A question of de-risking

Edmund Tirbutt explores the various options DB trustees have to de-risk their schemes

Summary

- Trivial commutation has been found to be the most popular de-risking choice. However, small pots typically account for less than 5% of the total assets of DB schemes, so therefore will not significantly improve funding positions.
- DB members transferring to DC to take advantage of the new freedoms could involve greater sums of money than trivial commutation, but the difficulty obtaining the required advice is proving a barrier.
- The bulk of de-risking activity is often tweaking investments, such as diversifying away from equities and implementing LDI.
- Buyouts and buy-ins are relatively scarce, with deals last year only accounting for £13bn out of the £1.5trn DB assets in the private sector.

With the 2014 Budget changes having significantly raised the amounts that can be taken from trivial pensions, trivial commutation exercises have been figuring prominently in the thoughts of those involved with de-risking defined benefit (DB) schemes.

Trivial commutation

Indeed, research results released by Xafinity in May found them to be the most popular de-risking choice, with 62 per cent of schemes considering implementing an exercise.

Small pension entitlements are expensive to administer as they involve a fixed cost element per member, but in reality the approach constitutes more of a housekeeping exercise than a serious attempt to reduce scheme liabilities. Even under the new rules it can only be used to secure the exit of those aged 55 or over with single pots worth up to £10,000 – or combined pots worth up to £30,000.

LCP partner Richard Murphy says: "Anecdotally, a very high proportion of those with benefits worth below £10,000 have taken them, and I have known the amount to be as high as 80 per cent with some schemes. But trivial pensions typically account for under 5 per cent of total assets of DB schemes so, although it's a good initial step to take, it won't solve major funding problems."

Switch to 'freedom'

Attempts to de-risk by persuading scheme members to switch to defined contribution (DC) schemes and take advantage of the new pension freedoms introduced this April can potentially involve far greater sums of money. But they are also doing relatively little to reduce scheme liabilities, despite being the subject of a lot of talk.

Standard Life investment director George Emmerson reports that although his company is receiving "lots of enquiries" for such switches he understands that only around 5 per cent are actually going ahead.

The fact that switchers must receive independent financial advice is proving a major obstacle to overcome. Many independent financial advisers (IFAs) are not willing to advise on the matter for fear that things will blow up into a mis-selling scandal, and those willing to advise will in most cases tell clients not to go ahead because the transfer value typically doesn't reflect the costs of buying equivalent benefits from an alternative provider.

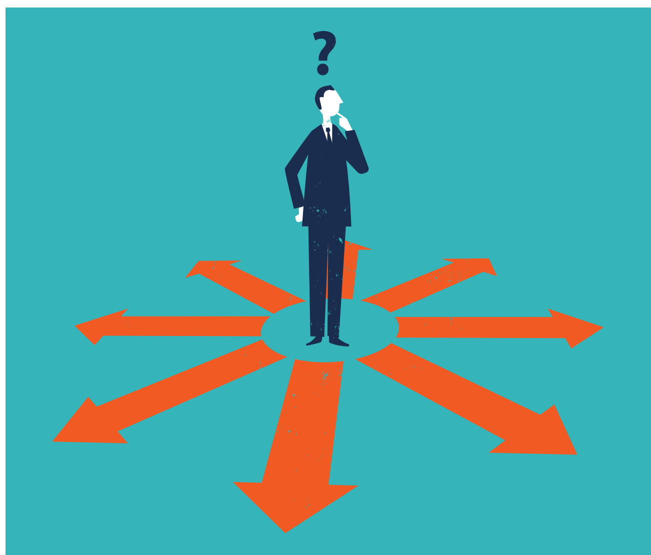
Even clients who want to go ahead and switch despite being advised against doing so by an IFA can find it hard to find a DC provider willing to accept their transfer because of fears of repercussions further down the line.

The few who could benefit from switching to DC include the seriously ill, as they would get a full transfer value even if they only had a few years to live, and those with very large pensions who may wish to take a partial transfer and leave in only what they need to live off – but not all scheme rules permit this. Some with large pots may also be attracted to the fact that DC schemes enable wealth to be passed to next of kin tax-advantageously.

City Noble director Eamonn O'Connor says: "I don't think transfers from DB schemes are in most members' interests. When incentive-exercise schemes like this first started at around the turn of the century it was noticeable that small employers with most to lose financially were the most active. Larger organisations were concerned about the reputational risk, but this has now changed as the value of DB liabilities has been such an astronomical issue to deal with."

PTL managing director Richard Butcher estimates that around half the employers he knows aren't prepared to consider such switches as they are not in their members' interests. Of the other half prepared to consider it, about half are motivated by the realisation that there are circumstances when it can be in some members' interests whilst the remainder consider the issue in a more hard-nosed way.

First Actuarial director Henry Tapper says: "Just about everyone has spotted that the pipes are blocked and is trying to find a way forward, and the obvious thing to do is get everyone in a room and agree on objectives-based approach to transfers rather than purely financially-based one. The TVAS (transfer value analysis system) required by the regulators is being used in isolation and not in conjunction with an objective-based approach. For example, if someone is having their home repossessed it should be a more important consideration than what the TVAS calculation says."



Investment

For the time being, therefore, the bulk of significant de-risking activity involves tweaking investments. The National Association of Pension Funds (NAPF) reports that last year over three quarters of pension schemes didn't look beyond this for de-risking.

Mercer head of UK DB risk Alan Baker says: "Our 2015 asset allocation survey has the UK on average at 33 per cent equity holdings, whereas five years' ago the corresponding figure was 50 per cent. Over the period there has been a switch to lower-risk assets and other forms of growth assets, with corporate bonds, infrastructure, property and hedge funds all proving popular. But the biggest trend has been an increase in leveraged LDI (liability-driven investment)."

Nevertheless, some question whether the regulatory pressure forcing DB scheme investment managers to invest in short-term assets to meet long-term liabilities is healthy. The best investments for meeting long-term liabilities are arguably longer-term ones with higher volatility and, maybe also, low liquidity.

Aegon investment director Nick Dixon says: "The real problem the industry faces is that regulations are forcing people to mark to market, and the owners and managers who run DB schemes effectively get more regulatory credit if assets are perceived to be low risk. Finance directors are in trouble if they make the wrong asset allocation calls on pensions but if they make the right calls for the long term they get no credit as it's not immediately apparent."

Bulk annuities

This focus on short-term assets and the inability to achieve significant transfers to DC schemes is inevitably reducing the chances of DB schemes being able to afford a buyout – which can cost 10 per cent to 15 per cent on top of the technical provision for scheme liabilities. Buy-ins, which secure a bulk annuity to match the liabilities of current pensioners, are also relatively scarce.

JLT Employee Benefits director, head of buyouts, Martyn Phillips, says: "Last year there were only 160 deals completed for buyouts and buy-ins combined and these accounted for £13 billion out of £1.5 trillion total DB assets in the private sector. But in total over the last decade the market has written over £80 billion of these buyout and buy-in risks, so they are starting to have a material impact.

"I think trustees and sponsors need to look at this illiquid market carefully because insurers are sometimes able to offer good pricing. So there is a big case for taking advantage of opportunities and bringing the end goal forward."

Punter Southall head of de-risking solutions Colette Christiansen also stresses that bulk annuities for buyouts and buy-ins have become increasingly available since insurers lost standard annuity business as a result of this April's new pensions freedoms.

She says: "A lot of trustees just sit around talking about de-risking but they should do something. They are probably waiting for interest rates to rise and funding levels to get better but if that happens it will happen for everyone and the prices of bulk annuities will go up."

Governance

De-risking of governance also seems destined to enjoy higher prominence. A survey carried out by Russell Investments in September 2014 found that nearly a third of respondents feel the cost of poor governance could be more than 1 per cent of assets per annum – which could be the equivalent of the de-risking achieved by a 25 per cent switch from equities.

Russell Investments managing director of client strategy and research Sorca Kelly-Scholte says: "Many trustees feel they can't afford to switch out of equities because of lack of return, so de-risking on governance could make it affordable. Some trustees are appointing the resources to implement strategies but retaining the decision making themselves, so they are not getting best value. They need to align agents' interests and then empower them to act on their behalf."

Written by Edmund Tirbutt, a freelance journalist