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Briefing note

Rising yields – what does this mean for employers and their DB schemes?

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Yields have risen at an unprecedented rate in September and October 2022. This has given employers and trustees major challenges over the past few weeks on collateral for their LDI mandates but it also gives employers an opportunity to significantly accelerate endgame planning for their DB schemes. Now that the dust is starting to settle, here's a checklist of 5 key points for employers in relation to their DB scheme.

1) Assess your funding position

With yields now at least 2% pa higher than they were at the start of 2022 (and sometimes 3% pa higher depending on the day), pension liabilities will typically be over a third lower than they were at the start of the year. Assets values will have also reduced substantially but typically schemes in deficit will have seen a material fall in the £ amount of their deficit – and even schemes in surplus should have seen their buy-out shortfalls reduce.

It has, however, been a turbulent time with most schemes being forced to sell assets into a falling market and each scheme's actual experience, and in particular any material changes to their interest rate and inflation hedge strategies, will have impacted on how they fared. The first step is therefore to assess your scheme's financial position – the funding position, the scheme's asset allocation and the adequacy of scheme's LDI collateral position.

2) Review the investment strategy

Rising yields have generally led to very significant improvements in funding positions. As an example, the Technical Provisions deficit for one scheme we advise has reduced from £25m at 31 March 2022 to £5m in October 2022. Schemes with lower hedging levels and bigger deficits have seen the largest improvements in funding positions. These improvements may mean the assets don't have to work as hard as before. Therefore review the investment strategy to lock in the favourable funding positions where possible. It may be the case that growth assets can be sold to fund LDI collateral calls because that level of return is no longer needed.

3) Review deficit contribution levels

The ability to review deficit contributions depends on where you are in the triennial valuation cycle, but the massive shrinking of deficits means this should be considered. If you have a March 2022 valuation that has not yet been

signed off, consider the impact of market movements since the valuation date in the final package. Typically schemes do not hedge the deficit. Yields have risen by more than 2% since 31 March, bringing unhedged deficits down by 40%. The £ amount of any deficit contributions you are paying is therefore now far more valuable than it was before, opening the door to reducing contributions or shortening recovery periods. If you do not have a valuation on the go now, it does remain possible to revise schedules of contributions mid valuation cycle if there has been a material change in the funding or covenant position for the scheme. Discuss with your trustees whether this would be appropriate, particularly if these market movements have pushed your scheme significantly ahead of plan. Alternatively, consider using an escrow arrangement at least until your next formal valuation has been concluded to avoid the risk of trapped surpluses.

4) Reduce commutation factors

Most schemes review their commutation factors triennially and then leave them fixed for 3 years. This is generally a reasonable approach when yields are stable. Real yields were around -2% pa for most of 2020 and 2021, when many schemes last reviewed commutation terms. However, they are now +1% pa or higher, and so have risen by over 3% pa since many schemes last reviewed commutation terms. The value of neutral commutation terms has therefore come down around 40% since 2020 or 2021. Check that your trustees are reducing commutation terms back to market consistent levels. If they are not doing this, it is likely creating a funding strain. Most schemes also anticipate commutation in their valuation, and therefore reducing commutation terms can lead to an immediate improvement in the funding position.

5) Review timescales to insurance buy-out

Whatever might have happened to your Technical Provisions funding position, it is likely that your funding position on an insurance buy-out basis will have improved even more significantly. Schemes rarely hedge the full buy-out liabilities so rising yields has had a proportionately higher impact on buy-out funding positions. Furthermore, credit spreads have widened, reducing buy-out pricing. You should therefore review your timescales to insurance buy-out and take action if this timescale has come in significantly.

From an employer perspective, you need to understand the scheme rules around triggering and implementing a buy-out and wind-up well in advance of reaching this point. Ordinarily the employer can start the process by giving notice to cease to participate in the scheme. But the trustees often then have a choice on whether to buy-out or run-on, and sometimes have the ability to augment members' benefits. Nailing down this process early with the trustees is therefore important. Ordinarily an employer would only want to give notice to cease to participate, conditional on the trustees proceeding with a buy-out and not augmenting benefits.

The insurance market is also likely to become increasingly busy, meaning you need to show insurers that you are buy-out ready so that they prioritise your scheme. For smaller schemes, knowing which insurer to approach will become increasingly important, as many insurers will only quote for smaller schemes if they are given exclusivity on the transaction.

Conversely, if the company does not want to use risk transfer (for example, because it is concerned about the accounting implications), the company will need to engage with the trustees at any early stage to avoid sleepwalking into partial or whole scheme buy-ins. This is because the trustees can implement these without company agreement.

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