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Navigating the key issues facing schemes in 2023

Welcome to the third issue of the annual UK pension scheme survey from the Pensions Management Institute ("PMI") in conjunction with Schroders Solutions.

Introduction

Ronan O'Riordan
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Head of UK Client Solutions, Schroders Solutions

Gareth Tancred
Chief Executive, Pensions Management Institute (PMI)

The Fiduciary Management Strategic Forum was created in partnership with the PMI. This group represents many of the third party evaluation firms involved in the Fiduciary Management market, along with senior independent trustees. The forum's mandate is to discuss the key areas affecting pension schemes across all governance models and sizes.

The industry saw much transformational change in 2022, so the survey focused on the liquidity crisis concerning gilts in the Autumn and the potential knock-on effects it may have for pension schemes. We considered its impact on schemes in several areas, including governance, liquidity, and endgame strategy. Environmental Social and Governance (ESG) considerations will, we believe, be a key theme again in 2023, given the evolving regulatory environment and industry guidance in this area.

The results of the survey are relevant to trustee boards to understand industry trends and plan for the year ahead. By carrying out this research, we can share some valuable knowledge about the issues facing schemes. This will help market participants to plan and prioritise and help us work with them to develop solutions and services that match their changing needs.

We hope you enjoy reading the findings.

The dawn of a new pension scheme era?

2022 turned out to be an extremely eventful year for markets, driven by the Ukraine war, an energy and cost-of-living crisis, and the "Trussonomics" fallout. As we head into 2023 with the dust settling from the "gilts liquidity crisis", we consider what this means for trustees and their stakeholders. In 2023, we had our highest response rate from a wide range of respondents, which has led to some very interesting findings.

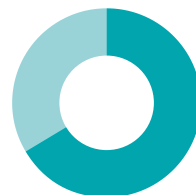
Foreword

41%

of respondents found their investment governance model needed improving as a result of their experience in the gilts liquidity crisis

48%

of respondents will review the operational aspects of investment strategy to improve post-crisis operational resilience.



2/3rds

of respondents said schemes will favour targeting a lower return objective for longer to reach their endgame.

Wider pension issues such as Guaranteed Minimum Pension (GMP) equalisation, insurer capacity and data quality are the top three hurdles to buyout

Room for improvement in investment governance

Governance is always a hot topic for trustees as they grapple with implementing effective arrangements to address their regulatory and operational requirements alongside securing benefits for members. Many more schemes found themselves in scope for Task Force on Climate-Related Financial Disclosures (TCFD) in October 2022, whilst all schemes now have the Pension Regulator's (tPR) single code of practice and DB funding code to get to grips with. However, whilst these governance challenges have been many years in the making, 2022 presented a new governance challenge that nobody expected — the gilts liquidity crisis. The gilts liquidity crisis put many trustee governance structures to the test with complex investment decisions required in short timescales with imperfect information.

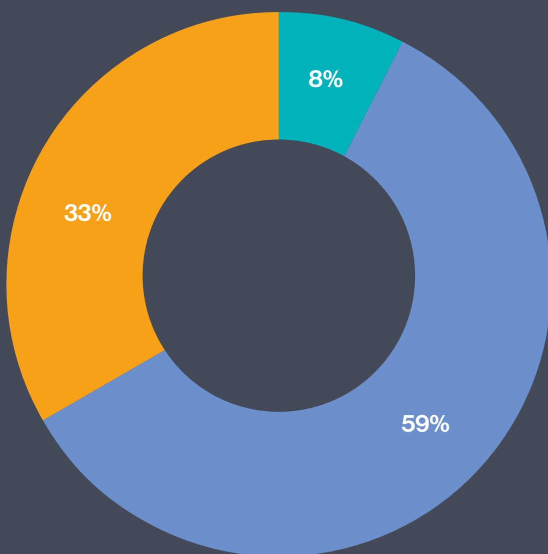
Whilst many were happy their investment governance model navigated this challenging period adequately, some 41% of respondents found them to be lacking in some respects. Larger schemes overall appeared to have fared better, with more tools and resources at their disposal. Respondents for schemes with less than £1bn in assets were over **twice** as likely to say their investment governance model didn't provide enough support in the crisis as those with assets over £1bn. This highlights the potential governance challenges smaller schemes face, particularly in market stress.

"The LDI liquidity crisis highlighted the importance for trustees that have delegated their investment arrangements to a third party to ensure they understand how their investments are managed. Whilst the day-to-day management of the investments can be delegated the trustee is still responsible for the investment strategy. The experience of fiduciary managers during the LDI crisis was mixed, re-enforcing that there is no silver bullet to investments and that trustees need to be able to understand and challenge the investment approach of their fiduciary manager. With more schemes adopting low risk investment strategies as they de-risk it is important that the matching portfolio receives as much scrutiny as the growth portfolio, as in some cases it could be the biggest area of risk."

Andre Kerr, Head of Fiduciary Management Oversight,
XPS Pensions Group

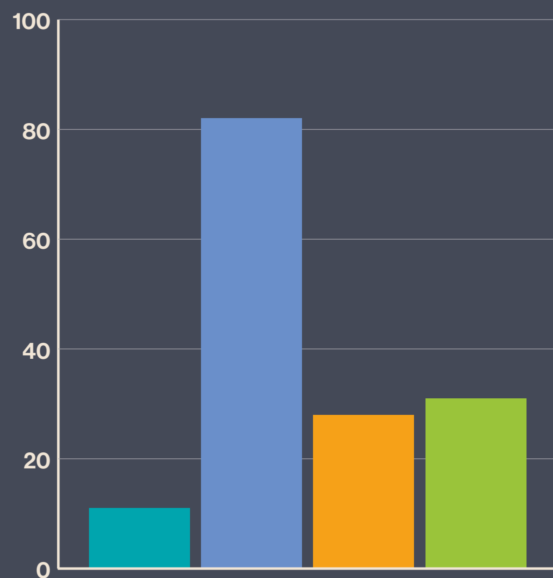
Schemes are increasingly seeking to enhance their governance model through greater adoption of professional trustees, fiduciary managers and third-party evaluators. All respondents reported using at least one of these services.

Did your investment governance model (Advisory or Fiduciary Management) provide necessary support during the Q3 2022 liquidity crisis?



No - 8%
Yes, absolutely - 59%
Yes, but room for improvement - 33%

Use of professional governance services

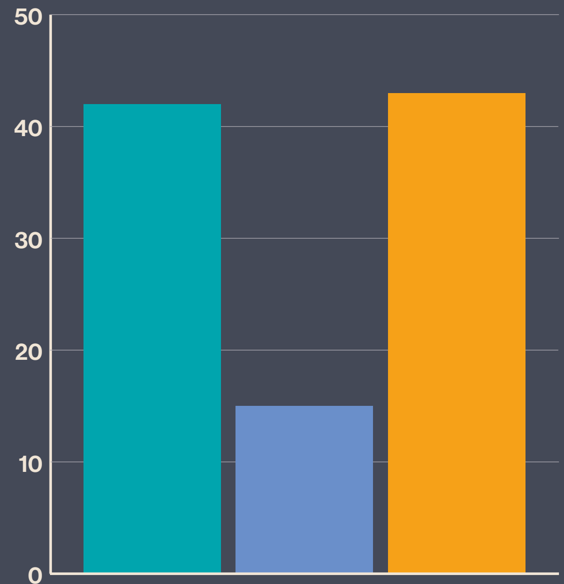


Sole Trustee - 11%
Professional Trustee - 82%
Third-party evaluator - 28%
Partial or full fiduciary management - 31%

Out of our survey respondents, 31% delegate to a fiduciary manager. The number of schemes using fiduciary management continues to grow. Indeed, the UK fiduciary management market has grown by just over 70% over five years[1]. Based on our survey results, over 270 UK pension schemes could move from traditional advisory to fiduciary management in 2023[2]. We have also experienced an increase in the role of independent trustees, alongside an emergent shift to sole trusteeship for schemes of all sizes.

Of our respondents, 28% were using a third-party evaluator in some way. Our research shows an increase in the number of respondents who see value in using a third-party evaluator to oversee a fiduciary manager. This increased from 27% of respondents in 2022 to 42% in 2023[3]. In contrast 85% of respondents did not believe that they needed more independent oversight of their investment governance following the recent crisis.

Attitudes to independent oversight



Independent oversight of fiduciary management adds value - 42%

We need more independent oversight of our investment governance arrangements following the recent crisis - 15%

Our board would need independent advice when selecting a fiduciary manager - 43%

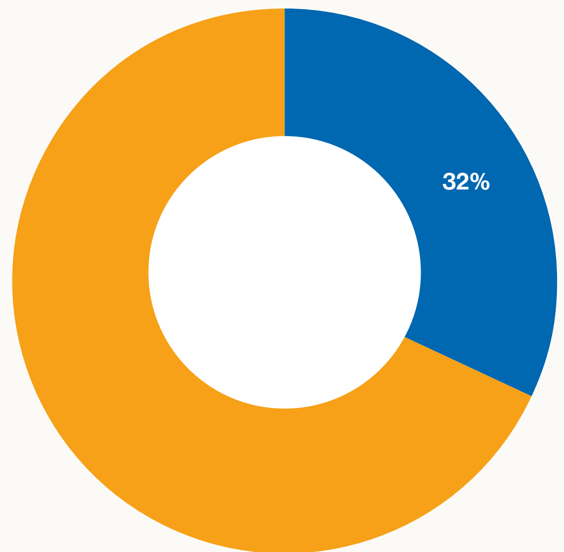
"Recent events have highlighted the need for trustees to ensure that their investment governance models are both robust and flexible, to take account of increasing regulatory requirements as well as being operationally able to cope with unexpected market challenges."

Tova Docherty,
Professional Trustee, Capital Cranfield Pension Trustees

Gilts liquidity crisis calls for greater resilience – are trustees doing enough?

As schemes mature, there is an increasing need to ensure adequate liquidity to meet pension payments. Through September and October 2022, the need to meet Liability Driven Investment (LDI) collateral calls at short notice placed a further strain on scheme liquidity. This highlights the importance of resilience across overall pension scheme strategy and the value of regular portfolio stress testing. Looking forward, regulatory and industry guidance to operate at lower levels of leverage as well as more conservative risk modelling seems likely to compound this as LDI managers increase the level of assets that schemes must set aside to meet the possibility of collateral calls.

We asked survey participants to reflect on their recent experience and their lessons learnt. One third of respondents noted that they underestimated their liquidity needs pre-crisis, will review their liquidity position, and that a reduction of allocations to illiquid assets is a priority.

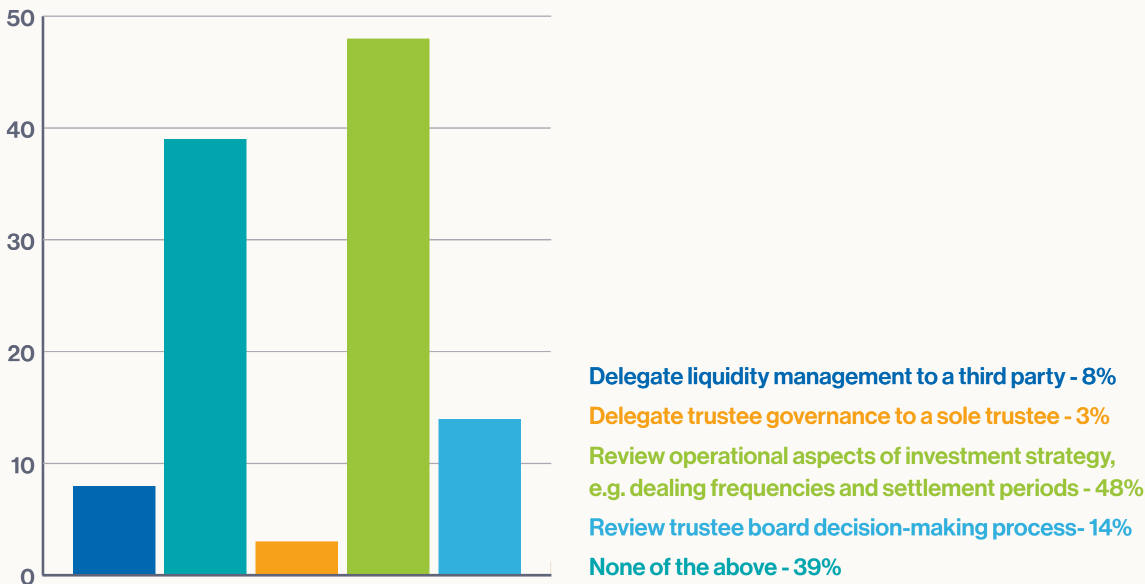


We underestimated our liquidity needs ahead of the gilt crisis, we will be reviewing our liquidity position and reducing our allocation to illiquid assets is a priority - 32%

> **"**The gilt crisis was a massive test of governance, operations and liquidity. It highlighted that you only need one weak link to break the chain, and it was interesting that the weak link could be different for each scheme – for example a particular LDI fund, an out of date signatory list, a particular fiduciary manager's operations, not enough liquidity in the strategy. There is no simple solution. Delegation is just replacing one link for another, so it is important to be sure that it creates a stronger chain.**"**
>
> **Rob Guthrie,** Partner, LCP

Half of those polled highlighted they would review an often overlooked aspect of investment strategy implementation - the operational setup. Many strategies classified as "liquid" (as priced daily or weekly) were of little help to schemes in meeting their liquidity needs in this extremely stressed period. Additionally, nearly one in seven respondents said they would review the trustee board decision-making process to improve operational resilience.

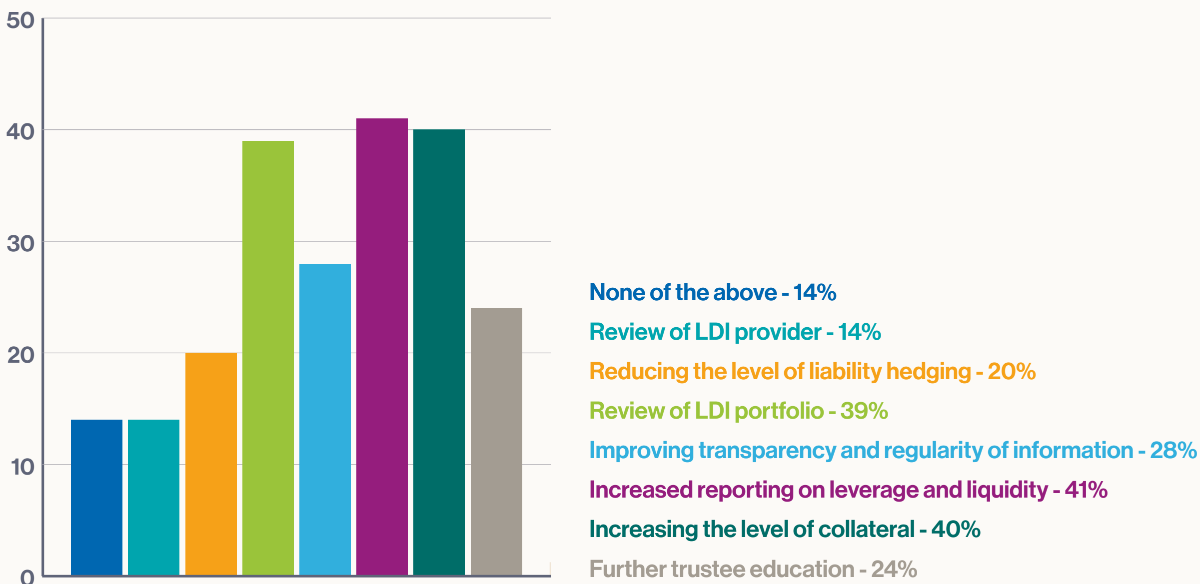
What steps do you plan on taking to improve operational resilience as a result of the gilt crisis?



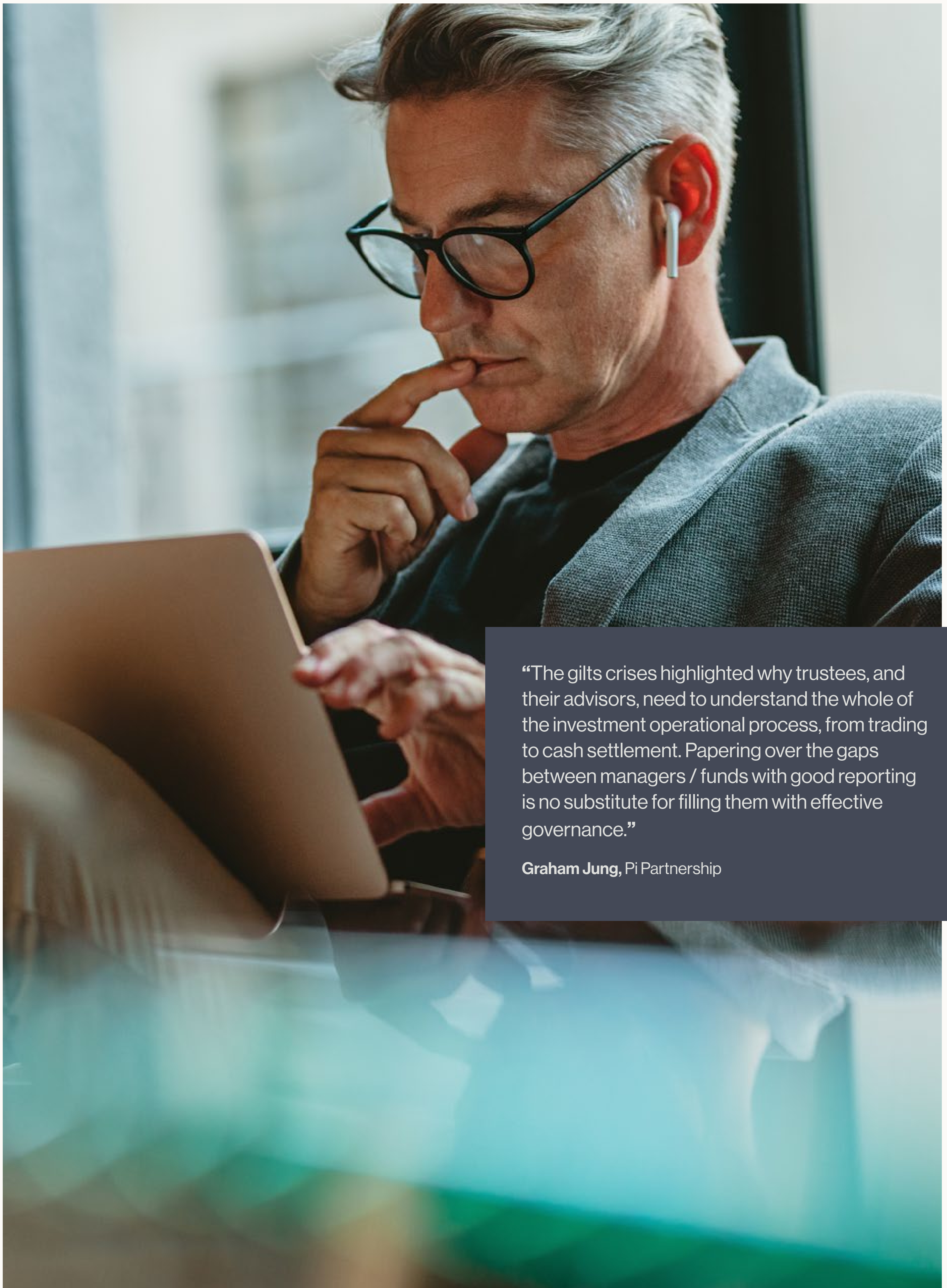
It could be concluded that, although overall many respondents felt their investment decision-making process was robust enough, it was liquidity and operational efficiency that had caused issues and could usefully be reviewed in line with tPR's guidance to trustees.

With the dawn of 2023 and the dust settling, we asked trustees what their top LDI priorities were. The results highlighted trustees want more from their LDI providers - increased reporting with more regularity and transparency being top requirements. Reviewing LDI portfolios and increasing the level of collateral were also high on respondents' to-do lists, as two-fifths cited them as priorities. Our research also found only 14% schemes will be reviewing their LDI provider as a post-crisis priority. This would imply that 86% are planning to retain their existing LDI provider for the time being.

What are your priorities for LDI coming out of the gilt crisis?



With explicit guidance issued from tPR urging trustees to take action to maintain an appropriate level of LDI resilience and improve operational governance, our survey results beg the question "are trustees doing enough?". Trustees will need to consider governance arrangements and LDI priorities in tandem with any potential new regulation and industry guidance following the various on-going reviews of the causes and consequences of the gilts liquidity crisis.



"The gilts crises highlighted why trustees, and their advisors, need to understand the whole of the investment operational process, from trading to cash settlement. Papering over the gaps between managers / funds with good reporting is no substitute for filling them with effective governance."

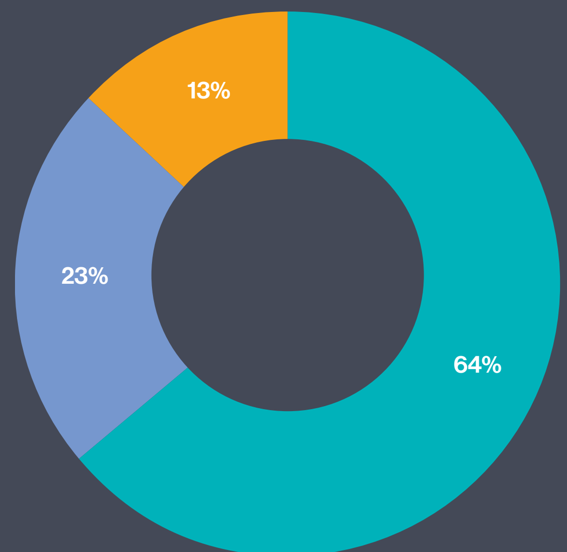
Graham Jung, Pi Partnership

Heavy reliance on managers and advisors for ESG compliance

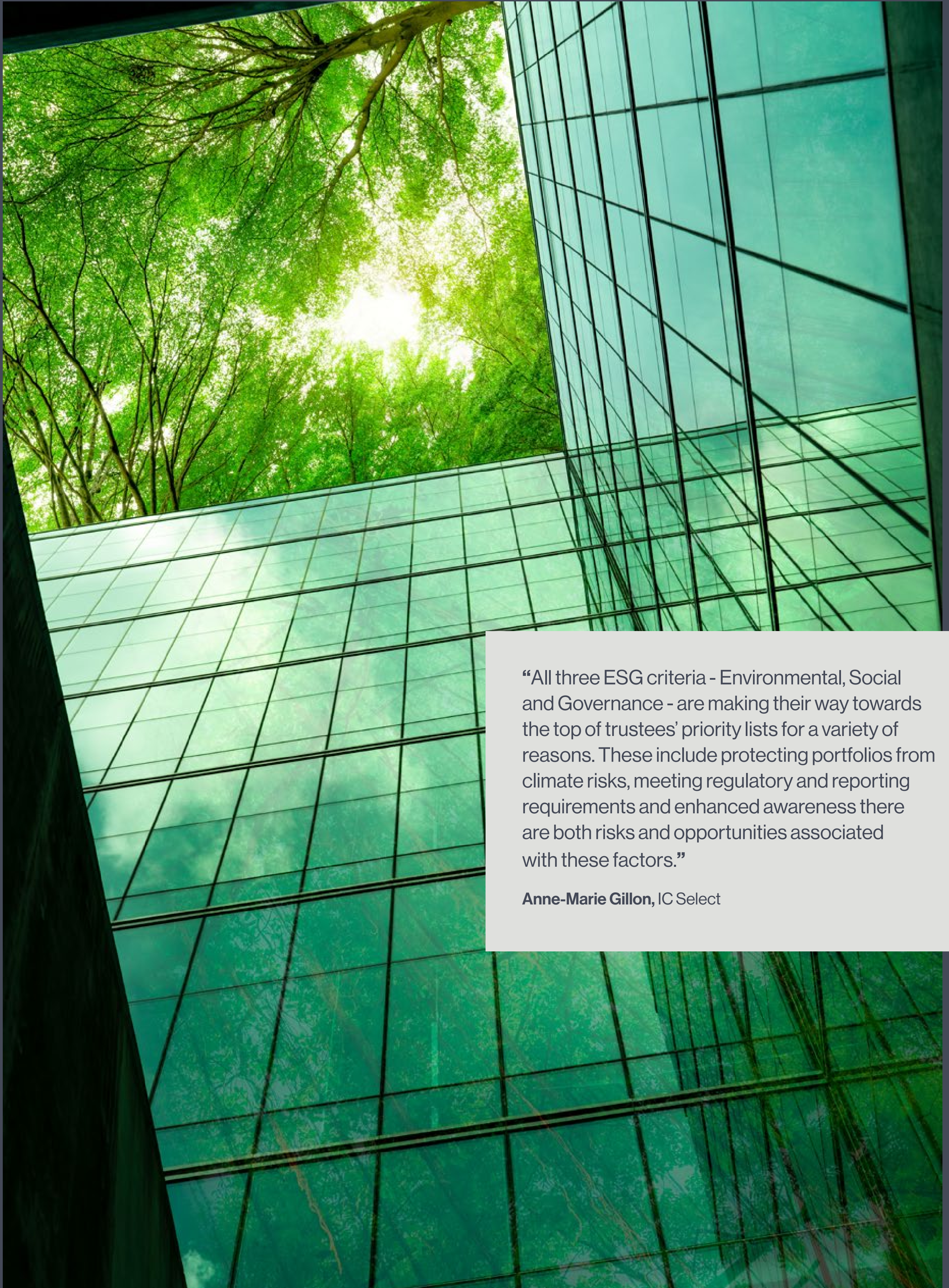
Awareness of ESG issues remains an increasing priority for trustee boards. Not only ensuring compliance with regulatory reporting but also seeking to understand their portfolio positioning today and how it might change through time. This has been a continuous theme since we started producing this survey and shows limited signs of abating.

That said, trustees have done a lot in the last 12 months. Two-thirds felt they know enough about ESG and climate risks to make informed decisions on investment strategy and for ongoing oversight. However, in this fast-paced area of the regulatory landscape trustees must ensure they don't get left behind. For example, along with climate risk, we believe that natural capital and biodiversity are going to be a growing area of focus for investors, including pension schemes. Pension schemes are likely in future to have to consider the development of nature-positive targets, similar to net-zero carbon targets. This is likely to be paired in due course with an increase in governance and reporting requirements, as we have seen with the new mandatory TCFD requirements.

Our board knows enough about its ESG and climate risks to make informed decisions



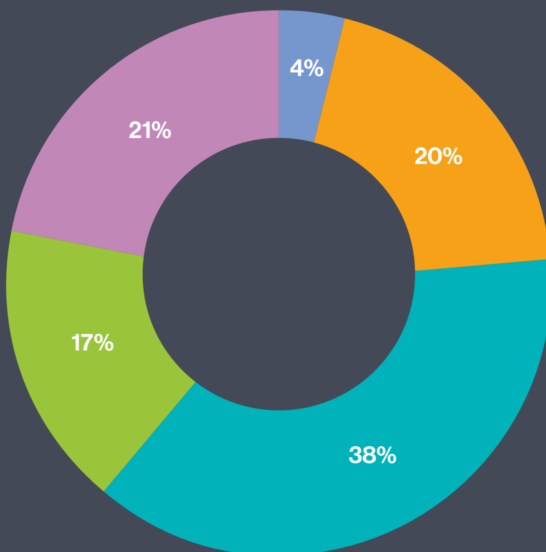
Agree - 64%
Neither agree or disagree - 23%
Disagree - 13%



> “All three ESG criteria - Environmental, Social and Governance - are making their way towards the top of trustees’ priority lists for a variety of reasons. These include protecting portfolios from climate risks, meeting regulatory and reporting requirements and enhanced awareness there are both risks and opportunities associated with these factors.”
>
> **Anne-Marie Gillon,** IC Select

Department for Work and Pensions (DWP) guidance encourages trustees to set up their own stewardship policies and engage with their managers. Over three quarters of our respondents have set stewardship priorities, or are working towards them. One in five respondents delegates stewardship to their managers. Those that delegate stewardship to their managers need to ensure they engage with them on how they are using their stewardship powers to align with best practice.

Which best describes the trustees' position?



Other - 4%

We delegate stewardship to our managers - 20%

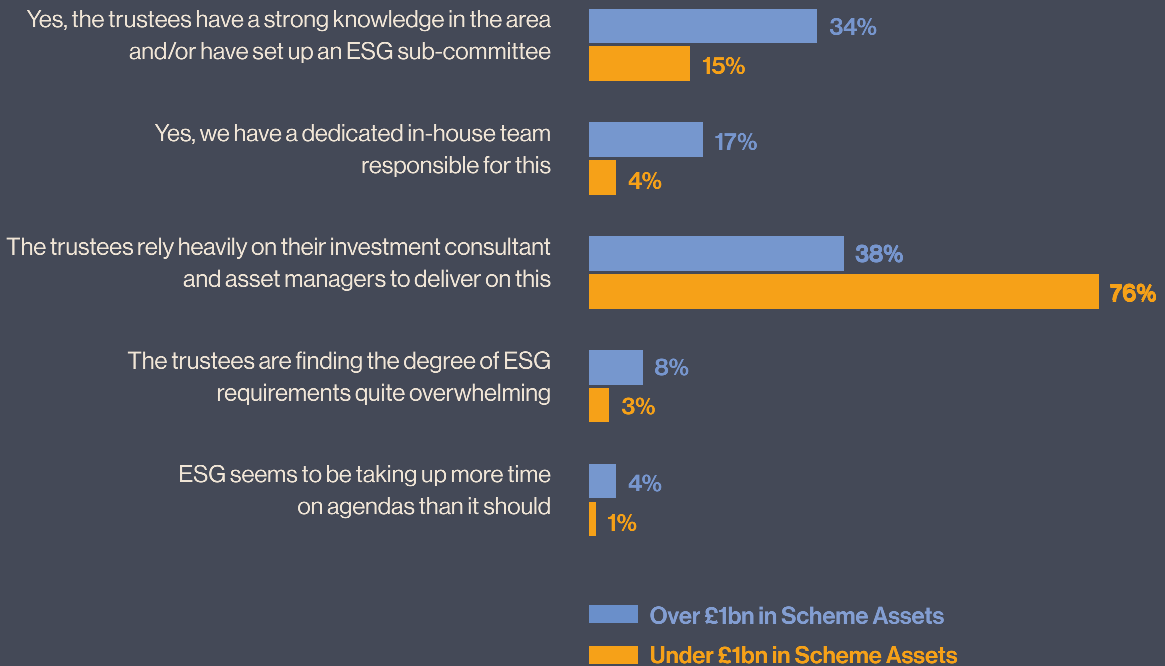
We have a set of stewardship priorities and regularly engage with our managers to ensure their policies align with ours - 38%

We have a set of stewardship priorities but we don't have a good understanding of our managers' policies or the actions they take - 17%

We haven't set our own stewardship priorities yet, but we're working on it - 21%

Indeed, 58% of respondents remain heavily reliant on their investment advisors and / or investment managers to stay on top of regulatory guidance and ensure ESG compliance. This was even more pronounced for schemes with less than £1bn in assets at 76%. In doing so, the level of transparency and disclosure as an industry continues to improve. This ensures that trustees can assess their journey so far, and start establishing forward-looking goals. We see some boards establishing ESG sub-committees to ensure a dedicated focus on this area.

Do the trustees believe they have the necessary knowledge and resource to comply with all the new ESG requirements being imposed by regulation and best practice?



"Despite the fallout in markets, the PwC Low Reliance and Buyout Indices show that, on average, schemes are in a much healthier position. We expect the Pension Regulator's newly proposed DB Funding Code could have a material impact on the funding and investment approach taken by some schemes, particularly given the requirement to have a plan to move towards a low dependency investment allocation as the scheme matures. Better funding positions mean that for many schemes the move towards a simple low dependency investment allocation can be accelerated.**"**

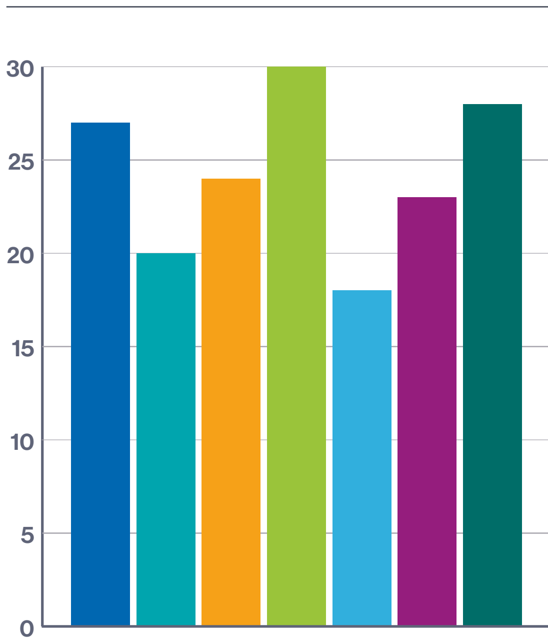
Keira-Marie Ramnath, Head of Fiduciary Management Oversight and Selection, PWC

Lower for longer to reach the endgame?

The material increase in interest rates over 2022 has implicitly reduced the cost of insuring pension scheme liabilities with a third-party insurer, i.e. buy-in or buyout. For many schemes, their timeframe to buyout reduced significantly despite market volatility in 2022. But, given that expected demand for buy-ins and buyouts exceeds insurer capacity in 2023[4], are all schemes rushing for the same "narrow" door? We wanted to understand how schemes can get better prepared today to manage expectations of all stakeholders and avoid disappointment.

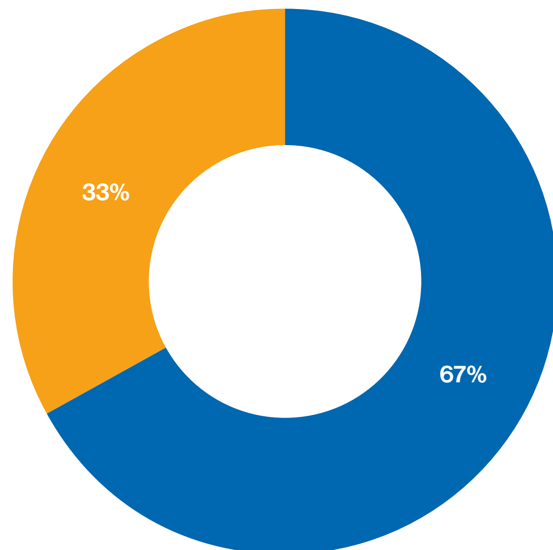
Our participants highlighted their top three hurdles to buyout were GMP Equalisation, insurer capacity constraints and data quality. To avoid being at the back of the queue with insurers, trustee boards and sponsoring employers should tackle their liabilities and data today. One in four respondents said differing sponsor views were also a major buyout hurdle. This presses the importance of engaging with sponsors early-on and maintaining a collaborative approach throughout the process.

What do you see as the major hurdles for achieving a buyout for your scheme?



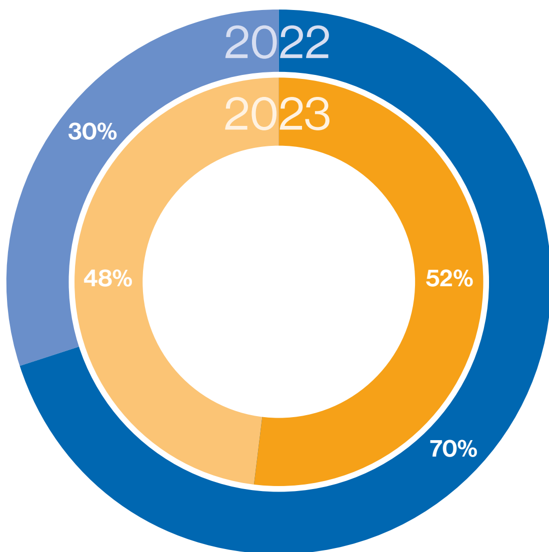
Data quality - 27%
Current pricing - 20%
Sponsoring employer having different views - 24%
GMP Equalisation - 30%
None of the above - 18%
Not applicable - 23%
Insurer capacity constraints - 28%

One of the other implications of the recent gilts liquidity crisis is the design and implementation of de-risking plans and investment strategy. Many trustees are considering if they can still maintain the same levels of return as they targeted pre-crisis. With higher interest rates leading to lower liability values, some schemes may only need lower levels of return to meet their endgame objective. In fact, two-thirds of our respondents said schemes will favour targeting a lower return objective for longer to reach their endgame. We believe that this is partly driven by regulatory guidance, but also by a desire by trustees for greater certainty and stability of their investment journey.



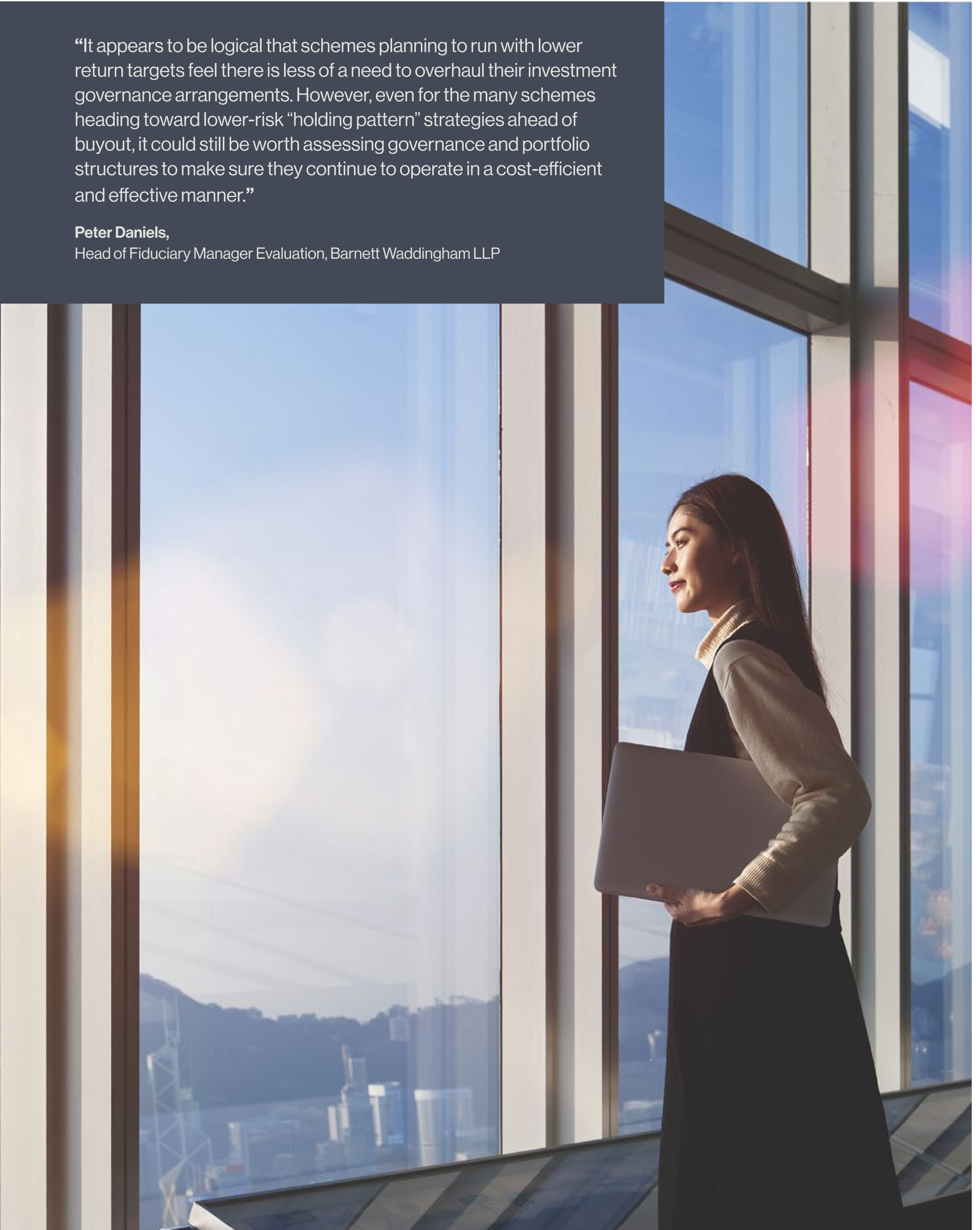
Schemes will favour targetting a lower return objective for longer to reach their endgame - 67%

Half of respondents felt schemes should re-assess their investment governance model as they get closer to the endgame. The result from the same question in 2022 was higher at 70% of respondents. Perhaps Investment Consultants and Fiduciary Managers responded to our a call-to-action in 2022 "to ensure their endgame strategies, solutions, and service meet the needs of pension schemes for the final leg of their journey"?



Trustees should re-assess their investment governance model (advisory or fiduciary management) as they get closer to the endgame

> **"**It appears to be logical that schemes planning to run with lower return targets feel there is less of a need to overhaul their investment governance arrangements. However, even for the many schemes heading toward lower-risk "holding pattern" strategies ahead of buyout, it could still be worth assessing governance and portfolio structures to make sure they continue to operate in a cost-efficient and effective manner.**"**
>
> **Peter Daniels,**
> Head of Fiduciary Manager Evaluation, Barnett Waddingham LLP



"Change seems to be a permanent status for the pensions industry and 2023 is no let up on that. So, with that in mind, it's really key to make sure you have the right governance structures in place to allow trustees to concentrate on what matters. As we've seen recently, that's particularly key for investment processes where you may need to react very quickly to the unexpected."

Alan Baker, Trustee Director,
LawDeb Pension Trustees

Other priorities?

Although our survey focused on the gilts liquidity crisis and ESG, we also asked respondents what other themes they consider important for 2023. "Too many to name", was one response, reflecting the sheer weight of tasks and obligations trustees have on their to-do list. Indeed, the results from this question are too many to name here as well, but the most popular answers were pensions dashboards, the new DB funding code and tPR's single code of practice.

D day for Pensions Dashboards?

Pensions dashboards will allow savers to see most of their future pension information online and all in one place for the first time. Whilst much of the detail is still in development, large schemes, such as master trusts will connect in spring 2023. Most schemes are due to connect from 2024. Schemes with fewer than 100 members are currently not in scope, but may be included in future legislation from 2026.

Schemes with staging dates in 2024 and beyond will watch with interest to see how smoothly the first onboarding round goes in 2023. In the meantime, trustees can start talking to their pensions administrator and software/IT suppliers to understand their plans and decide how to connect. Schemes will need to ensure data is available, accurate and accessible. If the scheme is conducting any other data projects (for example GMP equalisation or risk transfer exercises) this may be an opportunity to also consider dashboard requirements.

A new DB Funding Code

TPR's second consultation on its funding code of practice should land any day now. The draft code will set out how it should operate, including the last details of the proposed 'Fast Track' and 'Bespoke' approaches to compliance. It remains to be seen how much thinking has changed and how tPR will address concerns raised since the first consultation two years ago. It will also be accompanied by refreshed guidance on assessing employer covenant. If tPR's plans stay on track, the code will launch in late 2023.

Once the second consultation is launched, trustees and sponsors should benchmark their current approach against tPR's finalised expectations. Working collaboratively to review long term plans and identify a preference for fast track or bespoke compliance will be important. If schemes have a valuation in early 2023, the code will not yet be enforceable, but it will be difficult to ignore.

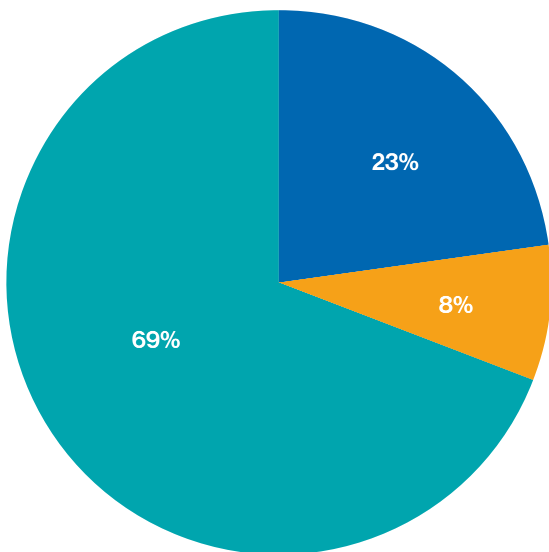
A new single code of practice

It has been over a year since tPR held a consultation on the draft content for a new single code of practice (the "Single Code"). The consultation noted a move to replace ten of the fifteen existing Codes (those dealing mainly with governance and administration matters) with one consolidated code. One of the major new items is the Own Risk Assessment. Trustees will need to evaluate their governance effectiveness and efficacy of risk controls. Delayed by the recent government upheaval, we understand the Single Code will be laid in parliament early in 2023. Demonstrating compliance with the Single Code is no small task. If trustees haven't done so already, they should undertake a gap analysis to understand the work that is needed to meet tPR's expectations. Although tPR has said that there is no formal grace period for compliance (unless specified otherwise), practical reality means that schemes should aim to at least have a plan in place to fill identified gaps from day one .

About the study

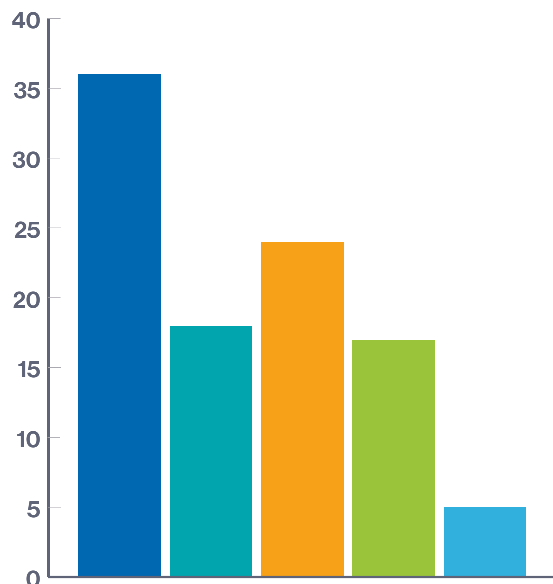
This survey analyses the perspectives of UK pension schemes with 130 respondents. The research was carried out via an online survey from 14 November 2022 to 3 January 2023. Throughout the report, we complement our findings with commentary and insights from Schroders Solutions and industry experts.

Breakdown by investment governance model



Full fiduciary mangement - 23%
Partial fiduciary management - 8%
Traditional advisory - 69%

Scheme assets under management



Less than £500 million - 36%
£500 million to less than £1 billion - 18%
£1 billion to less than £5 billion - 24%
More than £5 billion - 17%
Not applicable - 5%

Thanks to all research group participants

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Ajeet Manjrekar - Head of UK Client Solutions, Schroders Solutions
Gareth Tancred - Chief Executive Officer, The Pensions Management Institute
André Kerr - Partner, Head of Fiduciary Management Oversight, XPS Pensions Group
Peter Daniels – Partner, Head of Fiduciary Management Evaluation, Barnett Waddingham
Alan Baker - Director, LawDeb Pension Trustees
Anne-Marie Gillon, CFA - Director, IC Select Ltd
Graham Jung - Pi Partnership
Melanie Cusack - Client Director, Zedra
Anthony Webb, FIA - Head of Fiduciary Clients, Isio
Rob Guthrie - Partner, Lane Clark & Peacock
Keira-Marie Ramnath - Head of Fiduciary Management Oversight and Selection, PWC
Tova Docherty - Professional Trustee, Capital Cranfield Pension Trustees
Richard Wohanka - Independent Trustee
Lynn Ellis - Independent Trustee, Trafalgar House
Paul Brine - Trustee Director, Dalriada Trustees
Matthew Mignault - Director, Ernst & Young

[1] Source: IC Select, "Fiduciary Management Market Survey", September 2022

[2] Based on 5.4% of respondents stating they would be moving from traditional advisory to a fiduciary management arrangement in the next 1 months and the number of schemes in the PPF Purple Book 2022, which is listed as 5,131 eligible UK DB schemes.

[3] Source: PMI, Navigating the Key Issues Facing Pension Schemes 2022

[4] Source: LCP "Insurance enters a new phase: a skyrocketing market", October 2022.

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