Aon Investment Research 2020

Covid, climate and compliance

Are you ready for the new investment challenges?

Empower Results®

Contents

Foreword

2020 has been a year of significant change for UK pension schemes' investment strategies — even before we take the effects of the COVID-19 pandemic into account. Governance has come under ever-greater scrutiny from The Pensions Regulator, responsible investment is rising rapidly up the trustee agenda, and pension schemes are demanding ever greater cost transparency from their providers.

Over the summer, we set out to listen and to understand how investment decision-makers were responding to all these changes and accompanying challenges. Through a series of in-depth interviews, we were able to gain real-world insights into key trends, common approaches — and differences — to paint a picture of current thinking in pensions investment.

Inevitably, the pandemic was a common thread running through all the discussions. And, while it's still too early to understand its longer-term effect on schemes and markets, the crisis has already started to reshape investment strategy decisions and the way these are made.

Now, more than ever, investors need support to continue to protect the retirement income for their members and to manage the increased pressure and demands on their investment governance and operational strategies. We have specialist teams and deep expertise to help you to rise to all these challenges — from governance, responsible investment and investing for the endgame to costs and transparency and the DB funding code of practice.

We look forward to continuing the discussion with you.

Emily McGuire
Partner, Aon

About the research

In July and August 2020, Maggie Williams, an experienced pensions commentator, writer and editor, carried out in-depth interviews with 20 pension scheme decision-makers on behalf of Aon. Interviewees were drawn from a wide range of disciplines — professional, independent and member-nominated trustees, third-party evaluators and pensions managers — representing both defined benefit (DB) and defined contribution (DC) schemes. Scheme sizes ranged from a £10 million defined benefit scheme, to over £10 billion.

The interviews focused on five key areas:

- Investment governance
- Responsible investment
- Investing for the DB endgame
- Costs and transparency
- Investment implications of the DB funding code of practice

Our thanks go to everyone who took the time, during very difficult and challenging circumstances, to participate in this research and to provide valuable insights.

Aon insight
Investment governance

Prior to COVID-19, trustees of both DB and DC schemes were facing an increasing governance burden, brought on by a raft of new regulations and compliance requirements. The pandemic further added to this burden and tested governance processes to their limits. The economic crisis demanded fast decision-making, and even faster action, to rebalance investment portfolios – at a time when Boards were quickly reorganising the day-to-day running of their schemes. As a result, investment decisions are now made very differently: shorter, more frequent and focused remote meetings have replaced the pre-pandemic quarterly meeting schedule.

For some, this change has enabled much nimbler decision-making, and those schemes with more resources and sufficient resilience built into their investment strategies have fared well. Conversely, schemes with relatively limited resources experienced a more challenging time and often lacked access to the full range of investment strategies needed to navigate a crisis.

It is interesting to observe the comments by some interviewees that they expect the pandemic to accelerate levels of interest in delegated investment. This is certainly something we are seeing through our work with schemes of all sizes, both DB and DC. Our most recent Global Pension Risk Report showed that interest in delegated investment was expected to grow. We are also seeing a similar trend in DC. Aon's UK DC Pension Survey 2020 showed that 35% of employers with their own trust-based arrangements and 20% of those with contract-based plans are looking to move to a master trust. Of these, 54% with their own trust wanted to move due to the cost, time and resource pressures of running their own plan.

There is no sign that pressures on costs, time and resource will abate any time soon – and, the outlook remains incredibly uncertain, with continued market volatility and dislocations expected. Delegated investment offers a way to respond to all these challenges and for schemes to achieve their objectives with more certainty. As with all governance models, it has been robustly tested during the pandemic and through the market turmoil – and, the benefits of the delegated model have really come to the fore.

More information about how we have been positioning our portfolios and supporting our delegated clients is available in the *Further reading and resources* section of this report. We also welcome the opportunity to discuss how our teams can support you as you continue to protect your members retirement income and navigate the significant operational challenges you're facing at this time.

Tony Baily
Investment Partner, Aon

Sonia Gogna
Fiduciary & OCIO Solutions, Aon

Around
2/3
of DB scheme delegate manager monitoring to their advisers

Source: Global pension risk survey, 2019 UK findings

1 in 3
DC schemes do not measure progress against their objectives

Source: How do you measure up? Aon DC survey 2020

Could COVID-19 change scheme governance forever?

COVID-19 has caused many difficulties for pension schemes and their members. But it may have initiated the biggest shake-up in scheme governance for decades. Trustee boards have had to rapidly re-invent many aspects of how they run their scheme on a day-to-day basis. Respondents reported more frequent ‘bite-sized’ remote meetings instead of all-day quarterly meetings, carefully prioritised agendas structured around questions that require immediate answers, and faster decision-making.

Almost all participants said that this has been beneficial for general decision-making and that trustees had quickly got used to a new style of working. The logistics of setting up a board, or investment sub-committee, meeting have been simplified because trustees no longer need to travel to a meeting, and there is less requirement for traditional large meeting packs.

> "Our governance has held up really well, I think. We have been able to make quick decisions and that has probably been helped by the fact that people don't have to be in the same room. Also, that you don't have to find the time for people to travel – because we have people from all over the country on our boards – has actually helped the governance structure."
>
> Investment specialist, DB multi-employer scheme

However, some aspects of trusteeship, such as discussing complex, contentious topics, are less well suited to video conferencing. Chairs of trustees said that they found it difficult to ‘read the room’ over a video conferencing link, and so understand whether trustees understand a proposal correctly, or to use cues such as body language to understand their response to it. Two professional trustees expressed concerns that elements of investment oversight were being put on hold or given a ‘light touch’ during lockdown.

Boards that were close to making major changes to their investments – either as a result of a review of their investment strategy or appointing a new manager – have had some of the biggest challenges during lockdown. Trustees and advisers said that they have had to carefully question whether decisions made in a pre-COVID-19 market environment were still suitable in the light of the pandemic.

> "We will do fewer in person meetings and we will do more ad hoc online meetings. It has been quite a learning experience for many executives in our organisation who have never really held conference calls, let alone shared screens and worked with Zoom."
>
> Independent trustee, large DB scheme

Whether new approaches to governance will be retained over time remains to be seen. Some schemes are already reporting plans to move back to more traditional quarterly trustee meeting structures, but in other instances there is more enthusiasm to retain the benefits of more regular, remote meetings.

"Where there's a really sharp focused decision to make, governance during the lockdown has been better than it was before. However, if something needs training and developed discussion, that's where it becomes much more challenging."

Professional trustee, large DB schemes

Respondents were hopeful that boards and the rest of the pensions industry will continue to streamline some governance processes post-pandemic. These include making greater use of technology to resolve barriers to action, such as the requirement for 'wet signatures' to action a new mandate.

Three participants said that their schemes have seen a reduction in the amount of executive support available to the trustee board over time. This has made tasks such as preparing board meeting packs more difficult. They felt that shorter, more frequent, meetings that have been driven by the COVID-19 crisis, were better suited to this more limited support.

"We did have a few practical difficulties at first when we went into lockdown, because some of the asset managers were still very insistent on hand-signed forms to set up new mandates. A very pleasing side effect of the crisis has been wider recognition that actually you can move to a more modern set-up using tools such as DocuSign."

Professional trustee, large DB schemes

Looking to the longer term

Aside from the short-term shocks of the COVID-19 pandemic, many longer-term challenges remain for investment governance.

While scheme size is not directly correlated to the quality of board governance, there was a consensus among our respondents that larger schemes with bigger governance budgets are able to consider a wider range of investment opportunities and approaches. They are also able to act more efficiently when it comes to decision-making around investment strategies and implementing new ideas.

"On a practical level some schemes still don't spend enough time, effort or resource on their governance framework. And that it itself can then limit the options that advisers can bring to the trustees."

Professional trustee, large DB schemes

Several third party evaluators talked about the importance of an appropriate governance framework that enables trustee boards to use the limited time they have to discuss investment in the most effective way. That framework needs to include a clear strategy, investment beliefs and investment principles that can guide future decision-making.

However, several professional trustees expressed concern that increased pressure from The Pensions Regulator is driving boards to spend more and more time on compliance — which is not always equivalent to good governance. The result is that, even for schemes with a clearly defined governance framework, investment decision-making is sometimes being pushed to one side by compliance demands.

"So, irritating though it may be, it is useful and, in a way, comforting. You can always scream and shout and hurl abuse, but actually, TPR are drawing attention to things that we would not have dealt with otherwise. So, they might even get a Christmas card."

Member-nominated trustee, large DB scheme

For DC schemes, the chair's statement was identified by several trustees, third party evaluators and other decision-makers, as an example where excessive compliance is hindering good investment governance. "Trustees have only got so much time available. If they are spending the whole time talking and worrying about the chair's statement, are they actually looking at the investments properly?" asked one professional trustee.

Respondents also said that in some schemes, employers are questioning the costs of in-house DC scheme governance within trust-based schemes. This is starting to accelerate a trend towards using master trusts and GPPs for DC provision, which eliminates the need for an in-house trustee board.

Where DC schemes continue to operate in-house, there is a move away from creating bespoke or white-label default funds, and towards using off-the-shelf solutions or delegated approaches to investment. Related to this, some respondents felt that trustees of DC schemes are not always sufficiently aware of the complexities of what is required of them investment-wise, especially when it comes to factoring in freedom and choice.

> "Trustees are spending a hell of a lot of time on compliance. Not governance, compliance. I don't think it is enhancing the governance as a result. Because they have only got so much time available, if they are spending the whole thing talking about, the DC chair's statement, are they actually looking at the investments properly?"
>
> Member-nominated trustee, large DB scheme

Changing models of trusteeship, whether a shift to sole trusteeship for DB schemes, or encouraging more diversity on trustee boards in DC schemes, is also affecting scheme governance according to several respondents. In particular, one respondent felt that this could drive better engagement with aspects of investment such as responsible investment. "The increase in the use of sole trustees will force the responsible agenda more. Sole trustees can express their views on it, rather than having to take account of widely-ranging views often seen on trustee boards. That could lead and accelerate change."

Trustee education is also an important aspect of long-term governance. Associated with this is the perceived competence of trustee boards to manage investment governance and decision-making.

The shape of investment decision-making

Respondents reported varying quality of investment decision-making in the schemes that they work with — but are also exploring an increasing number of tools and approaches to help trustee boards of all types and sizes.

Those include fiduciary management for DB, better use of investment subcommittees, appointing an independent trustee or using an investment platform for DB or for DC. Deciding which solutions, or mix of solutions, would help an individual scheme depends on the scheme's circumstances and their broader framework for decision-making.

In one instance, a large scheme that had been able to drive investment innovation with its asset managers because of its size, wanted to make the solution it had created available for smaller schemes to use as well. One of its trustees said: "I think there is a part for larger scheme to play, to help smaller schemes. I think you have a responsibility to do that. We want to give that opportunity for other, smaller, schemes to be able to do some of these things we've been able to do. It's important to be open with your ideas and let them be shared."

"My challenge with trustees is, they like talking investments. It's sexy. They like seeing managers. They like having beauty parades. In my view, it is completely pointless. It's, do you buy the Aldi cornflakes or the Kellogg's cornflakes? They're both going to be cornflakes. So, do you actually need to open them up and see the individual pieces, without tasting them?"

Professional trustee, DB and DC schemes

Aon's 2019 Global Pension Risk report showed that around a quarter of UK DB schemes delegate full fiduciary mandates and 30% are using partial mandates. Respondents in this research said that they were seeing interest in fiduciary management grow, particularly from DB schemes.

Most of the interest was for full mandate appointments, rather than single strategy solutions — although some professional trustees and third party evaluators speculated that they may see more interest in single strategy solutions in future. Some respondents anticipated that the market volatility caused by COVID-19 could accelerate interest in fiduciary management, as also occurred after the 2008 global financial crisis.

"Our view is that trustees should focus on high-level strategic decisions. My experience is that there has been a lot of focus on things that are interesting but don't move the needle. Of course, delegation needs to be framed properly because the trustee board retains accountability. The goals of the investment committee remain the same, but they are seeing the strategic decisions only."

Investment professional, large DB and DC scheme

However, there continues to be resistance to fiduciary management from some trustee boards that see day-to-day decision-making as the trustee's responsibility, even though in some instances respondents, and especially professional trustees, felt that this lengthens decision-making time and may limit the investment options available to the board. One trustee chair argued that better resourcing for trustee boards would be preferred over fiduciary management: "there is an argument that fiduciary management works better for small schemes with less resource — but so would getting more resource."

> "I'm an unashamed fan of fiduciary management. Because it stops meddling. It stops procrastinating, and it stops all the subjectivity that trustees and companies can bring. It brings the buy-in power, it brings the economies of scale, it enables you to be buying people's best ideas. I don't think it's any coincidence that the schemes I've had that have been in fiduciary have got to a far better place far quicker than the others that haven't. That doesn't mean the traditional model doesn't work, because it does. But it's just harder for it to work."
>
> Investment professional, large DB and DC scheme

Where fiduciary management is being used as part of a DB scheme's investment governance, third party evaluators report more interest from schemes in oversight of the manager, "That is definitely part of retender exercises," said one. "A lot of schemes that went into fiduciary management without a competitive exercise are taking action."

Aon insight
Responsible investment

The world is facing a barrage of profound challenges: climate change, declining biodiversity, social inequality, rising populism — and a global pandemic. These create both risks and opportunities for investors.

Responsible investment is not a 'magic bullet' for solving these issues, but it does have the potential to play a powerful role in helping address them. No surprise then that there has been an increase in positive sentiment towards responsible investing in recent years.

Regulation is also accelerating the integration and adoption of responsible investing. Simultaneously, a growing body of research — and a broadening and deepening of market practice — is illuminating the investment case for it. However, more regulation, more information and more choice do not always lead to more progress.

As our interviewees highlight, there is work to be done to turn sentiment into policy and practice — but many investors lack the detail they need to adopt responsible investment in a way that is right for their schemes. This matches our own experience with the wide range of UK schemes with which we work. DB & DC schemes, large and small — all have unique circumstances and beliefs. As a result, investors need a lot of support to navigate this complex, multi-stage journey of integrating responsible investment into their portfolios.

We are working tirelessly to provide this support for our clients, drawing on our decades of combined experience and breadth of expertise. We are also innovating to help bring clarity to our clients' responsible investment journey. For example, we have developed the unique *Responsible Investment ViewPoints* methodology, which draws on behavioural science to establish and understand scheme-specific beliefs around ESG opportunities and risks. This has been used by over 70 of our clients to support the development of their responsible investment policies and strategies. For clients ready to implement responsible investment strategies, we offer a wide range of services to do this — from one-off and stand-alone exercises to comprehensive advisory partnerships, as well as our delegated investment and single-strategy solutions, which include Aon's Global Impact Fund. You can learn more about all the ways in which we can support you here and we look forward to continuing the journey with you.

Tim Manuel
Head of Responsible Investment, UK
Aon

"I have left trustees in no doubt about their responsibilities and legal obligations to protect people's pension pots from climate change risks,"

Guy Opperman, MP
Minister for Pensions and Financial Inclusion
March 2020

Responsible investment regulation: moving from 'must do' to 'want to do'

By October 2020

All trustees of both DB and DC schemes must include in their Statement of Investment Principles (SIP) their policy on:

- how financially material considerations including, but not limited to, ESG factors are taken into account in trustee investment decisions;
- the extent (if at all) non-financial matters such as member views are taken into account in trustee investment decisions;
- how they reflect their stewardship policy (eg. how rights relating to investments, including voting rights, are exercised)

The SIP must include details of trustees' arrangements with asset managers on these three points, and both DB and DC schemes must publish the scheme's SIP on a publicly available website.

From October 2020

Trustees of DB and DC schemes must publish an Implementation Statement in their first Annual Report published after that date, and no later than October 2021.

In the case of DC trustees, this must set out how the SIP has been followed and acted on during the scheme year. It must also include a description of the voting behaviour by or on behalf of the trustees, including the use of proxies.

For DB trustees, the Implementation Statement must now include information on the scheme's stewardship policy and trustee voting behaviour.

The Implementation Statements for both DB and DC schemes must be available online, free of charge.

By October 2021

Both DB and DC schemes must publish their Implementation Statement online.

Reporting requirement	Scheme type	
	DC or hybrid	DB only
Description of any review of the SIP during the period covered by the Statement including an explanation of any changes to the SIP. If the last review was not within the period covered by the statement, include the date of last SIP review.	✓	✗
Details of how and the extent to which, in the opinion of the trustees, the SIP has been followed during the year.	✓	✓ In relation to voting and engagement only
Description of voting behaviour (including 'most significant' votes by, or on behalf of, the trustee) and any use of a proxy voter during the year.	✓	✓

Source: PLSA Implementation Statement Guidance, July 2020

Current requirements from The Pensions Regulator (TPR) mean that the basics of responsible investment are now a 'must do' for all DB and DC schemes.

Our research found that decision-makers' views on adopting a responsible investment approach remain mixed. While some trustees (both member-nominated and professional) are still unconvinced about the rationale behind responsible investment, our research also found passionate advocates who are committed to pursuing and defining best practice for their schemes — and in some cases the wider industry.

"I'm wholly supportive of the ideas [of responsible investment], but what I don't like is any form of arbitrary implementation, which is political correctness, for instance. That, to me, is just silly."

Trustee, DB schemes

86%

of schemes globally consider responsible investment at least 'somewhat important'

Source: Aon Global Perspectives on Responsible Investment 2019

Only 1 in 10

DC schemes assess their default option against ESG criteria

Source: How do you Measure Up? Aon Defined Contribution Member Survey 2020

However, in general, progress towards a responsible investment approach has been slow. Even boards that are committed to embedding responsible investment throughout their investment approach admit that the process of documenting scheme beliefs, and implementing them in the portfolio, takes time.

Among respondents sceptical about responsible investment, concerns included a lack of long-term evidence on the performance of ESG funds, risk versus reward, and the cost involved in changing strategies or transitioning between managers, particularly in a de-risked portfolio.

"Legislation should be about pointing and nudging schemes in the right direction – and about disclosure. Disclosure makes trustees think harder about it. That's better than just saying, 'You have to put your investments in ESG funds.'"

Pension committee chair, DC schemes

Confusion about what is expected from schemes by TPR is also still a factor, as well as a perceived mismatch between fiduciary duty and responsible investment.

More proactive decision-makers are starting to put pressure on asset managers and consultants to improve the quality of reporting, analysis and product design, which is still perceived as variable. "Many consultants and asset managers are still in a 'greenwashing', minimum compliance place, unless you demand different. I am now demanding different," said a professional trustee.

"Trustees see the relevance of ESG. They support the principles of it, they want to be able to demonstrate they're compliant with it. But to be frank, it's not driving investment behaviour, it's not driving investment decisions. I can't think of a single situation where that has been a determining factor."

Professional trustee, DB schemes

"What does the Regulator want? Does it want pension schemes to invest in a sustainable and responsible way, or does it want the asset managers to consider that when they're making their investment decisions? Because the two are very different. We can do the latter, to get managers to consider it. But the former, of having investment offerings that are sustainable across all asset classes? We're still a long way from that. You only really have that in the equity space at the moment."

DB third party evaluator

Respondents' views on their role in responsible investment varied. Some clearly saw responsible investment as the responsibility of schemes themselves, with a strong appetite to set their own investment beliefs and hold managers to account. Others want asset managers and consultants to 'do ESG' for them, by providing ideas and recommendations that incorporate responsible investment principles.

Aon's *Global Perspectives on Responsible Investment* 2019 survey also found schemes starting to become more engaged with responsible investment. 47% believed that their own organisations had a part to play in implementing responsible investment, an increase of 11% from the previous year. However, 56% of pension scheme respondents said that they still believed investment managers were responsible for responsible investment.

The responsible investment journey

The process of defining and moving to a responsible investment portfolio takes time. One participant from a DC scheme estimated that the process had taken three years to date — and is still a work in progress.

"It's not a single decision to adopt ESG, it's lots of different decisions and a much longer process than people think. There are many component parts all the way through: what are your beliefs, how are you going to implement ESG, how does it fit into your investment strategy, how do you educate the trustees to get the best out of it?."

Pension committee chair, DC schemes

21%

leap in positive sentiment towards responsible investment in the UK

2018: **66%** | 2019: **87%**

Source: Aon Global Perspectives on Responsible Investment 2019

That journey includes trustees establishing their responsible investment beliefs, updating the SIP and other investment-related documentation to reflect those beliefs, then researching and appointing asset managers to enact the changes to the portfolio. Decision-makers and the schemes that they represent are at very different points in that process.

"The people in our business looking at sustainability haven't really engaged with us on the pensions side, even to make sure that what we're doing doesn't contradict what they're saying. I've been surprised that it hasn't been pushed up the agenda more ... I've tried to engage with them, and they've just looked a bit quizzical. Clearly, we are not quite there yet."

Employer representative, DB scheme

Both third party evaluators and professional trustees said they are seeing more commitment to responsible investment from the schemes they work with. In some instances, where a parent company has a strong belief in responsible business, there is support from the sponsor to make sure the pension scheme upholds the same values – but this is by no means universal.

Commentators with an international perspective said that UK schemes have lagged behind other parts of Europe when it comes to responsible investment. However, there are signs that the UK is now starting to catch up. This reflects the findings from our global responsible investment survey, which showed the had the biggest gain in positive sentiment towards responsible investment.

"Trustees lagged behind their continental European counterparts quite considerably, until about two years ago. That is now changing for the better. They are starting to become a bit more demanding of their external suppliers in this area."

DB governance specialist

Taking action: implementing responsible investment

As schemes move slowly from the theory of responsible investment to making changes to their portfolios, more attention is being paid to the products available in the market, and how effectively asset managers are managing them.

"The products are improving, particularly around passive funds with tilts. I think that's a really helpful development because it's a relatively small shift in risk terms but can have quite a decent impact."

Professional trustee, DB and DC schemes

Most of the focus to date has centred on equities. Decision-makers who already take a responsible investment approach said that their scheme's beliefs can be applied to most of the equities-based products that they invest in with relative ease. That should also be good news for decision-makers concerned about the complexities of moving to a responsible investment approach, as it gives them a like-for-like replacement for equity products in their portfolio.

However, respondents admitted that there are challenges around more complex investment vehicles, such as hedge funds and also diversified growth funds, due to the range of different assets that they contain.

"I've asked my consultants to model climate change risk in the same way they model interest rates or inflation risk. Interestingly one consultant has started to go down that route. They're the only one I've come across who's really trying to quantify that risk and build it into their models."

Trustee, DB schemes

They also felt that there is still work to be done by asset managers to improve the standard of reporting on their responsible investment practices and stewardship. "Often investment managers make responsible investment too complicated. And, we've found too much 'cut and paste'. We've had to go back to them and say "No, try harder." They've got to be able to communicate with the end user," said the chair of a large DC scheme.

Investors are also starting to demand more from consultants and asset managers to provide much more detail around ESG factors, including how their products address climate change risk.

"There has been more work done proving all the various things that people are asking: 'Is flying really that bad? Is it really that bad to invest in fossil fuels? Are members really that worried about it?' Now we know, yes, they are worried about it."

Professional trustee, DB and DC schemes

Education and good quality communication both have a major role to play in helping to make responsible investment more accessible and tangible both for trustees and scheme members. A third party evaluator for DB schemes said: "The more the trustees understand about ESG, the more they can make informed decisions or have an opinion around what they want to do on behalf of the scheme. But trustees and members both struggle with tangibility — they understand the concept but the tangible point of what they can do is more difficult."

"We are seeing more and more innovation in the market, from index providers to active managers. They are trying to... really engage with the underlying companies in which they invest and add value that way."

Third party evaluator, DB schemes

Few decision-makers are directly asking members for their views on responsible investment, even though the Regulator now expects trustees to document this. Several commentators, especially trustees, also said that they are unsure how they could use the results of such an exercise in a meaningful way.

"When we prepare our questions for our asset managers this time, we want to ask businesses how many people they've furloughed and why they furloughed those staff. I think there are some large organisations that might have used furloughing to protect the salaries of senior people."

Pension committee chair, DC schemes

Heightened awareness of the importance of climate change, and high-profile industry campaigns such as Make My Money Matter, are pushing demand for greater transparency about how members' money is invested in DC schemes in particular. However, one third party evaluator expressed concerns about how members are being polled about responsible investment, and the effect that the answers might have on investment strategy:

"If you are trying to engage members, you must be very, very careful what questions you ask, how you ask them, and then quantify a potential impact. If you say 'would you prefer your pension scheme not to be invested in X, Y and Z' and we strip those investments out, it could increase our cost by 10 basis points, and it could harm return in the short-term by 50 basis points. Is that acceptable, yes or no?"

We've done that with a couple of schemes already, and we got quite a good response to, "Yes, I care about these issues, and 'yes I don't mind too much if there is additional cost'. But when we ask about the effect on returns as well, it's a different response."

"Will awareness of these factors be enduring or just short-lived? You can almost say society is a proxy of that. You'll see some people during COVID-19 have changed their lifestyles. And you can see others that, as soon as restrictions are lifted, will go back to normality as quickly as possible."

DB third party evaluator

Responsible investment and COVID-19

COVID-19 has made the 'S' and 'G' of 'ESG' front page news. The way in which businesses have treated employees during the crisis, and the quality of some corporate governance have become high profile stories in recent months. But, the extent to which these factors will make a difference to schemes' investment behaviour over time remains to be seen.

Aon insight
Endgame planning and de-risking

Investors have more endgame options than ever before. Consolidators, capital-backed investment solutions and insurance – all can support trustees and sponsors to get to their endgame more quickly. It is encouraging to see that schemes of all sizes are carefully considering the full range of options now available to them.

No aspect of investment has been left untouched by the COVID-19 pandemic, and endgame investment strategies are no exception, as the research shows. Whether schemes are aiming for self-sufficiency, considering buy-ins, looking at commercial consolidators or are on a longer-term path to buyout, there has been a lot of scrutiny of investment strategies.

The crisis has underscored the need for an asset strategy which is robust and tailored towards the endgame. For example, if trustees are targeting self-sufficiency they must be able to deliver the cashflows the scheme needs in a variety of different ways. Preparing assets to reduce risk versus insurer pricing can be the difference between buy-ins and buyouts being affordable or not.

The need for assets and timeframes to be flexible has also been accentuated by the wider range of settlement options (including consolidators) and attractive insurance pricing opportunities for those schemes that could transact during and following the COVID-19 market uncertainty. Identifying the endgame early, preparing your assets with that endgame in mind and building in flexibility is key.

The crisis has also led to heightened awareness of the impact of any risks schemes are running in their portfolio and underscored the need to de-risk holistically. Reducing longevity risk, managing other liability risks and reducing investment risk — all will enable schemes to get to their endgame more quickly and with less risk along the way. We are increasingly seeing schemes using partial buy-ins as a tool to de-risk and longevity swaps are now available to a much wider range of scheme sizes (£100m+).

The need for an investment approach that, in all market conditions, provides predictable returns with an appropriate level of risk, and enables schemes to meet their cashflows, remains a priority. With our combined risk settlement, investment and delegated expertise, we are well positioned to support you with your endgame asset strategy and to minimise risk and maximise the flexibility of your scheme.

Lucy Barron
Investment Partner, Aon

Endgame and investment strategy

As increasing numbers of DB schemes close to future accrual, trustees have had to make careful decisions about their schemes' long-term strategies and how their investments will help them to achieve their longer-term goals of self-sufficiency, consolidation or buyout.

The need for an investment approach that, in all market conditions, provides predictable returns with an appropriate level of risk, and enables the scheme to meet its cashflows, remains a priority.

“More schemes want a predictable, steady return rather than a stellar, unpredictable one,” said a professional DB scheme trustee, summarising a general investment trend among the schemes he worked with. This was also the view of a third party evaluator working with DB schemes: “Most of the asset classes that we're looking at now are low-risk. Credit is probably the biggest example, or schemes looking to extend their hedging using Liability Driven Investment (LDI). It's been a while since I was involved in an equity manager selection.”

> “If you think you've got a fighting chance of going into buyout within say three to five years, you're not going to sign up for something that's illiquid, or something that an insurer won't want, or will say: ‘I don't really want it, can you sell it on the secondary market?’”
>
> Professional trustee, DB schemes

One professional trustee added that there are similar shifts in delegated investment mandates as endgame gets closer: “They are becoming more straightforward, because we don't need the bells and the whistles that we once did. We are moving away from illiquids, and from more esoteric asset classes.”

For schemes that are aiming for buyout, making sure that their portfolio is going to be attractive to insurers is a priority. However, as one professional trustee pointed out, this can be difficult to gauge. “All sizes of schemes are asking advisers: ‘what sort of portfolio should we be holding that is going to be most empathetic to what an insurer wants?’ But all insurers are different, so you can't always replicate that exactly.”

Respondents felt that schemes planning for buyout in the short to medium term were less likely to hold illiquid assets, in case they limited the opportunity to transact quickly. However, for respondents with schemes aiming for self-sufficiency or with a longer time horizon for buyout, some interviewees argued that less liquid assets could provide attractive regular income streams to meet liabilities. “Secure income assets, such as private debt and infrastructure, might lock you in for a period, but will produce cash,” explained one professional trustee and scheme chair.

A professional trustee said that he had begun to see a greater focus on longevity hedging, mirroring wider market trends. In 2019 there were several large market deals, including a £7bn longevity swap carried out by HSBC — the second-largest deal of this kind. “Longevity hedging is notoriously expensive and complex, and not really something that's done for schemes below a certain size, albeit the landscape is changing,” said a professional trustee. “Our advisers did some analysis for one of our large schemes and it showed that a longevity swap might be an answer for us, rather than a buy-in. We've also seen other large schemes looking at this recently.”

The effect of COVID-19 on endgame planning

COVID-19 has inevitably impacted endgame planning and investment strategy. One participant felt that the wider effect on the economy could mean trustees have to re-interpret their view of ‘low risk’. “My macro view is that the recession has barely started, and credit is where the damage is going to happen,” said a trustee of three DB schemes. “I’m very much in risk-off mode… the fact the stock markets have bounced back isn’t a concern, as it’s default rates I’m watching for.”

> "Risk-management has been key for many clients over the past years. They have taken off a lot of equity risk, they've increased their hedge levels. Although they did feel the impact of COVID-19 and what happened to markets in Q1, I do think it could have been a lot worse. Five years ago, the impact on a lot of schemes could've been much greater."
>
> Third party evaluator, DB schemes

Respondents’ views were mixed on whether the pandemic has made moving risk to an insurer more attractive. A third party evaluator perceived some advantages: “Transferring to an insurer has major benefits because they’ve got natural hedges within their book of business, as well as huge assets. They can afford to take advantage of some more long-term investments that a pension scheme getting close to its endgame cannot do. They’ve got a different and larger opportunity set than a pension scheme at that stage has. But it comes down to how affordable it is for the scheme.”

Schemes that have hedged investment risks generally found their investments well protected in the early weeks of the pandemic when stock markets plummeted. “I think trustees recognise that we are in an uncertain world and risk management becomes more and more important. But behaviourally it has been difficult for some trustees who put hedging off to now do it because suddenly it is more expensive,” said a third party evaluator. “The general trend [beyond COVID-19] has been that it has got more expensive to hedge, but it continues to be beneficial to do so.”

> "We've been suggesting to clients who were part-way through a transition or had agreed a transition [during COVID-19], to go back and ask themselves: What is the reason that is driving this change? Is that reason still valid? And how does the current environment impact that, in terms of liquidity in the market, any increase in trading costs, etc.?"
>
> Third party evaluator, DB schemes

For schemes that had already planned transactions that would remove risk from the investment portfolio when lockdown started, the crisis meant having to question whether that activity was still valid. However, as one third party evaluator pointed out, decisions needed to be seen in context of the scheme’s long-term goals, not just as a knee-jerk reaction to current events.

“I had a client that was significantly de-risking and we still went ahead during the pandemic. A trustee challenged saying, ‘Are we not locking in those losses?’ The response back was, ‘You’ve already got a strategy that is generating far more return than you need. We’ve identified that it’s not well-diversified, you’ve got a lot of risk, a lot of exposure to equities. All those points are still valid. And we don’t know what direction equity markets could take from here. They could get worse; they could get better. But actually, let’s go ahead and make that change, increase the hedging, reduce equity exposure’.”

"We keep 1–2% of the assets in cash just in case. Back to March when COVID-19 hit the UK I did get worried that we might not even be able to sell gilts, potentially. So, we took the precaution of increasing the cash allocation just to make sure we could meet the monthly pension payroll, but that was very much a one-off."

Trustee, large DB scheme

Investment strategies for cashflow negative schemes

Almost all the respondents work with at least one scheme that is cashflow negative (ie. money coming into the scheme is less than that being paid out as pensions). While in most instances, cashflow negativity is a long-term result of a DB scheme being closed to future accruals, for some schemes it has been caused by a short-term cessation in deficit repair contributions (DRCs) from the employer due to COVID-19. Although a pause in DRCs is a temporary scenario, in some instances COVID-19 will have longer-term impact on the strength of the employer covenant. That, in turn, will affect the scheme's investment strategy.

"All schemes have a much bigger emphasis on cashflow sensitivity. It's a part of everyday behaviour now and very high on the agenda. The focus is around what future cashflows are required and whether these are going to come from cash, from the company or from realised investments."

Professional trustee, DB schemes

For schemes that are long-term cashflow negative because of scheme maturity, consistently performing investments become pivotal. "The last thing you want to do is draw down from an investment which has just lost a lot of money in a volatile time," said a third party evaluator. However, the difficult balancing act for schemes that are both cashflow negative and have a significant funding deficit is that they will require some volatile assets to generate returns. "You are left to balance generating return, generating income or finding cash, and managing risk."

Even before the pandemic, schemes were already battling with a low interest rate environment, making it more difficult to find assets that will help to match cashflows. "[Low interest rates] are encouraging some schemes to look at riskier bonds – which clearly raises the question of how much risk they should take. They are also looking at different types of assets which generate income, such as long lease property" said a third party evaluator.

"For schemes that have been made temporarily cashflow negative (because of stalled DRCs) it's led trustees to ask 'how am I handling liquidity? It's also encouraging schemes to have some rules-of-thumb, such as having some months of expected outgoings in cash, and rebalancing into that. The last thing you ever want is to be a forced seller of assets."

DB third party evaluator

Schemes faced with a short-term shortfall from sponsor DRCs have had to be nimble in their decision-making. "The crudest way is just to disinvest, but you're at the behest of market timing," said another third party evaluator. "For those pension schemes that are also cashflow negative on an ongoing basis it might be sufficient to turn on income streams from share classes that they invest in, for example, to weather the immediate problem."

The benefits of using LDI have also come to the fore for some schemes during the crisis. "fortunately, lots of pension schemes haven't become cashflow negative during this period because they've had LDI funds," said one third party evaluator.

Scenario analysis: what might the future hold?

Scenario analysis – predicting what might happen to a portfolio during different market and other conditions – can help schemes understand and manage the investment risks they might face in the future. Respondents generally felt that using scenario analysis was beneficial. Both professional trustees and third party evaluators felt that its use would increase in future. "Scenario analysis and talking about risk needs to be tangible and understandable," said a third party evaluator. "Just saying 'this is a 5% or 1 in 20 risk over a three-year period' means nothing. What does it *actually* mean? Is it, say a 30% fall in equity values, or an X% rise in inflation, for example?"

"There is no point just labelling ideas as 'scenario one, two, three and five'. Name them, so trustees can think, "This is the geopolitical event or issue that could cause this to happen," so a bad Brexit, for example. Then, put some rough numbers on the impact on equity markets, currency, credit spreads, gilt yields and inflation. It doesn't need to be too complex, but it's giving it an idea of the direction of travel."

Third party evaluator, DB schemes

A professional trustee echoed the need to make scenarios both tangible and actionable but questioned the extent to which scenarios are helping trustees make decisions. "Scenario analysis predictions are often very heavily caveated. Consultants are trying to be helpful – but they are not sticking their neck out enough and saying they want trustees to base their behaviours on those scenarios," said a DB professional trustee. "As a result, I'm not sure it is changing anything."

"When you are going through a quiet period of 5 or 10 years of everything generally going in a positive direction, there can be a tendency to forget about risk events coming around and hitting you out of the blue. But that is the very nature of risk and uncertainty. I think now that such an event has happened it will probably make more trustees realise that actually we need to get risk off the table."

Third party evaluator, DB schemes

Both forward-looking and historical analysis can provide benefits, argued one third party evaluator. "We'll put a portfolio into our model and say, 'how would it have performed in the last 20 years, and what would the effect of each year be on the funding level?' It's a crude measure but you can see how one portfolio versus another might have fared in the global financial crisis, and why. You can then roll that into your forward-looking modelling."

"Sometimes cashflow planning only looks at normal market conditions. But trustees need to look at what happens in a stressed scenario, how does that impact the liquidity of the scheme? Because if you don't, you're almost saying, 'We know we're going to have a problem in a stressed market environment.'"

Third party evaluator, DB schemes

Are consolidators a new endgame destination?

Transferring to a commercial consolidator is another option now available to trustees planning their scheme endgame. The Pensions Regulator announced an interim regulatory regime for consolidators in June 2020, setting out expected governance standards and requirements for financial sustainability. This could give trustees more confidence in considering a consolidator in the future. “I definitely think there’s a space for consolidators,” said one professional trustee. “Provided [consolidators are] conducted and regulated well, there’s no reason why they can’t be a success.”

Given that consolidation is still a relatively new proposition, few schemes have seriously considered it yet. “I feel like consolidation has been discussed a lot, but I haven’t seen many of my clients actually take that forward just yet,” said a third party evaluator.

Overview of consolidation options

	Pooling			Transfer of asset / liability risk	
	Assets	Liabilities	Governance	To a third party	Off balance sheet
Sole trusteeship	✗	✗	✓	✗	✗
Pooled investment funds / fiduciary management	✓	✗	✗	✗	✗
Buy-in	✓	✓	✗	✓	✗
Master trust	✓	✗	✓	✗	✗
Commercial consolidators	Varies	Varies	✓	✓	✓
Buy-out	✓	✓	✓	✓	✓

Source: Aon’s UK Risk Settlement Market Review 2020

For schemes that are already on a clear path towards insurance de-risking, respondents felt that the new option to consolidate would be unlikely to encourage them to change course, either in terms of their endgame or their investment strategy. “I doubt whether consolidators are for us, just because of the position we’re in,” said a DB scheme trustee. “We’ve got a very good funding level, almost fully funded on a buyout basis. It would be hard to say, ‘we’ll go down the consolidator route rather than the traditional insured route’.”

Some participants also felt that the consolidator options in the market at present might not fit the needs of all schemes.

“I think one of the current consolidator propositions should be quite attractive to small schemes, but I suspect their business model doesn’t work for them,” said a trustee. “I think that’s where help is most badly needed, however. Anyone with a scheme size under £100m is, I suspect, struggling both at the trustee board level and at cost level.”

> "I think it is extremely unlikely that we would consolidate with anybody else. We haven't had enough discussion to even think about it. Our company covenant is a very important issue, and until COVID-19 was absolutely rock-solid."
>
> Trustee, DB scheme

In the short term at least, respondents didn't feel that the option of consolidation would make any difference to their investment strategies: "I don't think you're going to alter your investment strategy or amount of risk just because the consolidator option exists. You'd only do that if you'd actively engage in a consolidator conversation with your employer," said a professional trustee. "It's a bit like a conversation with an insurer. You only invest in a way that's empathetic to an insurer when you're close to that outcome."

One respondent who is personally involved with a DB consolidator, said that for consolidators themselves, the biggest challenge is to "make sure we can combine both the economies of scale that consolidation offers, and the bespoke approach to match the pension funds life cycle."

Aon insight
Costs and transparency

We are still at the start of the journey to improving investors' awareness and focus on charges. It's a journey that has been started several times before but never completed. This time it feels, and is, different. There is now a real impetus (and regulation) behind improving transparency of asset manager costs.

Over the summer of 2020, we surveyed over 100 pension scheme trustees and almost all agreed that cost monitoring should be an integral part of a trustee's investment manager monitoring toolkit. As a minimum, they all expected to require full transparency from their asset managers in future.

The FCA's desire for a standardised and consistent template for the disclosure of charges has culminated in the release of the Cost Transparency Initiative (CTI) templates. However, the templates should not be seen as an immediate panacea to the ills of opaque and inconsistent disclosure practices.

Our team has been at the forefront of the initiative and has worked with almost one thousand 'completed' templates from managers. There is still a lot of work to do: the quality of submissions needs to improve markedly before trustees can start to use the data with some degree of comfort around its veracity. For example, in one exercise, we analysed 150 cost submissions from managers and only around a quarter contained data which was usable without further recourse or resubmissions from the asset managers.

There are concerns that giving investors access to more information about charges may lead to unintended, and potentially negative, consequences for pension schemes. For example, there are fears that the provision of data on transaction costs (which can account for up to 50% of a pension scheme's total investment charges) may lead to less efficient portfolio structures in the pursuit of lower costs. We think these fears may be unfounded. Virtually all the trustees we surveyed recognised that transaction costs are necessary to produce investment returns and that 'large' costs are not necessarily a bad thing, provided these are fully understood by trustees. At Aon we believe the important thing is to understand the costs, monitor the trends over time and ask managers to explain if, and when, divergences begin to emerge.

In time, we expect the quality and quantity of data to improve and, with it, the ability to benchmark your pension scheme's charges and performance against the rest of the industry. This will drive even more value for scheme members. Aon will continue to be at the forefront of these initiatives for our clients, and the wider industry, with the aim of increased costs transparency in the near future.

Neil Smith
Head of Costs & Transparency, Aon

Cost is whose problem?

Institutional investors, and particularly trustees, say they have a responsibility to drive greater transparency around costs. "At the end of the day, the more money trustees are paying in fees, the less they are delivering to members," said a professional trustee of a DB and DC scheme. "You need to be able to challenge the providers for the fees they are charging and the basis of them and determine if they are reasonable or not."

A professional trustee, working with both DC and DB schemes, concluded that both regulators and investors need to drive greater transparency. "It has to be a combination of institutional investors and regulation. Finally, we are getting some traction on the regulation side and that's making quite a difference. Institutional investors could do more – and could stick together more."

"Some managers claiming to be active are really index-hugging, and yet charging an active fee. That is unreasonable and must be challenged. Trustees do have a responsibility to improve transparency, but at the same time, the fund managers must be reasonable."

Trustee, medium-sized DB scheme

This view was echoed by a third party evaluator: "Clearly, trustees are in a position of influence, but only if they act collectively. The question, then, is how do you enable that to happen? I'm not sure I have the answer, but asset pooling is one example, and I would like to think that fiduciary managers who look after vast sums of aggregate pension scheme assets have the ability to drive change." Very large schemes could also be able to apply pressure in isolation, but the same respondent concluded that "for a regular small or medium-sized scheme, there is very little they can do by themselves. But it is beneficial for everyone if change can happen."

"Just how effective regulations will be [at improving transparency] is interesting, because you still hear stories of different providers finding clever ways to report costs differently within new rules. Other providers complain then that [trustees] can still not compare like for like."

Third party evaluator, DB schemes

Transparency around charges is integral to building trust between asset managers, consultants and trustees. "A lot of trust is built through the scheme and consultant relationship," said a third party evaluator. "Part of that is being transparent and ensuring that trustees do understand what they're paying for. I think that's best practice." The same respondent felt that progress had been made recently to improve levels of trust: "I think over the last year or two, transparency has got better. Having independent oversight helps with that, and fiduciary managers have got better too." However, there is still work for some trustee boards to do: "There are probably still some schemes out there who could understand a bit better what they're paying, in terms of different layers of fees."

The relationship between cost and value

Even with greater transparency, respondents said that cost information alone would not drive their investment strategy or asset class selection. Rather, it would be used as the basis of discussions with asset managers about future cost management. “It’s all enabling the end user to take a view of value for money. It doesn’t mean you pay the cheapest,” said one professional trustee.

“It is always a difficult conversation for schemes, because fees are certain, and returns are not,” added another respondent. “It would be wrong to choose investments based only on the lowest possible fees because you would put all your money in passive equities, which is probably not appropriate for most schemes.”

> On one hand, it's the net performance that is important to me. But we should also be saying, ‘You should be transparent about what you are charging us.’
>
> Professional trustee, DB and DC schemes

“My philosophy is that you have to pay good money to get good advice. You must give people leeway to express themselves, and you must pay for that. I don’t think it’s any coincidence that the schemes following this mentality are the ones which have got to the best place.”

The exercise of exploring costs in depth can drive wider governance changes in the portfolio. One DB trustee gave the example of how an exercise to examine costs had led to consolidation of passive mandates across several schemes with a single manager. The trustee estimated that the scheme had roughly halved the cost of its passive management in doing so.

When costs are carefully monitored, they can help to drive decision-making at asset class level as well. A trustee of a large DB scheme, with a DC section, running its own in-house investment team said “[Cost monitoring] provokes conversations about why we own a particular strategy and whether it is a good deal or not from a cost benefit perspective. On occasions it has led to some interesting conversations about why we are taking on something that is so expensive when it is not obvious we are getting the returns.”

All respondents felt that reducing costs would not hinder creativity either for schemes or asset

> “Asset managers are always going to need to look for differentiators to be attractive. They can just about differentiate with cost, but I don't think that's enough. I think there will be more innovation, not less, if the schemes demand it because they want the business.”
>
> Professional trustee, DB and DC schemes

managers. They felt that asset managers would still have sufficient capacity to innovate and would need to do so to attract volumes of assets in the future.

The Cost Transparency Initiative and standardised reporting

Cost transparency is complicated by inconsistent formats and reporting, but there is action from within the pensions industry to address this. All respondents were aware of the industry-driven Cost Transparency Initiative (CTI), which aims to introduce a set of standards and common templates for asset managers to use with pension schemes. However, only around half have explored its potential for their own scheme. Three respondents had been directly involved in helping to shape the CTI standards.

Respondents saw CTI as a positive move that will be beneficial but is still at an early stage. Yet more work and wider adoption is needed. "At the moment, [CTI] is something of a struggle because the data that comes out is still not particularly transparent," said a professional trustee who also chairs boards. "You have to take the information with a fairly large pinch of salt. But the initiative and the direction are incredibly helpful."

> "We're already starting to talk to the individual managers to say, 'Well that just looks off the mark'. If they refuse to do anything about it, we're then starting to question whether that is a trigger to make a change. Or, if we like the asset class, to identify a replacement manager who will manage it in a more transparent way."
>
> Investment manager, DC scheme

The same respondent gave an example of a scheme that estimated its annual investment costs were between £7m and £8m before using the CTI approach. "The far more accurate and detailed assessment of the costs truly staggered the board and were closer to £15m."

Some participants said that they are using their own in-house processes or other industry templates, such as the DC Workplace Pensions Template (DCPT), to collect cost information. With no regulatory guidance, schemes and their managers select what they feel to be the best approach for their needs. "We get our transaction cost data from our platform provider," said one DC scheme trustee. "We can ask them to report either way (using CTI or DCPT). They have opted for DCPT and unless there is a strong steer from a regulator, or otherwise, I don't see us changing."

> "I don't think [CTI] will change our approach a lot in the UK [as we have already explored costs in detail]. The challenge for us will be how we comply with any future reporting requirements in the most cost-effective way. But we might surprise ourselves. We might find something where there is a cost saving but I suspect it won't be massive in our case."
>
> Trustee, DB scheme

Without regulation to mandate an approach, most respondents felt that inconsistent data will continue to be the norm, and make it difficult to compare like with like, even within an asset class. Inconsistency in cost reporting is not just an issue for schemes that want to better understand their investment costs. It is also causing issues for decision-making. “There is no uniformity in how managers are reporting,” said the investment manager of a large DC scheme. “You end up comparing apples and oranges which doesn’t serve anyone’s benefit.”

Some respondents questioned if the amount of time and money involved in improving transparency justified the benefit they would achieve. However, others have already seen sizeable savings from improved cost transparency. Participants felt that as an aggregate across the DB pensions industry, there will be savings – but the benefit will vary from individual scheme to scheme. “Do the benefits outweigh the costs [of carrying out transparency exercise]?” asked one DB trustee. “Maybe on an industry level the answer is yes, but not for all schemes.”

> "My observation on transparency would be there's a cost to working out, writing down and publishing what your costs are. So, if we're going to be asked to spend more money to prove that we're saving money, we have to ask, where is the balance?"
>
> Trustee, large DB scheme

What to do with cost data?

Once schemes have more transparent information about their costs and charges, how will that affect decision-making, both in terms of selecting providers and making decisions on asset classes? "Up to now, many decisions have been cost-driven, but those haven't always reflected the true cost," said a professional trustee. "Having a complete picture is always going to help you make the right decisions."

A professional trustee questioned whether all boards have the governance capacity and skills required to analyse data about costs collected using CTI and other templates: "If we were drilling into this in any detail, I would engage a third party with the requisite skills to advise me. I'm a professional trustee, but I'm not an investment expert. I would still need a third party to help me decide whether the fees are fair."

The blend between active and passive management is one area where cost and value are hotly debated. "I think there are areas where active management is absolutely required. You need to be able to see what the actual difference in cost is and whether that provides good value. On DC, cost information is critical because there's no way individual members are going to be able to see what they're being charged," said a professional trustee with responsibility for both DB and DC schemes.

Costs and charges – the DC Chair's Statement

DC scheme trustees are already engaged to some extent with cost transparency, as well as the relationship between charges and value for money. With a charge cap in place on the default fund, plus TPR requirements to show costs and charges borne by members during the scheme year – and over time in the Chair's Statement – it is a part of running a compliant scheme.

However, several respondents felt that the information required for the Chair's Statement offers little benefit, either to the scheme or to its members. In fact, one felt that the information reported in the statement might have a negative effect on investment innovation: "It's been quite unhelpful for investment. You are having to input the cost and charges illustrations into your Chair's Statement and report on the level of transaction costs. It's making actively managed funds look much more expensive, with much, much higher transaction costs. All the other benefits of active management – the volatility dampeners, the controls, the ability to shift, make practical calls, strategic calls – are not really factored into the limited capacity that's asked for in the statement. Arguably, it is pushing trustees towards more passive mandates."

"As an end user, we should expect transparency. It never ceases to amaze me that when we first had to disclose costs on a chair's statement, that asset managers said, 'We don't know how to get the transaction costs accurately.' You just think, 'Don't you remunerate your staff with bonuses based on all transactions?' To drive change, we should demand it."

Professional trustee of DB and DC schemes

As there is a direct relationship between charges and DC members' savings, communicating information on costs and value in a meaningful way is another important consideration.

However, respondents felt that the Chair's Statement requirements do not fulfil this brief either. "For the average member, [Chair's Statements] are very difficult to understand. I think there is good information in there, but there is an education piece for members to help them understand it," said the investment manager of a large DC scheme. "I think it can be improved. That impetus should come from The Pensions Regulator in terms of clear language initiatives to make this better."

"It's really important to understand the nuances of transaction costs, and the tweaks that asset managers make. We need standardisation and transparency in DC – you could end up spending so much time on this."

Pension committee chair, DC scheme

Aon insight
The Pension Regulator's defined benefit funding code of practice

The new DB funding code of practice (Code) is expected to have a significant impact on the development of scheme 'journey plans' and investment portfolio de-risking. While The Pensions Regulator (TPR) does not signal a complete change of direction in the draft Code, it does make its expectations much clearer and has underscored the "need for greater transparency and accountability around the risks being taken on behalf of members and employers".

One way it aims to achieve this is by formalising long-term objectives and the timescale to reach them. As a result, trustees will be required to measure their progress more rigorously, and to have a strong understanding of how their funding level and scheme maturity will develop over time.

There is recognition that many schemes, and sponsors, have work to do when putting journey plans in place. The pandemic-driven market crisis initially saw scheme funding levels deteriorate and sponsor covenants worsen – and this tested contingency plans. Schemes with a robust integrated risk monitoring framework were able to identify issues and take remedial action quickly.

Some interviewees expressed concern that schemes may be forced to de-risk to satisfy the requirements of the Code. However, the Regulator has emphasised the need to retain flexibility, and underscored that lower risk does not necessarily mean lower return. For example, the draft Code indicates that it is acceptable to deviate from the defined 'Fast Track' approach if additional risk is offset through alternative financing arrangements.

There was also concern about the potential increase in demand for certain asset classes, such as high-quality bonds, as schemes move towards lower-risk portfolios. In our Consultation feedback, we raised similar concerns. It is our hope that the final Code will allow for full flexibility around portfolio design, to enable Trustees and sponsors to develop the most appropriate and cost-effective strategies to meet their scheme objectives.

Although the final details of the Code are yet to be published, its principles can be used now to guide the setting of schemes' long-term objectives, the journey plan, and regular monitoring framework, required to achieve them.

It is encouraging to see that many have welcomed the additional guidance provided so far and this should empower trustees and sponsors to work together towards agreed goals.

Shelley Fryer
Principal Consultant, Aon

The Pensions Regulator's new DB funding code of practice will introduce many new practices and principles for both pension schemes and their sponsors.

The Pension Regulator's new defined benefit funding code of practice will introduce many new practices and principles for both pension schemes and their sponsors.

Long-term planning

Trustees must set a scheme-specific Long-Term Objective (LTO) for their funding and investment strategy. This must explain how the scheme will become fully-funded on a low-dependency basis. Trustees must also set a journey plan to achieve the LTO.

TPR expects members' accrued benefits in open schemes to have the same level of security as accrued benefits in closed schemes and trustees' plans must demonstrate this.

Employer covenant

The role of the employer covenant in scheme funding is being augmented, with an increasing emphasis, and guidance, on how long schemes should be reliant on it.

Investment risk

Levels of investment risk should be supportable and trustees must be able to demonstrate this.

Recovery plans

Where a funding shortfall arises, this should be funded by an appropriate recovery plan. Employer covenant, affordability and scheme maturity will influence the appropriate length and structure of the recovery plan.

Note: The timeline for the DB funding code of practice has been affected by COVID-19. The first consultation on the Code, originally scheduled to close in June, has now been extended to September 2020. In 2021 there will be a further consultation on the fine details of the approach. The comments in this report relate to the draft of the Code published in June 2020.

Heading in the right direction?

While the details of the Code are still to be confirmed, scheme decision-makers have already been assessing its potential impact.

For the most part, reactions to the draft code were positive. “It’s good to move corporates’ line of sight towards a longer-term objective,” said a professional trustee and scheme chair. “It gives a sense of purpose as to why cash is being paid into the scheme. There’s also a shared objective to get to a point where the sponsor doesn’t have to pay any more into the scheme. You can say, ‘we’re doing this for a reason’. It’s also a really powerful message to deliver to members as well.”

Some respondents felt that they are already complying with many of its principles. “Asking ‘What are your objectives for this scheme? What are you trying to achieve?’ has always been an ideal approach. I think it’s a good idea.”

> "I have a lot of sympathy for CFOs because for the last decade or more, each triennium they commit to paying more into the scheme and you get to the next valuation and the funding situation has got worse again. There's a real sense of 'What am I doing this for?' Having a long-term objective with some measurable milestones does really help to articulate why you're doing it."
>
> Professional trustee, DB schemes

Others saw the new Code as a powerful tool for trustees when negotiating with sponsors: “There are a lot [of sponsors] out there who just grind things down at every valuation to get away with the minimum they can with no long-term thought process. They want to be shot of the scheme, but they don’t want to do anything to get shot of it. That’s quite difficult and this will generate some challenging scenarios for trustees — fortunately backed up by the Code.”

> "The regulator is saying: 'We're not asking you to do anything new here, we're just asking you to draw a line through your technical provisions basis, to something that is more prudent.' And the best way to describe journey planning to trustees is it's just an extension of the recovery plan."
>
> Professional trustee, DB and DC schemes

Most commentators were agreed that the current technical provisions regime has “outlived its usefulness,” as one commentator described it. “There are so many schemes that have pretty much reached the peak of the technical provisions regime and are paddling round in a circle now.” However, a professional trustee questioned how easy The Pensions Regulator will find it to draw a line between the Bespoke and Fast Track options it will offer within the Code. “I also think it will prove more challenging to handle open and less mature schemes. For those, the expectations might be a bit of a pipe dream.”

Are schemes and sponsors prepared?

While the Code might already feel familiar to some schemes, it will require changes in behaviour for both trustees and their advisers. "In the past, actuaries have not set a long-term funding target, they've just strengthened the technical provisions basis. I'm not a fan of that, as it doesn't really solve the long-term problem" said a third party evaluator. "You can leave the technical provisions alone and target something completely different, whether that's almost eradicating investment risk from the portfolio so you're not reliant on a sponsor; carrying out a buyout; or being completely independent and running a low-risk strategy."

The approach laid out might already be familiar to some schemes, but respondents still felt they would have work to do to make sure they are compliant. One trustee of a large DB scheme said: "Our UK plans have had what I think of as a long-term funding objective for some while now. Our technical provisions basis will move towards that over time, just naturally, because of the way it's designed. We might not have it in precisely the format that we need to have it to satisfy the Regulator, but I think we're very close. I think that can be brought together relatively easily."

> "I'd like to think all my schemes are as well prepared as they can be, because they tend to have very open relationships with the company, there's a very, very good dialogue. If you go about the conversation in the right way, you'll tend to get the right response."
>
> Professional trustee, large DB schemes

However, until the Code is finalised, some respondents remain cautious. "As yet, the Code is not driving behaviour, but it's becoming more and more of a talking piece. The advisors are doing a good job of bringing it to the fore, but they seem to be urging some caution that the position isn't clear yet, so therefore don't start adapting your behaviour based on things that aren't quite set in stone," said a professional trustee. "It's positive because it will force more sponsors to understand the pension scheme's journey. Good trustees do this anyway, but it all reinforces the importance."

> "TPR have brought the funding code in because the current legislation only gives trustees power up to 100% of technical provisions. That leaves a massive gap where there is no requirement on the sponsor to the fund. I try to bring the sponsor in and get them to understand that this isn't a scenario where the less you can pay the better. It's actually a partnership on a journey. It can be in everyone's interest to have a sensible plan that makes the sponsor's costs more predictable over time and work together on that journey towards the ultimate destination of the scheme."
>
> Professional trustee and scheme chair, DB schemes

What are the obstacles?

While respondents were generally positive about the Code, they foresaw a few obstacles to implementation.

The COVID-19 pandemic has not just affected the release schedule, it has also made it a very difficult time to implement some of its ideas. “The timing is lousy. Clearly COVID-19 has had a very negative effect on some schemes and their sponsors. If you are asking people to look at long term objectives for low dependency, starting from this point is not ideal. Funding levels might have fallen, and the end of the journey looks further away, in a difficult economic environment,” explained a professional trustee.

> "The biggest problem with the Code is that it implies the approach the Regulator was using for years has changed. Previously the view was that if you are a strong employer you could have a long recovery period. Now TPR is saying, almost overnight, 'we have changed our mind. If you are a strong employer, you should have a really short recovery period.' I don't have a problem with the Code. It's the conversations with the sponsors that are the tricky bit."
>
> Professional Trustee, DB schemes

Getting commitment from sponsors to a new way of thinking was a common concern for respondents. “A lot of companies feel they’ve got to the top of the mountain and just want time to pass until the scheme naturally evolves to a buyout. Now there is going to be more of an impetus, from the Regulator, advisers and the trustees to say, “You’ve got to get there with even more certainty, and that is going to require either some more de-risking, more cash or some more pledged assets.” So, I think it might be a bit of a culture shock for some employers.

Another respondent added, “it’s quite a sea change to say that if employers have got the money, it needs to be in the scheme. It might not look like a big change, but it is, because we’ve always had ways to keep cash out of the scheme, using vehicles like a parent company guarantee or other options. This seems to be a move away from that.”

The same respondent identified challenges with explaining the new regime to some sponsors. “I’ve met resistance from overseas sponsors in a couple of places. The ideas don’t always translate well, although I’m not sure why. It may be when we can actually put the Code in front of sponsors that it will help, but some are very focused on kicking the pension scheme along to the next valuation.”

"We're expecting, for one of our schemes which is approaching a valuation, a much more prudent, conservative funding strategy having to be implemented, with some more long-term thinking. That will lead to significant increases in contribution structures, over a much shortened recovery period. There are going to be some implications for us."

Group Pensions Manager, DB schemes

Some respondents questioned the definition of 'long term' in the context of the Code. "Most investment strategies should have had a term-based objective, but sometimes, it is a little bit confusing as to what is medium and long-term. Does long-term mean we ultimately want to go to buyout? Or is it, we just want to be self-sufficient and not have to rely on the sponsor? Or is it, less volatility in our funding levels?"

Another objection that a respondent had experienced was a risk of trapping surplus. "There are all sorts of mechanisms and ways you can deal with that, and as the industry recognises tried and trusted ways of ensuring you don't do trap surplus, then that will take that argument away."

How will the Code affect schemes' investment strategies?

Respondents felt that the Code would have a significant impact on the investment approach for some schemes. "This won't be the case across the board because lots of schemes are already very substantially de-risked. But some may be taking more risk than they should. This is an opportunity for the trustees and the company to stand back and say, 'The ground beneath us is shifting, the expectations are shifting, so we need to shift our behaviour'."

"TPR is quite focused on de-risking," added a professional trustee. "This is rightly so, particularly if buyout is the target for most schemes. Having measures which match that goal has a lot of sense to it. But I do feel it'll be a bit of a shame if it rules out any scope for difference of approach."

> "The journey plan and long-term objectives give really good visibility on the time horizon, and on the expected return required over that period. That should affect the investment strategy, and it gives you flexibility to build in coping mechanisms in the journey plan."
>
> Third party evaluator

Respondents said that ensuring that trustees can genuinely manage their investment strategy is another consideration. "[The Code has] much more awareness of governance budget when looking at appropriate strategies for schemes. The focus is on understanding what you've got, why you've got it, and how it's performing," said a third party evaluator.

The Code's focus on a journey plan towards a long-term objective will inevitably help to shape the investment approach. "It should make schemes think 'we've got a journey — where are we now and where do we want to get to?' That should change the investment approach — and good consultants have been trying to have this conversation for a while," said a professional trustee.

"You also need variations of a plan that you can put in place if things aren't going well — and if they are going better than expected," added a third party evaluator. "And I think that's the big thing a journey plan brings. It gives you good visibility over the return you need and the time horizon, so you can assess what investment toolkit you need."

> "It is acceptable to take more risk if the sponsor can credibly stand behind you and that risk but I think generally across the rest of spectrum of covenant strengths, schemes should be moving towards lower risk and a low dependency target."
>
> Professional trustee, DB Schemes

The Code could drive a shift towards lower-risk portfolios, and respondents generally saw this as a positive move. "More schemes that I deal with are at a point where buyout is feasible. So, if the timeline is going to get progressively shorter, you need less investment return, therefore you should be taking less risk.

However, there were some concerns about the effect of a low-risk approach on open schemes. "If you are open to future accrual, then you have a long-time horizon and can afford to have risk, as long as you know the downside. This perception that it's not right to have risk is an issue for those schemes."

What assets will schemes use?

With schemes likely to move to a lower-risk investment strategy, focused on a long-term objective, because of the new Code, how will that affect the asset classes that they invest in?

"We are seeing residual growth assets generally in equities or diversified growth funds," said a professional trustee. "We are also seeing a move into secure income assets. The increased focus on ESG and responsible investment will also now see some appetite for investments like green bonds in journey plans."

"There's still plenty of need for companies to issue debt at the moment and little limit to the number of new opportunities that are coming to market for pension scheme investors."

Professional trustee, DB schemes

However, credit is likely to be an increasingly important component of many portfolios. Respondents expect demand for corporate bonds to continue, even though COVID-19 has affected the ratings of many businesses in the short term at least. "A lot of schemes I'm involved with are approaching corporate bonds on a buy and maintain basis. There's less around active management for corporate bonds – as long as the covenant of the issuer is good, they can just let it mature over time and the capital will return in due course."

"There is a worry that everyone will be searching for the same assets," said another commentator. "The question is whether there are enough credit assets for everybody, and the pricing impact if everyone is after the same assets. I do think that is a real problem in terms of gilts, particularly at the long end where demand is so strong."

Although alternative ideas to long-dated credit are available, some respondents felt that the more variety of ideas are needed. "There is a very slow reaction to a lack of availability of low-risk investment ideas."

"The pandemic has shed a light on so-called less risky assets, such as commercial property, long-lease property and ground rent. Some of those assets just don't have a marketable value at the moment. So, are they less risky? They have different risks certainly. I think that's going to pan out in the future."

Third party evaluator

Complexity in investment portfolios is also a source of risk, which is not always rewarded. "We feel as a company that the investment structures put in place over the years are far too complex. We're not huge fans of having a whole spectrum of different asset sectors," said a group pensions manager. From a corporate perspective, you just sit there and think: that's all well and good. But, what are we gaining?"

Contacts

Emily McGuire
Investment Partner
emily.mcguire@aon.com

Investment Governance

Tony Baily
Investment Partner
tony.baily@aon.com
LinkedIn

Sonia Gogna
Fiduciary & OCIO Solutions
sonia.gogna@aon.com
LinkedIn

Joanna Sharples
Partner, Head of DC
Investment Strategy
joanna.sharples@aon.com

Responsible investment

Tim Manuel
Head of Responsible Investment, UK
timothy.manuel@aon.com

Geri McMahon
Principal Consultant and Responsible
Investment Strategy and Solutions Lead
geri.mcmahon@aon.com

John Belgrove
Senior Partner and Director
of Forward Thinking
john.belgrove@aon.com

Endgame planning and de-risking

Lucy Barron
+44 (0)20 7086 0532
lucy.barron@aon.com

Colin Cartwright
+44 (0)20 7086 9044
colin.cartwright@aon.com

Ben Steen
+44 (0)20 7086 8071
ben.steen@aon.com

Costs and transparency

Neil Smith
Head of Costs & Transparency
+44 (0)20 7086 9266
neil.smith.2@aon.com

Chris Hawksworth
Senior Investment Consultant
christopher.hawksworth@aon.com
+44 (0)113 394 3426

Matthew Sanderson
Investment Consultant
matthew.sanderson@aon.com
+44 (0)113 291 5022

TPR DB funding code of practice

Andy Corvesor
Senior Partner
+44 (0)1727 888 665
andy.corvesor@aon.com

Shelley Fryer
Principal Consultant
+44 (0)121 262 5173
shelley.fryer@aon.com

Daniel Haxby
Principal Consultant
+44 (0)20 7086 9132

With thanks to our researcher and author: **Maggie Williams**

Maggie is an experienced pensions commentator, writer and editor with over 20 years' writing and interviewing experience. You can find out more about her through her LinkedIn profile.

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