CARTWRIGHT

# Industry Update – 2023 banking crisis
# What can defined benefit pension scheme trustees do?

## Background

Sharply rising interest rates over the last year have caused significant challenges in the banking system. This has led to concerns of another financial crisis, similar to the Global Financial Crisis in 2008.

If so, we are in the early stages. Credit Suisse's financial weakness resulted in its acquisition by UBS over the weekend of 18/19 March. This came after three US regional banks were closed a few days before raising further concerns about the impact on the global economy and banking sector.

Stricter regulations and greater capital reserves mean banks should in general, be better prepared to handle shocks, than they were fifteen years ago. However, all commercial banks hold only a fraction of deposits as cash reserves and so, by design, are still susceptible to bank runs and closures from time-to-time. Bailouts by central banks or forced acquisitions as and when needed are, in our view, extremely likely but not guaranteed.

Central banks have been raising interest rates in order to combat inflation. Over the past month, both the Federal Reserve and Bank of England have signalled their intent to keep raising interest rates (the European Central Bank raised its interest rate last week). They now face a difficult decision this week as raising interest rates could increase pressure on commercial banks' balance sheets. A pressure which may in turn negatively impact the wider economy; as banks are less willing to lend to companies and households. On the other hand, the risk of not raising interest rates is that inflation gets out of control.

On a positive note, the central bank bailouts over the past week or so have calmed the financial markets and given investors breathing space to check that their portfolios are in order. Whilst 24-hour news encourages the opposite, it's important at times like this to remain calm and take pragmatic, reasonable and prudent decisions that should not be regretted in hindsight.

## What can defined benefit pension scheme trustees do?

There are a few actions that can be considered to mitigate the risks, many of which should be taken even in the absence of a banking crisis.

1. Review the level of cash held in the scheme's bank account, regularly sweeping any excess cash into the invested assets. This is general good cash management, as holding too much cash in the bank account (paying little or no interest) creates a cash drag on the scheme's investment returns.

2. Consider the options for a second bank account with a different bank, which could be via the sponsoring employer. This enhances the scheme's operational resilience in the event of a bank failure (pensions can still be paid), as well as providing capital protection. Sometimes pension payroll is paid by the employer first before being reimbursed by the scheme – this also provides some protection if the employer uses a different bank to the scheme.

3. Ask the sponsoring employer what potential impacts there could be on their business, and therefore on the strength of the employer covenant, if stresses in the banking system continue.

4. Review if there are opportunities to reduce the investment risks within the scheme. Many schemes are now better funded than they were a year ago (we estimate over 1,000 schemes have a buyout surplus) and so de-risking is now more affordable.

5. Act promptly to implement any agreed asset transitions. Also, consider phasing asset transitions to reduce the impact of markets moving against the scheme on one day. Paying a fund manager to avoid out of market exposure has always been good practice, but now looks even more necessary. Note that transaction costs may be higher than normal in stressed markets.

6. Review the overall liquidity within the scheme's assets, particularly if the scheme uses LDI and/or is expected to have relatively large cash outflows for whatever reason (e.g. cash equivalent transfer values).

7. Identify if there are any asset classes that would be attractive if they were cheaper. For example, illiquid assets such as property or volatile assets such as equities. Hold some assets in near cash in preparation as "dry powder".

8. Other investment opportunities may arise. With a clear strategic framework in place, it will be easier for the trustees to assess the opportunity and, if relevant, take advantage.

9. Financial market volatility is now more likely. Funding level triggers can help to quickly take advantage of this volatility as and when it happens.

10. Some trustees may wish to assess the exposure that the scheme's investment funds have to the banking sector or specific banks. However, a note of caution. By its very nature, a banking crisis tends to be systemic and affect entire economies in ways that are not transparent. As such, they are difficult to predict or determine in advance. So, finding out that a scheme has low direct exposure to the banking sector is likely to provide false comfort. Having said that, we are currently investigating the diversification of counterparties within our buy-list LDI funds.

If you would like to discuss any of these matters further, please get in touch with your usual contact at Cartwright.

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