



Aon Investment Research 2020

Covid, climate and compliance— are you ready for the new investment challenges?

Focus on The Pension Regulator's defined benefit funding code of practice

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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

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.

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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?”

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Further reading and resources

[COVID-19 Response Webinar: Investment Focus – Understanding the Bigger Picture](#)

[Aon Webinar: Funding Code Consultation](#)

[The Pension Regulator: Defined benefit funding code of practice consultation](#)

With thanks to our researcher and author:

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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.

Aon Investment Research 2020

This report forms part of a body of research into current thinking in pension investment.

Access all the reports in the series to discover key trends and common approaches among pension scheme decision-makers as they rise to the challenges presented by covid, climate and compliance.

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Compliance code: A269-310321