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# Gilt market turmoil: Impact on defined benefit pension schemes

**The recent gilt market turmoil has had a profound impact on the investment strategies and journey plans of defined benefit pension schemes. As rising yields caused spiralling demands for collateral from liability hedging strategies, schemes were forced to realise other investments, often at unattractive prices.**

There have been clear 'winners' and 'losers' during this crisis. Schemes that fared better typically operated segregated liability driven investment (LDI) strategies (and/or had fiduciary management arrangements), had nimbler governance structures, clear collateral waterfalls that had been fully stress tested, and engaged sponsors that were willing (and able) to provide liquidity support when required.

On the other hand, schemes that were most challenged were often in pooled LDI arrangements, more highly levered and slow to act in realising the necessary liquidity to meet collateral calls. Schemes that have been unable to maintain their hedging arrangements may have been sorely punished in recent weeks as markets have settled and yields have fallen sharply.

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## Sponsors to play a greater role in setting scheme investment strategy

With the return of a calmer market environment, pension scheme trustees and sponsors are assessing the impact on their scheme, redrawing funding and investment strategies, and seeking to learn lessons to manage liquidity risks better in the future.

With the sponsor the ultimate underwriter of the risks brought by these events, the recent gilt market turmoil will have brought home to all stakeholders that the pension scheme's investment strategy is a key risk for sponsors. The impact on schemes has not been uniform and most sponsors will be better served by a 'fresh start' approach focussed on corporate as well as trustee objectives.

Irrespective of how the scheme has been impacted, all sponsors will need to engage with their trustees to:

1. Review their immediate liquidity position and investment strategy. Many schemes may now be overweight illiquid positions which will need careful rebalancing over time. Some sponsors are beginning to explore the role that they can play to help trustees exit these positions in a cost-effective way.

2. Perform an "LDI Healthcheck". This should examine:

   a. Operation and structure of LDI mandate including, type of mandate (segregated or pooled), collateral requirements (collateral waterfalls and collateral buffers) performance and reporting and potentially a review of benchmarks.

   b. Strategic considerations including hedging targets and leverage levels.


## Addressing the funding level impact will require all schemes to take action

Finally, sponsors will need to address the impact on their scheme's funding level and arrangements. Here the actions needed will be less uniform, but can broadly be placed into three categories:

1. **Improved funding level** – Many schemes will have found that their funding level has been improved by the sustained underlying increase in yields over the last 12 months. But where deficit repair contributions (DRCs) are required under an agreed recovery plan, they will continue until the trustees and sponsor agree to stop them. The next triennial valuation is the usual time to reassess whether DRCs are needed, but sponsors should be considering whether to request an acceleration of this date (or timetable for the valuation) and/or the use of an escrow account to allow ongoing contributions to be returned to the sponsor if it is agreed that they are no longer required. This will help to ensure that sponsor capital is used in the most efficient way in a challenging economic environment, although some funds may need or want additional (albeit temporary) cash pending the sale of more illiquid assets to help rebalance investment strategies.

2. **Worsened funding level and stronger covenant** – Where funding levels have worsened, sponsors will need to ensure honest appraisal of their covenant by trustees and guard against an overly prudent approach to addressing an enlarged deficit. Sponsors with stronger covenants should be making the case for how they can continue to support reliance on investment returns by schemes, and that additional funding can be provided on a contingent basis that allows it to be withdrawn if the funding level improves.

3. **Worsened funding level and weaker covenant** – Where funding levels have worsened and sponsors are also assessed to have a weaker covenant, challenging conversations could arise with the trustees demanding additional funding that sponsors cannot afford to provide. Even in situations where sponsors are unable to provide liquidity facilities to help ease investment transition plans, they should still engage with trustees to understand liquidity requirements and help them consider the provision of external liquidity arrangements. Often, the way through will be with the use of creative solutions such as capital-backed journey plans that focus on providing trustees with near-term covenant support in exchange for a longer timeframe over which funding levels can be restored.

In the current environment, there is a lot for sponsors to do both to support their business and to protect members of their schemes. Proactively managing pensions risk by corporate sponsors is more important than ever before.

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