After the storm: The future for UK defined benefit pension schemes

In the autumn of 2022, the pensions market was rocked by the UK government's mini-Budget. Now that the thunder has subsided, DB pension schemes are assessing ongoing risk – with some facing a difficult future

The UK's mini-Budget of September 2022 set in motion a chain of events that radically changed the funding positions of UK defined benefit (DB) pension schemes. The then Chancellor of the Exchequer's ambitious spending package was designed to boost growth and increase productivity after a period of relative decline, which was exacerbated by the global pandemic and the outbreak of war in Ukraine, which saw the onset of rising inflation. This, however, led to a market rout, plummeting bond prices and a rise in the cost of borrowing.

This in turn plunged many schemes into significant disruption. An unparalleled rise in gilt yields saw the value of long-dated gilts decline, creating a 'doom loop' for pension funds that used government bonds to hedge their liabilities.

As more and more DB schemes were forced to sell gilts to raise capital due to falling gilt values, prices fell further, until the Bank of England began to purchase long-dated gilts, easing the pressure.

Although the passing storm has, ironically, improved the funding levels of many DB schemes, it leaves sponsoring companies and scheme trustees with questions. How should they act to mitigate scheme risk? Is there a credible path to scheme buyout and should they take it? Should they stay the course alone?

As we evaluate the long-term impact of the 2022 Great Gilt Storm, the industry needs to focus on the challenges ahead. In particular, it must assess the journey for schemes with different characteristics and provide solutions that give trustees more options and a better outcome.

The why of LDI

As the pension crisis of 2022 unfolded, attention focused particularly on the role of liability-driven investment (LDI) strategies, and the use of collateral and leverage within schemes.

LDI is designed to help pension schemes balance their assets against liabilities that can fluctuate due to factors including longevity risk, inflation risk and interest-rate risk.

These strategies use physical bonds and derivatives such as swaps to manage interest-rate and inflation risk. To protect against fluctuations in values, pension schemes are required to post collateral to guarantee against loans, often using long-dated gilts (pension schemes' collateral requirements increase as interest rates increase).

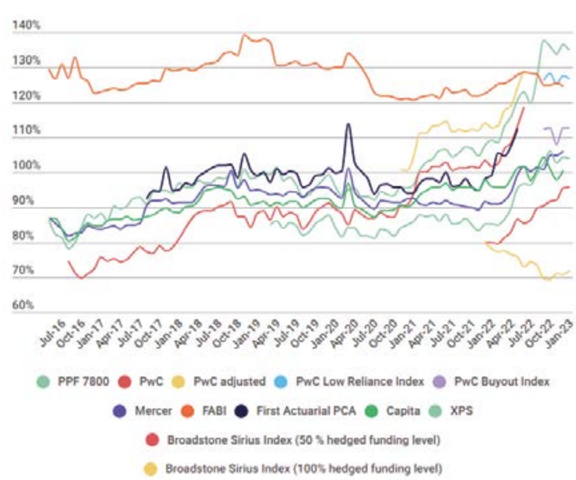
The use of LDI has been a net benefit to pension schemes. The British Telecom Pension Scheme stated that at its last valuation the £8 billion deficit would have been £7.6 billion higher in the absence of the LDI hedging programme, requiring BT to pay 'significant additional contributions' *[Source: BT Pension Scheme Management (BTPSM) LDI0037, November 2022]*.

As trustees digest the effects of the 2022 mini Budget on their schemes, there are important technical lessons to be learned about the use of collateral and leverage, as well as new challenges to be faced in a changed pension landscape.

The aftermath

The events of September 2022 have significantly changed the position of UK DB schemes, largely for the better. The aggregate surplus of the 5,215 schemes in the Pension Protection Fund 7800 index increased by £60.7 billion to £374.5

Funding Levels of UK Defined Benefit Pension Schemes



Sources and explanations: **PPF 7800**: 5179, all schemes; **PwC**: Scheme-specific, all schemes. Discontinued in June 2022. **PwC adjusted**: Alternative assets and assumptions. Discontinued in June 2022. **PwC Low-Reliance**: Discount rate assumption of gilt yields plus 0.5%. **PwC Buyout**: All schemes based on PwC's indicative market pricing. **Mercer**: Accounting, FTSE 350; **FABI**: Best-estimate, all schemes; **First Actuarial PCA**: Accounting, all schemes. Discontinued May 2022; **Capita**: Accounting, FTSE 350; **XPS**: Gilts+0.5% for all schemes; **Broadstone Sirius** indices monitor how various pension scheme strategies are performing on their journeys to "low-dependency" or self-sufficiency and is based on Broadstone clients using its Sirus platform.

billion at the end of September 2022 compared with the previous month. *[Source: Pension Protection Fund]* Although much of this increase can be attributed to the rise in interest rates, which has lessened the value of pension scheme liabilities more than the value of assets, there are a range of other factors that influenced scheme outcomes.

Schemes that did particularly well shared the following attributes:

• A prudent view of the amount needed to set aside to be used as collateral, significantly more than pre-crisis stress tests suggested

• A clearly set out liquidity waterfall showing the order in which assets were to be sold to meet or top up collateral requirements

• A clear governance structure with executives empowered to take quick action without approvals from investment committees or the trustee board

• Schemes that utilised an OCIO provider fared better due to their ability to efficiently make decisions and implement

• Strong investment expertise and training on the trustee board and investment committees pre-crisis

• Clear stakeholder management and communication at all levels of governance, particularly with the pension scheme sponsor

Stormproofing for the future

Having weathered the storm, trustees are left navigating changed landscapes, with more questions still to answer.

They are left with more illiquid assets in their portfolios than perhaps they would like, with many schemes actively looking to sell illiquid assets and others wondering whether to sell at a discount or hold on for longer.

The reality is that future shocks or crises that threaten DB pension schemes are unlikely to unfold in the same way as in 2022. Trustees must, as always, pay close attention to policy as well as wider economic developments. But central to success is avoiding a response that is narrow and unable to adapt.

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