



CMS Pensions Investment and Risk Briefing

August 2023

Welcome to our latest briefing on topical issues facing occupational pension schemes in the risk and investment spheres.

Welcome to the third edition of the CMS Pensions team's Investment and Risk publication. Since our last edition, risk and investment issues continue to dominate the agendas of trustee board meetings. In this issue, we explore some of the topical issues currently facing occupational pension schemes in both the risk and investment spheres.

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Bulk annuity market update – records continue to be broken

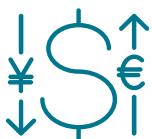


Overview

The bulk annuity insurance market – commonly referred to as the buy-in or buy-out market – continues to see unprecedented levels of activity and the demand shows no signs of abating. 2022 saw 200 transactions completed for the first time ever, with more than £44 billion of business written across buy-ins, buy-outs and longevity swaps. Of particular interest is that, for the first time, six of the eight insurers in the market secured a 10% market share, up from five in 2021, four in 2020 and just three in 2019.

CMS' market-leading de-risking team also had a very strong year, acting on 23 transactions with a combined value of more than £15 billion – a third of all transactions by value.

There has been a very strong start to 2023, with PIC recently concluding the £6.5 billion RSA schemes transaction (on which CMS acted for PIC). 2023 may see demand outstrip supply for the first time, raising the question of what schemes need to be doing to ensure high levels of transaction certainty, making them more attractive to insurers in a congested market.



What is driving the demand?

2022 was a year of significant economic uncertainty and volatility: Russia's invasion of Ukraine, rising inflation, Kwasi Kwarteng's "mini budget" and the short-lived but devastatingly impactful period "Trussernomics". However, despite this, buy-in and buy-out pricing continued to improve over the course of 2022, principally driven by widening credit spreads.

One of the peculiar outcomes of the economic uncertainty and volatility was that the dramatic increase in gilt yields resulted in significant improvements in funding levels for many schemes, particularly those that had not hedged as much risk.

The combined impact of insurer pricing improvements and scheme funding improvements has been an acceleration in market activity, resulting in a very busy conclusion to 2022 with close to two-thirds of the transactions being completed in the second half of the year.

A further consequence of the improved funding levels is that pensioner-only buy-ins, historically the most popular route for schemes to de-risk, only accounted for a quarter of transactions in 2022 (down from more than 70% just five years ago). Full-scheme transactions incorporating deferred members are now more viable economically and provide the sponsor with the full de-risking and balance sheet impact they are looking for.



The consequence of high demand

Many schemes that have seen their funding level increase have locked in those gains, meaning that demand in the bulk annuity market is likely to remain high for the foreseeable future. 2023 may be the first year in which demand outstrips supply. There are eight insurers participating in this market and each approach by a scheme requires a significant time investment to price the liabilities.

This bottle-neck could have the biggest impact on smaller schemes as insurers may be tempted to focus their attention on larger transactions that will yield a higher return.

There have also been innovations in the market to help smaller schemes (typically under £100m) transact more efficiently. For example, CMS has partnered with Hymans Robertson to develop a streamlined offering, giving schemes the ability to leverage the negotiating power of experienced advisers and streamlined processes, by using pre-negotiated contractual terms. This should help smaller schemes transact in a cost and time efficient manner.



What should schemes looking to undertake a buy-in do to improve the prospects of a successful transaction?

In the current market, insurers are likely to be more selective about which transactions they will quote for. This puts the onus on schemes being 'transaction ready'. What do we mean by this?

- **Data quality:** ensuring scheme data is in good order and has been through a process of cleansing before going to market. This should lead to improvements in pricing and reduce the prospect of a true-up payment being payable after the buy-in has been completed and the insurer data cleanse completed.
- **Benefit certainty:** it is critical that schemes have a solid understanding of the benefits payable to all members, including historic leavers, whose benefits may be different to more recent members. This process culminates in a benefit specification which will form the basis of the benefits insured with the insurer. The process of agreeing the benefit specification involves the lawyers, administrators, actuary as well as the Trustees and generally the sponsor, particularly if any corrections to benefits are required. This is a time-consuming process but is a crucial step in demonstrating to insurers that the scheme is ready to transact.
- **Clarity of transaction type:** does the scheme want a 'vanilla' transaction or to incorporate residual risks cover? Residual risks is beyond the scope of this article, but it is important to have the discussion on this early in the process as it has a big impact on timing and costs of the transaction. Although the market is constantly evolving, residual risks cover is still a product that is more applicable to larger schemes going to market.
- **Having the right advisers:** in a congested market, insurers are increasingly looking at the scheme's advisers – having experienced de-risking advisers, both the broking consultants and the legal advisers, can have a big impact on the transacting process. Trustees will benefit from advisers who understand the market, insurers' different approaches and the scheme's leverage.
- **Knowing what a successful transaction looks like:** this is an important point to understand, and it will vary from scheme to scheme and trustee board to trustee board, but it is helpful for trustees to discuss and agree what a successful outcome looks like – and to keep that in mind throughout the process. At the same time, be prepared to be flexible if it helps the scheme achieve the outcome.

LDI turmoil: a prescription for resilience?

What has TPR been doing?

TPR issued guidance¹ in April 2023, which replaced its earlier statements with short-term actions² and other actions to ensure that LDI mandates are resilient³.

The 2023 Annual Funding Statement refers Trustees to TPR's April 2023 guidance. The draft DB funding code⁴, which has now been delayed until April 2024 in any case, has limited discussion of LDI with a focus on the need to ensure adequate levels of liquidity. The usual approach is to set out its expectations for Trustees; Trustees not following them should expect to need to justify why.

TPR has also indicated in correspondence with the Parliamentary Work and Pensions Committee that it is considering potential notifiable events relating to LDI holdings and buffers.

What does TPR expect schemes to be doing?

TPR's focus has been on the level of resilience schemes should maintain when using leverage, rather than stating that leverage should not be used.

The April 2023 guidance greatly expanded on its initial statements, capturing many additional best practice points which we and other advisers have been highlighting.

Recommended level of buffer

Following the Bank of England⁵, TPR's guidance expects a minimum "market stress" buffer of 250 bps plus an operational buffer.

The market stress buffer is on the basis that schemes would be able to replenish the buffer within 5 days. Higher buffers may be needed if schemes do not have sufficient liquidity or have arrangements more risky than "typical" LDI. Conversely, arrangements that are intrinsically less volatile than a gilt related LDI fund could justify a lower buffer.

The operational buffer should at least reflect gilt yield volatility in normal market conditions and will depend on a balance between frequent collateral calls and capital tied up. Deciding on an operational buffer (if not set by, for example, a pooled LDI manager) will include considering the cost to the scheme from asset sales and whether there is sufficient liquidity.

¹ TPR, 24 April 2023,
<https://www.thepensionsregulator.gov.uk/en/document-library/scheme-management-detailed-guidance/funding-and-investment-detailed-guidance/liability-driven-investment>

² TPR, 12 October 2022,
<https://www.thepensionsregulator.gov.uk/en/document-library/statements/managing-investment-and-liquidity-risk-in-the-current-economic-climate>

³ TPR, 30 November 2022,
<https://www.thepensionsregulator.gov.uk/en/document-library/statements/maintaining-liability-driven-investment-resilience>

⁴ TPR's draft Defined Benefit Funding Code of Practice, 16 December 2022, <https://www.thepensionsregulator.gov.uk/en/media-hub/press-releases/2022-press-releases/consultation-published-by-tpr-on-new-db-funding-code>

⁵ Bank of England, 29 March 2023,
<https://www.bankofengland.co.uk/financial-policy-summary-and-record/2023/bank-staff-paper-ldi-minimum-resilience>

Consider governance

TPR wants Trustees to review governance arrangements and to consider if there were any difficulties responding to the market during the 2022 volatility. Lessons should have been learned and issues addressed. TPR's recommendations include:

- Clarity on who can authorise collateral calls, the extent of their authority and the required processes. Signatory lists should be kept up to date.
- Considering if authority should be delegated to advisers and properly documenting this. Trustees should anticipate how advisers will handle their affairs when there is a squeeze on their resources.
- Consider if technology can speed up processes by avoiding manual intervention.
- Planning which assets will be used to meet calls, including defining a waterfall if necessary. Plans should anticipate stressed market conditions and how much time will be given to meet collateral calls.
- Considering other sources of cash such as a facility from employers or repurchase agreements.
- Stress testing funds and processes and considering how the scheme will be affected by cumulative collateral calls.

Role of the investment consultant and LDI manager

The Financial Conduct Authority has also issued guidance⁶ for LDI managers. TPR says that Trustees should understand the extent to which their manager follows the FCA guidance and, for pooled funds, that of the 'National Competent Authorities' (the Central Bank of Ireland and the Commission de Surveillance du Secteur Financier of Luxemburg, who recommended a buffer of 300-400 bps⁷).

One thing we have seen, and TPR has now picked up on, is how Trustee oversight can be constrained by reporting on LDI arrangements that is infrequent, inconsistent and with a lag.

TPR appreciates that frequent reporting can be more costly, so it is often sensible to have triggers in place for additional and timely updates to be provided to enable proper monitoring in times of stress.



⁶ FCA, 24 April 2023, <https://www.fca.org.uk/publications/multi-firm-reviews/further-guidance-enhancing-resilience-liability-driven-investment>

⁷ National Competent Authorities, 30 November 2022, https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/funds/industry-communications/industry-letter-liability-driven-investments-funds.pdf?sfvrsn=61e09b1d_8

How else can Trustees ensure resilience?

Many who fared well in the crisis were those who were able to take effective steps to manage the issues as they arose. This often depended on what their LDI manager was doing and enabled them to do.

Points which Trustees may want to think about with their LDI managers on top of what TPR has already highlighted are:

- Are there restrictions on how the Trustees can trade? Issues such as long settlement times or rigid trading mechanisms can leave the Trustees exposed if markets turn.
- Should the scheme be managed to a target hedge ratio? Waterfalls will reflect which points “trump” others (e.g. selling growth assets before hedging assets) in urgent situations.
- If a managed target is not in place, could there still be automatic managing of the position in adverse conditions?
- Are other third parties, such as custodians, able to react quickly enough?

More fundamentally, the crisis has also exposed that some Trustees need to consider the role and extent of leverage in their LDI funds. TPR is not saying that schemes cannot use leverage, but any borrowing still needs to be permitted under a scheme’s rules and appropriate to the scheme.

Trustees may also want to discuss this with their employers. Experience during the 2022 turbulence was that employers, often at very short notice, had to make decisions about, for example, whether to put in place short-term liquidity arrangements for their schemes and/or whether to accept a reduction in hedging levels (recognising that in many cases no-one knew what level of reduced hedging schemes were experiencing). Having the discussion with employers now about the use of leverage in their LDI funds should mean that everyone is better prepared in the hopefully unlikely event of future turbulence.



TCFD reporting

From 1 October 2021, trustees of authorised master trusts and larger schemes with relevant assets of £5 billion or more need to consider and report on climate-related risks and opportunities in more detail than before. From 1 October 2022, the requirements were extended to trustees of schemes with relevant assets of £1 billion or more. Trustees need to demonstrate that they have engaged to understand the range of climate-related risks and opportunities their scheme is exposed to and taken proportionate action to address those risks as outlined in [TPR guidance](#).

TPR anticipated difficulties in scenario selection and data quality/availability in its [blog on challenges and opportunities](#). It also recognised the difficulty of balancing between the level of disclosure necessary to meet the requirements in the regulations and the expectations set in the Department for Work and Pensions' (DWP) [statutory guidance](#) whilst keeping the reports accessible and useful. This has proved to be a challenge to the first wave of schemes reporting and TPR has recently published a [review](#) of these.

The 2023 review

The 2023 review was badged as high-level feedback on the first reports but it also contains some warnings for trustees that the lessons contained in the report should be adopted going forward (or explain why not) and that in future TPR may not be as understanding, issuing penalty notices where reports fall below expected standards and regulatory requirements. Failure to publish a report is subject to a mandatory fine of at least £2,500 and further discretionary penalties can be made for failure to comply with some aspects of the requirements even where a report is published.

Data

It is noted that the time spent on calculating and disclosing emissions data in this first round of reports might have negatively impacted on the interpretation and investigation of data but TPR expects this to get better going forward. Data quality and coverage is expected to improve over time as investment firms respond to requirements and trustees and advisors learn from experience, so schemes need to evolve in practice around ingathering, analysing and reporting on this data going forward. This will increase in scope of emissions from year two of reporting. This will involve work throughout the year to understand

where gaps in data arise and causes to ensure that improvements can be made and that adequate reporting on challenges and data limitations is possible in subsequent years. Trustees will need to engage with their advisors to ensure this improvement of data quality happens.

Scenario analysis

In scenario analysis more consideration could have been given to influence of climate-related opportunities on the investment strategy (rather than focusing solely on risks). Several schemes used different scenarios for different parts of the portfolio, or different scenarios for assessing the assets and employer covenant. It is suggested that a single set of scenarios are used consistently to make the report easier to understand. It was also noted that there must be clear evidence to support the statements made in relation to scenarios and statements and that these need to be consistent.

Employer covenant was specifically highlighted as an area that trustees should consider in the scenario analysis of impact of climate related risks and opportunities. Some schemes only reported on the impact on assets, but the employer covenant is relevant for defined benefit schemes. It is also interesting to note that master trusts are also asked to consider setting out processes for assessing the potential impact of climate-related

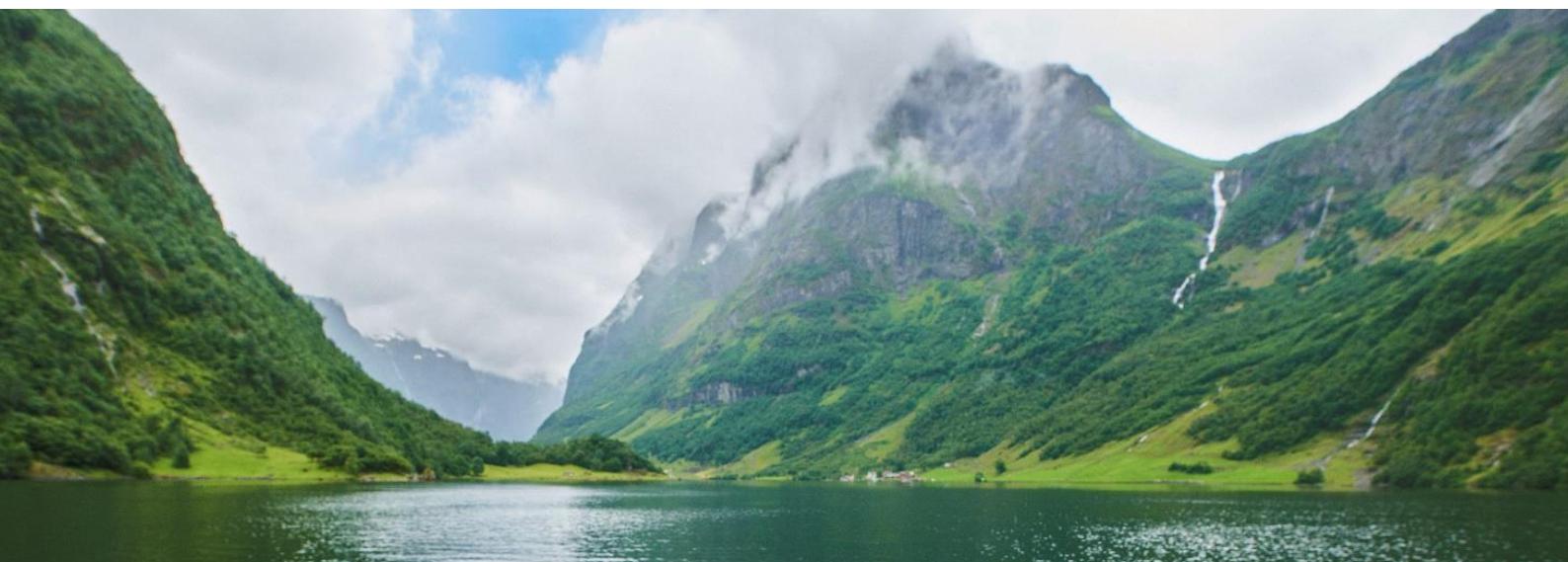
risks on the scheme funder. Whilst this is not the same as assessing the covenant of an employer in a DB scheme, it is a new measure to report

against and will require additional work and data for master trusts preparing future reports.

General improvements

As well as the specific concerns on data and scenario analysis, the review notes a wide variation in approaches in all aspects, noting good practice to consider adopting in future and improvements to be made including:

- Ensure the report includes enough background information on the scheme to allow easy interpretation of disclosures - especially for more complex, hybrid or sectionalised schemes.
- Focus on improved accessibility, including gathering member feedback on the first climate reports to see how they can be made more useful to members.
- More detail on how often and to what extent climate change risk is discussed by the trustees - including specific examples of information considered, new risks identified, or specific actions taken to manage risks (for example a change in investment manager).
- Trustees must describe the processes they have established for identifying, assessing and managing climate-related risks in relation to the scheme. It was noted that some reports just provided a list of identified risks but what is actually required is detail on the process and person(s) responsible for identifying and managing these risks.
- It should be clear if there are parties other than the trustee undertaking scheme governance activities in this area of risk assessment. If there are parties, for example teams within a sponsor or funder, who undertake this work this should be detailed in the report (including conflict management).
- Trustees must also report on the basis on which they assess competence of those undertaking activities on their behalf with respect to climate change risks.
- For data omissions, trustees should explain the steps taken to improve data for future reporting and demonstrate how they have engaged with providers to seek improvements. It should also be clearer which proportion of assets and the asset classes that emissions data is available.



Illiquid Assets

The government's response to the DWP's consultation will see new disclosure regulations come into force from 1 October 2023. The Occupational Pension Schemes (Administration, Investment, Charges and Governance) and Pensions Dashboards (Amendment) Regulations 2023 ("the 2023 Regulations") will only affect relevant defined contribution pension schemes i.e. those with DC benefits other than where they relate to additional voluntary contributions ("relevant DC schemes"). The 2023 Regulations are a means through which the government aims to encourage and facilitate trustee investment in a wider range of products, namely illiquid assets.

New Disclose and Explain Policies on Illiquid investments

Trustees of relevant DC schemes will be required to amend their SIP so as to include their scheme policy on illiquid investment. The policy must contain a statement confirming whether or not investments held in the default arrangement will include illiquid assets. Illiquid investment assets being those "which cannot easily or quickly be sold or exchanged for cash and, where assets are invested in a collective investment scheme, includes any such assets held by the collective investment scheme".

Where scheme investments include illiquid assets, the policy must include details about the members whose investments will be affected and a description of and an explanation for the types of illiquid asset investment used. Where investments will not include illiquid assets, the policy must include an explanation of why the trustees have chosen not to invest in this way and any future plans for investment. These changes introduced by the 2023 Regulations are set to add greater transparency and accountability for investment decisions made by Trustees.

These new illiquid asset disclosures will apply on the first occasion that the default SIP is updated after 1 October 2023 and the policy must be included from 1 October 2024 at the latest.

Reporting obligations on Asset Allocation

There will also be a public disclosure requirement for relevant DC schemes in relation to asset allocation. Trustees must review their default arrangements in order to calculate and disclose in their annual Chair's Statement the percentage of assets allocated to each of the following asset classes:

- (a) cash;
- (b) corporate or Government bonds;
- (c) shares listed on a recognised stock exchange;
- (d) shares which are not listed on a recognised stock exchange;
- (e) infrastructure;
- (f) property which does not fall within the description in paragraph (e);
- (g) instruments creating or acknowledging indebtedness which do not fall within the description in paragraph (b); and
- (h) other - any other assets which do not fall within the descriptions in paragraphs (a) to (g).

Schemes must also provide explanations of these asset classes in a “clearly identifiable manner” so as to help member understanding. These reporting duties should be adhered to in the first Chair’s Statement for the scheme year that ends after 1 October 2023 with the information also published on a publicly available website.

Trustees should have regard to the statutory guidance for assistance with their duties and when making the asset allocation calculation.

Performance-based fees and charge cap

The 2023 Regulations will also amend the Charges and Governance Regulation by excluding “specified performance-based fees” (“**SPB fees**”) from The Pensions Regulator’s

charge cap limit. These changes apply to default funds of occupational money purchase pension schemes used for automatic enrolment or collective money purchase benefits.

SPB fees will incur when a fund’s performance exceeds a pre-agreed investment return. Trustees must have regard to statutory guidance in order to determine whether the criteria have been met for a specified performance-based fee to fall within or out with the scope of the charge cap. These requirements would prevent scheme members from receiving money for outperformance but then not being reimbursed in the instant of poor performance. Schemes must disclose any SPB fees relating to scheme investments in the Chair’s Statement and ensure that this information is published on a publicly available website.



Get Involved

CMS Pensions LawCast webinars

We regularly add new content to our CMS Pensions LawCast webinar series. Click [here](#) to view our latest LawCasts on the draft DB Funding Code and residual risk transactions plus expert content on other hot topics such as pensions dashboards, recent case law and the pensions agenda for 2023.

CMS Pensions Law Appraised

We have launched our new app for iPhones, called [Pensions Law Appraised](#), which offers real-time guidance on the latest legal pensions law developments.

We have called this innovation 'Pensions Law Appraised' because we want as many people as possible to have relevant pensions law issues raised for them in a way that gets to the heart of the matter, with our expert appraisal of the significance of such developments.

It is also a great way to help pension scheme trustees to comply with their statutory knowledge and understanding duties.

To start using it, scan the QR code below or click [here](#) to download it.



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