# Outlook for DB Pensions in 2022

January
2022

# A foreword from our CEO, Advisory

**The dawning of a New Year provides us with the chance to reflect on what we've experienced in the year just gone and what challenges and exciting opportunities lie ahead.**

After a difficult start to 2021 as the UK endured its third lockdown, the vaccine rollout allowed a return to some sort of normality during the year. Although the pandemic is far from over, unprecedented Government support (and peacetime borrowing) appears to have so far shielded many UK companies from the worst of the pandemic's effects on the economy, and many businesses have used it as a launchpad to drive innovation.

More recently, COP26 put climate change firmly at the top of the policy agenda and new regulations from the Department for Work and Pensions (DWP) positioned UK pension schemes as leaders in governance and reporting of climate risk. Combined with the new Pension Schemes Act 2021, the compliance burden has undeniably increased; it should lead over time to safer, more sustainable futures for pension members.

2021 was also the year we said a fond farewell to the Lincoln Pensions brand as it became Cardano Advisory. This transition reflects a recognition that together, our extraordinary teams across Cardano, can better serve our clients with covenant , sustainability and pensions advice.

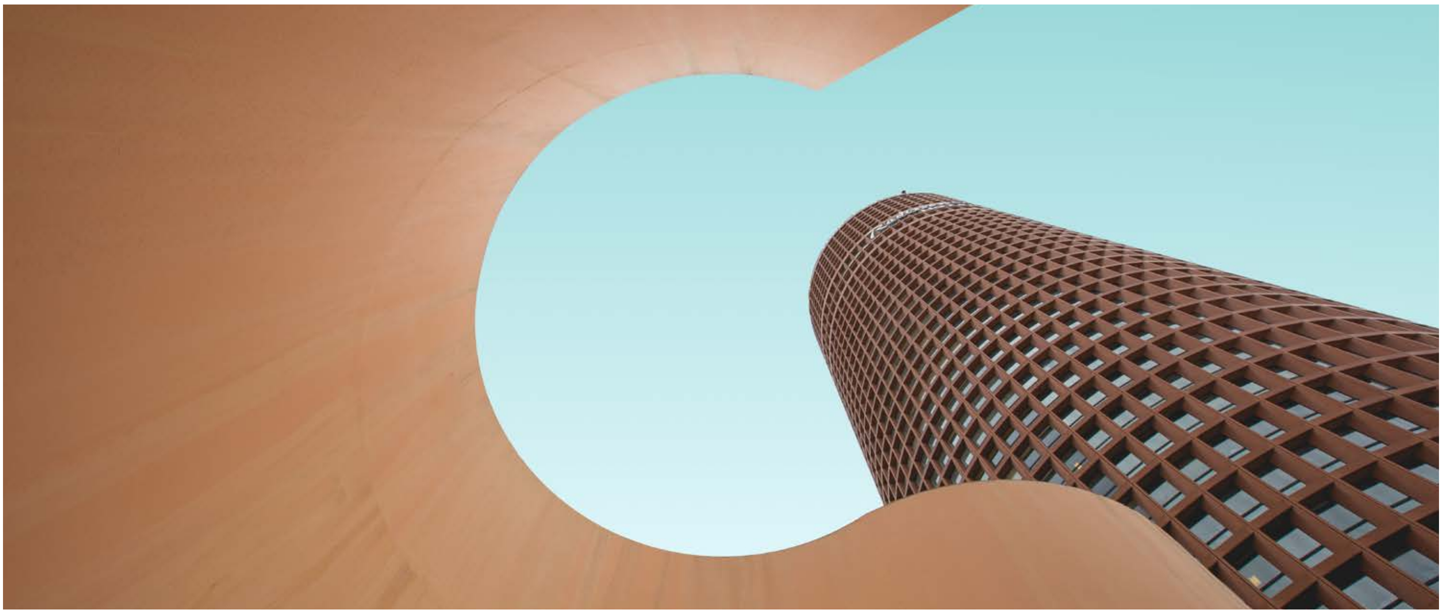
Looking ahead 2022 is likely to have a difficult start with economic growth appearing to be slowing following further restrictions due to the pandemic and geopolitical tensions. Furthermore, the tightening of monetary policy in response to rising inflation could compound the withdrawal of fiscal policy support in the UK, and lead to rising stress in UK companies. Trustees and sponsors will need to be proactive around protecting their members and their businesses.

**"There is a lot on the agenda for 2022 and in 12 months' time I expect we will all be reflecting on a pretty significant year."**

Importantly, the Pensions Regulator (TPR) will consult on its new funding code of practice. I do not envy their challenge of striking the right balance between ensuring schemes are adequately managing their risks and allowing UK companies to recover and compete in this challenging environment.

The articles that follow explore the key themes that we expect to emerge during the year. There is a lot on the agenda for 2022 and in 12 months' time I expect we will all be reflecting on a pretty significant year.

**Darren Redmayne**
CEO, Advisory
D.Redmayne@cardano.com



# The Pension Regulator's new DB Funding Code of Practice: Covenant should be at its core

**Covenant is at the heart of whether the sponsor of a DB scheme can deliver on its pensions promise. While the strength of a covenant is often shown as a rating on a scale, the real value in a covenant assessment is applying the conclusions more widely in a scheme's strategy.**

First, covenant must provide funding to schemes where they are in deficit and underwrite risks in the scheme's journey plan. If an investment shock happens or members live longer than expected, it is the covenant that the scheme will turn to for more funding or ongoing support over an extended journey plan.

For this reason, covenant will naturally be central to TPR's new DB funding code of practice, which is expected to be released for consultation in 2022. TPR has already confirmed that it expects to take a dual-track regulatory approach to reviewing completed scheme valuations: "Fast Track" for those schemes meeting certain low-risk parameters (which remain to be defined), and "Bespoke" for all other schemes.

It remains to be seen whether TPR allows reliance to be placed on covenant for its "Fast Track" regulatory process (or whether this process is reserved for only very well-funded schemes with low dependency on their sponsor) – if it does, then covenant will directly impact funding needs for sponsors.

Where schemes don't qualify for "Fast Track", they will need to evidence to TPR how their risks are supported by the covenant. This will require coordination between trustees and their advisors to balance covenant and scheme risks, with scenario testing to demonstrate how the covenant could support an increased deficit and/or extended journey plan.

Amongst all the noise that will accompany the new funding code, trustees will need to remember that this is just a regulatory approach. Even where scheme risks are reduced to a level TPR considers sufficient for "Fast Track" regulation, doing the right thing for members will normally mean planning to go further to reduce the residual covenant and scheme risks facing their pensions.

**"Even where scheme risks are reduced to a level TPR considers sufficient for "Fast Track" regulation, doing the right thing for members will normally mean planning to go further..."**

An enduring covenant is still required to support the scheme and reduce regulatory risk. Rather than seeing covenant as a scoring system, it is an integral part of risk management: trustees will need to look through the financials to the sponsor's underlying risks and opportunities and how they may change over the long-term. So, for many schemes where improved funding levels have accelerated end-game discussions, understanding and mitigating long-term covenant exposure will also become a focal point in 2022.

With so much economic and regulatory flux, covenant will prove a hot topic for 2022!


**Emily Goodridge**
Director, Advisory
Covenant Assessment
E.Goodridge@cardano.com
M: 07880 138 735

# Pension Schemes Act 2021: Rising deal activity will bring DB schemes to the fore

**In 2021, the Pension Schemes Act 2021 came into force with the aim of ensuring better protection for DB pensions. Key new components included criminal sanctions for certain offences, changes to the Regulator's Contribution Notice power designed to make it easier to use, and an enhanced notifiable events regime (which is still under consultation).**

Headlines initially warned of material interruption to UK corporate practice and that companies with DB schemes would become pariahs to the investment community. Talk of executives wearing orange (or black and white hoops depending on what vintage TV you watch) became a running joke.

But while there is undeniably more to think about when corporate activity involves a DB scheme (not helped by draft regulations which will be hard to apply in practice; and a lack of clear regulatory guidance), we expect the main impact to be simply a further evolution in engagement between UK corporates and DB pension trustees.

With deal volumes expected to rise further in 2022, we expect more high-profile stories where the position of the DB scheme is centre stage. This will place pressure on trustees and TPR to respond in a balanced fashion that both protects members and avoids a situation whereby the new rules stand in the way of ordinary and responsible business activity.

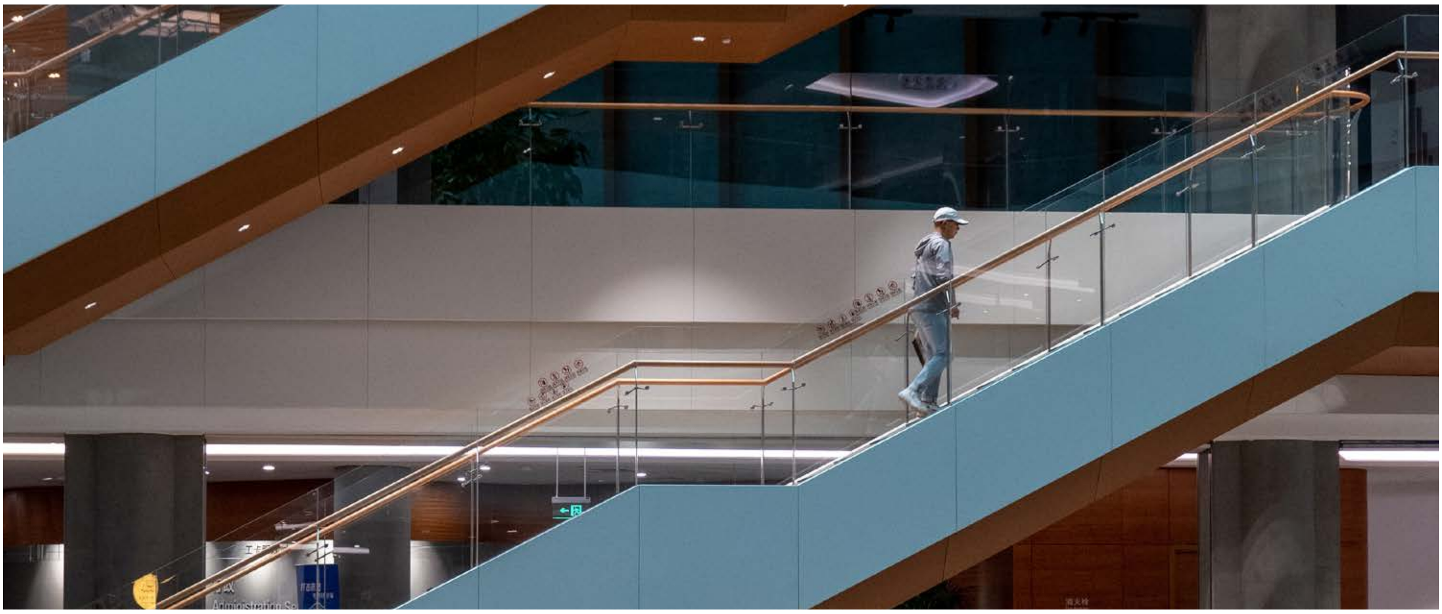
For corporates, we expect a greater focus on internal governance arrangements to quickly identify and manage pensions risk, particularly in light of the proposals for new notifiable events. The key challenge for the largest corporates will be to make sure that all corporate actions taken by directors are screened for a potential impact on the pension scheme – where organisational hierarchies don't match a strict legal entity structure, improved lines of communication may be required.

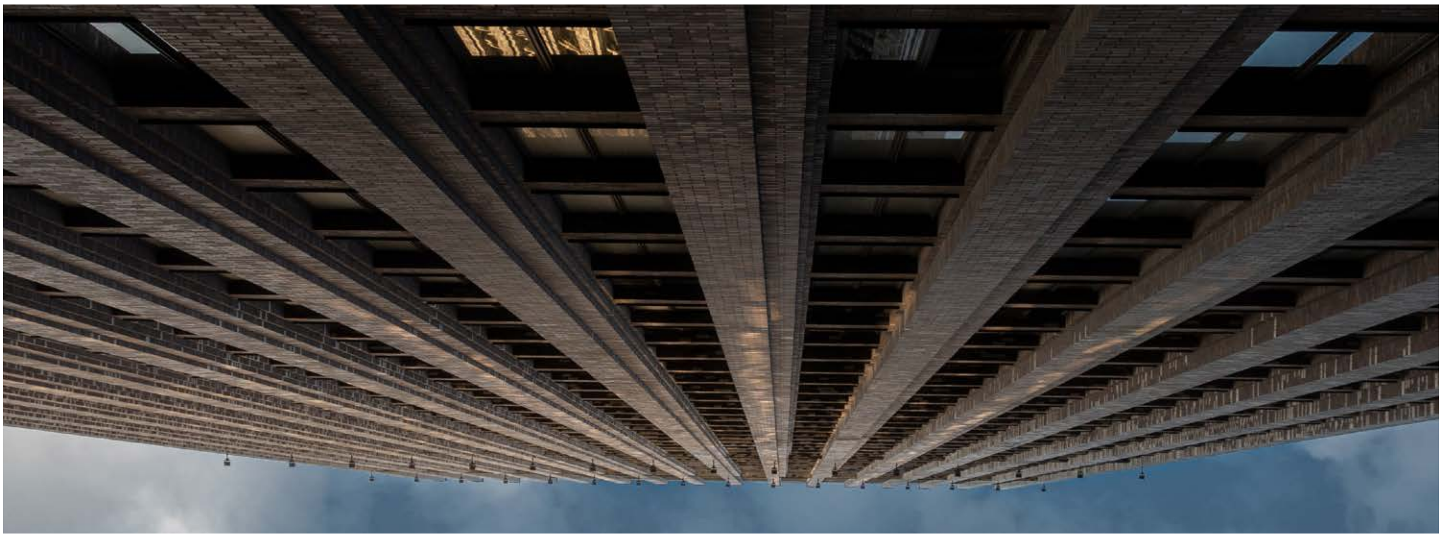
**"With deal volumes expected to rise further in 2022, we expect more high-profile stories where the position of the DB scheme is centre stage."**

For investors, while some may regard the risk budget for DB schemes as too high, others will see an opportunity for value creation if pensions risk can be managed appropriately. Private equity, in particular, should recognise that TPR is more likely to scrutinise deals where substantial leverage is involved (especially if security is involved) and protecting the position of the scheme will become more important than ever.

Finally, in 2022, we expect an increased focus on codifying information sharing arrangements to help corporates and trustees review corporate events under these new obligations. Although the full extent of the enhanced notifiable events regime remains to be agreed (and current proposals may be unworkable), the direction of travel is clearly toward sharing more information with schemes and putting in place formal agreements which will both facilitate this and protect parties from regulatory scrutiny.

**Alex Hutton-Mills**
Managing Director, Advisory
Pensions Corporate Finance
A.Hutton-Mills@cardano.com
M: 07799 764 357





## End game: Surging insurance demand will drive consolidation

**After a quiet start to 2021 for insurers, 2022 could see a return to multi-billion pound transactions as well-prepared schemes seek to capitalise on improved funding positions. With surplus demand for insurance expected to outstrip the capacity in the insurance market by the middle of this decade, trustees and sponsors of smaller schemes may need to work harder to make their schemes more attractive to insurers.**

Completing a first transaction of any size to establish a relationship and terms with an insurer for the future may be one approach to mitigate this dynamic in 2022, but trustees will need to carefully balance this against the implications for their investment strategy and time frame for reaching their end game funding target.

Regulatory change for insurers is another important topic for 2022. The Prudential Regulation Authority (PRA) is expected to launch a consultation on the future of the regulatory regime for insurers, Solvency II by the summer. Changes proposed by the PRA could have meaningful implications on the capacity and pricing offered by the industry, and the prevailing politics of deploying capital for national investment projects may play a part.

Equally, changes could impact the level of protection offered to policyholders, and trustees pursuing a transaction should recognise that what could be considered a strong capital position at the point of signing may be eroded by some of the changes being considered. Larger schemes may be able to manage this uncertainty by requesting capital protections.

But these changes likely won't fully address the fundamental mismatch in supply and demand to the extent funding levels continue to improve as we saw in 2021, and some schemes may struggle to find a willing counterparty when they are ready to transact.

At the same time, many corporate covenants will be ill-placed to cope with technological leaps and the impact of tightened climate regulation may make them suboptimal platforms for a long-term run-off strategy. Furthermore, recent changes introduced to the Pension Protection Fund (PPF) levy calculation will make it more costly for pension schemes to attempt to operate with only a special purpose (non-substantive) sponsor.

**"Changes proposed by the PRA could have meaningful implications on the capacity and pricing offered by the industry..."**

The answer lies in consolidation, which has been sitting on the Regulator's desk for approval for some time. The recent regulatory approval of Clara provides a welcome respite, with the prospect of a raft of 'proof of concept' deals during 2022. But much more work will be required for these solutions to grab a meaningful market share. Other innovative platforms are expected to emerge over the course of the year and into 2023. Ultimately, consolidation won't be right for all schemes, but it can offer a valuable option in the trustee and sponsor toolbox.

End-game strategies are set to be an even more important topic for trustees and sponsors to tackle in 2022, and with a capacity crunch looming for UK life insurers, kick-starting consolidation of the right schemes is a must.

**Adolfo Aponte**
Managing Director, Advisory
Covenant Risk Solutions
A.Aponte@cardano.com
M: 07534 922 955

## DWP's climate governance requirements: External scrutiny will lead to enhanced reporting and disclosure

**Since the DWP set out the new Task Force on Climate-related Financial Disclosures (TCFD) reporting and climate governance requirements, many across the pensions industry have been working hard to understand and implement them.**

It fell to the largest schemes with assets of more than £5 billion to go first, with those with less than £1 billion to follow next year – with the possibility that smaller schemes will also be included over time.

With limited guidance from the DWP on both what is required and what the expected output is, it is no surprise that a range of approaches have been taken so far. Some schemes have focused on mere compliance with the new requirements, while others have sought to engage deeply with the core issues, consider what they may mean for members and think about how they can respond to protect them.

The one common factor has been the question from trustees: "how do my fiduciary duties and objective to ensure benefits are provided in full relate to these new reporting and disclosure requirements"? The simple answer is that we believe trustees fiduciary duties are almost always fully aligned with ensuring a sustainable sponsor and scheme. Trustees should continue to make decisions they consider to be in the best interests of their members, which will include taking into account the risks that a scheme faces from climate change.

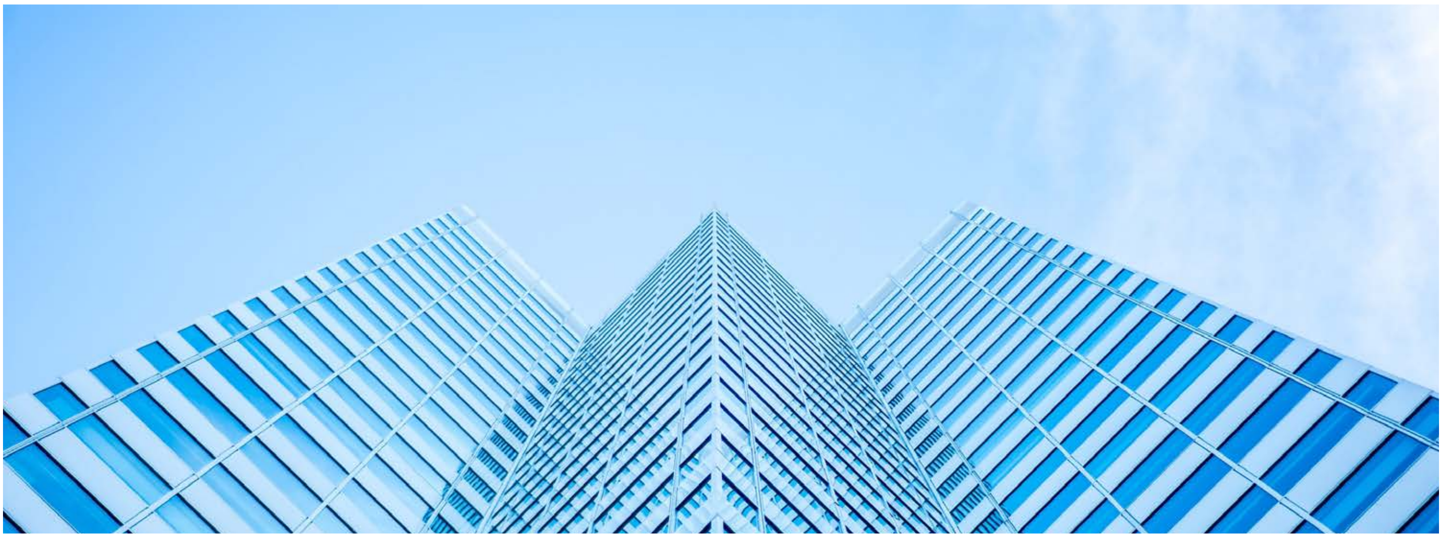
That being said, 2022 will see significant activist and media scrutiny of the TCFD reports that the largest schemes will be required to publish and this could bring the risk of reputational damage for sponsors of schemes that are not doing enough (whether in terms of their due diligence, disclosure or strategy). As a result, market practice is likely to shift and require greater engagement with the issues for smaller schemes that follow.

**"2022 will see significant activist and media scrutiny of the TCFD reports that the largest schemes will be required to publish and this could bring the risk of reputational damage for sponsors of schemes that are not doing enough..."**

Furthermore, where sponsors decide that they want their scheme to go further (for instance, to reduce the carbon footprint of their investment strategy), foregone investment returns or increased risk from reduced diversification could mean that the scheme needs to be suitably compensated by the sponsor.

We expect 2022 will see sustainability and climate change gain increased prominence on trustees' agendas. Not only will many new schemes be brought into the reporting scope during the year, but external pressures are likely to require the schemes to go further than simply compliance with the new regulations.


**Michael Bushnell**
Managing Director, Advisory
Sustainability, Funding and Journey Planning
M.Bushnell@cardano.com
M: 07921 992 479

## Investment Markets

**Investment markets enter 2022 at an intriguing point in the economic cycle. The combined fiscal and monetary policy support that has propelled markets over the past 7 quarters is starting to be unwound. However, it is not clear if the disruptive effects of the pandemic are definitely behind us.**

What we are almost sure to see in the next twelve months is a deceleration in the rate of change of both global growth and inflation. Both growth and inflation are expected to stay positive at a healthy clip but we will inevitably see a slowing. The economic cycle is maturing and the global economy is coming down from the policy induced highs of the 2020/21 period. 2022 promises robust but lower growth, maybe more benign economic conditions than we have been accustomed to recently.

Within this economic environment we will see a tightening of monetary policy from the world's central banks. It is a little unusual, but not unprecedented, to see monetary policy tightening when growth and inflation are both decelerating – it last happened in between mid-2018 and mid-2019.

And, if we look to how markets performed during this mid-2018 to mid-2019 period, we see a possible template for how 2022 could play out; range-bound equities (albeit that is in the context of quite a wide range), higher market volatility, less downside risk in government bonds and continued strength of the US dollar.

Even if the best of the current market cycle for equities might now be in the rear view mirror we do see a conducive environment emerging for the dynamic risk management of growth assets within a balanced market exposure approach. Specifically we see that government bond yields have re-established some credibility, sympathetic to the prospective path of monetary policy, and now present a more valuable counterweight to equities.

Volatility is generally welcomed in the active management world, even in conditions where you might prefer not to have broad market exposure. Heightened volatility always creates an environment in which active managers can thrive. Deploying capital into hedge fund investments, or removing the market exposure of active long-only managers by using derivatives, might prove to be as fruitful a strategy in 2022 as it has been for most of the post-COVID period so far.

**"Inflation may prove to be not quite so transitory as the world's central bankers would lead us to believe..."**

There are risks to such a benign outlook; inflation may prove to be not quite so transitory as the world's central bankers would lead us to believe, new COVID variants may impact upon the smooth re-opening of the global economy, or geopolitical hotspots in Ukraine and Taiwan may flare up.

But, cast you mind back to the mid-2018 to mid-2019 period for a second time. This period will also be remembered for the sharp drawdowns of December 2018 when US Federal Reserve policy tightening coincided with fears of a slowdown in corporate earnings – it almost seems quaint to recall that Apple and Tesla both issued profits warnings in the first week of January 2019!

With less one-way expectation in the market outlook once again, having equity protection in your portfolio construction toolkit might be helpful next year too.


**Nigel Sillis, CFA**
Client Portfolio Manager,
Cardano Investment
N.Sillis@cardano.com
M: 07973 412 955

**Cardano**
9th Floor
6 Bevis Marks
London
EC3A 7BA

T: +44 (0)20 3170 5910
E: enquiries@cardanoadvisory.co.uk

Cardano Advisory Limited (formerly Lincoln Pensions) is part of The Cardano Group. Cardano Advisory Limited is registered in England and Wales number 06402742. Registered office: 10 Queen Street Place, London EC4R 1AG. Authorised and regulated by the Financial Conduct Authority.