employer covenant working group

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CONSULTATION RESPONSE: THE WATES CORPORATE GOVERNANCE PRINCIPLES FOR LARGE PRIVATE COMPANIES

PRODUCED BY THE EMPLOYER COVENANT WORKING GROUP LIMITED (ECWG)

1. BACKGROUND

The Financial Reporting Council, on behalf of James Wates CBE, has published a consultation on corporate governance principles for large private companies (**the Consultation**). Large private companies will be encouraged to follow six principles to inform and develop their corporate governance practices and adopt them on an 'apply and explain' basis. To quote James Wates:

'Good business well done is good for society. Private companies are a significant contributor to the UK economy, providing tax revenue and employing millions of people. They have a significant impact on people's lives, and it is important they are well-governed and transparent about how they operate'.

Defined benefit (**DB**) pension scheme members are acknowledged in the consultation document as significant stakeholders in private companies. Indeed, particularly following recent large-scale corporate collapses, there is a high level of public and political interest in the governance of companies in respect of their pension schemes. Corporate disclosures can play a useful role when monitoring and assessing the financial strength of the scheme employer in the context of funding DB pension schemes (i.e. the employer covenant), particularly in the strategic report, which provides an opportunity to address material risk issues not covered by basic accounting disclosures.

The Employer Covenant Working Group (**ECWG -** http://ecwg.co.uk/#) operates in the defined benefit pension scheme market, providing a forum for employer covenant advisors to:

- Discuss technical, legal and regulatory issues relevant to providing financial advice to clients - trustees or sponsoring employers - on matters connected with the employer covenant.

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- Participate in discussion around relevant matters such as the Pensions Regulator, Pension Protection Fund and FRC and, where appropriate, to promote the views of the Working Group with such bodies.
- Act as a vehicle for raising the standards of, and promoting, the employer covenant financial advisory industry generally amongst the pensions community, including trade bodies, professional groups and potential clients.

Currently, in the view of the ECWG, while financial statements are an important source of information regarding employer financial performance and position, the pension and risk disclosures are of limited value to trustees in understanding corporate risk, or for other users of financial statements in understanding the impact on companies of DB pension risk, given the current UK funding regime.

The ECWG welcomes the Consultation and sees a significant opportunity to improve reporting and governance for the benefit of trustees and other users of financial statements.

2. OBJECTIVES

This document is intended by the ECWG to address relevant questions (**the Questions**) raised by the Consultation and to suggest means of directing large private companies to the pension disclosures that would be appropriately transparent and informative to stakeholders. Please not that we are engaging separately with the FRC on disclosures by listed companies.

3. APPROACH

We have not originated any specific research in producing this document and have relied principally on our own practical experience in using financial statements and the following key documents:

- Principles of covenant assessment for scheme valuations - a practical guide for advisors, trustees and sponsors (http://ecwg.co.uk/docs/ECWGPrinciples.pdf) (**POCA**)
- Corporate reporting thematic review pension disclosures November 2017 (https://www.frc.org.uk/getattachment/538ec144-05a0-499c-99b4-3f93bd21ad0b/091117-Pension-Disclosures-CRR-thematic-review.pdf) (**CRTR**)
- The Pensions Regulator's Code of Practice 3 – Funding Defined Benefits (http://www.thepensionsregulator.gov.uk/docs/code-03-funding-defined-benefits.pdf) (**CoP3**)
- Guidance on the Strategic Report - https://www.frc.org.uk/getattachment/fb05dd7b-c76c-424e-9daf-4293c9fa2d6a/Guidance-on-the-Strategic-Report-31-7-18.pdf (**GSR**)

While respective equity investor and creditor (including trustee) interests and the information available to them are usually not consistent in all respects, we have adopted the perspective of an otherwise uninformed user of financial statements (i.e. we have made no assumptions about knowledge that individual stakeholders may have from other sources). In this regard we note that while trustees are company creditors, rather than equity investors, s172 of the

Companies Act (**the Act**) requires that company directors, as well as promoting the interests of members as a whole, should have regard to a range of matters including:

- The likely consequences of any decision in the long term (Comment: DB schemes are very long-term vehicles and short-termism in their management can have adverse long-term consequences)
- The interests of the company's employees (Comment: which may include DB scheme beneficiaries)
- In certain circumstances, the interest of creditors of the company (Comment: this is particularly important where there are threats to the viability/solvency of the employer)

It is in this context, where there are material defined benefit obligations, that we have sought to address the Questions, which are:

1. *Do the Principles address the key issues of the corporate governance of large private companies? If not, what is missing?*

2. *Are there any areas in which the Principles need to be more specific?*

3. *Do the Principles and guidance take sufficient account of the various ownership structures of private companies, and the role of the board, shareholders and senior management in these structures? If not, how would you revise them?*

4. *Do the Principles give key shareholders sufficient visibility of remuneration structures in order to assess how workforce pay and conditions have been taken account in setting directors' remuneration?*

5. *Should the draft Principles be more explicit in asking companies to detail how their stakeholder engagement has influenced decision-making at board level?*

6. *Do the Principles enable sufficient visibility of a board's approach to stakeholder engagement?*

7. *Do you agree with an 'apply and explain' approach to reporting against the Principles? If not, what is a more suitable method of reporting?*

8. *The Principles and the guidance are designed to improve corporate governance practice in large private companies. What approach to the monitoring of the application of the Principles and guidance would encourage good practice?*

9. *Do you think that the correct balance has been struck by the Principles between reporting on corporate governance arrangements for unlisted versus publicly listed companies?*

In this document we follow the structure of the Questions and include in the Appendices fuller explanation of some of the issues involved and some recommendations.

4. DO THE PRINCIPLES ADDRESS THE KEY ISSUES OF THE CORPORATE GOVERNANCE OF LARGE PRIVATE COMPANIES? IF NOT, WHAT IS MISSING?

To quote, the Principles are:

1. *Purpose – An effective board promotes the purpose of a company, and ensures that its values, strategy and culture align with that purpose.*
2. *Composition – Effective board composition requires an effective chair and a balance of skills, backgrounds, experience and knowledge, with individual directors having sufficient capacity to make a valuable contribution. The size of a board should be guided by the scale and complexity of the company.*
3. *Responsibilities – A board should have a clear understanding of its accountability and terms of reference. Its policies and procedures should support effective decision-making and independent challenge.*
4. *Opportunity and Risk – A board should promote the long-term success of the company by identifying opportunities to create and preserve value and establish oversight for the identification and mitigation of risk.*
5. *Remuneration – A board should promote executive remuneration structures aligned to sustainable long-term success of a company, taking into account pay and conditions elsewhere in the company.*
6. *Stakeholders – A board has a responsibility to oversee meaningful engagement with material stakeholders, including the workforce, and have regard to that discussion when taking decisions. The board has a responsibility to foster good relationships based on the company's purpose.*

The ECWG is of the view that broadly the Principles address the key issues although we consider that there are two areas where greater emphasis would be beneficial, being:

- We believe that the Principles should include specific reference to 'transparency', per James Wates' statement above. While it is explicit in Principle 6, that engagement with material stakeholders should be 'meaningful', communication and disclosure should also explicitly be 'appropriately transparent', considering any commercial/competitive sensitivities. This is particularly important in areas as complex as DB pensions, where basic accounting disclosure requirements do not fully reflect the requirements of the UK DB funding regime, which imposes rigorous governance requirements, including for cash allocation to pension contributions and for risk management. The operation of the regime is explained in Appendix 1, 'Employer Covenant, how it is assessed and how the assessments are used', which sets out how the regime addresses the relationship between schemes and sponsors and how the long-term credit risk in the sponsor is used to inform scheme funding and investment decisions. We believe greater pensions and related governance disclosure is consistent with the imperative in Principle 6 that '*a board should demonstrate how the company has undertaken effective engagement with material stakeholders and how such relationships have been taken into account in its decision-making'*.

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- The Consultation adopts a principles-based approach, which the ECWG agrees is generally more flexible and effective than a rules-based approach as it is usually less open to 'gaming' of the system, if applied diligently and in good faith. However, experience shows that, even between listed companies which are subject to greater transparency under The UK Corporate Governance Code (2014), DB disclosures are inconsistent and fall short of providing the information required for stakeholders to adequately assess relevant DB risks and how boards are managing them. We address the need for more specific direction in this area (while hopefully staying true to the principles-based approach) more fully in answer to the following question.

5. ARE THERE ANY AREAS IN WHICH THE PRINCIPLES NEED TO BE MORE SPECIFIC?

While the principles-based approach adopted in the Consultation, and the principles themselves, would be helpful in promoting good corporate governance, in summary the ECWG believes that current practice in DB pensions reporting falls short of the requirements of the GSR, the provisions of which include:

- *'Disclosures should not be limited to the matters stated in the Act. Entities should consider all of the resources and relationships which are necessary for an understanding of the development, performance or position of the entity's business. Such resources and relationships could include customers, suppliers, the entity's pension scheme and intellectual property;*
- *The key stakeholder relationships may be those set out in section 172(1), however, companies are encouraged to consider all relevant stakeholders in making the section 172(1) statement. In particular, companies are encouraged to consider disclosures regarding their relationships with pension schemes, pensioners and their entire workforce; and*
- *Principal risks should include, but are not necessarily limited to, those risks that could result in events or circumstances that might threaten the entity's business model, future performance, solvency or liquidity, or result in significant value erosion. In determining which risks are the principal risks, entities should consider the potential impact and probability of the related events or circumstances arising and the timescale over which they may occur'.*

The requirements seem quite clear, so as they are not generally being met, we consider that more specific guidance would assist in directing companies to the disclosures that would be appropriately informative to stakeholders, in this complex area, perhaps by way of examples.

We provide a fuller analysis in Appendix 2, 'Adequacy of Current Pension Disclosures'. While the research on which this is based was in relation largely to listed companies, the ECWG believes that the principles of transparency and disclosure are equally relevant to private companies where they have material DB exposure, not just in terms of the absolute deficit, but also in relation to cash allocation, risk and potential volatility over time.

We address suggestions for improvement to the company reporting regime in Appendix 3, 'Potential Improvements in Company Reporting on DB Pensions'. In summary the recommendation is that disclosures should explain how boards have assessed pension risks, how significant and likely adverse outcomes might be and how they are managing the cash/risk trade-off.

6. DO THE PRINCIPLES AND GUIDANCE TAKE SUFFICIENT ACCOUNT OF THE VARIOUS OWNERSHIP STRUCTURES OF PRIVATE COMPANIES, AND THE ROLE OF THE BOARD, SHAREHOLDERS AND SENIOR MANAGEMENT IN THESE STRUCTURES? IF NOT, HOW WOULD YOU REVISE THEM?

The principles are sufficiently flexible to be applied in most situations, providing they are applied diligently and in good faith. However, in our view, an there is an important structural issue in relation to the direct and indirect pension obligations of significant group subsidiaries on which more specific guidance would be beneficial.

Most guidance on DB disclosure relates to consolidated group positions, rather than individual group companies, at which level DB schemes may sometimes be treated for purposes of disclosure as DC. As with cross guarantees and security, exposure to DB liabilities and risks at the individual company level can be obscure and represent a threat, at that level, to directors and stakeholders who do not appreciate the full extent of 'off balance sheet' obligations.

Multi-employer DB schemes can be structured on a 'sectionalised' or 'last man standing' (**LMS**) basis. LMS is similar to joint and several guarantees, whereby all or any employers could theoretically be left with secondary liabilities up to the entire residual DB obligation in a group insolvency. Currently subsidiaries are not always required to disclose their individual DB exposure. The view of the ECWG against this backdrop is that while this may be unsatisfactory from the perspective of external stakeholders in individual companies, the analysis of primary liabilities can be complex, so pragmatically may not always be warranted for purposes of general disclosure. In such circumstances it may reasonably be left to the board of directors and individual stakeholders to exercise judgement and/or until financial distress becomes a clear and present danger. However, in our view the fact of undisclosed primary obligations and/or cross exposure of a scheme employer to indirect, secondary obligations should be noted within 'other obligations' in a similar way to debt obligations.

7. DO THE PRINCIPLES GIVE KEY SHAREHOLDERS SUFFICIENT VISIBILITY OF REMUNERATION STRUCTURES IN ORDER TO ASSESS HOW WORKFORCE PAY AND CONDITIONS HAVE BEEN TAKEN ACCOUNT IN SETTING DIRECTORS' REMUNERATION?

DB pensions are a form of deferred worker compensation. In our view the Principles could achieve this objective if applied diligently and in good faith, providing our recommendations on DB pension disclosure are adopted. We believe that while the Principles as presently expressed are sound, there is still scope for important governance issues to be missed, or obscured by those who are motivated to do so.

Director compensation packages and share ownership (particularly in private companies) often include incentivisation to maximise dividends. As set out above and in the Appendices, DB deficits may be addressed by cash contributions and/or by investment outperformance. High investment outperformance generally comes at the price of higher volatility and risk, so in some circumstances higher cash contributions and lower investment risk may be a safer and more appropriate route. At present DB accounting treatment and disclosures do not fully address risk and the longer-term dynamics of funding deficit recovery plans. As recent high-profile collapses have demonstrated, it is currently open to boards who wish to maximise

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cash flow for dividend purposes, to influence trustees to take more investment risk than companies can reasonably support, essentially 'betting the farm'. We believe adoption of our recommendations in Appendix 3, which would promote a robust and transparent approach to DB risk management, as well as enhancing the utility of financial statements, would help address this important governance issue.

8. SHOULD THE DRAFT PRINCIPLES BE MORE EXPLICIT IN ASKING COMPANIES TO DETAIL HOW THEIR STAKEHOLDER ENGAGEMENT HAS INFLUENCED DECISION-MAKING AT BOARD LEVEL?

If an approach is adopted along the lines suggested in Appendix 3, a natural consequence would be that the results of negotiations with DB scheme trustees would be disclosed or, if no recovery plan has been agreed, that fact would also have to be disclosed, together with details of any regulatory intervention.

9. DO THE PRINCIPLES ENABLE SUFFICIENT VISIBILITY OF A BOARD'S APPROACH TO STAKEHOLDER ENGAGEMENT?

Principle 4, Opportunity and Risk, provides that the responsibilities of boards include '*agreeing on how the principal risks should be managed or mitigated to reduce the likelihood of their incidence or magnitude of their impact; and establishing clear internal and external communication channels on the identification of risk factors*'. We fully agree with this but, as we have explained, DB issues can be complex and more specific guidance than is currently contained in the Principles would be beneficial to directing boards to helpful governance and other disclosures in this area.

If an approach is adopted along the lines suggested in Appendix 3, a natural consequence would be that the results of negotiations with DB scheme trustees would be disclosed or, if no recovery plan has been agreed, that fact would also have to be disclosed, together with details of any regulatory intervention.

10. DO YOU AGREE WITH AN 'APPLY AND EXPLAIN' APPROACH TO REPORTING AGAINST THE PRINCIPLES? IF NOT, WHAT IS A MORE SUITABLE METHOD OF REPORTING?

Yes, if approached diligently and in good faith and supported by robust monitoring of compliance. See the answer in section 11 below.

11. THE PRINCIPLES AND THE GUIDANCE ARE DESIGNED TO IMPROVE CORPORATE GOVERNANCE PRACTICE IN LARGE PRIVATE COMPANIES. WHAT APPROACH TO THE MONITORING OF THE APPLICATION OF THE PRINCIPLES AND GUIDANCE WOULD ENCOURAGE GOOD PRACTICE?

We consider that monitoring by the FRC along the lines adopted for listed companies (see https://www.frc.org.uk/directors/corporate-governance-and-stewardship/uk-corporate-governance-code) would be appropriate, particularly given that the Consultation is aimed at large private companies, which can be larger and have a more significant impact on the community than many listed companies.

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12. DO YOU THINK THAT THE CORRECT BALANCE HAS BEEN STRUCK BY THE PRINCIPLES BETWEEN REPORTING ON CORPORATE GOVERNANCE ARRANGEMENTS FOR UNLISTED VERSUS PUBLICLY LISTED COMPANIES?

Per the answer in section11 above, we see no distinction in the context of DB pensions between listed and large private company requirements. We believe that both listed and large private companies should adopt a more transparent approach to DB pension and related risk and governance disclosures and that both should be consistently and thoroughly monitored.

13. SUMMARY AND CONCLUSIONS

In summary the ECWG believes that current DB and related risk and governance disclosures do not fully meet the requirements of the Principles (or the GSR) and that more specific guidance would help address this. Where the funding of the pension scheme is critical to the viability of the company there should be a statement that the board has considered the viability of the scheme, on which the survival of the company is ultimately predicated, and explain how they have reached a robust conclusion on it. Here is an opportunity to significantly enhance information for the benefit of trustees and other users of financial statements.

In the view of the ECWG, the additional disclosures and commentary proposed in this document:

- While being more specific than presently proposed (which we believe is warranted in respect of material DB obligations), would be consistent with the Principles;
- Would provide a much clearer picture of the extent of pension risks over time and the likelihood of them materialising to all stakeholders, including trustees;
- Would demonstrate to stakeholders that management and the board of directors have a clear understanding of DB risks in absolute and relative terms and show how they have prioritised cash allocation and risk taking in this context;
- Would provide a platform for greater consistency of information;
- Would minimise the scope for surprise on adverse funding outcomes and/or poor corporate performance and help avoid strong 'knee-jerk', adverse reactions in the investor, creditor, media and political communities;
- Could help avoid dysfunctional corporate decision making, in that that the current narrow disclosure of the accounting deficit can be an obstacle to appropriate funding solutions and risk management because boards do not wish to be seen to be running an accounting 'surplus', which usually cannot be recorded on balance sheet and which may wrongly be seen by investors as suboptimal allocation of capital;
- Could help avoid dysfunctional corporate decision-making, where directors wish to act in self-interest by maximising dividends (and therefore their compensation or their returns as shareholders) at the risk of potentially unmanageable pension funding outcomes;
- Would help bring large private company governance and reporting into line with the requirements of the pensions regulatory regime;

- Would help bring large private company reporting into line with the requirements of the Guidance on the Strategic Report;
- Should not add significantly to costs as leading practice requires that the data should usually be generated for scheme valuations and monitoring in any case.

We welcome the opportunity to present our thoughts on this important matter and would be pleased to discuss the proposals in this document and contribute to any ongoing debate.

APPENDICES

1. EMPLOYER COVENANT, HOW IT IS ASSESSED AND HOW THE ASSESSMENTS ARE USED

In the view of the ECWG, while company financial statements are an important source of information for trustees and other stakeholders on the financial position and prospects of companies, the current pensions disclosure requirements do not provide sufficient information for trustees to appropriately understand corporate risks or for other stakeholders to understand the impact material schemes can have on their sponsoring companies. In large part this is because disclosures do not currently reflect the UK DB funding regime, which imposes significant governance, cash allocation and risk management requirements. The employer covenant (i.e. the long-term credit risk in the sponsor) informs scheme funding and investment decisions and in this appendix, we explain how the regime operates.

The POCA document sets this out in some detail but in summary:

Employer covenant is defined in the pensions Regulator's CoP3 as representing 'the extent of the employer's legal obligation and financial ability to support the scheme now and in the future'.

CoP3 has the following to say about understanding risks over time:

'Trustees should seek to understand the risks across the employer covenant, investment and funding strands. In particular trustees should understand the extent of the scheme's reliance on the employer covenant over time on the basis of a range of plausible future scenarios. These scenarios should capture investment risk, the impact of potential or actual maturing of the scheme and the impact of the contribution patterns which are proposed for the scheme (and the risks to those contribution patterns) compared to the employer covenant available under various scenarios. This is because the employer underwrites both the short- and long-term risks to which a scheme is exposed.'

When analysing the strength of a sponsoring employer's covenant, we are primarily concerned with its ability to deposit cash (or other assets) into the scheme, as and when it is required. This may include:

- payment of contributions for benefit accrual;
- making good any shortfall of assets relative to liabilities calculated on the appropriate basis (funding deficit); and
- making good any further funding shortfall resulting from any downside experience in a scheme's agreed investment strategy.

At a high level, assessments should enable trustees to form an objective view on the ability of the sponsoring employers to meet schemes' demands for cash, now and in the future where there are competing demands for finite cash resources. A proportionate analysis therefore should include:

- Identification of the legal obligations;
- Consideration of the employer's ability to generate cash:
    - immediately (availability of liquid assets/finance);
    - in the short to medium term (trading/cash flow analysis);
    - in the longer term (market analysis); and

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- in the event of distress (structural priority and/or insolvency analysis).

Practitioners typically express the results of their evaluations through some sort of valuation methodology or rating scale.

In the pensions regulatory framework, employer covenant is inherently linked through 'Integrated Scheme Funding' to both investment strategy and the valuation of liabilities, and consequently any surplus or deficit. When considering investment and funding strategies, trustees and employers should consider the relative risks and rewards of different options. The assessment of employer covenant underpins decisions on the level of risk that it is appropriate to take, as it informs an assessment of the ability of the employer to underwrite downside experience. It is important to both trustees and corporates to achieve funding strategies in which the key risks of covenant, investment and funding are compatible with one another, reflecting risk appetite and subject to risk capacity. The level of risk that is ultimately appropriate to accept in any funding or investment strategy is therefore a function of the reward inherent in that strategy and the ability of the employer covenant to underwrite the risks. In general terms, however:

- A stronger covenant would typically allow more flexibility in determining appropriate investment and funding strategies, as the covenant would be sufficiently strong to repair any downside experience over a reasonable period.
- A weaker covenant would typically limit the appropriateness of riskier, high return-seeking strategies, as the employer may not be able to repair downside experience over a reasonable period.

Therefore, covenant strength is assessed not just in relation to the size of the funding deficit at any given time but also the overall risks in the scheme relative to the employer and how these may play out over time, which can be critical to the assessment of future corporate viability for all stakeholders. This is because, while schemes themselves are rarely, directly the sole triggers for corporate insolvency, they can act as an impediment to raising the capital required to maintain and grow business operations.

The above summarises leading practice however it is important to recognise that in the experience of ECWG members it is not universally adopted. There is a range of potential reasons for this, including:

- There is a learning curve for corporates, trustees and advisors in adopting leading practice – enhancing corporate reporting and governance requirements could help address this;
- There can be a concern that output from the analysis may expose inconvenient truths and be unwelcome - cost can be used to rationalise non-compliance;
- The cost of the analysis may not always actually be proportionate to the absolute and potential exposure, which may (rarely) be immaterial.

While analysis needs to be proportionate to the circumstances, the ECWG believes that it would generally benefit trustees and other users of financial statements for corporate reporting on material DB pension obligations and governance to reflect the practical requirements of the pensions regulatory framework, which would bring reporting into line with the GSR.

2. ADEQUACY OF CURRENT PENSION DISCLOSURES

The Act provides that '*the strategic report should provide shareholders of the company with information that will enable them to assess how the directors have performed their duty to promote the success of the company for the benefit of shareholders as a whole, while having regard to the matters set out in section 172*'.

Main content-related objectives include:

- to describe the principal risks the entity faces and how they might affect its future prospects;
- to provide information to enable shareholders to assess how directors have had regard to stakeholders and other matters when performing their duty under section 172.

The strategic report should therefore address material DB pension obligations, risk and governance, and below we address current practice. The CRTR cites examples of good practice regarding DB pensions disclosures in the following relevant areas:

- Funding in future years
- Maturity profile of obligation
- Investment strategy risks
- Net pension assets
- Disaggregation of plan assets
- Valuation methodology for unquoted assets
- Principal risks and uncertainties (presented in the strategic report)

To illustrate how far the disclosures go, extracts from 'helpful examples' of disclosures include:

- 'Small adjustments to the assumptions used to calculate the pension liability, or significant swings in bond yields or stock markets, can have a large impact in absolute terms on the net assets of the Company and Group. A decrease in the discount rate by 0.25% per annum (i.e. 2.60% to 2.35%) would increase the Scheme liabilities by 3.50% i.e. £7.331 million. An increase in the rate of inflation by 0.25% per annum (i.e. 2.35% to 2.60%) would increase the Scheme liabilities by 1.90% i.e. £3.980 million. An increase in life expectancy of 1 year would increase the Scheme liabilities by 3.3% i.e. £6.912 million.' (Carclo)
- 'If there's an increase in the pension deficit at the next valuation date, we may have to increase deficit payments into the Scheme. Higher deficit payments could mean less money available to invest, pay out as dividends or repay debt as it matures, which could in turn affect our share price and credit rating.' (BT)
- 'Accounting standards require all companies to assume their pension fund grows at a standard rate reflecting a relatively low level of risk. We take slightly more risk in our pension scheme, increasing the potential fund growth, and helping to keep the overall costs lower. We are able to take this risk because of the strength of our business. Generally, because of how our fund is invested the accounting deficit will be higher than the actuarial deficit.' (John Lewis)

In the view of the ECWG, while these disclosures are helpful as far as they go and represent positive developments in company reporting, there is arguably a number of further improvements that might be made by reference to the requirements of GSR and the Principles, particularly Principle 4, Opportunity and Risk:

- While Carclo provides some quantification of the risks to which it is exposed, no context is offered on the relative significance of the risks, the likelihood of them materialising or, if they did, on how, explicitly, they might impact the company's cash allocation and risk management priorities.
- In its strategic report, BT provides a bland and rather obvious statement on the potential consequences of downside risk materialising but no quantification of how likely the downside scenarios are or how significant they might be, which could have been achieved by a commentary on the sensitivities disclosed in the helpful pensions note to the financial statements. The note includes an analysis of the impact on the £6.4bn accounting deficit of three, individual 1 in 20-year events occurring. These are material and arguably warrant greater prominence given that, per the 2018 annual report:
    - They are respectively £2.9bn (discount rate, including countervailing investment volatility), £1.3bn (inflation rate) and £2.1bn (longevity) and may occur cumulatively;
    - Net assets were £10.3bn (including £17bn of intangibles);
    - Pension benefits are forecast to remain in payment for over 60 years;
    - The latest (June 2017) scheme funding deficit, which drives cash contributions, was £4.9bn larger than the accounting deficit at £11.3bn.

  It might also have been helpful to have included an analysis of investment volatility and an indication of how all four sensitivities might impact the more relevant funding deficit.

- John Lewis asserts that it is able to underwrite the risks in its investments strategy. Elsewhere in the annual report they set out a sensitivity analysis and state that 'the work that we've done over the past year has really reduced the risk and means that we'll have a much more affordable pension scheme and the cost will be less volatile for us in the future'. However, while they set out relative sensitivities they do not provide a clear statement on the likelihood or absolute extent of the inherent risks that might materialise.

While 'boiler plate' reporting is discouraged, the CRTR highlights considerable latitude and inconsistency in pensions risk and governance reporting. In the ECWG's view there is a case here for being somewhat more prescriptive because it would help direct corporates to the type of disclosure that is helpful and would also help avoid boards being concerned about highlighting their own pensions issues when others are not required to.

Furthermore, in the experience of ECWG members, the current narrow accounting disclosures can give rise to corporate decision making which can be incongruent with the needs of the pension scheme and other stakeholders. The accounting deficit can be an obstacle to appropriate funding solutions and risk management because boards sometimes do not wish to be seen to be running an accounting 'surplus', which usually cannot be recorded on balance sheet and which may wrongly be seen by investors as suboptimal allocation of capital. An example of this view is a statement made in GKN's defence of the hostile Melrose takeover: 'Melrose's plan to contribute up to £1 billion into the UK schemes would create potential value leakage of more than £300 million, given the UK schemes' IAS

19 deficit of £674 million' (20 March 2018 - Statement re pension schemes – original statement removed but verifiable by the FT: https://markets.ft.com/data/announce/full?dockey=1323-13577764-59P1JTKEQTPQPAO2IK7JNF9BK7).

The CRTR also states that '*we were pleased to see that where the amount of the deficit was significant to the balance sheet, a small number of companies referred to the funding of the pension scheme as one of the key assumptions used in the projections for the viability statement*'. While there are no proposals of which we are aware to make the Viability Statement a requirement for large private companies, the Strategic Report is a requirement and the GSR is clear that *'entities should consider the potential impact and probability of the related events or circumstances arising and the timescale over which they may occur'*. In the view of the ECWG the requirements of the Consultation bring into play funding and governance of pension schemes on which there should be a statement that the board understands the interdependencies of the scheme and the company and has considered the viability of the scheme, on which the going concern assumption (in the long term) is predicated; the board should then explain how they have reached a robust conclusion on the viability of both aspects.

We set out in Appendix 3 below some thoughts on how pensions risk reporting might be improved in terms of quantification and consistency.

3. POTENTIAL IMPROVEMENTS IN COMPANY REPORTING ON DB PENSIONS

While generally already known to trustees, there are some relatively straightforward additional disclosures that would be useful to other users of accounts and which could be adopted as best practice. At present disclosure of the accounting deficit is required as a consistent measure between companies but it is otherwise largely academic in a pensions funding context (other than insofar as it can be an obstacle to companies funding schemes to an appropriate level to avoid creating an accounting 'surplus').

The deficit that ultimately drives cash allocation is the ongoing funding deficit, as required by pensions legislation, so this is a key consideration and should ideally be disclosed together with the details of the recovery plan in a similar way to contractual payment obligations for leases. The company may also wish to provide some balance by disclosing the neutral valuation (or 'expected outcome'), although because this is not a prudent basis, guidance on disclosure need not be directive.

Also, the s75 (buy-out) deficit is the relevant measure on employer insolvency or other scheme termination event. Both of these measures are readily available outputs from the scheme funding process but at present are not generally disclosed. While they are not always immediately relevant in a going concern situation, in circumstances where they become relevant and are then disclosed, stakeholder communities can react with surprise, possibly 'adding fuel to the fire'. In the ECWG's view minimising the scope for surprise is desirable and making such disclosures as a matter of course could help achieve this.

Moving on to perhaps more novel proposals, there are potentially significant improvements that could be made in the disclosure of scheme risks over time. In the experience of ECWG members and as recent high-profile collapses have shown, companies can prioritise the allocation of their cash resources inappropriately, forcing trustees to take on higher investment risk than is safe in order to address the deficit, essentially 'betting the farm'. It is not always apparent to us that management either understands the extent of the risks this generates, or notwithstanding s172 of the Companies Act, are adequately focused on it due to the long time-frames over which they might materialise. We therefore consider that improvements in disclosure would be beneficial, in particular to highlight the cash/risk trade-off.

There is a significant amount of information on DB risk generated during scheme valuations and in intra-valuation monitoring, which could be used to enhance corporate disclosures, including data from integrated risk management (**IRM**).

IRM is the concept of looking at DB pensions financial risk 'in the round' and understanding who takes what risk over what period and what can be done to manage and mitigate it. In its December 2015 Regulatory Guidance TPR describes IRM as a risk management tool, a method that brings together the identified risks that a pension scheme and its employer face to see what relationships there are between them. The three fundamental risks to DB schemes are grouped in terms of employer covenant, investment and funding; IRM investigates the inter-relationships between these risks and seeks to understand how risk in one might affect the others and how these risks might be mitigated and managed.

There is a range of metrics to be applied when considering investment risk, depending on the asset classes. This is a highly specialist area in which companies need to work closely with investment professionals.

For example, while it is not the only tool available, a commonly used measure of investment risk presented by a portfolio of assets is 'Value at Risk' (**VaR**), which looks at the potential change in value of an asset or portfolio over a defined period for a given confidence level. So 'one-year VaR95 of £10m' means that there is a 5% (or one in 20 year event) chance of the value of the asset in question deteriorating (or improving) by £10m in value over a one-year period.

A common approach is to compare (say) 1 or 3-year VaR with a measure of the ability of the sponsor to repair a negative VaR outcome through additional contributions or assets over a reasonable time period.

VaR is sometimes also applied to give a measure of the potential change in funding deficit (i.e. looking at all risks rather than just investment risk). The likelihood of the scheme reaching defined funding target levels over a pre-agreed period itself depends on a range of variables:

- the chosen funding target(s) and assumptions behind the targets (Technical Provisions, PPF s179, self-sufficiency, solvency) including those affecting the liabilities, such as mortality and the benefit structure; and
- the time period to reach the agreed funding target(s) and likely re-setting of these through the triennial valuations.

These are inherently bound up with the assumptions in the investment strategies adopted in order to reach these targets and the underlying covenant strength required to underwrite them.

Using such data, a statement on risk and viability, which in the view of the ECWG would be consistent with promoting the Principles, meet the requirements of the GSR that *'entities should consider the potential impact and probability of the related events or circumstances arising and the timescale over which they may occur'* and be more helpful to users of financial statements than current reporting requirements, might be along the lines of:

'Per note [x] to the financial statements, the Company has significant pension obligations. [The neutral deficit (or 'expected outcome') is £x, however] consistent with UK law the Company has agreed* a recovery plan with the Scheme Trustees to address the scheme funding deficit of £y over [n] years from [date], the date of the latest triennial valuation. At the end of this period it is expected that the Scheme will be [self-sufficient/remain reliant on the company to underwrite scheme risks], including investment, interest rate, inflation and longevity risks. Until the Scheme is fully funded and de-risked to self-sufficiency or bought out, the Company is expected to be exposed to volatility as actual experience may not match the valuation assumptions adopted. The Board has considered the extent of this potential volatility and has formed the view that the extent of the downside risks arising from the Scheme and its funding and investment strategies is [manageable through the balanced recovery plan agreed with the trustees/represent a threat to the viability of the Company]. In reaching this conclusion the Board has considered a range of data and plausible scenarios for investment volatility including, for example, three-year VaR 95. In a one in 20 year down side event, the deficit could increase by more than £x. While investment values may recover and addressing the increased deficit would be a matter of negotiation with the scheme trustees, illustratively, this could add [y] years to the recovery plan, assuming a consistent level of contributions. Alternatively, if the length of the recovery plan was to be maintained, contributions would have to be increased by £[z] per annum with effect from the next valuation on [date], which in the opinion of the Board the Company could [accommodate/not afford] while meeting other priorities for cash allocation.'

*If there has been a failure to agree a recovery plan this fact should be disclosed together with the background on the reasons and amounts in dispute and on any regulatory intervention (by way of example see disclosures by Coats Group - http://www.coats.com/index.asp?pageid=84&year=2017).

The above statement is intended to be directional, not prescriptive and would need to be tailored to the specific circumstances.

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