INSIGHT

DEVELOPMENTS IN OCCUPATIONAL PENSIONS

JANUARY 2023

hughespricewalker

CONTENT

JANUARY, IT’S TIME FOR RESOLUTIONS

2022 was a turbulent year for pension schemes. Trustees had to make critical decisions and often in a very short period of time. Agendas of meetings have been particularly lengthy and extra meetings were often called at short notice to help make the right decisions.

It doesn’t look like trustees and employers can relax in 2023 as their path is packed with things to do.

We have set out below a list of requirements with the relevant dates that trustees and employers should keep in mind.

January 2023 and ASAP:

- Considering collateral waterfall arrangements, investment strategies and funding plans
- Completing a gap analysis of the Effective System of Governance (ESOG)
- Moving forward with Guaranteed Minimum Pension (GMP) equalisation
- Addressing climate change risks (and opportunities)
- Diarising the Own Risk Assessment (ORA) whereby trustees will be required to evaluate the effectiveness of their system of governance and the efficacy of the risk controls in place.

31 January 2023 Annual deadline for schemes to submit event reports to HMRC (for the 2021/22 tax year).

31 March 2023 Expected TPR deadline for submission of DB & hybrid scheme returns, and PPF levy deadline for contingent asset and asset-backed contribution certificates and special category employer applications.

3 April 2023 PPF levy deadline for submission of supporting contingent asset documents.

6 April 2023 Exemption of performance fees from the DC default fund charge cap and new performance fee-related disclosure requirements for DC schemes expected to come into force.

28 April 2023 PPF levy deadline for submission of deficit reduction contribution certificates and exempt transfer applications.

30 June 2023 PPF levy deadline for submission of full block transfer certificates.

31 August 2023 Start of the pensions dashboards staging timetable.

1 October 2023

- New default arrangement illiquid investment disclosure requirements for DC schemes expected to come into force.
- New default arrangement asset allocation disclosure requirements for DC schemes expected to come into force.

October 2023

The draft funding code of practice for defined benefit (DB) pensions schemes was published in December 2022 by the Pensions Regulator (TPR) and the final regulations and code are currently planned to come into force in October 2023.

October 2023

New Statutory Money Purchase Illustration (SMPI) statements shown on pensions dashboards from October 2023.

How HPW can help you

Please get in touch with us if you need any support.

We would be happy to discuss any requirements with you to make sure you are aware of your obligations and the timescale to comply with them and to support you with anything you may need.

INVESTMENT – LOOKING BACK OVER 2022, AND LOOKING FORWARD TO 2023

It has escaped nobody's attention that 2022 was a very turbulent year for global investment markets, which has had major ramifications for defined benefit pension scheme funding. Individual pension schemes may have fared better or worse from these market movements by the year end however, depending on factors such as their investment strategy, hedging arrangements, benefit structure and governance arrangements.

In overview, the year saw steep rises in bank base rates, longer-term fixed-interest yields, and inflation measures fuelled by factors such as the war in Ukraine, the consequential rises in energy and food prices, fears of a global recession, and continuing uncertainty over the implications of COVID on economic activity.

Political instability and sterling weakness in the UK resulted in additional domestic interest rate volatility and inflationary pressures. The 12-month CPI measure of UK inflation stood at 9.2% at the year end.

2022 investment returns

UK gilt yields had been increasing before the start of 2022, but the pace quickened remarkably over the year with the 20-year index yield increasing from 1.22% to 4.16% over the course of the year. Yields had reduced slightly by the year-end from earlier spikes after the ill-fated mini-budget in September following a rapid change in UK Government policy. Real yields also moved into positive territory, with the UK 20-year index rising from -2.49% to 0.47% over the year.

Global bond prices also fell significantly in value with the general rise in market yields. However credit spreads remained broadly constant, at around 0.7% for UK AA rated bonds, after some temporary widening earlier in the year.

The value of shares also fell across the world although a wide range of returns was recorded depending on the geographical market and sector. Tech stocks in the US were particularly hard hit with some key stocks recording a 40% drop in value, whilst conversely the energy sector showed record gains. Overall the S&P 500 TR (-18.1%) and the Euro Stoxx 50 TR (-9.5%) were both down, while the FTSE 100 TR (+4.7%) managed to deliver a small positive gain over the year.

In terms of relative nominal return, a UK pension scheme would therefore have benefitted from a strategy more focused towards UK shares and a lower allocation to bonds particularly with shorter duration.

Many schemes however had adopted significant matching strategies, known as liability driven investment (LDI). In these strategies bonds, cash and derivatives are held to immunise scheme funding levels against the effect of changes in long-term interest rates and inflation rates. The leverage from the derivatives can enable full interest rate and inflation immunisation even if not all the scheme's assets are in LDI. The leverage however can require cash calls from other scheme assets when interest rates rise.

The rapid rise in interest rates during September and October required these schemes to provide significant additional liquidity at short notice to maintain the hedge positions, causing strains on investment manager governance, and bond markets, triggering emergency Bank of England intervention in the gilt market. These events caused the Pensions Regulator to issue new guidance to trustees to ensure LDI positions are not over-leveraged and able to withstand higher sudden yield rises than before.

Despite the fall in the nominal value of the LDI portfolios during the year, many schemes were able to maintain funding levels with a commensurate fall in the value of liabilities, although the performance of the remaining asset classes would also feature in the final outcome. For many schemes, the solvency deficit has reduced as a result of the higher discount rates now being used.

Outlook for 2023

Economic forecasters are predicting generally lower global economic growth for 2023, with a possible recession looming for some nations. Key issues include whether economies can manage down current high levels of inflation to avoid stagflation scenarios, and the stance taken by central banks on the course of interest rates.

The ongoing development of global conflicts and restoration of international trade flows will also be significant issues. It is expected capital markets will ultimately re-price the potential economic effects of climate change although this may occur further into the future. In the shorter term, investors may bid up prices where there appears to be good value, including current UK stock market ratings.

For UK pension schemes there will be important developments for considering both funding and investment strategy. The parliamentary inquiry into LDI may further reshape the way pension schemes operate LDI strategies, taking further the recent Pensions Regulator recommendations. Also, the issue of the second draft consultation on the new funding code includes several proposals on forward looking strategies for investment and funding, that may be effective for actuarial valuations from October 2023 onwards.

PPF PUBLISHES FINAL LEVY RULES FOR 2023/24 LEVY YEAR

In December 2022 the Pension Protection Fund (PPF) published its final levy rules for the 2023/24 levy year. Following widespread support for consultation proposals on the rules there will be a significant reduction in the total levy; in the PPF's policy statement it confirms that 98% of schemes are expected to pay a lower levy in 2023/24 and the majority of schemes paying a risk-based levy will see it fall by more than half.

The levy estimate for the 2023/24 year is £200m, which is around 50% of the 2022/23 estimate. The main changes from the 2022/23 levy rules are as follows:

- The levy scaling factor and scheme-based levy multiplier are reducing by 23% and 10% respectively.
- The methodology for calculating insolvency risk scores will remain the same, while the increments between the levy bands will be reduced. This means that for the same insolvency risk score as the 2022/23 levy year, the levy rate used in the calculation could be up to around 70% lower. For example, a scheme in band 10 will have a levy rate of 1.16% for the 2023/24 levy year compared to 3.83% for the 2022/23 levy year, a fall of around 70%.
- Following the changes to the asset split to be shown in the Pensions Regulator's scheme returns for 2023, the PPF has updated the asset stress factors to be used in the levy calculation.

The levy rules, policy statement and supporting appendices and guidance can be found at https://www.ppf.co.uk/levy-2023-24.

TIME TO PLAN YOUR SCHEME RETURN AND CHANGES FROM 2022

The Pensions Regulator (TPR) will be issuing scheme return notices from 1 February 2023, with the scheme returns due to be completed and submitted by 31 March 2023. Similarly to 2022, the 2023 scheme return will be issued in two parts: part 1 will be completed using an online form and part 2 will be completed in TPR's Exchange system.

The main change to the scheme return for 2023 is the updating of the asset breakdown, following a joint consultation with the Pension Protection Fund (PPF). A tier-based system has been introduced and schemes will be assigned a tier based on their total Section 179 liabilities:

- Tier 1 (simplified): less than £30 million
- Tier 2 (standard): £30 million to £1.5 billion
- Tier 3 (enhanced): £1.5 billion or higher

Tier 2 and 3 schemes will need to provide more detailed information about the bonds and equities held, e.g., the split of bonds by maturity (less than 5 years, 5 to 15 years and more than 15 years). Tier 3 schemes will also need to provide information on risk factor stresses. There is a new 'Diversified Growth Funds' asset class for all tiers and the 'Hedge Funds' and 'Commodities' asset classes have been removed. Tier 2 and 3 have an additional 'Absolute Return Funds' asset class.

Schemes in Tier 1 will have the option to move to either Tier 2 or Tier 3 if they wish to provide more information. Schemes in Tier 2 will have the option to move to Tier 3.

TPR's guidance on scheme returns, including example returns for DB and hybrid schemes, can be found here.

TPR PUBLISHES DRAFT OF THE DB FUNDING CODE OF PRACTICE

In December 2022 the Pensions Regulator (TPR) published its draft funding code of practice for defined benefit (DB) schemes and a consultation document.

The consultation runs until 24 March 2023 and the final code is expected to come into force in late 2023 along with the Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2023.

The draft code is split into three main sections and has four appendices:

- Section 1: The funding regime
- Section 2: Long term planning
- Section 3: Application
- Appendix 1: Responsibilities and roles
- Appendix 2: Key documents, reporting requirements and intervaluation requirements
- Appendix 3: Low dependency funding basis expectations for setting assumptions
- Appendix 4: Allowance for expenses in low dependency liabilities

Each section includes chapters which sets out TPR's expectations considering the legislative requirements. These expectations include:

- Trustees should set a plan for how they will achieve low dependency on the employer and a journey plan to reach that point;
- Trustees should assess the employer covenant while considering their journey plan, including consideration of cash, prospects and contingent assets;
- Funding assumptions should be set consistently with the journey plan;
- Schemes open to accrual should allow for future accrual where they can justify that approach; and
- Trustees and employers should assess reasonable affordability when determining the appropriateness of recovery plans.

TPR has confirmed that the draft code will only be applicable to schemes with valuation dates on or after the commencement date.

The draft code can be found here.
The consultation can be found here.

TPR REVISED GUIDANCE ON TENDERING FOR FIDUCIARY MANAGERS & SETTING OBJECTIVES FOR INVESTMENT CONSULTANTS

Background

In 2019 the Competition and Markets Authority (CMA) issued an Order which introduced trustee requirements in relation to investment governance:

- Since December 2019, trustees have been required to set strategic objectives for their investment consultants for both new and existing appointments.
- Trustees who wish to delegate investment decisions for 20% or more of their scheme assets to a fiduciary manager, were required, from 10 December 2019 onwards, to run a competitive tender with at least three unrelated firms.
- Pension scheme trustees, investment consultancy and fiduciary management firms, were required to submit compliance statements to the CMA by 7 January each year.

What's new?

As a result of new regulations made by the Department for Work and Pensions (DWP), with effect from 1 October 2022, monitoring compliance with the CMA Order requirements is now being carried out by the Pensions Regulator (TPR) rather than the CMA.

- TPR has revised its guidance on the tender process for fiduciary management services and trustees setting objectives for their investment consultants.
- Trustees are no longer required to submit annual compliance statements. Compliance statements from Investment Consultancy (IC) Providers and Fiduciary Management Providers should continue to be sent to the CMA annually.
- Under the scheme administration regulations, from 1 October 2022, trustees of a 'relevant trust scheme'[1] must set objectives for each IC provider and review their performance against those objectives at least annually.
- Trustees must also review an IC provider's objectives at least every three years and after a significant change in investment policy.
- Where an existing IC provider has strategic objectives which were set before 1 October 2022, trustees must complete the first review of those objectives within three years from the date they were set under the CMA order.

To identify if there is a need to set objectives, trustees should consider and/or take advice on whether they are or will be receiving investment consultancy services (as defined in the CMA order until 1 October 2022, or in the scheme administration regulations on and from 1 October 2022).

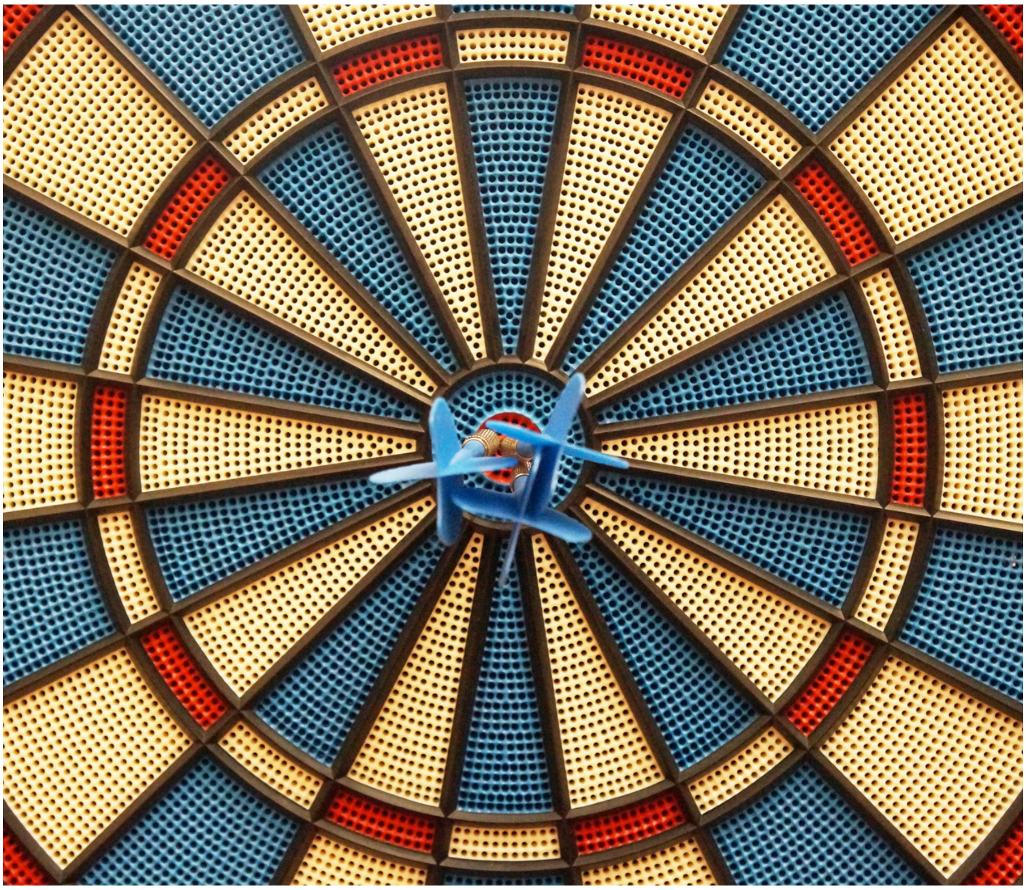
Trustees should be mindful that other types of advisers, who may not identify themselves as investment consultants, could be providing investment consultancy services.

As part of the effective system of governance framework, objectives set for investment consultancy services may be recorded in minutes or in a standalone document. The Pensions Regulator encourages trustees to take a clear and proportional approach when doing so.

[1] Relevant trust scheme

A relevant trust scheme is an occupational pension scheme established under trust that is not:

- a scheme which is not registrable under the Pensions Act 2004
- an executive pension scheme as defined in the scheme administration regulations
- a relevant small scheme as defined in the scheme administration regulations
- a scheme to which regulation 2(c) of the Occupational Pension Schemes (Trust and Retirement Benefits Exemption) Regulations 2005 applies



MAINTAINING LIABILITY-DRIVEN INVESTMENT RESILIENCE

In autumn 2022 unprecedented increases in gilt yields were experienced, which put huge pressure on leveraged liability-driven investment (LDI) funds, resulting in additional capital calls on defined benefit (DB) schemes, highlighting the need for schemes to be able to raise liquidity at short notice and the risks of losing hedging during a period of high volatility.

The Pensions Regulator issued a statement in October 2022 ‘Managing investment and liquidity risk in the current economic climate’ and has set out further recommendations for improving resilience and operational governance of DB schemes in response to statements on the resilience of LDI funds made by the Central Bank of Ireland (CBI) and Luxembourg's Commission de Surveillance du Secteur Financier (CSSF), known together as National Competent Authorities (NCAs).

The Pensions Regulator expects schemes to maintain a liquidity buffer and recommends that trustees review their procedures including the following:

- Confirm authorised signatories are up to date and that robust governance procedures exist to ensure decisions and instructions can be carried out swiftly.
- Specify the dates and amounts when collateral / margin calls need to be made.
- Specify what assets would be sold, when the sell instructions would need to be given, and when the cash would be settled.
- Trustees should liaise with LDI fund managers to check the liquidity of the assets that the schemes intend to use to meet cash calls and be aware of the risk that some funds may defer redemption if they are unable to meet liquidity needs.
- Document arrangements and review them regularly.
- Schemes may consider establishing a short-term loan facility with their sponsoring employer to assist with liquidity. Any arrangement should be documented and reviewed regularly with clear reference to the loan period, amounts owed and any terms and conditions.

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FRAMEWORK FOR PENSIONS DASHBOARDS

Effective from 12 December 2022, the Pensions Dashboards Regulations 2022 provides the legislative framework for pensions dashboards. The legislation sets out significant roles for The Pensions Regulator (TPR) and the Financial Conduct Authority (FCA) to regulate the compliance of pension providers and schemes providing data to individuals via their chosen dashboard. This new law requires pension schemes to make their data digitally searchable for display on dashboards, starting from Summer 2023, setting out the staging dates as follows:

Wave 1 Large schemes (over 1000 active and deferred members)
Large pension providers (those with 1,000 or more active and deferred members) are in the first wave. The connection deadline for large master trust and most providers of personal pensions is the end of August 2023.

Staging Break - money purchase schemes used for automatic enrolment (from the end of September 2023), and then non-money purchase schemes (from the end of November 2023). Both groups will be ordered by size. Public service pension schemes will be at the end of September 2024.

Wave 2 Medium sized schemes (100-999 active and deferred members) will connect in a second wave, from the end of October 2024 to the end of October 2025.

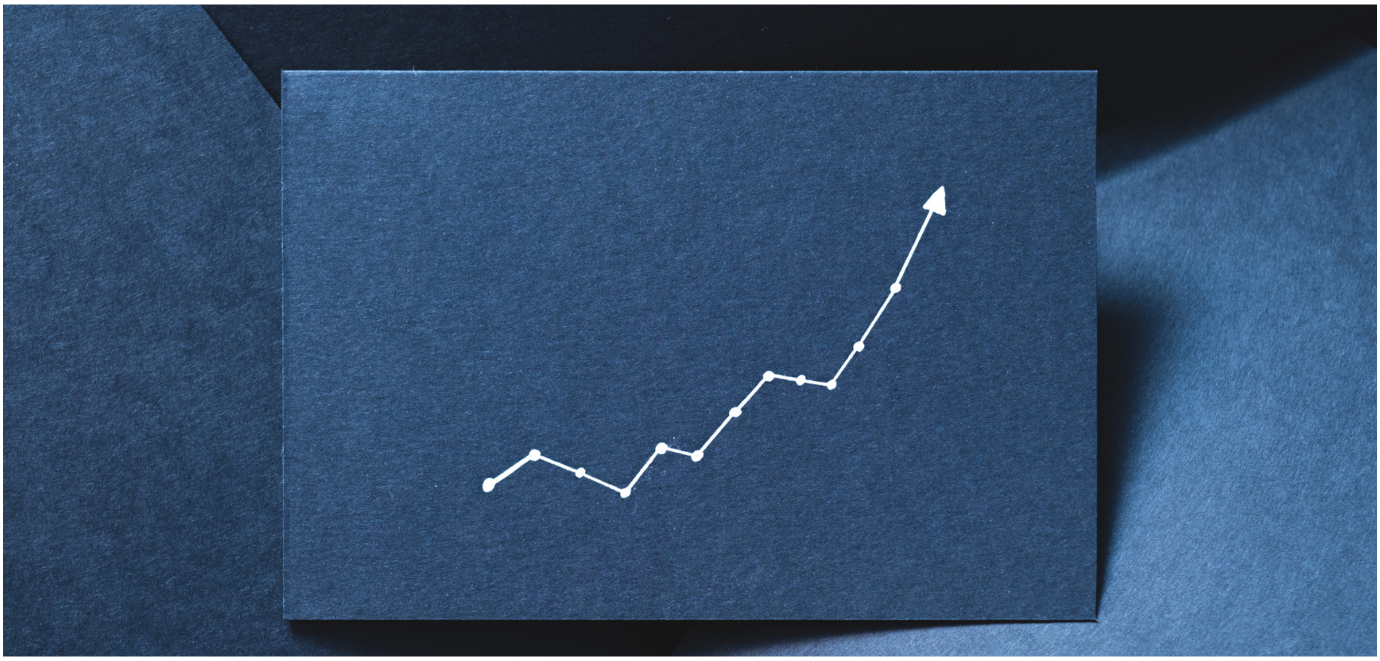
Number of active and deferred members on the reference date*	Staging Deadline
850-999	31 October 2024
750-849	30 November 2024
600-749	31 January 2025
500-599	28 February 2025
400-499	31 March 2025
320-399	30 April 2025
250-319	31 May 2025
195-249	31 July 2025
155-194	31 August 2025
125-154	30 September 2025

*reference date means the scheme year end date falling between 1st April 2020 and 31st March 2021, inclusive of both these dates

The legislation does not currently extend to smaller schemes. Further legislation is expected to extend compulsory connection to these schemes from 2026.

Pensions dashboards services will only launch to the public once full assurance of the security of the ecosystem and the service has enough coverage of pension providers/schemes and contains sufficient information so that it is useful to a significant majority of people.

DISCRETIONARY PENSION INCREASES: WHAT ARE THE CONSIDERATIONS?



In our Q4 2022 Insight we published an article on discretionary pension increases (here) and explained that trustees should consider whether to apply discretionary pension increases to some or all pensions to mitigate the spike in inflation.

Conversely, deferred members are likely to receive full inflation protection in the year and therefore trustees may not need to consider discretionary pension increases for them.

We have now set out below a list that both trustees and employers should consider when deciding whether or not to award discretionary increases and the extent of any increases:

- The level of current inflation and how it compares to guaranteed pension increase provided by the scheme;
- One of the Trustees' main aims is to pay the benefits promised under the rules of the scheme;
- The extent of any deficit or surplus on both scheme funding basis and buy-out basis;
- If discretionary pension increases are awarded, pensioners would benefit and the security of the deferred members' benefits would decrease;
- The covenant of the employer. The stronger the covenant, the more likely it is that discretionary pension increases can be afforded and granted;
- Past practice;
- Any conflicts of interest that a trustee has, should be managed;
- The decision, either way, should be recorded by both the employer and the trustees.

If you are considering applying discretionary pension increases your first step should be reviewing your scheme rules to ascertain under which circumstances discretionary increases can be provided.

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

PASA GUIDANCE ON DC TRANSFERS

Did you know that transfer volumes processed via the Origo Transfer Service increased by 132% between 2015/16 and 2021/22? Pensions Dashboards will likely drive a further increase in transfer volumes.

This is one of the reasons why, last October, the Pension Administration Standards Association (PASA) issued its Good Practice Guidance on DC Transfers.

This Guidance, which has the primary aim of improving the overall saver experience through faster and more secure transfers, sets out:

- A standardised and non-prescriptive process flow for transfers, highlighting the important 'what' rather than the 'how'.
- A recommendation trustees agree acceptable Service Level Agreement timescales for processing transfers upfront with their administrators, set within the context of an ever-changing regulatory environment.
- Template communications to provide an important leg-up, particularly for smaller organisations with smaller resource pools.
- This guidance includes two useful process flows, one for quotation request and one for settlement process and the following templates:

1 - An example Quotation Acknowledgement Letter to inform members about pension scams, financial advice and guidance, setting expectations of the next steps and timeframes.
2 - An example Acknowledgement Letter to be used when transfer forms are received, along with a tick list which may be included in transfer packs to guide members and their advisers through the requirements, to ensure they provide all the necessary documentation for a transfer to proceed in a timely manner.
3 - A Transfer Template which aims: (i) to make it easier to understand what information is required before processing a transfer; (ii) to highlight scenarios where the saver is required by law to take appropriate financial advice; (iii) to improve the level of information made available to advisers; and (iv) to ensure savers and their financial advisers are in possession of all the information necessary to make an informed decision.

The Guidance also provides a list of useful references and links listed below:

- The Pensions Regulator Guidance on dealing with Transfer Requests
- The Pension Regulator Guidance on Communicating and Reporting: DC Schemes
- PSIG Code on combating scams
- Joint Money Laundering Steering Group Guidelines
- Certifying a document

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