The end's in sight?

Summary
- The buyout market is worth an estimated £770 billion over the next decade, according to the Pensions Policy Institute.
- As schemes increasingly look towards their endgame, trustees must consider the suitability of their investment portfolios.
- Trustee boards must also be ready to deal with setbacks, such as changing longevity data.
- The insurance market has been adding capital to back future transactions, as well as expanding their operations.

The DB endgame nears for many schemes. Nick Reeve considers the journey to completion and its implications

The maturing of the UK's defined benefit (DB) pension market is becoming more obvious. According to the Pension Protection Fund's *Purple Book*, just 12 per cent of private sector schemes are still open to new members, and a similar proportion of the overall membership of DB schemes is actively accruing benefits.

A recent paper from the Pensions Policy Institute (PPI) forecasts that, as funding levels improve, the proportion of schemes that would be ready for an insurance buyout would rise from 6 per cent as of 2019 to 72 per cent by 2030. This translated into a potential buyout market worth £770 billion over the next 10 years – which would require annual volumes almost double this year's expected record-breaking £40 billion in pension risk transfer activity.

In addition, as schemes have matured, The Pensions Regulator (TPR) has begun to revise the way it oversees DB funds. TPR is currently working on a new two-tier regulatory regime to enable it to give more targeted attention and supervision to complex schemes and offer a 'streamlined' approval system for more straightforward schemes to get their funding plans cleared.

As part of this new approach, DB schemes will be expected to have a clear idea of their long-term objective, whether it be self-sufficiency, insurance buyout or commercial consolidation. How should trustees go about establishing a clear roadmap?

Investment strategy

In a report published in November, consultancy Hymans Robertson found that the number of schemes targeting buyout had tripled in four years. One of the chief drivers of this shift was a growing concern about scheme covenant. High-profile bankruptcies, such as BHS and Carillion, have likely served as a reminder of the ramifications of employers failing to support a DB scheme.

Preparing a scheme for transfer to an insurer places several requirements on trustee boards, not least of which is ensuring the asset portfolio is ready to be moved across. Liability-driven investing (LDI) is a must for schemes considering the insurance market, according to LCP partner, Dan Mikulskis.

He adds: "When you get very close to buyout you might be working with one insurer in particular, and they might give you a price lock portfolio, which will basically be the portfolio that would match any changes in their price. That gives the scheme a target to aim for.

"Before that point, you're going to want to be in liquid assets: gilts and corporate bonds for a large part of it, and then other assets that you can release very quickly."

A major investment trend for DB pension schemes over the past few years has been private markets investing, including private equity and private debt. But while these asset classes can get pension funds closer to their goals through uncorrelated returns and an element of illiquidity premium, trustees must ensure they can wind these positions down before transferring the scheme to an insurance company.

"A private debt fund that pays back

over a seven-year life may be just about okay, but you probably wouldn't want to be getting into those afresh," says Mikulskis. "We've worked with clients to work out property holdings, for example, to find it either a secondary market or transfer them under a fund-of-funds structure. There are various ways of approaching it, but you definitely want to get ahead of that."

Speed bumps

Once a trustee board has decided on buyout and found an appropriate insurance counterparty, it is very unlikely that the transaction will not go through. However, there are problems that can emerge unexpectedly.

Legal & General managing director for pension risk transfer, Chris DeMarco, says that, while these problems are surmountable, they can act as speed bumps. He highlights longevity data as one such potential data point that could change the position of some funds.

"There was an observation last winter that there were fewer deaths than had been anticipated in the statistics," he says "Is that going to affect the longevity trend of the past three or four years? If it does, that could increase scheme liabilities and push people a little bit further away."

In addition, a sharp downward move in interest rates in September caught some schemes preparing for buyout off guard, DeMarco adds. These schemes were hedged to a technical provisions level but not to full buyout, which is typically higher.

The future of insurance

If the PPI's calculations are correct in its assessment of a £770 billion buyout market between now and 2030, can the insurance market cope with this demand?

Many consultants have predicted that 2019 will be a record year for total pension risk transfer volumes, and several insurers have reported a full pipeline of pending transactions stretching into 2020. However, providing this capacity longer term and coping with the expected growth in demand will require several factors to remain in insurers' favour.

First among these is the reinsurance market, which usually takes on longevity risk linked to bulk annuities. Prudential Financial in the US has been active in this space for some time, but there are other providers that have supported buy-ins and buyouts in the past two years. Prudential signalled its commitment to the UK market in August by signing a longevity reinsurance deal with Phoenix Life, which the US company said meant it provided support to insurers accounting for roughly 90 per cent of the annual volume of buy-ins and buyouts.

Second is the ability to source assets. Several insurers told *Pensions Age* that they had been actively increasing their capabilities in this area. As finding yield has become harder in traditional bond markets, some insurers have looked to alternatives to bolster their income-generating portfolios. Pension Insurance Corporation (PIC) has invested substantial amounts into UK social housing and other real estate projects aimed at accessing reliable income.

Capital raising has been a common theme this year, with PIC and Rothesay Life – the UK's two main pure-play pension insurers – both raising funds in preparation for future transactions. However, as insurers grow, there may be less need for new capital injections, according to DeMarco.

"As the back book matures, it releases capital to support new business," he says. "At a certain critical size, it begins to provide an underpin to the amount of business that we can write where we perhaps don't need any further capital. In a way it becomes self-supporting. It gives me optimism that there is plenty of capacity."

PIC's assets under management grew from £13 billion at the end of 2014 to £31.4 billion at the end of 2018, according to annual reports – an increase of more than 140 per cent. Rothesay Life's assets almost tripled in the same period, from £12.8 billion to £36.3 billion.

Where the capacity crunch has already been felt most is in human resources. One insurance company professional highlights that firms will need to bulk up their teams, as the record-breaking activity in 2019 has soaked up a lot of capacity across insurers, law firms and brokers. In addition, as high volumes become more common, providers will have to expand their middle and back office functions such as payroll and administration.

DeMarco says: "Generally speaking, we feel more comfortable *[with capacity issues]*. We spent a lot of time gearing up for this sort of situation a few years back. This may be the first year when we've been taxed with regard to the human element. I think we were stretched – and we are probably have one of the bigger teams in the market."

The beginning of the end

As the PPI paper points out, even if the insurance market grows as expected there will still be a significant number of schemes that opt for run off (or enter the PPF). It estimates that even closed schemes have an average lifespan of 26 years, rising to 35 for those still open to new entrants.

"The PPI data indicates buyout is inexorable," says DeMarco. "We're going in a single direction. If there is a pullback it will be a temporary one. On a longer-term basis, the slope of the line is upwards."

Rather than the endgame coming in 2030, it is likely to just be the beginning of the end for many more schemes.

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