HYMANS ROBERTSON

Current issues

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Articles this month:
Revising the DB funding Code (phase 2)
Purple Book 2022
Regulating actuaries in the public interest
No immediate change for money purchase pensions illustrations
Ombudsman round-up
Green lights a-QAS the board

Revising the DB funding Code (phase 2)

The Pensions Regulator launched its long-anticipated second consultation on a new Code of Practice on defined benefit (DB) scheme funding. There were few real surprises, after nearly two years of discussion of the Regulator's 'Fast Track' and 'Bespoke' compliance approaches. The new Code is expected to come into force from 1 October 2023, alongside the Department for Work and Pensions' Funding and Investment Strategy (FIS) Regulations.

Consultation details

This second stage of the consultation process builds on the overarching principles for scheme funding that the Regulator aired at stage 1. The consultation package includes the draft Code that the Regulator proposes to apply to valuations from 1 October 2023, with the intended parameters for the 'Fast Track' approach contained in a separate document. The consultation exercise runs until 24 March 2023.

Key details in the new Code

The draft Code sets out principles for compliance with the expected FIS Regulations. Trustees should comply with the Code, but are encouraged to do so in a way that is suitable for their scheme's circumstances. This maintains the vital concept of scheme-specific funding introduced by the *Pensions Act 2004* (though we remain concerned that the DWP's draft Regulations are overly restrictive and require revision). The 204 pages of material confirm most of what the pensions industry was expecting, but there are a few novel points.

- Fast Track is reframed as the tolerable level of risk in normal circumstances. It is not supposed to be risk free, nor the minimum for compliance, but the Regulator is unlikely to scrutinise a valuation further if a scheme's actuary confirms that its strategy meets each of the Fast Track parameters.
- The Fast Track parameters sit in a separate document, outside of the Code. Although the Regulator expects to keep Fast Track stable over time, this means that any changes arising from the planned annual and triennial reviews can be implemented without needing to go through Parliament.
- As expected, new legal requirements include setting a long-term, low-dependency objective (LDO) when a scheme reaches 'significant maturity', with a journey plan for how its asset allocation will become '*broadly cashflow matched*' and '*highly resilient*'. All this must be covered by a Funding and Investment Strategy, and summarised in a Statement of Strategy, agreed by trustees and sponsors.
- The main easement for open schemes is factoring-in future accrual and new joiners when calculating the way in which a scheme's duration is expected to evolve. This will lead to them having longer journey plans than closed schemes, providing more scope to take more investment risk.

- The onus is on trustees taking the Bespoke route to demonstrate how they comply with the principles of the Code. The central concept is that risks are supported by the sponsor. Although there is little detail on how the Regulator will actually regulate schemes using the Bespoke approach, it is at pains to say that it will *not* be comparing them to the Fast Track.
- Although there is one Fast Track for the whole range of sponsor covenants, covenant gets a much larger spotlight. The Regulator identifies three horizons that trustees should consider—visibility, reliability, and longevity—expecting trustees to know what their sponsor's free cashflow is and for how long into the future it remains visible. Trustees are also expected to consider the sponsor's long-term prospects (and environmental, social and governance credentials), and there is more clarity on the use of contingent assets.
- Recovery plans are to be set in the context of the sponsor's cashflow availability (in terms of annual amounts and length), and within the principle of 'reasonable affordability' there is room to take account of the sponsor's need to invest in its business (so long as the scheme is treated fairly).
- Reservations for future expenses are expected, either in full if expenses are paid by the scheme, or beyond the sponsor's visible cashflow period if expenses are paid by the employer.
- Unsurprisingly, there is some detail on using leveraged liability driven investment (LDI), with trustees expected to maintain enough liquidity to cover a 3-to-4% rise in gilt yields, have clear collateral waterfalls and have strong operational controls.

Summary of Fast Track's main parameters

The proposed parameters are towards the soft end of the range towards which the Regulator has managed the industry's expectations:

- An LDO discount rate of gilts+0.5% (with consistent inflation), when a scheme's remaining duration is 12 years.
- Technical provisions at least a set percentage of LDO liabilities depending on remaining duration (85% at 20 years).
- Recovery plans up to 6 years (3 years if past significant maturity). No asset out-performance allowed, and no more than CPI-linked in terms of back-end-loading, but trustees can allow for post-valuation experience.
- A funding stress test of up to 4.5% for asset risk, based on a 1-in-6 Value at Risk (VaR) using the Pension Protection Fund's methodology.
- The Regulator is content to leave trustees in control of setting demographic assumptions that suit their scheme.

The Regulator has worked hard to avoid 'low dependency' turning into 'no risk at all'. The draft Code sets out example asset allocations, hedging levels and what assets the Regulator thinks of as being '*broadly cashflow matching*'. This follows on from the DWP's draft FIS Regulations, and is more prescriptive than we would like to see. The consultation pack speaks at length about systemic risks and the risks of 'herding'; which this level of detail may exacerbate.

The Regulator has included an impact assessment of expected trustee behaviours (which could be paraphrased as '*Who's expected to level up and level down to Fast Track?*'), with a conclusion that it's likely to reduce funding targets by £5bn across the UK's 5,051 DB schemes. However, neither this consultation exercise nor the DWP's in summer 2022 have put a figure on the cost of additional contributions that could be put on stressed sponsors and sponsors of very mature schemes. If the Regulator's vision for Bespoke compliance pans out as it hopes, this may all be fine, but we remain concerned this won't be the case due to over-prescription by the DWP legislation.

Purple Book 2022

The Pension Protection Fund (PPF) has published the Purple Book 2022, which looks at the state of affairs in defined benefit (DB) schemes as at the end of March 2022.

The PPF's analysis shows that the number of schemes eligible for its protection has continued to fall, with 5,131 DB schemes covered in 2022, compared to 5,220 at the end of March 2021. For the first time the number of schemes open to future accrual is less than 50% of schemes (48% are open and 52% are closed to all accrual). Membership of DB schemes has also dropped to 9.6 million from 9.7 million in 2021.

The net funding position of DB schemes on the section 179 valuation basis (as used for PPF levy purposes) has improved to a surplus of £193 billion in the year to 31 March 2022, compared to a surplus of £46.9 billion the year before. Section 179 liabilities have fallen by 12% over the course of the year (the largest annual fall recorded).

Other points of note include:

- the aggregate proportions of schemes' assets invested in equities and bonds were broadly unchanged from those recorded last year (the proportion in equities rose slightly from 19.0% to 19.5% and the proportion in bonds fell slightly from 72.0% to 71.6%);
- in the year to 31 March 2022, 14 new schemes entered PPF assessment, compared to 30 new schemes that entered assessment in the previous year; and
- the introduction of a useful website feature that allows users to select data to create graphs and tables.

Regulating actuaries in the public interest

The Financial Reporting Council (FRC) has published a set of general principles that will be used to assess whether its successor, the Audit, Reporting and Governance Authority (ARGA), should take regulatory, supervisory or enforcement action outside of its normal regulatory perimeter. That could happen if, for example, an actuary's behaviour is perceived to bring the profession into disrepute. The principles consist of a series of reflective questions that ARGA will use to conduct a 'public interest test'. The results of this test will be used to determine whether the public interest is best served by taking regulatory action.

The principles are split into three sections:

(1) Is there a need to take regulatory action to maintain justifiable public confidence in—

- the regulated professions and activities (i.e. accountancy, audit or actuarial)?;
- corporate reporting as a whole?; or
- corporate governance as a whole?

(2) Does the nature, extent, scale and gravity of the matter give rise to a serious public concern and does it currently or potentially—

- concern a body of systemic importance or one whose shares are traded publicly?;
- affect a significant number of people?;
- cause (or have the potential to cause) significant financial loss or other harm?; or
- relate to criminal, illegal, fraudulent or unethical behaviour?

(3) Is it proportionate to undertake the action or activity, and has consideration been given to whether relevant regulatory action is being taken by another regulator?

The FRC plans to review the appropriateness of these principles periodically to ensure that they remain fit for purpose.

It's reassuring that the FRC is proactively considering circumstances where ARGA may need to step in to protect the public interest in areas outside of its day-to-day regulatory scope. However, as the majority of ARGA's activities will be focused on public interest entities (PIEs) and current plans include expansion of the PIE definition to include a wider cohort of regulated bodies, this will only serve to reduce the number of potential exceptional circumstances where ARGA may need to act outside of its planned boundaries. Therefore, whilst the principles developed appear sensible, in reality it's likely they will seldomly be used.

No immediate change for money purchase pensions illustrations

Following its annual review of the assumptions for statutory money purchase illustrations (SMPIs), the Financial Reporting Council (FRC) has announced that it does '*not see a significant benefit for users from requiring any changes to be made to existing v4.2 of AS TM1 prior to implementation of AS TM1 v5.0 in October 2023.*' Version 4.2 will therefore remain in force for SMPIs produced between 6 April 2023 and 1 October 2023. Version 5.0 is intended to standardize the actuarial assumptions and the annuitization basis, increasing consistency between different providers' illustrations, in preparation for the launch of pensions dashboards.

Ombudsman round-up

Optimum Retirement Benefit Plan [CAS-80110-K1M0]

Following an investigation by the Pension Ombudsman's Dishonesty Unit (set up in January 2022), the Pensions Ombudsman (PO) has directed the trustees of a scheme to return over £12m. The investigation revealed a catalogue of dodgy dealings including multiple breaches of trust and maladministration. Details of the case have been shared with the Pensions Regulator and the Solicitors Regulation Authority (one of the trustees is a lawyer).

Mrs G [PO-26616]

Teachers' Pensions has been directed to reinstate (or otherwise find a way to provide) benefits that were worth over £217,000 in February 2015, because it had failed to institute procedures to spot potential scams and warn members, in line with the pension liberation fraud guidance from the Regulator that was in force at the time.

(Not so) new Deputy Pensions Ombudsman

Anthony Arter, the current PO, is staying on as Deputy Pensions Ombudsman for another twelve months after he hands over the keys to Dominic Harris, in January: in part, to help resolve the Dishonesty Unit cases that he has already heard.

Green lights a-QAS the board

Following a rigorous and wide-reaching independent audit conducted by the Institute of Chartered Accountants in England and Wales (ICAEW), the Institute and Faculty of Actuaries (IFoA) has confirmed that Hymans Robertson has met the required standards for reaccreditation to the IFoA's Quality Assurance Scheme (QAS).

The QAS is a voluntary, outcomes-based scheme for organisations that employ actuaries, and membership of the scheme demonstrates an organisation's commitment to delivering high- quality actuarial work. The scheme has continuous improvement at its heart and to attain accreditation organisations are required to demonstrate the required standards in three key areas: professionalism, development and training, and organisational culture. Adherence to these standards is assessed through a thorough review of the policies and procedures in place, and interviews with staff across various levels of seniority to hear of their experiences of working within the organisation. The items audited as part of this recent reaccreditation exercise ranged from file reviews of work issued to clients, assessment of work review practises to ensure quality control of actuarial advice, and analysis of the results from feedback surveys issued to clients and staff, amongst many other things.

We're delighted to have been reaccredited to the QAS and continue our work with the IFoA to stay ahead of the latest standards. We've been a member of the QAS since its establishment in 2016 and have found participation in the QAS valuable in identifying our strengths, and areas in which we could do more. We'll continue passing on the benefits of our QAS membership to our staff and clients throughout the year ahead.

And Finally…

A pre-Christmas (other seasonal festivities are available) blog from the Pensions Regulator restates its Truman-esque 'if you can't stand the heat, get out of the kitchen' message encouraging DC scheme consolidation. It stresses the need for improvements in investment governance (as well as devoting significant space to the challenges of investment in illiquid assets). The actual phrase used is the agreeably pithy (as long as one can take the corporate-speak neologism), '*upskill or up sticks*'.

If readers will indulge us engaging a spot of amateur literary criticism, *AF* was somewhat less enamoured with a pun about the required '*Upskill climb*'. We reckon that the metaphor that the author was reaching for was '*upskill battle*' (which *AF* has copyrighted in 75 countries, so pay up or eat dirt, Mr So-called Regulator). '*Upskill climb*' seems to contain redundancy, tautology, or *otiosity* (he says casually, deploying a word learned from judges in pensions-law cases). After all, some element of climbing is inevitably entailed when travelling uphill, and the climbing trope typically conjures mental pictures of mountainsides, vertical obstacles, or at the very least some perceptible incline (one can of course 'climb down'—see Liz Truss, post-mini-Budget).

Otherwise it's not a 'climb'; it's a 'walk'…

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