also be used to fund dividends in the future, particularly in the event that interest rates increase and the US parent's debt burden becomes more onerous; and
- **The Sponsor participates in a cash pooling arrangement** to which it is a net lender. The Trustees do not have full visibility over the counterparties to the cash pooling balances.

FUNDING:

- **The current technical provisions basis is in line with a strong covenant**. The Trustees did not seek a formal covenant assessment at the last valuation but assumed a robust covenant based on the Group's significant scale relative to the obligations of the Scheme.
- The Scheme is 70% funded on a Solvency basis and there is no LTFT in place; and
- The Scheme's Actuary considers that peak cash outflows will occur in c.5 years.

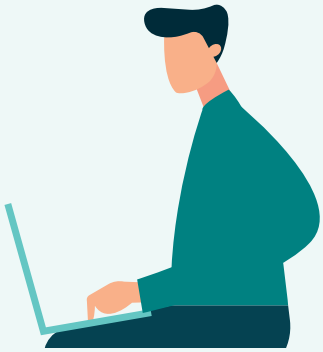
INVESTMENT:

- **The Scheme's assets are c.50% invested in equities and other growth investments, with a significant proportion of the exposure held in European equities**. The remainder of the Scheme's assets are invested in a portfolio of matching assets. As such, overall inflation and interest rate hedge ratios are relatively low, a position which is supported by the US parent company's pensions experts; and

- **The Scheme's assets currently provide adequate cashflows to make pensions payments, without needing to use deficit repair contributions (DRCs) or divestiture of assets**. However, as the Scheme progresses towards peak cash outflows, divestiture of assets may be required.

STEP 3: SET OBJECTIVES

- The Trustees meet with representatives of the Sponsor (the pensions manager and finance director) in order to discuss journey planning, the regulatory landscape, and the Trustee's objectives in that context.
- The sponsor initially queried why such conversations can't be withheld until the next actuarial valuation, but the trustees explain that valuations are effectively a "pit stop" along a pension scheme's journey, providing an opportunity to ensure that schemes are progressing towards a LTFT, including an up-to-date assessment of risks. As such, an "end game" should be selected for a scheme as soon as practical, with subsequent valuations serving as distinct staging post to assess risks in an integrated fashion.
- The Sponsor and Trustee agree that there are three "end game" options for the Scheme:
  - Buy-out with an insurer;
  - Low-covenant dependency run-off style-solution; and
  - Pension consolidator vehicle.
- The Trustee concludes that buy-out is the most appropriate end-game target in consideration of the following:
  - Whilst covenant strength has deteriorated over the past five years, the sponsor's business remains relatively robust and there appears to be visibility over the estimated time-frame to buy-out of ten years;
  - The Scheme's actuary has commented that the relatively mature membership profile of the Scheme, combined with it being closed to new members, has limited demographic risks somewhat. It also allows for the possibility of periodic buy-ins of pensioner members, thereby "locking in" positive funding experience and further reducing risk; and
  - The Sponsor's view is that achieving a scenario where the Scheme no longer sits on the balance sheet as soon as possible is desirable, as many of its competitors no longer / never had any defined benefit funding obligations. The Sponsor is open to new funding solutions such as consolidators but would rather wait until there is wider experience of these models before committing to such an end-game. Therefore, buy-out is the preferred option today.



STEP 4: DETERMINE STRATEGY

- Whilst buy-out is confirmed as the "final funding target", the Trustees argues that a "secondary funding target" is in order to bridge the gap between the current technical provisions deficit and the final funding target. Ideally this would provide a target approximately halfway towards buy-out, with built in security should the journey begin to move off-track.
- The Sponsor agrees to the concept, with the secondary funding target to be finalised as an outcome of the actuarial valuation.
- There is also an agreed de-risking plan over the period to buy-out, triggered once certain funding levels have been reached.
- Together with their legal and covenant adviser, the trustees prepare a (non-binding) Memorandum of Understanding (MoU), setting out the journey planning objectives and a commitment to finalise the specific details on the journey following the actuarial valuation next year. It is agreed this will include setting a formal secondary funding target that bridges the gap between the current TP basis and buy-out.

2. IMPLEMENTATION

STEP 5: IMPLEMENT THE STRATEGY (ACTUARIAL VALUATION)

- The Trustees again sestablishes a sub-committee to run the valuation, reporting to the board as and when matters develop. To ensure continuity from the principles agreed under the MoU, this includes the same committee members as for the journey planning process.

COVENANT

- The Trustees are informed by their advisers that the covenant rating is between Tending to Weak and Tending to Strong on TPR's rating scale. Whilst the Group is strong, the Scheme does not have any codified legal access to the value it represents and thus, this is not a factor in the rating.
- In terms of affordability from the sponsor's operations and cash flows, this has deteriorated since the last valuation. However, the sponsor continues to hold the material intra-group receivable which could significantly boost affordability.
- The covenant adviser notes that the covenant rating would be improved to between Tending to Strong and Strong if the receivable could be provided as security.

FUNDING

- The Scheme Actuary informs the Trustees that the Scheme is now 100% funded on a TP basis. However, the TP basis reflects a Strong covenant.
- The investment risk required to get to buy-out within 10 years is not aligned to the current covenant rating.
- The Scheme's peak cash flow is approximately four years away.

Noting the up-to-date covenant findings, the Trustees plan to make changes to the investment allocations as follows:

Interest rate risk

- Whilst changes in interest rates have somewhat offsetting impacts on the scheme and sponsor (through impact on dividends to service Group debt), the impact on the Scheme will be greater. Therefore, the Trustees aim 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 introducing a currency hedging overlay programme to hedge FX risks inherent in the Scheme's overseas equities.

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 covenant rating and affordability constraints.
- The Trustees appreciate that maintaining the current, comparatively high, allocation to growth assets is helpful in the context of the journey plan to buy-out. 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 arecession.

OUTCOMES

- The Scheme's covenant rating is initially 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.
- However, the Sponsor wants to avoid this outcome and, through discussions with the Trustees and covenant adviser, offers to provide the intra-group receivable as a funding underpin allowing an improvement in the covenant rating and higher levels of investment risk to be taken.
- The Sponsor is not willing to agree to de-risking in the TP basis from the status quo. However, as a compromise, in order to support reaching the secondary funding target in five years, the intra-group receivable is "ring-fenced" from other uses and will make up any shortfall that may exist in five years' time.
- 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 and FX risk.

- The Trustees work with their lawyers to ensure the MoU is updated to reflect the secondary and final funding target timeframes. A side agreement captures the security arrangement concerning the intra-group receivable.

STEP 6: MONITORING

MONITORING FRAMEWORK

- In order to monitor progress along the journey plan, 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. 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 intra-group receivable on an annual basis. This also includes a review of the amount of the Group's credit rating and liquidity, for the purpose of ensuring recoverability of the receivable has not deteriorated;
  - A notification framework is agreed with the sponsor covering any material developments with the sponsor, including dividends, use of the intra-group receivable and the Sponsor's FX and interest rate exposures; and
  - 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.

UNEXPECTED EVENTS:

- Should the strategy set out above not be successful, the Trustees and Sponsor agree on a list of contingency measures which could be enacted, further to the intra-group receivable arrangement:
  - 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.

NOTES

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