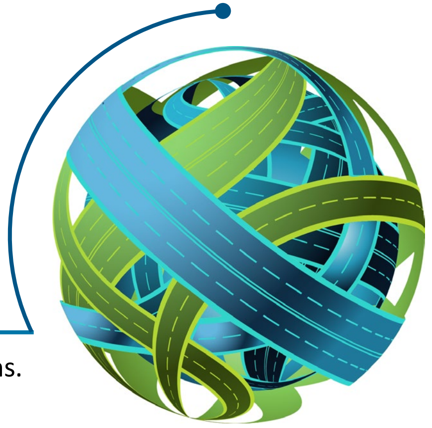
Deloitte.

Funding Code of Practice

2023 to do list



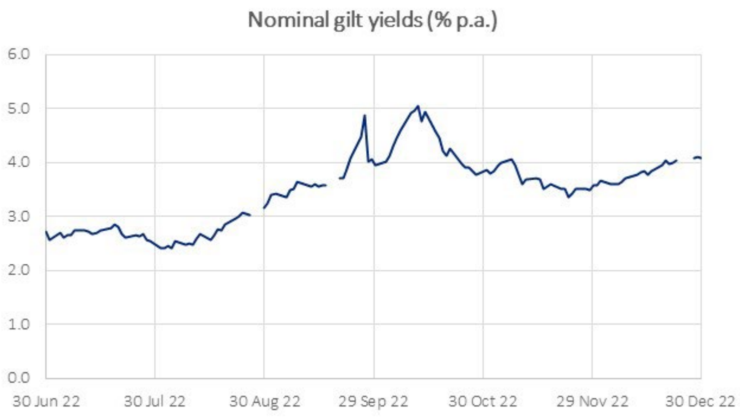
The volatility in gilt yields towards the end of last year proved especially challenging for many UK pension schemes and had a pronounced impact on funding positions. As a new year begins, trustees and corporate sponsors should take action to review and enhance their funding approach, investment arrangements and governance frameworks.

A volatile last few months of 2022

Nominal and real gilt yields have been trending higher for some time in response to the sustained and historically extreme rise in UK CPI. With gilt investors already pricing in more aggressive policy action from the Bank of England, the then Chancellor Kwasi Kwarteng's "mini-budget" on 23 September triggered a pronounced sell off. Whilst a loss of confidence in the UK government was the trigger, moves (which equated to a 1% rise in 20 year spot yields over 3 business days) were accentuated by leveraged LDI portfolios and funds as investment managers were forced to trim hedging exposures in response to a severe reduction in available collateral.

Gilt markets ultimately became dysfunctional and the Bank of England was forced to step in on 28 September 2022 to stabilise prices, restore market functionality and prevent a broader crisis across UK financial markets.

With the Bank of England closing its emergency bond-buying operations on 14 October 2022, there was some concern that gilt market volatility may return. However, the change in Chancellor and scrapping of many of Kwasi Kwarteng's spending plans restored calm. Gilt yields have since fallen from recent highs but remain elevated relative to their level at the beginning of September.



Source: Bank of England

2023 to do list

In response to a particularly turbulent end to 2022, we strongly advocate that defined benefit pension schemes take the time to review their funding positions, investment arrangements and governance frameworks. We summarise overleaf the key actions which should ensure that trustees and corporate sponsors are suitably informed, and that their pension schemes are suitably adjusted to a much-changed investment market and economic outlook.

What action should trustees and corporate sponsors take in 2023?

Review funding positions

Since the end of June 2022, nominal and real gilt yields have risen materially. With the discount rate of many schemes tied to gilt yields, liability valuations will have fallen significantly. However, the promise and size of any funding gains will depend on how the scheme's assets are invested and the actions taken during the recent LDI crisis. Understanding your scheme's funding position will be central to any further actions.

Understand Asset allocation moves

Significant investment market moves coupled with collateral related transactions may have caused many pension scheme asset allocations to drift materially from agreed investment strategies. Allocations to private market assets are likely to have increased with valuations of such assets traditionally slow to react to volatility in public markets. Trustees and sponsors should note that rebalancing back to benchmark may not represent the most appropriate course of action.

Reassess likelihood of achieving LTFT

Changes to funding position and asset allocation will affect the chances of meeting defined long term funding targets. Whilst deficits may have fallen as a result of the rise in gilt yields, reduced allocations to return seeking assets and declining expected returns on those assets in premium over gilts terms, will have slowed the future pace of funding improvements for many schemes.

Investment strategy reviews

Changing funding positions and asset allocations, and their impact on the pace of future funding improvement warrant a review of investment strategy. Existing strategies may struggle to achieve funding goals, whilst in some cases, funding improvements could be captured by de-risking. Recent market movements will also impacted the relative attraction of different asset classes. Liability hedging levels and collateral sufficiency should be key considerations.

Review of liability hedging

Leveraged LDI investing will continue to be subject to increased scrutiny. Leverage levels across pooled vehicles and segregated mandates have already fallen requiring more assets to hedge the same amount of interest rate and inflation exposure. Schemes should be aware that gilt yields could move in either direction; high levels of inflation is continuing to create upward pressure on yields, whilst a weak economic outlook is having the opposite effect. Moving to a segregated approach may create more flexibility but manager appetite, fees and governance issues should all be considered.

Enhancing collateral sufficiency

Gilt moves in September and October were extreme, but the period emphasised the challenges associated with maintaining collateral sufficiency. Schemes should review the procedures in place with their investment managers and where possible, automate the process. Broader changes to investment management arrangements may be warranted to increase the available pool of liquid assets. Some schemes could explore short-term borrowing facilities with scheme sponsors.

Review liability approach

The use of LDI mandates and funds is largely centred around the use of "gilts plus" discount rates. Alternative approaches to discounting future liability cashflows are available but bring other challenges. The scheme's longer term funding objectives are an important consideration (e.g. low dependency or buy-out) impacting the nature of the underlying target.

Review governance arrangements

Governance processes were certainly tested in 2022. We believe that it is prudent to review your scheme's governance arrangements with the goal of ensuring that there are the capabilities and mechanisms to make swift yet informed decisions as needed. Establishing investment sub committees and arranging investment-related training (including LDI) may prove particularly beneficial.

Stay informed

Significant regulatory developments are possible during 2023. The Pensions Regulator has launched its consultation on the new DB funding Code of Practice which will have a major bearing on both a scheme's "end-game' investment strategy and the timeframe over which to achieve that strategy. There is a parliamentary investigation into the LDI crisis and any regulatory measures introduced could have a material impact on future pension scheme investment strategies. In 2023 it will be more important than ever to stay in touch with your advisors.

Deloitte contacts

Deloitte have a specialist team of pensions advisors (covering actuarial, legal, covenant and investment issues) who support many companies and trustees in running pension arrangements. If you would like to discuss these issues further, feel free to get in touch with one of the team below or your usual Deloitte contact.

Deloitte Insights

Corporate and trustee pensions teams

Lesley-Anne Brown
lesleybrown@deloitte.co.uk
020 7007 4503

Karen Parker
kaparker@deloitte.co.uk
020 7303 4626

Mark Jones
markjones@deloitte.co.uk
020 7007 2363

Mark McClintock
mamcclintock@deloitte.co.uk
028 9053 1429

Investment team

Richard Slater
ricslater@deloitte.co.uk
0131 535 7602

Yona Chesner
ychesner@deloitte.co.uk
0161 455 8791

Kevin Humpherson
khumpherson@deloitte.co.uk
0131 535 7287

Deloitte.

Designed by CoRe Creative Services. RITM1093909