# *Seize the moment*

**A pivotal opportunity for corporate sponsors of DB pension schemes**

November 2023

**Helping corporate sponsors**

# *Seize the moment*

## – A pivotal opportunity for corporate sponsors of DB pension schemes

For decades, the narrative on Defined Benefit pension schemes has been around clearing deficits, reducing investment risk, and ideally getting the scheme off the corporate balance sheet as soon as possible.

But the dramatic events of the last year have allowed sponsors to see their DB pension scheme as an opportunity and not simply a risky cost. In particular, conversations are increasingly turning to the management of DB surpluses rather than rescuing schemes in deficit. And there is now a once-in-a-lifetime opportunity for firms to ensure that they are making the most of the hard years spent building up this much stronger position.

The central message of this report is that there are multiple “endgame” options now available to schemes and new innovations are coming forwards all the time. A strategy which seemed right when set a couple of years ago could be missing out on important new opportunities.

For those firmly on the path to buy-out, there are still important strategic decisions to be made about timing and making sure that best value is secured, and this report provides fresh perspectives on these key issues.

But for those schemes willing to consider running on, there are options including making use of DB surpluses to support DC provision, offering discretionary increases to existing DB members as well as making sure that any eventual buy-out is done at the right time and at the best price. And all of this is independent of any further reforms we may see as part of the Chancellor’s “Mansion House” agenda which may provide further space for seeing a pension scheme as an asset and not a burden.

We also focus in this report on the changing investment landscape, including how to view LDI strategies one year on from the crisis of autumn 2022. Where schemes have found themselves with unexpectedly high levels of illiquid assets, we offer insights on how best to respond, as well as setting out a range of non-LDI-based strategies for improving scheme liquidity. We also analyse the extraordinary recent movements in the gilts markets and reflect on what this means for your scheme.

In the final two sections of the report, we survey a huge range of issues affecting corporate Britain and its pensions landscape. This includes everything from the growing government interest in “Collective DC” pension arrangements, the potential for DB superfunds to finally become significant players, and the rapidly changing bulk annuity market, where we provide insights on the latest developments. We also look at issues of particular relevance to company accounts, including making full use of the latest data on scheme-specific mortality.

With so many other issues competing for the time and attention of business leaders, a relatively mature DB scheme can easily slip down the priority list. But our message is both urgent and optimistic – time devoted now to making sure your scheme is on the right course could reap rich rewards in years to come.

*Sir Steve Webb*

*Partner at LCP and Pensions Minister 2010-15*

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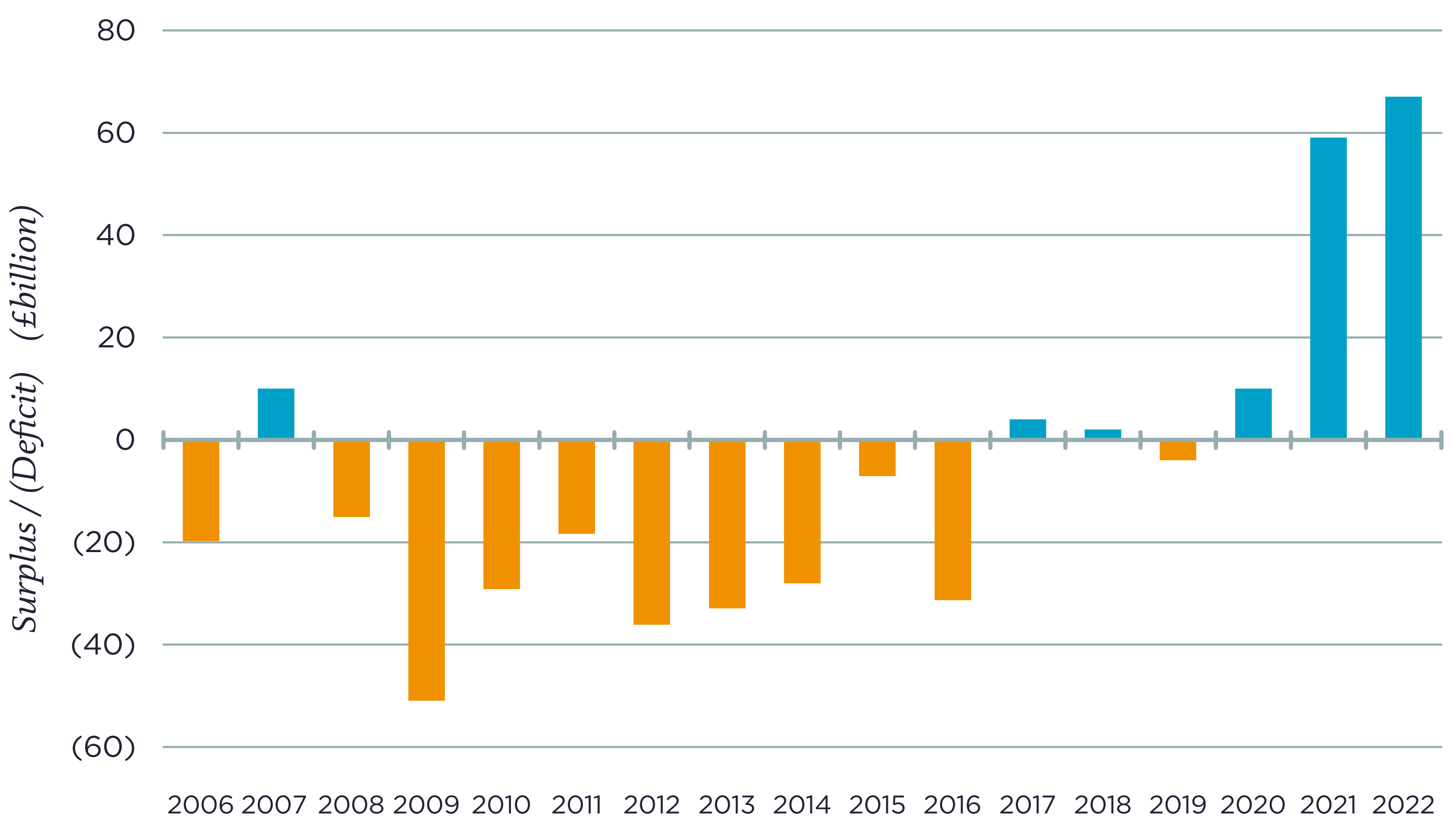
# 1.1 Where are we now

## Improvement in funding levels

LCP's **Accounting for Pensions** report earlier this year reported that the UK pension schemes of FTSE100 companies had record levels of accounting surplus, with recent estimates from LCP Pensions Explorer at the end of September 2023 around £70bn surplus broadly equating to a 120% funding level. These levels of surplus are unprecedented and were unthinkable just a few years ago.

**Estimated combined IAS19 position of FTSE100 companies at calendar year-ends**




Source: LCP Accounting for Pensions, 2023

This improvement in pension scheme funding position – along with improvements in insurer pricing - has led to a boom in the pension bulk annuity market. Our **de-risking report** suggested that 2023 remained on track to be the busiest on record with a prediction of £45bn of buy-ins and buy-outs, and perhaps as much as £600bn of pension liabilities transferred to insurers over the next decade – this represents almost a half of all UK DB pension liabilities being secured within the insurance regime.

That said, given the significant surpluses and evolving regulatory landscape, companies and trustees are now also increasingly considering alternatives to securing benefits with an insurer as soon as it is affordable.

*UK DB pension funding levels have never looked better, and now is the time for sponsors to view pensions as an asset rather than a risk.*

*Gordon Watchorn* *Partner, LCP*

# *1.1 Where are we now Continued*

## Why consider something different from a full buy-in insurance transaction?

**Value for money:** Perception of current poor value for money. This could be particularly relevant for schemes with a significant non-pensioner membership whereby waiting to transact will be expected to lead to gains on an insurer basis as members retire and take cash lump sums.

**Member upside:** Benefits are locked in as part of a transaction and this removes the potential for future discretionary increases. Running the scheme on to generate surplus could lead to additional discretionary increases and improved benefits for members.

**Sponsor upside:** Certain sponsors may prefer solutions that enable them to retain upside (and risk), rather than pay away profits to an insurer.

**Benefit options / member technology:** Pension schemes may offer members non-standard benefit options or services, such as a Pension Increase Exchange at retirement, ongoing IFA support, or self-service technology, which may be difficult or expensive for insurers to offer. Securing benefits with an insurer could therefore reduce the range of options available to members.

**Control:** Trustees and sponsors may have concerns around relinquishing control of the scheme and passing the administration and ongoing communications to a third party where they have no influence on standards or level of member experience, particularly over the longer term.

**Open schemes:** Where schemes are currently open to accrual of new benefits, full insurance may not be possible or be prohibitively expensive or complex.

**Covenant:** Where the sponsor covenant is strong, or if there are appropriate covenant protections in place, there may not be any significant additional security of moving to an insurer.

**Assets:** Whilst a pension scheme may be fully funded on paper, illiquid asset holdings may prevent schemes from accessing the insurance market in the short-term.

**Scheme size:** Whilst the bulk annuity market is now able to accommodate significantly larger transactions, the UK's largest schemes may prefer to utilise their own economies of scale to deliver a cost-effective risk-managed run-off strategy, whilst retaining expected upside over the longer term.

# 1.1 Where are we now Continued

When a scheme has a big surplus and there are all these reasons to run-on, why do sponsors typically place such a focus on transacting with an insurer? The answer – there is such a focus on removing downside risk that little consideration is given to the potential upside that the scheme, its members, and other stakeholders including the sponsor are missing out on as a result.

*An intense focus on protecting against what could go wrong means there has been little consideration of the likelihood or consequences of what could happen and how things could improve for all when things go right.*

*Alex Whitley* Partner, LCP

Over the last few decades, markets changed, life expectancies increased, and regulatory goalposts moved. This led to schemes targeting increasingly prudent measures, with any deficit emerging having to be paid off quickly by the sponsor. DB pension schemes quickly became a millstone round sponsors' – weighing down corporate growth, discouraging sponsor M&A, sucking in available free cash, and absorbing management time. This has led to most pension schemes within the private sector closing to new members and offering new employees a Defined Contribution pension instead.

It has been well-documented that the the level of DC savings is not enough and the current DC generation is projected to not have sufficient pensions to be able to retire. This leads to challenges with future generations being able to retire, as well as systemic questions about the fairness across generations.

*The current regulatory regime robustly protects the DB generation. Have we really got the balance of focus right, when those with DC benefits are far more exposed to risk and expected to achieve less comfortable retirements?*

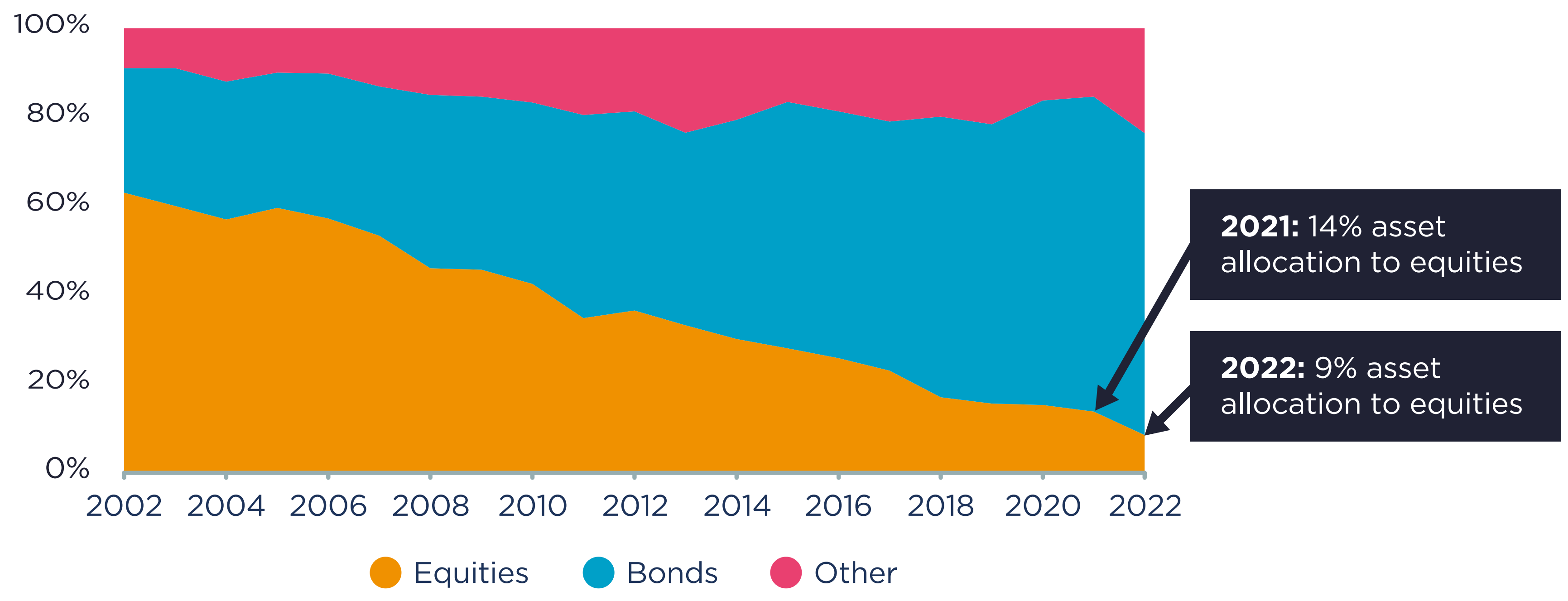
*Steve Hodder* Partner, LCP

# 1.1 Where are we now *Continued*

## A dramatic shift to low-risk investments

The focus to protect against the downside and the need for additional contributions has had wider investment implications too. Pension schemes have greatly de-risked their investment strategies. They are no longer investing strongly in equities or other growth assets. Our Accounting for Pensions report earlier this year set out how the asset allocation of UK pension schemes sponsored by FTSE100 companies has evolved over the past 20 years. Holdings in equities and other growth assets have plummeted – with now less than 10% of scheme assets in equities (broadly £30bn) compared to over 60% just 20 years ago.

**Estimated overall asset allocation for UK pension schemes sponsored by FTSE100 companies**




With a focus on de-risking, matching liabilities, and protecting against possible future bad news, projected best estimate future investment returns have dropped to around 0.8% pa above gilts for the FTSE100 pension schemes. Looking at UK schemes as a whole using data collated by the PPF, the picture is only marginally better with best estimate returns of just over 1% pa above gilts, albeit this does not pick up all the asset changes caused by the 2022 gilts crisis.

Given UK DB pension schemes cover over £1 trillion of assets, is it right to invest in this ultra-low-risk way? If schemes were able to invest for and focus on the long-term instead of the need to protect against short-term bad news, this could lead to better outcomes for all. Not just better outcomes for scheme members and sponsors, but also the wider UK as investment would be freed up.

# 1.2. Endgame objectives

Whilst the specifics and detail will vary according to the individual rules of each pension scheme and the circumstances and objectives of the sponsor, we are currently in a regulatory environment whereby endgame options are limited. The ultimate targets are:

1. **Buy-out with an insurer:** this breaks the link between the scheme and sponsor. All ongoing scheme risk and management is eliminated, and at the point of wind-up, the scheme is removed from the sponsor's balance sheet.

2. **Run-off until the last member leaves:** retain the link between the scheme and sponsor and run the scheme off (this typically takes around 80 years or so). The trustees continue to administer the benefits and invest the assets, and the sponsor remains on-risk should the position worsen.

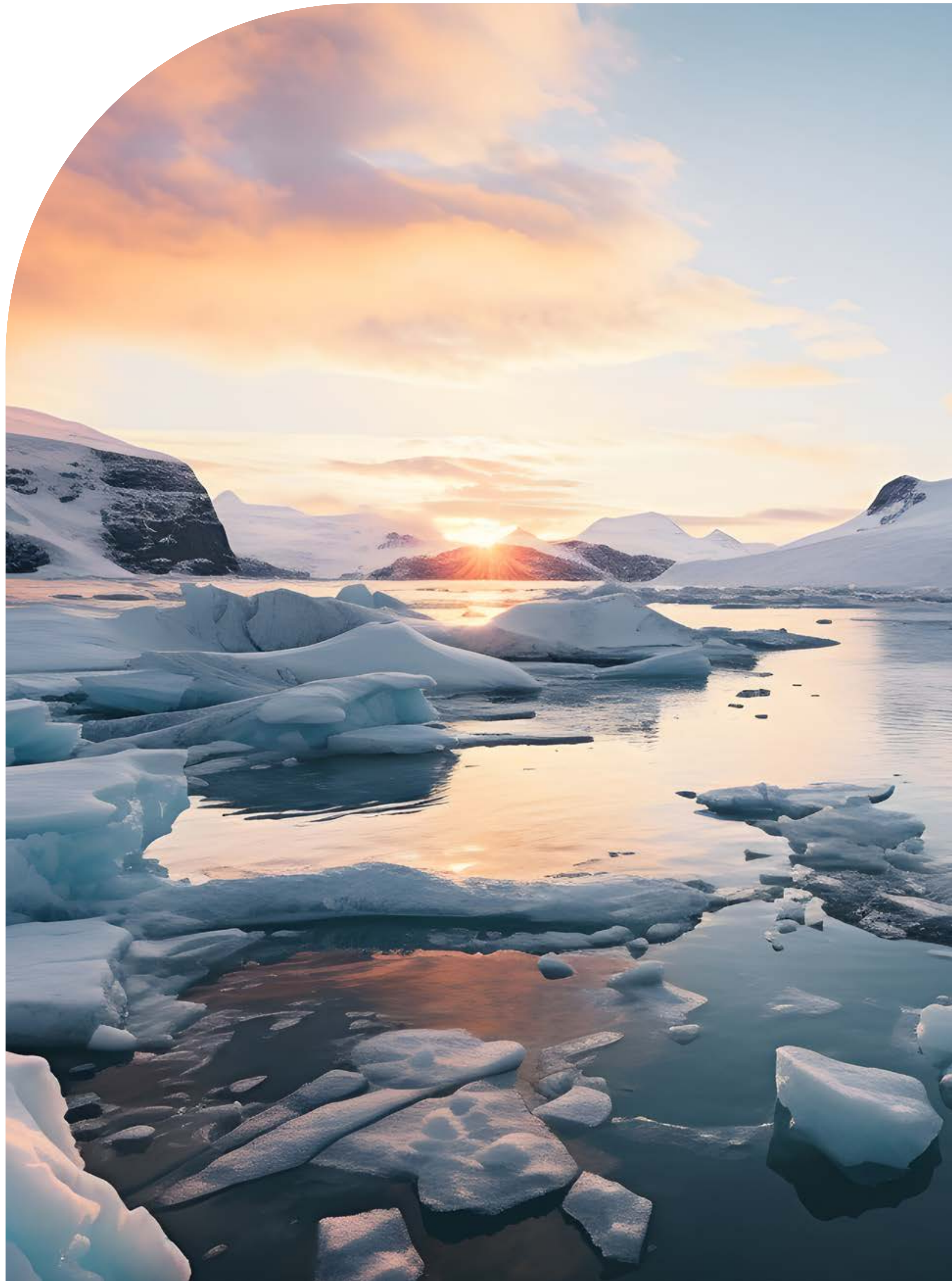
From a sponsor perspective, superfunds are a distinct endgame from buy-out and run-off, as they sever the sponsor link. From a scheme perspective, superfunds can be an intermediate step to buy-out or long-term run-off.

In addition to determining the endgame target, the preferred timeframe is a critical strategic decision. If buy-out is the target, should you aim to get there as soon as affordable and practicable (perhaps with a one-off final contribution) or should you wait? Waiting can improve the position as:

- More members retire and pensioners are cheaper to insure than non-pensioners.
- Scheme members may take transfer values or cash lump sums at retirement and these will typically be on terms that cost less for the scheme than the insurance cost.
- Increased time for future investment returns.

However, by waiting, sponsors run the risk that the funding position worsens, insurer pricing gets more expensive, or there could be material changes to the covenant of the sponsor.

As a result it is important that any endgame plan or framework remains flexible and can respond to ongoing changes in circumstances. Plans should be regularly reviewed to ensure they remain fit for purpose and that no party gets overly fixed on a particular outcome.

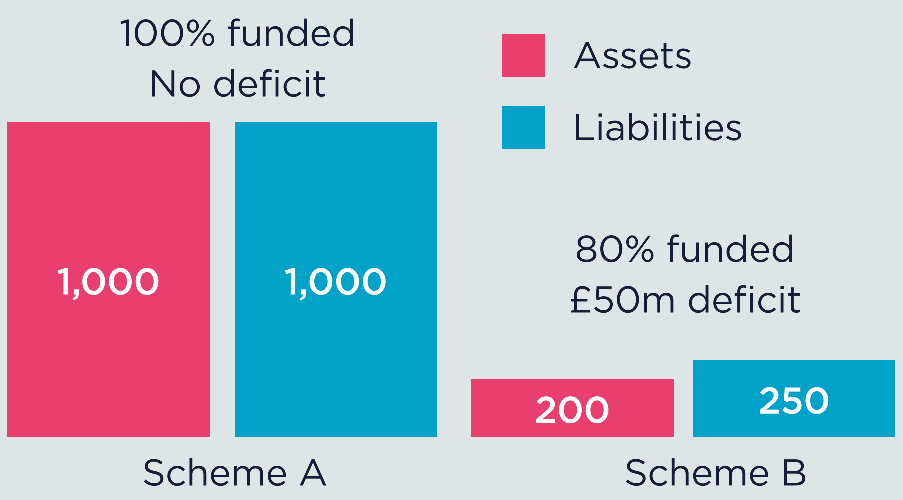


# *1.2. Endgame objectives Continued*

## Case study: waiting to transact to improve the position across all the Company's pension schemes

### 1) Context

The Company sponsors two UK DB pension schemes:




- Given 100% funded, the Trustee was considering implementing a full scheme buy-in for Scheme A.
- Scheme B was projected to reach full buy-out funding with no additional contributions in about 15 years.

### 2) What happened?

- Analysis of Scheme A's membership shows that a significant surplus was expected to emerge over the short term as members retire.
- Given the membership profile, this was projected to generate £50m of surplus within two years.
- The Company requested that the Trustee delayed a full buy-in of Scheme A in order to grow the surplus.
- In return for this, the Trustee requested a reduction in investment risk, increased covenant assessments, and new proactive monitoring of the funding level to quickly identify should the position weakens.

### 3) The outcome

- After two years, the aggregate funding position was that the schemes were fully funded (surplus in Scheme A, deficit in Scheme B).
- Scheme A completed a full buy-in, with the residual surplus transferring to Scheme B.
- Scheme B then completed a full buy-in – over 10 years ahead of schedule and no new cash commitment from the sponsor.
- Both schemes subsequently wound-up reducing ongoing governance costs and management time and removing the DB schemes from the corporate balance sheet.

**In summary:**

- Leveraged size of larger scheme and expected future gains against buy-out at retirement to generate surplus to improve outcomes for other stakeholders.
- Provided additional protections for the Scheme Trustee to reassure and reduce downside risk should the position change.
- Both Schemes were able to fully secure benefits with an insurer – and over a decade faster than if they had only insured Scheme A initially.
- Established an efficient route to remove all pension risk from the Company's balance sheet.

# 1.3. The current landscape – journey plans and use of surplus

Whilst targeting either an insurer buy-out or run-off, schemes can utilise one or more of a growing number of solutions to reduce risk that the scheme goes off-course and potentially help the sponsor to realise value along the way.

**There are a wide range of solutions currently available to support schemes as they target their chosen endgame. The table to the right highlights some of the current key options available to pension schemes - the table is not exhaustive and the detail for each is not fixed. Most options provide flexibility and the option for schemes to adjust the terms so that they best meet their objectives.**

*There is a growing number of new and innovative solutions available to support schemes – choosing the right one and at the right time needs careful attention.*

*Jonathan Griffith* *Partner, LCP*

| *Option* | *Key features* |
|---|---|
| **Breaking the link to the sponsor through a superfund:** | |
| **Clara** | • Successfully completed the Pensions Regulator's assessment process in November 2021.<br>• Capital provided by Clara to support the plan and the link to the sponsor is broken.<br>• Typically target an insurance buy-out within 5-7 years. |
| **Retaining the ongoing link to the sponsor:** | |
| **Clara Connected Covenant** | • Similar to the Clara superfund proposition, except that the sponsor remains attached to the pension scheme and liable for the scheme's liabilities should Clara default and become insolvent. |
| **Aspinall** | • One transaction completed in Q1 2020.<br>• Provide additional capital and protections for risks (including longevity) over a scheme's journey to its preferred target endgame. Typically aims to reach target over c.5-7 years.<br>• All scheme assets are invested in a special purpose vehicle, which is co-owned by the Trustee and Aspinall. |
| **Pension Safeguard Solution** | • Provide additional capital and protections for risks (including longevity) over a scheme's journey to its preferred target endgame. Typically aims to reach target over 15+ years.<br>• Given timeframes, able to support schemes that are further from full insurer pricing. |
| **PSF Covenant Plus** | • Launched in 2023.<br>• Trustee retains significant control. Assets remain largely within the existing scheme structure.<br>• Additional capital provided to protect against downside risk, and this is transferred to the scheme should the funding position deteriorate outside agreed boundaries. |
| **Captive structures** | • Introduce sponsor-backed captive insurer or reinsurer.<br>• Schemes undertake buy-in / buy-out transactions with this insurer (sometimes via an intermediary), passing both financial upside and risk to sponsor. |

*Note that other solutions have previously been available (such as Assured Payment Policy or Insured Self Sufficiency) and others are expected to be introduced to the market shortly.*

# 1.3. The current landscape – journey plans and use of surplus *Continued*

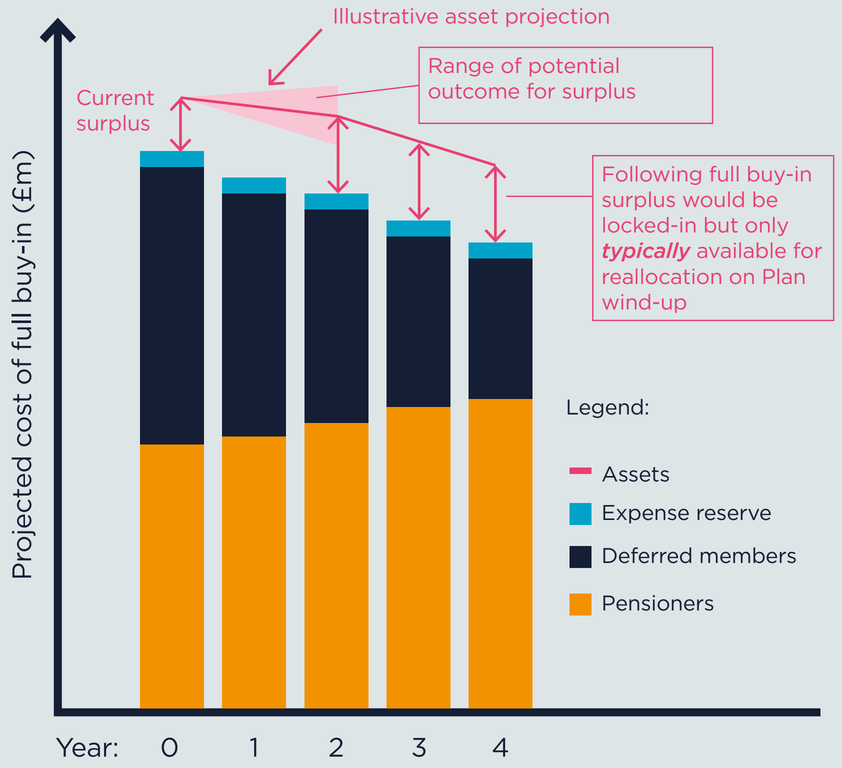
## Case study: Using surplus to fund DC contributions

### 1) Context

- The Group sponsors a UK DB pension plan with assets of c.£2bn and current strong funding levels.
- The Trustee was focussed on insurance as an endgame for the Plan and the Group engaged LCP to advise on working with the Trustee to achieve this aim.
- LCP took a **fresh approach** and proposed an alternative way to meet the Trustee's aim whilst also deriving value from surplus assets.
- LCP's advice to the Group focussed on two key questions:
    1. **When is the optimal time to insure the Plan?**
    2. **How could surplus be extracted before a buy-in to create a 'win/win' for the Trustee and Group?**

### 2) When is the optimal time to insure the Plan?

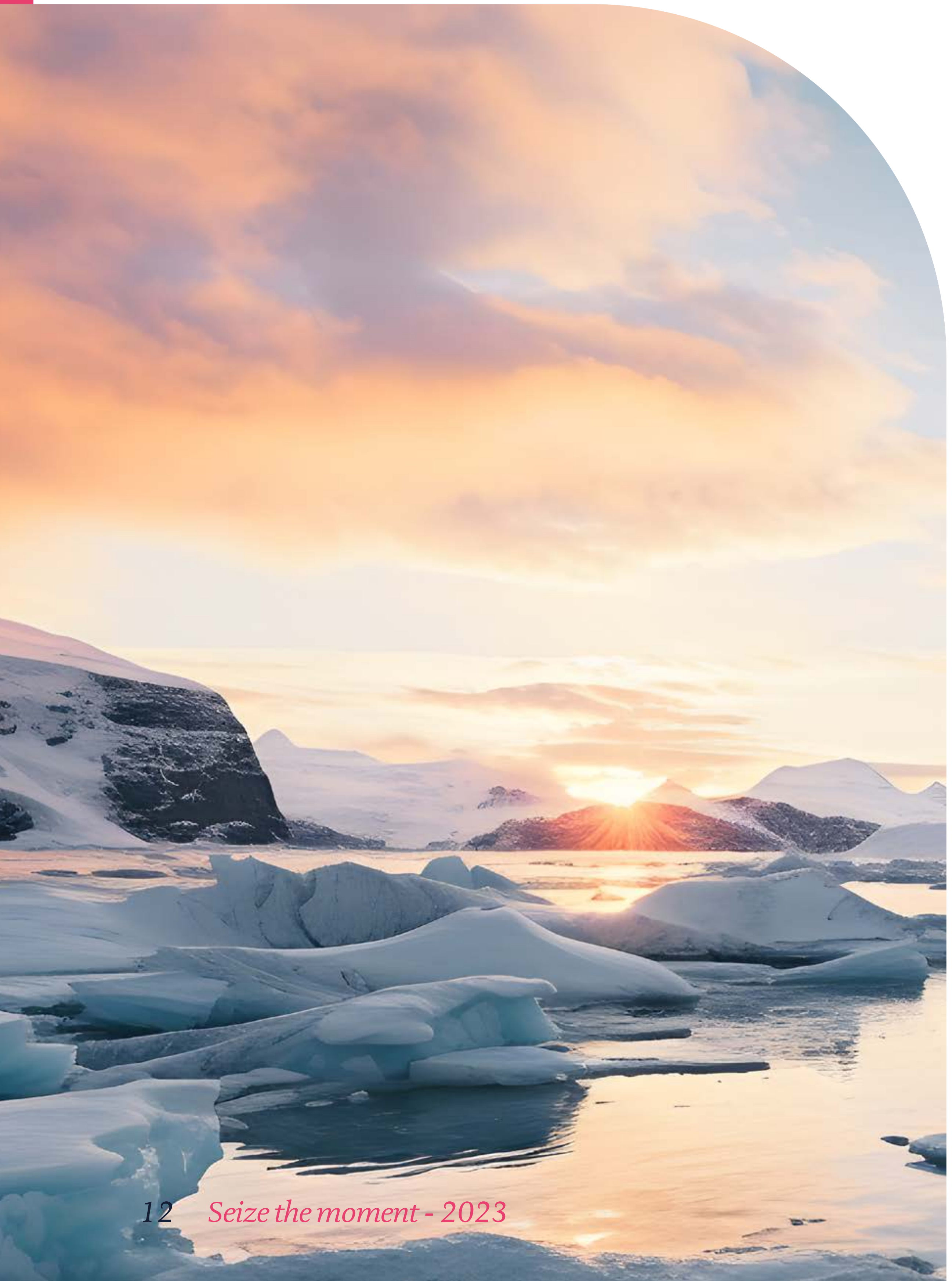
- With the insight from **LCP's market leading de-risking and Health Analytics teams**, we were able to:
    - **refine the Trustee's estimate of the cost to insure the Scheme to better reflect current levels of insurer pricing.**
    - **recommend data and benefit actions to improve outcomes when engaging with insurers in future.**
- The Trustee advised that the recommended data and benefit work could take up to four years, meaning that this would be the earliest point at which the Plan could transact to be sure of optimal engagement from insurers.
    - LCP analysis showed that the **Plan surplus is estimated to grow by c.£40m pa over this period** (after allowing for risk management steps including the alignment of Plan assets with buy-in pricing).
    - LCP advised that some of this **emerging surplus could be extracted** over the period before a transaction, leaving a **large "residual risks buffer" to protect members' benefits** from any adverse changes.




**In summary:**

- Fresh approach to deliver the Trustee's aim informed by LCP's market leading de-risking practice.
- A proposal for stabilising the surplus, harnessing LCP expertise of how insurers invest.
- Established a **tax efficient** route for accessing surplus with immediate **cashflow benefits** to Group with a 'buffer' for **member protection.**
- Leveraging LCP insight and experience to develop a balanced and fair proposal for the Trustee.

# 1.3. The current landscape – journey plans and use of surplus Continued



When reviewing endgame options, pension scheme trustees will need to have regard to members' best interests. Whilst the covenant is strong and there is significant surplus, the risk to members' benefits of running on to grow the surplus is low. However, it will often be appropriate to consider:

- **Investment strategy:** design a balanced strategy whereby significant risks such as inflation and interest rates are hedged, but there is sufficient allocation to longer-term growth assets.
- **Funding:** regularly monitor the funding position in order that changes in position are identified quickly and appropriate actions taken accordingly.
- **Covenant:** increase covenant reviews to monitor longer-term viability of the sponsor.
- **Contingent funding:** it may be appropriate to put in place further **protection** such as guarantees, letters of credit, or a charge over assets.
- **Governance:** regular reviews of the plan to ensure it remains on target.

*Journey plans might go exactly to plan, but a robust strategy builds in clear protections for both upside and downside events. Contingent funding solutions are one of the key tools in that regard.*

*Phil Cuddeford* Partner, LCP

# 1.4. Looking ahead – change is coming (probably)

At his Mansion House speech in July 2023, the Chancellor announced a raft of reforms designed to ensure that the money saved in UK pension schemes is used more productively. Many of the announcements related to better use of funds invested in DC pension schemes but, for the first time, the Government has made clear its willingness to turn its attention to the much larger sums currently held in over 5,000 DB pension schemes.

Whereas workplace DC pension schemes are currently worth an estimated £500bn, the assets in DB pensions currently sit at well over £1 trillion, according to the latest estimates from the Office for National Statistics.

DWP has now published a 'call for evidence' on 'options for Defined Benefit schemes' and the results of this consultation are expected before the end of the year. Should any changes be recommended, implementation could take many years but the future pensions framework could be substantially different to the one we operate in today.

Whilst this may not change the endgame for some, any new framework has the potential to fundamentally change how pension scheme sponsors and trustees currently view their legacy DB pension scheme.

## Protection Supporting Prosperity

One of the principal reform options discussed in the consultation document is an idea developed over the last year by LCP. This is designed to free up well-funded DB pension schemes to invest for long-term growth instead of continuing to move into more and more low-risk, low-return assets. The idea does this by creating an innovative new way of making sure that DB member benefits are secure, dubbed "Protection Supporting Prosperity", freeing up well-funded DB pension schemes to invest for long-term growth. Longer-term higher returns generated by this approach can be used for the benefit of members, savers, companies and the wider UK economy.

**The key features of the LCP proposal are:**

- It would be an opt-in regime, available only to well-funded DB pension schemes;
- Such schemes would be allowed to pay an increased levy (a 'super levy') to the Pension Protection Fund. In return for this, the level of cover provided by the PPF would rise to 100% of scheme benefits. This would ensure that member benefits were fully protected even in the unlikely event that the sponsoring employer were to become insolvent;
- With this security for member benefits in place, the trustees and sponsor could then adjust the DB scheme's investment strategy to target a higher level of long-term growth;
- Over time, these higher returns would be expected to lead to pension schemes having more money than required, and, provided there is a clear 'buffer' above the minimum level required to opt in to this regime, any additional money could be used by the employer to the benefit of scheme members, the business and its employees.

**The potential advantages of this approach include:**

- The money invested within DB schemes could be used more productively, including in UK equities and/or long-term illiquid investment supporting infrastructure projects and the transition to Net Zero;
- DB member benefits would be 100% secure for the first time.

**By generating a larger 'pot' a wider group of stakeholders could benefit, including:**

- The 'DC generation' of savers could benefit either through surplus funds being transferred from a DB scheme to a DC scheme in the same trust, or through the employer using some of the 'super-surplus' taken out of the scheme for higher DC contributions;
- DB members, who might be offered 'discretionary' increases above the minimum level specified by the scheme rules - for example, many DB members had increases in April 2023 capped at 5% or lower (some with zero increases) when inflation was over 10%; discretionary benefit increases could help to close some of this gap;
- The sponsoring employer itself, which could benefit from using surplus funds to invest in the business and/or benefit the wider workforce and investors.

# 1.5. What should sponsors do now?

Despite the funding gains and potential to improve outcomes, targeting insurance and transacting as soon as it is affordable will continue to be the right solution for some.

This was historically the default target endgame and is possibly the endgame that trustees (and potentially their advisers) will adopt under the current regime unless the sponsor drives the agenda and sets a timeline for an alternative approach.

Given the potential upside for all parties is so large – particularly in the context of the wider corporate business and existing DC benefits – it will be important for pension scheme sponsors to review current plans and desired timeframes and consider the options and implications before embarking on a particular route.

*With a wider range of options available, sponsors should engage with their scheme trustees to discuss journey plans and whether the current endgame really is in the best interests of members. The Mansion House proposals make this an even more important consideration.*

David Fairs *Partner, LCP*

# *Investment considerations - introductory comments*

From an investment perspective, not much has happened in pensions over the previous 12 months...

On a serious note, the repercussions of high inflation, the Liz Truss era, rising interest rates and an "LDI crisis" to boot have impacted every market in which pension schemes invest and have caused more disruption to markets than the previous decade combined.

In our **2022 report** we discussed inflation hedging and how pension schemes can get the best value. As inflation continues to be at elevated levels and will likely remain volatile, our overview of options available to help schemes reduce costs whilst hedging inflation risks remain as relevant today as they were last year.

*With pension reforms on the horizon, now is the time to take a step back and re-assess corporate objectives around pensions. The opportunity to access value through arising pension surpluses is high, but care needs to be taken to avoid being tripped-up by sub-optimal use of LDI and volatility in the gilt market.*

*David Wrigley* *Partner, LCP*

In this investment section, we provide our thoughts on what corporate sponsors should be considering:

1. A year on from the "gilt crisis", what are the key lessons learned (and that continue to be learned) on LDI? And how can sponsors ensure their scheme's LDI mandate is as efficient as possible under new regulations, whilst protecting against the next crisis?
2. The knock-on impacts of the gilt crisis on private markets and the risks/opportunities sponsors need to consider for illiquid assets.
3. What the future might look like for gilt markets and might similar events happen again? After all, if the government is going to issue more gilts than ever before, if the Bank of England is moving from buying mode ("QE") to selling mode ("QT"), and if pension schemes are increasingly moving towards insurance solutions, then who is going to buy all the gilts? And what does that mean for gilt yields, LDI and hedging moving forwards?
4. A quick round-up of other investment topics that should be high up on your agendas.

*The endgame target is key to understand when exploring the optimal investment strategy.*

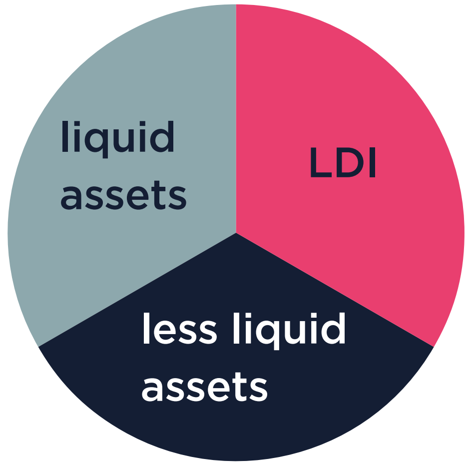
*Charlotte Gale* *Associate Consultant, LCP*

# 2.1. LDI crisis – after a year of reflection, what are the key lessons learned and what steps should corporate sponsors be considering?

## Lesson 1:

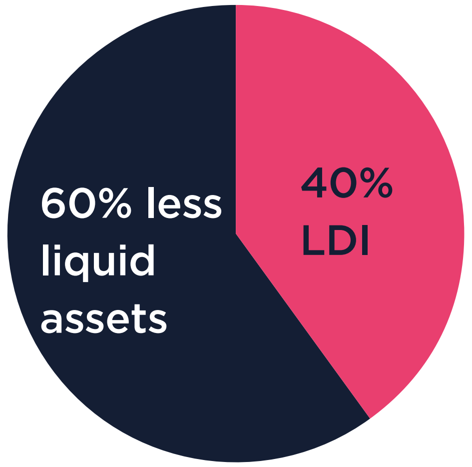
**Leverage and illiquidity do not mix without due care and attention**

Take a hypothetical pension scheme portfolio consisting of equal allocations to:




Prior to 2022, this may have seemed like a well-diversified and balanced investment strategy.

However, this all changes once you've already had a big rise in gilt yields, as happened in 2022. That same scheme highlighted above would likely have topped-up its allocation to LDI to support the hedges in place - in doing so it would have sold most of its liquid assets and therefore ended up heavily overweight in less liquid assets.




Clearly, this is now a less comfortable position, particularly if those less liquid assets are illiquid and difficult to rebalance.

**Actions for sponsors:**

- Challenge previous thinking.
  - For the proportion of your liabilities "matched" by illiquid assets, is LDI really needed?
  - Should schemes really be adding leveraged gilt exposures on top of illiquid assets that match liability cashflows?
  - Might a better approach be to value those liabilities with reference to the yields on the illiquid assets (rather than arbitrarily valuing with reference to gilt yields)? This would reduce the quantum of LDI needed, acting as a release valve. That same scheme shown on the left would not have used leverage to the same extent, would not have needed to sell all their liquid assets, and could more comfortably maintain a portfolio of illiquid assets running off to meet a series of cashflows.
- Ensure schemes have sufficient liquidity alongside their LDI portfolio, with clear plans on how and from where additional collateral should be sourced.
- Consider if, when, and how to reduce illiquid holdings (see section 2.2) given how big they may have become.

# 2.1. LDI crisis – after a year of reflection, what are the key lessons learned and what steps should corporate sponsors be considering? Continued

## Lesson 2:

**Consider loan-like solutions as further lines of defence against a liquidity crisis**

**Actions for sponsors:**

Consider the following examples.

### Corporate loans / facilities

Essentially these can be lines of credit extended from the sponsor, and agreed with trustees. We've seen good examples of how such arrangements have been used during periods of market stress, providing a bridge in the timeframes for redeeming assets to support liability hedges.

### Facilities to release cash against corporate bonds

For any scheme that has investments in corporate bonds, it would be prudent to make sure that facilities are in place that allow cash to be accessed against these corporate bonds without needing to sell them down (possibly in a stressed market).

### Facilities to release cash against other assets, including buy-ins

It is worth exploring options to release cash against illiquid assets, including any buy-in policies to help manage short-term cashflow needs or act as a contingency when such a need arises.

# 2.1. LDI crisis – after a year of reflection, what are the key lessons learned and what steps should corporate sponsors be considering? Continued

## Lesson 3:

### Reduce the risk of being forced to sell assets

**Actions for sponsors:**

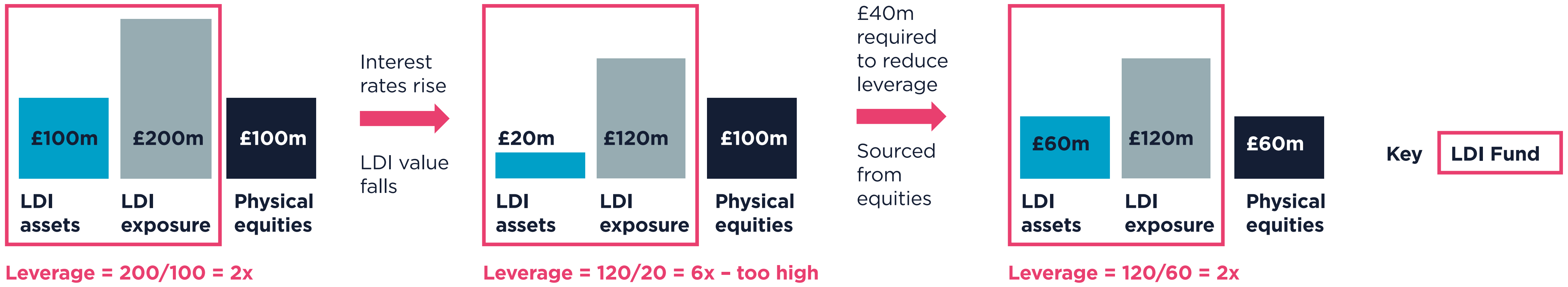
Sponsors should ensure their schemes have sufficient liquidity buffers in place, to reduce the risk of having to sell other assets at short notice, with associated costs and possibly selling assets in a bad market environment.

This can be difficult for schemes with higher return requirements who may struggle to hold most of their assets in liquidity buffers. But there are a number of ways in which schemes can restructure their investments to more efficiently achieve both goals of holding sufficient liquid assets whilst retaining exposure to higher returning investments.

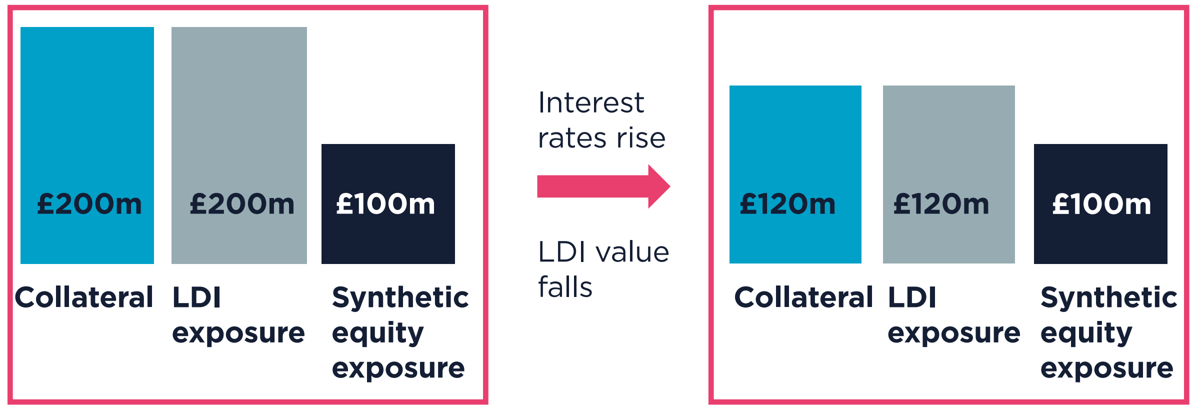
One such way is to access equities and credit exposures "synthetically", using derivatives to mimic returns on the underlying assets. The capital that would otherwise have been tied up in equities and corporate bonds can then be used to support both the profits/losses emerging on these new contracts as well as providing an extra buffer for liability hedges. This allows pension schemes to divorce decisions around rebalancing LDI portfolios and when to reduce exposures to equities/credit.

## Case study

Suppose a pension scheme has an investment strategy that is £100m invested in equities, £100m allocated to LDI that hedges £200m of liabilities, and 2x leverage. Suppose gilt yields then rise, such that the value placed on the liabilities falls by £80m. In such a scenario the LDI assets would also fall by £80m, reducing to £20m. So, to rebalance the leverage within the LDI portfolio, the scheme would need to sell £40m of equities, possibly at a time when equities have done badly.




An alternative for this scheme would have been to have £200m in LDI and £100m in synthetic equity exposure. If those same liabilities fall £80m, there is no need to do anything, there is still £120m of LDI assets backing £120m of liabilities. The allocation to equities can then be managed independently without the same forced selling pressures. Obviously this comes with additional complexity, but for schemes that want to retain significant exposures to equities AND have large liquidity buffers, the extra complexity can be worthwhile.



# 2.1. LDI crisis – after a year of reflection, what are the key lessons learned and what steps should corporate sponsors be considering? Continued

## Lesson 4:

Most importantly, expect the unexpected. Could something like the sell-off in LDI happen again? Absolutely, you only need to look at some of the dynamics within the gilt market to see that a difficult transition is under-way (see section 2.3).

But of course, the next crisis may not look like the previous one. Might deflation be a tail-risk scenario (see section 2.4) that pension schemes need to be particularly cautious about?

**Actions for sponsors:**

In addition to the actions above, bolstering working relationships with trustees can also play an important role in allowing schemes to be able to react quickly and effectively when needed, whilst being able to openly consider a wide range of available options (such as all of those highlighted in this section).

# 2.2. Illiquid assets: pain in the neck or great opportunity?

You wouldn't naturally assume that some of the most impacted markets from the gilt crisis are those that have no connection to the gilt market. Yet many pension schemes that invested in assets such as private equity/credit, property and infrastructure have now found themselves to be keen sellers of those assets.

As the value of schemes' LDI portfolios plummeted on the back of the gilt crisis, their relative allocations shrank. Many schemes also reduced their holdings in other liquid assets (such as equities and corporate bonds), as these were often used as the next port of call to top up collateral in LDI portfolios and thereby bring leverage levels down. These movements have led to many schemes being in a position of having a far larger proportion of illiquid assets in their portfolio, and thereby having limited flexibility and available sources of liquidity.

### Actions for sponsors:

1. **Reconsider why you are investing in illiquid assets and how your allocation will evolve over time. Those who are long-term buy-and-hold investors should take different actions to those who are only temporarily investing in illiquid assets.**

- Are you a long-term holder?

  If so, then as highlighted in Section 1, you should consider how the projected asset cashflows match your projected liability cashflows. If they are a good match for some of your liabilities then you should consider excluding those liabilities from your hedging arrangements, reduce your leveraged gilt exposures and dial down leverage. For this to be most effective, it will also be worth valuing those matched liabilities with reference to the yield (return) on the illiquid assets, and not with an arbitrary reference to gilt yields. Such an approach is commonly referred to as "asset-led discounting" or "dynamic discount rate".

- If you're not a long-term holder, then do you need an exit plan?

  If for example, you are planning to sell down your illiquid assets over time, perhaps as part of a de-risking plan or aim to complete an insurance transaction, then you will need to think carefully about how/when you sell down these assets. Alongside this, you'll need to consider how to invest the sale proceeds and how the reinvestment risk is managed in the meantime.

  New options are emerging for selling down illiquid assets, and given the range of exit options available for pension schemes in optimising such a sale-down process, LCP has created its own **Illiquid Asset Solutions Group**. In most cases, many of the following options should be considered for realising best value on exit:

  - Selling directly with the manager (primary market).
  - Appointing a broker to privately sell the holding to another investor (secondary market).
  - Optimising the timing for disposing the asset once it has decreased in size and largely wound-down.
  - Sponsor buying back the asset onto its own balance sheet (perhaps at a fair, but discounted value).
  - Transferring the asset directly to an insurance company as part of a bulk annuity transaction (perhaps after a period of re-structuring).
  - Lending against the illiquid asset, as an alternative to selling.
  - If pursuing an insurance transaction, agreeing to defer payment of part of the premium relating to an extended wind-down / sale process of illiquid assets.

# 2.2 Illiquid assets: pain in the neck or great opportunity? Continued

**2. Consider whether now is a compelling time to *buy* illiquids**

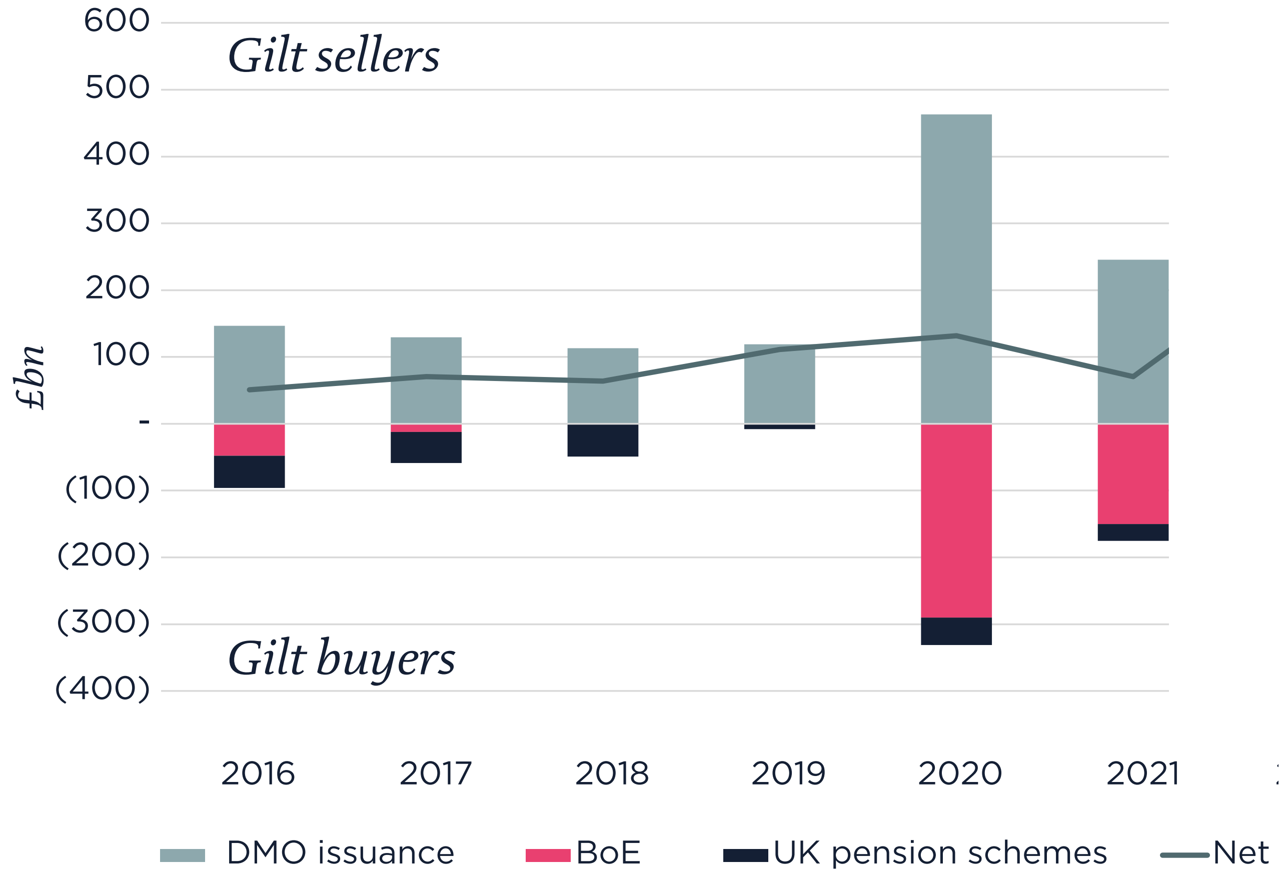
- Many pension schemes want to reduce their illiquid holdings. In many cases, these sellers will be willing to accept a "haircut", particularly if the illiquid assets are a barrier towards finalising an insurance transaction. Therefore, for pension schemes that don't have an issue investing more in illiquids, taking on these assets can offer a good investment opportunity given:
  - the entry price can be at a significant discount, perhaps in the range of 10-20% depending on the assets;
  - unlike primary investments into illiquid assets, the portfolio of assets you are buying is already built and known (reducing the initial costs and uncertainty associated with making "blind" commitments);
  - the timeframe over which the illiquid assets run off has already been reduced, in turn reducing credit risks and meaning illiquidity risks last for a shorter period.
- With changes afoot for the DB pension scheme landscape (see Section 3 of this report), many will now be considering the value associated with running on their pension scheme for an extended period, perhaps to access surpluses or use DB funds to pay DC contributions.

  In light of this, previous views around needing to manage the investment strategy under a super-conservative strategy might change. For a pension scheme whose time horizon might now be longer than previously thought, there is a strong case for buying illiquid cashflow-matching assets, particularly if they can be bought at a discount. A good-value long-term portfolio of assets with an associated asset-led discounting approach can provide a lot of value for pension scheme members, the sponsor and employees. Such approaches will likely compare favourably to a portfolio of gilts (see next section) and can offer an attractive alternative to insurance transactions.

# *2.3. Should we expect more volatility within the gilt market and, with the role of pension schemes diminishing, who's going to buy all the gilts?*

The supply/demand dynamics within the UK government bond market are nothing short of scary. It's an incredibly concentrated market, particularly for long-dated bonds and index-linked gilts, which are almost entirely owned by either UK DB pension schemes or the Bank of England. In fact, even including shorter-dated gilts (which pension schemes do not tend to invest in), these two investors make up around 70% of the total gilt market.

What's more, these two key investors have been big buyers of gilts over the past decade. The following chart shows the supply of gilts to the market place (in grey) since 2016, and estimates of the amount being bought by UK pension schemes (in dark blue) and the Bank of England (under its QE programme, in pink). The net supply to the market may have been around £50-100bn pa on average.



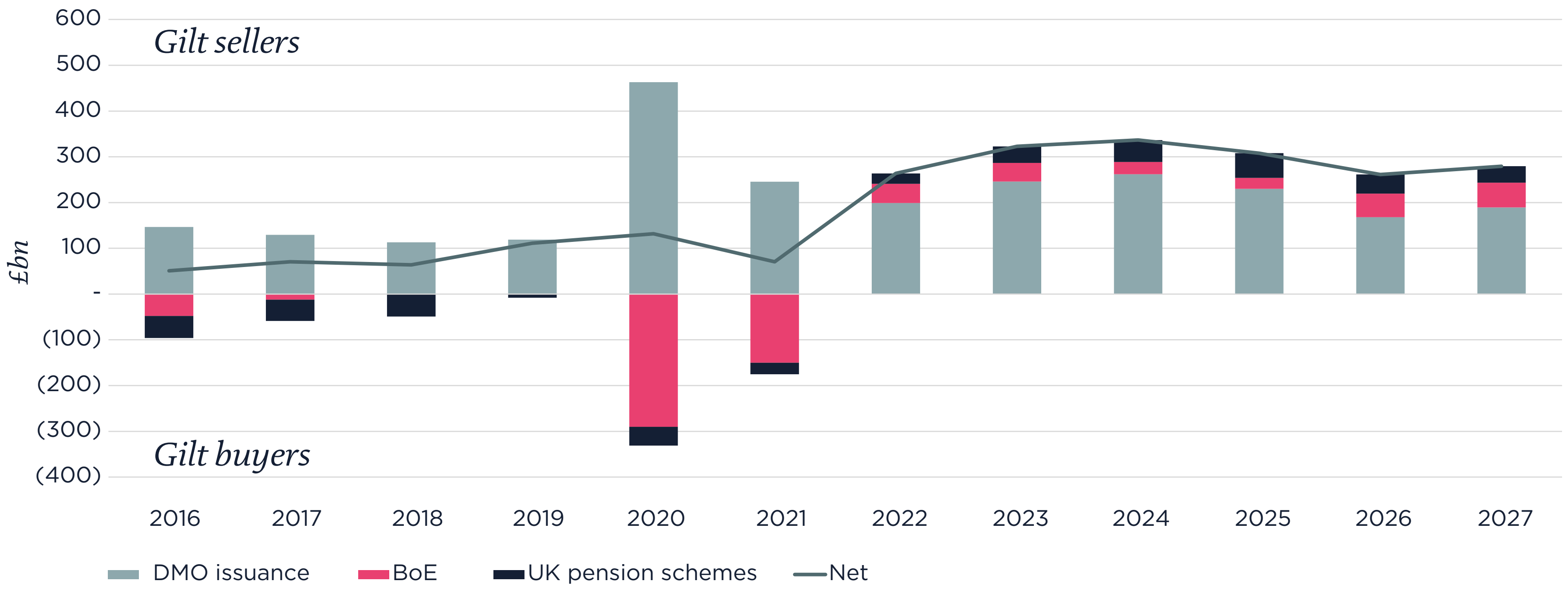

Source: DMO, BoE, LCP estimates

In recent years this dynamic has helped to support the price of gilts and allowed for new issuances to be easily absorbed.

However, this dynamic is now in reverse and may continue that way over the coming years as:

- The Bank of England continues with its policy of reversing QE and actively **sells** gilts to the market; and
- Pension schemes implement insurance transactions and the insurers then sell the gilts, so that they can generate a higher return.

The next chart extends the previous one, but with a projection over the coming years. The net supply of gilts to the market, allowing for the actions of pension schemes and the Bank of England, might have changed from around £50-100bn to around £250-300bn per year – that's quite a shift!




Source: DMO, BoE, LCP estimates

# 2.3. Should we expect more volatility within the gilt market and, with the role of pension schemes diminishing, who's going to buy all the gilts Continued

So, seriously, who is going to buy all these gilts and what might the impact be on the gilt market? There will need to be a transition towards replacing the buyers of gilts at unprecedented levels.

Now, of course, the DMO is well aware that issuing longer-dated and index-linked gilts will be more of a challenge, and have already shortened their issuance and will increasingly be targeting different areas of the market, most notably overseas investors (think sovereign wealth funds and central banks) or individuals (who may see this as a good opportunity rather than leaving money in bank accounts earning lower levels of interest).

But that in itself is a problem when inflation is high and interest rates are high, as it means high levels of interest on national debt and uncertainty around refinancing. Even at these elevated levels, it's not obvious that these buyers have the appetite, or the capital, to plug the level of demand that pension funds previously provided.

All of this means there is a very real chance that we get bouts of further market volatility as this tricky rebalancing process plays out in practice. It's perfectly possible (some may say likely) that we see sell-offs in the gilt market and spikes in gilt yields, given the classic economic relationship between increased supply and reduced demand.

The above points need to be weighed against the extent to which this is already factored into the existing price and counter-arguments that bonds may perform particularly well in a recessionary scenario that may be just around the corner. Indeed, there are many factors that could cause bond prices more generally to increase and yields to fall. To name just a few: if inflation gets under control; if base rates are cut; if recession looms large; if QE is restarted; if long-dated gilt / index-linked gilt supply is constrained. None of these are scenarios that can be ruled out with a high degree of confidence.

**Actions for sponsors:**

1. **Be prepared for volatility** – in both directions. The lessons learned from the "LDI crisis" highlighted above are crucial for this.
2. **Consider a dynamic approach to hedging** – if the supply/demand dynamics of the gilt market are likely to cause disruption, then consider how else to hedge your liability measures. A common approach is to use swaps rather than gilts, particularly if that generates a higher return. If the gilt market is going to be volatile going forward, then having the flexibility to switch hedging instruments as the relative value changes can add lots of value. Many funds are available to pension schemes that do just this and have demonstrated significant long-term value since their introduction around a decade ago.
3. **Consider alternatives to matching liabilities with bonds** – insuring your scheme is one such example. In previous sections, we have also covered the merits of matching liabilities with long-term illiquid assets and changing the approach by which liabilities are valued. Being less exposed to how the gilt market supply/demand dynamics play out may be a worthwhile strategy.

# 2.4. Other investment topics that should be on your agenda

**Investing for buy-out**
For many pension schemes, including those that are small and running costs may be disproportionately high, insurance will be the right solution. For those schemes targeting insurance, it is important to remember you need 3 strategies for meeting this target:

1. A **funding strategy** to ensure the scheme is well enough funded to approach the market and afford the insurance.
2. A **data strategy** to ensure an insurer is willing to provide you with a reasonable price.
3. But equally importantly, if not more, an **investment strategy** to ensure a) once you get well enough funded, you stay well enough funded and b) you can actually pass across the assets. For the former, schemes should consider how best to hedge insurer pricing (including how an insurer would price your particular inflation increases) and having sufficient credit within your portfolio (given an insurer will typically invest heavily in credit, this is a key input into the price they will charge you). For the latter, you will need to have liquid assets, or those that you can pass across to an insurer. See section 2.2 for further commentary on the options available.

**Equity protection**
Equity valuations have held up well compared to their bond counterparts, and many relative price metrics on equities vs bonds may not scream "buy, buy, buy". See on the right for a simple chart comparing dividend yields with base rates over time. Whilst these aren't like for like, it's clear that dividend yields are relatively low and history shows this relationship has a habit of reverting.

**Dividend yields compared to UK base rate since 2008**


Source: LSEG Datastream

With this in mind, what should pension schemes consider doing with their equity allocations? There are 3 main options:

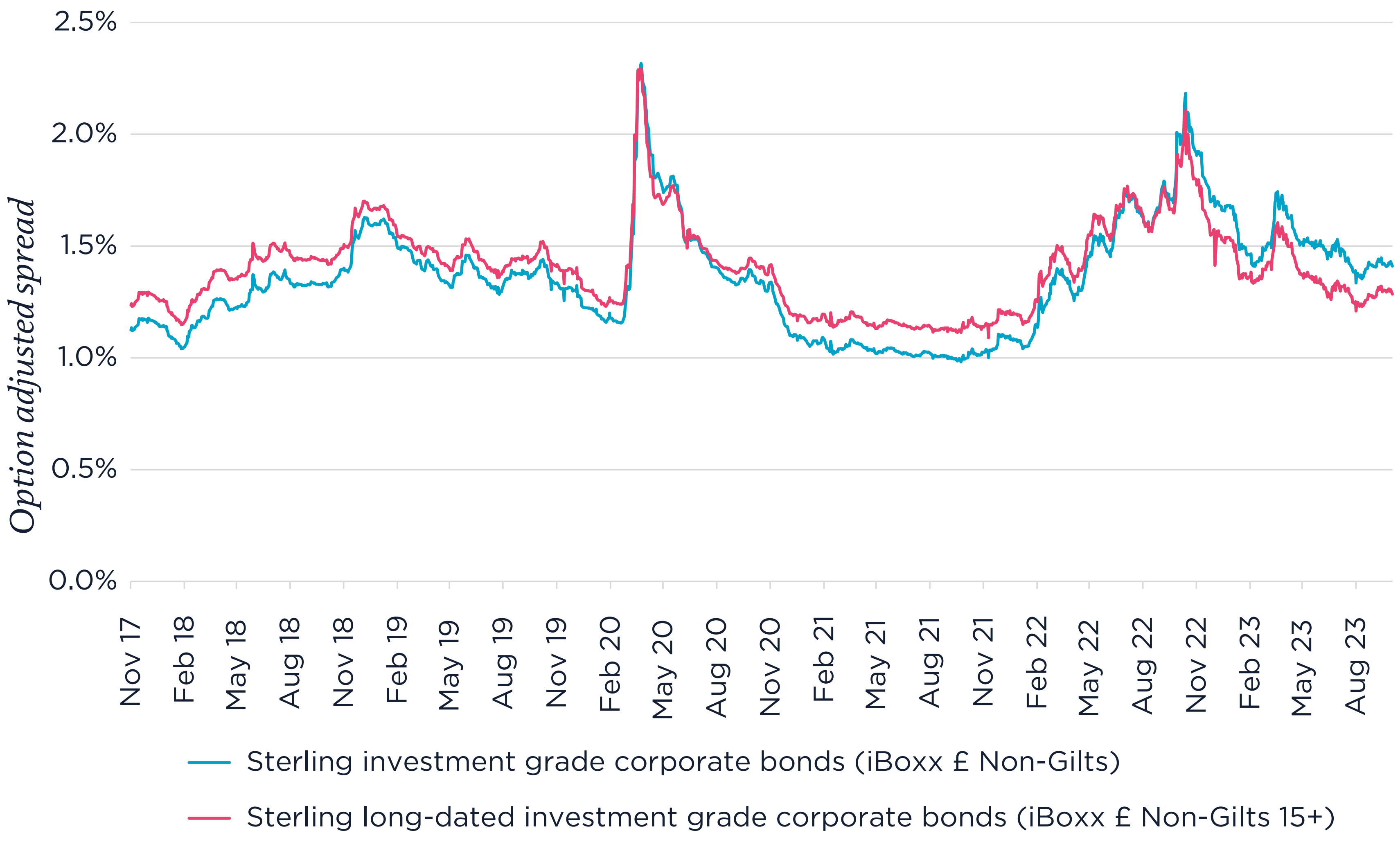
1. Sell, for example, if you don't need the returns or can generate returns more reliably through other assets.
2. Ride it out, and perhaps keep your fingers crossed that an equity market downturn doesn't coincide with an actuarial valuation date, or when you want to sell.
3. Restructure your exposure to equities using equity options, so that you have some downside protection. A common approach is to forego exceptional equity returns to pay for some downside protection. Such an approach can coincide with a future actuarial valuation date to reduce the risk of the sponsor needing to make additional deficit contributions.

# 2.4. *Other investment topics that should be on your agenda Continued*

**Investing in credit**

It can be very appealing to just buy a portfolio of corporate bonds and hold them to meet future cashflows. Job done. But is this necessarily the best way to invest in credit? With shorter-dated credit offering higher spreads above gilt returns (see chart below) and noting how it is safer to lend money for shorter periods, then does investing in short-dated credit and then rolling the exposures have a place?

**Sterling investment grade credit spreads**




By combining short-dated and long-dated corporate bonds, investors can reduce their default and downgrade risks, and generate a higher return. Add to this the potential to invest in investment grade asset-backed securities (think mortgages), which can offer both higher return and better credit rating than corporate bonds. This shows how credit portfolios can be improved compared to a simple buy and hold portfolio of long-dated corporate bonds.

**Credit-linked LDI**

We know, the last thing the world needs is more complicated LDI. But hear us out...

If we go back to basics, then LDI is all about hedging the price of buying government bonds later, whilst being able to invest in other assets in the meantime. But might it make more sense for pension schemes to hedge corporate bond prices? Why? Because in doing so you can get the following benefits:

- Higher returns; being willing to take the additional credit risk of corporate bonds typically comes with an expected additional return of around 1% pa. With LDI portfolios now a very large proportion of pension schemes' asset portfolios, this can make a big difference;
- Better alignment with IAS19 accounting liability measures, given this discounting measure is based on corporate bonds rather than government bonds;
- Better alignment with insurer pricing, given insurers typically invest most of the assets in corporate bonds and often hold fewer government bonds;
- Bigger cash buffers than holding the corporate bonds directly (for the reasons set out in Section 1 and with parallels to the case study on synthetic equities).

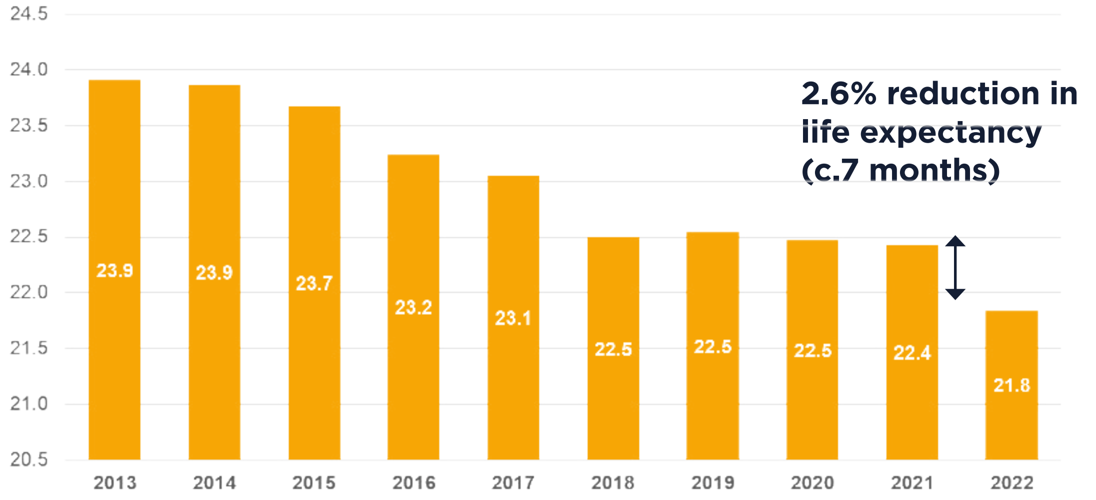
Through investing in credit-linked LDI, schemes can access all the above benefits.

# 2.4. Other investment topics that should be on your agenda Continued

**Investing in the energy transition**
The amount of capital that needs to be invested to support the energy transition, and the investment opportunities available, are staggering. Yet most pension schemes invest relatively little in what must be a once-in-a-lifetime investment opportunity. For those schemes with long time horizons looking to run-off their pension schemes and generate attractive investment returns, this is certainly an area worth greater focus.

**Longevity hedging**
Within your LDI portfolio – it is perhaps odd that most pension schemes will hedge the vast majority of the risk of the liability cashflows increasing due to inflation, but often do not hedge the risk of those cashflows increasing due to longevity. With life expectancies not having increased in line with previous assumptions (see the chart below), pension schemes will have made a relative gain from not hedging. For some schemes it will make sense to now lock in these relative improvements in the funding position.

**Typical life expectancy for 65-year-olds**




Add to this the reinsurance costs for hedging longevity having fallen significantly, and LDI managers being able to manage the longevity hedge alongside the inflation hedge; it can be compelling.

Of course, care needs to be taken so that any longevity hedge has flexibility to be passed across to an insurer at a later date, as circumstances can always change.

**Refresh liability hedges**
LDI managers do not know if your liability cashflows have changed unless they are told. When members' life expectancy changes, or they transfer-out, retire early, or take up other options available to them, the LDI manager will not know and carry on hedging the previous cashflows provided to them. Given the big changes we've seen in life expectancy, it is worth schemes taking proactive actions to make sure liability hedges remain fit for purpose.

**Beware of deflation**
For many pension schemes a deflationary scenario, or the increased likelihood of deflation scenarios in the future, is a particularly painful scenario. Pension payments usually cannot be reduced and have a floor to inflation increases. Inflation hedges do not usually have the same characteristics, meaning when inflation falls a scheme's assets can fall by more than its liabilities. One way to correct for this is to reduce inflation hedging as inflation falls, which in itself leads to a risk if all pension schemes are trying to rush for the exit at the same time.

Whilst this may not be a likely scenario, the risk may have increased due to volatile inflation and commodity prices and we all saw what happened late last year when pension schemes (who own most of the index-linked gilt market) herded in the same direction.

Solutions to this include a) be ahead of the curve when rebalancing inflation hedges b) reassess the way in which inflation is hedged (an approach of selling inflation hedges when they become cheaper may not be optimal) or c) hedge inflation using other assets that may contain a floor (such as long-dated property leases).

**Address climate change risks**
Many pension schemes have taken positive steps to reduce the risks associated with climate change within their equity and corporate bond portfolios. Solutions include investing in an index that tilts exposure away from higher emitters, or accepting higher emitting firms but only those with clear climate transition risk management plans as well as active stewardship (such as encouraging those without clear plans to create them). The elephant in the room is that DB pension schemes don't actually tend to invest much in equities and they have a much bigger holding in gilts. How should pension schemes use their position as the key lender to the UK government to manage climate risk on behalf of their stakeholders? It's a tricky question the industry currently faces and our CEO has some thoughts: **Aaron Punwani: The guilty reality of pension scheme action on climate change (professionalpensions.com)**

# Important changes in the pensions landscape for corporates

*By understanding the intricate moving parts of the DB pension scheme regime and how they best fit together, you can unlock the full potential of improving funding positions, ensuring that members safely receive their benefits whilst simultaneously creating avenues for corporate growth and stability.*

*Jon Forsyth* Partner, LCP

## Mansion House reforms

In the Chancellor's Mansion House speech in July 2023, a whole raft of reforms were announced that are designed to ensure that money saved in UK pension schemes is used more productively. Whilst some of the announcements related to better use of DC funds, the Government made clear its willingness to turn its attention to the much larger sums of money held in over 5,000 DB pension schemes.

### New options for DB schemes

With c.£1.5 trillion sitting in workplace DB schemes, the DWP has published a call for evidence on 'options for DB schemes'. One of the principal ideas discussed in the consultation is one **developed by LCP**, designed to free up well-funded DB pension schemes to invest for long-term growth instead of continuing to move to more and more low-risk, low-return assets. See section 1.4 of this report for more details.

### What else?

In addition to the above, the Mansion House speech also brought development in a number of other areas, many of which we cover elsewhere in this report, including:

- Confirmation that the DWP will deliver an extension to its Collective Defined Contribution legislative framework (more below);
- Opening up new possibilities on DB superfunds, as covered in section 1 of this report;
- A new call for evidence on **Trustee capability, advice and duties;**
- Although not the focus of this report, it's also worth noting the various key developments in the DC pensions space, with the **Mansion House Compact** aiming to boost returns for savers and to increase investment in British businesses; confirmation the **value for money framework** will go ahead, and a **decision on small pots**.

### So what?

There is a lot to process here and it is worth keeping an eye on developments – although the timings are tight we could see some key changes in the pensions space before the end of this parliament, and as always change means risks and opportunities for sponsors.

*Whilst this list of pensions developments remains extensive, corporates should hone their focus more towards opportunities rather than solely on risks.*

*Dev Gandhi* Senior Consultant, LCP

# *Important changes in the pensions landscape for corporates* Continued

*For those firmly on the path to buy out, there are still important strategic decisions to be made about timing and making sure that best value is secured.*

*Steve Webb* Partner, LCP

## Pension surpluses

In **last year's report** we focussed on what DB surpluses mean for sponsors, and one welcome consequence of the gilts crisis was that due to gilt yield rises most schemes have since seen their financial situation improve still further. Against this backdrop of increasing yields, the average pension scheme's buy-out funding level has accelerated beyond that expected from c.70% in 2019 to c.90% today – and some estimates have more than 1 in 5 UK DB schemes in surplus even on a buy-out basis.

As we covered in our 2022 report, there are a number of ways the additional surplus could be used, such as:

- Using the surplus in one scheme to fund a deficit in another scheme sponsored by the same employer;
- Using the surplus to fund future DB accrual or DC contributions;
- Using the surplus to pay ongoing expenses;
- Funding partial buy-ins to remove risk over time;
- Augmenting member benefits if the sponsor believes this is appropriate;
- Taxed refund of surplus to sponsor (usually during scheme wind-up); and
- Some combination of the above.

**So what?**

Sponsors should take advice on how/when the scheme rules permit refunds of surplus, and set their surplus strategy accordingly.

# *Important changes in the pensions landscape for corporates Continued*

## Contingent funding solutions

Contingent funding solutions continue to play a role in the new pensions landscape, and can provide significant benefits for both sponsors and members. With improved funding positions, an ever increasing risk of overfunding, and a new funding regime expected, contingent assets are being adapted to meet the needs of all pension scheme stakeholders. We explore these themes in more detail and consider how these options have been used in practice in our summer 2023 **webinar**.

**So what?**

These approaches are not just for valuations – they can provide a great outcome for all parties in many situations and help you achieve a wide range of objectives. It's worth ensuring you understand all the options and consider their appropriateness for your schemes.

## A changed bulk annuity market

Against the backdrop of much improved funding positions for many schemes, the DB de-risking market for buy-ins and buy-outs is arguably busier than it has ever been, with a **step change in activity** and likely record volumes of transactions in 2023. Opportunities with good pricing are very much still available, provided you have done your preparation work on data and benefits, and you present a united front between trustee and sponsor to give insurers confidence that the deal will go ahead. 2023 has even seen a **new entrant to the market**, which promises to ease some capacity constraints.

**So what?**

For those sponsors whose schemes are sufficiently well funded, and who are keen to get them off their balance sheets, good opportunities are still there. Sponsors should be on the front foot and own the process.

## Long-term targets and journey planning

Improved scheme funding and the expected new funding code are inspiring more schemes and sponsors to refresh their thinking on long-term targets, with an increasing array of endgame options available to pension schemes, as highlighted in Section 1.

Firming up the journey plan on how to get to the chosen endgame is clearly beneficial for the scheme and sponsor alike – knowing the steps you expect to take on the way, and ensuring you're able to capture opportunities and mitigate risks as you go along, means a smoother and more cost-efficient journey overall.

Many sponsors, often alongside their trustees, are also engaging in "war-gaming" to plan for particular scenarios and ensure that all stakeholder objectives are aligned. This enables sponsors to react quickly to adverse scenarios and risks, and to capitalise quickly when opportunities arise.

**So what?**

Sponsors should consider whether they wish to drive these conversations forwards with the trustee, and at the very least to be actively involved. Ensuring that sponsor objectives are taken into account (and agreeing these objectives) and making these plans as efficient as possible will be objectives shared by sponsors and trustees.

# *Important changes in the pensions landscape for corporates Continued*

## The new funding code

There have been many delays, but with the regulations surrounding the new funding code currently expected to come into force from April 2024 shortly followed by the code coming into force, sponsors should still be planning for the new DB funding regime.

The expectation is that all schemes will be required – by law – to target a low-risk investment and funding strategy by the time they reach a certain level of maturity, and trustees must follow the principle that deficits should be paid off as soon as the employer can "reasonably afford". Improved funding positions may alleviate some of the pressures of paying off deficits quickly, but concerns may remain about targeting a low-risk investment and funding strategy in short order.

The regulations also bring covenant into legislation for the first time, setting out the matters to be considered in its assessment – including cash flow, sponsor prospects and the likelihood of insolvency. And we expect much more detailed covenant guidance to be issued by TPR in due course.

**So what?**

Sponsors should consider the impact of trustees potentially pushing for lower risk funding and investment strategies. There is still uncertainty but higher funding targets and shorter recovery plans are likely outcomes for many. In respect of the expected covenant guidance, sponsors should be prepared for more requests for support and information from trustees.

## Macroeconomic impact on sponsor covenant

Whilst many schemes are facing improved funding positions and therefore some reduction in the reliance on the sponsor, many other schemes are heightening their focus on the strength of the covenant. In particular, in an environment of high interest rates impacting the cost of servicing debt, and high inflation increasing the costs of goods and services, many businesses are struggling. And that's before considering the potential medium to long term impact of Covid-19 and its interventions, Brexit, political uncertainty and net-zero policies.

**So what?**

Sponsors should take the front foot on these discussions to help their trustees consider all the facts before concluding on a potential weakening of the covenant, and the strengthening of funding target that would likely follow.

# *Important changes in the pensions landscape for corporates Continued*

## Mortality / Longevity changes

Over three years on from the beginning of Covid-19, we are still seeing large ongoing excess mortality.

Combined with the outcome of the 2021 census that resulted in heavier mortality tables, pension schemes are seeing reductions in assessed liability values. Further insights are available in our **2023 longevity report**.

**So what?**

All else equal, sponsors are likely to continue to see reduced liabilities coming through for funding and accounting due to mortality assumptions over the coming year. 2023 data so far shows 4-6% higher mortality than 2019, with early estimates suggesting that the CMI 2023 tables expected to be released in Q1-Q2 2024 could lead to a further 1-2% reduction in liabilities. See also the Accounting section of this report (section 4).

*CDC means providing more valuable pensions within existing sponsor budgets – potentially a win-win for sponsors and employees.*

*Steven Taylor* Partner, LCP

## Pensions tax

In an effort to keep those aged over 50 in work (and in particular doctors, many of whom have been adversely affected by tax restrictions), the Chancellor's budget in March 2023 revealed significant increases in the Annual Allowance and the removal of the Lifetime Allowance charge, which took effect from April 2023. The Lifetime Allowance is then set to be abolished fully in 2024/25. There are also proposals to introduce two new limits on lump sum allowances.

However, there are a number of uncertainties and technical issues with the draft legislation, which is very complex, and there is not much time to fix them.

**So what?**

Whilst mostly good news for scheme members, especially higher earners, there could be impacts on member behaviours (e.g. opt out rates) and there's also the potential for some pitfalls from the new legislation given it is being rushed. It's worth sponsors keeping an eye on developments here.

Where sponsors have Unfunded Unapproved Retirement Benefit Schemes (UURBS), they should consider any cost and accounting implications of these changes on those arrangements.

## Collective Defined Contribution (CDC)

Developments in the CDC arena continue to evolve at pace. Upcoming legislation, trailed in the Mansion House speech should enable Royal Mail to finally launch the first CDC scheme and also pave the way to wider multi-employer schemes. Longer term, a further consultation is expected on "decumulation only" schemes, which could ultimately be transformative for millions of people currently saving in DC arrangements.

**So what?**

CDC schemes are designed to meet a twin challenge – how to provide better quality pensions for current employees, whilst doing so in a way that is affordable and avoids the risk of sponsor deficits. CDCs achieve this by pooling investment and other risk, in particular enabling assets to be invested in growth assets for far longer than under a typical DC approach.

Modelling approaches can vary but suggest a regular DC saver could achieve an additional 50% or more lifetime income from a CDC scheme than a typical DC arrangement. All this is achievable because, unlike under DB, there are no guarantees. Whilst members earn an additional target pension each year, annual changes are then made to future pension increases to offset emerging investment and other scheme experience.

# *Important changes in the pensions landscape for corporates Continued*

## Pension scheme governance and Professional Trustees

The market for professional trustees continues to grow, with our **latest report** showing that 50% of UK pension schemes now have a professional trustee on the board, and 150 new Professional Corporate Sole Trustee (PCST) appointments in the last year alone. Drivers for this continue to be the growing regulatory requirements that trustees must be familiar with, increasing recognition of the value of experienced professionals when undertaking major projects (e.g. insurance transactions), issues with succession planning and the desire to streamline governance and costs.

### So what?

The use of a professional trustee is beneficial to both trustees and sponsors. A sole trustee model will not be right for all schemes, but can offer streamlined decision making and access to the professional trustee's experience of a wide range of schemes and circumstances.

## High inflation

Whilst levels of inflation have fallen from their highs in late 2022 / early 2023, with 12 month RPI and CPI peaking at 14.2% and 11.1% respectively in October 2022, inflation still continues to persist at a relatively high level and threatens to stay a little while longer.

As well as the direct impacts on many businesses, there are lots of implications for pension schemes, including funding and accounting positions, hedging levels and the impact on member benefits.

### So what?

Sponsors should ensure they understand the pension and covenant impacts of high inflation and are liaising with trustees to stay on top of the matter.

## Discretionary increases

Given persistent high inflation, some trustees and members are likely to ask sponsors to consider agreeing to discretionary increases, especially where scheme pension increases are capped (or there are no inflationary increases at all). Sponsors will need to consider whether this is appropriate, taking into account the accounting impact, equity between employees and members of the pension scheme, and setting precedents, amongst other factors.

### So what?

There have been some high profile cases in the public domain where members have requested a discretionary increase and the sponsor has refused. It's important that sponsors are proactive and carefully manage expectations and communications – and are able to demonstrate that due process has been followed.

# *Important changes in the pensions landscape for corporates Continued*

## And much more...

Just in case the list above wasn't enough, this table gives a quick rundown of some other pensions developments that sponsors should keep an eye on.

| *Development* | *So what* |
|---|---|
| **Pension Schemes Act 2021** – most of the provisions have been in place for a while now, and processes should have been adapted as needed. If not there are potentially large risks so quick action is encouraged.<br>Sponsors should also keep an eye out for the new Notifiable Events regime and make any updates to processes swiftly. | Sponsors should ensure they understand the regulatory boundaries and have robust governance processes including contemporaneous records of decision making (i.e. not after the event). |
| **Cyber risk** – in an increasingly digital landscape, cyber risk stands as a prominent concern in relation to pension scheme data, highlighted by recent breaches that have made the headlines. | Sponsors and trustees should understand these risks and create a robust response plan to address potential breaches swiftly, undertaking training where necessary. LCP has prepared a cyber security checklist for this. |
| **Artificial Intelligence** – another very hot topic that goes much wider than pensions. But in a rapidly evolving pensions world, AI can offer unprecedented opportunities for efficiency and insight, such as in the fields of member engagement, making financial decisions and improving understanding of investment options, to name just a few.<br>There are now also mainstream providers using AI technology to give answers to members' financial questions.<br>We delve into the transformative potential of AI in our latest podcast series: **Beyond Curious with LCP.** | Sponsors should seek to understand any developments their trustees and competitors are considering in this area, and understand the risks and opportunities. |

# *Important changes in the pensions landscape for corporates Continued*

| Development | So what |
|---|---|
| **PPF levies** – the latest PPF Annual Report showed it is now in **very good financial health**, with a funding reserve (surplus) of £12.1bn as of 31 March 2023. The PPF has signalled it will collect only £100m of levy in the 2024/25 year, which is one-sixth of what it collected just four years ago. | Great news for sponsors that aggregate levies are lower now and likely in the future for the vast majority of schemes. Where PPF levy is material (or will increase due to higher insolvency scores), sponsors should seek estimates for budgeting purposes and make sure mitigating actions are being explored. |
| **GMP equalisation** – the industry wheels have been turning on equalising benefits for GMPs. There is often considerable technical and logistical complexity, but there is plenty of helpful guidance from PASA, and increasing amounts of growing industry expertise. Visit our **GMP insights hub** for more details. | Where not done already, sponsors should be understanding the impact of different options and engaging with their trustees on the best options to focus on. As well as managing the considerable risks involved, there are opportunities for those who consider this carefully, including the possibility of reshaping benefits and/or combining with certain member options (see below). |
| **Member options** – there have been **seismic shifts in the DB transfer market**, with transfer values halving in some cases and members increasingly finding it difficult to access good quality financial advice.<br><br>Given this, as well as the new economic environment of high yields and high inflation, more and more schemes are taking action in this area. This could include putting in place IFAs to assist members in making important decisions, or adding options like bridging (or "levelling") pensions where benefits are re-shaped to give a smoother total income when combined with the state pension. | A good member options policy can reduce reputational risk, improve engagement and accelerate your journey to achieving your objectives through the funding gains seen when members exercise their options. High inflation and rising yields are a good reason to look again at what is on offer and the terms – noting some factors like commutation may now be overly generous after years of pressure to increase them. |
| **Potential issues with historical benefit changes** - whilst there have been a number of legal cases concerning pensions over the last year, one of particular interest is involving Virgin Media, where the High Court has restated the position that an actuarial confirmation is a necessary condition when changes are proposed to certain scheme benefits accrued between 1997 and 2016. | Sponsors should consider working with their trustees to test the impact of any missing documentation, with those looking to transact with insurers in the near term paying particular attention to this. |
| **ARGA delayed** - the establishment of the Audit, Reporting and Governance Authority (ARGA) will likely not be implemented until after the next General Election now. The ARGA was intended to replace the FRC with more powerful regulation and promised an overhaul of the UK's audit and corporate governance regimes. | Once in force, the new regulator is expected to drive much more audit market competition and lead to increased accountability for directors on bonuses and dividends. |

# *Important changes in the pensions landscape for corporates Continued*

| *Development* | *So what* |
|---|---|
| **Responsible investing** – **philosophies** regarding responsible investments continue to attract more focus. | Sponsors should engage with trustees with a view to ensuring the investment strategy of the pension scheme is aligned with corporate values. |
| **Climate risks** - climate considerations should be factored into pension scheme decision making. Whilst the worst physical impacts of climate change may still be some years away, the transition to a green economy is likely to mean many emerging risks and opportunities for investors. | This will remain an area of fast evolving disclosure requirements and associated reputational risks, and it is important for sponsor and trustee actions and messaging to be joined up. **LCP Beacon** allows sponsors and trustees to consider the impact of climate change on the sponsor covenant. |
| **Pensions Dashboard** – a delay to the connection deadline was announced from 31 August 2023 to 31 October 2026. | Make sure this isn't slipping too far down the agendas for trustees and administrators – they should continue to prepare at the same pace for the Pensions Dashboard through exercises such as data-cleansing, which will also benefit other projects. |
| **Executive pensions** – the overall level of remuneration paid to company executives, and how this compares to their employees, remains a focus of attention. You can read more about this in our **2023 Accounting for Pensions report**. | To avoid the risk of a "red-top", and for wider reputational reasons, companies who have not already made progress in this area should look to do so soon. |
| **Diversity, Equity & Inclusion** – this remains an area of focus. | Sponsors should be considering if the make-up of their trustee boards is promoting or limiting effective decision making. See **The Pensions Regulator's guidance** on helping improve pension scheme equality, diversity and inclusion. |
| **DC and financial wellbeing** – not the subject of this report but as ever there is lots going on.<br>Recent legislative changes, such as the extension of auto-enrolment to individuals over 18 should help to improve retirement incomes to some extent.<br>Alongside the cost-of-living difficulties, the pension gender gap in workplace DC pensions is an issue many are grappling with.<br>Good financial health can be a win-win – a good financial wellbeing strategy will pay for itself many times over. | Sponsors should keep up to date on the latest trends and ensure their offering remains competitive and valued by employees.<br>Our recent **analysis of the gender pension gap** sheds some light on the main sources of inequality.<br>And read our **latest financial wellbeing report** to learn more about why your strategy here is so important and what you can do to improve it. |

# *The current strong accounting position: What's driving it? and what does it mean for corporates?*

Across the UK as a whole, the pensions accounting position looks healthy. As discussed in Section 1 of this report, at the end of last year the FTSE 100 showed a record surplus.

During the year we've seen sustained high levels of discount rates. Whilst the steep rise in rates following last year's gilts crisis fell off from initial highs, this was followed by a further steady drift upwards meaning current discount rates are in excess of 5.50% (Oct 2023).

**Typical accounting discount rates over time**


Source: LCP Analysis

This rise in corporate bonds yields has reduced pension liability values by well over 40% from the discount rate low of December 2020 (when rates were 1.25% pa).

Despite the high discount rates and resulting fall in liabilities, there has been some drop off in the accounting surplus for some well-funded schemes that sought to hedge the liabilities on other funding measures (that used more conservative assumptions). This reflects differences in how the various liability measures respond to movements in gilt markets and corporate bond spreads and was discussed in more detail in Section 1 of **LCP's Accounting for Pensions 2023**.

Inflation has remained high, with most schemes seeing the annual 2.5% or 5% cap on pension increases bite. However, as this is broadly in line with expectations at the start of the year it's had less of an impact in terms of experience losses going through the accounts.

**Key Action:**

**Get a current estimate of the accounting position to ensure no surprises at the year-end**

## Implications for Sponsors

With a few notable exceptions, the generally high level of surpluses, smaller liabilities and less volatile financial conditions have given welcome relief from the turbulence of the last few years.

**Key Action:**

**Understand your objectives and how they influence your approach on the assumptions**

For some we expect this to result in less strategic focus on the assumptions underlying the surplus or deficit shown on the pensions balance sheet, and a greater focus on ensuring a smooth path through audit. This will not always be an easy task, with the heightened general focus on auditors and seemingly ever-increasing professional requirements.

**Key Action:**

**Engage with auditors to understand their needs and expectations in advance of year-end and manage the process**

However, for those who wish to invest more time in setting their assumptions there are opportunities to look harder at the judgements made around discount rate and mortality in particular.

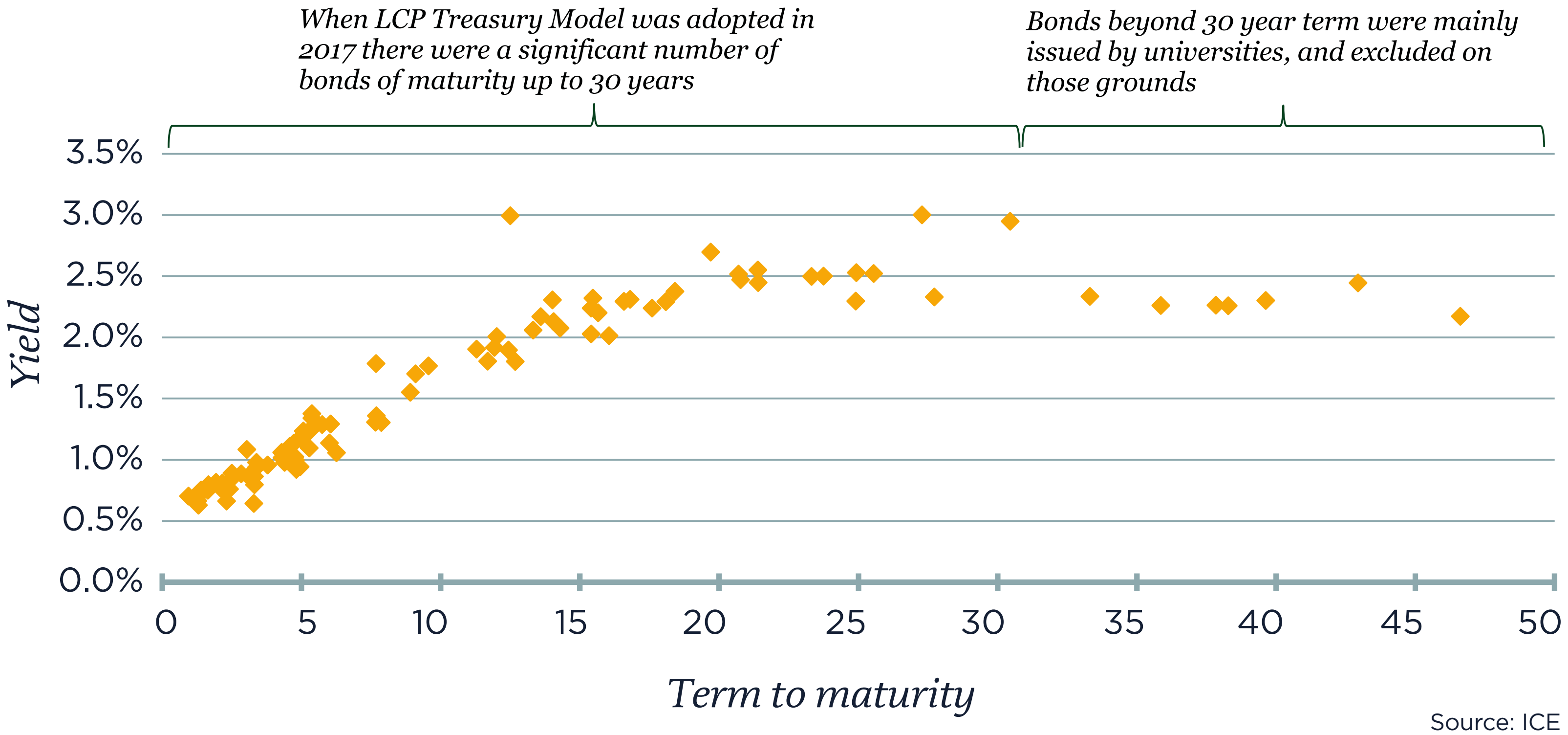
*The steady rise in discount rates has contributed to a fall of over 40% in accounting liabilities since late 2020 and record surpluses. Many Sponsors are rethinking their accounting priorities in light of these new conditions.*

*Helen Draper* Partner, LCP

# Discount rates: Yields are high and a shift in index constituents creates scope for change

Discount rates have risen significantly and have been key in driving down liability values (and often pension scheme assets). However, the other less obvious news story is the change in the constituents of the AA-rated corporate bond universe, particularly at the longer maturity end that is so key for discounting long-term pension payments. This change could encourage sponsors to look afresh at their approach.

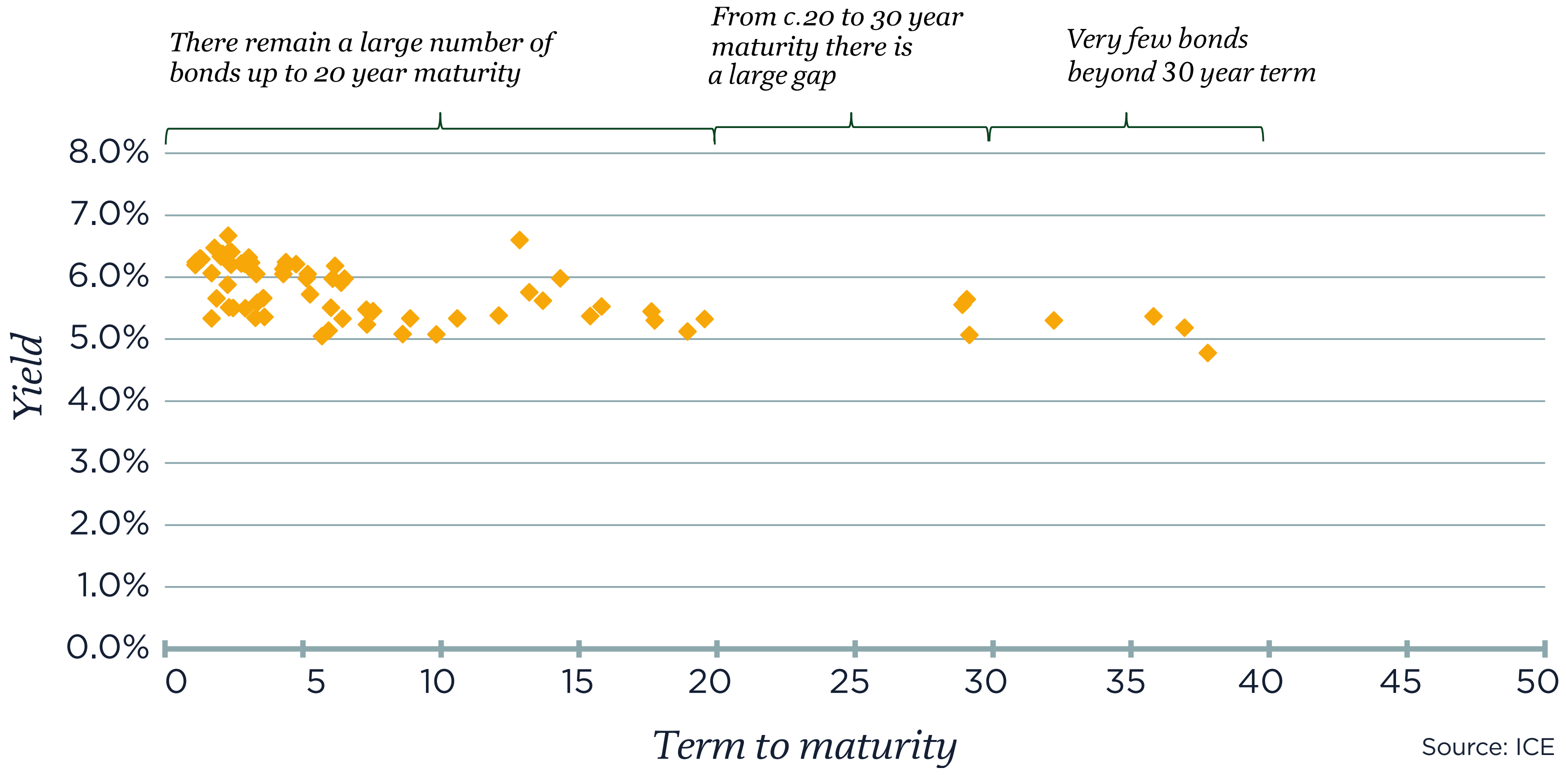
For example, this was the AA corporate bond universe in 2017:




Source: ICE

You can see that there are very few bonds at the longer terms relevant for the profile of a typical pension scheme, so the challenge becomes how do we use the information that we have to extrapolate this to the terms we need. The way this is done can have a significant impact on the final discount rate and thus on the balance sheet position disclosed. The success of the LCP Treasury Model was to do this in a robust way, based on a transparent approach used by the US Treasury that gave a result that was attractive to Companies, and accepted by auditors.

This is the AA corporate bond universe today:




Source: ICE

You can see that there are still very few bonds with a term of over 30 years. But, there are also significantly fewer bonds now in the index between 20 and 30 years.

Though existing methods may remain acceptable, there are strong arguments that the further reduction in longer dated constituents calls for a change in the extrapolation approach. For some sponsors, working with their advisers to think harder about these issues could result in higher discount rates and a significant balance sheet improvement (with liabilities falling by up to around 2.5% compared to existing methods).

*The AA corporate bond universe has changed significantly – a fresh look at how discount rates are derived may well be needed.*

Sarah Lossin Partner, LCP

# Mortality: The legacy of the Covid-19 pandemic

**Key Action:**

**Consider mortality carefully, not only in the context of corporate accounts, but the wider implications including funding and de-risking**

For most sponsors a key area of focus is likely to be mortality, and it will be high up on the auditors' check-lists. This is important whether or not you are focussed on the balance sheet position. Having a strong, defensible, objective view on mortality often benefits the sponsor in other (non-accounting) funding, scheme factors, member option exercises and de-risking discussions, where margins above the "best estimate" assumptions used for accounting are often included. This helps more informed decision making in wider discussions, that often include other stakeholders such as pension scheme trustees.

Assumptions to estimate life expectancy are made up of two parts: an assessment of current mortality rates (the base table) and a projection of how mortality rates will change in the future.

## Mortality projections and the legacy of the Covid-19 pandemic

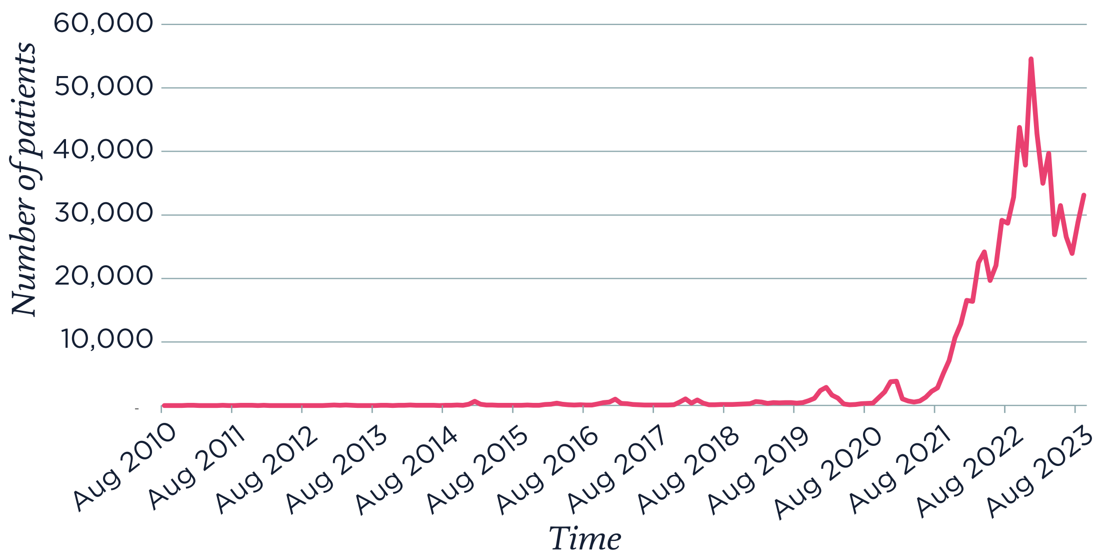
Actuaries have typically set mortality assumptions by projecting historical trends. However, in light of the past few years, with exceptional mortality experience caused, directly and indirectly, by the Covid-19 pandemic, trends are becoming increasingly difficult to interpret. A forward-looking approach, reflecting current and expected future drivers of mortality, is becoming increasingly important to derive robust mortality assumptions.

As we approach the end of 2023, mortality experience year-to-date has remained heavier than pre-pandemic trends, despite deaths attributed directly to Covid-19 reducing significantly. Some of the drivers behind these excess deaths are linked to the persistent impact of the pandemic on the health system, for example increased hospital waiting times, and missed or delayed diagnosis of diseases during the peak of the pandemic, leading to adverse patient outcomes.

Considering these indirect drivers in setting mortality assumptions can help ensure assumptions are robust and reflect the latest expectations of future mortality rates.

Further details can be found in our latest Longevity report: A new era for longevity.

**Number of A&E patients waiting more than 12 hours from decision to admit to admission**




## CMI 2022 mortality projections model

The CMI 2022 mortality projections model was released in June 2023. It contains a new parameter ("w2022") which, like the related parameters included in the 2020 and 2021 versions, can be used to determine the weight to place on 2022 mortality data for the national population, to which the model is calibrated.

However, unlike the previous two versions, where the default within the "core" projection was to completely ignore 2020 and 2021 by applying no weight to those years, the new CMI model applies a default "core" 25% weighting to 2022 mortality data.

This in isolation has the effect of reducing life expectancies by around 1.7% at age 65 compared to the core CMI 2021 model.

The model used to project mortality rates is built around data obtained from the Office for National Statistics (which records death registrations) and an estimate of the population based on projections from the latest census results. The CMI 2022 model incorporates the 2021 census data for the first time, which also reduces life expectancies by around 0.5% on average.

Therefore, updating to the latest core projections can result in life expectancies of scheme members falling by more than 2%, before making any adjustments to the default model.

# *Mortality: The legacy of the Covid-19 pandemic* *Continued*

## What weight should be applied to 2022 data?

The pandemic has fundamentally changed the landscape for mortality projections, bringing expert judgement to the forefront of the assumption setting process. The direct repercussions of the pandemic, the strains on the healthcare system, and the economic pressures affecting both individual households and government spending, have significant ramifications for future trends in mortality.

As we enter what could be a ‘new normal’ after the pandemic, having an up-to-date and regularly reviewed best-estimate mortality assumption, reflecting the latest information and emerging evidence, is more important than ever to ensure that estimated liabilities, and future journey plans, remain fit for purpose. At LCP, we have fully integrated the insights of our health experts, comprised of epidemiologists and healthcare professionals, to inform our view of what this new normal will look like.

From these insights, we know that we will not all be affected the same way by the current drivers of mortality, and so it is important to reflect the profile of your members when setting your longevity assumption. For example, there is evidence that those living in the most deprived areas not only have the lowest life expectancy today but are likely to be most adversely affected going forwards.

Therefore, in some circumstances, placing more weight on the most recent data could be justified, reducing the rate at which mortality rates are assumed to improve over the short- to medium-term. There is however a balance to be struck, with high weightings close to 100% resulting in what could be deemed by some to be less realistic best estimates – for example, mortality rates continuing to increase year-by-year over the medium term.

**Case study:**

LCP advise the sponsor of a large pension scheme where no allowance was being made for the impact of the pandemic in their mortality assumptions.

Ahead of the annual IAS19 exercise and in preparation for the upcoming triennial valuation, we analysed the demographic profile of the membership, as well as recent mortality experience in the scheme, to determine a robust, forward-looking best estimate mortality assumption.

By analysing the socio-economic make-up of the scheme and comparing the scheme’s mortality experience to the general UK population, we were able to objectively demonstrate the direct and indirect impacts of the pandemic on members of the scheme. As well as adjustments to the base table, we determined an appropriate adjustment to the mortality improvement assumption.

Overall, our analysis supported a 3-4% reduction in liabilities through updates to the mortality assumptions. This analysis was provided to the sponsor’s auditors to support the change in assumption for IAS19 purposes. It was also provided to the scheme’s trustees and used as the best estimate assumption from which a prudent funding valuation assumption was developed, ensuring that the level of prudence was appropriate and understood by all parties.

*As we navigate the aftermath of a global health crisis, our understanding of mortality evolves. The legacy of the pandemic is impacting population health, the healthcare system, and therefore our projections of life expectancy. Robust analysis of pension scheme membership can help ensure that mortality assumptions are up to date and appropriate to your journey plans.*

*Stuart McDonald MBE,* *Partner, LCP*

# Looking to the future

## Endgame and de-risking

Whilst a range of innovative strategic "endgames" are emerging for schemes, most trustees and many corporates have at least one eye on a potential future buy-out.

As discussed elsewhere in this report, there are several key benefits to an insurance transaction. However, it can also have a significant impact on the accounting figures by almost certainly weakening the balance sheet position and potentially resulting in a significant P&L charge.

Whilst the accounting treatment would rarely be expected to drive strategic decision making, given the importance and significance of the potential impact of de-risking transactions on accounting figures, it is vital that the issue is considered and managed carefully from the early stages.

For those sponsors who report under US GAAP, it is important to understand that the accounting treatment of buy-outs is quite different to IAS19 and UK GAAP (sometimes with options for the sponsor, and sometimes giving unintuitive results). This therefore needs to be considered carefully at an early stage.

In our experience, provided it is assessed early, then with effective communication and internal and external messaging, the accounting impact of a de-risking transaction can be managed and the benefits to the business made clear.

*It's important to fully understand the accounting implications of a full scheme insurance transaction very early in the process. The answer to this can be very different depending on apparently small factors, and is fundamentally different under US GAAP.*

*Phil Cuddeford* Partner, LCP

**Key Action:**

1. Understand your objectives, and how they influence your approach to the assumptions.
2. Consider mortality - not only in the context of corporate accounts, but wider implications including funding and de-risking.
3. Get a current estimate of the accounting position to ensure no surprises at the year-end.
4. Engage with auditors to understand their needs and expectations in advance of year- end and manage the process.

## Some other issues to consider

**Surplus recognition - assets and tax treatment**

**Pension scheme exercises including GMP equalisation, discretionary increases and introduction of new member options**

**Modelling inflation and how to allow for the term structure given RPI reform and high current inflation, with knock-on impacts to OCI experience item**

**Updates to member option factors and ensuring changes are reflected in accounting numbers**

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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, insurance, energy, health and analytics.*


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