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No more natural guard rails?

Lessons from the new DB funding code

Imagine a bowling game with guard rails to help guide the ball down the lane.

When DB pension schemes were early in their lifecycle, the equivalent of these guard rails was time. Schemes had many years to let expected asset returns help them recover from any funding deficits before pensions had to be paid out. Even better, contributions paid in to fund new accruals had the effect of gently steering the funding level back towards 100 per cent. Just like a young bowler who could rely on guard rails to reduce the risk of a bad outcome, pension schemes in their early years were more innately resilient to short-term fluctuations and risks.

Avoiding going off the rails

However, as pension schemes have matured, the natural guard rails have been removed. With schemes having to pay out an increasing proportion of their assets each year to pay pensions, any short-term fall in funding levels can quickly accelerate. There's no longer the luxury of time for the funding level to recover. Just as a bowler needs to hone their technique and precision to achieve a good outcome without guard rails, we believe pension scheme trustees and sponsors must now adopt a rigorous risk management approach to ensure their schemes remain financially stable.

With its new DB funding code of practice that came into effect in September 2024, The Pensions Regulator made it very clear that the natural guard rails are gone, and it's time for pension schemes to up their game.

In our view, the regulator has rightly highlighted the importance of improved risk management for mature schemes, with a focus on ensuring that assets backing liabilities offer high resilience to short-term adverse changes in market conditions and can match cashflows. The new funding code is less prescriptive than many had initially feared, but as a result the regulator has placed a greater governance burden on trustees, asking them to justify that their specific strategy is fit for purpose.

Bespoke bowling options

The flexibilities afforded under the new funding code are important, however, as what is suitable for one scheme may not be suitable for another. The regulator has focused heavily on the importance of different employer covenants, and while some schemes remain in deficit, others are now in surplus. Many will want to work their surplus assets harder to seek to deliver an increased cushion against adverse events, improve member benefits, or reduce the cost of pension provision for employers. While some schemes are looking to improve portfolio liquidity ahead of a potential buyout, others are targeting run-on, and may be comfortable seeking to harness an illiquidity premium.

For schemes targeting run-on, even temporarily, the regulator's warning around the need for good governance and high-quality risk management appears to have been heard. Employers are increasingly appointing professional trustees to help manage their schemes, who are in turn looking to beef up investment governance arrangements. An increasing number of larger and mid-sized schemes are looking to appoint an OCIO provider or single implementation manager, while take-up of a fiduciary management governance model continues to be popular among smaller schemes.

Whether small or large, we believe mature pension schemes can learn from the experience of life insurers, who are used to managing risk closely relative to cashflow-negative liabilities in their annuity 'run-on' portfolios. While important differences in regulatory regimes remain, with its increased focus on cashflow matching and risk stress testing, the latest DB funding code aligns approaches more closely for pension schemes and insurers.

Striking the right strategy

There's a lot of information for trustees, sponsors, and consultants to absorb in the new funding code, and for many the devil will be in the detail. But as the next actuarial valuation cycle approaches, we'd encourage trustees to first take a step back and think about their overall governance and strategy, and whether they're ready for the new challenges that managing a mature pension scheme can bring.

Now that DB schemes have matured, those natural early-year guard rails have gone. Just as professional bowlers do when seeking to improve their average score, schemes need a strategy that avoids the gutter balls.

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Key Risks

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