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A summary of the recent Mansion House speech

On 10 July, Chancellor of the Exchequer, Jeremy Hunt, delivered his first Mansion House speech. Following the recent market focus on pensions, it was unsurprising that Defined Benefit (DB) pension schemes featured at the heart of the speech.

Whilst it was acknowledged that reducing inflation remained the key near-term economic priority, the Chancellor looked further ahead and set out plans to increase returns for pensioners, improve outcomes for investors and unlock capital to support growth businesses. Changes to DB pension policy is one way the Chancellor is seeking to implement this broader economic strategy; it is therefore important that the proposals related to the pension industry are considered within the context of these broader economic aims.

Following the speech, the Chancellor confirmed that any future policy changes would follow three golden rules:

1. Decisions would seek to ensure the best outcome for pension savers, with any changes to investment structures putting their needs first.
2. The Government would prioritise a strong and diversified gilts market, recognising the key role that they play in the UK economy.
3. Decisions taken would be intended to strengthen the UK's competitive position as a leading financial centre able to fund public services.

One of the key proposals put forward by the Chancellor was the intention to develop a permanent superfund regulatory regime to ease consolidation and increase scale in the management of DB schemes. The superfund regime and the potential merits to schemes with limited prospects of buying out in the insurance market have been well discussed. Through its consultation entitled "Options for Defined Benefit schemes: a call for evidence" (to which the Cardano Group intends to respond) the government is now exploring the possibility of alternatives to commercial consolidation vehicles, such as the Pension Protection Fund (PPF).

Another area that the government is investigating is capital inefficiency for DB schemes that are in surplus. Given the restrictions on corporates being able to access surpluses once they arise, the government is exploring structures that could incentivise increased investment in return-seeking assets without unduly risking the security of member benefits. Given the significant improvements in scheme funding levels over the past twelve months, this topic has become relevant to more schemes and their sponsors.

The government's goal is to redirect capital accumulated in pension schemes to support the UK economy, through increased investment by DB schemes in "productive finance" which includes start-ups, infrastructure and private equity. Policy and related changes to consolidation options or the treatment of schemes' surpluses could certainly help to achieve this goal; however, any change would need to be considered in the broader DB pensions framework (including legislation, regulations and scheme liability profiles) and would need to ensure member benefits were suitably protected.

Industry stakeholders have been asked to input into these potential policy changes (including through several consultations, as referenced above), and the Chancellor has promised final decisions will be made ahead of the Autumn Statement later this year (typically delivered in November). Change is certainly afoot but, as always, the devil will be in the detail. Our multidisciplinary team is actively engaged in responding to the consultations and related discussions with stakeholders including the PPF, so we are well placed to guide trustees and corporates through the changes, whatever form they ultimately take.

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DB Sponsors facing debt maturities

On 3 August 2023 the Bank of England raised the interest rate to 5.25%, reaching a 15-year high in the UK. Despite the rate of inflation having marginally reduced, borrowing costs are anticipated to persist at elevated levels.

Consequently, and in light of the significant wall of debt maturity expected in the UK over the next two to three years, many companies will be facing the risk of escalating interest costs when they are already experiencing cash-flow pressures due to increased operating costs as a result of inflation.

This impending challenge is particularly relevant for those sponsors of DB pension schemes that have limited liquidity, low financial flexibility due to high levels of leverage (either financial or operational) and/or are loss-making.

As a result of having to refinance facilities at significantly higher rates, sponsors may seek to engage directly with trustees regarding current or future covenant support, which may include requesting a deferral of deficit repair contributions (DRCs). Such requests should be considered by trustees carefully, with suitable mitigations obtained if a deferral is considered appropriate.

Trustees should also be aware of potential shifts in lender demands during a refinancing, with potential implications for the scheme, for example shifting the scheme further down the creditor waterfall, resulting in a lower recovery in a downside scenario.

What should trustees do?

- Be proactive in considering upcoming sponsor refinancing requirements, requesting key information about the latest trading dynamics and how these might dovetail with any upcoming refinancing requirements
- Have a clear picture of the scheme's covenant support structure both on an ongoing basis and in a downside scenario (including potential scheme recoveries)
- Ensure that the scheme's position is considered by the sponsor as part of any refinancing discussions from the start. This will need engagement with the sponsor well in advance of the debt maturity date
- Carry out contingency planning to understand the potential impact of corporate events (including debt refinancing) and to develop a framework of mitigating actions to protect the scheme and its members.

Ask the Analyst: The International Sustainability Standards Board (ISSB) Framework

The ISSB recently released two new International Financial Reporting Standards (IFRS) focused on sustainability - IFRS S1 and IFRS S2. They require companies to disclose sustainability-related information alongside financial statements, emphasising four core elements: governance, strategy, risk/opportunity management, and metrics. IFRS S1 outlines disclosure requirements for sustainability-related risks and opportunities, while IFRS S2 focuses on climate-related disclosures. These standards are effective from 1 January 2024, with a 12 month grace period, allowing companies to build up reporting capabilities

UK pension schemes are not subject to these standards, however, the introduction of IFRS S1 and S2 is expected to improve sponsor disclosure, enabling trustees to understand the financial impact of sustainability factors relevant to their sponsors.

In the rapidly evolving landscape of sustainability reporting, trustees should consider seeking expert support when assessing the new standards, and in understanding how these standards look to support and foster a resilient and sustainable future for the scheme and sponsoring company.

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Regulatory developments: Funded Reinsurance and its implications on insurer buyout

The bulk annuity market is expected to experience record volumes in 2023 and beyond. Whilst insurers are well-capitalised today, their capacity to write annuity business is ultimately limited due to its capital-intensive nature.

Funded reinsurance (FundedRe) is a mechanism that allows insurers to offload both longevity and asset risk, thus meaning that insurers can use their capital more efficiently across a larger volume of transactions. In recent years, the use of FundedRe has increased given the surging demand for bulk annuities. In undertaking FundedRe, as the insurer offloads longevity and asset risk, the insurer increases its exposure to the risk of its reinsurer counterparty defaulting.

In response to its increasing usage, the Prudential Regulation Authority (PRA) undertook a thematic review of FundedRe over H1 2023. The PRA believes that its increased usage could create risks to policyholder protection if its use becomes 'systemic', especially given the tendency for FundedRe to be written with reinsurers that operate outside of the Solvency II insurance regime, and noting that the reinsurers tend to run increasingly credit-focused investment strategies with limited diversification.

Given its increased usage, and in light of the growing scrutiny by the insurance regulator, schemes looking to buyout need to carefully consider insurer counterparty risk, including the implications of FundedRe, during their process to select a suitable insurer.

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