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2020 Vision for DB Pensions

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We are now settling into 2020; the start of a new decade and a new Parliamentary session. Thinking back to this time in 2010, few would have predicted where we are now. As Bill Gates once said:

> **“We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten.”**

A quick look back at the world in 2010 certainly highlights the significant change we have seen over the past ten years.

Looking back to 2010

- Gordon Brown was UK Prime Minister as the Leader of the Labour Party, ahead of almost a decade of Conservative governments
- The phrase “Brexit” would have been met with looks of bewilderment
- The UK economy had just experienced its first quarter out of recession whilst the UK had just begun a program of Quantitative Easing
- Greece and Ireland were in the process of seeking bail-outs from their financial crises
- Donald Trump was still known as a property mogul and TV personality, as Barack Obama was coming to the end of his first full year in the White House
- Many companies which defined the decade including AirBnb, Uber and Instagram were little more than ideas.

The decade of DB

The landscape also looked quite different from a pensions perspective as we entered the 2010s:

The landscape of DB in 2010

Schemes were still going through their first triennial valuations under the updated funding regime, calculating Technical Provisions liabilities to meet the Statutory Funding Objective.

The yield on long-term gilts was around **4.5% p.a.** compared to the recent lows of **c0.8% p.a**

Schemes were starting to engage in buy-in / buy-out activity, with the market seeing **c£5bn** in transactions compared to **c£30bn** expected in 2020

The Purple Book 2010 showed an aggregate funding surplus for schemes in the UK (on a s179 basis) of **£38.3bn** compared to a deficit of **£12.7bn** in 2019

Equities dominated most scheme's investment allocations, with **42%** of total assets. This has almost halved by the end of the decade (**24%** based on the 2018 Purple Book)

There was no requirement to enrol employees in a pension scheme, as preparations were just beginning for Automatic Enrolment due to come into force in 2012

It would take a brave individual to predict where the world, or the DB pensions industry, will be at the start of the next decade. The uncertainty surrounding Brexit, US/China tensions, IndyRef2, climate change, and the evolution of technology means we could be in a very different place in 10 years' time.

Whilst we may not want to hazard a guess at whether we will have people on Mars or flying cars by 2030, we have a clear view on the key themes we expect to dominate the DB pensions landscape over this year.

Themes to look out for in DB pensions in 2020

Much of what we expect for the rest of the year is a continuation of themes that emerged during 2019. Below we outline five themes for trustees and sponsors to look out for.

1

Shift in the regulatory landscape

2020 is expected to see a number of long-discussed legislative and regulatory changes come into effect.

The UK's new Government has revived the Pension Schemes Bill 2019/20. The Bill will strengthen the Pensions Regulator's hand by enhancing its investigatory powers, by requiring those involved in certain corporate transactions to notify TPR and make related statements, by amending the contribution-notice rules in TPR's favour, and by introducing new criminal offences and civil penalties for misbehaviour in connection with DB schemes. Trustees of DB schemes will also be required to formulate and agree with the employer a 'funding and investment strategy' (FIS). Having consulted the employer, trustees will have to produce a 'statement of strategy' describing their FIS, as well as the extent to which it is being implemented, the main risks to its successful implementation, and their reflections on any important decisions taken. The statement will be signed on the trustees' behalf by their chairperson and sent to TPR, and providing false or misleading information in the statement will be a criminal offence.

We are also on the brink of a new DB Funding Code from TPR; a stronger and more directive Code with significant implications for many trustees and sponsors. It will introduce a set of standards covering funding targets, recovery plans, and even investment strategy. Trustees will need to comply with this set of "fast track" standards or justify a different "bespoke" approach. More details on the Code and actions trustee and sponsors can be taking now to prepare can be found in our blog "To comply or explain, that is the question".

2

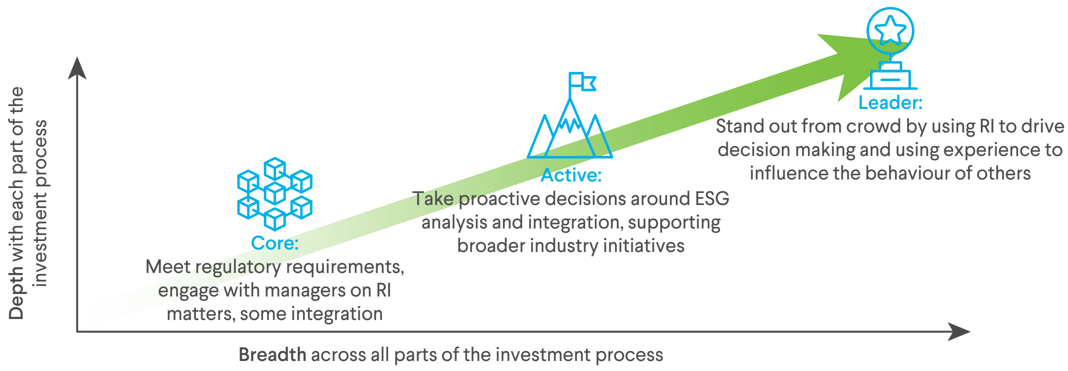
The continuing rise of ESG

2019 was a milestone year for Greta Thunberg, as her efforts as a climate activist saw her go from a Swedish schoolchild to TIME person of the year. For UK pension schemes, 1 October 2019 was a milestone date, with trustees of both DB and DC schemes now required to produce a Statement of Investment Principles which sets out both how they take account of financially material considerations and their policies in relation to the stewardship of investments, including specific reference to climate risk.

On the spectrum of different behaviours, those who wish to treat these changes as a compliance activity sit firmly in the bottom-left of what we refer to as our core-active-leader framework while others wish to be more active or even industry leaders, as set out below.

Both minimum standards and best practice are being pulled progressively higher. Revisions to the FRC Stewardship Code and the efforts of the Principles for Responsible Investment are continuing to raise the requirements for signatories who, by definition, seek to exemplify high standards. This upward trend means that what may be considered the active responsible investor of today may become the core level of compliance tomorrow. Recent amendments tabled to the Pension Schemes Bill continue to highlight the interest politicians are now taking in this area.

We expect 2020 to see more engagement from trustees in ESG issues. Far from being a tick-box exercise, this should be seen as an opportunity to create extra value in terms of investment returns. Also given the size of DB assets, the ESG decision-making process can also be viewed as adding value in terms of the social impact of those investment decisions.



3

End game planning

As the Pensions Regulator (TPR) continues to emphasise the importance of setting an appropriate Long Term Objective (LTO), the majority of trustees either plan to, or have already, reviewed the end goal for their DB pension scheme. Our Trustee Barometer research in 2019 highlighted that 20% of trustees believe sponsor failure to be the biggest risk to their scheme's financial health. Reflecting this, trustees are increasingly considering alternative end-game solutions which remove the reliance on their sponsors long-term sustainability. The market is evolving to meet this demand, as set out in our paper "Understanding your DB destination".

DB consolidation has attracted significant headlines over the last year, but the market is yet to take-off properly, and it was notably absent from the 2019 Pensions Bill. Still, we expect to see the first transactions to commercial consolidators in 2020. Once proof of concept is established and the authorisation regime is in place, transaction volumes are likely to grow significantly. Our FTSE350 pension analysis report shows that most schemes still pass the gateway test, and that the required cash injection is a significant multiple of the existing cash contribution commitments, meaning trustees should seriously consider this option if it's put on the table. Traditional DB Master Trusts are also an attractive option for smaller schemes, particularly as funding levels improve and investment strategies are de-risked, at which point the desire for employer control reduces. We expect to see continued growth in this market.

2020 is also expected to be another busy year for the buy-in and buy-out markets, with total transaction volumes expected to exceed £30bn. As more schemes consider their end-game strategies, we are also likely to see more schemes converting their longevity swaps into buy-ins or partial buy-outs. We have supported clients with this over the past year and expect to see this become more common over 2020. Read more in our 2020 Risk Transfer Report

Managing the last stage in a scheme's journey is complex and we're seeing more trustees keen to "get their house in order", either because they have the end in sight or because they want to "get their house in order" before long standing trustees or pensions managers retire. 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 2020. Trustees should not 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.

4

Increasing focus on member options

Around £80 billion has already been transferred from DB schemes since the pension freedoms were introduced over four years ago. Despite recent headlines around demand slowing down, the opportunity to transfer has clearly continued to resonate with members, with a staggering £30 billion being moved in the last twelve months alone. Over the next 5 years or so we'll see the significant majority of DB members reach age 55 and therefore become eligible to access their benefits and the pension freedoms. This will lead to unprecedented demand from members for quality choice and support. A potential 5 million individuals will need to be guided through the complex maze of options they'll be faced with.

In our recent survey, detailed further in our "Evolution of member options" paper, almost a third of trustees confessed that 'adapting to Freedom and Choice' is one of the biggest challenges they'll face over the next 12 months. Despite some increase in Trustees taking more responsibility over the last year, there is still a lot of uncertainty when it comes to whose responsibility it is to educate and better equip members to make good retirement choices. With this in mind, we have identified three key priorities for trustees over the coming year:

1. Provide valuable choice to members
2. Communicate these options effectively
2. Support your members in making the right choice.

We expect, and hope, to see more trustees improve the way they engage with members and support them around their options in 2020. This can only be a good thing for all parties.

5

Turbulent financial markets at home and abroad

It is impossible to consider the rest of the year without mentioning Brexit. The dominant feature of the UK's political landscape in 2019, 2020 is sure to see another year of ups and downs in the value of domestic shares, bonds and currency as a result of Brexit negotiations. Whilst the UK has now officially left the EU, the negotiations on a new trade deal are in early stages. The Prime Minister hopes for this to be signed off by the end of the year, and both UK and EU markets will continue to be volatile until the future relationship is known.

There is an additional uncertainty moving into 2020 on the future of RPI. In 2019 the Government responded to the House of Lords Economic Affairs Committee's January 2019 report, Measuring Inflation, which recommended that problems with the RPI be 'fixed', and to proposals from the UK Statistical Authority ("UKSA") that the publication of RPI should cease. There is an expectation that RPI will be aligned with CPI-H sometime in future, but the timing of any alignment is unclear. Any additional information which comes to light in 2020 could lead to immediate changes in the level of RPI, and important decisions for trustees in relation to the impact for their scheme. 2020 is also election year in the US which, coupled with the current tensions between US and a number of nations in Asia, could lead to significant changes to the political and economic landscape globally.

Finally, the ongoing Coronavirus outbreak shows no signs of slowing down. This could have a major impact on the global economy over the coming year, and considering resilience to various pandemic scenarios can be considered an important part of schemes' Integrated Risk Management.

In summary, 2020 looks set to be a big 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.

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