DB destinations: Time to choose

The Pensions Regulator's (TPR) 2019 Annual Funding Statement encourages trustees to set a long-term funding target (LTFT) and a plan for getting there. Aligning trustees' funding targets with their de-risking plans is a welcome development, but there are questions about how trustees and employers will incorporate an LTFT into a journey plan

TPR highlighted that good practice often involves trustees and employers agreeing a clear strategy for achieving their long-term goal. TPR wants to bring this good practice into the scheme funding regime and one key feature of that is setting a LTFT. The example LTFT given is a funding reserve (target asset value to hold) that is large enough for the scheme to have reduced dependence on the employer and a high degree of resilience to investment risks. This is recognition that schemes' payments may run over several future decades, a period over which employer support and governance standards may diminish.

TPR expects that schemes' future investment and funding strategies, prior to becoming fully funded on the LTFT, are aligned with this target using journey plans, which look beyond becoming fully funded on the current statutory funding target, the Technical Provisions basis.

This will be a significant development for many trustees, especially of small schemes, since they will not have documented an LTFT or written a long-term plan. They will need to decide whether they should target the cost of insured buyout, the cost of consolidation in a superfund, or a self-sufficiency basis derived from the cost of running their scheme in a low-risk way.

What are the possible long-term funding targets?

Buyout

Some of the biggest schemes in the UK have signalled their intention to ultimately buyout. For example Rentokil has insured all of its scheme liabilities (circa £1.5 billion) and expects to wind up the scheme next year.

The argument for buyout as the LTFT is even more compelling for smaller schemes, due to their relatively high running costs per member, inability to access sufficient affordable expertise, failure to consistently meet the regulator's expectations on good governance, and highly variable funding outcomes due to the concentration of risk among a small number of lives.

There are challenges to having buyout as the LTFT. Many consider it to be the gold standard, because the tight regulatory regime that insurers observe means that members face low risk. However, it is also perceived to be the most expensive possible funding target. In March 2018, UK pension schemes had a Technical Provisions funding level of 91 per cent compared to an average funding level of 73 per cent on a buyout basis. Disclosing a buyout LTFT may unnerve employers when they see that the scheme has a large shortfall on this basis that may be identified by investors and lenders.

Some trustees have questioned whether buyout is an appropriate target because they think they may struggle to obtain competitive quotations from insurers. Our experience, however, is that well prepared schemes manage to obtain at least one insurance quote regardless of their size. Also, schemes' ability to meet the LTFT will change as they mature: there is more insurer competition for pensioner-only transactions and the cost of insurance also falls as members get older. Therefore, over the long term, insurance may be easier to obtain.

When setting the journey plan to their LTFT, trustees and their advisers may make allowance for heavier scheme mortality experience and greater investment outperformance than insurers might assume prior to reaching the LTFT. This may make the path to the LTFT appear a little less expensive and will require planning on expected timescales to reach the LTFT as the length of the journey plan will be a key determinant of the expected savings available.

Even so, some trustees will struggle to produce a credible investment and contribution plan to get them from fully funded on a Technical Provisions basis to fully funded on a buyout basis. TPR will have to intervene when there is no credible plan to reach a LTFT.

It is difficult to predict the long-term direction of insurance pricing. With nearly £2 trillion of UK pension liabilities heading for the exit and the opportunity for insurers to take on international business, demand for insurance may exceed supply over the long term, leading to a potential increase in insurance prices. Also, step changes in insurance prices are often driven by regulatory changes, which are hard to predict.

Superfund consolidation

It is currently difficult to make an accurate assessment of the cost of entering a superfund consolidation arrangement as there have been no transactions to date and the rules governing these arrangements have not been finalised.

Unlike for insurers, who offer indicative pricing that can be verified

against actual transactions, it remains unclear what the cost of entry to a superfund will be, but, based on approximate analysis and the limited information available, we expect it to be 5-15 per cent below the cost of buyout for a typical scheme. However, until the superfunds achieve significant scale, offering this pricing may be challenging. Therefore, it is questionable whether trustees should use this as their LTFT while there is so much uncertainty.

Based on the expected pricing of superfund consolidation providers, the more mature a scheme becomes, the greater the convergence of the superfund consolidation price with the buyout price. Therefore, for significantly underfunded schemes that expect to have a journey plan spanning decades, the increasing maturity of the scheme may imply that the cost may converge on the buyout cost. In these circumstances, there will be little difference if buyout or superfund consolidation is named as the LTFT. For schemes that can afford to buy out within the foreseeable future, they are unlikely to have access to superfunds due to the gateway proposed by TPR. However, this still leaves a significant proportion of schemes that may select the superfund consolidation route as their LTFT once the market develops.

Self-sufficiency

For many schemes, reaching a level of funding that allows them to enter a superfund or to buy out may be some decades away. Therefore, they may target a self-sufficiency measure as their LTFT or as an interim step along their journey plan. Trustees and advisers have often struggled to define self-sufficiency. TPR has helpfully given guidance that the LTFT should reflect reduced dependence on the employer and a high degree of resilience to investment risks. However, even within this framework, there remain a number of areas that trustees will need to consider if they are to set self-sufficiency as their LTFT – some are listed here.

Reserve for future running costs

For small schemes, the present value of future running costs until the last member is paid may be 10 per cent of total scheme liabilities. To be truly self-sufficient, trustees will need to make allowance for this significant cost that most assume will be picked up by the employer.

Some advisers are trying to consolidate small schemes into efficient, all services arrangements to lower running costs (eg defined benefit master trusts or merging schemes with the same employer). With improved technology, one may believe that running costs will drop significantly over time. However, there are large barriers to overcome. For example, the fixed costs of automating processes are disproportionately large for small schemes. TPR appears to have no appetite for allowing trustees to simplify schemes, which may help to lower running costs (eg harmonising benefit definitions across schemes). Trustees have some existing powers to simplify benefits across different schemes, which could potentially lower future running costs. However, most trustees are reluctant to use these powers due to the creation of winning and losing members under any revised approach. Therefore, it appears that running costs will remain high.

Reserve to protect against investment risk

TPR talks about setting an LTFT with high resilience to investment risks. Therefore, if trustees and employers agree to take significant investment risk over the long term, presumably TPR will expect them to hold an additional reserve against this.

Reserve to protect against risk of data or benefit errors

When assessing the risk that they face, many trustees do not take account of the possibility that data or benefits may be incorrect. A common assumption might be that, if additional liabilities are identified, the employer will address the cost. To be self-sufficient, this risk needs to be eliminated (through data and benefit audit and ongoing maintenance) or a reserve held against the risk. It is difficult to determine what may be a suitable reserve. As an example, an insurer might charge trustees 1 per cent of the value of liabilities to hold data and benefit risk. However, they would only do this after carrying out extensive due diligence and correcting any errors – most ongoing schemes have not undertaken this so one could argue that the reserve within an LTFT for this risk should be higher.

Reserve to protect against small scheme mortality risk

Finally, small schemes face higher mortality risk as it is difficult to predict the lifetimes of small groups of members. A self-sufficient arrangement will hold a reserve against this risk.

If trustees require reserves to cover running costs, investment risks, data risks and small scheme mortality risk, a self-sufficient measure of scheme liabilities may end up similar to the cost of entry to a superfund consolidation arrangement or even the buyout cost.

Conclusion

TPR's annual announcement will put greater pressure on trustees to plan for the long term. They may face difficult negotiations with employers about the ultimate destination of the scheme since this will determine the expected cost of getting there. Currently, we expect the most common LTFT to be the future buyout cost. However, many trustees will use an interim step of targeting a low-risk self-sufficient position that is below the buyout cost. If the superfund consolidation market develops, it may be possible to target the cost of entry to these arrangements at 5-15 per cent below the buyout cost.

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