Final frontier

Improved funding ratios, better hedging and attractive pricing has helped many DB schemes navigate their way to de-risking solutions, finds Sara Benwell

Summary
- Attractive pricing and improved funding ratios mean that more schemes are targeting insurance solutions.
- But innovations in the market mean that the journey has changed substantially.
- Schemes should constantly review plans to make sure they can move quickly when opportunities arise.

De-risking has long been at the heart of defined benefit pension scheme investing. But in recent years, the game has changed.

New innovations mean that the options available to schemes have diversified, while better appetite from insurers has led to more attractive pricing and the ability to take smaller steps along the way.

Exploring the new end games

By and large most pension schemes are targeting one of three options – buy-in (or a series of buy-ins), buyout or self-sufficiency.

Choosing between these different endgames (and in particular between an insurance solution and self-sufficiency) can be a tricky decision for many schemes.

This may be the reason that some schemes are choosing to keep their options open, especially if the trustees are looking over a longer time-horizon.

This flexibility may be practical, after all you never know what's around the corner, but Russell Investments managing director, head of strategic client solutions, David Rae, cautions that it can cause problems with more esoteric asset classes.

He says: "The biggest challenge is dealing with illiquid investments that may be suitable for long-term self-sufficiency but may not be eligible as part of a buyout premium. The structure and terms of any illiquid allocation will need careful consideration for schemes that want to retain flexibility about the end game."

The trick, when determining both the endgame and journey path is to make sure you're having early conversations with your sponsors, says Deloitte Financial Advisory Pensions Team director and head of national strategy Simon Kew.

He explains: "We are seeing a marked increase in sponsors interacting with the trustees of their defined benefit pension schemes, jointly looking at the longer term aims for the fund as, ultimately, each party wants to reduce volatility but close the funding gap.

"This can involve the employer or a wider group providing assets or other security, money in escrow for instance, that gives the scheme added comfort to be more adventurous in their investment strategy but removes the possibility of a trapped surplus – something that is still a significant concern for sponsors."

One factor that has tipped the balance toward an insurance solution rather than self-sufficiency is the improvement in many schemes' funding ratios.

BMO Global Asset Management head of LDI client portfolio management, Simon Bentley, explains: "Strong returns from growth assets over the past few years, along with deficit recovery contributions, have allowed some schemes…to reach the point where a buyout is affordable.

"At the same time, many schemes have been increasing their hedge ratios to further reduce funding ratio volatility as they move towards their chosen end-game."

The net result of this has been a bumper year for de-risking, with over £20 billion worth of transactions expected to take place by the end of 2018.

Aviva Investors head of investment solutions, John Dewey, adds: "No two pension schemes are alike, and their paths towards delivering on their promises to

members may not be either. Today, buy-ins, buyouts and self-sufficiency are all distinct objectives.

"As closed pension schemes mature, many face common challenges: cashflows become more pertinent as income is needed to pay member benefits; if markets falter, these schemes may have less time to recover; and similarly, their fates become more dependent on factors outside their control, such as members' expected lifespans and the health of their sponsors."

Decades of de-risking to go

There is a huge disparity in the timescales for DB de-risking. Some schemes can expert to insure away most or all their risk in the next decade while others have time horizons of 20 or 30 years.

Part of this is due to a scheme's membership profile and how long it has been on the de-risking journey. Those who have already insured away lots of risk, who have a strong sponsor appetite or who have a membership that is rapidly decreasing as people take their pensions may be looking at solutions in the near term.

Others with large deficits will likely be looking at longer recovery plans and finding that they are quite some way from an end game whether that's self-sufficiency or having transferred all their risk to an insurer.

Rae says: "[*Reviewing the scheme journey*] has become an almost continual exercise. Real time risk management is critical to ensure schemes are in a position to benefit from emerging opportunities or control for events."

More steps on the journey

While each endgame solution is distinct, that doesn't mean that schemes might not have a journey plan that involves a mix. For instance, a scheme may choose to use insurance solutions to remove tranches of risk along the way, while still aiming for self-sufficiency.

One of the biggest changes in the DB de-risking landscape has been the emergence of smaller transactions like top slicing and smaller buy-ins. This has meant that schemes no longer have to consider one very expensive solution, and instead can look at more affordable ways to insure out chunks of risk from their schemes.

This is borne out by yearly de-risking data. Research from Hymans Robertson showed that the value of buy-in transactions in the 12 months to July 2018 was £11.7 billion, compared to just £3.2 billion for buyouts.

However, Rae cautions that this step by step approach is not without risk for schemes running a large deficit.

He says: "We think this approach can work for schemes who are well funded and have less need for leverage to hedge liability valuation risks. For less well funded schemes, small buy-in transactions can actually reduce the investment and risk management flexibility."

Another key change has been the way that trustees prepare for de-risking. Transition funds have allowed smaller schemes to access hedging tools usually preserved for larger arrangements, reducing risk in the approach to buy-in or buyout.

The increased appetite for bulk annuity deals has also encouraged more trustees to be agnostic about their choice of hedging asset.

Bentley explains: "Historically, trustees generally felt that gilts were the 'least risk' hedging asset as this matched the gilt based discount rate used by most schemes. However, an insurer will value its liabilities using swaps and so swaps are a better match for buyout pricing. When taken in the round, trustees are increasingly indifferent as to which hedging asset they hold, preferring to target the cheaper of the two."

The other trend worth mentioning is the large number of requests for DB pensions transfers. Research from Russell Investments has found that this activity has materially impacted outcomes against journey plans for schemes, but experts are divided as to whether it has a positive or negative impact.

Willis Towers Watson senior director of transactions, Shelly Beard, argues that for most schemes transfers have a positive impact. She says: "The growing demand from members for DB transfers can cut the cost to the employer of getting the remaining non-pensioner liabilities off its books."

Of course, on an individual scheme level, the impact will depend on which pensioners are transferring and why. If transfers are more common among single members in poor health the scheme is going to be left with its highest risk members, for instance.

Making good progress

Market trends suggest that trustees' interest in bulk annuities will continue to grow in the next couple of years.

However, demand will largely be driven by affordability. Recently, pricing has been very attractive as insurer capacity has been high.

Beard says: "Some schemes will be closer to buyout than they think… We have recently seen some of the most competitive buy-in and buyout pricing for a decade, particularly for pensioners…As more members retire and move to pensioner status, the buyout cost for them reduces."

Legal & General director of pension risk transfer, Frankie Borrell, concludes: "A tail-off in longevity improvements, employer deficit contributions and better than expected asset performance have contributed to pension schemes having healthier funding levels. These improved funding levels, alongside attractive pricing from insurers, have led to growing interest from trustees and corporate sponsors.

"Many sponsors have reconsidered their de-risking strategies and discussed bringing forward their first or next bulk annuity, with those who are looking to avoid volatile funding levels seeing the current market as an opportunity not to be missed."

Written by Sara Benwell, a freelance journalist