Employer pension briefing, Quarter 4 2022

If you are the sponsor of a Defined Benefit (DB) pension scheme, then you should be engaging with your scheme trustees to understand how the recent extraordinary gilt market movements have impacted the funding of your scheme and what this means for future strategy.

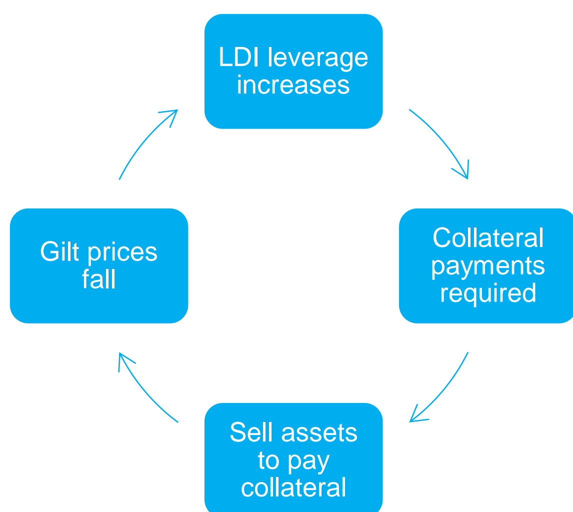
Some schemes may be struggling with the liquidity for capital calls from LDI funds. Others may now have an opportunity to protect material funding improvements.

The long-term cost of your DB pension scheme is primarily driven by its investment returns, and now is a critical time for employers to take a proactive approach to engaging with the trustees on future strategy.

Why did Liability Driven Investment Funds (LDI) make the news?

It's not often that DB pension scheme investments make the front pages, so it would be remiss of us not to start with the current gilt market volatility that resulted in Bank of England intervention.

The final weeks of September saw unprecedented volatility in bond markets following Kwasi Kwarteng's mini-Budget on Friday 23 September. Gilt yields – already at levels not seen since the 2008 financial crisis – spiked, increasing by around 0.85% pa between the start of Monday 26 September and end of Tuesday 27 September.



However, suggestions that pension schemes were close to insolvency were wide of the mark. What some DB pension schemes did face was a liquidity problem – collateral requirements from LDI managers meant schemes were having to find cash to top up funds or risk losing some of their interest and inflation protection.

The Bank of England stepped in on 28 September to prevent a fire sale of assets to meet these collateral calls. Of particular concern to the Bank was that some of those assets being sold to make collateral payments were gilts. This pushed the price of gilts down further. As a result, LDI funds needed more collateral. Some of the assets sold to make those collateral payments were gilts. This pushed the price… you get the idea.

There were significant concerns that this cycle could have seen the price of long-dated gilts collapse, hence the Bank's intervention.

In spite of these fears and the Bank's intervention, from a funding perspective, providing schemes had been able to meet collateral calls and keep their interest rate hedges in place, the net effect would have been neutral or potentially positive, as liability values would have also tumbled.

In the immediate aftermath of the Bank's intervention, gilt prices recovered somewhat. However, at the time of writing, there is still extreme volatility in the gilt market, with schemes having to manage collateral calls.

Andrew Overend, partner and Joint Head of Investment, has prepared a detailed video on LDI markets up until 7 October 2022. Watch our LDI video.

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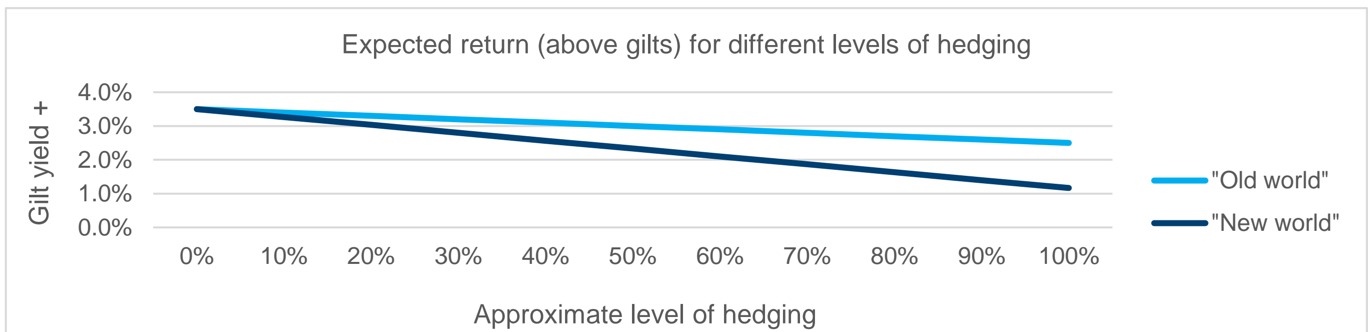
A new macroeconomic era?

Looking beyond the short term, it's likely that changes in markets will impact the long-term investment and funding strategies for many pension schemes.

We believe we will see LDI funds having to operate with a much lower target level of leverage (and a narrower band of acceptable levels of leverage). This means that LDI funds will be less 'capital efficient' than they have been previously, and that there will be more frequent collateral calls. LDI fund managers are likely to require schemes to hold safer and more liquid assets alongside any LDI holdings to meet these collateral payments.

Ultimately, this means many schemes will face a starker choice between risk and return. The choice may be between maintaining expected return (and existing funding targets) with a higher level of risk, or maintaining a similar level of risk but reducing expected return (and either pushing back funding targets or asking sponsors for more cash).



**Assumes a return of gilt yields +3.5% pa on a diversified portfolio of 100% "growth assets" for illustration*

These changes come at a time of regulatory uncertainty, ahead of the introduction of the new funding regime and the likely requirement to have a plan for each DB scheme to reach a low dependency funding target. However, it's not all bad news – many schemes will have benefitted from the increase in gilt yields over the past 12 months, meaning they may already be ahead of schedule on their funding 'journey plan'. In particular, shortfalls against buy-out or low dependency measures may well have fallen as gilt yields have increased.

Actions for sponsoring employers

Investment and actuarial advisers should be keeping your scheme trustees up to date on developments. It's likely that the primary concern at the moment is making sure any collateral payments are made to LDI funds to keep existing levels of interest rate and inflation hedging in place.

Over the longer term, however, there are some fundamental decisions that will need to be made around investment and funding strategies. Sponsoring employers need to be part of these discussions and decisions.

Over the coming weeks, we'd recommended that you:

1. Ask for an updated funding position and details of how any LDI strategies have fared over recent weeks. Consider delaying sign-off of any changes to contributions (from an actuarial valuation) until the current position is clear.

2. Consider your scheme's funding position against any longer-term targets, whether this is your scheme's funding basis, buy-out or low dependency.

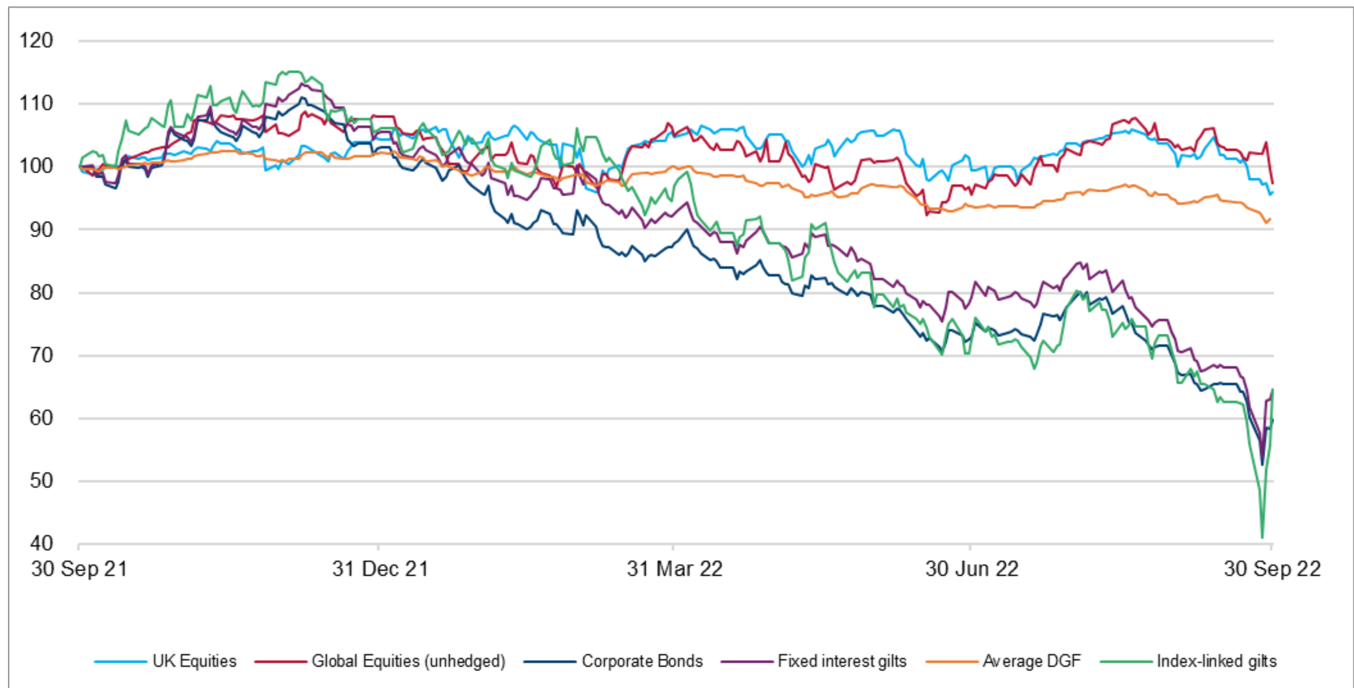
3. Consider the risk and return of the current strategy and how that might change given the changes to the structure of LDI funds. If you're keen to maintain expected return, you may need to help trustees justify the increased level of investment risk required.

4. Consider how your pension cost accounting position has changed in recent months. Rising bond yields will serve to reduce FRS 102/IAS19 pension liabilities, but these will be offset by asset losses over the year. We expect most employers to see a balance sheet improvement, but exactly how much will depend on the specifics of your scheme.

Changes in markets since 30 September 2021

As we mentioned above, the volatility in the final week of September has brought a period in which bond markets saw significant losses to an end. Since 30 September 2021, corporate bond values have fallen by nearly 40%, with government bonds not far behind (35–36%).

UK equity returns over the full year have been relatively flat in comparison, falling by around 4% since 30 September 2021. Global equities have fared worse, with losses of 15% to 20%. However. falls in the value of Sterling over the year will have offset most of these losses where holdings were not currency hedged.



Impact on scheme liabilities

While the chart above doesn't make for pleasant reading, we shouldn't forget that there are two parts to a pension scheme. Falling gilt prices mean rising gilt yields and these often drive funding discount rates, as well as buyout pricing and low dependency targets.

As a result of the significant increase in gilt yields over the year, the value placed on scheme liabilities will have fallen dramatically (and for those few employers who have schemes that are open to accrual, future service costs will have also fallen at the same time).

We expect most schemes to have seen their funding positions improve over the year to 30 September 2022. Improvements will have been greatest for schemes that didn't have material levels of liability hedging in place (and so have not seen asset values fall by as much).

	30 September 2021	30 September 2022	Impact on the liabilities of an average[1] scheme
Corporate bond yield[2]	2.0% pa	5.1% pa	-45%
Gilt yield[3]	1.4% pa	4.0% pa	-40%
Market-implied inflation[4]	3.8% pa	4.0% pa	+3%

1 An average scheme is taken to have a duration of 20 years and around 75% of liabilities linked to inflation
2 Yield on the iBoxx over 15-year AA-rated corporate bond index
3 Bank of England nominal gilt curve over a duration of 20 years
4 Gilt market-implied inflation at a term of 20 years from the Bank of England implied inflation curve

For more information on the implication on funding positions, especially if you have an upcoming valuation date, you might find our *Finance Director's guide to 30 September 2022 actuarial valuations* useful. Ask your First Actuarial contact for a copy if you don't already have one.

Cost of living crisis

Not content with a single economic crisis, the UK is still facing exceptional levels of inflation, with RPI inflation reaching 12.3% for the 12 months to August 2022. The Bank of England base rate has risen to 2.25% and the Bank is trying to control this. Part of the increase in gilt yields is undoubtedly driven by expectations of further interest rate rises.

While increases in inflation (both actual and expected) increase liability values, most schemes cap inflationary increases in some way. Many trustees, particularly those of schemes that have seen material improvements in funding levels, may be considering whether pension increases this year should be above the minimum required by scheme rules to help members cope with the rising cost of living.

In most cases, trustees do not have a unilateral power to pay discretionary increases, and even where they do, we would expect this to be a joint decision between the sponsor and the trustees. If you or your scheme's trustees are thinking about discretionary increases, make sure you take advice about the potential implications.

Get in touch with our experts

To discuss your scheme, contact your usual First Actuarial consultant or any of our employer services team.

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