Hot topics for DB schemes in 2019

What should be at the top of trustees' investment and governance agendas in 2019?

As trustees seek to navigate a market backdrop that is no less challenging than in 2018, there are some "must do's" that schemes should have on their business plans and there should also be some time set aside for considering industry developments, and whether they might be appropriate.

Responsible investment regulations

The pace of regulation around responsible investing has quickened considerably over the last year. New regulations for occupational pension schemes introduced in October 2018 require all trustees, by October 2019, to set out more explicit policies on addressing financially material considerations, including Environmental, Social and Governance ("ESG") considerations and climate change.

The UK has already implemented IORP II, a new European Pensions Directive in January 2019, which shifts the focus of pension schemes from effective "internal controls" to establishing and operating an "effective system of governance". This would include, among other things, consideration of ESG factors in investment decisions. Regardless of their views on Responsible Investment, it is an issue that pension scheme stakeholders must now address with increased diligence.

Strategic risk management and implementation governance options

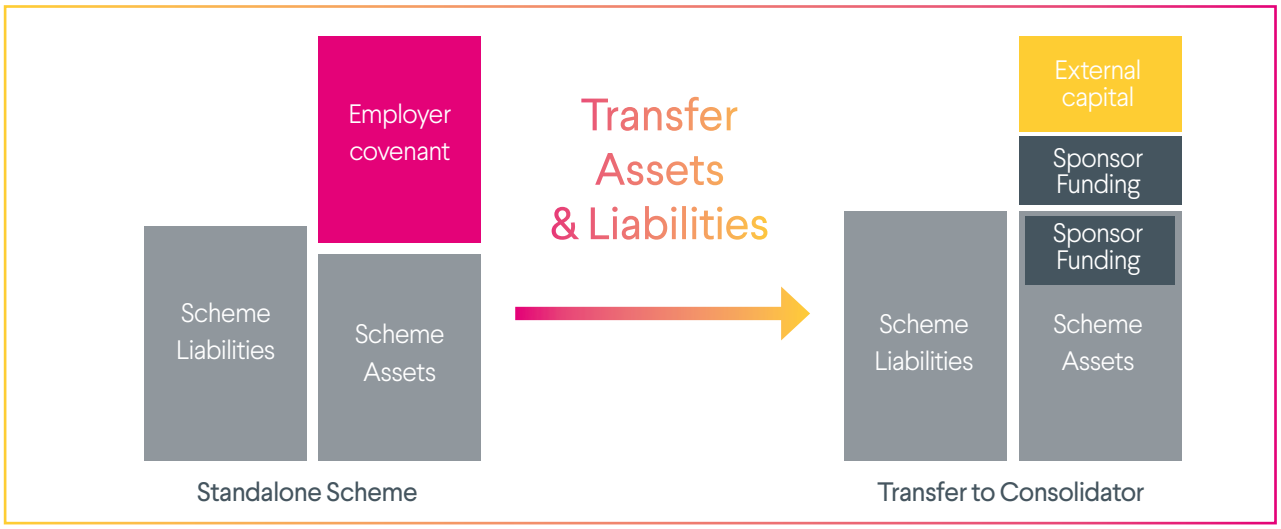
As schemes mature, and in many cases, as they become a legacy rather than an integral part of employee pay, trustees and sponsors are looking for efficiencies in the way they manage their schemes, including all aspects of governance. Investment is by no means exempt from this.

Traditionally, in an investment advisory model, an investment consultant is employed to provide advice on the strategic and implementation aspects of how the assets are to be managed, while trustees retain control of decision making.

There are now a wide range of partially and fully outsourced models that some trustees may find provide a more suitable balance to meeting their governance needs. We highlight some below:

- **Fiduciary management** provides trustees scope to outsource all aspects of implementation, albeit they cannot get away from the need for some oversight of what the fiduciary manager is doing on their behalf. Strategy still typically relies on some trustee input and decision-making.
- A **platform solution** can be seen as a route to accessing something halfway between traditional advisory and fiduciary management models, offering the investment administration simplification of the implementation, while retaining full implementation decision-making.
- A scheme can transfer risk as well as decision-making by passing responsibility for payment of a proportion or all of its liabilities to an insurer. These **annuity settlement** transactions (buy-in or buy-out) transfer the risk of assets failing to meet liabilities as they fall due to an insurance company. As outlined in our recent **Autumn 2018 Investment Perspectives**, we do not see this trend reversing anytime soon.
- An alternative to the insurer risk transfer route is the consolidator. In this case, a scheme's assets and liabilities (and associated risks) are transferred to the consolidator (see Figure 1), typically a large, sectionalised scheme that accepts transfers from existing DB schemes. A cash injection is also usually required from the employer / sponsor as part of the transfer to provide the capital buffer the consolidator requires to cover the risks taken on. This new approach will not be suitable for all schemes, but an increase in the range of options is welcome.

Figure 1: Example transfer to consolidator (showing funding sources)



All trustees should consider from time to time whether their current risk management and governance arrangements remain appropriate for their current circumstances. This article just provides a flavour of some alternatives that are available.

Cashflow-driven investing (CDI)

CDI is a strategy for investing in assets that deliver relatively predictable cashflows, structured to meet benefit payments from income and maturity proceeds, rather than sales of assets.

A natural baseline for a low risk CDI portfolio would be to use a combination of gilts and high quality corporate bonds. However, this would result in a return only marginally in excess of gilts, and is likely to prove too expensive for all but the best funded schemes. Instead, it is possible to deliver an enhanced return over gilts with a high level of confidence by investing in a portfolio of diversified income assets such as infrastructure and property, capturing risk premia from credit, illiquidity and complexity.

CDI becomes increasingly relevant as schemes mature. Most schemes should be at least planning the type of approach that best fits their circumstances, or even looking now at implementation options.

As the CDI strategy cashflows and return profile are predictable, it is possible to align it with the funding plan to provide an integrated risk management framework, i.e. setting a discount rate based on the CDI asset yield (with an appropriate haircut for default risk) rather than using a fixed "gilts plus" approach.

Brexit

Sorry, but there is no getting away from it! At the time of writing (mid-January), we are no more certain about the outcome of the Brexit process than at any point since the June 2016 referendum, even though the UK is still set to leave the EU on 29 March 2019. The long term nature of pensions means that trustees and sponsors should be careful to avoid knee-jerk decisions. But against the backdrop of the current uncertainty, trustees and sponsors will want to understand the risks and how best to manage them over the coming months.

The type of Brexit that will be faced by the British people is still hugely uncertain. Initially categorised into three main categories: 'soft', 'hard', and 'no-deal' Brexit, this formed the basis of scenario analysis we carried out last year. However, the option of no Brexit ("remain" or some form of it) is also now a realistic contender, increased in likelihood following the rejection by Parliament of Mrs May's proposal.

Until December, most forecasts were still based on the central assumption that there will be a Withdrawal Agreement about as soft or even softer than the Chequers proposal. Reflecting this, domestic market movements have largely followed global trends in recent months, rather than been driven by specific Brexit risk, and the Consensus Forecast for UK GDP growth in 2019 is 1.5% (i.e. higher than 2018) and UK CPI inflation is expected to be a little above 2%.

Conversely, a no-deal outcome is generally taken to mean that UK will trade under World Trade Organisation ("WTO") arrangements and is viewed as disruptive: UK growth forecasts for 2019 would be expected to be cut below 1% and some envisage a recession or near-recessionary environment. A spike in UK inflation would be expected, driven by currency weakness. The view that a no-deal Brexit will cause short-term economic disruption is relatively uncontroversial. It is also the consensus view that a no-deal Brexit will be bad for UK growth over the long term, but we note that views on this are far from uniform. One other plausible Brexit-related event that may arise is the end of the current government and its replacement by Labour; generally viewed as a negative outcome for the City. While a 'no Brexit' option would be considered business friendly, it has other potential repercussions.

Investment agendas for 2019

If you would like to explore any or all of the above themes in further detail, please get in touch with your Hymans Robertson investment consultant. We will also aim to keep you in touch with developments of these themes and with any new key issues that arise to ensure that your agendas remain up-to-date throughout 2019 and beyond.

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