

## NAVIGATING THE MARKET TURMOIL

# Checklist of issues for trustees of DB pension schemes to consider

As schemes negotiate the ongoing fallout from the mini-budget, we look at what the gilts market volatility means for DB pension schemes and the practical actions to consider.

Gilt yields have been rising at an unprecedented rate throughout 2022. However, in the days following the mini-budget, the speed and scale of yield rises placed immense pressure on many DB schemes to meet urgent collateral calls on leveraged LDI programmes. Although yields have fallen back since the subsequent Bank of England intervention, they still remain at the highest levels for a decade.

In the aftermath, attention should be turning to reviewing funding positions, collateral sufficiency, investment strategies and endgame journey plans. With rising interest rates also impacting the value of member options like transfer values and commutation, there's plenty for trustees and sponsors to be working through in the weeks ahead.

**Read on for our brief guide to the key actions to consider.**

### 1 Assess the impact on scheme funding

The funding impacts for individual schemes will be varied depending on the extent of interest rate and inflation hedging in place and how this held up through the market volatility.

Schemes with lower hedging levels are likely to have seen large improvements in funding positions, with the increases in long-term gilt yields equivalent to around a 40% fall in a typical scheme's liabilities. However, others with leveraged LDI may have seen funding positions deteriorate if hedges were cut back before the Bank of England intervened and yields fell back. The urgency of collateral calls left some schemes selling what they could, rather than what they wanted.

Trustees should engage with their advisers to gain an updated assessment of the position and feed this into decision-making.

### 2 Reassess LDI liquidity – reduce the hedge or post more collateral?

The intervention by the Bank of England has provided some relief with regards further urgent collateral calls. However, LDI managers will be reducing leverage levels and adopting more prudent management frameworks.

As such, trustees will need to continue to assess collateral sufficiency and reposition portfolios to ensure they are in a strong position, with sufficient liquidity to meet updated minimum requirements. Schemes with allocations to illiquid assets will need to give particular consideration to managing this.

This will require a lot of schemes to choose between less hedging or lower returns.

In some cases, hedges may have to come down if there are insufficient liquid assets in the scheme or returns from other assets are still needed. Although this would mean the funding level is less well protected against a fall in bond yields in the future.

Alternatively, it may be possible to post more collateral to maintain hedges. Particularly if funding is ahead of plan and other assets no longer need to generate the same level of return.

Consider if updated cashflows should be produced to support a review of your hedging benchmark.



### 3 Review investment strategy

Given market moves and asset sales, asset allocations are likely to have drifted materially out of line versus target. Trustees should consider rebalancing. More broadly, it would be sensible to review strategic investment allocations and opportunities in the current environment.

As noted above, funding improvements may mean the assets don't have to work as hard as before so growth assets can be sold down to fund LDI collateral calls. Taking some risk off the table could stop funding going backwards.

For those schemes with scope to increase the overall level of hedging there is an opportunity to lock in recent gains. There is a risk that funding gains will be reversed if interest rates fall.

Schemes with 'soft' or 'hard' de-risking triggers, usually linked to funding improvements or market conditions, should review whether these are still fit for purpose given portfolios may have been materially reshaped following collateral calls.



### 4 Assess any impact on your employer covenant

Engage with your sponsoring employer to understand the risks the current environment poses to covenant.

For example, increased borrowing costs, high inflation and energy prices may push up costs with the employer having limited ability to pass these onto customers in response.

The impact will be employer-specific but combined with factors like lingering Brexit uncertainty, the sponsor covenant for some schemes may be uncertain. Consider whether any further information needs to be requested and any knock-on effects for the funding and investment strategies.

Trustees who consider their sponsor or guarantor to be at particular risk may want to seek additional security.

There may also be ways the employer can support the scheme. For example, loaning capital support or accelerating deficit contributions to improve liquidity.



### 5 Review cashflow management

As well as managing collateral waterfalls trustees will also need to be thinking about maintaining sufficient liquidity to meet benefit outgo. Trustees should review cashflow projections and revisit cashflow management procedures. It would be sensible to review disinvestment practices.

If the scheme has found itself with a technical provisions surplus far quicker than expected, the sponsor might push to turn off deficit reduction contributions. It is possible to revise schedules of contributions mid valuation cycle if there has been a material change in the funding position for the scheme. However, usual considerations around building in sensible contingencies would apply (eg mechanisms to turn contributions back on if funding deteriorates). Implications for cashflow management would also need managed.



## 6 Review operational governance

Recent events have shown how important it is that trustees are able to act quickly when needed. This includes having robust governance in place to buy and sell investments and take decisions. The speed at which trustees have had to act, and the complexity of the decisions they have had to make, will have been a challenge for many.

Is there a clear protocol for co-ordinating an emergency response? Is everyone clear on the quorum required for decision-making? Can enough people sign documents if required?

Taking the opportunity to review signing authorities and signatory lists to ensure that these are up to date would be a sensible step.

Adding a professional trustee might also be worth considering in certain circumstances.



## 7 Consider transfer values

Although the rise in interest rates does not directly impact the pension which a member can expect to receive, it has significantly reduced the 'actuarial value' of that pension.

Transfer values have fallen by around 40% this year. Expect that to prompt questions from members who see values plummet. Whilst those using their transfer to secure an annuity should see improvements that will offset falls, others will be looking to draw it down as cash. Be ready to answer questions and deal with any complaints.

For schemes, yield volatility increases the risk of quoting guaranteed terms that turn out to be too high or too low. Although transfers can typically be suspended for up to 3 months (without going over disclosure deadlines), suspending for any period of time clearly leads to a build-up of quote processing down the line when transfer quotes are turned back on. It may also be unpopular and difficult to explain to members.

Amidst ongoing volatility, a sensible first step would be to review current terms (including for the impact of any investment strategy changes and reductions) and decisions around if and when to pause transfers (eg if certain yield shifts are breached).

Trustees might want to more actively monitor volumes. This would also help with ensuring they can meet any cashflow needs.



## 8 Review commutation factors

Trustees should review cash commutation factors given these are often fixed for periods of time. This leads to leads to the possibility of existing terms being too generous.

In many cases unless factors were fairly low, they could now be higher than cost of pension on the funding basis. Trustees will of course want to approach making any reductions thoughtfully in case gilt yields fall again.

As well as accelerating a review of terms, it may be worth building in explicit triggers for review / updating or even moving to monthly market updates if practical from an administration perspective. For schemes with a buy-out target in mind this would align with how an insurer would approach setting terms.

Similar principles apply to other fixed factors such as early and late retirement terms though typically they are less sensitive to rates.



## 9 Consider communicating to members and prepare for queries

Press headlines may prompt some concern and enquiries from members. Therefore, it may help to have a Q&A ready for responding to questions. Consider a member communication or announcement posted on website to reassure members that pensions are not at any immediate risk.



## 10 Reassess endgame plans and buyout 'readiness'

With some schemes seeing material improvements against the cost of securing benefits with an insurer, trustees and sponsoring employers should be reviewing long term funding and 'endgame' plans.

Typically, schemes won't be hedging the full buy-out liabilities so rising yields have a proportionately higher impact on buy-out funding positions. Improved funding and insurer pricing means that many schemes may find buy-out affordability is now much closer than expected. Though for others that were close to transacting or looking at doing a partial buy-in, changes could actually be an unwelcome headwind.

Whilst schemes can't insure liabilities overnight, irrespective of how well funded they may be, if buyout is now looking to be within reach there's no better time to start preparing. As well as looking to lock-in gains, consider pushing on with buy-out 'readiness' actions, including focusing on benefit specifications, data cleansing, and GMP equalisation. Looking ahead the risk transfer market looks set to continue to be busy to it'll pay off to plan ahead.



**Please contact your usual Hymans Robertson consultant if you would like any further information or to understand the position of your scheme before making any decisions.**