Andrew Reid, Managing Director and Head of DB Relationship Management, BlackRock

Laura Blows, Editor Pensions Age

The DB pension landscape

Pensions Age speaks to BlackRock managing director and head of its DB relationship management team, Andrew Reid, about the DB pensions landscape

The funding levels for DB schemes have improved significantly over the past few years, and we've also seen a number of policy changes. Please could you provide us with an overview of the DB market?

Funding levels have improved over the past five years or so. Driving that have been significant increases in real interest rates (interest rates relative to inflation), sponsors have been making substantial contributions, and growth assets have generally performed well.

If you look at some data that The Pensions Regulator produced as at the end of last year, over three-quarters of DB schemes are fully funded on a low dependency basis and over half are fully funded on an annuity buyout basis.

In addition, there have been a number of regulatory reforms announced. The rationale behind these is that the government wants to ensure members get the best possible outcomes and increase investment in productive assets in the UK, to spur on the UK economy.

So, with that in mind, a Pensions Bill was published earlier this year with two chief points for DB schemes. First, setting out a legislative framework and streamlining the regime for pension superfunds, and second, increasing the flexibility that DB schemes have to use any surplus in those schemes.

There was also a clarification of a previous judgment – the *Virgin Media* case, where some companies were worried that they may have invalid benefit changes that were made in the past because a particular actuarial certificate wasn't obtained. The government has now confirmed that a scheme can get that certificate retrospectively.

Also, last year, new investment and funding regulations came into force, along with the new DB funding code.

What do these changes mean in terms of DB endgames, and how can trustees ensure the path they take will meet all stakeholders' needs?

In terms of stakeholders, let's start with the members. Members want the benefits they've been promised. They want security and they may also want the assets behind their pensions invested in a particular way to benefit society or the environment.

Trustees will want to ensure that members' reasonable expectations are met. They'll want to run the scheme in accordance with the trust deed and rules, and all relevant law and regulation, and they have very, very strong regard to members' best interests. They'll also want to run it at reasonable cost, but they will also not want to take undue investment risk that could jeopardise the security of benefits.

Finally, the sponsor will probably want all of the above, but they do have some slightly competing objectives at times. Of course, they want members to have benefit security in a well-funded scheme, but they also have competing uses for their cash, so there is a balance to be struck there.

Thinking about these objectives and how they feed through into the endgame, the two main versions of endgame are still what we're seeing happen and expect to happen in the future. These are a 'pensions risk transfer (PRT)', where the responsibility for paying some or all of the pensions is transferred to a third party, typically an insurer, via an annuity policy and running on the pension scheme.

Within the pensions risk transfer market, the government is keen to increase the superfund market, so we expect to see more superfund players and more trades there.

Then there is 'running on', where the trustee will continue to run the scheme on as it is. Some schemes would like the best of both worlds, where they run on but want the flexibility to do PRT at very short notice. We are seeing some investment policies for that. Finally, we are also seeing a desire to be able to use surplus flexibly.

What endgame trends are you seeing for the larger-sized DB schemes?

Within the firm we recently looked at 107 schemes, with around £400 billion of assets. We would say this is an indication of direction, rather than a full survey – it does not have the rigour of that. We split the results according to schemes over £1 billion of assets and under £1 billion.

For the over £1 billion ones, roughly 60 per cent of them were expecting to run on in at least the short to medium term, 30 per cent pension risk transfer and 10 per cent undecided. Of the ones under £1 billion, it was 40 per cent run on in the short to medium term, 30 per cent PRT and 30 per cent undecided.

In terms of things we're seeing with bigger schemes, the first one is cashflow-driven investment (CDI) as well as seeing a trend of pension schemes doing more with fewer asset managers – so CDI would be an example of that.

Another is bringing other asset classes within the LDI portfolio, post the gilt volatility of 2022. The number of such mandates we had was six before autumn 2022 and now it is 36 and growing.

Overlapping with this is the increased investment in liquid fixed income assets, and giving the LDI manager more tools in order to raise cash quickly if needed.

The final thing is an increase in OCIO or fiduciary mandates. These aren't for everyone, but they're getting more important for an increasing proportion of our clients.

Of these endgame options for larger schemes, how many of these can be used for the smaller- and medium-sized schemes? What innovation generally are we seeing in the market to cater to these size of schemes?

We and other managers have been thinking quite a bit about how we can port some of the innovation we use for the bigger schemes to benefit the smaller schemes too.

For instance, the whole scheme solution we have for smaller schemes. It's pretty flexible. It can be used to target an endgame of just running on or an endgame of PRT. It uses a number of building blocks, such as liquid growth funds like equity – active equity, indexed equity, a diversified growth fund, some gilt funds, and the key building block is what we call an integrated LDI fund.

This integrated LDI fund borrows the techniques that we've been speaking about for the bigger schemes. It hedges interest rate and inflation risk. It does all of the governance required with an LDI portfolio, ensures there are adequate levels of collateral and manages that process for the client. And it has the capability to use the repo tools that larger schemes have just added to their toolkit.

It seems quite a dynamic marketplace for DB endgames. Looking to 2028, what do you think the shape will be for the DB marketplace?

I think the most attention is on flexibility of use of surplus. Opinions vary a bit on what's going to happen.

The DWP did an impact assessment that estimated over the next 10 years, around £10 billion worth of surplus would be used. Now that might seem quite low compared with the £160 billion total surplus on a low dependency basis it used in its assessment.

On the other hand, in an LCP survey, some 60 per cent of respondents said the new surplus proposals could affect their scheme's strategy but it's too early to say.

There are a great number of things to think about in using surplus. What does a scheme do with surplus if it is to be used? Maybe enhance member benefits with discretionary pension increases, or refund some to the sponsor, or use it to meet future contributions, probably for the defined contribution section of the scheme? Every scheme is different. They have different rules, different trustee and sponsor appetites for risk, and it will vary with funding position, with covenant, etc.

Above all, you need to make sure that if you do use surplus, then there's adequate security for the member benefits. Some schemes are thinking about changing their asset policy a bit to invest in a way to generate, at an acceptable risk level, further surplus. We've done some research on this, which we're publishing in a paper soon, looking at different investment portfolios on different endgame scenarios.

It's important to mitigate risks by matching cashflows, and we consider the additional benefits and risks of adding some liquid growth assets like equity and some illiquidity, say through private credit.

The results are very interesting. For example, for long-term run on, incorporating a modest amount of such assets in the portfolio can easily improve the expected return by 1 per cent a year. If you have a fund of £1 billion, allowing for compounding and asset growth, that would be well over £10 million a year of extra surplus generated compared with a low dependency basis of gilts and corporate bonds. And the downside position is improved, too.