Challenging Times Ahead for Trustees in 2020

AMNT WINTER CONFERENCE 2020

10 February 2020

Sir Steve Webb, AMNT Autumn Conference - 10/02/2020

INTRODUCTION:

Trustees gathered at the AMNT's Winter Conference to hear about the most important pension scheme issues of the day. A host of distinguished speakers addressed them on what's next in terms terms of regulation, scheme valuations and ESG, among other areas.

The Pensions Regulator (TPR) used the conference to exclusively reveal what it thinks the future of trusteeship and governance should look like. TPR's executive director for regulatory policy, analysis and advice, David Fairs, outlined the highlights of its response to its recent consultation.

TPR will spearhead a working group which is dedicated to making trustee boards more diverse, streamline its approach to trustee training, and encourage struggling schemes to consolidate, among other measures (see p4 for more details).

Former pensions minister Steve Webb is one of the best placed commentators on the policy agenda in the UK. Therefore, it's no wonder that he used this conference as an opportunity to highlight three lesser-spotted points in the Pension Schemes Bill, as well as one notable omission. Find out what they were on p8.

Many trustees are wrestling with the complexities of GMP equalisation, following the Lloyds Judgement of 2018. The good news is that trustee boards can start the process now. There are several resources they can look to for help, explained Willis Towers Watson's Richard Akroyd. Discover how to get ahead of the game on p12.

Finally, the Australian wildfires have vividly illustrated the critical importance of ESG in today's world. ESG is not just a 'nice to have' feature of trustee governance, but a vital component of risk management. To find out what your trustee board can do to make their voices heard, turn to p10.

A plethora of regulation, as well as continued macroeconomic uncertainty, means times are challenging for trustees. However, we hope our conferences will help you to cut through the uncertainty and feel empowered to make the best possible decisions for scheme members.

We hope you enjoy reading this report. If you couldn't make it to this event but would like to attend future conferences, you can find out more about what's in the pipeline here: https://amnt.org/future-amnt-events/.

Content Page

Regulator swoops on poor scheme governance

Many savers in small pension schemes are receiving poor governance and value for money, said David Fairs, the Pensions Regulator's executive director for regulatory policy, analysis and advice.

The regulator believes that while many pension schemes are very well governed, standards are inconsistent. Only 4% of micro pension schemes (with between two and 11 members) and 1% of small schemes (between 12 and 99 members) meet all the regulator's governance standards.

Fairs announced a range of measures to tackle poor governance at the Association of Member Nominated Trustees' (AMNT) Winter Conference on 10th February 2020. He shared exclusive insights from the regulator's response to its future of trusteeship and governance consultation. The consultation ran from July to September 2019 and received 114 responses – a record for the Pensions Regulator.

Create more diverse trustee boards

"We believe an effective trustee board is not just diverse, but inclusive," said Fairs. Accordingly, the regulator will create an industry working group to help pension schemes to make their boards more diverse.

"We anticipate this group will define what diversity means, how boards can maximise their potential, and produce practical case studies to show how trustee boards can become more diverse," explained Fairs.

In its initial consultation, the regulator asked for views on whether every trustee board should have a professional trustee. Fairs said: "We recognise there are not enough professional trustees for every pension scheme to have one. In the consultation responses, the only people in favour of professional trustees being put on every board were the professional trustees. Given the feedback from the consultation, we don't anticipate doing anything in this space at the moment. By holding fire, we will see how the new requirements impact on trustee boards and standards of governance."

Finally, Fairs voiced concerns about sole trusteeship as a model. "We will continue to scrutinise those schemes, and we welcome the proposal from the Association of Professional Pension Trustees to develop an industry code."

A streamlined approach to training

The regulator will streamline its approach to trustee knowledge and understanding (TKU). "We are combining our 15 codes of practice into a single, web-based code," announced Fairs. "The new single code will include new topics, including ESG and climate change, which trustees have been asking for guidance on."

There will be a range of ways trustees can complete their TKU every year, such as through industry-based training or completing the trustee toolkit. The regulator also plans to review and update the Trustee Toolkit. Lay trustees will be expected to complete 15 hours a year of training, and professional trustees will be required to complete 25 hours.

Some trustees told us their employers were not giving them enough time to learn, even though the law dictates they should be given this time. "We will be running a targeted campaign, reminding employers of this rule," said Fairs.

DC consolidation for underperformers

Small and micro DC schemes which are underperforming should consolidate, said Fairs. "We don't plan to be prescriptive – if you are a small scheme doing everything right, you can carry on. If not, we will be strongly encouraging consolidation."

The regulator is working with the Department for Work and Pensions and the insurance industry to create a smoother path to consolidation, said Fairs.

What the Pension Schemes Bill will mean for funding

The Pension Schemes Bill will introduce a range of new measures. But one of its most important elements for trustees is the new funding requirements it will introduce. How can you prepare? Willis Towers Watson's Adam Boyes explained at the AMNT's Winter Conference.

Discuss the long-term objective

The bill introduces a requirement for trustees of defined benefit (DB) schemes to have an investment and funding strategy which specifies the intended funding level. The strategy must also outline the investments the trustees plan to make in order to achieve their goal.

Many trustee boards will already have a long-term strategy, but even those that do will have some work to do. "I expect most will review their targets and think hard about them again," said Boyes. "It may be that the change is more around the documentation of those targets. Other schemes may have targets that are too weak for the regulator's liking. Open defined benefit schemes might be most affected, as this could impact future accrual."

Under the new bill, an employer will have to agree to the scheme's proposed funding and investment strategy. As Boyes explained: "A statement of strategy must be prepared by the chair of trustees to explain whether the strategy is being successfully implemented or corrective steps to be taken, the main risks faced and how these will be managed, reflections on past decisions and lessons learned. The technical provisions will have to be calculated in a way that is consistent with the strategy."

Three ways to prepare

The proposed new requirements are still in draft. However, schemes with upcoming valuations should start to prepare, advised Boyes.

1.Make your next valuation a strategic one

Define or revisit your long-term target, said Boyes. Make sure it is realistic. "If you are aiming too high, even if it's in the long term, it may have implications for today."

Another point to consider is whether your scheme could seek other forms of security, suggested Boyes. Are there other ways to improve your scheme's funding position?

2.Take a prudent approach

This may involve holding more money than you think you will need. Explore other risk management techniques, said Boyes. For instance, many schemes have not yet considered how they will mitigate longevity risk.

3.Make the most of technology

Valuation technology has come a long way. These days, going into valuations, trustees often have a good idea of the scheme's position. "Is there something you can put in place now that would have real tangible benefits for the scheme if funding deteriorated? What if things get worse – could you put money in straight away?" asked Boyes.

There may be a lot to consider and Brexit continues to create major uncertainty. However, armed with the right information and with a clear set of objectives, trustees can make a huge difference to their funding at their scheme's next valuation, concluded Boyes.

Three lesser-spotted points in the Pension Schemes Bill

It paves the way for collective defined contribution and sets new rules for DB scheme funding. Really, it's no wonder that the long-awaited Pension Schemes Bill has prompted much discussion among trustees. However, according to former pensions minister Steve Webb, there are three under-rated points in the bill which merit further attention.

The risk of jail

Clause 107 of the bill is theoretically aimed at people who recklessly underfund pension schemes, said Webb (who is now a partner at consultancy LCP). Yet the broad language of the clause risks unintended consequences – at its most extreme, risking jail terms for trustees.

The bill proposes making conduct which risks accrued scheme benefits a criminal offence. Webb summarised: "If you do something, the result of which accrued benefits are less likely to be received, you are on the hook."

Webb questioned whether this wording is reasonable. The bill means that trustees could face consequences if they "ought to have known" that a decision would have adverse consequences for beneficiaries. Pension scheme decision-makers do not have the benefit of hindsight and must make decisions based on the information available to them, argued Webb.

If trustees object to the wording of clause 107, they only have a limited amount of time to voice their concerns. "We need to act now, while the bill is in the House of Lords," urged Webb. If not, the government's comfortable majority means that it is highly likely to pass uncontested through the House of Commons and into statute. He urged the AMNT's members to write to any contacts they have in government to voice their concerns.

Webb has several other objections to the bill: "It puts people at risk and makes them less likely to want to be trustees."

Plus, the bill might make trustees more cautious, for fear that a less conservative investment decision might prove risky, even if the cautious route isn't necessarily the best one, said Webb. "If I go this way, I might get a slightly better return. But in five years, if someone scrutinises my decision, I might want to be conservative," he summarised.

Pensions transfers

Webb welcomed the clause of the bill which clarifies trustees' powers to block members' requests to transfer out of pension schemes, where the trustees are sceptical about where the money is going. He summarised: "Trustees ought to have more powers to block transfers. This bill will reinstate what we thought was the position. That is a good thing."

Pensions dashboards

Trustees are in danger of underestimating the amount of work an operational pensions dashboard could create, warned Webb. "Imagine you have a 35-year working life with six pensions and none of them make any sense because the company name has changed since you worked for them. What is the first thing you are going to do? Phone up."

Schemes should consider investing in telephone handling companies, suggested Webb. There will also be a huge role for administrators and data cleansing companies. "Sooner or later, schemes are going to have to provide the data and answer an awful lot of questions. It is a good thing, but think about it."

What's missing from the bill?

Defined benefit (DB) consolidation is not mentioned in the bill. The government is interested in consolidation – as Webb put it, "If you were David Fairs, wouldn't you rather regulate ten big schemes than thousands of small ones?" – but it is struggling to reach cross-governmental agreement on how to regulate consolidators.

Market factors are at play, said Webb. Insurers are unenthusiastic about consolidators, because they are essentially competitors with lower solvency standards.

"The PRA [Prudential Regulatory Authority] argue the right level of solvency is that of insurers," said Webb. "Otherwise, consolidators could undercut insurers. The worry is consolidators will be allowed but regulated within an inch of their lives – they could run out of money and go away. [The government] couldn't get consolidators in the bill, despite a four-month delay to try and get them in. There is a heck of a row going on in government."

Act now on ESG

Australia's recent calamitous wildfires have brought home the vital importance of environmental and social governance (ESG), said Janice Turner, co-chair of the AMNT. "ESG is nothing less than assessing and mitigating the risk to our assets. It is getting easier and easier to understand how climate change is going to affect the sustainability of our investments," she said.

Turner added: "Already an area the size of England has been incinerated [in the Australian fires]. Now there has been torrential rain in the same area. That has led to landslides and floods. How secure do you think your investments in the south east of Australia are? What if California is next? Suppose that affected the film industry, or Silicon Valley?"

Red Line Voting, the AMNT's long-running campaign, aims to give trustees a voice as shareholders on issues like climate change. Together, trustees hold significant weight as institutional investors. But because many individual pension schemes are small, they have historically delegated their voting rights to investment managers.

This must change, said Turner. She recalled her initial moment of realisation: "The Shareholder Spring of 2012 crystallised things. There was a big shareholder rebellion about excessive executive pay. [Turner's trustee board] wanted to join in as shareholders to vote against excessive pay. But when we tried to do that, we discovered we weren't allowed to. My very small pension scheme with £20m in assets was invested in pooled assets. The fund manager said there was no demand from pension schemes – and we believed them."

Afterwards, Turner was determined to make a change. Years of research and consultation led to Red Line Voting. These voting instructions on the key ESG issues are informed by the UK Governance Code, the UN Global Compact, the FRC and CPD, among other influences.

Turner summarised: "Red Lines are the UK's first easy to use template policies on the environment and on social issues. They apply to UK stock market-listed investments. They link to resolutions typically laid at all AGMs. The fund managers are at liberty to vote against our instructions, but if they do, they need to explain why."

Environment

Developed in accordance with the United Nations Global Compact

Climate change: Environmental Sustainability

Climate change: disclosure of information

Climate change: international agreement

Social

Developed in accordance with the United Nations Global Compact & UK Corporate Governance Code

Corporate Social Responsibility

Equality monitoring & ethnic representation

Women on boards

Living wage and contracts

UN Global Compact

Corporate governance

Developed in accordance with the UK Corporate Governance Code

Directors and the Nomination Committee

Auditors & Audit Committee

Tax policy

Pre-emption rights

Takeovers / Dividends

Executive remuneration

When the AMNT launched Red Lines, many pension schemes adopted them, but fund managers flatly refused to accept them, recalled Turner. In response, the AMNT lobbied the government, the Pensions Regulator and the Financial Conduct Authority.

Turner explained: "The AMNT complained to the FCA, requesting that they investigate this market failure and propose remedies. This was taken up by the Treasury Select Committee – ahead of the General Election, the chair wrote to the head of the FCA to ask about progress."

The AMNT is still waiting for a response from the FCA.

Agents of change: Four ways trustees can be a force for good

-Adopt an ESG voting policy if you haven't already

-Send it to your fund managers requesting that they align with it and operate it on a comply or explain basis

-If rejected, you can include in your Sip that you are only delegating your stewardship to your fund managers because they have refused to accept your policy

-Compare your policy with those of your fund managers and hold them to account for differences – and look at their voting record if you can

…And investment consultants can:

Downgrade their rating of fund managers who fail to respect their clients' policies

With their large numbers of clients and weight of assets under management, investment consultants have huge potential to be powerful agents of change. The AMNT held a roundtable with them in 2016 and produced a report, Holding Investment Consultants to Account. "It tells trustees what they should be entitled to expect," summarised Turner.

Trustees must insist their voices are heard on ESG issues, concluded Turner. "The buck stops with you. The fund managers don't lose out. The investment consultants don't lose out. It is our beneficiaries who lose out. We have to take control and arrive at our own conclusion on ESG materiality and act on it. We have to demand our policies are respected by those we pay so much money to for their services."

To learn more about Red Line Voting, visit http://redlinevoting.org/

How to make your pension scheme more attractive to insurers

As funding levels improve, more and more trustees are thinking about what the end game might look like for their DB pension schemes. Preparation is essential when preparing for a buy-in or a buyout, said Willis Towers Watson's Costas Yiasoumi. In conversation with Sammy Cooper-Smith, head of business development at Rothesay Life, the two discussed how pension schemes can put themselves in the best possible position to agree a deal.

Why is it important to make your scheme look attractive to insurers? There has been a rush of money into the market as schemes' funding levels have improved and longevity rates have worsened, said Cooper-Smith. "Over the last 18 months, we have turned down 46 pension schemes who have approached us. There is so much business in the market, how do we go about working out which deals to work on?"

Cooper-Smith summarised the issues which are important to insurers. First, clear objectives and a realistic price target show that trustees have thought about the process and are committed.

Second, good quality data will put schemes in a good place to transact. This includes marital status data (including spouse's information) member data which is in a good condition and up to date information about people who have passed away in recent years (known as experience data).

Third, attractive schemes will have undertaken a so-called matching adjustment, where they move their investments into a portfolio which mirrors that of an insurer. If they haven't already moved their investments, they will have a clear transition plan. For instance, schemes with illiquid assets will have a plan as to how they are going to transfer these to an insurer.

Trustees and the scheme sponsor should be aligned on their approach to an insurance transaction and be clear about its financial implications, added Yiasoumi. One great way to keep lines of communication open is to establish a working group, with buyout advisers, sponsor, and other advisers (where necessary) attending alongside some or all of the trustees. If the company is associated with a trade union, it's also a great idea to include them in the working group.

A little-known elephant trap for schemes can be working with the wrong advisers. "There are a couple of [law] firms who are known to make things more difficult," said Cooper-Smith. Insurers are more likely to view lawyers they have done business with before and who ensured the transaction went smoothly, more favourably.

Quoting on a transaction takes days of time for an insurer. In a competitive market, there is only a finite amount of time they can afford to dedicate to new business. By planning carefully for a transaction, trustees can put themselves in the best possible position to negotiate a good deal.

Creating a better climate for end investors

Over 70% of trustees believe they should not get involved in managing climate risk, according to a recent survey by Professional Pensions. However, in reality, regulation will demand that trustees tackle these issues, said Mike Clark, managing director of Ario Advisory.

"ESG is a matter for investment managers and you as trustees should supervise it," summarised Clark.

All large pension schemes will need to make climate change disclosures by 2022, because of the work of the Taskforce on Climate-related Financial Disclosures (TCFD). "You can't just delegate this to your investment managers," said Clark. "There is climate risk in most funds you are in, so you need to start thinking about it from a strategic risk perspective."

Trustees who have not yet engaged with climate risk could look to various others in the industry for guidance. The HSBC Pension Fund's DC default fund is climate aware, said Clark. Additionally, the Bank of England is proposing stress tests for insurers; trustees may find its scenarios a helpful reference point. The Church of England pension scheme has signed up to the Net Zero Asset Owners' Alliance, a group of asset owners who believe we need to commit to a low carbon world.

In a move which Clark heralded as "the big one", the Department for Work and Pensions is convening a pensions climate change risk industry group to prepare guidance for pension schemes on climate-related issues.

Trustees can also look to the AMNT's Red Line Voting, which provides clear voting guidance on climate change for their investment managers.

Finally, trustee boards can become agents of change by asking good questions of their investment managers and advisers, said Clark. He suggested, "Ask advisers: 'Tell me about my portfolio and its exposure to climate change.' Or ask managers: 'What do you think about the Barclays resolution and how are you voting?'

Climate change may seem far away, but its real-world implications are seismic. Trustees will have to engage with it sooner or later – so why not act now?

What are the biggest risks trustees face?

Sukhi Randhawa, investment strategist at Willis Towers Watson, Bob Scott, senior partner at LCP and Stuart Breyer, CEO of Mallowstreet were each asked to choose their three top risks for trustees, in a panel session chaired by Alan Gander, who sits on the AMNT's management committee.

Sukhi Randhawa's top three risks

"Climate is a huge topic of discussion," reflected Randhawa. "When I was thinking about what we talk about with clients and reflecting on all the bits of pensions regulation that have come out recently – every risk seems to boil down to sustainability. So, if I was to think about the top three risks, they all have that sustainability theme."

Trustees should evaluate their climate risk, working with advisers to establish how their assets are invested and the potential issues that could arise, said Randhawa.

Second, with markets uncertain, trustees should consider the sustainability of their investment portfolio. "Whilst we have seen plenty of schemes move away from the mainstream into illiquid assets, for example, there are not many schemes which have sufficiently diversified. DC schemes, in particular, given their operational daily pricing constraints," observed Randhawa.

Finally, keeping on top of regulation has become a big risk for trustee boards, said Randhawa. "The world of pensions has become so much more complex. Over 700 pieces of regulation have come out on sustainability over the last five years from 50 economies in the world. Do trustee boards have enough resource? What are the reputational risks associated with poor governance?"

Bob Scott's top three risks

For LCP's Bob Scott, administrative errors pose a significant risk to trustees. "Most schemes have yet to do a GMP equalisation exercise," he said. "One of my colleagues says regularly that if he could go to a scheme and ask for 12 calculations, in 90% of cases he will find an error. Those can arise due to inadequate data, due to schemes not following the rules, due to decisions not being executed properly, due to administrators following protocol that was not in line with rules."

These issues can be relatively minor, or major – for instance, where a scheme did not complete its documents fully for 20 years. GMP equalisation and bulk annuity transfers are both likely to shine a spotlight on data errors, with some complicated consequences, said Scott.

Scott's second big risk for trustees was changes in key personnel. "As the current generation moves on, that creates a hole that needs to be filled but it also means the skeletons they had in their drawer will come to light. They can lead to issues such as unexpected errors in benefits calculations."

Regulation was Scott's third key risk. Clause 107 in the Pensions Schemes Bill makes conduct which risks accrued scheme benefits a criminal offence. Scott gave a real-world example of how this could impact trustees. If trustees find that benefits have been overpaid and decide not to reclaim them from a 70-year-old, they could be complicit in a criminal act and face up to seven years in prison, because they could be endangering the security of the scheme.

The sheer volume of regulation is another risk for trustees. "There is a vast amount of regulation which has been backed up since Brexit and is coming out onto the books," said Scott.

Stuart Breyer's top three risks

Climate risk was Mallowstreet CEO Stuart Breyer's top risk. "There are really simple things you can do as trustees," he said. "For every investment decision made, you can ask, what is the impact to climate?"

A lack of cognitive diversity on trustee boards was another of Breyer's top risks. "How are trustee boards ensuring there enough different viewpoints around the table to make sure they are making the right decisions?"

Achieving long-term funding targets is another key risk, said Breyer. "A very small proportion of pension schemes have done risk transfer exercises. There is very limited capacity [among insurers]. There are questions and challenges about how pension schemes can achieve long-term funding targets."

Five ways to become good communicators

Good communication is always about encouraging people to do something, observed Vincent Franklin, co-founder and creative partner of Quietroom, a writing and strategic consultancy.

To get a rocket off the ground, you increase the fuel and reduce the friction. Member communications should work the same way, said Franklin. "Good communication is about increasing the fuel to change behaviours and reducing the friction which stops people from doing it."

Make it all about members and what they can get.

Member-nominated trustees are really important because they bring in the voice of members, observed Franklin. "The danger is we go local, we become experts and forget to bring members' voices into the room. We talk that pensions talk. Don't ask pension savers to be interested in the process – ask them to be interested in what happens when they get there. Change the way you talk about what a pension is – people want to know what a pension is and what it does for them."

For example, the expression "self-serve" is intended to make people feel in control. However, in an area where they don't feel confident, the concept of DIY is terrifying. Instead, use expressions like "easy access" or "fast track", suggested Franklin. "Don't talk about the process, talk about the benefits to me, because that will make me more interested. We have to make it easy for people, not difficult."

Don't scare people with complexity.

People don't want to have to choose from a bewildering array of options. That's why around 80% of people who visit Starbucks choose the middle size of three. "People choose the middle because it represents not having to make a choice," said Franklin. "The more complicated and difficult it is, the more likely it is that my money will go cold and back in my pocket."

Vincent Franklin's pensions jargon-buster

Salary sacrifice "Can you give me any other context in which the word sacrifice is a good idea? 'Pension booster' is much nicer! Think about the way those words land."

Responsibility "There is so much emphasis on being more responsible. You can't ask people to be responsible unless you tell them they have great power. Members are interested in this and telling them real stories about things that they own and can change – that makes them powerful. You can't just sell responsibility without power."

We can assist you "What people really want is help"

Advice "People often ask for advice, without realising the definition of the word has very different implications in our world. We have to challenge the words we use. It's not fair to steal their lexicon and then use it to create a barrier between us."

We don't 'contribute' "We save."

Provides "Using the word 'give' allows people to feel emotionally engaged and join in the conversation with you."

Tell a story.

"If we don't tell stories in a way that is compelling and sharable, then the bad stories will trump us," said Franklin. For that reason, trustees should remove jargon, and the associated unintended hints that saving into a pension is a difficult process, from their communications.

Frame choices carefully

"Phrases like 'Guaranteed income' and 'Flexible access' are abstract concepts, a way of going into something, a verb without a person attached," observed Franklin.

By contrast, 'Take it all in cash' or 'Leave your money invested' are command sentences. These are all phrases pension schemes often use in retirement communications. People are far more likely to gravitate towards command sentences. "What are the two things we don't want people to do? Take it all or leave it," said Franklin.

He concluded that it's vital to help people through language.

Use words that build the right relationship

"To change the way people behave, we need to change how they feel, not just what they know," said Franklin. "Sometimes we think if we just give people one more compelling statistic, they will change their behaviour."

In reality, this isn't how the process works. "People make emotional decisions and they selectively choose the data to support those decisions," said Franklin.

Instead, use words that make people feel confident. In a US study, one half of participants were told they were taking a geometry test. The other half were told it was a drawing test. In the geometry test, the high achievers beat the low achievers. In the drawing test, high and low achievers did equally well.

Thank you for reading this summary. If you would like to attend the next AMNT conference or find out more about the AMNT, please contact Shelley Ismail: Shelley.ismail@amnt.org or visit https://amnt.org/.

Written by Louise Farrand
Design by Shelley Ismail, AMNT