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What's been happening and what's on the Horizon in the world of pensions

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The £1.5tn asset pool of the UK's 5,000+ increasingly well-funded corporate defined benefit (DB) schemes, is attracting considerable attention from a variety of interested stakeholders. Notable amongst these are bulk annuity providers, for whom a now widely anticipated buy-in and buyout bonanza lies in prospect. However, against the backdrop of widespread regulatory-driven and buyout-targeted investment de-risking, an alternative and almost diametrically opposed direction of travel for UK corporate DB has been proposed by consultants LCP and WTW — each of which seeks to benefit multiple stakeholders. This edition of Pensions Watch considers the key facets of these proposals and asks whether they could realistically reverse a deeply entrenched de-risking mindset and the notion of a swift transition to buyout being the only end game in town.

A swift transition to buyout has seemingly become the only end game in town...

On 22 September 2022, then Chancellor, Kwasi Kwarteng unveiled the biggest tax give away since the "Barber Boom" of 1972. Targeting a growth plan akin to Chancellor Anthony Barber's "dash for growth", the gilt market was immediately spooked by the unfunded and uncosted nature of these gargantuan tax cuts, culminating in unprecedented fixed income market turmoil, as gilt yields recorded their biggest ever one day move and soared to 14-year highs. However, despite the consequent significant losses incurred by Defined Benefit (DB) scheme liability driven investment (LDI) portfolios, what immediately became apparent was that DB funding levels had, in the main, improved to such an extent[1] that buyout had, almost overnight, become a viable proposition for many — at least for those in an appropriate state of preparedness.

In fact, over the weeks and months that followed, a swift transition to buyout began to be framed as the only end game in town, despite the obvious capacity constraints of bulk annuity providers and the general lack of readiness of many well-funded DB schemes to progress to buyout in the short to medium term. Indeed, although accepting that for most, if not all, schemes, buyout is the natural ultimate end game,[2] such is the momentum that has been building around more immediate buyouts, it's recently been suggested that, by end-2026 up to £300bn of DB assets and liabilities could transfer to insurers, while by 2029 more than half of UK corporate DB assets could be in the hands of insurers.[3]

...yet further reinforcing the regulatory-driven move to de-risking

Prior to this dramatic improvement in scheme funding ratios, which have since been bolstered by an equally dramatic tightening of monetary policy to suppress persistent price inflation, most of the UK's 5,000+, mainly closed, corporate DB schemes were assuming investment risk and chasing returns, commensurate with their funding position and the strength of their sponsor's covenant, in order to plug the longstanding gap between the value of their assets and projected liabilities. However, that's not to say they all were. Indeed, well-funded schemes, although in the minority, were, in moving to a low dependence funding and investment strategy, de-risking into lower risk and returning assets. In fact, some had been doing so for years. That said, with buyout some way off for most, buyout and run off, or DIY buyout, were fairly evenly matched as the formally targeted end game of UK corporate DB.

[1] This fortuitous result stemmed from a significantly higher discount rate, courtesy of higher yields, being applied to the valuation of DB scheme liabilities, which significantly reduced their value.
[2] After all, buyout, with all of the protections afforded to scheme members, not least the strict solvency regulations applied to insurers by the Prudential Regulatory Authority (PRA), means that member security is all but guaranteed, albeit at a cost. Consequently, it's increasingly become perceived as the end game gold standard.
[3] See: How is the insurance regulator responding to the rapid growth in the bulk annuity market? Charlie Finch. LCP. 31 July 2023.
The future of UK pensions: delayed and confused. Helen Thomas. Financial Times. 12 July 2023.

However, with more widespread improvement in funding has come even more widespread investment de-risking, compounded by an increasing number of schemes liquidating their, buyout unfriendly, illiquid assets in preparation for meeting insurers', increasingly discerning, entry requirements for the buying out of member benefits.[4] Ironically, while these insurers, principally as a consequence of regulation, tend to invest predominantly in bonds and other relatively low-risk/low-return bond-like assets, illiquid assets do feature quite prominently in their portfolios.[5]

So why do well funded schemes de-risk?

In short, because of the prudence and focus on security built into pensions regulation and the restrictions and punitive taxation applied to the withdrawal of scheme surpluses. To explain. Central to a trustee's fiduciary duty is ensuring that members' accrued benefits are paid in full and on time. However, this is juxtaposed with typically less than 100% of a member's accrued benefits being covered by the Pension Protection Fund (PPF),[6] the corporate DB pension scheme lifeboat, in the event of a scheme sponsor failing. Therefore, once a scheme is at or approaching full funding, not taking some investment risk off the table could be detrimental to member security if things go belly up. Moreover, if implemented in their current iteration next year, the Department for Work and Pensions (DWP) draft funding and investment strategy regulations could well exacerbate this state of play.[7]

This regulatory-driven de-risking is further compounded by another regulatory hurdle — the inability of sponsors to non-punitively access scheme surpluses. Currently, for most of corporate DB, only the surplus in excess of the amount required to buyout the scheme's liabilities with an insurer is accessible and only at wind up and only then at a punitive tax rate. The draft DWP regulations are unhelpful here too — frustrating the generation and distribution of surpluses. Therefore, scheme sponsors remain understandably reluctant to continue underwriting investment risk when full funding, even on a low risk basis, is reached or is in prospect. After all, they face the asymmetry of being unable to easily and non-punitively access, what is effectively, trapped surplus if thing go well and picking up the tab if things go badly.

A third reason for well-funded schemes to de-risk is to address the cash flow negative position that typically arises from an increasingly mature membership profile at this point in the funding journey. With more cash being paid out by almost three-quarters of corporate DB schemes in regular pension payments than is being received as cash contributions and investment income, the focus gravitates to generating a predictable and sustainable stream of secure income to plug this gap. Failing to do so risks being a forced seller of volatile assets in unhospitable markets. Therefore, this cashflow driven investment (CDI) typically adopts a buy-and-hold policy, in principally targeting those secure, mainly shorter-dated, lower risk income generative assets to assist in meeting pension payments as they fall due.

Is the de-risking narrative a fait accompli or is there another way?

Recognising that an increasingly significant percentage of corporate DB assets, in being systematically de-risked could, with the appropriate regulatory changes, incentives and protections, be invested more productively over longer timescales, consultants LCP and WTW has each started to socialise their respective propositions.[8] LCP formally launched its "Protection Supporting Prosperity" (PSP) proposition, via its "Powering Possibility in Pensions" white paper,[9] in April, with WTW following suit with its equally thoughtful "Six changes to seize the pension surplus opportunity" proposals,[10] in July. Crucially, both have already had extensive engagement with those policymakers and regulators who have the power to make their respective proposed new regimes a reality.

[4] It's been suggested that around one in five corporate DB schemes are fully funded on the high bar of the buyout basis. However, that's not to say all of these fully funded schemes are ready to go to buyout. Buyout readiness requires alignment of trustee and sponsor, good quality member data, clarity over the benefits to be insured, preparation of a benefit specification document, an appropriate asset allocation and clear asset transition plans.

[5] With bulk annuity providers looking set to benefit from less stringent Solvency II reserving and ALM requirements, over the next 12-18 months, these insurers may yet widen the range and extent of illiquid assets in which they invest. However, these relaxations and the PRA's nascent concerns about insurers' ambitions to expand market capacity to meet accelerating demand, may yet challenge buyout's gold standard nomenclature.

[6] Introduced under the Pensions Act 2004, as a public corporation of the Department of Work and Pensions, the Pension Protection Fund (PPF) began operating as the pensions lifeboat in 2005. The PPF now manages over £36bn of assets on behalf of over 270,000 members. The PPF applies three main reductions/limits to members benefits: 1) any member who hasn't achieved their scheme's Normal Pension Age has their pension reduced by 10%; 2) any member with service accrued before April 1997 loses any promised inflationary increase to those benefits, and 3) post-April 1997 inflationary increases are limited to 2.5% p.a. These reductions typically mean that the PPF covers around 85%-95% of the value of corporate DB scheme accrued benefits.

[7] As currently stated, the regulations would require very mature DB schemes to ensure their assets are highly resilient to short-term adverse moves in financial markets.

[8] Notably in response to the Work and Pensions Select Committee's call, in March, for evidence on DB schemes. See: Work and Pensions Committee's call for evidence on Defined Benefit pension schemes published on 16 March 2023.

[9] Please see: https://www.lcp.com/our-viewpoint/2023/07/lcp-powering-possibility-in-pensions

[10] Please see: https://www.wtwco.com/en-gb/insights/2023/07/six-changes-to-seize-the-db-pension-surplus-opportunity

LCP's and WTW's proposals

Designed to balance the needs of multiple stakeholders, each of which are poorly served to varying degrees by the inherent risk adversity of the current system, both LCP and WTW seek to reverse the deeply engrained de-risking mindset that increasingly characterises the corporate DB landscape. How? By incentivising well-funded DB schemes to adopt more growth-oriented and sensibly risked longer-term-focused run-on portfolios, with appropriate stakeholder protections in place. Here's exactly how.

With trustee and sponsor agreement, and subject to meeting a minimum, actuarially certified, qualifying funding level, appropriately well-funded schemes with strong sponsors, whether open or closed, would be explicitly (LCP)/ effectively (WTW) opted into a dedicated longer-term run-on regime.[11] Within LCP's proposed run-on regime, PSP, two principal changes are proposed. One is to increase member security by raising PPF coverage — via additional PPF levies, labelled PPF super levies, based on the usual metrics of scheme size, sponsor strength, funding and level of investment risk being run — to 100% of accrued member benefits. LCP calls this 100% PPF underpin, PPF super-protection.[12] Indeed, the 100% PPF underpin is considered by LCP as fundamental to providing trustees, who ultimately have a right of veto over any re-risking, with the appropriate incentive and comfort to move away from the current default position and engage in a conversation around re-risking.

While not dismissive, WTW is less convinced of the feasibility and equity of applying 100% PPF coverage to those schemes that opt into a long-term run-on regime, given the risk of adverse selection, questions over the equitable apportionment of PPF reserves between existing, new core and enhanced compensation claims and the inequity enhanced compensation creates for those members whose schemes are already in the PPF. Indeed, although acknowledging the merits of conducting a deeper dive into 100% PPF coverage, WTW believes that its six proposals (please see the breakout box below) will collectively be a more effective trigger in changing well-funded scheme investment behaviour. Notable here is its fifth proposal to revise the draft DWP funding and investment strategy regulations and sixth to create a broader regulatory remit for the Pensions Regulator (tPR), akin to that of the Financial Conduct Authority's (FCA's) new secondary objective.[13] That is, one that, rather than just protect DB members' accrued benefits, more generally "supports adequate retirement outcomes for members of workplace pension schemes" and "promotes wider UK prosperity".

In a counter to this position, LCP remains resolute in its belief that, in applying the 100% PPF underpin to the cream of well-funded schemes, there is unlikely to be any material adverse selection risk to the PPF or potential contagion to other PPF levy payers. In fact, LCP suggests it would be a net positive for the PPF and its finances, in generating both a new source of revenue — the PPF super-levy — and in prolonging an existing source of revenue — the regular levies from those schemes which would otherwise have been bought out.[14]

WTW's six proposals to seize the pension surplus opportunity

1. Create a legislative mechanism by which a DB scheme's surplus can be used to finance contributions to benefit DC members in a different scheme.
2. Reduce the tax rate on refunds of surpluses to an employer, ideally to align with the corporation tax rate.
3. Amend legislation to more readily allow refunds on surplus while a scheme is ongoing.
4. Remove some tax barriers to sharing surpluses with DB members.
5. Ensure that the final DWP funding and investment strategy regulations do not funnel schemes into obsessive de-risking, and that they allow open DB schemes to thrive.
6. Revisit the Pension Regulator's statutory objectives to encourage an approach to regulating DB pension schemes that considers members' broader interests beyond solely protecting accrued pensions.

[11] Given the well-funded entry requirement and the continued reliance on the sponsor covenant to support the scheme and underwrite its investment risk, the proposed regimes advanced by LCP and WTW are unlikely to compete with DB superfunds, or consolidators, even if the latter is operated by the PPF. Rather the proposed regimes would be complementary.

[12] LCP estimates this additional levy would impact investment returns, on average, by less than 0.1% p.a. Additionally, LCP notes, with reference to the PPF Purple Book 2022, that, "the PPF is currently very well-funded, with £11.7bn of its £39bn of assets at 31 March 2022 deemed surplus "reserves" – a funding level of 143%." Indeed, the success of the PPF to date suggests that marginally extending the PPF cover to 100% of accrued benefits for PSP schemes would be a viable course of action. Of course, one key consideration would be to ensure that this full coverage of member accrued benefits does not incentivise PSP schemes to throw caution to the wind when allocating to riskier asset classes. More on this shortly.

[13] The FCA has a primary objective of ensuring markets function well and three operational objectives comprising: consumer protection, market integrity and effective competition in the interests of consumers. On 29 June 2023, the introduction of the Financial Services and Markets Act 2023 created a secondary competitiveness and growth objective for the FCA (and PRA) to ensure its primary objective facilitates the international competitiveness and growth of the UK economy in the medium to long term.

[14] LCP contend that the only scenario in which the PPF could be adversely impacted would be if both a PSP scheme's investments performed badly and the sponsor went bust. Even then it is suggested that, as PSP schemes would start off so well-funded, the PPF could still make a profit if it had several decades to manage the assets, by generating far better returns than the heavily de-risked DB scheme would ever have done.

The other LCP proposal, which aligns with WTW's view, is to facilitate non-punitive, *ongoing* sponsor access to scheme surpluses, once a stipulated level of "super surplus", to coin LCP's terminology, has been achieved. Both suggest a trigger point of being fully funded on a low dependency basis — for instance 105% funded on a gilts + 0.5% per annum basis[15] — rather than the currently high bar of typically only allowing access once the actuarially-estimated buyout/solvency basis has been achieved. Of course, these distributable surpluses would be subject to strictly prescribed uses and limits, with the trustee and sponsor agreeing a surplus-sharing mechanism in advance.

WTW, in particular, is very prescriptive in its second and third proposals as to what needs to change here, in calling for a reduction in "the tax rate on refunds of surpluses to an employer, ideally to align with the corporation tax rate" and "amending legislation to more readily allow refunds of surplus while a scheme is ongoing".

Notwithstanding the need for a continued focus on secure income generating CDI assets and, of course, the need to allocate sufficient hedging and collateral assets to sustain a desired level of interest rate and inflation hedging, the expected result of these regulatory revisions would be to extend the lifetime of eligible DB schemes by incentivising and enabling those opted into the new run-on regime, to partially reverse, or slow the pace of, their de-risking and more immediate focus on buyout, by adopting a more growth-oriented run-on portfolio.

The characteristics and benefits of adopting growth-oriented run-on portfolios

Given these other moving parts, and factors such as the strength of the sponsor covenant, this would likely see anything between around 20% and 50% of the asset allocation of a typical long-term run-on scheme being devoted to public equities and more patient capital opportunities — notably UK infrastructure, assets supportive of the transition to net zero and productive capital[16] — all to the benefit of multiple stakeholders — ultimately the UK economy.[17] LCP suggests this refocused asset allocation could realistically be expected to add 1-2% per annum to investment returns, while WTW reminds us that such opportunities can prove more defensive to downside scenarios than supposedly lower risk, lower returning assets. LCP also suggests that a long-term run-on regime would be supportive, indeed more supportive than the buyout market, of the economically-crucial gilt market, at a time when new gilt issuance is likely to remain robust and quantitative tightening by the Bank of England lies in prospect.

By prolonging the lifetime of some of the UK's largest and safest DB schemes and facilitating the generation of a distributable surplus, should enable sponsors to deploy more capital into their businesses over time and help satisfy the Treasury's desire for pension scheme assets, more generally, to support economic growth.[18] The just transition to net zero, alongside the management of other ESG risk factors and impact goals, would also likely benefit, not least from schemes' longer-term investment horizons. Additionally, the potential enhancement of DB member benefits (think providing fuller inflation-indexation) would be high up on trustee agendas if investment risk was continuing to be run, with the fourth of WTW's proposals calling for the removal of those tax barriers that frustrate sharing surpluses with DB members.[19]

What measure really stands out in both proposals though is the desire to help address the intergenerational inequality inherent in the UK pensions system. That is, by using distributable surpluses to tax-efficiently augment the, typically inadequate, contribution rates of most UK workplace Defined Contribution (DC) schemes, even when the DC scheme isn't in the same trust as the DB scheme of the same employer group. WTW quite rightly suggests that in funding a DC scheme, "DB benefits remain funded to an appropriate level of benefit security".

Buyout remains an option and the ultimate end game

Crucially, opting into a long-term run-on regime would not preclude a scheme from bulk annuity purchase, if at any time that route was felt by the sponsor and/or trustee to be appropriate. Indeed, as noted earlier, for most, if not all, schemes, buyout is the natural ultimate end game, typically once a scheme is much more mature and much smaller in size. Moreover, as LCP notes, entering this regime could well enhance the probability of a scheme achieving funding to the ultra-high bar of the buyout basis, without the sponsor having to dig deeply into its pockets. Indeed, for this reason, LCP believes its PSP regime would enable a more orderly transition into the buyout market over the next couple of decades, thereby obviating the very real systematic risk of hundreds of billions of pounds flowing into the bulk annuity market over a relatively short timeframe in a relatively uncontrolled manner.[20]

[15] WTW suggests being fully funded on a low dependency basis after the surplus has been accessed. WTW also suggests underpinning the low dependency basis with prudent assumptions, not least the discount rate so as to increase the chances of actual investment returns from more growth-oriented assets exceeding the discount rate.

[16] Productive capital comprises private market equity capital and other patient capital that is channelled into start-ups, infrastructure and private equity.

[17] WTW notes the Pension Regulator's comment that, "around 20% to 30% [in growth assets] could be consistent with the DWP's draft regulations."

[18] In the absence of a UK Sovereign Wealth Fund, the UK Treasury continues in its quest to utilise the vast assets of UK pension schemes to underpin and stimulate economic growth. This was most recently outlined in Chancellor Jeremy Hunt's Mansion House Reforms of 10 July 2023. See: https://www.gov.uk/government/collections/mansion-house-2023

[19] To allow one-off discretionary payments to be made to members from surpluses, WTW suggests the creation of an Uncrystallised Funds Pension Lump Sum (UFPFLS) equivalent for DB schemes.

[20] To ensure that the bulk annuity market continues to provide a long-term safe haven for members pensions, the Prudential Regulation Authority (PRA) is undertaking a thematic review of the bulk annuity market to "seek assurance that… risk management disciplines are keeping pace with… growth ambitions." See: Insurance Supervision: 2023 Priorities. Prudential Regulation Authority. 10 July 2023.

Safeguards

Of course, for a long-term run-on regime to work effectively, certain safeguards would need to be retained with others put in place, not least to sidestep any potential moral hazard and systemic risks. The former would typically include the continuation of regular prudent actuarial valuations and stricter recovery plans to a defined secure level of funding if deficits were to emerge and continued regular assessments of covenant strength. This would be supplemented with protections such as prescribing maximum allocations to particular asset classes so as to protect the PPF from ultimately underwriting all manner of risks. Of course, just as now, excessive risk taking would be disincentivised by the PPF levy, while trustee and sponsor agreement on asset allocation would be crucial, as the sponsor would continue to underwrite the investment risk being taken to generate and grow a distributable surplus.

Why does this matter?

In short, despite their differences in a couple of areas, what LCP and WTW propose could be a genuine game changer. After all, the immense opportunity cost of regulatory-driven de-risking and restricting access to surpluses is proving detrimental to multiple stakeholders, ultimately denting the productive potential of the UK economy as a whole.

There is a better way, a much better way, and thanks to the exceptional thinkers at both WTW and LCP and their continued interactions with those policymakers and regulators who have the power to make these proposals a reality, we could soon witness a viable challenge to the long-established and deeply entrenched mindset of de-risking once full funding is achieved or is fast approaching.[21]

We might also see a more orderly transition into the buyout market, as well-funded schemes decide to run their schemes on over an extended time horizon rather than opt for what has rapidly become the consensus and highly unproductive default. Of course, trustees must adhere to the central tenet of fiduciary duty in ensuring pensions are paid in full and on time but not in a way that is to the detriment of all else.

[21] Indeed, on 10 August 2023, global professional services firm, Aon, on polling 330 webinar attendees, regarding alternatives to securing benefits with an insurer, found that 51% "were willing to consider running-on [their DB] pension scheme for the long-term with a low return self-sufficiency target". In addition, "30% of respondents favoured… running-on the scheme with an investment strategy aimed at maximising value for scheme stakeholders – including the sponsor.

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