100 HYMANS ROBERTSON

RECENT MARKET CHANGES

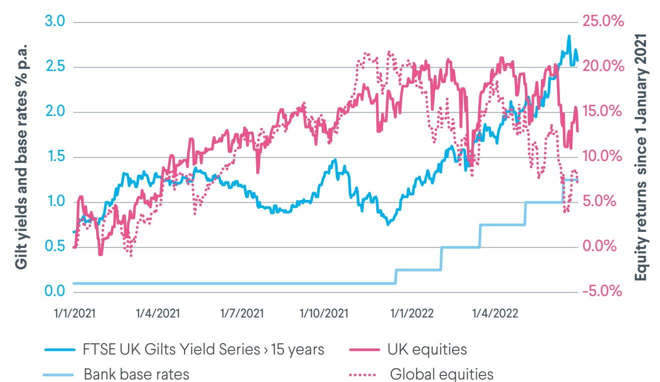
Checklist of issues for DB pension schemes to consider

Monetary tightening by central banks has sent long-term nominal and real gilt yields up by around 1.5% p.a. in the last six months amidst concerns about rising inflation. At levels not seen for more than seven years, and with published RPI and CPI also hitting 30-year highs, we look at what all this means for schemes and the practical actions to consider.

What's changed?

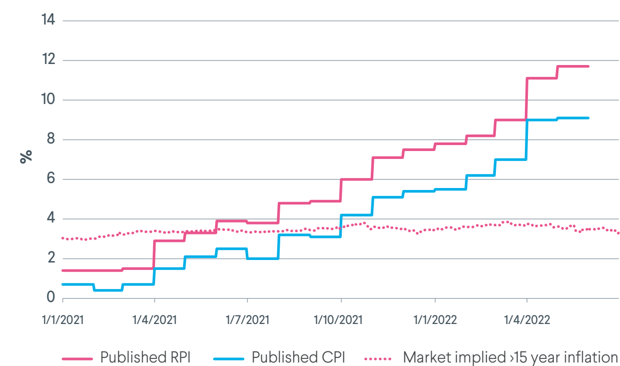
- CPI reached 9.1% in the 12 months to May 2022, the highest level since 1992, and is on course to reach 11% later this year. RPI was 11.7%.
- In response to rising inflation the Bank of England has increased base interest rates five times in the six months to June 2022, from 0.1% p.a. to 1.25% p.a.
- Long-term nominal and real gilt yields have followed suit, increasing by around 1.5% p.a. over the first half of 2022.
- Further yield moves will depend on whether there are more, or less, interest rate rises than currently priced into the market, alongside investor's longer-term expectations of growth, inflation, and interest rates.
- That increase in expectations for the path of interest rates has led to pressure on equity valuations, with global equities down more than 10% to end-June. Credit spreads have significantly widened year to date. Considerable uncertainty in the outlook remains.

Chart 1: Gilt yields, equity markets and base rates (2021-2022)



Source: Bloomberg

Chart 2: Inflation (2021-2022)



Source: Bloomberg

Whilst the impacts for individual schemes will be varied, it is important that trustees and sponsors understand the risks and take appropriate action. The checklist overleaf sets out 10 key issues for trustees and sponsors of DB pension schemes to work through.

10 key actions to consider...

1 Assess and monitor the impact on scheme funding

The funding impacts for individual schemes will be varied depending on the exposure to growth and credit markets and the extent of interest rate and inflation hedging in place. However, the increases in long-term gilt yields are equivalent to a c.25% fall in a typical scheme's liabilities.

With some schemes seeing material improvements, trustees and sponsoring employers should be reviewing long term funding and 'endgame' plans. Improved funding and insurer pricing means that schemes may find buy-out affordability is much closer than expected.

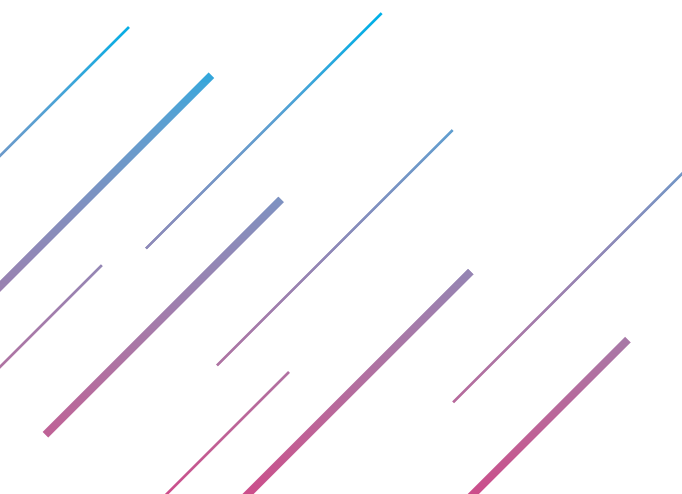
With uncertainty over the economic and geopolitical outlook, market volatility is likely throughout 2022 and it is important trustees are monitoring their funding position and alive to changes. Events of the last few years are a reminder that things can, and do, change quickly.

2 Manage liquidity for LDI collateral calls

Schemes utilising a leveraged LDI strategy are likely to have seen LDI managers seeking to recapitalise these funds as yields have risen. If yields continue to rise, further requests to post additional collateral could occur at short notice to maintain your liability hedge.

Coming at a time where other assets might be falling in value, it is important to ensure that sufficient liquidity remains in the portfolio to meet future capital calls and changes in scheme funding may be a key consideration as to what assets it makes sense to sell.

Therefore we recommend having a clear collateral management strategy in place and testing the resilience against future scenarios. Schemes with allocations to illiquid assets need to pay particular attention.



3 Refresh your liability hedging benchmark

It's important that your LDI manager's benchmark for hedging (your cashflows) is kept up to date. Otherwise this will become much less effective, something that's particularly important when conditions are volatile.

For example schemes that last revisited their liability hedge benchmark in early 2020, when expected inflation was materially lower, are likely to be incorrectly hedged on inflation. That's because the sensitivity of liability values to changes in future inflation expectations, and combination of fixed and inflation linked assets that provide the optimal hedge, depends on the impact of any pension increase caps (e.g. 5%) and floors (e.g. 0%) and how likely these are to bite.

Actual member experience – such as the impact of transfers out – is another source of drift between your hedging benchmark and scheme liabilities over time. To maximise the effectiveness of your hedging, we suggest the benchmark in place is reviewed and rebalanced as necessary.

4 Review the level of target hedging

Is there scope to increase your hedge? If you've been waiting for interest rates to rise before increasing your hedge, long-term interest rates are now at the highest levels for more than six years. It's a good time to reassess scope to increase your overall level of hedging and potentially lock in recent gains.

5 Revisit asset allocations and any need for rebalancing

Given market moves, trustees should review whether asset allocations might have drifted out of line versus target and consider rebalancing. More broadly, it may be a good time to review strategic investment allocations and the outlook for expected returns/risk in the current environment. As noted above, taking some risk off the table could stop funding going backwards should things change.

6 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 COVID-19 and 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.

7 Review discretionary pension increase powers

Current inflation is likely to outstrip most fixed increases and any inflation caps meaning pensions are less likely to keep pace with inflation. As such, there is a risk that trustees and employers will face calls to consider discretionary increases. Trustees should review discretionary powers, and historic practices bearing in mind this may not have been considered for many years and, in most cases, there may not be a well-articulated policy in place. Ultimately, decisions will be influenced by the funding position of the scheme and who has the power to exercise the discretion. As with all discretions, due process is key.

8 Consider communications to members and prepare for queries

Given the rising cost of living there may be some concern and increased queries from pensioners. When it comes to benefit increases, effective member communication may help to make sure members understand how any inflation caps will apply.

Nevertheless, trustees may need to brace themselves for increased queries and possible complaints from pensioners. It may help to have a Q&A ready for responding to enquiries.

9 Check approach to early retirements

It is fairly typical that members retiring early this year are likely to give up a high deferred revaluation increase in exchange for a materially lower pension increase in payment. That's because whilst pension increases in payment are capped on an annual basis (often at 5%), the revaluation of deferred pensions is usually capped over the whole period between when a member leaves and when they start to receive their benefits.

Although this is expected to be a relatively short-term issue, schemes may wish to consider the early retirement factors currently in force to make sure they reasonably reflect the benefits being given up. Trustees could also consider highlighting the difference between revaluation and pension increases in the information they provide to members (being careful not to stray too close to anything that might be construed as advice).

10 Review commutation factors and terms for other options such as pension increase exchange

Consider the need to review cash commutation factors given these are often fixed for periods of time. A shift in yields of 1% will typically reduce cash commutation factors by around 20% at retirement meaning its likely current terms represent relatively better value.

Whilst transfer values are automatically linked to market conditions, you should discuss with your actuary whether it is necessary to review fixed commutation terms. You may also want to revisit the actuarial factors and communications around other options such as pension increase exchange, where members can opt to give up inflation-linking for a higher, fixed pension at retirement.

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.

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