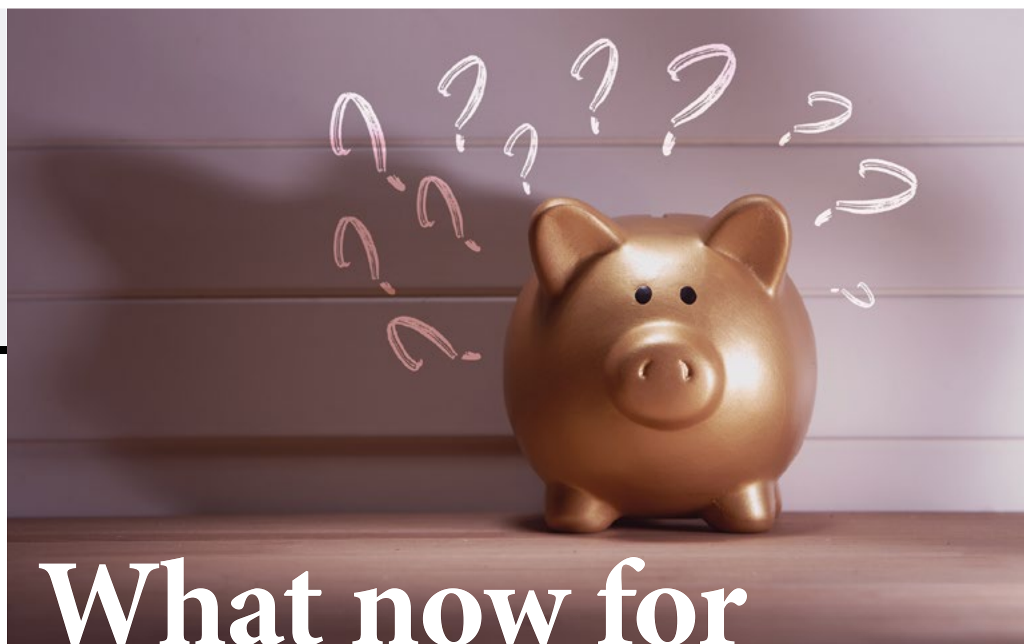
Summary
- DB funding levels are on track to be in a stronger position at the end of 2023 than at the start of the year.
- Allocations to illiquid assets is an obstacle to many schemes seeking a buyout.
- The upcoming DB Funding Code may require reform before it has even been introduced.



What now for DB funding?

With improved funding levels, DB schemes are in a healthy position. But ahead of the funding code and Mansion House reforms being implemented, uncertainty remains

It has been an eventful year for DB schemes' funding levels. Rising gilt yields resulted in falling liabilities so the funding positions of many schemes have improved. In November, Hymans Robertson found that UK schemes had reached a positive turning point with the amount in surplus increasing "significantly". From the previous year, the amount of DB schemes in surplus had risen from 27 per cent to 39 per cent.

"The significant increase in government bond yields over the last year has slashed the total value of DB liabilities," says Hymans Robertson partner and head of DB actuarial consulting, Laura McLaren. "This has improved funding levels, compounded by strong returns from growth assets, sponsor contributions and weakening longevity. Many schemes are now better funded than they have ever been."

Funding levels dictate options

Despite healthy funding levels, proceeding with buyouts may not be straightforward for some DB schemes. This is in large part due to liquidity complications, defined as a "liquidity kink" by Alpha Real. Rectifying this, and selling illiquid assets, is now more challenging, according to Broadstone head of trustee services, Chris Rice.

"A few years ago in the low-yield environment, schemes were happy to enter into less liquid assets to obtain yield," says Rice. "This is less likely to be required and illiquid assets make de-risking and buyout more complicated."

Depending on the assets held in a DB scheme's portfolio, this may require some investment allocations to be reconfigured, according to McLaren. She points out some trustees, in their endgame planning, may have more liquidity management to do than they would like.

"Cashflow management is increasingly important once contributions stop," says McLaren. "Schemes with LDI have needed to reposition their portfolios to have enough liquidity to support reduced leverage and more prudent management frameworks."

Schemes' healthier funding state has caused a surge in buyout activity. LCP data shows that in the first six months of 2023, £21.1 billion of assets were transferred to insurers, already reaching nearly half of the previous full year record of £43.8 billion set in 2019. Although positive, this is creating its own challenges, according to Van Lanschot Kempen head of client advice UK, Arif Saad.

"One of the biggest challenges many well-funded schemes face is the lack of capacity in the buyout market," says Saad, who explains the industry is therefore looking at other options following the Chancellor's recent announcement to reduce the surplus tax from 35 per cent to 25 per cent.

"The opportunity to 'run-on' pension schemes beyond buyout funding now looks more attractive than it has in the past, for schemes that wouldn't pass the gateway test for consolidation," adds Saad. "This alternative option becomes *[attractive]* when the buyout market is

selective about what deals it chooses to write."

Schemes may have better options, but the volatility of funding levels, and vulnerability to gilt yield movements, may still prompt a conservative approach. AJ Bell head of retirement policy, Tom Selby, points out that even a small movement in gilt yields can "move the dial" on the accounting liabilities of DB schemes by billions.

As such, he says some schemes may be wary of losing their comfortable funding positions: "The volatile nature of DB liability estimates means a deficit can quickly become a surplus, and vice versa, depending on what happens to gilt yields.

"Given this is entirely out of any pension schemes' influence, for most schemes the priority will likely be ensuring assets are sufficient to pay liabilities. Many will also inevitably be targeting insurance deals to get the risk associated with DB schemes off their books."

Meanwhile, the DB schemes that have not benefitted from funding improvements will still be reliant on employer cash contributions, which may put these sponsors in a difficult position.

"Where schemes are still some way off from being able to afford to transact with an insurer, the continued ability of the sponsoring employers to support the scheme will be key – the current higher interest rate and high inflation environment will be challenging for some sponsors," explains Barnett Waddingham principal and senior consulting actuary, Mark Tinsley.

"Trustees should therefore keep a close eye on funding and covenant risks, considering alternatives to cash contributions when there are short-term pressures."

The DB Funding Code

On 1 April 2024, The Pensions Regulator's draft DB Funding Code is set to come into force. It had been designed to outline how schemes should de-risk and allocate investments towards low-dependency funding. However, given it has been several years since the code was first proposed, many are now questioning its relevance – especially in its current guise.

"Given the substantial improvement in funding positions, many requirements of the new DB Funding Code seem superfluous," says Tinsley. "Given that these underfunded schemes are greatly diminished in number, it is essential that the additional costs of complying are minimised for well-funded and well-run schemes."

Given funding levels are healthier, there are concerns that the code, as currently drafted, could bring about unintended consequences. The code is designed to encourage positive behaviours at schemes in relation to funding, something that McLaren says has already happened organically in many schemes.

"As it stands, the funding code might bring a diminishing minority of schemes into line with good practice, but the additional prescription risks could constrain strategies across the board," says McLaren. "It is questionable whether the new code actually drives much additional long-term value for well-funded, de-risked schemes.

"It would be disappointing if the code disrupts well-planned scheme-specific approaches because it's not flexible enough, or if it adds an unnecessary layer of compliance and cost."

As well as fears over additional bureaucracy, many in the industry want the code to reflect recent changes in government policy – in particular the 2023 Autumn Statement and Chancellor's Mansion House speech.

In the latter, Chancellor, Jeremy Hunt, set out plans to encourage pension scheme investment in 'productive finance', which supports business and the wider economy. This prioritisation has created greater confusion when considered in the context of the funding code – especially as productive assets can sometimes be illiquid, adding to some schemes' pre-existing liquidity concerns.

"The Chancellor's Mansion House reforms, encouraging pension schemes to invest in productive assets and bolster the UK, are in contradiction to the previous direction of travel of the DB Funding Code," says Saad. "We expect to see greater alignment in 2024, particularly with the opportunity to 'run-on' pension schemes beyond full funding towards a later buyout."

Additionally, Hunt used his Autumn Statement to set out plans for the Pension Protection Fund to be used as an investment vehicle for smaller DB schemes. This, also, has created confusion and Isio director, Iain McLellan, has labelled it "unnecessary".

"We already have a number of innovative consolidation approaches developed by the industry that function well and are delivering the benefits of consolidation – improving the quality of governance, investment efficiency and member experience," McLellan adds. "We should be supporting these as an industry rather than waiting for a national scheme to emerge."

While the DB Funding Code has not yet been introduced, it is clear many are already calling for its redrafting. Not only have funding levels changed since the code's inception, but industry experts are concerned about the prospect of regulatory confusion.

"It will be interesting to see how the emphasis from Mansion House and the Autumn Statement on running-on get reflected when the funding code is finally launched," says Aon senior partner, Lynda Whitney. "The funding code draft was trying to squeeze open, ongoing schemes into broadly the same processes as closed mature schemes, and I suspect they may do some more work on this area."

Written by Jon Yarker, a freelance journalist