THE INSIGHT SHARING PENSIONS AND LIFETIME SAVINGS ASSOCIATION

PLSA TRUSTEE FORUM

LESSONS FROM LDI FOR SCHEME GOVERNANCE AND RISK MANAGEMENT MODELS

The PLSA Trustee Forum on 23 March 2023 saw senior pensions decision-makers, experts and regulators come together in London to network and debate the strategic issues and latest developments facing trusteeship in 2023.

Pension schemes have never been busier as they grapple with the aftermath of the liability-driven investment (LDI) crisis and what it means for the future of governance and measuring systemic risks.

Meanwhile, they must comply with a record number of disclosure regulations, which puts data at the top of the agenda in 2023 as schemes also get ready for pensions dashboards.

These were some of the biggest themes at the recent Pensions and Lifetime Savings Association's Trustee Forum, where we heard from regulators, trustees and PLSA representatives.

TCFD DISCLOSURES

One of the biggest struggles for trustees is the Taskforce for Climate Financial Disclosure (TCFD) regulation, which is perceived as rather excessive and costly.

It is becoming an enormous burden for trustees, and risks becoming more of a governance and regulatory risk mitigation exercise rather than addressing the things that need to be done.

One delegate said at the Forum that despite their scheme having no equities, they had spent hours in one investment committee meeting on TCFD and would need to produce a 30- to 40-page report. They said while it "wasn't going to add much to our own moral compass and the way that we apply it to the investments", TCFD was "taking up an awful lot of time that we could have been better spending doing something else".

There may be a need to make the TCFD reports less burdensome for trustees, which already have a lot on their plate, but also make them more digestible for members. Trustees are concerned about the law of unintended consequences and are wondering what the actual purpose of these documents is. Are they for the members or the regulators?

Investment disclosure has gotten completely out of hand and disproportionate to member needs and outcomes, but regulators think it's very justified, said another delegate.

It is clear the industry is not convinced that every single piece of disclosure currently required is adding anything functionally other than providing schemes with a lot of documentation, which they then don't look at.

Some pondered whether this is yet another way to squeeze smaller schemes out and encourage more consolidation.

RIGHT BALANCE IN REGULATION

There is a clear demand from schemes to strike the right balance when it comes to disclosure. Regulators say they need to understand whether certain aspects such as value for money, climate impact and investment costs are being measured and managed.

During a regulatory session, two experts explained there are many different levels of data needed to get an overall picture. "When running a scheme or a company, you need to understand the business, your investments and the members to make effective decisions," said one.

While the purpose of public disclosure is not necessarily to identify bad schemes, regulators think it is allowing a competitive market to emerge for all schemes to get better, and they think there is value within that in DC. The challenge is how those metrics and data translate into member decision-making.

There are behavioural biases, which mean pensions are not easily understood, and there are complex financial instruments at play when financial literacy is very low. "Public disclosure of that kind of information needs to be done in an appropriate way that will hopefully guide people towards good decision-making," said a speaker.

The panel discussed three levels of disclosure: what disclosure is useful for the end investor or scheme member; what's useful for regulators to be able to act when things go wrong; and what's useful in driving comparison to help decision-making?

The concern for regulators is that the way information is currently disclosed to investors and members is based on the centrepiece of prescribed information in a prescribed format. They pointed out that is not how consumers engage in financial services and pensions.

There was talk of how to shift to a system where consumers have information that allows them to understand without overburdening them while making sure the system delivers good outcomes. While the government is looking at what is an appropriate level of contributions, for regulators the focus is making sure the system is healthy, competitive, coherent, and driving real value for money. The latter is expected to become a bigger focus for regulators over the coming years.

It is not a reasonable expectation for the average person to have to unpick what their pension is invested in, said an expert. But that information could help them understand that there's maybe a gap between what their pension will achieve for them and what they're hoping for in retirement, so that encourages them to think they should save more.

For example, as someone approaches retirement, information that allows them to think about their options, which are really difficult decisions about what they want over time, and how they want to take that money?

Regulators are listening to pension schemes about their concerns over the sheer amount of disclosure and admit there are many requirements facing the pensions sector right now.

They appear to be considering a slightly different approach in the coming years. Regulators said there will be many changes over the next few years as they understand better how to engage consumers as they try out different tactics and approaches.

One speaker said they are trying to think less about setting new rules and more about can they test some ways of engaging consumers to see if they work. For example, how does that play out in online journeys, especially with the pensions dashboards – will that give different engagement points?

Rather than aspiring to place more burden on trustees, watchdogs do appear to be more focused on having the right regulation in place.

GOVERNANCE LESSONS FROM LDI

Last year's LDI crisis really shook the pensions industry and led many schemes to question their governance and risk management models.

A panel at the Trustee Forum highlighted that while there are many trustee boards that are well-organised and well-structured, there is a long tail of schemes where that is not the case.

Many of those were exceptionally lucky because they had not de-risked and benefited massively, with some schemes seeing their funding level improve from 60% to 100% funded. But they now need to get themselves into a position where they can take decisions, said a trustee. "For those schemes, it's really important for them to have the right mechanism to take advantage of the opportunity," they said.

And even pension schemes that were well hedged and successfully maintained their hedge were still warned not to become too complacent.

A speaker pointed out that if the LDI crisis had occurred years earlier, the outcome would have been much worse. That is because, since Covid in particular, there have been innovations in terms of video conferencing and an increase in acceptance of digital signatures.

There are many lessons to learn around governance which will help the future of all pension schemes. First, having trustee meetings on a bi-quarterly basis is not enough to deal with problems like this that require quick decisions to be made, according to a delegate.

If trustee boards only meet once every other month or twice a quarter, it is not impossible to commit to make decisions all the time because they will not necessarily get to the right place at the right time.

"In those cases, you must delegate that responsibility to other people to take decisions on your behalf within agreed parameters, and then you must test those parameters to make sure this will happen," they said.

A larger scheme with an in-house executive team with the ability to get a trustee board or investment committee together at the drop of a hat can begin to manage things on a day-to-day basis. Whereas it is much harder for a smaller scheme that does not have an in-house team.

"Do we need all nine members to be able to effectively make those decisions?" asked a senior scheme representative. "And if we don't, what groups need to be available to make those decisions?"

Their scheme has set up a material events committee, which is a subgroup of the board, to manage those sorts of events.

There were also concerns about schemes being encouraged to have too high collateral buffers to prevent another repeat of last year.

Another scheme representative said it was important not to be too cautious and over collateralise: "We're all systemically becoming more cautious because we all seem desperate not to sell assets at fire sale prices – so all that is a loss of value to members."

Some schemes are targeting such a high level of collateral headroom that another delegate said, "if you thought real rates are going to move that far, I'm not sure why you're hedging at all because you might as well just wait".

MANAGING RISK CONTAGION

The recent banking turmoil in the US and Switzerland has further raised trustees' awareness of managing risk contagion after 2022's LDI crisis.

It became clear among discussions at our Trustee Forum that there is so much day-to-day business, that trustees do not have time to do contingency planning for the risks they haven't thought about or don't know about. Trustee boards are not very good at scenario planning and blue-sky thinking, but it is so important that it is done and there were concerns it is not done often enough.

"It is very hard for non-executive trust people to devote the time to take themselves away from the drumbeat of activity that needs to happen. Most trustee boards are very good at having year plans and planning ahead for triennial valuations, but it's very important also to think a little bit further ahead of time," said a delegate.

Another scheme admitted that while they are good at thinking about the key risks that will disrupt the day-to-day, they are less good at accurately assessing the real risks when things are very left tail, when the frequency is very low, but the impact is very high.

While it is, of course, hard to predict everything, there are some things that trustees can begin to see coming.

A risk register helps identify, prioritise, manage and monitor the key risks to what schemes are trying to achieve, but it is clear there is more that schemes could look to do going forward.

A senior scheme representative spoke about their strategy days where they talk about things that can happen in the next six months as well as material events.

There is a lot to learn from programme management in terms of managing pension schemes, and there were calls for the industry to get better at using technology and tools that help schemes to manage through a crisis.

"When you're planning for critical paths, it is important to think about the things that can go wrong, and to have a critical path to study to ensure that you don't lead to a really big event," said a delegate.