Funding Code Insight:
What is the new Statement of Strategy document?

March 2023

Introduction

In our previous note on key aspects of the draft funding code, "What is Low Dependency and why it matters", we summarised the principles behind the low dependency funding and investment basis. We also considered the implications of setting an approach that has a low chance of requiring future employer contributions once the scheme is classed as "significantly mature".

We now turn our attention to the new governance requirements. Whilst the exact details and format are still unclear (and may of course evolve as a result of the consultation), we already know a lot of elements that will be needed. In particular, schemes will be required to document their approach in a formal Statement of Strategy, signed by the designated chair of the trustee board.

What is a Statement of Strategy?

Trustees will need to prepare a Statement of Strategy, which comes in two parts:

1. Part 1, records the Funding and Investment Strategy (FIS);
2. Part 2, records various supplementary matters including journey plans, risk management and some self-assessment of how well the funding and investment strategy is being implemented.

One of the reasons the new document is in two parts is to reflect differing powers of the employer. The first part needs to be agreed with the employer (as with current valuation documents) whereas part two will only require consultation with the employer (as with current updates to investment strategy).

It isn't clear at this stage what level of detail the Pensions Regulator will be expecting. They have indicated there will be some allowance for proportionality, but this appears to be risk and maturity driven so might not be of much help to many smaller schemes. We also note there appears a significant amount of overlap with existing documents such as the Statement of Funding Principles, Statement of Investment Principles and Integrated Risk Management documents but, at least for now, it appears these documents will continue to be required.

What is the Funding and Investment Strategy?

The FIS is part 1 of the new Statement of Strategy and must set out:

- the trustees' long-term objective;
- their chosen 'relevant date' (generally, the year they expect to reach the 'significant maturity' threshold but could be earlier);
- the funding level they expect to have reached at their relevant date (at least 100%) and how they plan to get there; and
- the investments they intend to hold at their relevant date (their 'low dependency investment strategy' as discussed in our previous Funding Code Insight).

Setting a long-term objective

When setting their overarching FIS for the scheme, trustees should ensure that their strategy sets out their ultimate planned funding "end game". This is likely to be either:

- Running off the scheme as the benefits fall due;
- Buying out members' benefits with an insurer; or
- Transferring the benefits to a consolidator e.g. Clara or Superfund.

We expect most trustee boards will have an idea in principle which of the three long term end game solutions they are likely to follow but they have probably not formally agreed this with the employer. In the case of a potential buy out, many will not have committed to a specific timescale, instead waiting to see what is affordable nearer the time and at what point the ongoing running costs become prohibitive in the context of the remaining membership. However, this level of detail will now be needed if consistent assumptions are to be agreed, particularly on investments and expenses.

What is needed in part 2 of the Statement of Strategy?

Whilst it is described in the code as simply covering 'supplementary matters', there is actually a huge amount of information required under part 2. Some of this will be provided directly by your actuary (although additional work will be needed as part of the valuation process in order to do so) but other elements will require trustee input.

The information required includes:

- The trustees' assessment of the strength of the employer covenant (this is another key area of change, with more detailed figures now required including cash flow information and 'reliability periods' rather than a broad overall level. This will be covered in a future Funding Code Insight);
- Actuarial information including:
    - The assumptions used to calculate technical provisions and an explanation of how the discount rate will change over time to become consistent with a low dependency funding basis.
    - The maturity of the scheme (calculated by the actuary) and an explanation as to how this will change over time.
    - The funding level on a low dependency funding basis together with the assumptions used and a comparison to the funding assumptions.
- The current strategic asset allocation and level of risk.
- Granular detail around the journey plan covering how this investment allocation will change to become a low dependency investment strategy by the relevant date.
- An assessment of the main risks in the funding and investment strategy.

- An explanation from the trustees of “how well the funding and investment strategy is being successfully implemented, reflecting on past actions and lessons learned, as well as any remedial action they plan to take.”

As if this wasn’t enough, trustees are also expected to explain how they are managing risks and to set out contingency plans to explain how they will respond if the journey plan does not progress as expected.

Given much more rigour will now be expected in terms of how you plan to move from your current position to your end game state, particularly for those close to reaching ‘significant maturity’, it is worth considering the journey plan in more detail.

The journey plan

The journey plan details the transition from your current investment strategy to one which meets the standard of a low dependency investment allocation (please refer to our previous note). When setting the shape of this transition, trustees should consider:

- The strength of the employer covenant (now and in the future) and the resulting level of risk that can be taken;
- Subject to satisfying any constraints imposed by the above, the maturity of the scheme; and
- The level of liquidity needed to meet expected (and some unexpected) cash flow requirements.

The plan should also be practical / realistic (i.e. consistent with the likely timescales for making and implementing de-risking decisions and spreading any asset rebalancing where this is likely to be appropriate).

In general, the Regulator is expecting trustees to determine a starting level of affordable risk (defined by the employer covenant) and that after a few years this ‘upper bound’ on justifiable investment risk will start to trend down towards a low-risk position. There is, however, flexibility in how the trustees structure their preferred path within these limits.

The employer covenant is central to the journey plan and scheme strategy. For weak employers the covenant may also impose constraints in the long-term position due to an inability to underwrite even limited downside risk in the short or medium term.

Trustees are expected to scenario test their journey plan based on various economic conditions and establish their impact on asset and liability values as well as quantifying potential risks, although it is currently unclear to what extent all of this supporting analysis will need to be detailed in the Statement of Strategy.

When must the Statement of Strategy be prepared?

The Statement of Strategy must be determined/reviewed and submitted to the Regulator within 15 months of the effective date of each actuarial valuation after the code comes into force (currently anticipated to be all valuations with effective dates on and after 1 October 2023). It must also be reviewed in conjunction with any changes to investment strategy or employer covenant and updated if needed.

The chair has responsibility for preparation of the Statement but given it is intertwined with funding and investment strategies and employer covenant we expect there will be a need for close collaboration with all of the trustee advisers. Any changes in one area are likely to have knock on impacts for all the other aspects and the valuation may become more of an iterative, multi-adviser process as a result.

Broadstone comment

Clearly a significant amount of extra work will need to go into production of the Statement of Strategy, even for schemes who are already relatively well funded and on a logical path towards an expected end game. We also foresee extended discussions with employers around the wording of the new document, which will need to be built into valuation timetables.

The list can appear daunting and arguably moves a number of elements from 'good practice' to a 'base requirement'. Whilst we hope (and will continue to push for) proportionality and simplification where possible, there is clearly a lot of additional work to do in documenting an approach and providing appropriate supporting evidence.

We remain concerned at the cost implications for smaller schemes, particularly in producing detailed plans that are highly likely to change in response to market events (even the best laid plans would probably have been re-written multiple times last year), and question whether the value added for the minority justifies the additional cost for the majority.

Finally, we wonder how honest trustees can really be expected to be in their self-assessment of their approach given this document is being reviewed by the employer (and probably various advisers) and submitted to the Regulator.

Please look out for our future Funding Code Insights, which will include articles on the new employer covenant expectations and the Regulator's 'Fast Track' valuation filtering mechanism.

Find out more

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