HYMANS ROBERTSON

DB predictions

Five key themes for 2019

With 2019 set to be another busy year in Defined Benefit pensions, we take a look at the five key themes likely to dominate over the next 12 months.

Regulatory change

Trustees and sponsors will really start to feel the Regulator's bite in 2019.
This will be felt in three ways:

1. **Greater reporting.** An expanded notifiable events framework, together with a new Declaration of Intent, means that companies need to get accustomed to submitting more information to the Regulator and submitting it more quickly. Although much of this responsibility will rest with sponsoring companies, trustees should engage with their sponsor and help their sponsor understand the new responsibilities.

2. **Greater clarity.** TPR has already made its position clear in a number of areas. For example, it expects schemes to be treated fairly relative to shareholders which broadly translates to deficit contributions being no less than dividends. We expect TPR to reinforce this message and other key points in its Annual Funding Statement, which it will be writing with one eye on the new Code of Funding Practice. Trustees should consider the implications, engaging with the sponsoring employer to avoid any surprises at the next actuarial valuation. Our FTSE350 analysis suggests 22% of the FTSE350 are at high risk of regulatory intervention unless pension contributions significantly increase at the next valuation.

3. **Greater intervention.** In 2018 TPR launched its plan for a clearer, quicker and tougher approach to regulating pensions. Many trustees and sponsors have already started to feel the impact. We expect this to continue into 2019 so trustees and sponsors should understand what might trigger regulator intervention and what to expect if the Regulator's jaws come down in their direction.

On top of all this, trustees will need to consider their strengthened duties in relation to responsible investment, the implications of the CMA review and, for the first time, they'll need to carry out a Value for Money Assessment - so a busy year ahead!

This time last year, 43% of trustees we surveyed said that keeping on top of regulatory requirements was a key challenge. With more change in the pipeline, we predict an even greater number will find this a key challenge in 2019 and beyond.

Take-off in the DB consolidation market

2019 will see the first schemes entering the newly emerging commercial consolidators. The recent consultation and guidance gives clarity and reassurance to schemes going down this route. Where commercial consolidation is not the answer, more traditional forms of consolidation can create value, particularly for smaller schemes, through reduced running costs, good governance and more effective investment strategies. Trustees need to understand the range of consolidation options and decide which is right for their members. They should not assume the status quo represents best value. Instead they should keep an open mind, consider the options available and objectively reach the best decision for their members. Our FTSE350 analysis suggests that 9% of the FTSE350 could get a clean break from their DB scheme by transferring to a commercial consolidator with a cash injection of less than 1 month's earnings. Furthermore 52% of the FTSE350 have more than 1 DB scheme and could reduce running costs and management time by merging these schemes.

Maximising value from lower risk strategies

As schemes continue to reduce investment risk, 2019 will see schemes searching for assets which can create more value. Key to value creation will be strategies that deliver predictable income and returns in excess of gilts with a high level of confidence. For over 4 years we've been talking to trustees and sponsors about the need for income to meet benefit cashflows and this will continue into 2019, with an increasing emphasis on capital efficiency. Following a 10 year bull run in equities, we predict that many trustees will consider reducing their equity allocation or protecting their downside exposure. Trustees will also need to consider their optimal levels of interest rate and inflation hedging and as hedging levels increase, liability benchmarks will need closer and more regular scrutiny.

Buy-ins will continue to be an important risk management tool and can be a great opportunity to create value. 2018 was a record year, with bulk annuity transactions exceeding £20 billion, a 50% increase compared to the previous record of £13.2 billion set in 2014. Competitive pricing in 2018 fuelled this demand and for the first year ever, demand from pension schemes to complete bulk annuities outstripped supply. This shift in supply and demand means pension schemes will need to be more prepared than ever in 2019, with a clear understanding of insurance companies and how they prioritise their efforts.

Using scheme assets to create value will be a big theme for 2019. First and foremost because it improves member security. But also because 2019 will be the first full year of DB Value for Money Assessments. We welcome this focus on Value for Money and think it's critical to consider 3 key pillars: setting the right long term objectives; achieving a capital efficient strategy; and maximising operational effectiveness. By exploring these 3 pillars of value creation, our analysis indicates that there's potential to create £275bn of additional value across UK DB, slashing the UK shortfall by more than half.

Holistic end game planning and GMP equalisation

End game planning is a growing trend which is set to continue for 2019. Having a very clear and shared understanding of the end destination is critical, along with the likely journey time. Managing the last stage in a scheme's journey is complex and trustees should have a detailed and holistic plan in place at least 5 years before reaching the finish line. Our analysis indicates that the finish line could be closer than many realise.

Bringing forward some elements of this work, such as data cleansing, can deliver significant benefits. The requirement to equalise GMPs will also act as a catalyst for schemes to start scheme-wide data cleansing in 2019. Trustees shouldn't underestimate the time or cost of tackling data cleansing and GMP equalisation. But there is a silver lining. Tackling scheme data early can create significant value through reduced admin costs, reduced risk and reduced insurer or consolidator pricing.

Implications of Brexit

Given the current turmoil over Brexit, it would be remiss not to mention the implications for DB pension schemes. We've been actively modelling the impact of stress scenarios on scheme portfolios based on various Brexit deals (soft, hard and no deal) rather than trying to predict the actual Brexit deal achieved, with some trustees taking early action as a result in order to manage their risks.

Trustees will need to stay close as the implications unfold, considering the impact in a number of areas, critically the employer covenant and capital markets. Trustees need to consider whether any contingency planning is needed or any reduction in investment risk. Some trustees have reviewed liquidity, hedging levels and currency exposure – and will keep decisions under review whilst Brexit negotiations take place. From an operational perspective, trustees should seek assurances from asset managers and custodians that they can ensure continuity of operations post Brexit. And on top of all of this, trustees will want to offer some reassurance to members by communicating the risk management actions they are taking.

In summary, 2019 looks set to be a bumper year for DB pensions, with substantial developments and issues on the horizon. Please contact your usual Hymans Robertson consultant if you would like to discuss these issues further.