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Sustainability Principles Charter

Accounting for Sustainability (A4S), The Church of England Pensions Board and Railpen have brought together pension funds, insurers, pension advisers (including Cardano as one of the signatories) and the regulatory community to produce a Sustainability Principles Charter (the "Charter") for the bulk annuity process.

The Charter seeks to align expectations around sustainability within the bulk annuity process. It sets out clear principles to drive greater transparency, reporting and engagement before, during and after a buyout or buy-in transaction between pension funds and insurers.

In 2023, approximately £50 billion of pension scheme assets and liabilities shifted to insurers, with a further increase anticipated in 2024. The UK pensions sector is increasingly reliant on a few regulated insurers managing historic inflows. Simultaneously, both insurers and schemes are integrating sustainability into their operations and investments. Therefore, before engaging with insurers, trustees need clarity on two crucial aspects:

1. How does the insurer's sustainability approach compare to the trustees' efforts?

2. Does the insurer's sustainability stance (including how they are planning for the future) expose them to more risk than peers?

There are two issues we see being addressed by the Charter. Firstly, while UK insurers have developed internal sustainability teams, limited public disclosure hinders comprehensive understanding. For example, we find insurers are continually updating their approach (for example in credit risk assessment or preferred illiquid asset classes) and engagement must therefore be an ongoing process. The Charter addresses this by promoting regular information sharing on values, investment appraisal, and policy changes. Secondly, comparing insurers is challenging due to idiosyncratic data and unclear policy evolution. The Charter aims to enhance clarity, provide a framework for comparability, and emphasise trustees' interest in insurers' long-term implementation of securing members' benefits.

Sustainability remains one of the only major structural risks which insurers do not yet explicitly or consistently assess and provide for. The Charter provides trustees with a pre-agreed framework to assess (or seek professional advice) on sustainability related information on insurers' assets, liabilities, policies, risk mitigation, and future plans, aiding them in making informed decisions when transferring scheme liabilities to insurers. This Charter is an essential first step in helping trustees make decisions when it comes to the suitability and resilience of insurers as the counterparty for their members and scheme.

Please do get in contact with Claire or the team at Cardano to find out more about how we can help with your sustainability planning.

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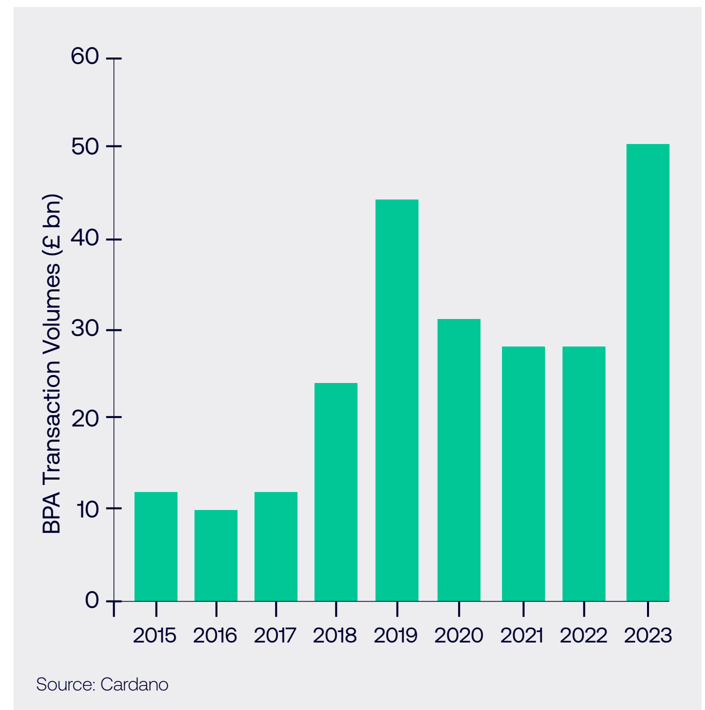
DataWatch:
Buy-in and buyout transaction volumes

2023 was a record-breaking year for the UK bulk purchase annuity (BPA) market, with total transaction volumes of around £50 billion. This is higher than the previous 2019 record of £44 billion, despite higher interest rates in 2023 reducing pension scheme liabilities and thus insurance premiums (i.e. normalised for 2019 interest rates the 2023 volume could be around £70-75 billion).

This increased demand was mainly driven by improved funding levels due to higher interest rates reducing liabilities by a greater amount than the value of pension schemes' assets. Like 2019, last year also saw an influx of 'mega-transactions' as many corporate sponsors of large pension schemes looked to reduce pension risk and were willing to contribute cash to do so. Around half of the £50 billion of BPA volumes were offloaded to insurers across just eight transactions. This included the largest single scheme buy-in transaction ever undertaken in the UK (£4.8 billion) which covered benefits for c.53,000 members of the Boots Pension Scheme (with Cardano as lead advisor).

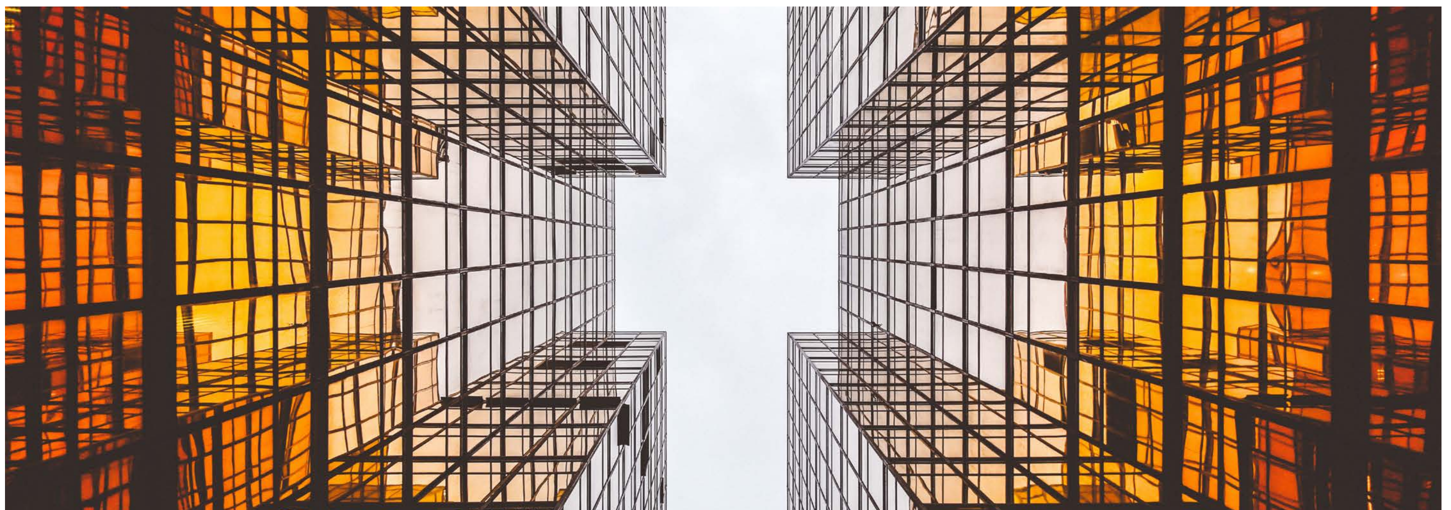
2023 saw around 250 transactions take place, up from 150 in 2019. This demonstrates that there is also plenty of opportunity for smaller pension schemes to gain traction in the insurance market. Strong demand is expected to continue into 2024 and beyond: we understand that there are 20 to 25 pension schemes of over £1 billion in size actively engaged with insurers now.

2023 also saw M&G re-enter the market writing two transactions totalling £617 million in the year. Royal London officially announced their entry into the market in March 2024 and there is one more entrant expected to formally join this year, showing the insurance market is ready to rise to the challenge of increased demand. However, Scottish Widows has announced they have sold their bulk annuity portfolio to Rothesay Life and they are exiting the market. This means the current number of BPA insurers stands at nine, but this is expected to be ten by the end of the year.



Source: Cardano

Please do get in touch with a member of the Cardano team if you would like to hear more about what the insurance market has in store for 2024 or how Cardano can help with your pension scheme's de-risking journey.



Ask the Analyst: Pension scheme surpluses

Increasing gilt yields in recent years have driven improvements in scheme funding levels and, as a result, we have seen an increase in scheme surpluses; however, examples of sponsoring employers accessing surpluses are few and far between. On 23 February 2024, the DWP opened its consultation on the 'Options for Defined Benefit schemes'. This consultation explores the implementation of reforms within the DB pensions sector that could lead to 'positive impacts for the wider UK economy', including reforms to the surplus sharing rules, with a view to making the use or extraction of surpluses easier for trustees and sponsors.

As part of its reforms, the DWP is considering the introduction of a 'statutory override' that will allow trustees to override scheme rules, when appropriate funding levels are reached. While these reforms should help to simplify the extraction of a scheme surplus, the government has highlighted the importance of implementing appropriate safeguards for member benefits to ensure that trustees and sponsors do not lose sight of their duties and obligations. Covenant will naturally be a key consideration in this regard.

While certain aspects of the Government's proposed reforms for scheme surpluses are subject to change following the consultation closing on 19 April 2024 (including the implementation of a statutory override), there may be a more immediate impact on some schemes following the Government's commitment (from 6 April 2024) to reduce the tax rate paid by sponsors on surplus extractions from 35% to 25%, to align this with corporation tax rates.

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Regulatory developments: Funding and Investment Strategy Regulations

The Department for Work and Pensions (DWP) published their final Funding and Investment Strategy Regulations in January 2024, which set out the legal requirement to consider covenant and provide helpful clarity on its definition, referring more clearly to the future ability to support a scheme and also requiring trustees to consider the impact of the recovery plan on the employer's sustainable growth.

However, in focusing on principles, the Regulations provide little additional clarity on how things will work in practice and risk several unintended consequences.

While it is positive to see that covenant should be the primary factor in determining the maximum level of funding risk, changes to the Draft Regulations create a risk that covenant is seen neither as a key factor in setting investment risk budgets nor as relevant beyond the point at which full funding on a low dependency basis is achieved. Ambiguity also remains as to what happens if a scheme is unable to achieve full funding on a low dependency basis by the Relevant Date.

We continue to advocate for an integrated approach, with covenant strength driving both investment and funding decisions over the journey plan, and beyond the Relevant Date in relation to how a surplus on a low dependency basis is invested, noting that 'low dependency does not equal no dependency'.

The updated Funding Code and Covenant Guidance (both expected later this year) should provide helpful clarification. While we look forward to this additional guidance, the final Regulations and the recent consultation on 'Options for Defined Benefit schemes' (see our Ask the Analyst article) represent a good opportunity for schemes and sponsors to engage with their advisors on establishing a clear plan for understanding and meeting the new requirements ahead of the first valuation post-September 2024.

Read our full Advisory and Investment perspectives here, or reach out to a member of the team at Cardano for more information about the upcoming regulatory changes in 2024.

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