Employer pension briefing, Quarter 1 2024

In this briefing, we highlight key pension issues for employers.

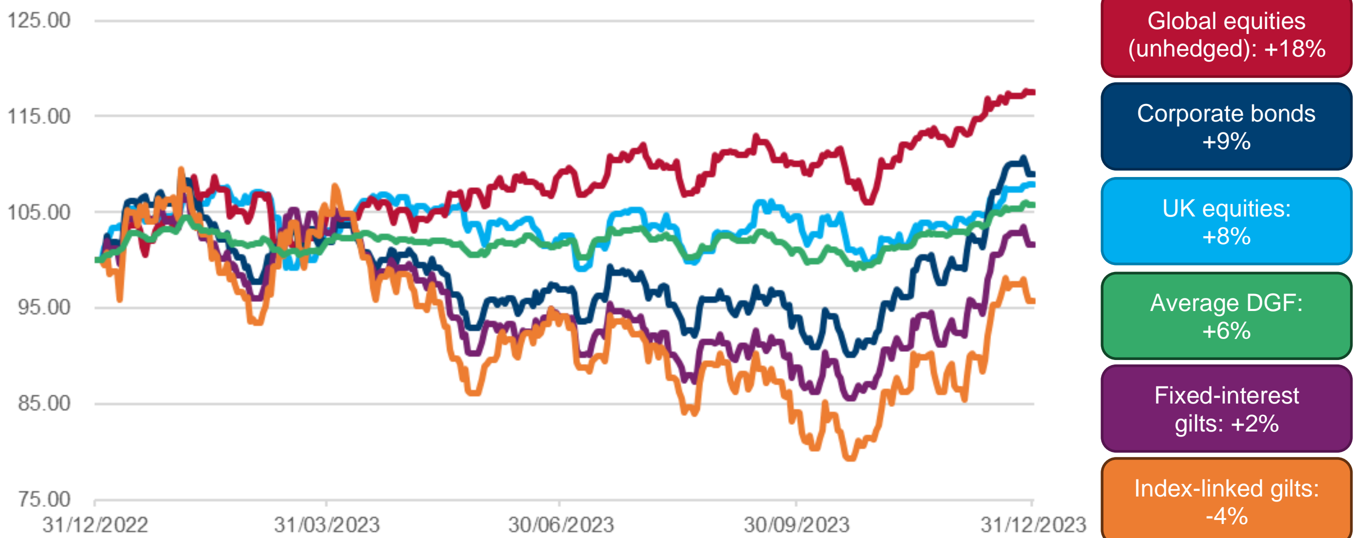
Around two-thirds of employers have a year-end at 31 December. In this briefing we explore what your Defined Benefit (DB) accounting disclosures as at 31 December 2023 might look like. We also discuss key developments in the pensions industry and how employers should be planning.

Changes in financial markets

After a difficult first three quarters of 2023, we saw bond markets rally over Q4, driven by an unexpected drop in the headline rate of inflation.

Over those first nine months, corporate bonds and fixed-interest gilts fell in value by 6% and 11%, respectively. Strong performance over Q4 saw both asset classes end the year with positive returns (9% for corporates and 2% for fixed-interest gilts). Index-linked gilts didn't fare quite so well – due to falls in inflation expectations – with losses of around 4% for the year.

Looking at return-seeking assets, it's been another positive quarter for global equities, with returns of 7% over the period contributing to growth of 18% over 2023. UK equities have lagged somewhat, returning 8% over 2023.



Have you reviewed your DB scheme's investment strategy?

We would expect most scheme trustees to have reviewed their investment strategy over the last 12 months or so, in light of the fundamental changes we've seen in investment markets. There is a requirement to consult with sponsoring employers on any changes to investment strategy (and consultation must involve a sharing of views, not simply a notification of intent).

If your trustees have not reviewed your scheme's investment strategy recently (and even if they have), now is a good time to consider whether the existing strategy remains appropriate and in line with your objectives, or whether there are any refinements that should be made.

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Changes to pension scheme liabilities

It will come as no surprise that scheme asset performance should not be considered in isolation. Changes in scheme funding levels will reflect movements in both assets and liabilities.

Bond yields

Corporate bond yields ended the year around 0.3% pa lower on average. In isolation, this could have increased accounting liabilities by up to 6%.

It's been a different story for gilt yields, which tend to drive funding, low dependency and buy-out discount rates. These are lower at shorter durations (perhaps reflecting the view that interest rates might fall sooner than was anticipated 12 months ago) and higher at longer durations. The impact on the discount rates used for your scheme will depend on its liability profile.

Inflation

Inflation remains higher than the Bank of England's 2% pa target, although it's significantly lower than it was 12 months ago. Schemes that provide inflation-linked benefits continue to see these benefits increase at higher levels than in previous years. The extent of any increase in your scheme's liabilities will depend on the profile of the scheme and the caps and floors that apply.

Summary

For year-end accounting disclosures, we'd expect liabilities to have increased, driven by the fall in corporate bond yields. The table below shows how the key financial assumptions have changed over the year:

	31 December 2022	31 December 2023	Impact on the liabilities of an average[1] scheme
Corporate bond yield[2]	4.8% pa	4.5% pa	+4%
Gilt yield[3]	4.1% pa	4.1% pa	-
Market-implied inflation[4]	3.6% pa	3.5% pa	-1%
Actual inflation (year to December 2023)	RPI: 5.2% CPI: 4.0%		Up to +2%

1 An average scheme is taken to have a duration of 15 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 15 years
4 Gilt market-implied inflation at a term of 15 years from the Bank of England implied inflation curve

What does this mean for your scheme?

The impact on each scheme will be different. Although liabilities are likely to have increased over the year, asset performance will vary significantly depending on scheme-specific investment strategies.

Those schemes that retain a material exposure to equities are likely to have seen an improvement in funding levels, while those that are heavily invested in gilts (or LDI) to hedge changes in funding liabilities may have seen their balance sheet position worsen due to the narrowing credit spread.

For more information on the implication on funding positions – especially if you have an upcoming actuarial valuation date – you might find our *Finance Director's guide to Defined Benefit pension scheme actuarial valuations as at 31 December 2023* useful. Ask your First Actuarial contact or **contact us** to request a copy.

Is 'running on' becoming a more attractive option for DB schemes?

With the recent improvement in funding levels, it's a good time for trustees and sponsors to take stock and consider their long-term objectives – especially now that low-dependency or buy-out targets may be within striking distance (or already reached).

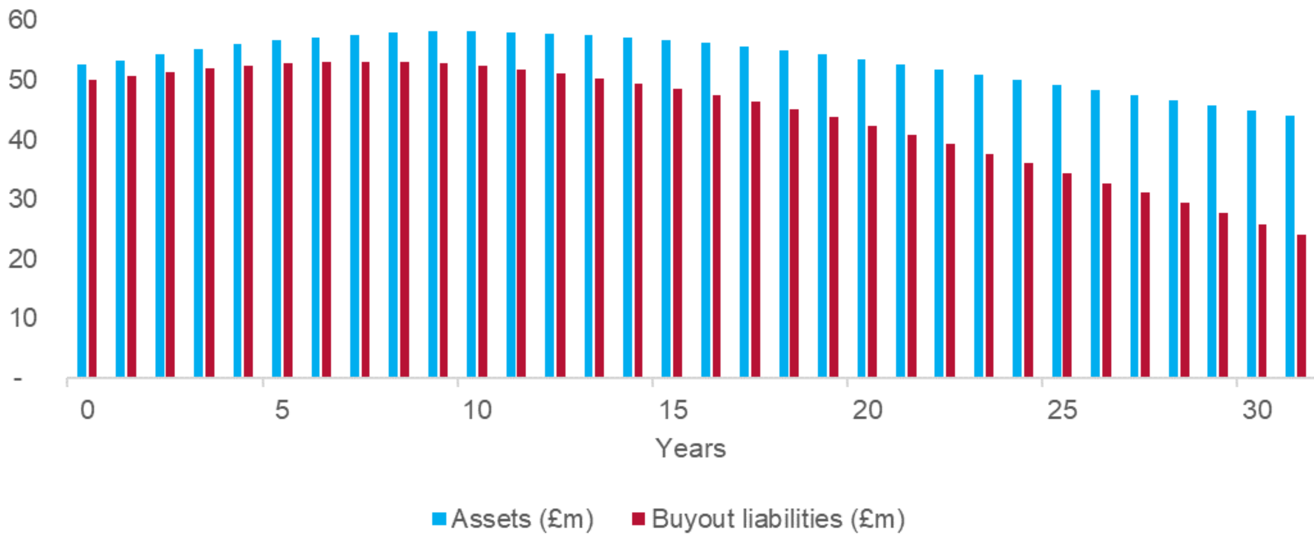
Indeed, 2024 is expected to be another record year in the bulk annuity market, with some commentators expecting the market to grow from the £50bn record achieved in 2023, to over £80bn in 2024. Yet with total DB scheme assets of over £1,400bn, a bulk annuity transaction is only likely to be the answer for a minority of schemes, in the short term at least.

Over the longer term, a buy-out is likely to be the right approach for many schemes and sponsors. However, it's certainly not a foregone conclusion, and should continue to be challenged by both trustees and sponsors.

Under a bulk annuity contract, the insurer invests very safely to match the benefit payments, operates efficiently, and expects there to be surplus assets to make a profit. Some sponsors and trustees are considering whether they can run schemes in a similar way. This is now commonly referred to as 'run-on'.

Industry and political support for run-on is growing. The Chancellor wants greater amounts of capital directed towards growing UK businesses, and the Government believes encouraging DB schemes to run on for longer is one way to achieve this. In the Autumn Statement, the Chancellor announced plans to consult on the details of how more DB pension schemes could invest for growth, building up larger surpluses and sharing the fruits of this surplus with the employer who continues to stand behind the scheme. As part of this announcement, the current **35%** tax rate on any surplus funds extracted from the scheme and paid to employer will be reduced to **25%** from 6 April 2024.

Could you and your pension scheme members benefit from running on? To consider that question, let's look at a £50m scheme that's slightly over-funded on buy-out (say 105%). The chart below shows how the assets and liabilities could change over the next 30 years if this scheme ran on and achieved an investment return of 0.5% pa above gilts while minimising ongoing running costs.



The above graph is a simplified example. A buy-out is a full risk transfer to an insurer, while under a run-on strategy some risks remain with the sponsor. However, it does illustrate that under a central scenario a material surplus is expected to emerge.

There are many considerations around how these surplus funds could be used, but this (simplified example) demonstrates the potential benefit of running on a DB scheme, even if your scheme already has enough money to secure benefits with an insurer. If you'd like to discuss potential end-game options for your scheme, please contact us.

DC ‘pot for life’ being explored

Another point to note from the Autumn Statement was a proposal to explore a ‘lifetime provider’ or ‘pot for life’ model, where employees could compel their employer to pay into a pension of their choice, rather than the workplace pension that their employer offers.

While this suggestion could eliminate the scenario of people accumulating lots of pension DC pots over their lifetime, it would introduce significant issues. For example, making pension payments to multiple providers each month could put a significant strain on payroll departments.

Even more importantly, this re-introduces the direct selling of pensions to individuals – a practice that ended badly with the last mis-selling review. There is a clear risk of employees being mis-advised to take out uncompetitive arrangements that may not be in their best interests. It also introduces another element of choice into a world where members already face difficult decisions about pensions.

The Pensions Regulator’s general code of practice

The Pensions Regulator’s (TPR) general code of practice has now been laid before Parliament and is expected to come into force on 27 March 2024.

The general code consolidates 10 of the existing codes of practice. It also introduces new governance responsibilities for trustees of both DB and DC schemes. Trustees should start working with their advisers to understand the implications for their scheme if they’re not already doing so. Existing governance policies should be reviewed in light of the new requirements, and monitoring arrangements put in place. You can find more about the general code of practice in our special briefing.

Auto-enrolment reform on the horizon

Since 2012, employers have been required to automatically enrol eligible employees into a workplace pension. To be eligible, employees must be between age 22 and State Pension age, earning more than £10,000 pa. Contributions must be made on earnings between £6,240 and £50,270 (as a minimum).

This initiative is widely seen as having been successful: total membership of Defined Contribution (DC) schemes increased from 2.1m in 2011 to 21m in 2019. Additionally, the Department for Work and Pensions (DWP) has reported that opt-out rates for eligible employees remain low at 12% from 2019 and 2022.

Despite the success of auto-enrolment, there remain opportunities for improvement. In particular, participation rates are low for those aged between 20 to 29, those with Pakistani, Indian and Bangladeshi backgrounds, and the self-employed (38% of whom do not have a pension).

However, a bill passed by Parliament in September 2023 allows Government to reduce the minimum age for auto-enrolment from 22 to 18, and to abolish the lower £6,240 earnings threshold before contributions are made. The Government has confirmed that they will consult on implementing these changes at the earliest opportunity.

Are you responsible for your employer’s DC scheme?

There’s lots going on in the world of DC at the moment (and not just with the ‘pot for life’ and auto-enrolment reform). Our specialist DC team is running a free, in-person training day in London on 20 March for anyone who is looking to improve their DC scheme governance or just update their DC knowledge.

Find out more and book a place.

What to expect over 2024

We are expecting 2024 to be a busy year for pensions. Here are some the key events sponsors should be aware of:

Period	What's happening?
Q1 2024	Government consultation on using DB scheme surpluses Call for evidence on the long-term direction of workplace pension saving Updated CMI mortality models and S4 base tables released 6 March: Budget – possible extension of auto-enrolment? 20 March – First Actuarial DC training day 27 March: New general code of practice comes into force 31 March: PPF deadline for contingent asset submissions
Q2 2024	New DB funding regulations and code expected to be published 6 April: Abolition of Lifetime Allowance (replaced with three new allowances) 6 April: Reduction in tax rate on refunds of surplus to employers from 35% to 25% 30 April: PPF deadline for deficit reduction contribution certificate submissions June: Virgin Media vs NTL appeal to be heard
Q3 2024	New funding code expected to come into effect September inflation figures published (which determine pension increases for many schemes) 2024/25 PPF levies issued
Longer-term	Introduction of multi-employer CDC schemes Introduction of DC 'pot for life' Pensions Dashboards goes live

Get in touch with our experts

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