What has 2024 got in store for DB pensions and how will fiduciary management evolve?

For a pensions market that is all but closed to new members, you would be forgiven for perhaps expecting defined benefit (DB) pension schemes to be taking it easy. In reality this couldn't be further from the truth. Mansion House reforms, increasing numbers of bulk annuity deals, and consolidation, all set against the backdrop of the upcoming General Election, mean that 2024 is set to be a year with many twists and turns.

Colleagues from across Cardano have contributed their thoughts on the macro-economic outlook for 2024, how fiduciary management will evolve to meet the changing needs of trustees and a focus on the risk-transfer market and what we expect to see in the year to come.

Macro-economic expectations: Hunkering down and being patient once more

By Shweta Singh, Chief Economist at Cardano

2023 proved to be a curious year for the global economy and for global investment markets. The global economy has continued to recover from its post-pandemic shock and, rather surprisingly, has remained resilient in the face of rising geopolitical risks and the ongoing cost-of-living crisis This overarching resilience, especially in the US, is notable because it has taken place within an environment that has seen the world's central banks deliver their most aggressive interest rate hiking cycles of recent economic history.

But, in our view, the global economy is limping-along rather than decisively establishing a new upward trend.

Across regions, there has been growing divergences. In the US and, to a lesser extent, in Japan, strong growth momentum through the Spring and Summer of 2023 has led many market commentators to upgrade their expectations for 2024. Whereas, in China, a muted response to the post-lockdown reopening of the economy has disappointed the more optimistic expectations of how China might support global growth.

On balance, 2023 has definitely surprised us to the upside. Yet we see darker clouds on the horizon.

The higher global interest rate environment is starting to bite; tighter credit conditions are weighing on housing markets; upon corporations' capital expenditure plans and upon consumer activity. Corporate bankruptcy rates and credit card and auto loan delinquency rates have started to increase.

We think that the prevailing consensus may be overestimating the strength of the present underlying growth momentum. Accordingly, whilst our expectations are pushed out a little further into the future, we expect the onset of a US recession in mid-to-late 2024. Ahead of this downturn in the US, we expect a recession to commence in the UK, and in the euro area too, a little earlier in the year to come.

Should 2024 play-out according to our expected pattern, a real dilemma will face the world's central banks. Whilst inflation is set to fall, it will remain elevated relative to central bank targets, largely due to relatively tight labour markets. Premature easing (as might be expected as a traditional counter-cyclical monetary policy response) risks giving away the gains made by the past tightening cycle. We are very much in the "higher for longer" camp and, accordingly, see the overall interest rate environment as being a headwind well into 2024. Shallow post-recession recoveries are expected. Importantly, we don't think that corporate earnings forecasts nor price to earnings ratios properly reflect this outcome. Equity markets start the year too high in our view.

Where does this leave investment markets and the prospects for UK pension schemes' growth portfolios?

Unfortunately, our forecasts show very few asset classes as having return expectations higher than cash over the forthcoming 12 months. For investors with high allocations to global equity markets this probably means that a review of the adequacy of protection overlay strategies is warranted. For schemes that are already substantially de-risked, 'less excitement' from rising government bond yields now looks to be more likely.

This promise of 'less excitement' does lead us to being a little more optimistic on the returns available from government bonds and credit. The higher yields that now prevail at least are starting to properly discount future economic conditions.

For 2024, it may be a case of hunkering down and being patient once more.

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The evolution of fiduciary management

By Patrick Cunningham, Partner and Co-Head of Clients at Cardano

The last year has been one of dramatic change. The year began with fallout from the gilts crisis. For many schemes, journey plans were accelerated and deficits became surpluses. Buy-ins and buyouts reached record levels, including the Walgreens Boots Alliance transaction on which Cardano just acted as lead advisor.

One superfund stepped forward, and another back,[1] adding a new pitstop on the way to buyout. Professional trustee (PT) firms consolidated, and we saw an increase in corporate sole trustee (CST) appointments. Once a solution for small schemes, CST is increasingly popular for schemes of all sizes.

That all means companies' and trustees' needs are changing, so fiduciary management will continue to evolve.

Looking ahead to 2024, the Pensions Regulator's new DB Funding Code and “Mansion House reforms”,[2] while somewhat mysterious, may lead to more change in an election year.

We foresee the following changes, most of which are already underway:

- Fiduciary management and outsourced chief investment officer (OCIO) approaches will play a growing role in some PT firms' initiatives to centralise, scale and quality-control governance and implementation for small and mid-sized schemes, many with CSTs. This will require flexibility in fiduciary managers' services, innovation in client reporting, and new approaches to pricing.
- Bespoke liability driven investing (LDI) strategies, whether segregated mandates or pooled funds-of-one, will be a competitive advantage for some fiduciary managers as trustees and third-party evaluators reflect on the lessons of the Autumn 2022 Gilts crisis, the importance of scheme-specific collateral flexibility, and the speed in trading into insurers' price lock portfolios. Why wouldn't you opt for bespoke LDI over commingled pooled funds at similar price points? The price points are similar for schemes with £150million+ in total assets or a £60million+ capital allocation to LDI.
- Fiduciary managers will up their reporting games on sustainability and ESG issues. The gold standard means going beyond descriptive portfolio statistics. It means providing management information to help trustees understand trade-offs and hold fiduciary managers to account on decisions. It means analytics that go beyond just carbon and climate, to focus on water usage, biodiversity, human rights, and other social factors.
- Fiduciary managers will more explicitly offer dual-track solutions for schemes who want:
  - Buyout: Fiduciary managers will continue to monitor and report on funding versus buyout liabilities. But they'll also do more to help clients cross the finish line. They'll take a more active role in critical workstreams, choreographing activities with administrators and other advisors at least a year before full funding. Fiduciary managers will be held accountable for transitions to price lock portfolios, including the disposal of illiquids. We're also likely to see some fiduciary managers broker risk transfers themselves.
  - Run-off: Fiduciary managers' governance frameworks, investment portfolios and risk controls will look more like insurers'. Market risk will narrow to interest rates, inflation, and credit (sovereign, public, private, and secured). At the same time, other risks will grow in relative importance e.g. liquidity risk, operational risk, and counterparty risk. The expertise required will be deep and practical, favouring asset managers i.e. the fiduciary providers who are direct market participants, not managers-of-managers.

With all this considered, new thinking and new skills will be required in 2024 to navigate the changes affecting pension decision-making and fiduciary management services. Diversity in all its forms – identity, biography, cognition – will be critical in driving good outcomes for scheme members and commercial success for the firms that serve them.

A deeper dive into the risk-transfer market and what we expect to see in the year ahead

By Adolfo Aponte, Managing Director of Risk Solutions at Cardano Advisory

The risk-transfer market continues to build momentum across its various products. 2023 saw a record number of transactions over a billion pounds priced by insurers. This translated into record-setting transactions, namely the full buy-in transactions between the Boots Pension Scheme and Legal & General,[3] which Cardano led, and between the two RSA pension schemes and PIC. We also saw the long-anticipated first consolidation transaction between the Sears Retail Pension Scheme and Clara. With new entrants expected in 2024 and a supportive regulatory backdrop, the risk-transfer market is set to be one of the most dynamic corners of the DB pensions industry next year.

Billion-pound transactions will dictate the key themes for the bulk annuity insurance market, with at least 20 such pension schemes expected to be priced in 2024. These ‘mega’ transactions have brought about a spur of innovation to address the challenges posed by underwriting benefits and illiquid assets at scale. Capacity is supported by a buoyant reinsurance market which has increased the appetite for annuity business following growth in mortality business being underwritten, primarily in the US, and substantial capital flowing into offshore funded reinsurance structures. No wonder the number of providers looking to enter the bulk annuity market is at an all-time high! We expect at least two of these to start writing new business during 2024.

Regulatory change should also be supportive of insurers, albeit the picture is somewhat nuanced if you look more closely. Solvency UK, the revised regulatory regime for insurers, should be in full swing towards the end of 2024. Key changes include the ability to invest in a wider spectrum of yielding assets and a reduction in the amount of capital insurers need to hold back to protect policyholders. However, there appears to be a general undertone of nervousness coming out of the PRA, who has made no secret of its reservations with some of the trends in the insurance market. The increased use of funded reinsurance and the larger transactions insurers are taking on are some of the key themes picked up by the PRA. Trustees and corporates looking to transact with an insurer in 2024 will want to carefully consider how they manage the resulting counterparty exposure.

But it is not all about buy-ins. There have been a number of sizable longevity swaps transacted during 2023. The drivers vary from schemes looking to lock-in reinsurance capacity to those seriously considering a run-on strategy. This latter driver could be supported by the tax changes recently muted by the government.

Consolidation is also on the agenda of some schemes still struggling to improve funding levels and exposed to a weaker employer covenant. The recent Sears transaction plus the watering down of capital requirements by TPR could inject some excitement back to the superfunds space. The other form of consolidation we will be keeping a close eye on in 2024 is the expanded role the government is proposing for the PPF. This change could be transformational to a highly fragmented DB pensions landscape, but with a general election around the corner we think this one may well drop into 2025 and beyond.

The bottom line is that there has never been so many options for trustees and corporates to transfer the risk embedded in their pension schemes. The single most important word for pension schemes looking to tap the insurance market is preparation. This is especially true for small and medium sized schemes who are having to work harder to make it through the insurers' triage process. Expert advice along the way is not only advantageous, it is necessary.

FOOTNOTE

1 Source: https://www.cardano.co.uk/perspectives/clara-is-this-the-beginning-of-a-trend-consolidation/

2 Source: https://www.cardano.co.uk/perspectives/covenant-quarterly-q3-2023/

3 Source: https://www.cardano.co.uk/industry-insights/cardano-lead-transaction-advisor-to-record-4-8bn-full-buy-in-with-boots-pension-scheme/