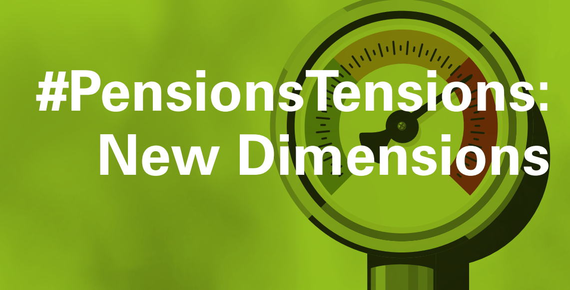


#PensionsTensions: New Dimensions

Part Two: Funding and Investments

Introduction

Welcome to the latest phase of our #PensionsTensions campaign, exploring the current challenges faced by trustees and sponsoring employers of occupational pension schemes. Effective risk management is undoubtedly the key to running a pension scheme well and is the dominant theme in The Pensions Regulator's (TPR's) draft single code of practice. Each factsheet in this series sets out our top "red risks", as well as some mitigation tips and a #PressureMeasure that shows whether we think the pressure on trustees and sponsoring employers is increasing or decreasing. Each factsheet assumes that there is an established risk management system on which additional measures can be built. Don't forget to check our time-saving tip!

In this factsheet, we examine the risks associated with funding and investments, focusing on the issues that do not neatly fall within TPR's integrated risk management framework.

Comment

The Pension Schemes Act 2021 (PSA21) introduces a requirement for trustees to have a long-term funding and investment strategy and agree it with the scheme sponsor. How those strategies are set and how they evolve will almost certainly be another source of #PensionsTensions.

Scheme Funding

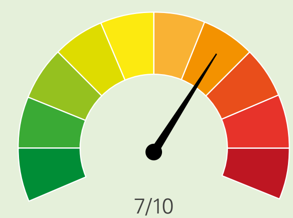
Schemes that do not already have a secondary or longer-term funding objective will need to set themselves targets, whether that be self-sufficiency, buyout or consolidation. This will add an extra dimension to actuarial valuation discussions and allowance should be made in the timetable to reduce the risk of coming up against statutory deadlines.

A number of schemes will already have been planning their endgames for some time. As schemes reach greater maturity and interest rates nudge upwards, there may be incentive for sponsors to increase the pace of funding; and there is even a possibility that trustees may face requests by sponsors to mitigate the risk of significant scheme overfunding. Trustees will need to assess their powers carefully in that scenario, and be mindful that the situations in which surplus assets may be returned to the scheme sponsor, especially if a scheme is not yet winding up, are limited. Both trustees and sponsors would also need to bear in mind the optics of such payments in the eyes of the scheme membership and more widely.

At the other end of the spectrum, schemes that are currently underfunded will be closely monitoring the sponsor's covenant in the second half of 2021. The phased withdrawal of UK government financial support measures is widely expected to reverse the current trend, which has seen falling numbers of corporate insolvencies. Sponsors may wish to explore putting in place contingent assets or the use of escrow accounts as a means of contingent funding. Trustees faced with such requests should ensure they understand the mechanics of the proposed arrangements and take legal advice on the protection it would offer in the event of the sponsor's insolvency.

Tensions remain high for schemes with liabilities linked to the retail prices index (RPI). These schemes will need to plan for the alignment of RPI with CPIH by 2030. The possibility of legal challenge to the decision by a number of large pension schemes means that schemes that retain sensitivities to RPI might be advised to wait until the law is clarified one way or another before making significant changes to the corresponding assumptions used for funding purposes.

#PressureMeasure: Funding and Investments



"Funding and investment will remain under the spotlight in the year ahead, but may be overshadowed by other emerging issues."

Investment Issues

The PSA21 contains new requirements on trustees to have governance processes in place that address climate change risks and opportunities in their investment portfolio and to disclose the steps they are taking. The draft regulations only apply, however, to the largest schemes, so there is a source of tension for smaller schemes (with assets below £1 billion) as to how much to embrace the political direction of travel. Trustees faced with competing time and resource pressures will need to strike a very difficult balance between desires to be best in class in addressing ESG issues and making sure they meet the minimum statutory and regulatory expectations in all other respects. Trustees should also consider the extent to which their approach can and should be aligned to that taken by the scheme sponsor; and the risks to the sponsor's own covenant in which ESG issues might raise.

Since the very strong recovery in equity markets that gathered momentum in the second half of 2020, it is tempting to think that investment performance can only ever go up. However, trustees risk taking their eye off the operational risks that their managers are running in whatever market conditions. Those issues include whether it is clear from the documentation the extent of trustees' rights in any rapidly developing downside scenario (such as poor fund performance, investment manager collapse, market failure or consequences of a cyber breach). Even if there is contractual protection, is the fund provider's insurance cover sufficient to provide protection when it is needed most?

Trustees who delegate to fiduciary managers are efficiently mitigating operational risk, but this comes with its own obligations in terms of complying with the CMA Order and managing delegates appropriately.

For many years, the existence of charge caps has been an irreconcilable barrier to defined contribution (DC) schemes wishing to include illiquid assets within their default arrangements. As we highlighted in our #PensionsTensions campaign in 2020, there is further incentive for the UK government to find a solution in order to support its intentions for economic recovery following the COVID-19 pandemic. This has led to consultations in 2021 by the Department for Work and Pensions (on incorporating performance fees within the charge cap) and the FCA (on lifting the cap on illiquid assets that can be held by DC default arrangements). Trustees of DC schemes will be watching developments carefully; and a number may, at the same time, be dealing with the consequences of illiquid investments in self-select funds, following the gating of some property funds during the early stages of the pandemic.

Red Risk Flags

- Have recent actuarial valuation discussions been completed close to (or after) the statutory deadline?
- Would the trustees currently have access to any security or assets on the insolvency of the scheme sponsor?
- Do the approaches of the trustee and sponsor align in relation to ESG issues and is there an open dialogue on the risks faced by the scheme sponsor?
- Are the trustees carrying out proper due diligence checks on their investment managers, even when performance is good?

Mitigation Tips

- Early engagement between trustees and sponsors on journey planning for the scheme will help create a more closely aligned approach to funding discussions.
- Contingent assets, escrow or other funding arrangements that are backed by legally enforceable terms will increase security for the scheme in the event of sponsor insolvency.
- Consider whether ESG obligations could be tackled by a sub-committee in order to manage resources; and identify what advice or other support is needed to ensure trustees can comply.
- Review investment documentation to ensure trustees are suitably protected.

What the regulator says

"It is important for trustees and employers to work together to manage the immediate impact of COVID-19, but they should also make sure they retain a focus on the long term – most specifically around planning and risk management." (TPR annual funding statement, April 2020)

Time-saving tip

Establishing a forum for ongoing discussion between trustees and the scheme's sponsoring employer in relation to long-term strategy can reduce tensions around the actuarial valuation deadline. Avoiding a last minute panic is not only likely to reduce stress levels and costs, but result in a better outcome for the scheme.

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