

SPENCE

Your Quarterly Pensions Update Quarter Two 2024



What's inside?

General Election	04
Investment Update	05
Run-on: the alternative endgame everyone's talking about	06
Buy-out - market and Pension Risk Transfer	09
New Defined Benefit Code of Practice: Further Delays?	10
Pensions Dashboards – The final countdown	11
Mortality Update	12



Welcome to your Quarterly Pensions Update

The purpose of this report is to update sponsors and trustees with recent pensions industry changes in the quarter.

For your convenience, Spence has summarised the key developments and highlighted the necessary actions sponsors and trustees may need to take.

The report combines brief written comment with links to any further relevant information and any deadlines you should be aware of. We trust you will find the update useful and informative. If you require further information about how any of the topics covered might impact on your scheme specifically, please get in touch with alan_collins@spenceandpartners.co.uk or your usual Spence contact.



General Election

While campaigning for office, Labour promised change. Now as the party of government – and with a huge majority – what change exactly will Labour bring? Will they stick to their manifesto, or will they deliver something else entirely?

When it comes to pensions, prior to their election, Labour made the expected noises about pushing for more consolidation, delivering better returns for savers, ensuring security for pensioners in retirement, and striving for greater productive investment for the economy. All rather consistent with the status quo but without providing much in the way of detail.

Where they have been more specific, Labour confirmed the triple lock on state pensions is being retained – but they did not match the Conservatives' promise of the "triple lock plus", which aimed to keep pensioners out of paying tax on their state pension.

But political parties also have a habit of telling the electorate what they want to hear, or being less generous, what they think they can get away with. Of more interest, in fact, is what Labour didn't say or refused to rule out.

For instance, there is speculation that Labour will seek to change or even remove the ability of future retirees to take the often popular option of tax-free cash on their retirement. There is also the prospect of changes to the rates of tax relief on pension contributions. The Conservatives promised to maintain the status quo on both of these matters, but Labour refused to give the same level of commitment. It will be interesting to see what Labour do next – clearly more penal taxation will be unpopular with the electorate who have just put their trust in them for the first time since 2010. More recently, there has been speculation in the press that Labour may seek to meanstest the "universal" state pension. If they go through with any of these changes, Labour will need to craft a clever narrative to avoid the potential fall-out from disgruntled savers who could see the government raid their retirement nest eggs and derail their retirement plans.

Following pressure during the election campaign, Labour seemingly backed down on reintroducing the Lifetime Allowance, but closer inspection of their comments reveals they haven't explicitly ruled this out and merely have no plans to do so.

Auto Enrolment didn't get a mention either in Labour's manifesto. Recent research from the Department of Work and Pensions shows that around 40% of the working age population are not saving enough for their retirement. The upshot will be yet more pressure on the state in years to come if this is not addressed. Perhaps the omission in itself was not surprising given the country is only just emerging from a cost of living crisis, however, Labour could well review Auto Enrolment contribution rates during the next Parliament.

Labour have been out of office for a long time. Commenting from the sidelines is one thing, now they have the responsibility. It remains to be seen whether they are capable of delivering.

Investment update

Q2-24 Market Commentary

The strong momentum witnessed by equity markets in the first quarter of 2024 carried on into the second quarter as continued robust economic growth was positive for growth assets with Global Equities and Commodities returning 2.9% and 2.9%* respectively. However, this did lead to a continuation of the higher for longer interest rate narrative that consequently weighed on Global Bond and Real Estate valuations which generated returns of -1.1%* and -1.4%* respectively during the period.

Growth Assets

Within Equities, Asia Ex Japan was one of the strongest performing regions returning 6.1% followed closely by Emerging Markets (EM) at 5.1%*. The Chinese government's decision to support the real estate sector was positive for Chinese equities as well as EM more broadly. The strength of the Chinese market coupled with the strong performance of A.I companies exposed to the Taiwanese stock market helped Asia Ex Japan deliver strong returns. US equity markets also performed strongly returning 4.1%, mainly driven by US technology companies. UK equities returned 3.7%, off the back of an improving economic environment. European Equities were marginally up at 0.3%. Positive gains across other European markets were offset by weakness in the French Equity market in June, as uncertainty around the outcome of the snap French Federal election weighed on market sentiment. Conversely, the Japanese Stock Market posted a negative return in GBP terms of -4.6%, despite generating some strong returns in Q1-24. The main driver of this negative performance was the continued depreciation of the Yen against the pound due to the Bank of Japan's (BoJ) decision to end 8 years of negative rates.

Commodities continued their positive momentum into the second quarter returning 2.9%*, mainly driven by a rally in industrial and precious metals off the back of continued robust economic growth.

Bonds

Most sovereign bond markets generated negative returns this quarter with the exception of the U.S returning 0.1%*. Japanese Government Bonds generated the worst returns, returning -2.7%*, due to the BoJ's decision to end 8 years of negative interest rates. Within credit, high yield produced a positive return of 1.4%, with resilient economic data being positive for credit valuations. Higher inflation numbers and better economic data weighed on the more interest-rate sensitive investment grade bonds which generated a negative return of -0.2%*.

Within the UK, long-term UK gilt yields increased by 0.2% to 4.6% as stickier services inflation dashed hopes of a June rate cut by the Bank of England, causing long-term rates to remain elevated. All else being equal, the move will have acted to decrease the value placed on pension schemes' liabilities.

Real yields increased by 0.2% to 1.3%. All else being equal, the move will have acted to decrease the value placed on inflation sensitive pension scheme liabilities.

Long-term inflation remained broadly the same over the period at 3.2%.

*All returns shown are shown in GBP terms unless stated otherwise, sourced: FTSE, Markit iBoxx*Local currency, except for EM and global indices, which are in US dollar, sourced: JPM and MSCI*

Past performance is not a reliable indicator of current and future results.

Data as of 30 June 2024.

Run-on: the alternative endgame everyone's talking about

For years, employers have seen Defined Benefit (DB) schemes as a liability with unexpected costs and risks and have wanted to get them off balance sheet to an insurer as soon as possible. But is the tide turning? Recent developments mean some employers may now see their DB scheme as an asset rather than a liability and look to run-on their DB scheme to access surplus. These developments include:

Development	Explanation	Impact
1) Rising yields	Yields have risen over 2% pa in the last 2 years shrinking DB liabilities by 40% and improving funding levels.	<p>Scheme shrinkage has reduced risk for employers, and improved funding levels have generated surpluses.</p> <p>The 2023 PPF Purple Book shows that for the first time, UK DB schemes in aggregate are in surplus on an insurance buy-out basis to the tune of £150bn. 63% of schemes are fully funded on a buy-out basis.</p> <p>Surpluses are therefore now real in many cases, and needing management, rather than being a concept in the future. This is forcing trustees and employers to appraise different endgame options.</p>
2) Barriers to accessing surplus are lowering	Mansion House reforms from 2023 have led to government initiatives to ease access to DB surpluses to encourage DB schemes to run on and invest in the UK economy.	<p>Tax charge on surplus refund reduced by 10% (from 35% to 25%) in April 2024, making surplus distributions less penal from a tax perspective. Tax charge remains nil for charities.</p> <p>DWP consultation in February 2024 is considering a statutory override to both ensure surplus is accessible and to lower the bar at which a refund of surplus becomes viable (see next section for more details).</p> <p>The Work and Pensions Committee issued a DB report in March 2024 with recommendations for government and TPR, including noting that "well-funded schemes should also be supported to run on as there are potential advantages for scheme members, sponsoring employers and the economy."</p> <p>The Pensions Regulator now appears supportive of run-on as a viable endgame.</p>
3) Insurers and administrators are resource constrained	Insurers are busy with transactions and administrators with the associated data work, and other data projects.	In some cases schemes are having to run on with a buy-out surplus rather than transact, on account of delays getting the scheme ready for buy-out or getting to the front of the queue with insurers. The delays are leading some employers to reassess endgame options when they might have previously transacted.

What are the key points in the DWP consultation about run on?

The government's stated aims in the consultation are to support schemes to invest for surplus in productive asset allocations by making it easier to share scheme surplus with employers and members, and to remove barriers to surplus extraction such as scheme rules and trustee duties. However they are also clear that surplus should only be extracted when safe to do so from a member benefit perspective.

The key proposals are:

- A statutory over-ride to scheme rules, so that all schemes can choose to share surplus subject to appropriate funding levels;
- Re-classifying lump payments so that they are not unauthorised payments, thereby making it more viable to share surplus with members with lump sum payments rather than additional pension which increases long term liabilities; and
- Introducing a funding threshold above which surplus can be extracted. Some of the options for this threshold include 105% funding on a low dependency basis or 100% funding on a buy-out basis.

How much value could be generated with run-on?

We've looked at a £100m scheme fully funded on a low dependency basis and assumed it can start distributing surplus at above 105% funding on a low dependency basis. The chart below shows the payout over the next 15 years if assets return Gilts + 2% pa (broadly in line with the return targeted by insurers). It shows payouts of c. £1m pa are realistic, equating to £15m over the next 15 years or 15% of current scheme assets.



What should trustees and employers consider with run-on?

Run-on requires alignment between the employer and the Trustees, and so surplus needs to be shared between the employer and the members. Trustees can only agree to an extended period of run-on if it's in members' best interests, and so sharing some of the surplus with members must be part of the package.

Trustees should consider a funding buffer to mitigate the risks of run-on, such as investment risk, longevity risk, covenant risk and expense risk, and only look to distribute surplus above the buffer. This could be achieved automatically depending on where the government set the funding threshold for surplus distribution.

Run-on is often considered as primarily viable for larger DB schemes where the running costs remain small relative to the asset base. However, in our view run-on is viable for smaller schemes too if they adopt lean operational models or one of the operational consolidation models in the market to keep running cost low.

Next steps

For now, in most cases, long term run-on remains a concept rather than operational. Employers and trustees need the outcome of the DWP consultation, and the subsequent regulations and guidance, before they can put the frameworks in place with confidence to effectively operate run-on and the associated surplus distribution.

Helpful Links

[Options for Defined Benefit schemes - GOV.UK \(www.gov.uk\)](https://www.gov.uk)

[Defined benefit pension schemes - Work and Pensions Committee \(parliament.uk\)](https://parliament.uk)

[Annual Funding Statement 2024 | The Pensions Regulator](#)

Buy-out - market and Pension Risk Transfer

The last 18 months have seen a substantial investment by bulk annuity insurers in developing more efficient and effective ways for smaller pension schemes (typically below £100m to £150m in size depending on which insurer you may be dealing with) to access the pension risk transfer marketplace, despite the continuing substantial demand from much larger pension schemes for bulk annuities.

During our regular catch-ups with the bulk annuity insurers, the Pension Risk Transfer team at Spence has sought to develop a robust understanding of each solution in the market, as it is clear that there are differences (some material and some subtle) which need to be factored in when bringing smaller pension schemes to the market.

The solutions that have formally been launched are as follows:

Aviva – “Clarity”

Just – “Beacon”

L&G – “Flow”

PIC – “Mosaic”

Beyond these four insurers, it is clear that other insurers active in the market are in the process of building their business case for developing similar solutions as this part of the private sector defined benefit pension scheme marketplace accounts for possibly 4,000+ of the circa 5,000+ private sector DB schemes (source, PPF Purple Book 2023). Effectively 80%+ of all possible future pension risk transfer transactions are going to be driven by the smaller end of the market.

In 2023, we saw a record total number of bulk annuity transactions in the UK – with over 220 deals being completed – but importantly, we believe in excess of 70% of these trades were for deals below £100m in size. Even what is often considered to be the poorly served ultra-small schemes (ie sub £10m in size) were extremely well supported by the market, with approximately 1 in 4 of all bulk annuity transactions in 2023 being for this size of scheme.

The key message to all trustees and sponsors of schemes below £100m in size is that, if you have determined that a bulk annuity is your desired/preferred end-game solution (once you have considered all your options for the long-term provision of benefits for your pension scheme members), then the pension risk transfer marketplace is currently flourishing for schemes like yours. These streamlined solutions focussed on smaller schemes, also should make it more cost-effective to work your way through the process for securing a bulk annuity policy.

And, significantly, with recent new entrants also vying for transactions at the smaller end of the marketplace, finding at least one, or more likely more than one insurer interested in engaging with your scheme, is likely only to improve in the short term.

New Defined Benefit Code of Practice: Further Delays?

On 22 May, the now former Prime Minister Rishi Sunak announced that the UK was going to the polls for an earlier than expected General Election. Along with a whole host of uncertainties created by the election, it has become even more unclear when the Pensions Regulator's ("TPR") new Defined Benefit Funding Code will be published, with TPR's original plans to publish by summer 2024 now seriously in doubt.

The Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2024 came into force in April 2024 and apply to pension schemes undertaking funding valuations with effective dates on or after 22 September 2024. The new regulations require trustees to determine a strategy to reach at least full funding on a low-dependency funding basis by a specified date, and by no later than the point at which the scheme reaches "significant maturity". On this basis, the scheme is not expected to require any further contributions from the sponsoring employer.

While the new regime has become law, the pensions industry has waited for some time for the publication of TPR's new Funding Code, which will set out their expectations as to what parties must do to comply with the new regime. The recent snap General Election, in which the Labour Party won a landslide victory and replaced the previous Conservative government, has created significant uncertainty around when the Code may finally be published. The regulations specifically point to the Funding Code and therefore without its final publication, stakeholders are left in limbo.

TPR had previously indicated the Code would be published in summer 2024. However, given the election, the fact that Parliament is about to go into summer recess over August and that the Code must be laid before Parliament for 40 days, it looks unlikely that it will be implemented before the new regime comes into force on 22 September 2024.

Fortunately, there is at least some breathing space for schemes undertaking funding valuations shortly after 22 September. Valuations can be signed off at any point up to 15 months after their effective date, meaning that even a scheme with a 30 September valuation will have until the end of December 2025 to comply with the regulations. If the Code were published shortly after the regime kicks in, it's unlikely to have any significant impact on schemes complying with the regulations.

That said, it's not impossible that the Code could face further and more material delays. With the new Labour government, it's not yet clear where the Code will rank amongst their priorities. They have said that they intend to carry out a wide-ranging review of the pensions landscape and it remains to be seen what precisely this will include.

While the General Election poses a potential delay to the implementation of the new DB Funding Code, the underlying goals of the new funding regime remain critical. Taken as a whole, the new regime aims to provide clearer guidance and stronger protections for DB pension schemes, which are essential for millions of scheme members. Stakeholders and policymakers will need to work collaboratively to navigate the uncertainties of the post-election period and ensure that the new Code is implemented effectively in due course.

Pensions Dashboards – The final countdown

We're less than a year away now from the staging date for the largest pension schemes and other schemes will find their staging dates approaching at pace.

Schemes can check their individual staging dates through the Pension Regulator's (tPR) website. Schemes with fewer than 100 Active and Deferred members are not required to connect to the pensions dashboard.

While the legal backstop date of 31 October 2026 remains, tPR is providing strong messaging through guidance and industry briefings that they expect pension schemes to connect by their staging dates, and that not doing so is likely to raise the risk of trustees not complying with their dashboard obligations.

No date has yet been set for the "Dashboard Accessibility Point", when the public will be able to log in and see details of their pensions.

The key steps for pension schemes as they approach their staging dates are summarised below:

- Check their staging dates
- Engage with their administration provider on their plans for connection across their book of pension schemes
- Assess the data required to enable members to locate their pensions via dashboard (the "find data" – see below)
- Assess the data required to enable members to see details of their accrued pensions (the "view data" – see below)
- Identify any contractual amendments required to cover their scheme's dashboard connection
- Review the likely impact of the launch of pension dashboards on their scheme's administration processes and member contact workloads

Find Data

This is each member's basic details, which will be input into the dashboard service and matched with the administrator's records to generate a match. Schemes have the ability to set their own matching criteria and a balance needs to be struck between a very tight set of criteria (which offers maximum data security but risks not returning results if there is a minor mismatch) and a looser set of criteria (more likely to allow members to access their records but could permit a false match). While on the surface, a tight set of criteria is more in line with scheme's obligations around data security, not returning results where the variance is for example one digit in a post code will increase the number of members contacting administration teams.

As well as establishing the matching criteria to use, schemes need to assess their own data quality and identify any improvements required to make sure that members can in practice successfully view their pensions.

View Data

Once the Find Data has been validated the dashboard should then serve the member with details of their accrued pension (or projected pension for active members). Schemes should liaise with their administrator to understand how these will be calculated – there are strict time limits around how long schemes have to provide figures. A highly digitised service will be able to provide figures in real time, whereas a more manual based operation is likely to require a significant amount of work to either calculate figures across the board on a regular basis, or deal with enquiries on demand.

Mortality Update

Trustees and sponsors of defined benefit pension schemes will be well aware that the longer scheme members live, the more expensive the cost of providing benefits. Equally, the longer scheme members are expected to live can have a significant impact on the cost of funding their scheme in the shorter term. If trustees assume longer life expectancy in their funding valuation, benefits are expected to be paid for longer and therefore pension scheme liabilities (and any deficit reduction contributions) will be higher.

Therefore, trustees and sponsors should carefully consider recent trends in life expectancy when setting assumptions. In particular, they should consider two recent updates from the Institute and Faculty of Actuaries, namely the release of the Self-Administered Pension Schemes ("SAPS") S4 Series of base tables and the Continuous Mortality Investigation Bureau's ("CMI") 2023 mortality improvement model.

Base tables, including the S4 tables, set out probabilities of death at each age. They are derived using past experience data and do not make any allowance for how mortality might change in the future. Therefore, when setting mortality assumptions, it is also necessary to make an assumption on any future improvement in mortality. This is where the CMI's mortality improvement model comes into play.

The combination of both the base table and the mortality improvement table results in an overall life expectancy assumption. Typically, we recommend using the latest version of these tables as they may be expected to result in more accurate life expectancies and so provide a truer picture of pension scheme liabilities.

The S4 tables are based on data from both private and public sector schemes covering the period 2014 – 2019, collected from actuarial consultancies, the Pension Protection Fund and the Government Actuary's Department. The S4 series includes a suite of pension amount weighted tables which were also included in the previous release – the S3 series. The new series also includes an additional 12 tables which incorporate an Index of Multiple Deprivation ("IMD"). The intention behind the release of these additional tables is to afford users greater scope to tailor their choice of table to their specific scheme.

The CMI 2023 improvement model is the latest model released by the CMI and is calibrated for the population of England and Wales up to 31 December 2023, based on publications from the Office for National Statistics and CMI estimates. Consistent with other recent versions of the model, the CMI have placed no weight on data from 2020 or 2021 as the default option, given the highly unusual mortality experience in those years. They have, however, opted to give some weighting to 2022 and 2023 data in the latest model, reflecting their views on the longer term impact of COVID-19. The CMI 2023 model uses a core weighting of 15% for both 2022 and 2023 data.

All else being equal, comparing the core CMI 2023 model with the previous core model (CMI 2022), life expectancies will typically reduce at age 65 by around half a month for females and one month for males. This translates into a negligible reduction in liabilities for a typical scheme. As ever, trustees and employers should continue to seek the appropriate actuarial advice when setting these assumptions for valuation purposes.

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