Uncharted waters – steering DB schemes after the mini-Budget storm

With the 2022 mini-Budget storm behind us, schemes with all types of funding arrangements must pay attention to their goals. Crises and threats to funds may emerge differently in future and there is a lot to learn from

Pension scheme trustees are still navigating uncharted waters after the events of autumn 2022. Sponsoring companies and scheme trustees must reassess their options for the coming years. This is especially true if they now find themselves with a larger percentage of illiquid assets in their portfolios.

Evaluating what worked well and what didn't during the mini-Budget pension crisis will ensure schemes are in a better place. This applies whether they want to continue on a self-sufficient basis or transfer risk via a buy-in or eventual buyout.

There is the danger that, instead of focusing on the challenges ahead, the industry dwells too much on the mini budget storm, focusing on narrow asset classes in a move that may not be in the long-term interest of scheme members.

The state of play

Whilst each pension scheme's circumstance is unique, it is possible to divide the UK DB market into three broad categories.

The first group encompasses schemes that are well-funded and intend to operate on a self-sufficient basis, or at least with low dependency on additional sponsor contributions.

These portfolios are less focused on growth and deficit recovery. Instead, they focus on predictable cashflows. Some will have in-house expertise and be able to access the full spectrum of investment opportunities across public and private markets.

The second group includes schemes that are well-funded but are seeking a path to buy-in or eventual buyout. Buyouts are often considered the gold standard for schemes who can afford them, because this strategy transfers both the risk and the legal obligation to meet scheme liabilities.

However, there are limits. The

buyout market currently has a capacity of £45-£60 billion per annum against the demand of transferring £200 billion of liabilities over the next three years. Insurers are confident that this capacity will increase *[Source: Lane Clark & Peacock LLP, 27 October 2022].*

The third group are schemes with a difficult path ahead. Some may have a significant deficit, meaning they are a long way from self-sufficiency or buy-in. Others may have extra challenges stemming from governance issues or covenants in need of change.

This is likely to be made more difficult due to a macroeconomic environment characterised by greater volatility in inflation and asset class returns. Given the regulatory requirements, any LDI strategies used will require more collateral after the events of last autumn.

Setting a course

Whichever situation schemes find themselves in, taking stock of the new pension landscape is vital. Most pension trustees and schemes feel they have managed the pension crisis comparatively well, but complacency is always dangerous.

All schemes will benefit from studying the factors that helped some endure the resulting volatility better than others. Success factors included having a clear liquidity waterfall – delineating the order in which assets were to be sold to meet collateral requirements – as well as a prudent view of the amount needed to be used.

Investment expertise and a clear governance structure also allowed schemes to perform well under pressure.

Even the most successful schemes, those in the first category mentioned above, will have much to learn from studying these factors. By considering what improvements can be made, they can be prepared should a similar crisis occur again.

All schemes, regardless of their current funding state, should also revisit their investment strategy to ensure it still meets the trustees' objectives.

Those in the second two categories, whether seeking buyout or facing an uphill struggle out of a deficit position, have further work to do.

Well-funded schemes in search of a credible path to buyout can take steps to reduce their costs and increase their competitive advantage to increase the likelihood of success.

Strategic moves could include attempting to access strategies that maintain funding levels while creating buyout-ready portfolios compatible with the requirements of insurers.

Reshaping portfolios to achieve risk and cashflow profiles consistent with self-sufficiency and low dependency could also make a potential buyout more likely.

For schemes facing a more difficult journey, understanding how to manage risk, either reducing the liability hedge or taking more risk on the return seeking portion of the portfolio in the hope of increased returns. Managing the subsequent trade-off between return-seeking assets and meeting collateral requirements is vital. They will need also to work out how to prepare for their scheme's conclusion while recovering its deficit.

Help needed

To meet the changing needs of UK defined benefits after the storm, the entire industry will need to work together to consider the appropriate changes needed regarding scheme governance, asset allocation and portfolio reconstruction.

Many schemes have a difficult journey ahead and all have questions in need of answers. Partnership and innovation from all participants in the pensions and investment industry will lead to better outcomes for pension scheme members, whatever their 'post storm' position.

Written by BlackRock managing director, head of UK institutional client business, Gavin Lewis, and Capital Cranfield professional trustee, Joanna Matthews

In association with BlackRock.