

Dalriada Trustees – Industry Changes

Your Quarterly Pensions Update

Q1 2018

Dalriada. *A better way*

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Introduction

The purpose of this report is to provide an update for pension scheme sponsors and trustees on recent industry changes in the quarter.

For your convenience, we have summarised the key developments and highlighted the necessary actions sponsors and trustees may need to take.

We also include links to further relevant information and any deadlines you should be aware of.

We trust you will find the update useful and informative. If you require further information about how any of the topics covered might impact on your scheme specifically, please get in touch with Adrian Kennett, adrian_kennett@dalriadatrustees.co.uk or your usual Dalriada contact.

NOTE

This document is aimed at providing you with generic information about recent developments in the pensions industry.

You should not take any action as a result of information included in this document without seeking specific advice in relation to the impact these matters might have on your scheme or company. Dalriada Trustees Limited accepts no liability for actions taken or not taken as a result of this document.

Recent Corporate Failures Drive Regulator's Annual Address

It did not take Holmes-ian powers of deduction to pick up the influence of recent corporate failures in the Pensions Regulator's annual funding statement that was issued on 5 April.

The annual "state of the nation" address on funding of Defined Benefit Pension Schemes made clear the disquiet from the Regulator that dividend payments were increasing but deficit contributions were not. The statement stresses the need for trustees to ensure "fairness" for their schemes relative to corporate shareholders/stakeholders. Where employers are strong, trustees should be "looking to fix the roof while the sun is shining" if you like. The Regulator has (pleasingly) avoided the temptation to try and fix parameters against which trustees should judge fairness. The current regime is founded on flexibility and we do hope this continues. Recent implications (in the Government's White Paper) that greater direction/restriction is coming leads us to fear a return to the days of a set Minimum Funding Requirement. The last attempt at MFR didn't work and was quickly swept aside. We suspect that any attempt to turn back the clock on this would meet a similar fate.

There was also a reminder that dividends are not the only target, with the introduction of what might become a buzz-phrase – "covenant leakage". This is really a catch-all phrase to describe any route by which the security of the scheme's position is damaged by corporate activity. For me, this points strongly towards trustees drawing up and monitoring some key indicators to monitor company performance and company strength and take action to prevent deterioration or react swiftly if there is a change. And remember, it can be just as important for trustees to react when their sponsor's position improves, allowing the scheme to share in this success and put their scheme on to a stronger footing.

The statement contained further "hints" that some trustee boards are not sufficiently well-equipped to tackle complex funding and investment issues. Trustees are expected to seek appropriate advice, especially where the board does not have the sufficient expertise or where potential conflicts exist.

Many other themes in the 2018 statement were follow-ons from 2017, such as the prominence given to the importance of contingency planning.

Recent Corporate Failures Drive Regulator's Annual Address Continued...



Helpful Links:

- <http://www.thepensionsregulator.gov.uk/press/trustees-must-treat-scheme-members-fairly-tpr-warns.aspx>

ACTION

Trustees and Companies should familiarise themselves with the themes of the funding statement and take action/ advice as appropriate. The Regulator has indicated that it will be more proactive, quicker to act and tougher on those who fail to act in members' interests.

DC Consolidation Aided by Upcoming Simplifications

It has been clear for some time that the Government and Regulators are very much in favour of consolidation in the world of Defined Contribution Occupational Schemes. To help oil the wheels of consolidation and to direct traffic towards authorised mastertrusts, some simplifications have been introduced with effect from 6 April 2018.

Firstly, trustees will be able to make the “investment” decision to transfer to an authorised mastertrust or a “connected” scheme without taking independent advice. This makes the process simpler but it is difficult to imagine that the majority of trustees will take such a step without some form of advice. So, in reality, we might not see much change here.

Where advice is required, the advisor will still need to be independent from the receiving arrangement. However, the test for independence has been relaxed somewhat. Previously, the adviser must not have provided advisory, administration or investment services to the receiving scheme or employer in the past five years – the “time-bar” on this will reduce to one year.

Up until now, one of the biggest nuisances with DC to DC transfers has been the requirement for trustees to obtain actuarial certification to permit the transfer. This requirement appears to be a hangover from the rules governing DB to DB bulk transfers and was never really “fit for purpose” in the DC to DC arena. Often, the DC scheme had no actuarial involvement and so an actuary was being called from the sidelines to answer questions that could easily be addressed by existing advisors or the trustees themselves. Pleasingly, this anomaly will be removed, albeit only from October 2019. We would have thought this requirement could have been dispensed with more quickly.

ACTION

Trustees and Employers should now review their DC benefit provision in the light of these changes to ascertain whether a more optimal governance structure is now achievable.

GDPR Compliance

The General Data Protection Regulations (“GDPR”) come into force on 25 May 2018. As Data Controllers, trustees (and employers) must not only comply with the new rules but must also be able to demonstrate this compliance. This includes setting a formal Data Protection Policy and (normally) notifying scheme members of the arrangements in force by 25 May. Trustees must also implement appropriate processing policies, storage arrangements and security measures and regularly test or review their effectiveness where appropriate.

Many schemes will already have robust arrangements in place to protect data and few, if any, schemes will be storing or using member data at all contentiously. Members will surely understand that the trustees need to keep their details to pay the benefits due so there shouldn't be any significant trouble for pension schemes from these new regulations. However, trustees do need to document their policies and procedures and should take the opportunity to identify and plug any gaps, as well as enhancing their data protection to current standards.

The Information Commissioner's Office (ICO) has also said that they don't expect to levy any fines on 26 May, probably just to give people time to complete their compliance efforts but perhaps partly because they're busy with Cambridge Analytica and Facebook at the moment. There will therefore still be a chance for improving data protection on an ongoing basis even after the new rules come into force and it will be important for Data Controllers to keep an eye on evolving guidance to make sure their policies and procedures remain fit for purpose in an ever-changing world.



Helpful Links:

- <https://ico.org.uk/media/1624219/preparing-for-the-gdpr-12-steps.pdf>
- <https://ico.org.uk/for-organisations/guide-to-the-general-data-protection-regulation-gdpr/>

ACTION

Trustees and employers should review the Regulator's 21st Century Trusteeship programme and consider whether their approach towards governance and trusteeship is of a high enough standard and what improvements, if any, could be made.

Reviewing your Currency “Hedge”

In the aftermath of the Brexit referendum, many pension schemes benefited considerably by a lack of currency hedging. Potentially in isolation though, as many other Brexit-related factors have negatively impacted funding levels. The depreciating pound meant that overseas equities which were not hedged against sterling gained around 7%-8% on currency movement alone. The majority of this can be attributed to the dollar movement.

This tended to be due to a lack of proactive advice, rather than a tactical masterstroke, as many schemes historically have not really thought about currency hedging. More recently however, the majority of investment advisers have brought currency hedging to the table, and if they haven't they should be. The argument being that the 7-8% gain would be lost should the pound dollar rate revert to more long term levels. With the Brexit uncertainty, the general feeling was to hedge your bets, and to implement a 50% currency hedge. Or hedge your hedge, so to speak!

This conversation should not be limited to passive equity mandates. The currency movement will have also impacted Diversified Growth Funds ('DGFs') who have made good or bad tactical calls. It is important that trustees understand how their DGFs are positioned, and test the benefit (or not) of the active management.

ACTION

- Check if your dollar hedge decision remains appropriate. Especially if you have made a short term call.
- Check if you have set your hedge to rebalance, or are you in a blended fund which naturally rebalances. If the answer to both is no, then your original hedge will now undoubtedly have moved as the hedged allocation protects against the currency movement. If you fail to rebalance this, and sterling depreciates, you will potentially lose recent gains.

Investment Topic Updates – Competition & Markets Authority (CMA) – Investment Consultants Market Investigation

As part of the Competition & Markets Authority's (CMA) investigation into whether investment consultants provide value for money, various working papers were published in March 2018 regarding the information provided by consultants on fees and quality, and asset manager product recommendations.

The papers state that currently trustees are not provided with the necessary information to judge if their investment consultants or fiduciary managers provide value for money. The potential competition concern is that trustees are not able to appropriately choose, nor monitor the performance of, their advisor, and as a result cannot drive competition between them. This means that trustees tend to remain with one consultant and do not change even if there are cheaper alternatives.

To reduce this problem the CMA suggests providing guidance or minimum standards to help trustees determine value for money, meaning requirements could be set such as standardised performance metrics and fee reporting. The CMA also mentions that information on fees needs to be improved for tenders as it can be difficult for trustees to compare different offerings. A potential solution could be using off-the-shelf materials for running better tenders, in addition to template documents including the aforementioned standardisation.

The CMA also conducted research into asset manager product recommendations on a sample of investment consultants and on a limited number of funds, and found that investment products rated 'Buy' by investment consultants generally do not outperform their benchmark net of fees; these are consistent with findings from a previous FCA report. Trustees need to be wary of potentially misleading claims from investment consultants that their manager research process adds excessive value, and they should also remember that asset allocation is what drives most of the returns, not manager selection.

We welcome the CMA review and are looking forward to the final conclusion next year; we feel that the outcome will result in a better service for clients and increase the quality of investment consultants and fiduciary managers.

Investment Topic Updates – Competition & Markets Authority (CMA) – Investment Consultants Market Investigation Continued...



Helpful Links:

- <https://assets.publishing.service.gov.uk/media/5a96db4ae5274a5b87c30054/icm-information-on-fees-and-quality.pdf>
- <https://assets.publishing.service.gov.uk/media/5ab38614e5274a3dc898e294/asset-manager-product-recommendations.pdf>
- <https://www.gov.uk/cma-cases/investment-consultants-market-investigation>

ACTION

Ensure your advisor or fiduciary manager provides a full break down of costs and fees. When tendering for a new advisor or fiduciary manager try to make fees as comparable as possible.

EIOPA Market Development Report 2017

EIOPA (European Insurance and Occupational Pensions Authority) is the EU's insurance and pensions regulator. As part of its remit, it annually monitors the development of the pensions sector throughout Europe. This year's report has recently been published, and there are four key points to take away from it:

1. Pension scheme membership continues to increase

EIOPA's data for the increase in pension scheme membership unfortunately excludes the UK and France due to lack of data. But the UK has seen an increase in pension scheme membership over recent years due to auto-enrolment. The total funds held in pension schemes across Europe fell slightly to €3.8 trillion with the main reason being changes in the Euro/GBP exchange rate.

2. There continues to be a shift from Defined Benefit towards Defined Contribution schemes

The shift from DB to DC schemes means that pension scheme members bear a larger share of the risks of funding for their retirement including investment risk and longevity risk. Also coinciding with this shift to DC schemes is a trend of lower overall contribution rates which could impact on income in retirement. Because of this it is important to ensure that members are adequately informed about their benefits including the risks that they bear and the costs and charges involved.

3. Growth in the number of Cross Border workplace pension schemes continues to stagnate

The growth in the number of cross border pension schemes (Institutes for Occupational Retirement Provision, or IORPs for short) has stalled since 2010, with sponsors, cross-border practitioners, social partners and academics pointing out that any further increases should not be expected. The main reason for this is that the legal framework for the protection of pension scheme members is set at a national level and the complexity of managing a number of these frameworks increase operational risks and costs for IORPs.

EIOPA Market Development Report 2017 Continued...

4. Multi-employer Cross Border IORPS have expanded

There are two key reasons for this expansion: 1. More IORPs are expanding their activities in additional host countries and 2. Service providers are establishing more cross border IORPS to attract multiple unconnected employers. EIOPA is reviewing ways to improve procedural transparency and efficiency for these funds. It also notes that the increasing trend towards IORPs comprising unrelated employers breaks the traditional mould of DB pension schemes being established by a sponsor (or group of sponsors) for their employees. This development should be monitored from a supervisory perspective as it may impact on the governance and management of IORPs.

Ultimately, it's a positive sign that more pension are saving into workplace pension schemes, however the trend towards lower average contribution rates raises the question about whether the amount people are saving will provide them with an adequate pension. With this in mind, we feel that it is important that members of DC funds are kept fully engaged and informed about their likely pension when they come to retire and how changing contribution rates will affect this.



Helpful Links:

- <https://eiopa.europa.eu/Pages/News/EIOPA-publishes-its-2017-Market-Development-Report-on-Occupational-Pensions-and-Cross-border-Institutions-for-Occupational-.aspx>

ACTION

Review communications to DC scheme members to ensure that they are properly informed of their potential pensions outcomes pension along with the charges and risks involved.

Security & Sustainability of DB Pension Schemes

Last year, we reported on the Green Paper issued by the DWP on the future of defined benefit schemes. Now, over a year since the initial consultation began, the DWP has (finally!) released its White Paper outlining the changes it hopes will bring about improved protection for DB schemes and their members.

In our response to the initial Green Paper, we agreed with the Government that there was no systematic problem in the industry and indeed they have concluded now that the existing system works well for the majority of schemes. However, they believe a tougher approach is needed to protect scheme members against “unscrupulous sponsoring employers”. The White Paper proposes a tougher approach amongst other changes. Legislation is required in some areas, so more consultations will follow throughout 2018 and 2019. However, below are the key aspects of the Paper.

The Regulator’s New Powers

To better protect scheme members from employers who don’t play by the rules, the Government has confirmed it will:

- Impose punitive fines on company directors who deliberately put their scheme at risk and make it a criminal offence for them to commit ‘reckless behaviour’. What this behaviour involves is still to be clarified.
- Strengthen the notifiable event framework so the Regulator is notified of certain events in advance.
- Require employers to consult with trustees and make a ‘statement of intent’ confirming they have appropriately considered possible effects of business transactions on the scheme and how any detrimental impact will be mitigated.
- Increase the Regulator’s information gathering powers, to allow for more efficient and effective investigations.

As you might expect, the Regulator has welcomed these new powers!

Security & Sustainability of DB Pension Schemes Continued...

Improving Scheme Funding

The Government has recognised concerns that in some cases, technical provisions are not set 'prudently' enough to ensure the long term funding of the scheme. Prudence is a subjective concept and the lack of any clear meaning in legislation allows trustees to view their scheme with only a short term outlook, when in reality a long term one is needed. The Government's solution is to commit the Regulator to revise its Code on Scheme Funding, focusing on:

- How prudence is demonstrated
- Appropriate factors to consider when determining recovery plans
- A long term view when setting the statutory funding objective.

We expect the Government to legislate at the earliest opportunity so as to ensure compliance from trustees and employers. The new code could have a significant impact on some schemes and not necessarily just those with 'unscrupulous employers'.

Trustees of final salary schemes will also be required to submit a Chair's Statement to the Regulator, alongside each triennial valuation, detailing their approach to the scheme funding objective.

Consolidation

The Government has long believed that there are material financial benefits for smaller schemes through scheme consolidation. Levels of governance, flexibility and the ability to benefit from economies of scale are lower in smaller schemes and members will not enjoy the same benefits as they could through consolidation. The Government will consult the industry towards the end of 2018 and work with the Regulator to raise awareness of consolidation opportunities with trustees.

ACTION

Clearly, there is plenty for trustees and employers to digest following the publication of the Government's White Paper. We would encourage you to seek advice to determine how the legislation due to come into effect will affect your scheme. Remember, some of the issues discussed above will be consulted on over the next year, so look out for this and expect further consultation towards the end of 2018. We will of course update you in later Quarterly Reports.

Updated mortality improvement projections

The Continuous Mortality Investigation ("CMI") – the group of actuaries who are tasked with carrying out analysis into mortality rates and trends in the UK – recently published its 2017 mortality improvement projections. These projections update the previous 2016 publication to take account of the emerging mortality data for 2017.

The headline result is that the 2017 projections show that the slowdown in mortality improvements is continuing. This means that although mortality rates continue to improve, the rate at which they are improving is reducing. Coming off the back of similar results in the more recent projection results, it suggests that we may be witnessing a change in the trend of mortality improvements rather than observing the effects of a short term deviation.

All else being equal this means that adoption of the 2017 projections should reduce the life expectancies of scheme members. We have found that life expectancies have fallen by around 2-3 months, on average, when the 2017 projections are adopted compared with the 2016 projections. As a result, adoption of the 2017 projections for mortality improvements should lead to a reduction in a scheme's liabilities, when taken in isolation.

The CMI has been careful not to give an explicit view as to the precise pattern of future improvements, and has built into their model an option to tailor the mortality projections according to the user's views on certain matters such as the balance between short term and longer term factors. Trustees and companies should engage in discussion with their actuary to explore this option and its impact on their scheme's funding position.



Helpful Links:

- [Link to news article in The Actuary](#)

ACTION

Trustees should liaise with their advisors to assess the impact that adopting the new CMI_2017 model of mortality improvements may have on their scheme's funding position. They should also discuss the flexibility within the projections that can be used to tailor the mortality assumptions in scheme's valuation.

Learning from Carillion – dealing with very weak covenants

Carillion's failure, subsequent to that of BHS amongst others, has shone a light on the risk to members' benefits and the responsibility of trustees to deal assertively with weak employer covenants.

At the time of writing (just after the quarter-end), TPR's annual funding statement has been published and appears heavily influenced by these high profile insolvencies.

Trustees of schemes reliant on these most challenged covenants need to be proactive and will have to make very difficult decisions often under significant time pressure. Anything less could mean detriment to members' benefits and adverse impact on the PPF (ultimately passed on to other levy payers).



Helpful Links:

- TPR Funding Statement <http://www.thepensionsregulator.gov.uk/docs/db-annual-funding-statement-2018.pdf>

ACTION

In this context trustees are obliged to:

- Understand and regularly monitor employer covenant and affordability –proportionality is crucial but with a very unstable covenant this will need to be frequent and in some depth.
- Have a contingency plan – TPR would like to see this bearing contractually enforceable remedies on the employer, but at the very least the trustees should know what they will do if defined distress triggers are hit.
- Negotiate robustly for equitable treatment of the scheme in its recovery plan – evaluating and comparing DRCs with shareholder dividend levels and other value leakage to related parties.
- Consider their powers and in the worst cases weigh up the 'nuclear option' where scheme wind up is in their control – there will be many factors to carefully balance and insolvency advice will be required.
- Last but by no means least, if employer insolvency remains a risk, the PPF would expect trustees to have considered this scenario and have a plan in place to ensure ongoing operation of the scheme post any employer insolvency. This is particularly important where the scheme relies heavily of services provided by the employer.

Coming Up Next...

In each Quarterly Update we like to finish by highlighting some of the major topics that we expect to hit the headlines in the next quarter. The last few Coming Up Next sections have had the White Paper as a constant addition, but as you'll have read, it has now been released and we can finally replace it with something else on the list! We anticipate Brexit will continue to take a lot of Whitehall's attention away from pensions over the coming period, but here are a few things to look out for:

- Another topic that has been "a regular" on this list has been the Government's response to the **Pension Cold-Calling** consultation. Well, the ban on cold-calling appears to have gathered pace, with the DWP to speed up the introduction of the ban by putting forward its own amendment to the Financial Guidance and Claims Bill. This is expected to be passed in June, with regulations to follow, so perhaps this one will vacate its space for the next, Coming Up Next!
- **British Airways v Spencer** – On 1 May 2018 the Court of Appeal is due to hear an appeal against the High Court decision that the trustees of the scheme validly exercised their power of amendment to create a unilateral power to award discretionary pension increases (following the change from RPI to CPI minimum indexation). The court also ruled that the trustees' subsequent exercise of the discretionary power to award a 0.2% increase for 2013 was valid and effective. The High Court case provided some headlines, so we expect the Court of Appeal case to be just as interesting.
- The consultation on the draft **Occupational Pension Schemes (Master Trusts) Regulations 2018** closed to responses in January, so we expect to see proposals off the back of that consultation in the coming months.
- Following on from the White Paper response, we expect the Government to release further consultations in 2018, on topics such as improving the scheme funding regime and the consolidation of small schemes.

Trustees and sponsoring employers alike should also be aware of the following key dates coming up:

- **8 May 2018** – Phase One of HMRC's new Manage and Register Pension Schemes online service to be introduced.
- **25 May 2018** – The General Data Protection Regulation (GDPR) comes into force.
- **25 May 2018** – Deadline for responses to the FCA's consultation paper on improving the quality of pension transfer advice.
- **19 June 2018** – Deadline for responses to the Pensions Regulator and FCA's consultation on a joint strategic approach to pensions regulation.
- **30 June 2018** – Deadline for a timetable on the new pension cold-calling regulations.

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