Defined Benefit (DB) pension scheme funding:

2020 reflection and predictions for 2021

In what has certainly been an unpredictable year, senior actuary Colin Parnell, Head of Bulk Annuities, looks at the key developments in funding for small to medium-sized UK defined benefit (DB) pension schemes during 2020 and considers what 2021 may bring.

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Employers and trustees should engage in contingency planning

The global economy took a significant hit in 2020 and the repercussions of this economic turmoil is likely to go on for some time.

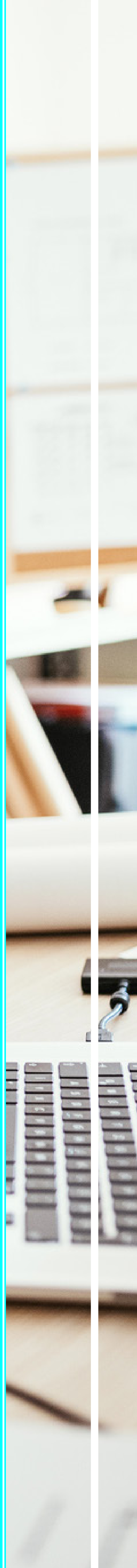
While this has affected the majority of organisations, small to medium-sized schemes are at increased risk of employer failure in 2021 and beyond. It's essential that these schemes undertake contingency planning so that they can identify and address any significant threats. Well-governed schemes establish regular flows of information, simple triggers and pre-agreed actions to manage their vulnerability.

Common characteristics of smaller schemes that make them particularly vulnerable

There are some key features that are more common to small and medium-sized schemes than larger ones. They make outcomes for small to medium-sized schemes more volatile than those of larger schemes.

- **More risky investment strategies,** as measured by a lower allocation to bond investments that closely match schemes' liabilities and higher concentration in growth assets (for example, UK equities)
- **Higher probability of employer default,** as measured by rates used for Pension Protection Fund levies
- **Higher proportion of schemes with low funding levels,** as measured by the proportion of small schemes with a buy-out funding level below 50%.

Source: Pension Protection Fund Purple Book 2020



Employer covenant – uncertainty and the end of insolvency protection

What happened in 2020?

There have been fewer corporate insolvencies in 2020 than there were in 2019, due to the range of Covid-19 support measures offered by the UK Government.

Despite a lot of discussion on the matter, only around 10% of UK employers deferred payment of deficit reduction contributions.

What's expected in 2021?

Insolvency protection and other support measures are due to end in 2021, which is likely to cause significantly more corporate insolvencies. Currently, some weak companies may be running like zombies until their inevitable demise in 2021.

Many economic forecasts are predicting widespread unemployment and employers fighting for survival – this may mean that pensions issues get pushed down the priority list. Contingency planning will enable organisations to give pensions issues due consideration, even in times of crisis.

Potential actions

Carrying out a detailed covenant review and putting an agreed process in place for receiving regular updates are vital. Contingency planning for challenging scenarios will help to identify any immediate actions and to react quickly to new events.

Most employers are viable and may simply want temporary flexibility to weather short-term difficulties (for example, through a temporary contribution suspension). Trustees need to question whether they're receiving enough information to allow such flexibility. They need to take care that they're not being moved to the back of the queue behind other creditors.

Only around 10% of UK employers deferred payment of deficit reduction contributions

Investment performance

What happened in 2020?

UK equities performed particularly badly (-10% or worse). Global equities performed relatively well (+10% or better). Many schemes have been significantly protected against falling long-term interest rates by holdings in government bonds, corporate bonds and leveraged LDI.

What is expected in 2021?

The Bank of England's Monetary Policy Committee described the UK economy's current position as "unusually uncertain" at its meeting on 16th December 2020. Therefore, I won't attempt to predict what will happen to investment markets in 2021. However, with so much uncertainty around investments, it's important that schemes keep on top of their contingency planning and risk assessments, so that they can act quickly when needed.

Potential actions

Some trustees and employers have delayed increasing their interest rate hedging with the expectation that rates will rise above what's already priced in the market in 2021 and beyond. However, it's impossible to predict the extent and timing of any rise in long-term interest rates so, in these cases, we recommend that parties reassess the level of risk they're running and agree to implement plans without delay in the event of pre-agreed scenarios happening. Triggers for action may include the level of risk currently being too high, given employer covenant; long-term interest rates rising; changes in covenant strength, or changes in the level of scheme funding. If you don't monitor the situation closely and have a prior agreement to act, it's unlikely that you'll be able to act at the right time.

UK equities performed particularly badly
(-10% or worse)

Scheme funding

What happened in 2020?

Funding levels have fallen for many schemes, primarily due to a fall in long-term interest rates and limited hedging of this risk among smaller schemes, but also as a result of disappointing returns from some growth assets (such as UK equities).

For smaller schemes, with moderate hedging, funding has typically fallen by up to 5%. Immature schemes with low levels of interest rate hedging and with relatively high allocations to UK equities have been particularly badly hit – we've seen reductions in funding levels of up to 10% in these cases.

What is expected in 2021?

We expect Royal Assent to be given for the Pension Schemes Bill, which will introduce greater legal powers for information gathering and enforcement action on scheme funding. Also, requirements around documenting long-term funding targets and journey plans (which include contingency plans) will be introduced for new funding valuations. The Pensions Regulator has already set out its expectations in various announcements – the Pensions Bill will turn 'should do' actions into 'must do' actions.

Potential actions

Undertake scenario testing of your scheme and agree contingency plans. You may agree longer deficit recovery periods subject to receiving regular employer covenant information and agreement to accelerate funding where employers perform better than expected. Trustees may agree to take investment risk when appropriate mitigation is in place, such as negative pledges from employers. This may take the form of a pledge by the employer not to share cash through intra-group loans that the pension scheme may find hard to retrieve in an insolvency event.

Funding has typically fallen **by up to 5%**

Political disruption

What happened in 2020?

The UK currently carries out around 50% of overseas trade with the EU and around 10% with the US. There was considerable press coverage of the recent UK-EU trade deal covering goods. However, we don't have an EU trade deal covering services – financial services being a key part of our foreign trade. Also, initial indications suggest that the US president-elect looks unfavourably on the UK's Brexit ambitions. Therefore, we expect political developments to continue to significantly affect pension schemes.

What is expected in 2021?

Potentially, barriers to trade will continue to affect employers' covenant strength and valuations of UK-based investments such as equities and corporate bonds.

Potential actions

Decide whether to reduce your schemes' asset allocations to UK investments (primarily equities) or wait for a potential upturn after Brexit is fully implemented, bearing in mind that things could get worse before they get better. Monitor the strength of employers' covenants closely where there is high exposure to the risk of a disorderly Brexit.

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Risk settlement market
(buy-ins, buy-outs and superfunds)

What happened in 2020?

2020 is expected to be the second busiest year for bulk annuity transactions, with £25bn to £30bn of new business written, down from £42bn in 2019. The absence of several multi-billion-pound transactions swamping the market in 2020 has enabled smaller schemes to gain insurers' attention.

What is expected in 2021?

We expect the buy-in and buy-out market to be more active than it was in 2020, as schemes adjust their plans and expectations for buy-out funding following market shocks in 2020.

The first scheme transfers to superfunds will receive a lot of press coverage as they aim to break the link between schemes and employers at a cost below the buy-out premium. The potential saving in comparison to buy-out may lead some trustees and employers to review their long-term buy-out funding targets. The initial cases are likely to be complicated to govern, with high advisor fees that may prevent the smallest schemes from transacting with superfunds in 2021.

Potential actions

Both insurers and superfunds will offer their best pricing to schemes that are well prepared – preparation is similar for either objective. Key areas for preparation are: equalisation (for example, GMPs); data quality (for example, tracing members and collecting marital data); clear benefit specification (legally reviewed); realistic pricing and contribution expectations agreed with the employer (recent actuarial estimate), and a simple plan to execute the transaction. We've never failed to get a buy-out quotation for a well-prepared scheme, including ones with less than £5m assets.

2020 is expected to be the second busiest year for bulk annuity transactions

Conclusion

Trustees' and employers' plans need to include contingencies for a range of outcomes. This new year, we'll be wishing for a swift end to Covid-19 and a smooth Brexit. However, it would be folly for trustees and employers to fail to plan for major disruption continuing deep into 2021.

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Biography of the author

Colin Parnell is a senior actuary and Head of Bulk Annuities at Capita Pensions. He has extensive experience of taking trustees through the journey to buy-out and plays a leading role in preparing schemes for the bulk annuity market and the execution of bulk annuity transactions. Colin has more than 17 years of pensions advisory experience and more than 50 bulk annuity transactions to his name, so he has seen most of the different journeys that can be taken to reach buy-out.