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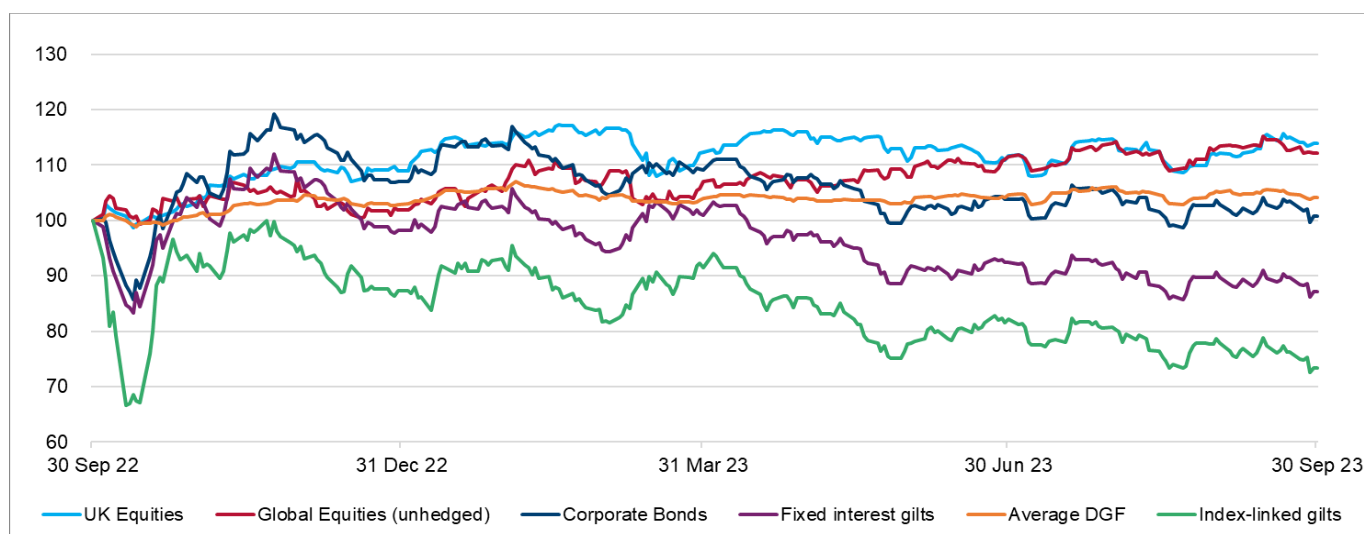
Employer pension briefing, Quarter 4 2023

In this briefing, we highlight key pension issues for employers. We focus on the impact of market movements on pension cost accounting positions and upcoming funding valuations. And we also highlight key developments in the pensions industry.

Changes in financial markets

Continuing fears about inflation have led to further falls in the value of government bonds over Q3. Although they didn't quite reach the lows seen in the final quarter of 2022 (it's hard to believe the mini-Budget was a full 12 months ago), long-dated fixed-interest gilts ended the year down by 13%, while their index-linked counterparts were down by 27%.

Equities had a relatively quiet quarter, with small positive returns on both global and UK equities contributing to total returns since 30 September 2022 of 12% and 14% respectively.



UK equities: +14%

Global equities (unhedged): +12%

Average DGF: +5%

Corporate bonds +1%

Fixed-interest gilts: -13%

Index-linked gilts: -27%

Are diversified growth funds still fit for purpose?

The aggregate return from the most popular diversified growth funds (DGF) was again flat over the quarter, a familiar story in recent years.

Driven by disappointing recent performance, increases in bond yields, and changes to the recapitalisation processes for a number of LDI investments, many scheme sponsors and trustees are considering whether the ongoing use of DGFs remains appropriate.

Our investment team have published a research paper, setting out their view on DGFs and whether and when they are a suitable asset class to hold. To request a copy, [contact Andrew Overend] from our investment team.

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Changes to pension scheme liabilities

Bond yields

While the past year's bond returns are clearly not good news in isolation, it's important to remember that changes in scheme funding levels will reflect movements in both assets and liabilities.

Falling bond prices mean rising bond yields, and since these yields drive the discount rates for most purposes, this translates to falls in the value of scheme liabilities. Over the course of the last 12 months, the increase in corporate bond yields alone could have reduced accounting liabilities by up to 5%. For employers with schemes that are open to accrual, next year's service costs will also be significantly lower.

Inflation

While inflation remains much higher than the Bank of England's 2% pa target, there does seem to be a downward trend (though we should not forget that lower inflation still means rising prices). Schemes that provide inflation-linked benefits continue to see these benefits increase at much 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

Overall, this means that despite high levels of inflation, we expect scheme liabilities to have fallen compared with the previous year-end.

	30 September 2022	30 September 2023	Impact on the liabilities of an average[1] scheme
Corporate bond yield[2]	5.1% pa	5.4% pa	-4%
Gilt yield[3]	4.1% pa	4.8% pa	-10%
Market-implied inflation[4]	4.0% pa	3.7% pa	-3%
Actual inflation (year to September 2023)	RPI: 8.9% CPI: 6.9%		Up to +7%

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?

It's impossible to say how individual schemes have fared. Although liabilities are likely to have fallen in value, asset performance will vary significantly depending on scheme-specific investment strategies.

Those schemes that didn't have material levels of liability hedging in place will have seen the greatest funding level improvements, 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 30 September 2023* useful. Ask your First Actuarial contact or **contact Sam Mullock** to request one.

Buy-out market update

Improvements in funding levels over the past two years mean that buy-out has become a real possibility for many schemes. There's a lot to do before buying out (particularly with limited insurer capacity), including getting scheme data, documentation and governance in order as well as selecting the right advisers.

Our **10 questions to ask** is a good place to start if you're thinking about getting your scheme 'buy-out ready'.

Have you had a DC health check?

There have been material changes in legislation over the last 12 months – from the removal of lifetime allowance charges to the extension of automatic enrolment. These changes make it more challenging to keep Defined Contribution (DC) pension arrangements up to date, and it's increasingly important for employers to optimise their schemes, reduce risks and safeguard members' funds and savings.

First Actuarial is offering a limited number of free DC health checks to give employers peace of mind and demonstrate commitment to employees by reviewing:

- **Charges** – Can you reduce the deductions from employees' savings pots by eliminating scheme charges that don't deliver value?
- **Your pension provider** – Has your scheme kept pace with developments in the DC market?
- **Investment strategy** – Is your default investment strategy still fit for purpose?
- **Tax efficiency** – Are there ways to increase your employees' take-home pay?
- **Auto-enrolment compliance** – Are you at risk of a fine or penalty notice?
- **Retirement options** – Are employees aware of the full range of pension freedoms they can access?
- **Environmental, social and governance** – Are your scheme's policies aligned with the views of the organisation and its workforce?

To request your free and objective assessment of your DC scheme, contact David Parfett and Lee French from our DC team.

Is financial stress impacting your workforce?

A number of recent publications have highlighted the potential impact of poor financial wellbeing in the workplace.

80% of employees believe stress related to financial wellbeing can impact performance in the workplace, according to a recent survey by YuLife and YouGov. And 72% of employees say the cost of living crisis has made them feel more anxious about their finances, as reported in Aviva's Working Lives 2023 report. The same Aviva report finds that only 42% of 45+ year-olds are confident about their retirement planning. These statistics back up what we often hear anecdotally from employers we work with.

We work with many employers who have put in place programmes to help employees improve their financial wellbeing, which can help improve performance in the workplace. To find out how we can help your employees, contact our contact Catherine Lockyer from our financial wellbeing team.

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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