Broadstone

High and rising gilt yields

What is happening and what needs to be done?

January 2025

Introduction

We have seen steady rises in gilt yields across 2024 and this has accelerated into the early days of 2025.

While Trustees and advisers should be mindful of knee jerk reactions to market movements, the rises we have seen (and national press coverage) should give Trustees reason to pause and consider the potential impact.

In this note we consider the rises and the actions that Trustees and/or Employers should take in response including checking their funding level, asset positioning and scheme factors.

Current gilt yields

During 2024 the UK 15-year gilt yield rose from around **4.0%** to **4.9%**. Over the past 10 days it climbed to a high of **5.2%** on January 7, 2025, its highest level since October 2008.

Higher yields can lead to increased borrowing costs for the government and businesses, potentially slowing economic growth. This trend underscores the delicate balance the Bank of England must maintain between stabilising inflation and supporting economic growth.

It should be noted that government bond yields have also risen in the US and Europe, although the UK has been particularly volatile. Also, the rises are predominantly at longer durations, with yields below 10 years not in such unfamiliar territory.

For defined benefit pension schemes, the higher long term yields should mean a reduction in the value placed on their longer term liabilities. However, many schemes are already hedging (large parts) of this risk within their investment strategy and so will see some corresponding movements in their asset values. The extent to which this matches liability changes will depend on the cashflow profile, investment approach taken and exposure at longer durations.

Key actions

Review hedging levels and collateral waterfalls

Those schemes that are not currently fully hedging their interest rate risk should see funding improvements, with the present value of their liabilities falling more than the scheme's assets. Such schemes may wish to protect those gains by increasing their levels of liability hedging now. Given market volatility, this could mean accelerating the normal decision-making process, in consultation with the employer.

Meanwhile, those schemes employing leverage within their investment strategy (e.g. through use of LDI funds) should expect collateral calls. Having a robust and clear collateral waterfall is essential to ensure the smooth movement of assets to maintain hedging at the required levels. You may also then want to check the remaining assets are well positioned in case of further calls in future.

Asset allocation and rebalancing

Significant movements in asset values can distort the balance of asset allocations in relation to a scheme's established strategy. Alongside rising gilt yields, rising global equity markets, tightening credit spreads and the recent weakening of Sterling are all likely to contribute to asset allocations deviating from their targets.

Whether in addition to, or in conjunction with, discussions around hedging and liquidity, we recommend you discuss the impact on your asset allocation with your investment consultant and consider whether rebalancing is appropriate.

Check funding position if appropriate

As noted previously, those with unhedged interest rate exposure should see an improvement in their funding level. Also, even where funding levels are relatively stable, lower liabilities will translate to smaller deficits. The position will continue to fluctuate and schemes in a steady ongoing state may be happy just to wait for their next funding review but others will want to be more proactive.

Employers paying material contributions or nearing the end of their recovery plans may want to check if these contributions are still required. Those with sizeable active memberships should see falls in the cost of ongoing benefits and employers currently in the midst of valuation negotiations may be minded to ask about the impact of post-valuation movements before agreeing contribution rates.

Finally, those who were waiting for buyout to become affordable may want to check whether an opportunity is now within reach (see also below).

Scheme factors

Whilst cash equivalent transfer values are typically market related and so should remain valid (subject to any strategic changes in investment strategy), cash commutation and early or late retirement factors may have been fixed at a date 12 or 18 months in the past.

Without review, you may find these no longer provide fair value of conversion (cash commutation terms might now appear too generous, whilst late retirement factors may be penal). This can be a tricky area to manage as it deals directly with member benefits but the extent of recent movements may well merit an extra review.

Buyout target

Many schemes have been having discussions about buyout and are considering their end-game options. Depending on how closely you have been monitoring your buyout deficit, the movement in gilt yields (plus changes in credit markets) could have a material impact on your time horizons for reaching a potential transaction point. Our specialist SM&RT team are well placed to advise on latest market developments.

Covenant

Finally, we note that rising gilt yields could affect sponsors with material levels of debt as the cost of servicing that debt could increase. Particularly where there are affordability or other covenant concerns, Trustees should be asking their sponsors about the impact of the rise in debt costs on cashflow.

Broadstone view

There is no need for panic – despite some of the alarmist headlines in the national press – but Trustees and employers should be actively considering the impact of high and rising gilt yields.

The more gradual nature of yield movements and reduced leverage in LDI investment mean that, unlike during the period following the 2022 budget, there are no immediate concerns and hedging strategies should all be working sensibly. However, the extent of the change over the past year or so is significant and may merit review or refinement of existing approaches as well as providing new or unexpected opportunities. Trustees should therefore consider their next steps across the areas we've highlighted as soon as possible, whilst recognising that yields will continue to fluctuate.

It may be no action is required, particularly for mature and well hedged schemes. However, many will find that some action is needed in response to this changing landscape. As always, well informed and collaborative discussions between Trustees and employers should deliver the best outcomes and help to ensure that opportunities and risks are not overlooked.

Find out more

For more information on how Broadstone can help you, please contact your Broadstone consultant or use the details below.

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