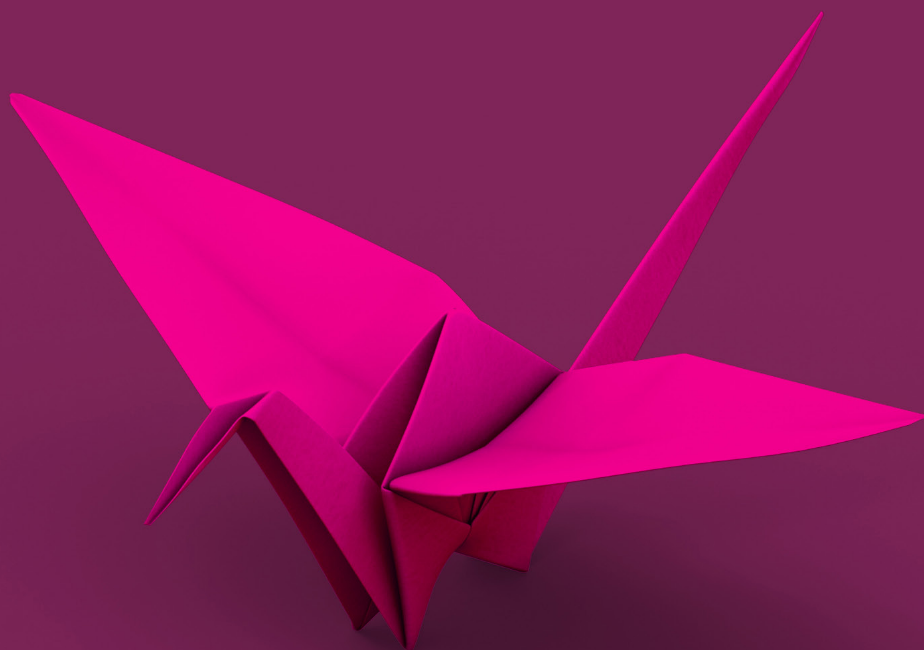
Your Quarterly Pensions Update

Dalriada Trustees – Industry Changes

Quarter Two 2024



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Introduction

The purpose of this report is to provide an update for pension scheme sponsors and trustees on recent industry changes in the quarter

For your convenience, we have summarised the key developments and highlighted the necessary actions sponsors and trustees may need to take.

We also include links to further relevant information and any deadlines you should be aware of.

We trust you will find the update useful and informative. If you require further information about how any of the topics covered might impact on your scheme specifically, please get in touch with Adrian Kennett, adrian_kennett@dalriadatrustees.co.uk or your usual Dalriada contact.

NOTES

This document is aimed at providing you with generic information about recent developments in the pensions industry.

You should not take any action as a result of information included in this document without seeking specific advice in relation to the impact these matters might have on your scheme or company. Dalriada Trustees Limited accepts no liability for actions taken or not taken as a result of this document.

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1 Investment Update

Market Commentary

The strong equity returns witnessed during the first quarter of 2024 carried on into the second quarter as continued robust economic growth was positive for growth assets with Global Equities and Commodities returning 2.9% and 2.9%* respectively.

However, this did lead to a continuation of the higher for longer interest rate narrative that consequently weighed on Global Bond and Real Estate valuations which generated returns of -1.1%* and -1.4%* respectively during the period.

Growth Assets

Within Equities, Asia Ex Japan was one of the strongest performing regions returning 6.1% followed closely by Emerging Markets (EM) at 5.1%*. The Chinese government's decision to support the real estate sector was positive for Chinese equities as well as EM more broadly. The strength of the Chinese market coupled with the strong performance of tech A.I companies exposed to the Taiwanese stock market helped Asia Ex Japan deliver strong returns.

US equity markets also performed strongly returning 4.1%, mainly driven by US technology companies. Whilst UK equities returned 3.7%, off the back of an improving economic environment. European Equities were marginally up at 0.3%. Positive gains across other European markets were offset by weakness in the French Equity market in June, as uncertainty around the outcome of the snap French Federal election weighed on market sentiment.

Conversely, the Japanese Stock Market posted a negative return in GBP terms of -4.6%, despite generating some strong returns in the first quarter of the year. The main driver of this negative performance was the continued depreciation of the Yen against the pound due to the Bank of Japan's (BoJ) decision to end 8 years of negative rates.

Commodities continued their positive momentum into the second quarter returning 2.9%*, mainly driven by a rally in industrial and precious metals off the back of continued robust economic growth.

Bonds

Most sovereign bond markets generated negative returns this quarter with the exception of the U.S returning 0.1%*. Japanese Government Bonds generated the worst returns, returning -2.7%.

Within credit, high yield produced a positive return of 1.4%, with resilient economic data being positive for credit valuations. Continued stubborn higher inflation in certain regions and better economic data weighed on the more interest-rate sensitive investment grade bonds which generated a negative return of -0.2%*.

Within the UK, long-term UK gilt yields increased by 0.2% to 4.6% as stickier services inflation dashed hopes of a June rate cut by the Bank of England, causing long-term rates to remain elevated.

Real yields increased by 0.2% to 1.3%. Within the UK, long-term inflation expectations as measured by the difference between yields on nominal and inflation linked bonds remained broadly the same over the period at 3.2%.

All returns shown are shown in GBP terms unless stated otherwise, sourced: FTSE, Markit iBoxx
*Local currency, except for EM and global indices, which are in US dollar, sourced: JPM and MSCI
Past performance is not a reliable indicator of current and future results.

Data as of 30 June 2024.

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2 DB Funding Regulations

Funding Code issues

Whilst the General Election of 4 July may be settled and now a distant memory (and one that some parties might like to forget), the timing of it has left many DB pension scheme trustees, sponsors and advisers somewhat unsettled.

The new DB funding regulations are already in place and come into effect for all actuarial valuations with an effective date after 22 September 2024. That may seem like a while away, but we've not yet seen the Pensions Regulator's (TPR's) revised Code of Practice on Funding and it must be laid in parliament for 40 days before it can take effect. The General Election's timing means there aren't enough days prior to 22 September in which parliament sits to meet this requirement (unless, of course, the new Labour government reconvenes parliament early from their summer recess).

Will Labour's Liz Kendall MP, the new secretary of state for work and pensions at the DWP, or perhaps Emma Reynolds MP, the new pensions minister, ensure a quick billing of the Funding Code in parliament, or will they have other ideas? We will need to wait to see.

So it seems that many trustees and sponsors with valuation dates in the final quarter of 2024 and early 2025 may need to think carefully about when and how to proceed with work on their actuarial valuation. We saw TPR's draft Funding Code at the end of 2022, but will recent events – for example, generally improved scheme funding levels and the proposed Mansion House reforms – mean further changes afoot? We already know that the timeframe in which a scheme is deemed to reach "significant maturity" was a point that TPR wanted to "reassess and revise".

In the meantime, what can trustees be doing? For some schemes – those that are well funded, with strong employer covenants, for example – they may choose to delay starting work on their valuation, comfortable that their scheme is in a good position, and in the hope that the Funding Code will be finalised in good time. After all, schemes have 15 months in which to complete the valuation process. Alternatively, those schemes who are already well funded on a prudent basis and have an established Long Term Objective, may wish to plough on with work on their valuation, comfortable that the Funding Code is unlikely to change things materially.

Other schemes may be in a less fortunate position and trustees may feel an urgency to make progress on their valuation. For these schemes, the Trustees might want to begin assessing the sponsor covenant and understand the levels of affordability to fund the Scheme as soon as possible. The Scheme Actuary could also be asked to prepare initial results on a number of different assumptions and estimates of "significant maturity", considering the "art of the possible", ready for discussions with the scheme sponsor and a quick submission to TPR once the Funding Code is released. Any increased adviser costs of doing so, should be carefully considered though – is the potential extra work justified, or can the valuation work wait? Of course, the use of valuation modelling tools, such as Mantle, which allow multiple funding bases to be considered in real time, can make this a more straightforward and efficient process, resulting in reduced costs and a faster completion time for a valuation.

As with many aspects of DB pensions, the right approach will vary by scheme. This is where a Professional Trustee can add real value to the process – we will know the right questions to ask of advisers and sponsoring employers to help ensure a smooth valuation journey.

It will be important, however, for all trustees to:

- Engage early with their advisers and the scheme sponsor
- Understand any changes in the sponsor covenant since the previous valuation
- Determine their Long Term Objective for the scheme
- Continue to monitor risks associated with their scheme's funding and investment strategy
- Keep a close eye out for the Funding Code's eventual arrival!

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3 General Code: Approaches to implementation

In summary, the new General Code consolidates and replaces the 10 existing codes of practice, and the focus is for the governing bodies to understand their obligations under the code.

Governing bodies should be focused on reviewing processes, policies and documents for the following key areas:

- Funding and Investment
- Administration
- Communications
- Disclosure
- Reporting

As we work with our clients on understanding and implementing the general code, we have found it helpful to take a step back and analyse all the differing approaches to implementation and the challenges faced by our clients.

Strong schemes are underpinned by strong governance, which should be proportionate to the size and complexity of the scheme. Thereby lies a challenge of assessing proportionality. This can be mitigated by ensuring that governing bodies take a broader wide angle approach and assess what is required and needed before delving deep into creating policies that may not be relevant.

There are two approaches that can be taken which embody all the requirements for implementation:

The Proactive Approach

This approach allows our larger well-funded pension schemes to adopt the ultimate package approach of setting up all policies, processes and procedures to ensure they are complaint now and for any changes in the future. This can be time consuming and not in line with proportionality however has allowed an excellent review of the scheme and its processes to ensure there is strong governance in place.

The Gradual Transition

This approach allows some of our pension schemes to take a phased approach, gradually integrating the code provisions into existing policies to make the process more cost efficient and focused on individuality of the scheme rather than a one size fits all model.

With both approaches we find that this project is more likely to result in a smaller number of relevant policies which are more effective and can become a catalyst for improved risk management.

There are several versions of ‘gap analysis’ work being carried out across pension schemes, and this will inevitably lend to stronger governance in the long term for pension schemes. On a short-term basis, it allows pension schemes to pinpoint gaps in current policies. This should then be followed by a resource allocation exercise to ensure the scheme allocates resources to meet the additional governance requirements.

Our clients know that compliance with the General Code is a team effort, Trustees, Actuaries, Investment Advisors and Lawyers must all work together to address all elements of the Code.

It is important to keep in mind that the General Code aims to enhance governance standards, therefore it is essential to go beyond the gap analysis and actively implement and stress test the necessary changes.

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4 Dashboards

Like many developed nations, the UK has a significant retirement income provision problem.

Some life expectation models show that a newborn today has a 50/50 chance of living to 100. The notion that they can leave education at 18, work until their early 60s, put away 8% of salary per annum, and accumulate enough to provide them with a reasonable standard of living for the next 40 years is just fiction. Paying 8% for 40ish years doesn't lead to a decent pension for another 40ish years.

The first step to addressing a problem is to accept that you have a problem and the introduction of Pensions Dashboards is a first step. Showing those who have yet to retire what they are going to get. Which, it is then hoped, will trigger them into thinking they need to save more.

Simple idea in theory. Non-pensioners go on to a website, enter a few details sufficient to identify themselves, and they are provided with details of all the pensions they have been saving.

The issue is, the more you go into the practice, the harder it gets.

All schemes (with over 100 relevant (non-pensioner) members) have to have secure and constant contact. Providing data in a consistent format. For every scheme type, be that for money purchase or defined benefit schemes. Schemes with different Normal Retirement Ages. Schemes with underpins. Schemes with different benefit structures. Schemes which haven't seen investment in data or systems technology for the last decade.

The introduction of Pensions Dashboards has already been delayed. The latest timetable consists of staging dates from 30 April 2025 with the long-stop for connection by 31 October 2026.

What key messages can we share about taking 130 schemes towards Dashboard connection:

1. This is the Trustees' problem.

It is tempting for trustees to look towards administrators and trust that their Dashboards connection is under control. That's a very dangerous approach. If a scheme fails to meet the connection date, and is unable to evidence strong governance, planning and control through the process, the Trustees are massively exposed. Trustees remain accountable to the membership and the Regulator for any actions parties they have delegated to take. Or doesn't take.

Trustees need to be equipped to as some basic questions such as I "who is your ISP (Integrated Service Provider)"? Or "where is the project plan?" and sit with people who know the answers and appropriately challenge them. Separate meetings should be arranged if necessary. If this doesn't go to plan, it is going to be the Trustees' problem.

2. The size of the problem should not be under-estimated

In our experience the average quote for a connection project is approximately 40% of the annual administration fee (not including any data cleansing activity). And an uplift in ongoing administration fees of 15% for dealing with the increased volume of queries and maintaining the connection to the Dashboard through an ISP.

Problems are coming home to roost. As a generality, investment in pensions administration systems in the last two decades has been lacking. Systems are therefore dated and clunky. Adding additional programming is challenging and complex. Data quality is poor. Trustees who haven't invested in maintaining quality data are now having to run quickly. The administration services industry isn't blessed with an overspill of experienced resources that isn't working on GMPE projects.

Given it is the Trustees' problem, and they only have a short period of time to deal with any issues their administrator provides them with, now is the time to have a long think about whether their administrator is their ideal long-term partner. You wouldn't want to engage in a massive project with them, only to think about removing them halfway through.

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3. **You need a plan.**

Given 1) and 2) above, a detailed plan is just a must. A plan showing accountabilities, responsibilities, deliverables, timescales and budgets. And trustees need that plan NOW. It cannot wait for a draft to be produced at the next quarterly meeting for approval at the meeting in six months' time. Because by then they may well be halfway through the remaining time they have to implement.

4. **Getting connection ready is only part of the challenge.**

Getting prepared for the dashboard is essential. However, trustees need to ask two further questions of their administrators:

- How are you going to convince me that when the Dashboard goes live, you have the resources to deal with queries which result?
- Can I please see the contract you are going to ask me to sign to provide live Dashboard services?

5. **Clear communication is key.**

When you first start out in pensions, there is the language of pensions to be learnt. GMPs. SPA. LDI. ERFs, etc, etc. Now there is an additional language to learn – which includes aspects of computer programming and data security.

The value of good communicators amongst administration companies is going to come to the fore during this period. Good client managers are going to be able to convert what can be technical concepts into language that all Trustees can understand and explain the value of the sizeable projects being undertaken. They are going to provide clear budgets – not those where the true extent of the costs only becomes clear once Trustees are so far down the road that they have little option.

In summary – the objective here is right. Members should have information to enable them to plan. Just don't think that getting there is simple.

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5 DC Update

Our latest DC update covers the defined contribution (DC) centric topics and upcoming key issues.

TPR's General Code of Practice

Published in January 2024, Trustees are now becoming more familiar with the Code. It represents a simplification and consolidation of 10 of the Regulator's previous codes of practice into a single code that is available online. The intent of The Code is to help Trustees establish an effective system of governance (ESoG) for their scheme and be able to evidence this.

The Code sets out TPR's expectations of the conduct and practice Trustees should meet to comply with their duties in pensions legislation. It states that Trustees must "use their judgement as to what is a reasonable and suitable method of ensuring compliance for their scheme", that "It is not necessary to follow all parts of a code of practice in every circumstance" and that "The absence of reference to any piece of legislation must not be taken to mean that governing bodies do not need to comply with that legislation".

In short, Trustees must apply proportionality, which will make their system of governance appropriately bespoke to their scheme, Trustees don't need to follow all aspects of the Code but should record the use of proportionality if an element of the Code isn't followed and Trustees should not rely on the Code in isolation, as the Code doesn't necessarily contain all that is needed for a scheme to comply with the legislation.

Evidencing an ESoG is therefore not just comparing what the Regulator suggests in the Code to what documentation Trustee have for their scheme. Applying proportionality to every aspect and function of the Scheme's activities enables the Trustees to identify the bespoke governance requirements for their scheme.

For schemes with 100 members or more, the Code also requires schemes to carry out an "own risk assessment" (ORA) of their system of governance. This is an internal assessment of the risks the scheme faces and how they are managed. Evidence will need to be provided for all documents and processes in place. Trustees will have different deadlines for completing their first ORA, depending on the date of the scheme year-end.

Scheme year end	First ORA deadline
31 March 2024	31 March 2026
30 June 2024	30 June 2026
30 September 2024	30 September 2026

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