Summary
- Until recently many DB schemes carried very large deficits, a state of affairs that forced trustees, sponsors and regulators to take action.
- A combination of strong investment returns, sound risk management and – to some extent – changing longevity risks have helped to reduce deficits and create surpluses for some schemes.
- Trustees and sponsors now need to redefine or clarify long-term objectives for schemes and adjust strategies, including investment strategies, accordingly.
- Growing numbers of schemes may now be targeting full buyout, in some cases within a much faster timeframe than had previously been assumed.
- Trustees and sponsors need to prepare schemes to meet their long-term strategic objectives, by refining risk management, administration, data management and governance, so they are ready to exploit new opportunities to lock in gains and remove risk.

Land of plenty

In just five years an aggregate deficit for the UK's DB schemes of £700 billion has become a surplus of £40 billion. David Adams finds out why and considers what scheme trustees and sponsors can do to make the most of a wonderful opportunity

There was a time, not long ago, when the backdrop to any discussion of DB pension schemes was the size of their deficits. In autumn 2016, PwC analysis suggested the aggregate deficits of the UK's (then) 6,000 DB schemes had grown beyond £700 billion, in part because yields on UK gilts had plummeted following the EU Referendum, but the aggregate deficit was still substantial in early 2020, when data from The Pensions Regulator showed a deficit that had grown again, from £159.2 billion in March 2019 to £203.4 billion a year later.

Yet just two years later, at the end of February 2022, there was an aggregate surplus, of £40 billion, up from around £30 billion a month earlier, according to PwC. How had this happened? And what should trustees and sponsoring employers be doing to take advantage of it?

A complicated reality

Pensions Age readers will understand that these headline figures simplify a complicated reality. For one thing, there are many ways to calculate scheme deficits. They include a Section 75 calculation, showing the cost of a full buyout; a technical provisions calculation, outlining the amount needed to pay members' benefits in full as they retire; a self-sufficiency/low dependency valuation, based on the assets needed to minimise dependence on a sponsor; and a PPF/Section 179 valuation, showing whether the scheme would have to go into the PPF if its sponsor became insolvent.

This makes any discussion of deficits difficult, even if headline figures are based on one or both of just two measures (buyout and technical provisions). Cartwright director of investment consulting, Sam Roberts, explains how this could play out in practice for an individual scheme.

"Two years ago, a scheme might have been 75 per cent funded on a technical provisions basis; and might now be at 105 per cent by that measure," he says. "But on a buyout basis the same scheme might have been 50 per cent funded two years ago and might now be at 70 per cent.

"So it's too early to celebrate," he concludes. "There's still a really wide range of funding situations."

An improved situation

But the situation has improved, thanks in part to the strong investment returns, primarily from equities; and to hedging strategies to mitigate market volatility and interest rate fluctuations. "Strong equity market returns have definitely helped, but when yields fell, if you didn't have that hedging in place then a lot of your gains would have been offset," says Hymans Robertson co-head of trustee DB investment, Elaine Torry.

Changing assumptions around life expectancy have also had an impact on liabilities, even if the long-term consequences of the pandemic on longevity will not become clear for some time. And more DB schemes have closed to new members and/or future accrual,

reducing the addition of new liabilities.

Pensions Insurance Corporation (PIC) chief origination officer, Jay Shah, says more employers and trustees now come to PIC to talk seriously about an endgame. "People used to talk about journey plans as a concept – now they say 'we think we're going to be fully funded in two years' time, or five years' time, so what do we need to do?'" he says.

Long-term goals

Indeed, however you measure it, a surplus, or the realistic possibility of a surplus, presents trustees and sponsors with a need to clarify long-term objectives for the scheme. "It's turned into a high-class problem," says Redington head of investment consulting, Patrick O' Sullivan.

Some schemes will target self-sufficiency; or consolidation of the scheme within a superfund; but that market is still in a relatively early stage of development. In the meantime, LCP predicts annual transaction volumes for bulk purchase annuities (BPA, including buyouts and buy-ins) of between £30 billion and £50 billion every year until 2025. The BPA market has also become more competitive, with five insurers now holding more than a 10 per cent market share, compared to just three in 2019.

A recent survey of 120 UK pension schemes by Aon found that 34 per cent are now targeting buyout; 26 per cent expect to reach their endgame within five years; and 47 per cent within the next five to 10 years. LCP partner Charlie Finch notes that two-thirds of recent de-risking transactions covered both deferred members and pensions, whereas this was the case for only 25 per cent of transactions five years ago.

If a scheme is going to move towards buyout there are further options to consider. It might take a phased approach, encompassing buyouts of groups of pensioners or deferred members, buy-ins to insure some scheme liabilities; or use of other de-risking solutions, such as an Assured Payments Policy (APP), through which an insurer provides a series of cashflows to a scheme, agreed in advance and unaffected by longevity or demographic factors.

Whatever the long-term objective, it is essential that trustees and sponsors have an accurate view of the scheme's funding position. "Schemes shouldn't be relying on triennial valuations or annual updates," says Legal & General new business director, Dave Matthews.

"Some trustees are thinking that buyout is a long way away, but this is work that has got to be done at some point," says Roberts. "Bringing that forward, making sure your member data is clean, helps. You've got to be ready to act, knowing what you're trying to achieve."

Sponsor attitudes

Meanwhile, the way that a surplus affects a sponsor's attitude to the scheme may vary, says Torry: "You get sponsors who are saying 'This is no longer a problem – get on with it, trustees.'" By contrast, other sponsors will be keen to move scheme liabilities off their balance sheet as quickly as possible: "There are sponsors who think 'we can really get this dealt with now; it's no longer a headache, but let's not lose the gains we've made,'" she adds.

One issue that causes some employers concern is the threat of their contributions to a scheme being trapped within its surplus. Solutions to that problem include use of an escrow account or a trust, into which the employer can put contributions ready to be used by the scheme if needed, but which the employer can then retrieve if those contributions are not needed.

Investment strategies

Improved funding and a redefinition of strategic objectives for the scheme will also influence investment strategies. Generally speaking, a surplus will encourage a move away from riskier, return-seeking assets like equities, into gilts and corporate bonds. Liquidity is also a crucial issue for any scheme targeting full buyout.

A less mature scheme can afford to keep more investment risk and illiquid assets in play, while mitigating some risks through buying longevity swaps, or using partial buyouts or buy-ins. But in general, costs will tend to be higher and working towards a long-term strategic objective a more complicated process than would be the case for a mature scheme.

Investment strategies may also be influenced by other factors: by a desire to use a cashflow-driven investment strategy to help meet scheme costs; by ESG considerations – or by the effects of inflation. O'Sullivan outlines one possible side-effect of rising inflation if investment returns continue to be strong but some pension benefits are capped: Investment returns could outperform liabilities. Trustees and sponsors would then need to consider if or how these excess gains might be passed on to members and pensioners, in line with fiduciary responsibilities.

These are all issues that trustees and sponsors should be considering if a scheme is now well-funded and they can begin planning for the endgame, whatever – and whenever – it is going to be.

"What the regulator says to trustees," says PwC director and pensions actuary, John Dunn, "is that by the time your scheme is relatively secure and you're at the peak of cashflow being paid out; that's where you want to be fully funded on a reliance basis, or being in a position to go to a buyout".

It will take many years for all of the UK's DB schemes to reach that point, but thanks to an unexpected series of events many may now do so, with potentially very happy results for members and sponsoring employers. This new land of plenty offers opportunities that would have seemed unimaginable just a few years ago; opportunities that trustees must seize if they get the chance.

Written by Dave Adams, a freelance journalist