A tale of two journeys

Chart your own course

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Chart your own course 2023

Mary Spencer
Investment Partner

It was the best of times

It was the worst of times

It was the strangest of times

Market turmoil, political chaos and further delays to long-expected regulation. Pension schemes have certainly had a lot to deal with since our last report. We've lost count of how many '1-in-20 year' events we've faced in the last three.

As usual, this year's Chart your own course report contains insights from our recent survey of the pensions industry. Thank you, if you responded – as well as providing us with valuable information, each completed entry prompted a £5 contribution to the Disasters Emergency Committee. We also use data on our own client base derived from our flagship asset and liability tool, LCP Visualise, to show trends in positions and activity across the year.

Chart your own course is designed to help trustees of DB pension schemes to design and manage effective strategic journey plans to achieve their chosen endgame, wherever they are on their journey. Read our report and look out for specific action points to help you move things forward.

Key insights from this report:

On the back of strong funding progression (20% fully funded on a buyout basis), 2/3 of survey respondents expect to undertake a final insurance transaction in the next five years

67%

Source: LCP Survey

But some schemes fell backwards over the year, and 18% don't expect to reach their end game for more than ten years

18%

Source: LCP Survey

What this means for you?

The insurance market is extremely busy, and this doesn't look likely to change. If this is your target, establishing how far away you are and preparing early is key.

The average allocation to illiquid assets is now over 10%

10%

Source: LCP Survey

And 10% of schemes have more than 30% in illiquid holdings

30%

Source: LCP Survey

What this means for you?

Illiquid holdings can offer attractive properties, but limit flexibility. Explore what your illiquidity tolerance is and how you can reduce your allocation if needed.

More than 1/3 of survey respondents expect their covenant to be reliable for more than ten years

33%

Source: LCP Survey

But half expect this to be less than five years – narrowing timeframes to achieve a strong position

50%

Source: LCP Survey

What this means for you?

Understanding covenant is more important than ever and should directly influence your journey-plan. Make sure you have appropriate expert advice.

A greater awareness on climate change and diversity, equity & inclusion issues, with fewer respondents unsure of their views

But limited progress in taking action, and significant minorities (30% on climate change and 20% on diversity, equity & inclusion) viewing these actions as not relevant or a burden

Climate change - 30%

DEI - 20%

Source: LCP Survey

What this means for you?

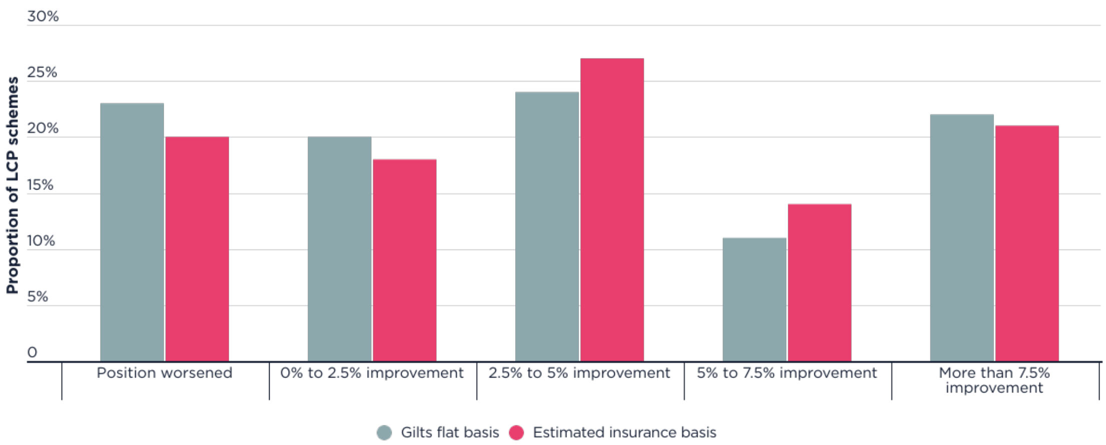
With plenty of TPR guidance already issued and further focus likely in the coming months, now is the time to start taking action in these areas if you haven't done so already.

Setting the scene

All change for pension schemes

We've become so used to dealing with 'unprecedented events' that it's hard to remember them all. But amidst all this, and in some cases because of it, DB pension schemes have not stood still in the last year. We've seen significant changes to scheme funding positions, driven by contributions, much higher gilt yields and falling life expectancies. Most schemes have fared very well, whilst others were caught by the gilt market crisis and high inflation, finding themselves worse off. A tale of two journeys indeed.

Around 20% of schemes saw a more than 7.5% improvement in their buyout position over 12 months, but a similar proportion fell backwards



Source: LCP Visualise

Among those who have seen improvements in their position, many are closer to their endgame than they thought possible in such short timeframes. It therefore comes as no surprise that we've seen a large uptick in the number of schemes revising their objectives and/or looking to approach the insurance market. We comment further on the implications of this in the endgame section of this report.

On the other hand, those who are worse off may need to re-plan their journey, creatively combining investment strategies and covenant support, to get their schemes back on track.

And a lot of activity to date

Given all this change it's no surprise to see that our survey respondents have been busy! Many of our respondents took multiple actions.

Most survey respondents have taken some action, with a focus on investment strategy

Source: LCP Survey

Almost half of respondents revisited their investment strategy and/or liability hedging strategy. This ranged from rebalancing because assets had moved out of line, to reducing or even removing leverage, restructuring liability hedging portfolios and increasing liquidity. More on all of these issues later.

Those revisiting their ultimate objective and journey plan usually cited significant improvements in their position – and many noted that they were now thinking about full insurance as a near-term possibility.

These results stack up with our own experience with clients. In fact, we wouldn't be surprised if the 30% of schemes who haven't taken action became a smaller proportion in time. TPR also encouraged schemes to revisit their plans in its latest Annual Funding Statement.

Views from the pensions industry – 2023 survey

Top priorities: reflective of an increasingly busy insurance market

Top priorities over the next 12 months

Source: LCP Survey

We again asked survey respondents what their top priorities will be over the next 12 months. Last year triennial valuation dominated. Whilst this remained a popular choice, we now see clearly the wider trend towards end game planning. A large number of schemes are focussing on an ultimate insurance transaction, including preparatory steps around data. Data is key whatever stage of the journey, but we're seeing increased focus given funding level improvements and issues being flagged from projects such as benefit specifications and GMP equalisation. Fewer respondents had a focus on improving their funding level (likely because that's already come through), but journey planning remains a strong priority, adjusting for significant market changes.

GMP equalisation is prominent (and was last year too), though in our recent survey of insurers, this not viewed as something that needed to be addressed pre-transaction. Based on our survey data, LCP's Alasdair Mayes recently explored how far schemes are on their GMP equalisation journey.

This time regulation creeps in too: perhaps with improved funding positions, some trustees are finding the headspace to tackle new requirements head on.

Speaking of regulation...

How respondents would improve pension regulations

Source: LCP Survey

We gave respondents one wish (in one(ish) word) to change pension regulations.

The results of this question are very similar between last year and this – continued calls for simplicity, consistency and clarity. The volume of new requirements and unexpected developments hasn't exactly eased – the tax changes in the March Budget being one obvious example – though much of the regulation that was anticipated last year remains to be released.

Given the desire for regulatory change, it is promising that more respondents are beginning to prioritise the requirements, even if begrudgingly...

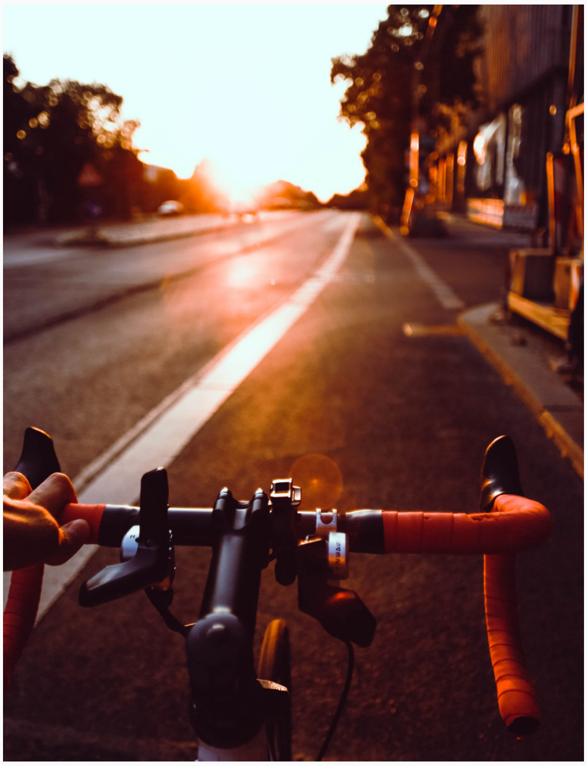
Curious?

There remains a lot to do on the regulatory side, including requirements around governance via the General Code. Perhaps this is a good place to start – getting the governance right should be the first step in any project.

Use the LCP GEARS framework to navigate your journey, no matter what stage you have got to

As before, we have built our report around the LCP GEARS framework, bringing to life how it can help you design your Strategic Journey Plan to achieve your chosen end game. In each section we build on the issues mentioned below, cover the results from our survey and share where our client base has got to.

Whilst the Pensions Regulator's new funding code has been delayed until 2024, we provide insights through the lens of what we expect this to look like. For an overview on how TPR is thinking about journey planning in the new world, click here.



Get the right governance structure in place.

The right governance structure looks different for each trustee, but two features are constant: being equipped to make good decisions; and creating the right environment.

We touch on the Pensions Regulator's General Code, including our early work on ESOG and how you can bring ORA to life. We also comment on the evolving market of Professional Trustees and summarise where the industry has got to on tackling Diversity, Equity and Inclusion.

Establish endgame and timescales.

So your pension scheme has made progress, but where are you heading? Having your ultimate target in mind helps frame all strategic decisions, particularly with an increasing range of options available.

We summarise how far schemes are on their journey, where they are headed, how long this might take and how you should think about the impact of insurance market dynamics.

Analyse what could change your journey.

Covenant is often the difference between a journey's success or failure, so it's where we've always started when considering integrated risk management. It's no surprise to us that the Pensions Regulator has emphasised this link in its draft new funding code.

We explain how to think about the interaction of covenant and other risks, as well as latest views on important factors such as longevity and climate.

Refine the steps you plan to take to reach your goals.

Your journey is driven by sponsor contributions and your funding & investment strategy, but also what members choose to do with their benefits. Taking these aspects in the round, and setting yourself up to react to change, is key.

In the current environment, we help you to ensure your risk reducing assets are robust; you capture current market opportunities; and you understand your membership's wants and needs (and the impact they could have).

Steer your journey dynamically and in a joined-up way.

Every journey is different, but planning for different scenarios and reacting quickly are always important.

We share some of our latest thoughts on well funded ('over' funded?) schemes, but also highlight approaches you could take if you're not quite there yet. This could include using contingent funding and/or alternative approaches to valuations, to creatively solve the challenges your scheme faces.

Transact successfully at the right time

For those targeting full insurance, understanding the steps involved in undertaking an insurance transaction, and preparing early, make an increasingly big difference for pension schemes.

Insurers now have the luxury of being picky, so demonstrating that you're prepared is key in achieving attractive pricing and terms to secure member benefits. Being small doesn't push you off the list - LCP Assure helps you implement these final stages smoothly.

Complete wind-up effectively

Securing all benefits with an insurer is a momentous occasion, but is not the end of the road. For members, trustees and sponsors, the final steps to wind up the scheme matter.

Get ahead of the process with early planning, strategically think about how you communicate to members and ensure project management is in place from the start.

Bringing it all together

We conclude by summarising our Strategic Journey Planning framework and how to prioritise different steps depending on your Scheme's position.

Additional resources

Relevant material at your fingertips
Access links to further reading on many of the topics covered in this report, and some of our recent webinars.

Our survey
Find out more about our survey participants and the questions we asked.

Get the right governance structure in place

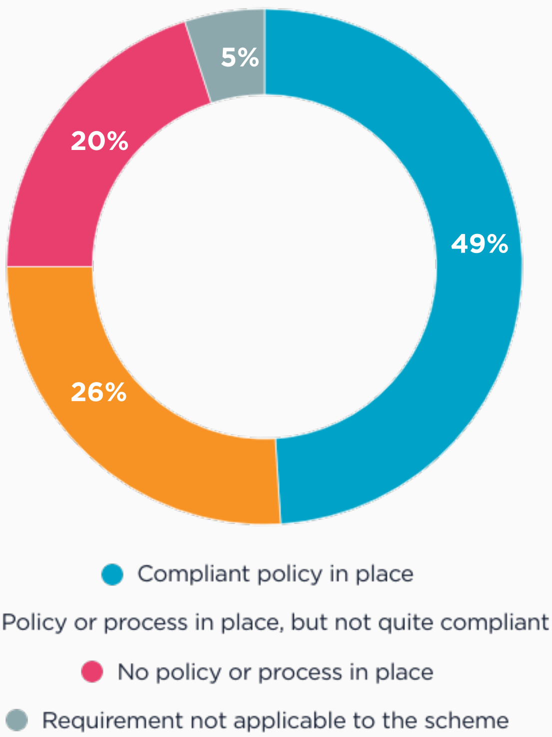
Why the General Code isn't just a "tick box" exercise

The long-awaited General Code (previously "Single Code") offers the perfect opportunity to check your governance structure is fit for purpose and enhance how you operate. We begin by helping clients establish an Effective System of Governance ("ESOG"), informed by a gap analysis review against the requirements. The chart summarises the results of the reviews we have undertaken to date.

On average, schemes already comply with half of the requirements under the Code, and are almost there with another quarter. "Red" ratings were concentrated in the new expectations.

Trustees should ensure they prioritise any actions in line with their journey plan. This could mean a strategic sub-committee with an appropriate decision making framework for a scheme exploring insurance transactions, or a review of the communications and communication policy for a scheme moving to full insurance position.

Most schemes are well on their way to compliance



Source: LCP Data

Cracking the Code

Cyber risk is a particularly hot topic and our initial ESOG gap analysis results showed there is more to be done in this area. Unsurprisingly, those who were better prepared tended to be larger schemes.

Improve your cyber security

- Assess security of scheme data. Seek assurances from key data processors.
- Review data breach response plans and business continuity plans.
- Establish and test cyber incident response plans with clearly defined roles.
- Write to members to reassure them. Pensioners in particular can be vulnerable to cybercrime: consider including guidance in your next communication.
- Arrange refresher training if required.

Read our full checklist here.

Owning your risks

The publication of the Code will also start the 12 month countdown to your first Own Risk Assessment (or "ORA") deadline. Rather than tackling the ORA from a purely governance perspective, we take a step back and consider your risks from a practical perspective, including how you will manage them along your journey. Your biggest risks are likely to change year to year: engaging with the ORA can help you deal with the unexpected and take advantage of market opportunities.

Curious?

Get in touch with our Pensions Management Consulting team to learn more about our fresh approach to ORA assessments.

Creating the right environment to make decisions

Dispersion on diversity, equity and inclusion

Strong practices on diversity, equity and inclusion support better decision-making and understanding of the diverse needs of pension scheme members. In March we were pleased to see the release of TPR guidance on how to get started. This complements our own Trustee guide which came out last year.

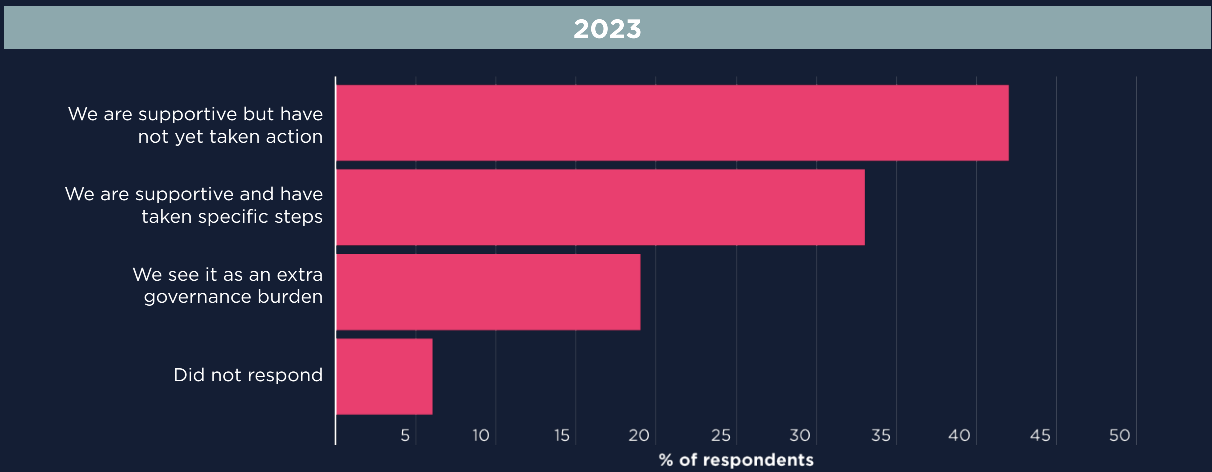
In our survey (see below), the biggest change over the last year is in those who did not respond – perhaps reflecting a greater awareness of the issues, whether supportive or not.

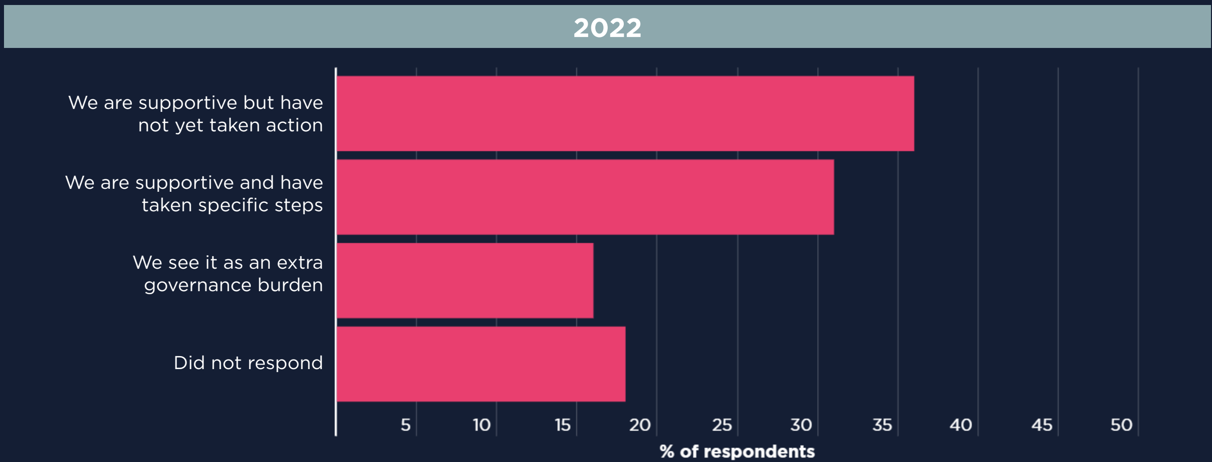
Curious?

Unsure where to start when tackling these important issues? Contact LCP Partner Zoe Burdo to understand how we can support your journey in a practical and pragmatic way.

The group who view these steps as an extra burden remain a significant minority. With all that's going on, this could be forgiven, but the importance shouldn't be forgotten. Hopefully the release of TPR's guidance convince some, and we hope it doesn't reach the point of formal obligations being required.

Most respondents are supportive of diversity, equity and inclusion related issues





Source: LCP Survey

Rise of the Professional Trustee

Around half of UK pension schemes now employ some form of professional on their trustee board. These individuals are in high demand to alleviate pressures for UK pension schemes, including increasing regulatory demands and the need for more stringent and clearly defined governance structures.

We have also seen a shift in the type of individuals who act as professional trustees. There is a growing trend of younger professionals with a wide variety of professional backgrounds. This reflects the need for diversity of thought and a fresh perspective on governance matters, amidst the changing dynamics of the pension landscape. Indeed this specific trend was highlighted in TPR's recent guidance, linked above.

The latest trend is the increased popularity of sole trusteeship. Traditionally focussed within smaller schemes (sub £100m assets), larger schemes are also starting to take notice. Many professional trustee firms have become more structured in the way they service these appointments to get the best out of the individuals they employ. Some adopt a team approach, pairing professional trustees with complementary skillsets and backgrounds, to retain challenge within the trustee group - TPR highlights that this is a good way of retaining diversity across decision-makers. We explore this in more detail in LCP's Sole mates report.

Curious?

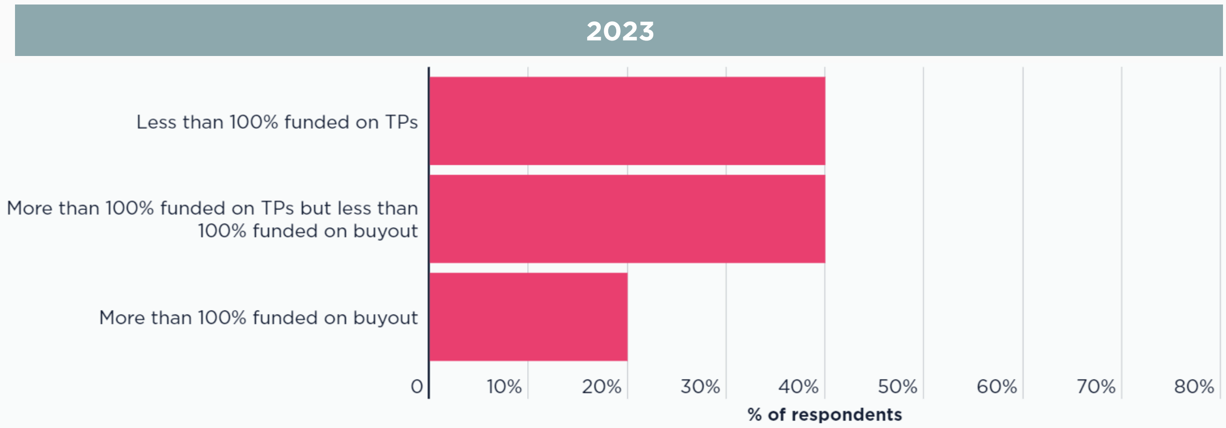
LCP works with many groups to help them find the right professional trustee for their scheme. If you are interested in learning more about the growth in this area, as well as the potential benefits and other considerations, please contact Nathalie Sims or Mathew Witherwick.

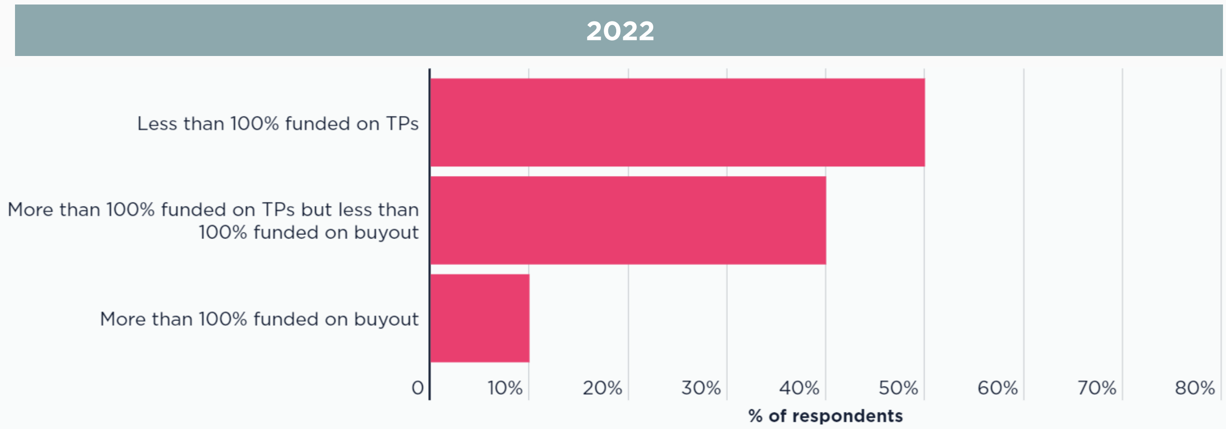
Establish your endgame and timescales

We have already noted that a majority of pension schemes saw their funding position improve over the year to 31 March 2023. In fact, over that period, we've seen a doubling in the proportion of schemes that we estimate are fully funded on a buyout basis (ie funded at a full insurance level). Across the country that's potentially 1000 schemes at the finish line!

However, there remain a material proportion of schemes underwater compared to their technical provisions, let alone insurance measures.

Divergence: half of schemes below water, but double the proportion who have made it to the end





Source: LCP Visualise. TPs is technical provisions.
"Buyout" represents funding to a full insurance level.

Curious?

If you're in the second camp with further to go, it's still important to think about your final destination. This should frame all journey-planning decisions to help you achieve your endgame through the smoothest course.

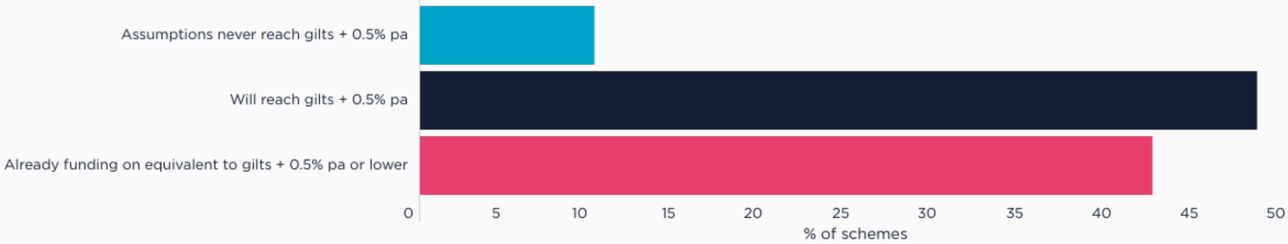
Endgame features

Whatever your chosen endgame, consistent features will apply:

- **Low-risk investment strategy:** most risks hedged and a healthy allocation to corporate bonds – this could sound like a run-off portfolio, but is also exactly the type of portfolio which offers a good hedge for insurer pricing.
- **Data and benefits clear:** insurers will insist on this, but feeling "self-sufficient" from your sponsor means avoiding additional liabilities emerging in future.
- **Full funding on a strong funding target:** gilts+0.5% pa is already a popular choice, and featured in TPR's draft Fast Track regime. This is neatly consistent with the current price to insure pensioner liabilities (albeit such pricing remains volatile).

The chart shows what is reflected in LCP client funding discount rates. 90% expect to reach funding equivalent to gilts +0.5% pa (or stronger), with almost half of these already funded to this level.

Most schemes already fund consistently with endgame features



Source: LCP Visualise

Where schemes are heading

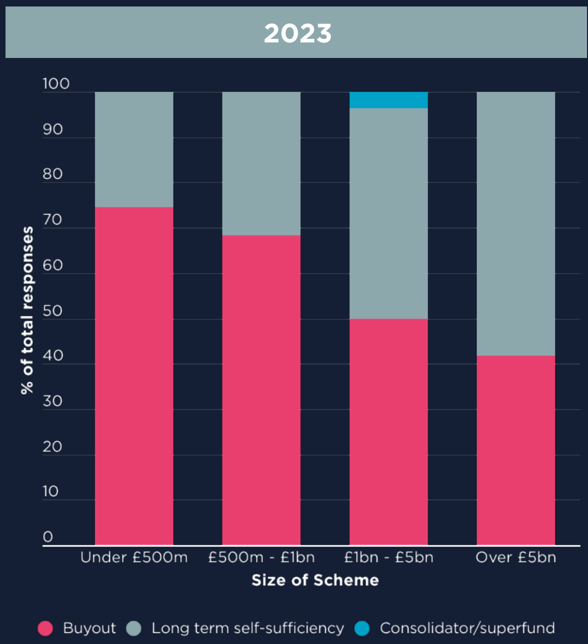
Our survey shows the overall proportion of schemes targeting full insurance has remained consistent over the past year at a little over 60%. This means that potentially 1/3 of schemes targeting buyout are already there – a big proportion.

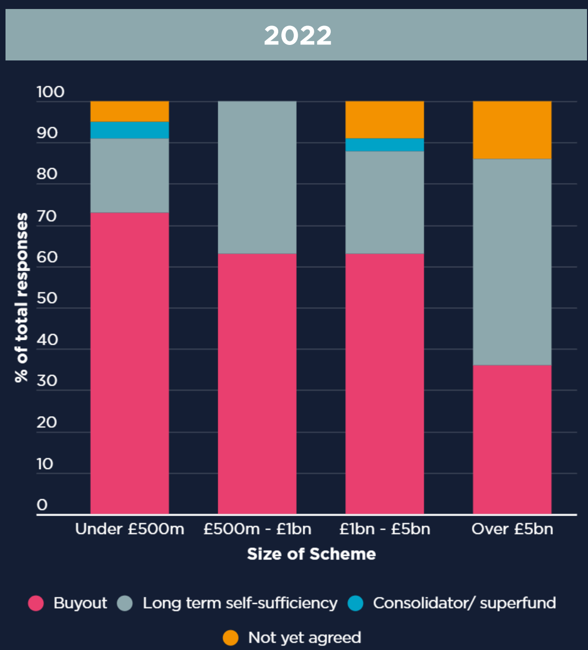
A small number of schemes continue to target alternative solutions such as superfund or capital backed journey plans.

Insurers (and advisors) have continued to show their ability to accommodate multi-billion pound de-risking transactions, supporting an increase in the proportion of schemes over £5bn targeting full insurance.

It remains the case that the trustees of smaller schemes are most likely to target full insurance via streamlined processes whereas long-term via self-sufficiency whereas long-term self-sufficiency is (just about) the preferred endgame for the largest schemes. This is consistent over time and reflects the greater governance budgets and economies of scale available to these larger schemes.

Smaller schemes are more likely to target an endgame of full insurance





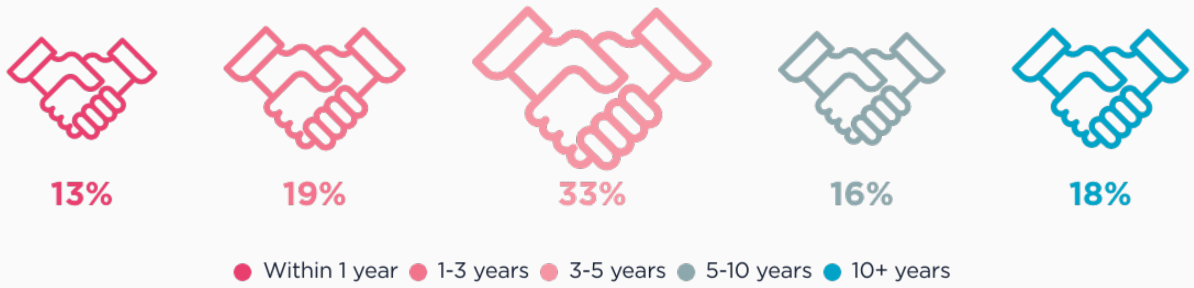
Source: LCP Survey

A race to the finish line?

LCP analysis in late 2022 estimated that the average time to reach full insurance had reduced by over five years, compared to a year earlier, illustrating a dramatic shift in demand. This tallies with our survey: almost two thirds of respondents expect their final transaction to occur within five years.

Surging demand has driven a step change in the de-risking market with insurance transactions on track to hit record volumes of £45bn-£60bn in 2023. Our May 2023 de-risking update analyses market data and trends, describing how schemes can navigate the current market, and our Beat the Triage report provides an insurer perspective and practical hints and tips on how to stand out to insurers.

Almost two thirds of respondents expect the final transaction to occur within five years



Source: LCP Survey

Curious?

If you're targeting full insurance and expect to reach that target within the next few years then it's imperative to commence appropriate, focussed preparations early. The expertise and insurer perspective of an experienced de-risking adviser can help you plan and prioritise your process.

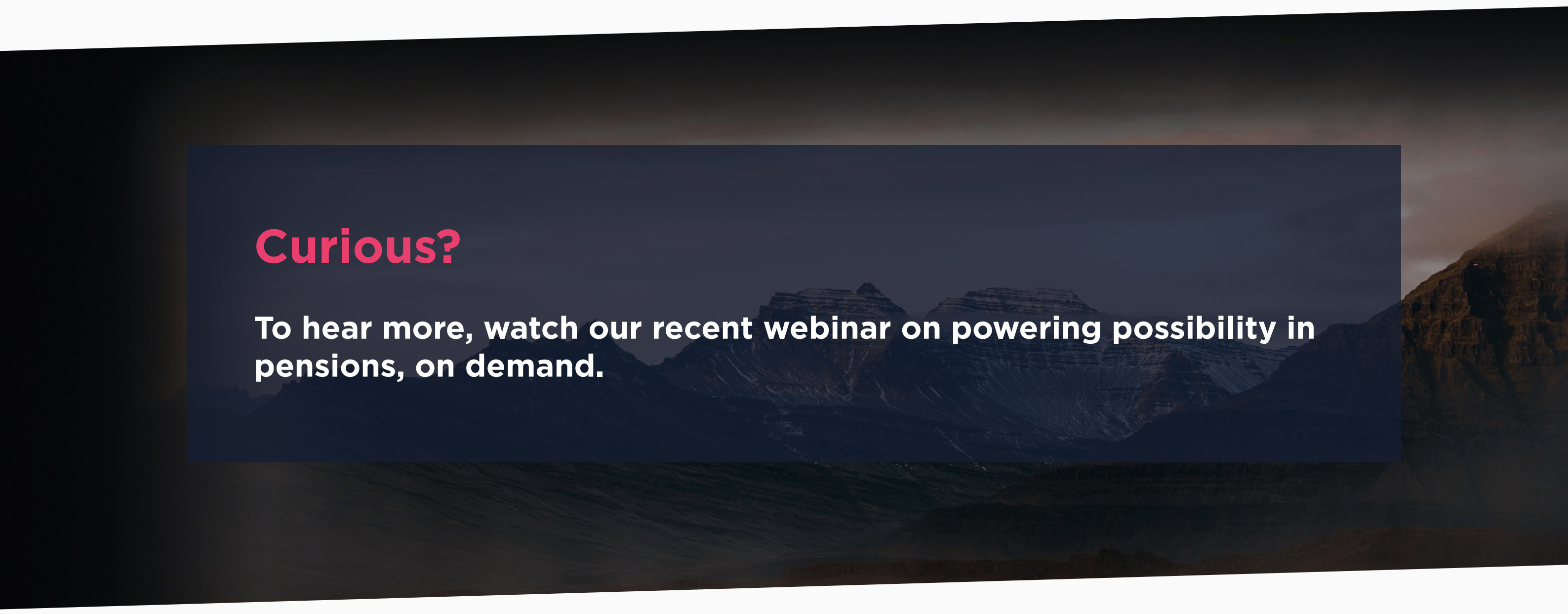
Is there another way?

UK DB schemes have never been better funded, and have never targeted lower investment returns. Yet, at the same time, there is a known need for investment in UK growth – whether to support the economy generally, to aid the transition to net zero, reduce demographic and intergenerational inequality – you get the picture.

This has left many of us in the market exploring alternative approaches that could, in some cases, achieve a “win-win” outcome. Ideas include running schemes on, using surplus to support future pension provision and giving schemes the flexibility to invest in strong, long-term UK growth propositions. This will only be appropriate for schemes with confidence in their sponsor covenant over the long-term, and where structures exist or can be established to divert surplus balances appropriately. But from our perspective it certainly warrants exploring.

What does “future pension provision” mean? It could be defined contribution (DC), or the new kid on the block, collective defined contribution (CDC) – either provide the runway needed to think appropriately long-term without additional strain on the sponsor.

At the other end of the spectrum, the PPF is thinking hard about conditions of entry and the level of benefits they can underpin. We see a consistency in all of these ideas: a questioning of status quo and willingness to explore new alternatives.



Curious?

To hear more, watch our recent webinar on powering possibility in pensions, on demand.

Analyse what could change your journey

A new regime

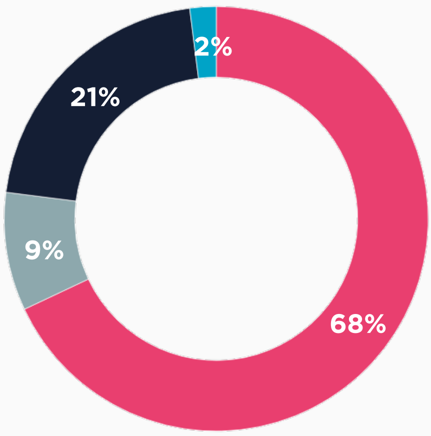
Pensions wouldn't be the industry it is without regulatory change, and it's certainly an important factor when planning your journey. Amongst the many regulatory developments we eagerly await, two are universally relevant as you design, implement and refine your journey plan. We already covered the General Code; the other, of course, is TPR's new funding code.

The implementation of the code itself, as noted, has been delayed to 2024, but following consultations over the last 12 months from DWP on the regulations and TPR on the code itself, we have a good idea of what the new regime is going to look like. It's well worth considering how TPR thinks about journey planning and what this means for your own plans.

Although for many schemes the new Code is unlikely to necessitate a significant change in approach or extra work, this is certainly not the case for everyone.

Covenant is a particular area where many schemes will need to go into more detail than before, and get to grips with some key new concepts (which we've explained below).

One third of schemes will need to enhance their approach to covenant assessment



- Covenant work is already sufficent
- We will ask for more information from the sponsor but do the assessment ourselves
- We will increase the level of detail requested from of our covenant adviser
- We will take independent covenant advice for the first time

Source: LCP Survey

Our survey results backed this up – more than 30% expect to increase the scope of their review or request more information, with some appointing an independent covenant adviser for the first time. When new covenant guidance is released (expected in September), we may see this number rise further.

Covenant is of course not the only focus in TPR's new funding code. We know to expect a renewed focus on investment risk, in particular the link to covenant.

Covenant assessment is evolving

We expect an evolution of TPR's current 4-point ratings scale into a more detailed framework under the new code, meaning trustees will need a more granular understanding of covenant dynamics. Forward-looking assessments will be required, 'focusing on an sponsor's prospects' and quantifying timeframes relating to covenant "reliability" and "longevity" periods, as well as what level of contributions are "reasonably affordable". These new concepts are similar to the way we already think about covenant.

At a glance: key covenant concepts

Reasonable affordability

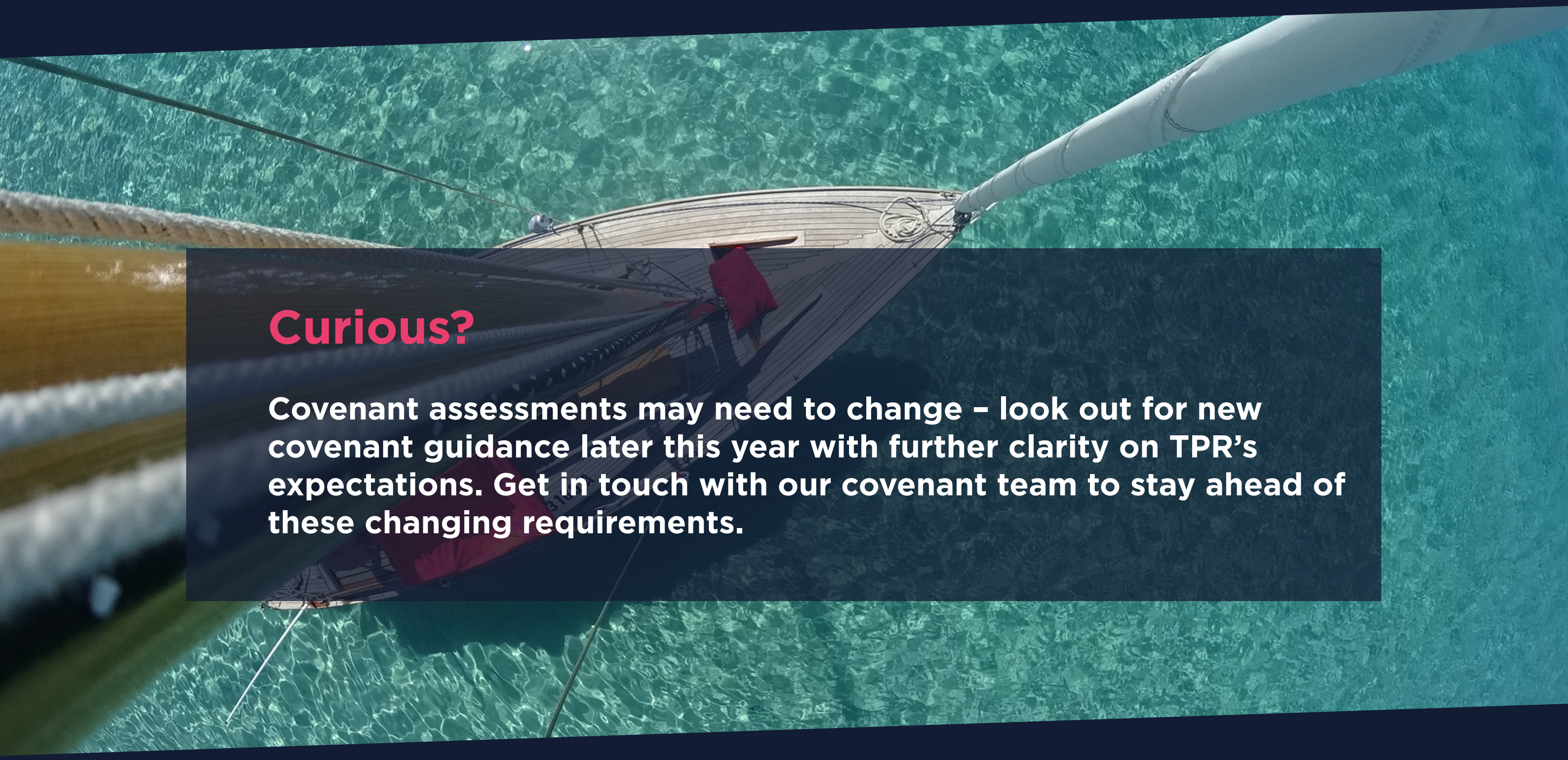
Allows for use of cash by the business (investment vs shareholders vs scheme and other creditors) and should directly influence the recovery plan. Schemes need to be fully funded "as soon as is reasonably affordable", so trustees will need their sponsor's financial forecasts to understand the dynamics over the "covenant visibility" period.

Covenant reliability

The period with reasonable certainty about the level of cash generated: one of the most critical aspects to grasp, as it will determine how long a scheme can run greater levels of investment risk and the maximum length of the time over which the sponsor must repair any deficit.

Covenant longevity

The timeframe over which the sponsor is reasonably expected to continue to exist. Influenced by sector outlook, competitive position, strategy and diversification, financial resilience and longer term risks (including climate – more below). Under the new code, schemes will need to be fully funded on a low dependency basis at the earlier of their covenant longevity or significant maturity dates.



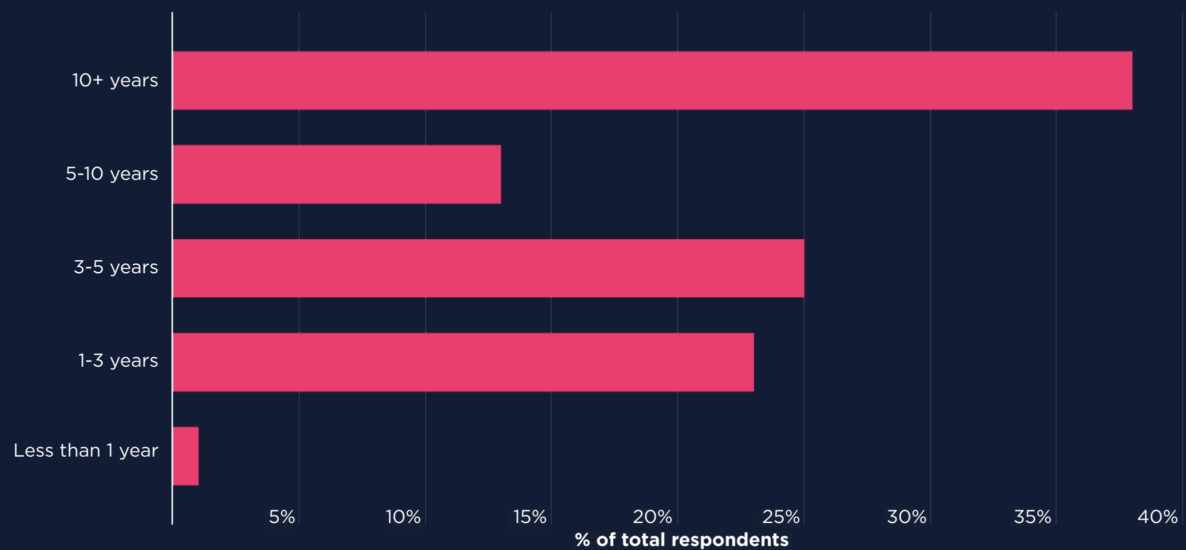
Curious?

Covenant assessments may need to change – look out for new covenant guidance later this year with further clarity on TPR's expectations. Get in touch with our covenant team to stay ahead of these changing requirements.

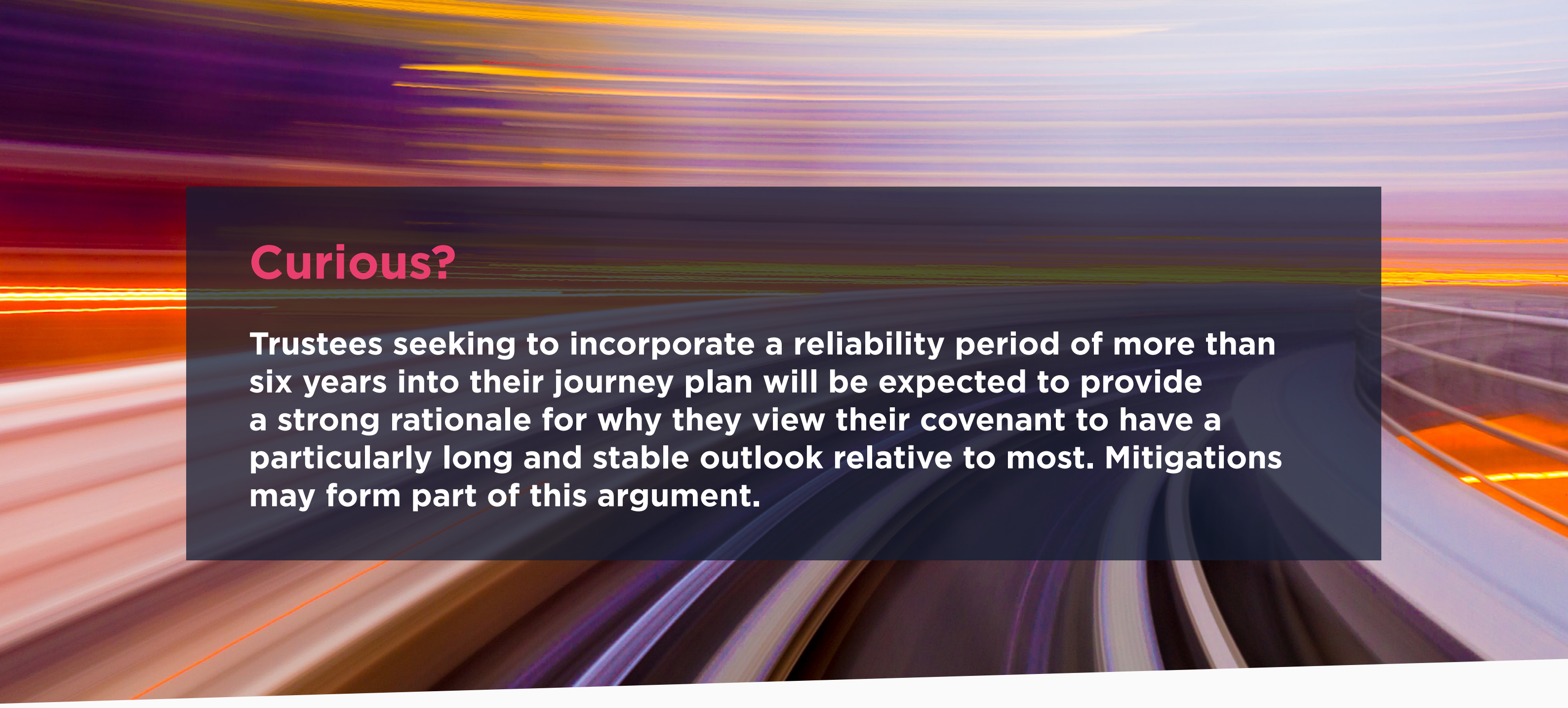
Covenant reliability – dividing views

50% of survey respondents considered their covenant to be reliable for more than five years, of which a majority felt confident for more than 10 years. We understand TPR expects most covenant reliability periods will be no more than 6 years due to the relatively high degree of uncertainty and risk for many businesses. In contrast, the other half of schemes saw near-term risks, with a quarter seeing less than three years ahead.

Half of respondents are not confident in their covenant for more than 5 years



Source: LCP Survey



Curious?

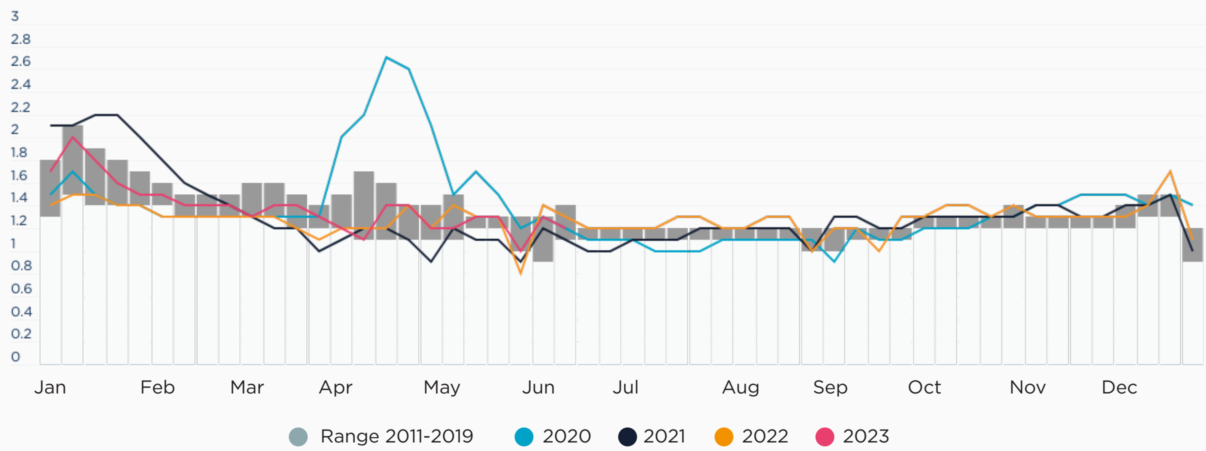
Trustees seeking to incorporate a reliability period of more than six years into their journey plan will be expected to provide a strong rationale for why they view their covenant to have a particularly long and stable outlook relative to most. Mitigations may form part of this argument.

How long members will live

In our recent longevity report we described a new era for longevity risk, requiring fresh thinking.

For many schemes, especially those further through their investment de-risking journey, longevity risk is a large and increasing part of their risk profile. It therefore deserves attention in the carefully planned final stages of the route.

Weekly age standardised mortality rate in England & Wales

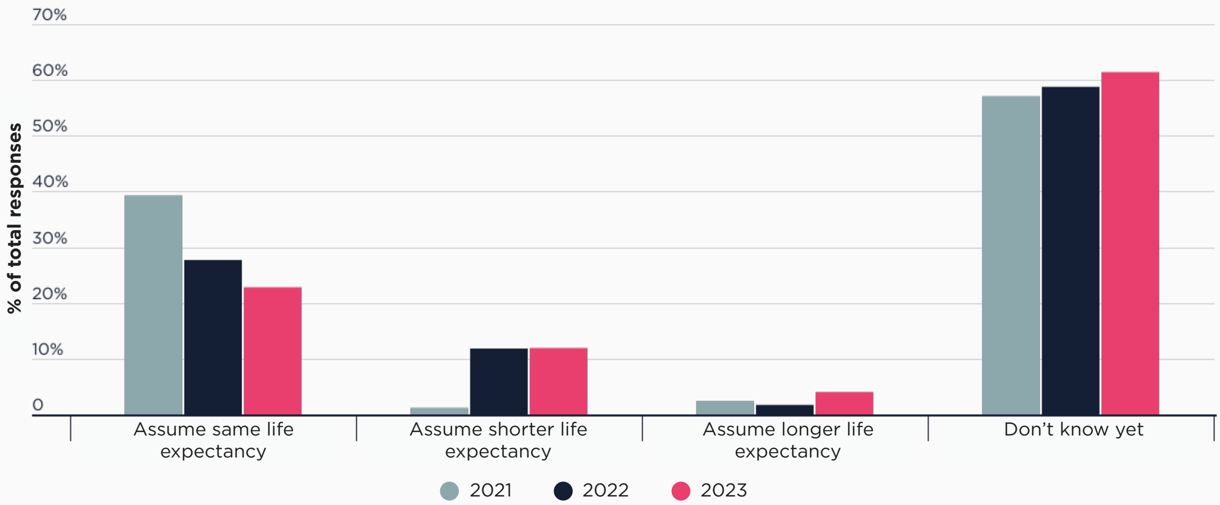


Source: LCP Longevity Report 2023 updated

The chart (updated from our longevity report) confirms continued heavy mortality rates. Why? Key drivers include ambulance waiting times, A&E admission times, health of our care workers and rates of missed diagnosis for certain conditions, plus of course severity of flu and Covid-19.

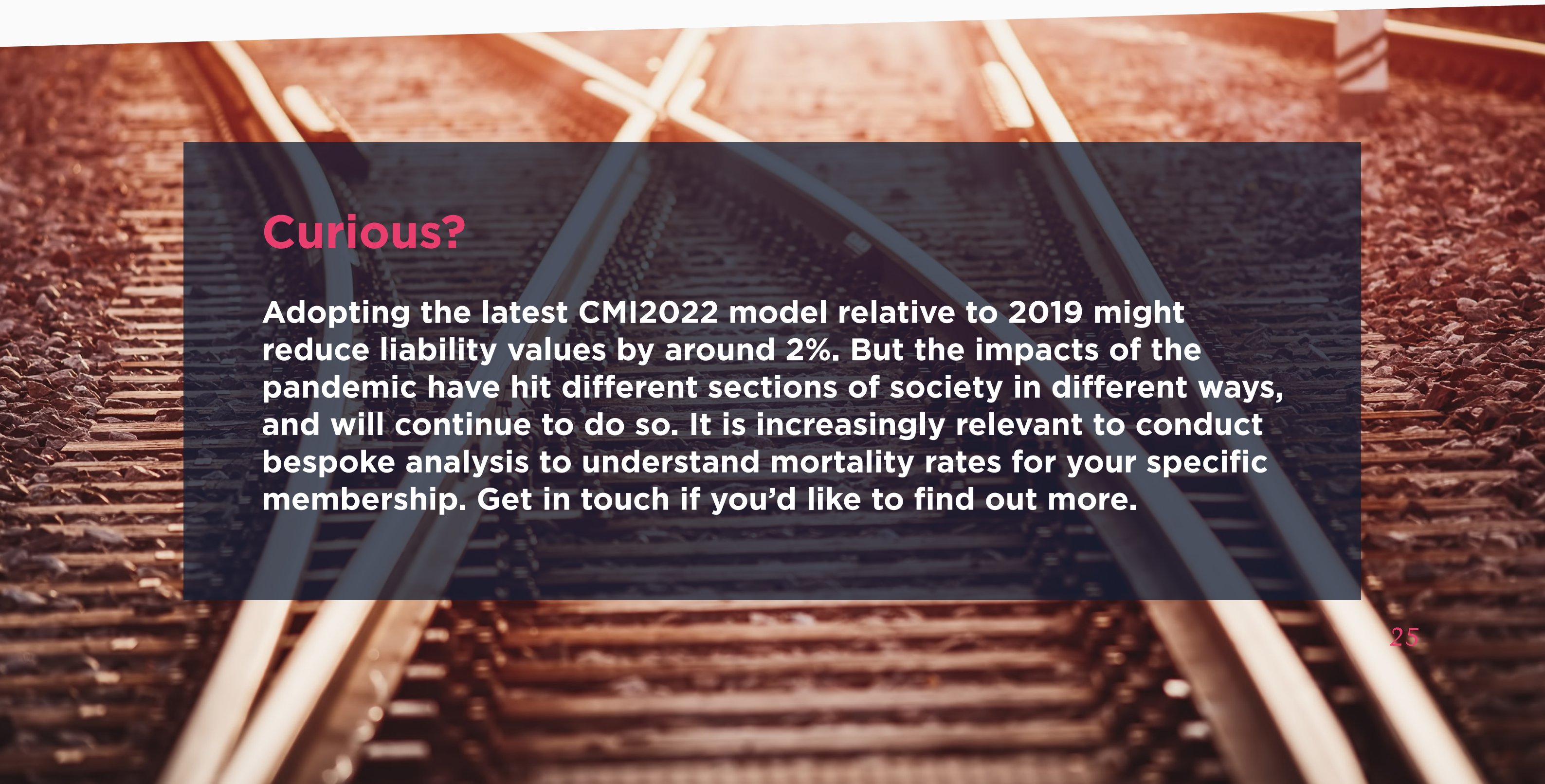
Our last three surveys have shown an increasing move to action from pension schemes, with more respondents assuming changes to life expectancy. But those assumptions aren't all in the same direction.

30% of respondents assume members will live for less time, but almost 60% are yet to reflect any change



Source: LCP Survey

At what point does anomalous data become a trend? For many of our clients, 2022 experience was the last straw. As valuations are completed in the coming 12 months with "post pandemic" data available, we'd expect the number making adjustments to life expectancy assumptions to rise further.



Curious?

Adopting the latest CMI2022 model relative to 2019 might reduce liability values by around 2%. But the impacts of the pandemic have hit different sections of society in different ways, and will continue to do so. It is increasingly relevant to conduct bespoke analysis to understand mortality rates for your specific membership. Get in touch if you'd like to find out more.

Journey planning through a climate lens

Of respondents have not yet considered whether to set a net zero target

Of respondents think a net zero target is not relevant for them

Source: LCP Survey

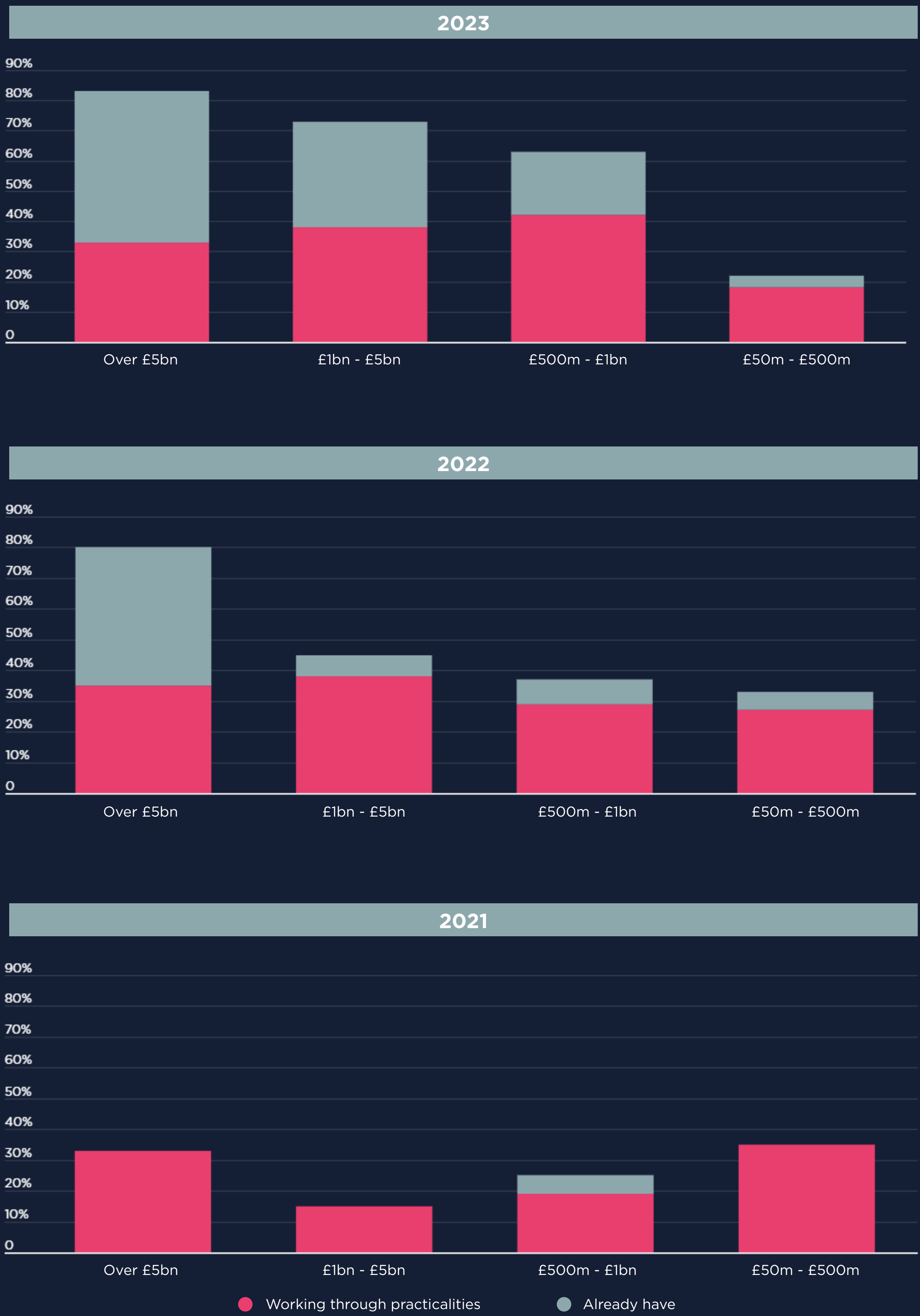
Climate change poses a serious risk to pension schemes both in the short and long-term, with the potential to affect all aspects of society. Actions committed globally remain far from what is required to limit warming to levels targeted in the Paris Agreement. But what can schemes do?

The key lever remains investment strategy and investment manager arrangements. Setting a net zero ambition, or going further and setting a formal target, demonstrates a pension scheme's commitment to mitigating climate risk. This is consistent with our own commitment to supporting change via the Net Zero Investment Consultants Initiative.

Unsurprisingly, the largest schemes have led the charge. Those with assets between £1bn and £5bn (wave two for TCFD) have surged forward over the last year, but it is encouraging to see the increase for schemes between £500m and £1bn, where no formal requirements yet apply. We also see progress from those considering to committing over time. Making a commitment is just the first step: much work remains in the coming years to ensure these targets are met.

However, some 19% of respondents have not yet considered whether to set a net zero target, and another 30% think it's not relevant for them. Smaller proportions than last year, but still a long way to go.

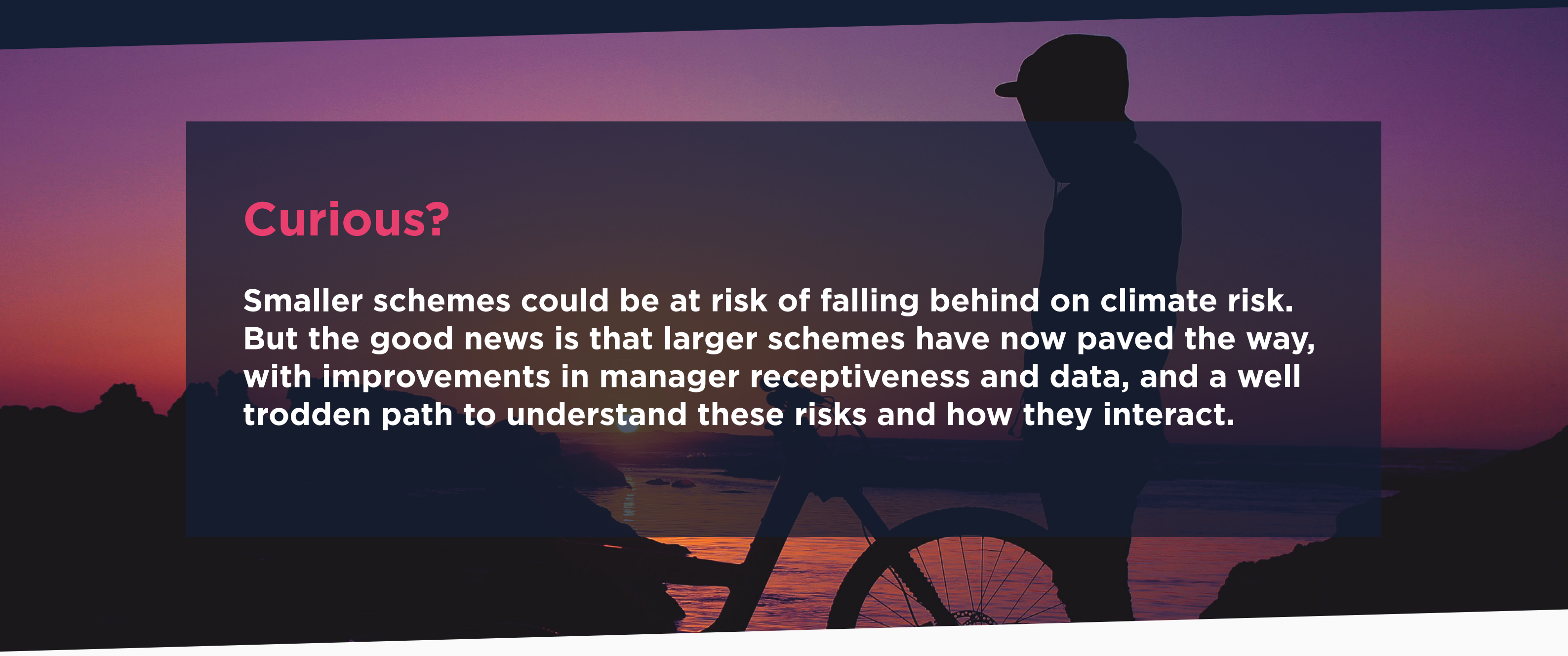
Strong increase in commitments from medium sized schemes, with the largest having already made good progress



Source: LCP Survey

From a journey-planning perspective, your sponsor's exposure to climate risk should shape the path you intend to take. In other words, using the covenant terminology we described above, climate change could impact covenant reliability, longevity and reasonable affordability.

It can be difficult to know where to start when exploring the climate risks and opportunities relevant for your sponsor, even more so when you need to incorporate these factors into a covenant assessment and ultimately pension scheme's journey plan. That's why we've launched LCP Beacon to tackle this challenge. It is an intuitive tool designed to help pension scheme stakeholders understand and engage with climate risks and opportunities, providing clear actions that are tailored to their circumstances.



Curious?

Smaller schemes could be at risk of falling behind on climate risk. But the good news is that larger schemes have now paved the way, with improvements in manager receptiveness and data, and a well trodden path to understand these risks and how they interact.

Taking a step back

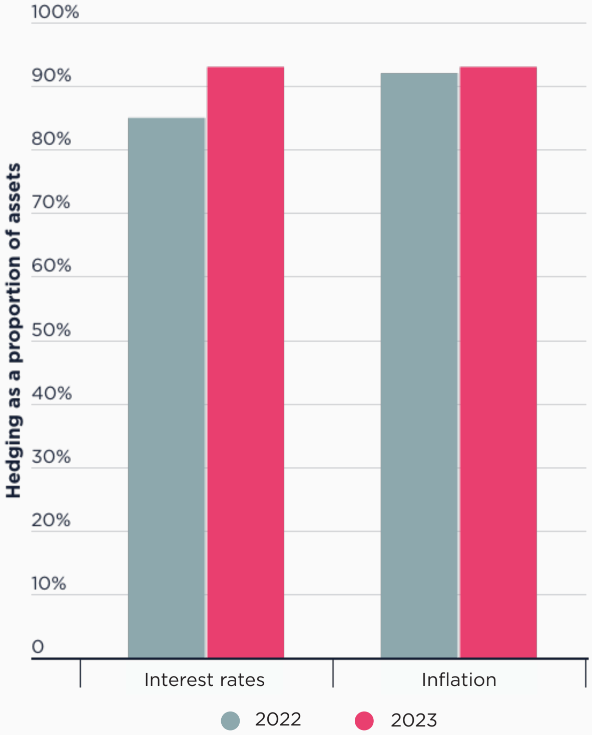
What happens in the real world impacts financial markets, and what happens in the financial sector impacts the real world – we do not operate in a vacuum. Therefore, all investors should be conscious of the impact of their underlying holdings on the real world – planet and people – as well as the profits from their portfolio. Our responsible investment philosophy describes what this means to us, and what our clients should expect as a result.

Refine the steps you plan to take to reach your goals

A well oiled machine

Our survey showed that the most common actions over the last year related to reviewing investment strategy. Of course this wasn't always by choice, with high inflation and a gilts crisis on our hands. The LDI market in particular is a fundamentally different beast than it was a year ago, and this has knock on impacts for investment strategy.

As a proportion of assets, interest rate hedging significantly increased, whilst inflation hedging remained stable



Source: LCP Visualise

Curious?

Our latest Strategic Portfolio demonstrates how we pull everything together into an efficient asset portfolio. Reflecting schemes at different positions, we include both high and lower return strategies.

Liability hedging

Locking in gains made via higher yields, the average level of interest rate hedging increased significantly over the year. It remains below 100% of assets, but may represent full hedging compared to liabilities, given many schemes are in surplus. Given inflation volatility, it is somewhat surprising those hedge levels haven't changed more. This could be reflective of schemes monitoring hedging levels more closely given everything that's been going on.

A new market norm for leverage

TPR, the Bank of England and the FCA all jumped to attention following the gilts crisis, each issuing guidance of their own, though with a broadly consistent message. The headline is lower leverage (and a change in language to focus on “yield headroom” – the level yields could increase before issues faced). We looked at where our clients sit today.

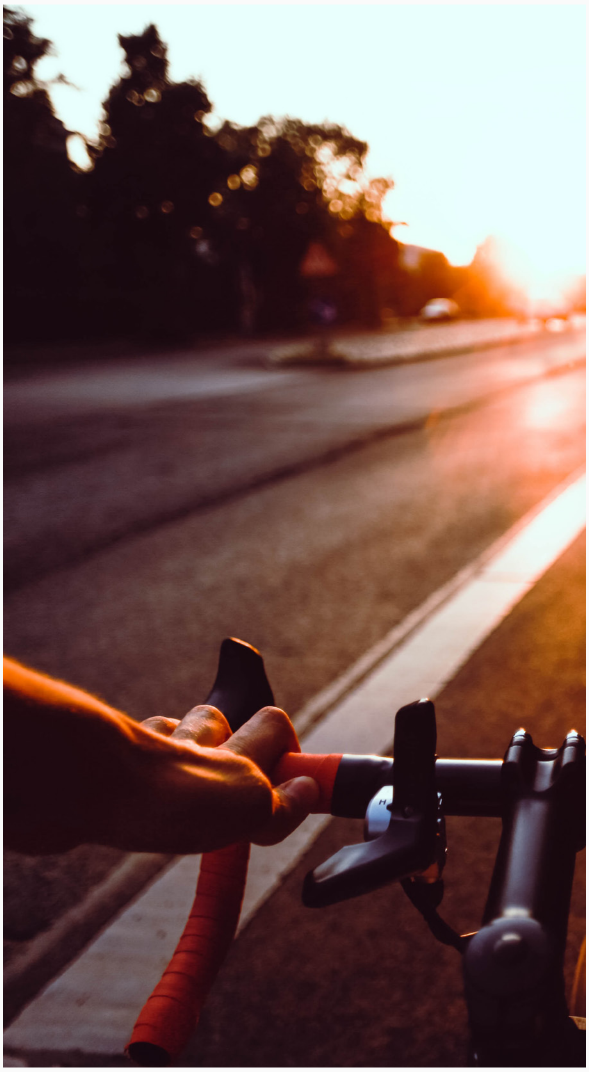
72%

of schemes had leverage between 1 and 2 times. This compares to historic levels of 3-4x in pooled LDI funds (though our clients usually held cash alongside these funds, which is also reflected in our calculations).

10%

of schemes no longer (or never did) use leverage to achieve liability hedging. With increased funding levels this is much easier to achieve, on average, than it has been in the past.

Source: LCP Visualise, as at 31 March 2023



Curious?

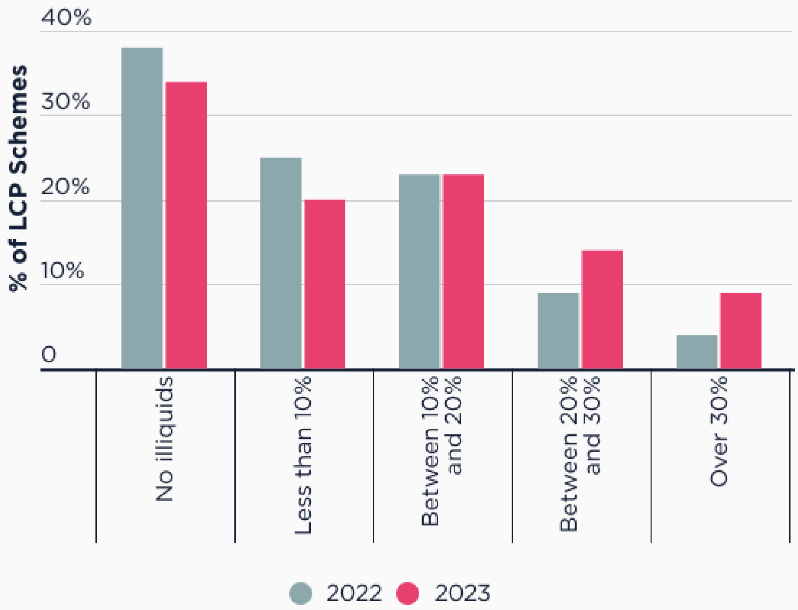
If you don’t need to use leverage, we advocate removing complexity and operational risk within your investment strategy. If you don’t have that luxury, there are still things you can do: revisit your collateral assets and ensure they are readily available for the LDI manager. In some cases this could include holding collateral assets with the same investment manager, or within the same fund structure if this option is available to you. Think about whether other asset exposures could be accessed in a different way, eg using derivatives, so that collateral can be increased, and shared between different positions.

The illiquidity bind

In a world of smaller numbers, allocations to illiquid assets have shot up. On average, schemes now hold over 10% in illiquid assets. We have also seen an increase in the proportion of schemes with more than 30% in these holdings.

Couple this with schemes hitting full buyout funding, and the market has had to respond. Pension schemes looking to reduce allocations need to work out how much of a discount on price they can afford to give up, and whether that is available in the market. Who's on the other side? Schemes with a long-term timeframe and more flexibility, tactical investors and some insurance companies are finding attractive opportunities in this market.

Around 10% of schemes have more than 30% allocated to illiquid asset classes



Source: LCP Visualise

Curious?

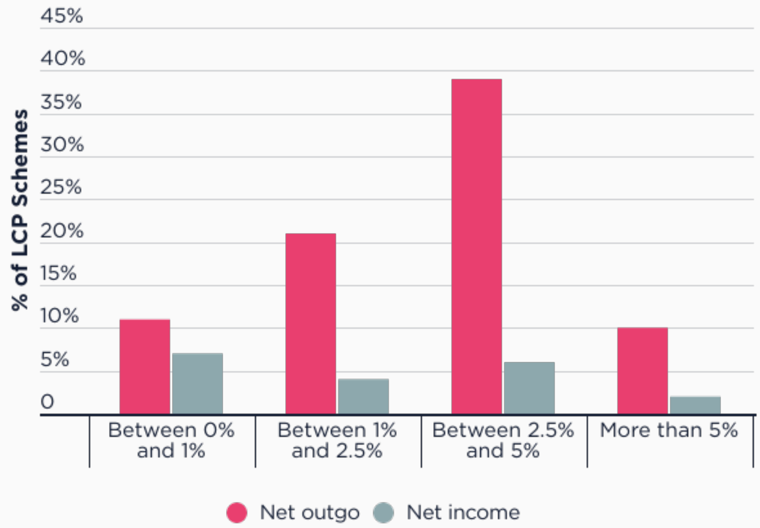
If you need to reduce your illiquid allocation but don't know where to start, speak to our Illiquid Assets Solution Group who have developed extensive experience in this area via large de-risking transactions for schemes that started with significant illiquid holdings.

Paying member benefits

As the DB landscape continues to mature, and higher average funding levels mean less contributions are required, more schemes have moved into a net cash outflow position. The number of schemes paying out more than 5% of assets in the next year (before investment income) doubled over the last year.

Combined with the increase in illiquid holdings, trustees should think carefully about how these payments will be met. Income-heavy portfolios tend to be more resilient to market conditions, giving you peace of mind that member benefits can continue to be paid.

80% of schemes are now net cashflow negative



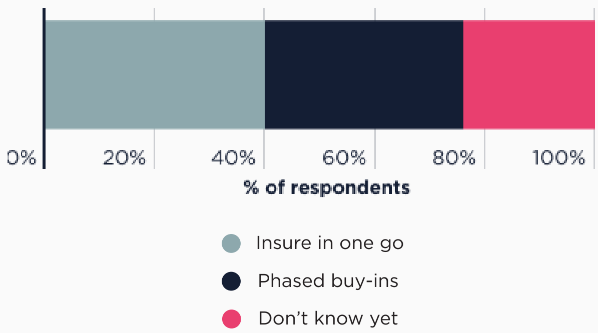
Source: LCP Visualise

Securing member benefits: what the journey looks like

If insurance is your end game, you need to decide whether to transact in one go or phase your approach – either route has pros and cons. Our survey showed, of those targeting an insurance endgame, for the 75% who had decided on their approach, the decision is currently broadly split.

We suspect a single transaction will become more common given the new LDI regime, with lower leverage meaning less scope to secure a portion of benefits, leaving the remaining assets to work harder. Improved funding levels and insurers' ability to write large, single transactions also supports this.

Schemes are split on their approach to securing benefits



Source: LCP Survey

The importance of data

No matter your target endgame, having good quality data and a clear understanding of your scheme's benefits is of paramount importance.

In a competitive de-risking market we are already seeing insurers triaging schemes based on their level of preparedness in this area, and we've been helping our clients to get 'transaction ready' ahead of approaching the market.

Curious?

Aside from ensuring that members are paid what is due to them, this work enables you to capture opportunities as they arise and limit the risk of future liabilities coming out of the woodwork at a later stage. Not to mention being very helpful in work towards GMP equalisation and Pensions Dashboards!

The member journey

In last year's report we described the win-win-win nature of a good member options strategy: potentially reducing journey-plan timescales, reducing costs and adding real value for members themselves.

DB schemes continue to mature, but our data shows that the vast majority still have a good number of non-pensioner members.

In the midst of a cost of living crisis, it is more important than ever to ensure that members have access to suitable options at retirement, including clear communications so that they understand what flexibility they have.

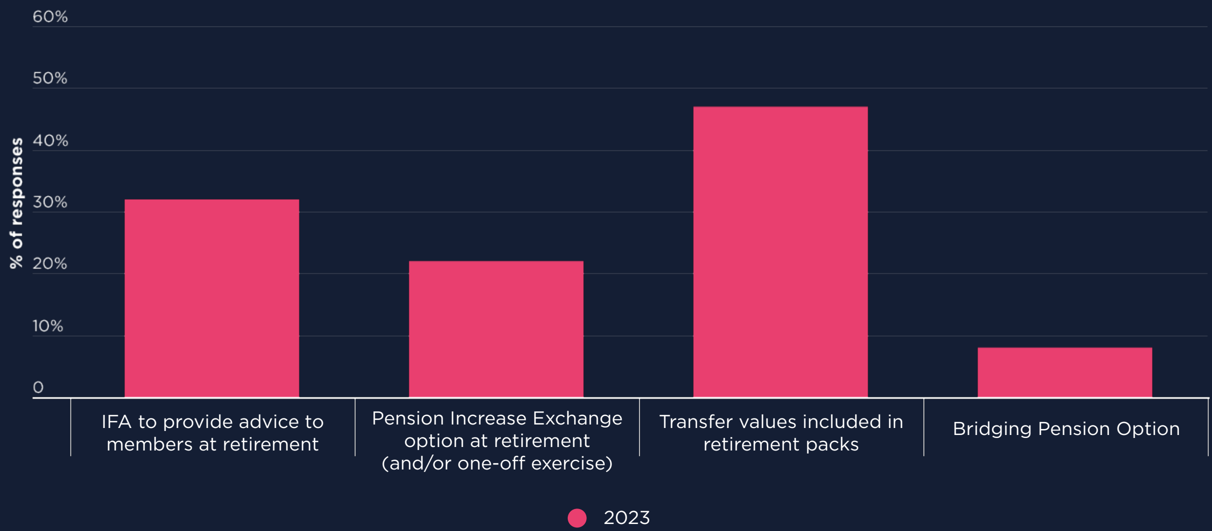
Source: LCP Visualise

Limited progress on options provided

Few new options have been introduced to members over the year, according to our survey. With the LDI crisis many trustees priorities have been elsewhere but we are now seeing considerations of the member journey return to the agenda. Further details of these options can be found here.

Separately, transfer values have fallen in value significantly due to the increase in gilt yields, driving the lowest take-up rate of quotations across our clients since the freedoms were introduced. Working through the GMP equalisation process can also present an opportune time to get your data in order more generally which, as we explain elsewhere in this report, can play a vital role in your strategic journey.

Transfer values in retirement packs remain the most popular option to offer members



Source: LCP Survey

Discretionary increases - a rare sight

Our survey also indicated that in the past year less than 5% of schemes have awarded a discretionary pension increase. In the face of high inflation and better average funding levels, this may seem surprising. But we know sponsors continue to be concerned about consistent treatment with DC members and/or salaried employees who may be getting even less than a capped pension increase – not to mention additional future costs, and the risks of setting a precedent.

GMP equalisation

More than 80% of survey respondents have started on their GMP equalisation journey but fewer than 5% have finished. This reflects just how large a task it is. In a recent update, LCP's Alasdair Mayes expands on the results of our survey questions in this area – including how far schemes are on their GMP equalisation journey, and what method they have chosen.

Steer your journey dynamically and in a joined-up way

Support to deal with uncertainty

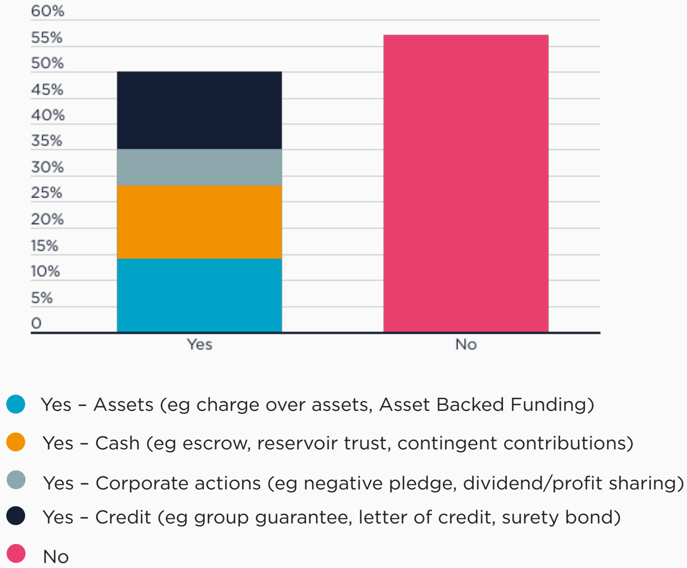
Contingent funding solutions remain commonplace

Contingent funding mechanisms enhance member benefit security by strengthening the covenant (access to additional support via a guarantee) or providing security over assets that would flow to the scheme if certain triggers are met. These solutions can reduce the level of cash contributions that are required while boosting the certainty of reaching the journey plan target.

Our survey showed that almost half of respondents have contingent assets in place, some utilising more than one type. The new funding Code, with stricter covenant assessment criteria, may lead to an increase in contingent asset solutions, where this is the only way of supporting the desired journey plan.

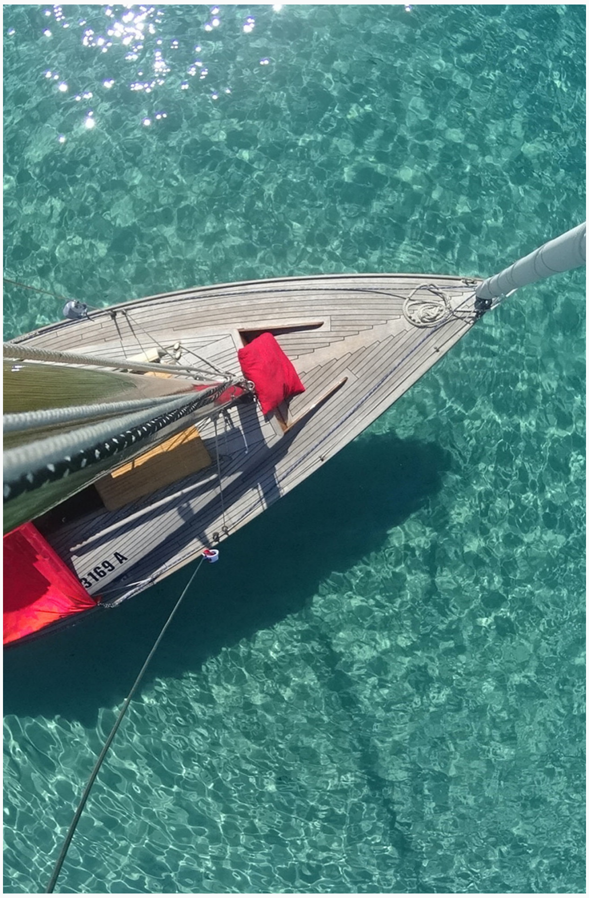
But a word of caution: the Code may also increase scrutiny on existing contingent assets and the incremental covenant value that they provide – particularly in relation to group guarantees.

A wide range of contingent solutions are used by schemes



Source: LCP Survey.

Some respondents had more than one contingent solution in place.



Surplus – a new concept for many!

As we've already shown, many schemes are approaching or in a position of surplus, particularly on an ongoing funding basis. Sponsors are likely to look to reduce or remove cash contributions into schemes, but combining this with contingent asset support can help to protect member benefits whilst protecting the sponsor against over-funding risk.

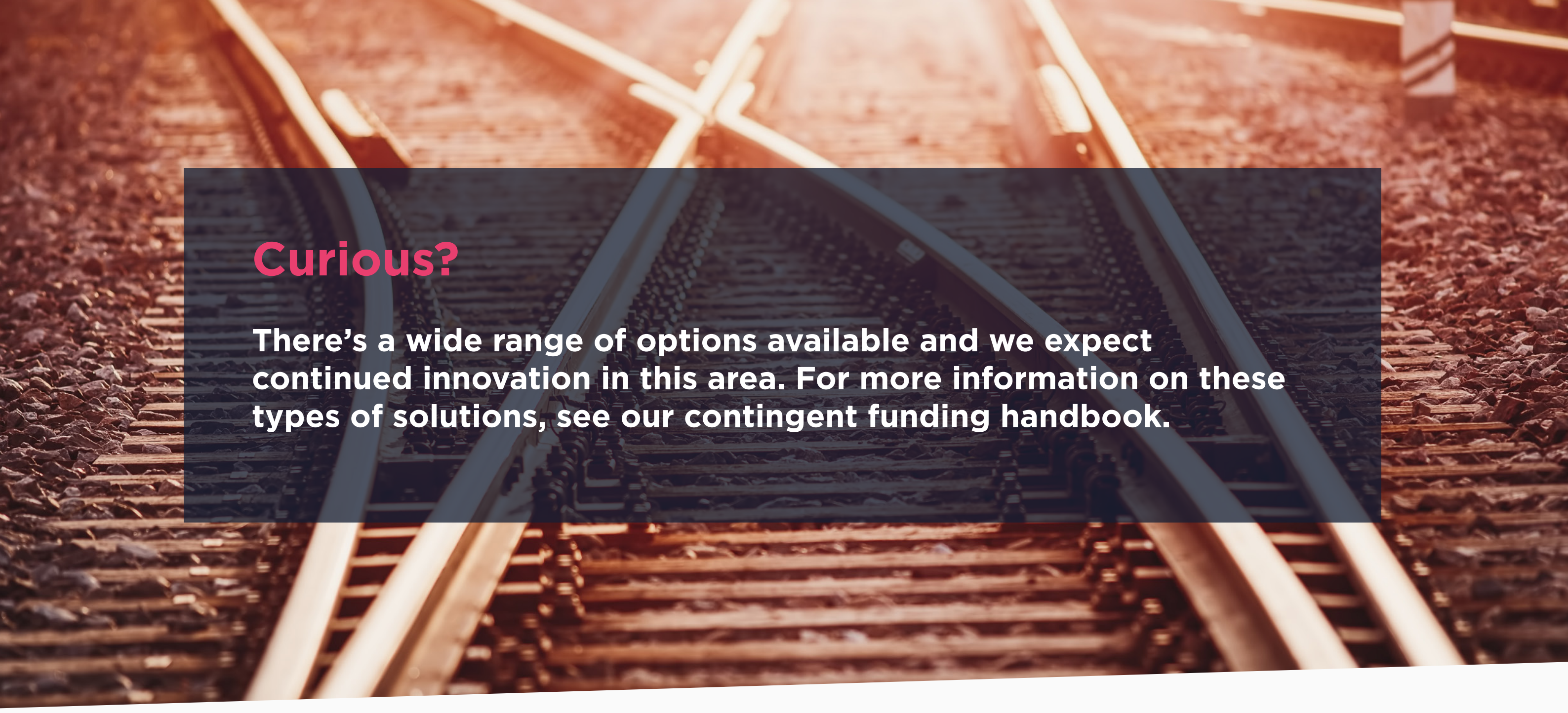
For those on the full insurance route, there is the question of whether surplus should be returned to the sponsor (once all benefits are secured, and less a hefty tax hit), or if some should go to the members in the form of additional benefits.

But of course some intend to run the scheme on for longer. Contingent assets play a role here too, given reliance on sponsor covenant long past the period of covenant certainty.

What does this mean for contingent solutions?

Simple escrow approaches are increasing in popularity, as well as bespoke flavours of escrow that deliver better tax, investment and accounting outcomes. Innovation in this area also includes escrow-style vehicles that allow meaningful investment returns, including a new "off the shelf" trust-based vehicle. This may be more appropriate for those further from their endgame.

The other key development is that, due to the rise in surpluses, some pre-existing contingent funding approaches are being wound down. The Regulator issued brief guidance to trustees on this in its 2023 Annual Funding Statement.



Curious?

There's a wide range of options available and we expect continued innovation in this area. For more information on these types of solutions, see our contingent funding handbook.

Building a dynamic approach into the system

Asset led discounting – poised to become more popular?

We've seen increased interest recently in "Asset Led Discounting" – also called "dynamic discounting" – where a scheme's discount rate is tied more closely to the expected return on the investments held now and in the future. This is in contrast to the approach most schemes currently use, which is to have a discount rate set at a fixed margin above gilts.

For schemes targeting running off over a longer time period, this "asset led" approach makes a lot of sense:

- Leads to more stable funding positions by reducing artificial volatility driven by the gilts+ approach;
- Reduces the risk of sub-optimal investment decisions (eg over-hedging, inefficient allocations to collateral);
- Enables greater focus on true investment risks, rather than just movements versus gilt yields.

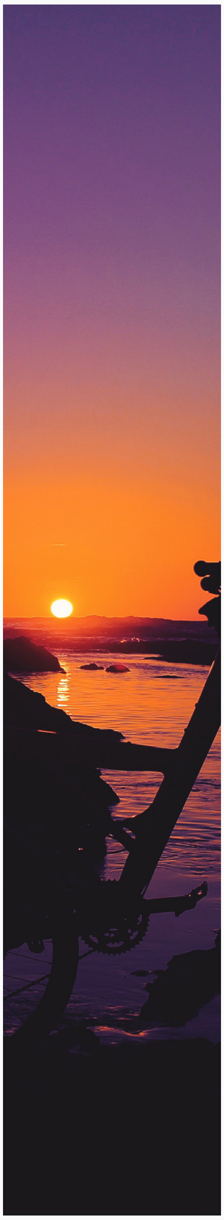
We've helped a number of schemes put in place this kind of approach already. It was also specifically mentioned in the draft new funding code, so we wouldn't be surprised to see it gaining more popularity over time, especially if alternative end games gain traction.

Curious?

Get in touch if you'd like to explore whether asset-led discounting could be a creative option for you, and how you should think about funding and covenant via this route.

Bringing it all together

If you're near the end of your journey...



1. Get the right governance structure in place

If you're heading down the insurance route, set up a strategic sub committee and work with a specialist adviser to demonstrate you're prepared, to increase insurer engagement in a very busy market. Data can be a particularly vital element of this preparatory work.

2. Establish your endgame and timescales

Make sure you're conscious about your chosen endgame. Consider the full range of options, including newer ideas, and that your chosen route is in the best interest for members.

3. Analyse what could change your journey

In many cases when you've materially de-risked, longevity risk becomes more dominant. Ensure you understand the latest trends and the impact this could have on your position.

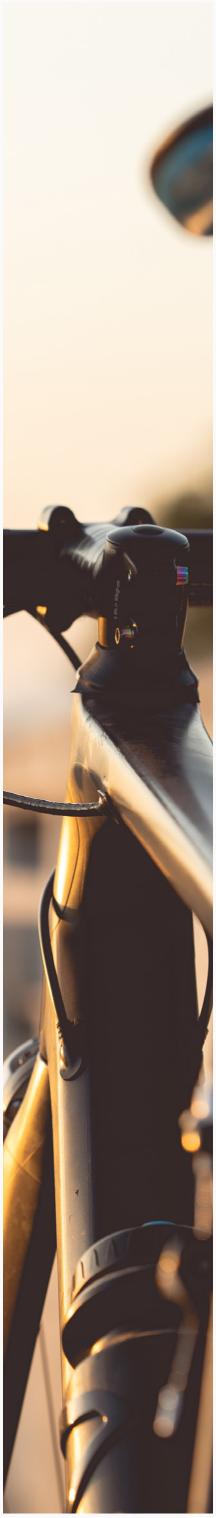
4. Refine the steps you plan to take to reach your goals

If your timeframe is short, flexibility of your investment strategy is key. Get to grips with the liquidity profile of your assets, and engage specialist help reducing illiquids if this could hold back progress.

5. Steer your journey dynamically and in a joined-up way

Understanding how your key metrics are moving and making swift decisions is even more important in the latter stages of the journey – tools like LCP Advance can help you see key metrics all in one place.

If you're **further from** the finish...



1. Get the right governance structure in place

Use the General Code as a prompt to review your governance approach. Consider whether you're up to scratch on diversity, equity and inclusion, and whether a professional trustee could help.

2. Establish your endgame and timescales

Keep your endgame in mind for all strategic decision making and ensure you have reflected these long-term plans in your funding approach, as is expected by TPR.

3. Analyse what could change your journey

Covenant may be your biggest risk: embrace the new concepts of visibility and reliability. Remember to incorporate factors such as longevity and climate change into overall risk assessment.

4. Refine the steps you plan to take to reach your goals

The investment landscape has changed since the LDI crisis. Think about what this means for your strategy and longer-term path, using LCP's strategic portfolio for inspiration on how to bring it all together.

5. Steer your journey dynamically and in a joined-up way

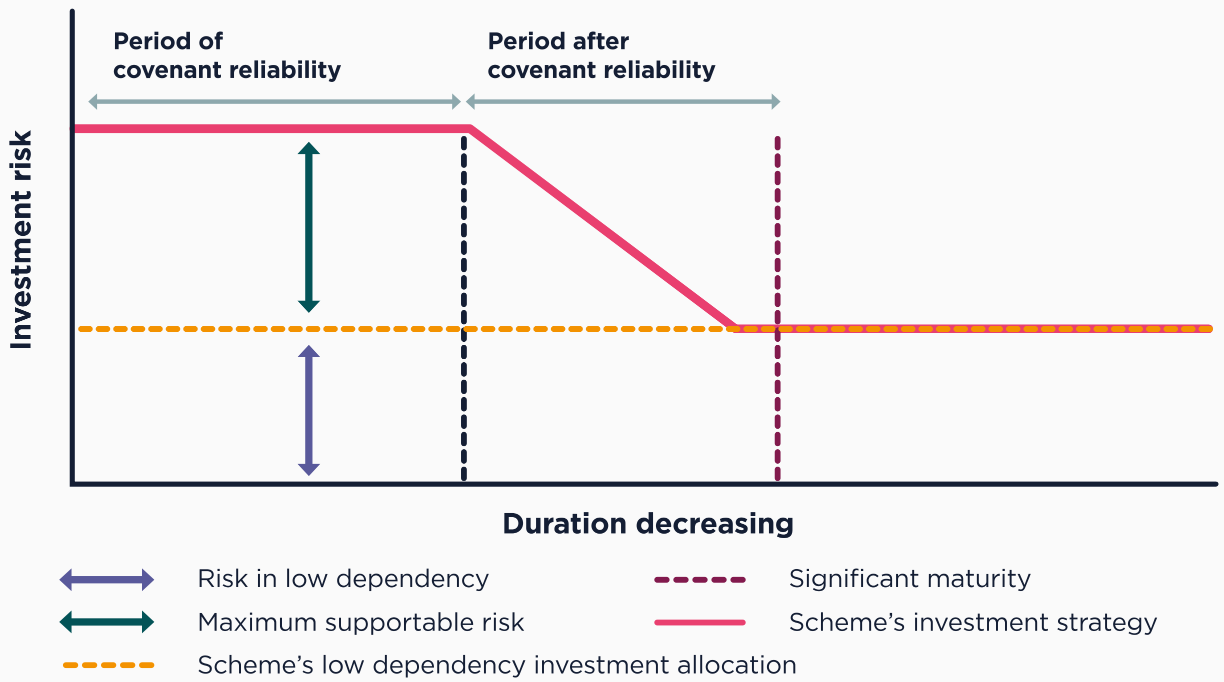
A longer journey has longer exposure to key risks including sponsor covenant and climate change. Put in place actionable contingency plans with mitigations to get you back on track if you get blown off course.

A strategic journey: the Regulator's perspective

The launch of TPR's new funding code has now been pushed back to 2024, but they have already been clear about their views on journey planning.

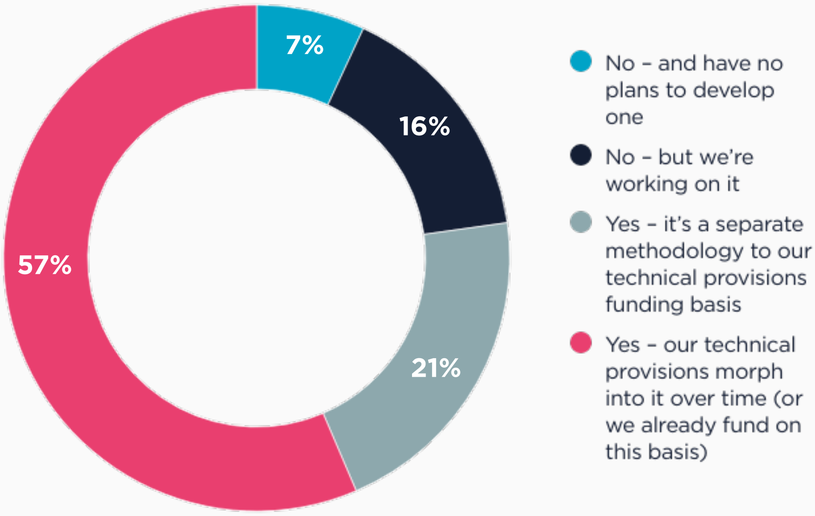
The diagram below, with our annotations, covers some of the highlights. We were pleased to see that TPR's thinking closely ties in with what we have seen as good practice for many years – in fact it maps seamlessly to the LCP GEARS framework! Higher funding levels may mean schemes find these requirements less onerous than had been expected. Of course not all schemes are in this fortunate position, and those who have moved backwards in their journey may need to think hard about the concepts on this page.

TPR expects strategic journey plans to be driven by covenant and to explicitly reflect longer-term objectives



Most schemes have at least taken the first steps to comply, with over 70% already having a long-term low dependency target: the majority of those already set their technical provisions consistently.

Half of schemes already appear to comply with TPR's expectations on long-term funding basis.



Curious?

For the 30% without a long-term low-dependency target in place, our framework will help you move through the required steps in a practical way, prioritising actions as relevant.

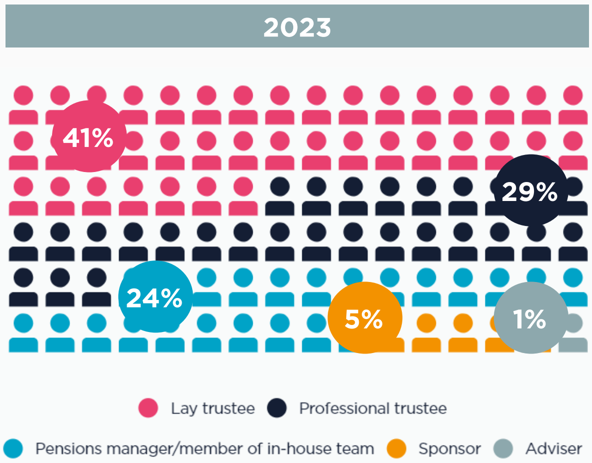
Curious?

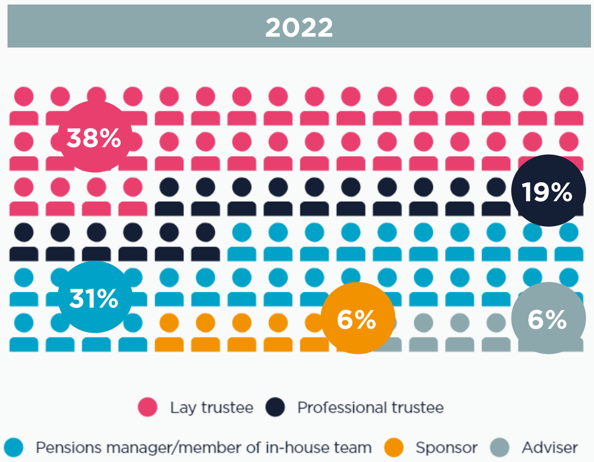
Additional resources to find out

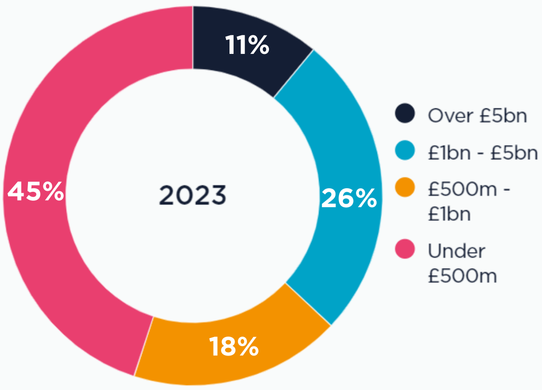
- LCP Strategic planning framework — Read More
- Strategic journey planning hub — Read More
- Our LCP GEARS blog series — Read More
- Our latest webinars, accessed and on demand — Watch now
- Diversity guide — Read More
- Professional Corporate Sole Trustee report — Read More
- Guide to ESOG — Read More
- Guide to ora — Read More
- LCP strategic portfolio — Read More
- Investment Uncut Podcast — Listen now
- Latest de-risking report — Read More
- Latest longevity report — Read More
- Contingent funding handbook — Read More
- Vista - our investment Magazine — Read More
- LCP's climate change and sustainability insights hub — Read More

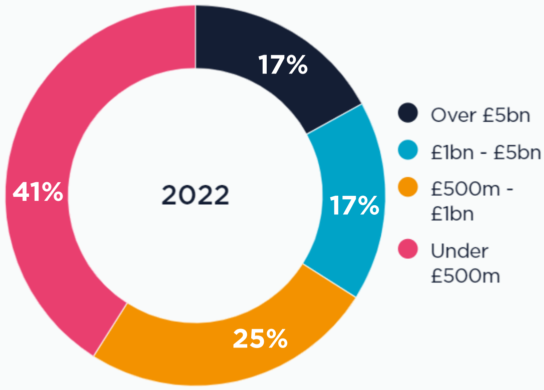
Survey

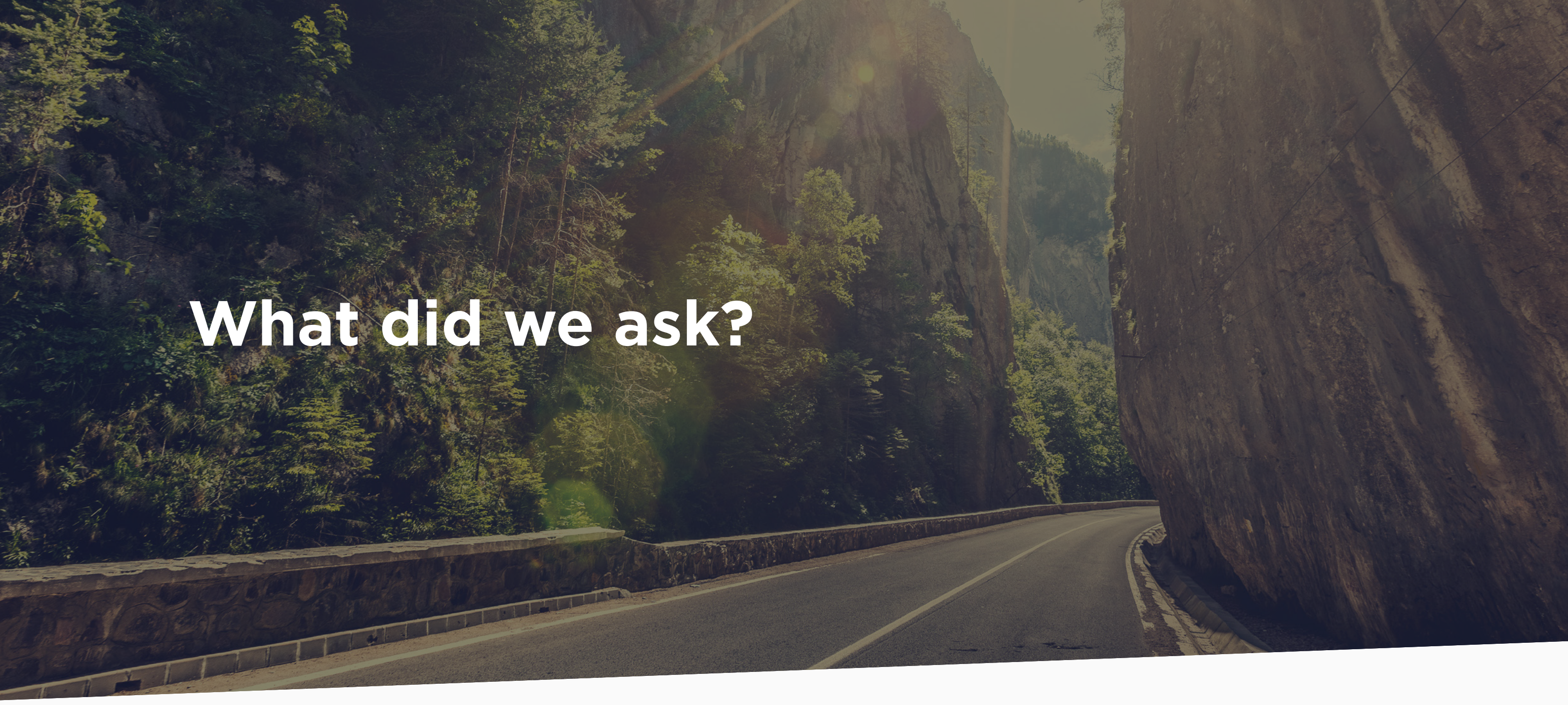
In our latest survey, respondents representing trustees, sponsors, pensions managers and advisers told us about their schemes and gave us their insights on the UK pensions landscape.











What did we ask?

1. Are you a trustee, sponsor, pensions manager/member of in-house team or adviser?
    - 1a. If a trustee, are you a lay or professional trustee?
2. What size is your scheme (asset size)?
3. Do you have a long-term low-dependency funding target?
4. What is the ultimate objective of your scheme?
    - 4a. Are you intending to use a phased buy-in approach, to insure all liability in one go or don't yet know?
    - 4b. What is the expected timeframe of your final transaction?
5. What actions have you taken in light of recent economic changes?
6. Do you expect the new DB funding code to change the way you approach assessing covenant?
7. How long do you think your employer covenant is reliable for?
8. Will you be setting a net zero emissions target for your scheme?
9. Does your scheme benefit from a contingent funding solution?
10. Have you adjusted your view of your members' longevity in light of the repercussions of the pandemic and the pressures on the healthcare system?
11. Which member options have you implemented or are in the process of implementing?
12. How far have you got with your GMP equalisation?
    - 12a. Which method have you decided to use?
13. What actions are you taking in relation to Diversity, Equity and Inclusion (DEI) issues?
14. What is your top priority for your scheme in the coming year?
15. If you could change one thing about the rules and regulations around pensions, what would it be?

What about our LCP client data?

Our data covers around 250 UK DB pension schemes advised by LCP, ranging in size from less than £10m to £15bn and collectively representing more than £150bn of assets. This includes schemes where LCP provides actuarial, investment, covenant or corporate advice (or a combination) so does not necessarily represent LCP's advice in all areas.

Thank you for reading!

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At LCP, our experts help to power possibility by navigating you through complexity to make decisions that matter to your business and to our wider society. We are powered by our desire to solve important problems to shape a more positive future. We have market leading capabilities across pensions and financial services, energy, health and analytics.

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