Smith & Williamson

Pension Trustee Bulletin

FOR OCCUPATIONAL PENSION SCHEME TRUSTEES AND THEIR ADVISERS

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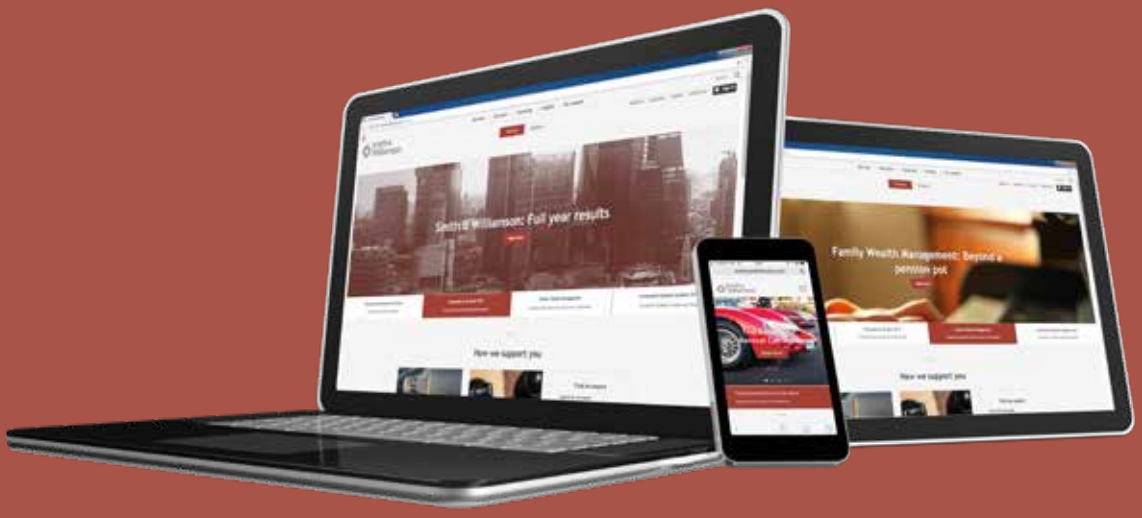

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Foreword

What do members want from their pension scheme? At the most basic level they want what we all ideally want from an investment: security and certainty. Security both for their contributions and that the pension scheme itself is secure. And certainty that they will both receive a pension and have some idea on how much they will receive.

We discuss three areas where scheme trustees and the Pensions Regulator ("tPR") are looking to bring increased security and certainty. These include examining the road map to buy-in or buy-out: the ultimate certainty for the benefits 'insured' through such arrangements.

We also look at the Government's efforts to further protect defined benefit schemes following the shake up brought about by the collapse of BHS and Carillion.

One of the least regulated parts of the pensions market has been master trusts. Now, with the rapid increase in the number of members and their benefits held within these trusts, tPR has brought in further regulations that should increase the level of security and certainty for members affected.

Another certainty you can rely on is that accounting for pension schemes does not stand still and we have provided a guide to the changes brought about by the 2018 revision to the Statement of Recommended Practice for Pensions.

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New 2018 Pensions SORP

Since the Statement of Recommended Practice Financial Reports of Pension Schemes (2015) ("the SORP") was published, there have been a number of amendments to the accounting standard FRS102 – The Financial Reporting Standard applicable in the UK and Republic of Ireland ("FRS102") arising from both users experience of implementing FRS102 and its first, triennial review. The SORP has been updated in 2018 ("SORP 2018") to reflect these, together with changes in relevant legislation.

Implementation

The SORP 2018 is applicable for years commencing on or after 1 January 2019. Early adoption is permitted although schemes must disclose this. As many schemes are already following the practices included in the SORP 2018, early adoption is likely to be the preferred course of action.

What has changed?

Comparative information

FRS102 has always required the disclosure of comparative information (in respect of the comparative period) for all amounts presented in the financial statements. However, it has been common practice to omit some comparative disclosures, particularly in respect of hybrid schemes: for example, only including scheme total comparative values on the face of the Fund Account.

The SORP 2018 has been amended to remind readers of the requirements of FRS102. In the case of hybrid schemes, it includes a practical suggestion to include the comparatives in a note if there are too many columns to comfortably fit on the face of the Fund Account or Net Assets Statement.

There remain two exceptions: a comparative investment reconciliation table for the prior period is not required and the derivative disclosures do not require comparative for the key contract disclosures that are required for the current period (for example, the type of contract, the period covered by the contract and the nominal value – see paragraph 3.10.6 of the SORP 2018 for further details).

Small schemes

FRS102 allows reduced disclosures in the accounts of small entities and there has been some discussion as to whether the same regime could be applied to smaller pension schemes. However, there is difficulty in applying the FRS102 definition of a "small entity" to pension schemes and the needs of each member in respect of the accounts do not differ merely due to the size of the scheme. As a result, the SORP 2018 "does not believe the Small Entities regime set out by FRS102 is applicable or relevant to pension scheme financial reporting".

Master Trusts

Although it was best practice for Master Trusts to follow the previous SORP, the SORP 2018 now specifically brings them within scope.

Leavers

There was an anomaly in the previous version of FRS102 where it did not include the title for 'payments to and on account of leavers' in the list of items to include in the Fund Account. This has now been corrected, although the ordering of the items in FRS102 is not in line with current industry practice.

Benefits

Guidance has now been provided on benefits where member decisions are pending at the period end. Previously, information on contingent liabilities in FRS102 was the only available guidance. In the case of such benefits, the SORP 2018 recommends that the existence of such benefits is disclosed in the notes to the financial statements with an indication of the amounts involved (if known). It also suggests that the notes explain when they will be accounted for – that is, on the date the member decision is received by the scheme.

Members are liable for taxation payable on benefits that exceed the lifetime or annual allowances. Where the trustees agree to settle the tax on behalf of the member, the SORP 2018 recommends that this is reported separately in the notes to the financial statements. Schemes have a choice as to how they account for the tax payable: it can be expensed (as the cost is paid through reducing the benefit payment to the member) or accrued as a debtor that is recovered from the member when their benefit is paid.

VAT

A statement has been added to confirm that amounts expensed should exclude recoverable VAT.

Investment Fair Value Hierarchy

The transitional option to use categories a, b and c has been removed from the fair value hierarchy ("FVH") disclosures and the SORP 2018 now requires the use of levels 1, 2 and 3. The fair value methodology remains unchanged, which requires fair value to be determined using categories a, b, c basis. This leads to the anomaly of a scheme having to fair value its investments on the basis of categories a, b, c but disclose the same investments in their accounts under levels 1, 2, 3.

Our recommendation would be to ensure that whoever is providing you with the required disclosures (normally, your investment consultant or manager) understands that now they need to provide you only with these disclosures using levels 1, 2 and 3.

Guidance taken from the joint PRAG/Investment Association publication on investment disclosures has been amalgamated in to the SORP 2018. This provides guidance on the allocation between the three levels.

Investment valuation

The FRS102 description of valuation techniques (used when valuing investments under category c) has been amended to include using a price "in a binding sale agreement". This could impact investment property where a sale agreement has been agreed post year end, for example. In such cases, the FVH of the investment is likely to move from Level 3 to Level 2 as the inputs to the valuation have become "observable".

Concentration of investments

The requirement to disclose details of investments over 5% of the total value of the net assets of a scheme has been updated to remind users that there is no need to 'look through' pooled investment vehicles to the underlying investments. The holdings in the pooled investment vehicles themselves should be disclosed unless the trustee "controls the investment mandate of the pooled investment vehicle", at which point the 'look through' basis should be used.

Investment disclosures

Where the accounts are being prepared for the Pension Protection Fund assessment period, the SORP 2018 has a reminder that the disclosures for investments must follow the Pension Protection Fund (Valuation) Regulations 2005 as these include some disclosures that have been removed for all other schemes.

Common investment funds ("CIFs")

Guidance for CIFs has been updated so that the trustees of the CIF decide whether it is a Financial Institution ("FI") (as per FRS102). If it does, the CIF will have to follow the disclosure requirements for FIs as required by FRS102 and the SORP 2018 recommends that they also follow the disclosure requirements of the SORP 2018. If it is not a FI, then the SORP 2018 recommends that it follows the pensions investment disclosure requirements around the FVH and risk disclosures as if it were a pension scheme.

Going concern

Guidance has been expanded around the circumstances that schemes may find themselves in when entering the Pension Protection Fund ("PPF") assessment period (following an insolvency event in the employer). It can be particularly difficult to assess the going concern status of such a scheme and the SORP 2018 now confirms that it is the likelihood of the scheme winding up (either on being transferred to the PPF or outside of the PPF) that determines whether the scheme can be considered a going concern or not.

Where there is a material uncertainty - such as where the funding levels are uncertain at the time the accounts are prepared - then the trustees must consider whether to adopt the going concern basis to prepare their accounts and disclose details as appropriate.

Related Parties

The definition of related parties has been revised in FRS102 so the SORP 2018 has followed and included an "entity, or a member of a group of which it is part, provides key management personnel services to the reporting entity (eg the scheme)…" as a further related party. This means that where trustees' (who are considered "key management personnel") services are provided through a corporate entity (such as a trustee company), that company falls to be a related party. Separate disclosure of transactions with the trustee company is required.

Details about a scheme

Certain information is required by FRS102 in respect of identification of the financial statements and the SORP 2018 has interpreted this for pension schemes and recommends that disclosures include:

- The fact that the scheme is established as a trust;
- The legal jurisdiction in which it is established; and
- The address for enquiries (which is already required to be included under Regulation).

Most schemes already provide such information.

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Buy-outs and Buy-ins... is it time?

With sponsors of defined benefit ("DB") pension schemes and trustees now looking to work in a collaborative way, many have a roadmap in place for taking DB liability risk off the table.

Roadmap planning is the most commonly cited priority both for pension scheme trustees and sponsors. There are a number of ways to do this but the most effective method to reduce or entirely remove the liability is through either a bulk annuity buy-out or buy-in.

In simple terms, a pension buy-out is where the trustees of a pension scheme transfer the assets and liabilities of the entire scheme to an appropriate insurer. A pension buy-in is the process by which trustees of a pension scheme buy an insurance policy to cover a group of their members, for example, current pensioners already in payment. The trustees hold the policy as an asset and remain responsible for paying the pensions. The members remain within the original scheme.

The number of DB pension scheme trustees targeting a buy-out with an insurer has increased significantly in the past five years. A report produced by Willis Towers Watson in April identified around a third (32%) of schemes surveyed were targeting buy-out outright, in comparison to only 11% in 2013.

This year has seen some of the most competitive buy-in and buy-out pricing for a decade. Since the start of 2018 there have been a number of high profile companies that have completed bulk annuity transactions for example Marks & Spencer and Menzies, and a number of insurers have reported that they have transacted bulk annuity business in excess of £1bn in the first half of 2018.

Some DB pension schemes may now be closer to buy-out than they know. This may because the insurers' life expectancy assumptions have softened since the last actuarial valuation or because a number of members have taken DB transfers from the scheme.

Consider your own scheme and the impact of these factors. In addition, ask yourself if the funding level improved because the scheme has a higher weighting in equites or is the sponsor now able to call on liquid assets to fund a buy-out which it didn't have access to 18 months ago.

The Prudential Regulation Authority ("PRA") is currently consulting on updating capital requirements for providers that hold equity release mortgages as assets to back buy-ins and buy-outs and these rules will come into effect at the end of this year. In 2019 Insurers holding these assets may become more prudent when pricing new business and so buy-in and buy-out pricing could increase.

Trustees of schemes that are actively considering de-risking should think now about their options, as the PRA's recommendations may result in quotation or transaction delays while insurers digest the proposals.For those schemes that have already completed a buy-in the trustees need to understand whether there will be any potential impact on their chosen insurer's solvency level as a result of a change in capital requirements.

What if you are going through a buy-in and buy-out now?

Schemes could be impacted by an increase in pricing immediately as a result of insurers taking steps to prepare for the new rules, and at each point of the risk transfer journey, whether they are still at the consideration stage or are close to entering into a buy-in or buy-out.

There may be some price volatility so trustees currently investigating pricing or those in the process of negotiating final terms of pricing, should look to secure good price lock-in terms. Deals can take a couple of months to negotiate and at the point of signing, trustees and sponsors don't want to find they are going to have to pay more for the risk transfer than anticipated.

Trustees and sponsors should therefore engage with their advisers and consult with several insurers to lock in good pricing now.

Smith & Williamson assists trustees and sponsors through the entire buy-out or buy-in process. Please do contact us if you wish to explore a bulk annuity exercise or need assistance on an existing project.

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Master trust legislation

2018 has been the year that the Pensions Regulator ("tPR") increased their focus on the position of master trusts in the pensions industry. The rapid growth of Master Trusts and their growing influence over a huge number of employed individuals and an ever increasing asset value under their control has made some individuals within tPR and central government very nervous. Appropriately, they have called for master trusts to be governed and run properly for some time and 2018 has been the year of legislation to enforce compliance with "best-in-class" behaviour.

How did we get here?

In 2014 tPR and the ICAEW introduced the Master Trust Assurance Framework (TECH 07/14 AAF 02/07). A number of master trusts went through the process of obtaining this independent assurance. However, only a few went the extra step to obtain tPR sanction (requiring some extra compliance information to be provided) so they could call themselves "accredited" (only nine master trusts as at June 2016). A revised AAF supplement (TECH12/16) was then required for any master trust wishing to obtain assurance for periods commencing on or after 1 January 2017. A few more Master Trusts obtained accreditation in the following months.

This approach did not satisfy tPR or the government that master trusts were being run in the best manner. As a result, a Pensions Scheme Bill was drafted, went through the consultation process, resulting in the Pension Scheme Act 2017 (issued 27 April 2017). This set out the need for formal accreditation of all Master Trusts to operate in the market place. It made it clear that the detailed requirements would follow, which they did in the form of the Occupational Pension Schemes (Master Trusts) Regulations 2018 (effective on 1 October 2018) ("The Regulations").

Where are we now?

The master trust industry; both the schemes and the professionals that advise them, have been consulted and involved in the process of drafting the Regulations; although their concerns have not been addressed in full. The final Regulations are detailed and onerous and no-one is in any doubt that operating in the master trust space is now expensive and challenging – amateurs or half-hearted organisations need not apply.

Each master trust must now obtain authorisation from the Pensions Regulator to continue to operate or, in the case of new Schemes, to commence operation. For those already in existence, (around 80 schemes), an authorisation application together with tomes of supporting evidence will need to have been made within six months of 1 October 2018. Around 33 schemes have submitted trial applications and information in a "dummy run" with tPR, from which they will receive feedback, allowing them to refine their actual submission before it is submitted in final form.

The key elements that each master trust will need to evidence exist and are in operation at the trust are as follows:

- Everyone involved in the trust are "suitable and appropriate" people
- The scheme is financially viable in the long-term
- The trust funder (the organisation backing it) meets specific requirements
- The systems and processes used to run the trust are appropriate to ensure it runs effectively
- The trust has adequate continuity plans to weather its future

Behind these broad requirements are detailed expectations set out in the authorisation application forms, which are still in line with the draft consultation requirements. This sets out the evidence requirements around each of the above elements and covers matters such as: how the trustees are comfortable that the underlying IT security, the operations of transactions and that the investment of member contributions are all happening as they should, with any issues being communicated and resolved as quickly as possible.

Failure to file an application will result in an inability to operate post 31 March 2019 and the master trust will need to wind up; finding another master trust for all of its members to transfer in to. Failure to be approved by tPR will mean much the same. So, the ability to remain in business is dependent on getting this right.

How can we help?

We are working with a number of master trusts to ensure they have adequate evidence around the systems and processes in place. Given the timing of the authorisation applications, this could be fast-tracking the completion of the next AAF report or providing a detailed findings report over the testing undertaken to date on an AAF report already underway. Alternatively, we could simply provide a sounding board around the levels of evidence and likely sources to support the assessment. If you would like to discuss any element of your application or position, please do not hesitate to contact us.

What does the future hold?

Authorisation is currently detailed as being a one-off exercise but, we imagine that, ongoing monitoring and information gathering is likely to follow in due course. How else can tPR be satisfied that the predicted £300bn*1 of funds (currently £20bn*2) will be held safely and, will provide the retirement incomes for at least 7 million individuals who will have savings within them?

1 Hymans Robertson Research 2017
2 The Pensions Regulator 2016

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Protecting DB Pension Schemes

March 2018 saw the publication of the Government White Paper "Protecting Defined Benefit Pension Schemes". The proposals set out focus on security of the arrangements and make clear the need for employer support and effective administration of all schemes.

The Regulator will revise its code of practice on DB funding arrangements. In addition, a new regime will be introduced that will focus on funding plans, reflecting a long term view of the overall scheme funding objective. Elements of the new requirement will be mandatory as, currently, the Code of Practice is only principles-based although The Pensions Regulator ("tPR") use it to inform their judgement where funding difficulties arise. The new regime will give tPR increased powers to enforce a prudent and appropriate funding approach.

DB Chair's Statement

It also introduces the idea of a triennial DB Chair's statement; much like the current annual DC arrangement. The proposal is that the regular declaration will be supplied to tPR with the full actuarial valuation.

Current suggestions for the content of the statement are:

- the scheme's long term "financial destination" and its strategic plan for reaching this;
- the key risks in trying to achieve this objective and how these are mitigated and managed by the trustees; and
- how the trustees are meeting key performance indicators over governance of the scheme e.g. value for money.

It is proposed that this statement will be mandatory and will be enforced by use of fixed penalty notices, as is the case for DC schemes. It will also be within tPR's powers to demand an "out-of-sequence" statement where it has concerns about any scheme.

Fines

The focus on protecting DB schemes will bring in the ability to impose punitive fines on those tPR consider "deliberately put their scheme at risk". In the worst cases, there will be a criminal offence that can be used against those who have "committed wilful or grossly reckless behaviour in relation to a pension scheme". Alongside this, will be a strengthened notifiable events framework and voluntary clearance regime.

Consolidation

The White Paper explains that consolidation is seen by Government as a potential solution to the currently costly buyout option for schemes (particularly smaller schemes). It sets out its plans to consult on proposals for a legislative framework and authorisation regime within which new consolidation vehicles forms could operate, with an accreditation arrangement to build longer-term confidence.

Increased powers

Note that, alongside all of the above, it is the intention to give tPR additional information-gathering powers similar to those it has for auto-enrolment and master trusts, including:

- rights to demand an interview;
- power to issue civil sanctions for non-compliance; and
- a power of inspection.

TPR will also have the right to disqualify specific company directors.

Other areas

Consideration was given in the Green Paper that preceded the White Paper to allowing employers to make changes to scheme rules moving the indexation of pensions from RPI to CPI. The White Paper firmly removes that possibility but does make clear that the Government or the tPR will have a watching brief on this issue and may change their views in the future.

Timescale

The timeline for moving from proposal to legislation is set out but, as most of the changes need primary legislation, the White Paper suggests that changes are unlikely to happen before the 2019-20 parliamentary session, at the earliest.

As ever with pensions, only time will tell when the legislation will come into force, and what the final requirements will be, and public high profile cases may change both the proposed actions and the timelines.

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