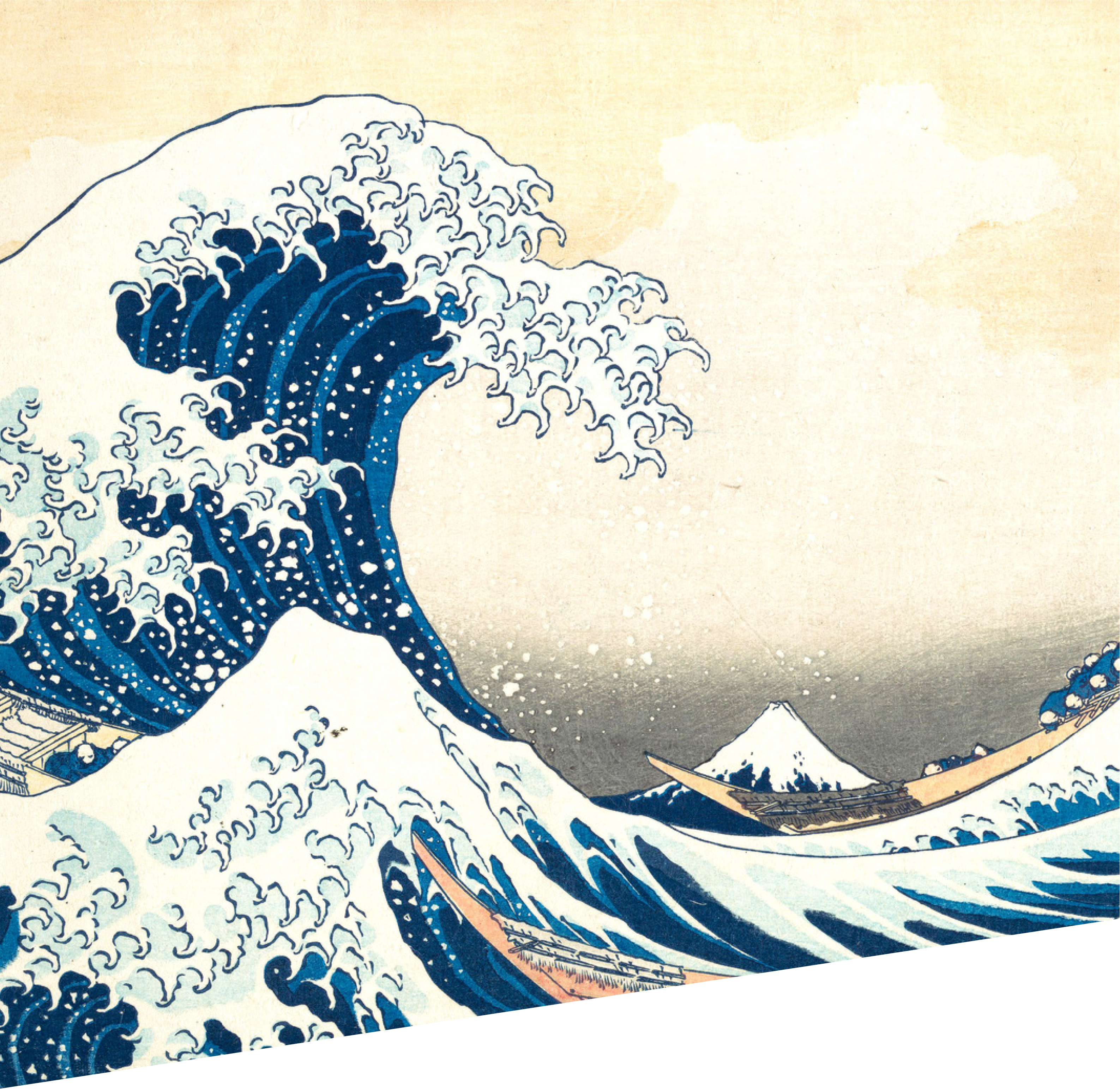


INSIGHT

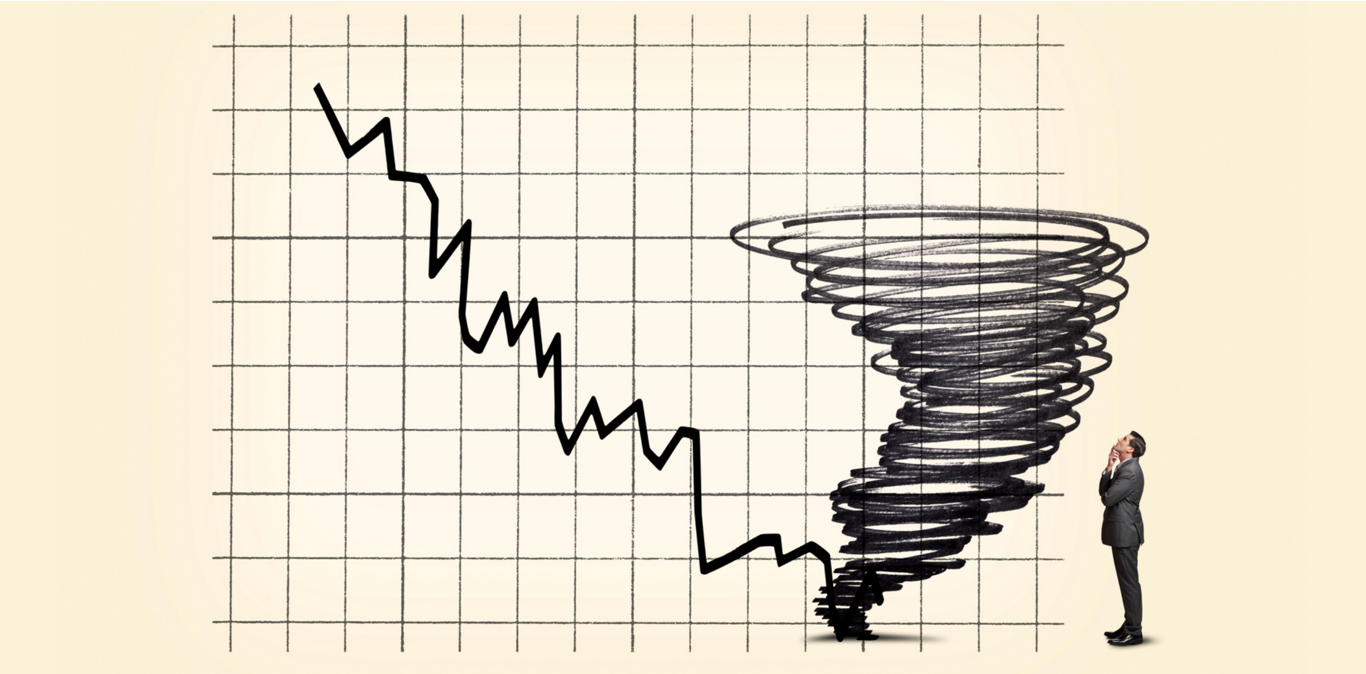
DEVELOPMENTS IN OCCUPATIONAL PENSIONS

OCTOBER 2022

hughespricewalker

CONTENT

VOLATILE MARKET CONDITIONS: WHAT DOES THE PENSIONS REGULATOR EXPECT TRUSTEES TO DO?



September and October 2022 saw extreme movements in government bond (**gilt**) yields, with the Bank of England's nominal gilt yields at all durations increasing by at least 1% between 31 August 2022 and 10 October 2022. Although this means that liabilities of defined benefit (**DB**) schemes, which are linked to gilt yields, will typically have decreased, schemes with Liability Driven Investments (**LDI**) have been exposed to potential liquidity issues as the LDI managers urgently seek collateral to maintain their liability hedging positions. Due to these calls for collateral, some schemes may have seen a reduction in their hedging position which means that their funding level is not as well protected against future falls in gilts.

The movements in gilts have also had an impact on defined contribution (**DC**) schemes. DC schemes do not use LDI funds so they are not impacted by the calls for collateral, however many members of DC schemes will have seen a fall in the value of their investments particularly if they are invested in gilts: as gilt yields rise, the value of gilts decreases. Typically members closer to retirement will have a higher proportion of their pension pot invested in gilts as they seek to reduce the volatility of the value of their investments. Conversely, increasing yields will likely lead to better annuity rates so members taking an annuity might find they can achieve a higher pension than they could have done before gilt yields increased.

The Pensions Regulator ("the **Regulator**") has published guidance which sets out the main points it expects trustees to consider when managing investment and liquidity risks in light of current market conditions.

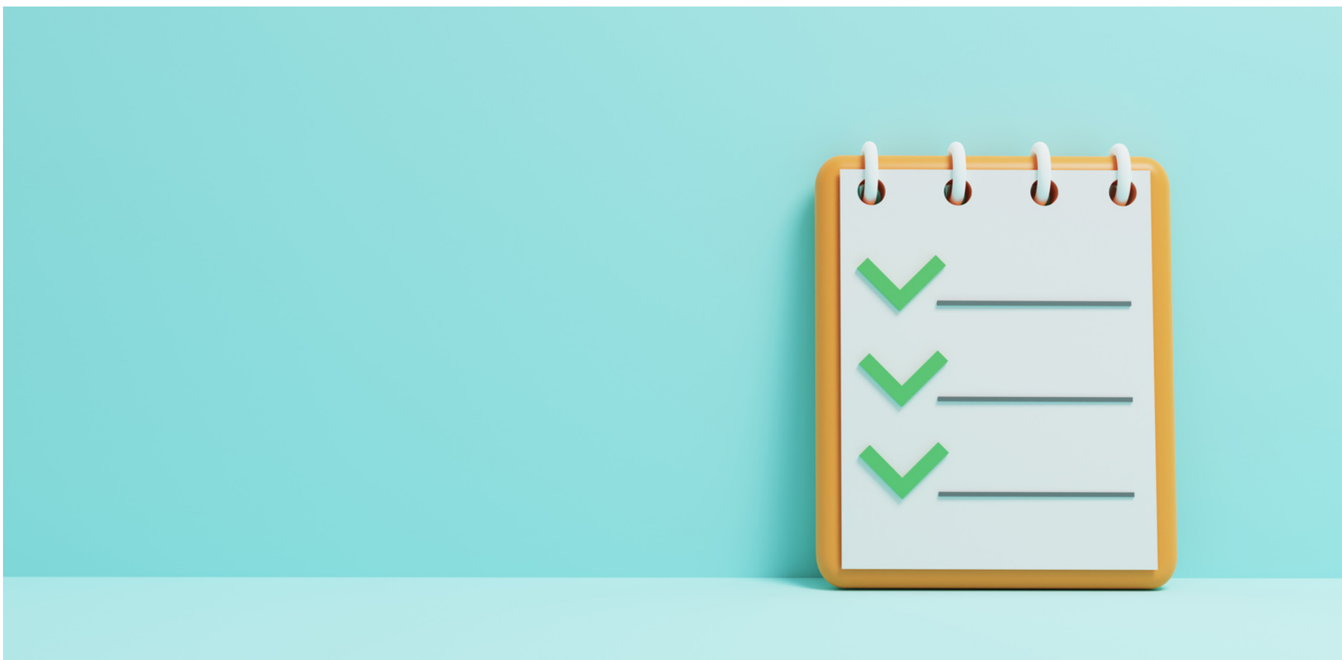
The guidance can be found here: https://www.thepensionsregulator.gov.uk/en/document-library/statements/managing-investment-and-liquidity-risk-in-the-current-economic-climate

Trustees of DB schemes are expected to consider the following points relative to their current position and how significantly the scheme has been impacted by market movements:

- Review operational processes: trustees should have robust procedures in place to help them respond to changes in market conditions, make decisions, and implement the responses.
- Review liquidity position: trustees of schemes using LDI should consider whether they have sufficiently liquidity to meet collateral calls in future volatile economic conditions.
- Review liability hedging position: trustees should consider the level of leverage and the impact on the scheme of further collateral calls. This should be considered by trustees of schemes using LDI already as well as those considering entering into LDI arrangements.
- Review funding and risk position: many schemes are likely to see an improvement in their funding position due to higher gilt yields, and schemes with funding triggers or long-term funding objectives in place may find themselves ahead of target. The balance of risk in the scheme's investment portfolio is likely to have changed so trustees should also consider rebalancing their risk profile.
- Consider how current yields impact other areas of the scheme: gilt yields also impact transfer values and, in some cases, factors used at retirement. Trustees should monitor the appropriateness of the assumptions used to calculate transfer values and factors. Volatile market conditions could also lead to an increase in pension scams so trustees should ensure they are following best practice.

Trustees of DC schemes are expected to:

- Maintain a long-term perspective when reviewing recent market volatility and performance.
- Review their investment strategy and operational factors in executing the investment strategy.
- Communicate with members who are approaching retirement to make them aware of their options and emphasise the importance of seeking financial advice.
- Encourage members to seek regulated financial advice or speak to MoneyHelper before making decisions about their pension savings in light of market conditions.
- Remain vigilant for scams and suspicious transfers.
- Review processes to ensure they can act quickly where necessary.



PROPOSED NEW FUNDING AND INVESTMENT REQUIREMENTS FOR DEFINED BENEFIT PENSION SCHEMES

Background

The DWP has issued draft funding and investment regulations for consultation within the pensions industry until 17 October 2022.

As the draft regulations currently stand, these will have major implications for the funding and investment strategies of defined benefit pension schemes, as foreseen from the provisions included in the Pension Schemes Act 2021.

A low dependency target

The core theme is that Pension scheme trustees will need to put in place a documented journey plan to target a low dependency position by the time the scheme reaches maturity.

This is expected to mean that by this time of maturity, closed schemes will not be expected to require future employer contributions, although the employer support would still remain in place.

There are three key aspects to this low dependency target:

- ***Maturity*** – this is expected to mean the weighted term of remaining benefits is no more than 12 years (in practice meaning most scheme members are pensioners)
- ***Low dependency funding basis*** – this is expected to mean a relatively prudent funding basis, which although not prescribed, might for example mean a discount rate of gilts plus a small margin, perhaps around 50 basis points
- ***Low dependency investment allocation*** – this is expected to mean an investment allocation which broadly matches expected future scheme benefit cashflows, and is therefore highly resilient to short-term market movements

Documenting the journey plan

Trustees will need to draw up a written “Funding and Investment Strategy” (**FIS**) document that is agreed with the sponsoring employer within 15 months of the triennial actuarial valuation date, as part of the requirements. At maturity, the scheme’s technical provisions will need to be consistent with the FIS.

During the journey plan the calculation of liabilities will need be consistent with the strength of employer covenant and the investment risk.

At each actuarial valuation or after any review of the FIS (for example in the light of intervening economic changes), the Chair of trustees will need to sign a Statement of Strategy (**SoS**).

This new document assesses progress against the low dependency target, whether the FIS is being successfully implemented, and what action the trustees will take to remedy and manage risks that it will not be implemented as planned, including reviewing the strength of employer covenant.

Some potential cost implications

Where the new requirements result in a scheme de-risking the investment strategy more quickly than currently planned, such as possibly a scheme with a weak employer covenant, this could reduce future investment returns and increase the long-term funding costs, set against lower risks.

One further key provision of the draft regulations is for recovery plans to be drawn up so that the technical provisions deficit is recovered “as soon as the employer can reasonably afford”. A hard interpretation of this could mean that employer will be required to fund deficits more rapidly than under current regulatory provisions.

Next steps

It is possible some requirements may change in the final version of the regulations as a result of consultation responses. In particular, further provisions may be made regarding the position of open schemes where maturity may be very far into the future due to the influx of new entrants.

There should certainly be extensive guidance on many aspects in the Pensions Regulator’s new Funding Code. This should cover the form of the SoS, and greater clarity on the interaction of the fast-track and bespoke approaches for the valuations. The new Funding Code is not expected to be issued until after the regulations have been finalised.

It seems unlikely therefore that the provisions will strictly apply to any actuarial valuation within the next twelve months, and it is possible these provisions will not become fully effective until 2024, without any requirement to apply these to earlier actuarial valuations.

In the meantime, we recommend trustees continue to give close attention to the current funding and investment approach, and any movements in the strength of employer covenant.

THE PENSIONS REGULATOR'S STRATEGY TO COMBAT PENSION SCAMS

Background

The Pensions Regulator's mandate derives from statutory objectives, set out in the Pensions Act 2004, amended by the Pensions Acts 2008 and 2014. One of these is to protect the benefits of members of occupational schemes.

In November 2020, The Pensions Regulator launched its 'Pledge to Combat Pension Scams' with more than 500 organisations having now made the pledge or self-certifying to meet the campaign's standards. From 30 November 2021 trustees and administrators must ensure that due diligence is carried out on statutory transfers and refer to member guidance if amber or red flags exist.
In August 2022, The Pensions Regulator revealed its scams strategy amid concerns that the cost-of-living crisis may leave pension savers more vulnerable than before. The Pensions Regulator wants the majority of schemes to provide pledge compliant scam protections.

Certainly, in light of HMRC data published in October 2022 confirming that in the second quarter of 2022 more than half a million people withdrew £3.6bn from their retirement pots (a 23 per cent increase on the same quarter of the previous year), the cost-of-living crisis appears to be affecting the way in which savers are acting and Trustees should be mindful of this.

The Pensions Regulator's plan to combat pension scams

The new strategy has the following aims:

- educate savers
- encourage higher standards by schemes, advisers and providers
- fight fraud through prevention, disruption, and punishment

The new strategy has the following desired outcomes:

- ensure all savers are aware of the risks of scams
- schemes reporting potential fraud to authorities, with most savers in schemes providing gold-standard protections
- use of improved data to report potential fraud to the authorities and create a hostile environment for scammers

The three-year plan

The Regulator has set out its three-year plan to work towards these outcomes.

Year 1 actions include

- Encourage schemes to engage with the Stronger Nudge to guidance and Scamsmart Campaign, and to include pension scam warnings in every annual benefit statement with a link to ScamSmart.
- Analyse amber flag data provided to Money and Pensions Service (**MaPS**) and review trends, encourage reporting of fraud.
- Encourage fraud reporting – including red flags.
- Assist with improving scam prevention warnings for savers transferring to self-invested personal pensions and small self-administered schemes.
- Investigate and prosecute scam cases, issue penalties, suspend and prohibit trustees.

Year 2 actions include

- Set up a new dedicated and fully funded Pension Scams Action Group (**PSAG**) scams hub to co-ordinate intelligence and direct fraud disruption and prevention activity.
- Review member communications guidance for scam-prevention messaging.
- Use amber flag data to implement policy changes.

Year 3 actions include

- Use the data collated to support PSAG partners' law enforcement efforts and for the Pledge to become part of the 'scheme oversight and customer service' Value for Money assessment for trust-based schemes.

What should trustees be doing?

Trustees should:

- think about what current processes they have in place to protect their members and what more they could do to improve member outcomes;
- consider the anti-scams wording used in their communications to ensure this is provided with annual benefit statements and required touchpoints;
- discuss with their administrators the level of red and amber flags they are seeing under the New Transfer Regulations and what steps if any the administrators have been taking to report these to Action Fraud; and
- consider making the Pledge by ensuring that they and their administrators meet the required actions and by completing the scams module of the Trustee Toolkit.

Hughes Price Walker (**HPW**) has made the Pledge with all employees involved in the processing of transfers having passed the scams module. If you have any questions about what the Pledge entails, please contact your HPW consultant.

DISCRETIONARY INCREASES – CONSIDER WHETHER APPROPRIATE

Pensions increase at different rates, with some linked to inflation subject to a cap (e.g. Consumer Price Inflation (**CPI**) with a maximum of 5%), some increasing at a fixed rate (e.g. 3%), and others not increasing. In light of recent high inflation – for example CPI inflation in August 2022 was 9.9% – trustees of pension schemes should consider whether to apply discretionary pension increases to some or all pensions, to ensure that the members of their scheme are not adversely affected by the spike in inflation.

The scheme rules will dictate under which circumstances discretionary increases can be provided. Examples include obtaining consent from the Employer or obtaining additional contributions from the Employer to meet the cost of providing the discretionary increases. In some cases trustees may need to obtain legal advice to clarify the position.

Trustees could decide to award discretionary increases to only a subset of membership, for example those aged over 65 by a certain date, however they should consider the impact on members not meeting the criteria.

If you would like more information or would like to discuss options for discretionary increases or other benefits, please contact your usual HPW consultant.

THE RPI DECISION: HAS UKSA ACTED LAWFULLY BY DECIDING THAT RPI WILL ALIGN WITH CPIH FROM 2030?

It is called the Retail Prices Index (**RPI**) decision and it was the central issue raised by the trustees of five large pension schemes who asked for a judicial review of the UK Statistics Authority (**UKSA**) and Chancellor of the Exchequer's decision to align RPI with the Consumer Price Index including owner occupiers' housing costs (**CPIH**).

For reasons to do with statistical methodology, the RPI produces an estimate of inflation about 1% higher than the CPIH and that will continue in the long term. The UKSA decided some years ago that the methodology of the RPI is flawed and so that index should cease to be used as the UK's measure of inflation and aligned with the CPIH in 2030.

According to the judgment, the impact of the long-run reduction of 1% in the RPI from 2030 onwards, affecting future interest payments to holders of the gilts, is said to be around £90 billion - £100 billion.

In summary, as reported in the judgement, the claimants advance the following three grounds of challenge:

Ground 1

The decision of the UKSA that the RPI should be amended by importing the methods and data sources of the CPIH falls outside the scope of the power to amend under s.21(1) of the Statistics and Registration Service Act 2007 (**SRSA 2007**).

Ground 2

The UKSA failed to have regard to the impact of the decision to change the method of calculation of the RPI on legacy users and, in relation to the compensation decision, the Chancellor failed to have regard to the interests of legacy users and to comply with the Public Sector Equality Duty (**PSED**) under s.149 of the Equality Act 2010.

Ground 3

The UKSA was under a duty to consult the public on its RPI decision and failed to do so and the Chancellor was under an obligation to consult with legacy users on the issue of compensation and failed to do so.

The decision

The High Court dismissed the application for judicial review and gave the following reasons:

(i) The UKSA has statutory power to amend the RPI, including the power to make “fundamental changes”, so correcting flaws in the RPI was legally allowed.

(ii) The argument that the UKSA had failed to take into account the impact of the RPI decision on legacy users of RPI was rejected.

(iii) There was no legal basis for asserting that the Chancellor of the Exchequer was obliged to consult on compensation for users of RPI.

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