DB risks - spotting shortfalls

With increasing numbers of DB schemes reporting rising deficits and difficulties, administrators, trustees and employers will be keen to tackle any issues that could cause the long-term failure of the scheme. Talya Misiri provides industry insight on the key risks facing DB schemes today

With prolific cases surrounding defined benefit pension schemes in the past few years, trustees and employers alike are likely to place great importance on the risks that scheme are or may face and consider ways of tackling these.

Significant risks that are being increasingly considered by DB schemes include affordability, governance, employer covenant and maintaining employer interest, among others.

The key risk and concern regarding DB pensions is evidently affordability issues, it has been agreed. Aon partner Matthew Arends notes that a key risk to the sustainability of DB pensions is "their affordability to the sponsoring employers". As demonstrated by recent insolvency cases in the past few years, the cost of DB pensions can weigh heavily on employers and lead to PPF entry for scheme members in extreme cases, he says.

To avoid this and keep up with growing liabilities, Aon's *2017 Global Pension Risk Survey* found that one third of respondents whose funding level had worsened expected higher contributions to be a consequence.

"If bond yields continue to stay low, coupled with low growth asset returns and escalating longevity improvements, the result could be a DB affordability crisis," Arends highlights.

Similarly, former Pensions Minister and current House of Lords member Baroness Ros Altman voices that for DB schemes closing to future accrual, "the sponsoring employer will, over time, have little or no interest in the scheme." Rather, the DB schemes will be "seen as a legacy 'problem' rather than as an employee benefit", she predicts.

"There will be no workers left in the scheme and the costs of continuing to run it will be seen as a non-core function that needs somehow to be eliminated. If the employer cannot afford buyout then there is clearly a risk of some other kind of event that would pose a danger to members in the future."

Lincoln Pensions managing director Darren Redmayne agrees that at present "many sponsors are struggling under the weight of continued funding demands of these schemes, coupled with competing demands from investors, rapid political, socioeconomic and technological change."

"If future affordability is perceived as too great a risk, pre-emptive action might be taken in the Department for Work and Pensions' DB White Paper," Arends observed.

In relation to this, Altmann also acknowledges that a further risk to DB schemes is the potential effects of interest rates on scheme investments. "If interest rates rise faster than anticipated, the bond investments made by pension funds to reduce risk turn out to fall by more than the fall in any discounted present value calculation of the liabilities and deficits rise further."

While not necessarily a risk to schemes, PLSA policy lead investment and DB Caroline Escott notes that cost transparency in DB schemes is a challenge that needs to be addressed.

"Better information about the levels of costs across all asset classes will provide an opportunity for schemes to negotiate their costs downwards, boosting the value of savers' returns. However, schemes need to make sure they communicate the right level of value for money information to members and other stakeholders to encourage an informed debate *[and stimulate engagement],*" she says.

Moreover, Redmayne notes that: "In an increasingly uncertain political and economic political environment, it is essential that trustees understand the risks associated with the sponsor covenant and adjust their investment and funding strategies accordingly."

Similarly, considering the risks related to the trustee and the employer of DB schemes, JLT Employee Benefits director Charles Cowling agrees that from the trustees' perspective, the "biggest risk is likely to be the failure of the employer covenant". This could be due to an insolvency event, he explains.

Lombard Odier Investment Managers head of solutions Ritesh Bamania, concludes that: "Overall, aspects that may have seemed trivial a few years ago need to be reconsidered in a new light, as not dealing with them could potentially lead to the next perfect storm for DB schemes at a time when sensitivity to risk is arguably at its highest."

Written by Talya Misiri

DB consolidation – the right move?

The Department for Work and Pensions' White Paper published in early 2017 introduced the possibility of consolidating defined benefit schemes to help improve member outcomes. However, there has been much debate as to whether this is the right move, Talya Misiri reports

As growing numbers of DB schemes struggle to meet their obligations, the DWP's White Paper published in early 2017 proposed the consolidation of schemes to help to improve scheme and member outcomes. While consolidation can benefit a variety of schemes and their members, however, it has been noted that there are some key challenges and potential losses for those who want to pursue this option.

Commenting on the proposal, TPT Retirement Solutions head of strategy and BD Paul Murphy says: "The key potential benefits… are economies of scale leading to reduced costs, access to more sophisticated funding and investment strategies and improved governance."

Murphy goes on to explain how consolidation is likely to be beneficial for trustees in particular. He notes that "bringing the management of schemes together under one set of trustees, taking advantage of an established professional approach will deliver significant cost and time savings".

Also, while in individual schemes if something goes wrong the liability lies with the trustees, "consolidation offers the business the comfort that these matters become the responsibility of the master trust trustees."

Nonetheless in regards to investments, Gatemore managing director UK Mark Hodgson argues that DB consolidation "leads ultimately to the narrowing of a scheme's investment universe". He continues to note that while the bringing together of smaller DB schemes could reduce costs, "trustees are blind to the future problems this creates".

Lincoln Pensions managing director Darren Redmayne agrees that although reducing costs and improving member outcomes through consolidation "makes sense in principle, there are potentially huge hurdles that would need to be overcome".

Hodgson adds that primarily, consolidation "cuts out a pension fund's ability to invest in smaller, better-performing investment funds and leaves no margin for error. If razor-thin fees are the priority over adding value, pension trustees shouldn't be surprised when returns plummet during a downturn".

Redmayne also reasons that consolidation may prove difficult for current scheme sponsors as they may lose interest as they lose control of the scheme. He voices: "It's not clear whether the sponsors would retain any long-term obligation to consolidated schemes. Many sponsors might be uncomfortable retaining an obligation to a scheme over which they no longer have control and which may contain deficits and risks relating to other schemes."

Late last year the PLSA also suggested the pooling of DB into large superfunds. The association noted that in a report supervised by The Pensions Regulator, two thirds, 65 per cent, of surveyed employers said they would support consolidation, particularly for shared administration (72 per cent), shared external advisers (66 per cent) and pooling assets under one asset manager, (54 per cent).

This was met with warnings that the ability to pass on pension liabilities could be abused. Aegon head of pensions Kate Smith commented: "Consolidation of weakened defined benefit (DB) schemes into a superfund may look like an attractive option to some stressed companies, but giving employers an option to walk away from their DB schemes creates a moral hazard that needs to be treated very carefully by government and regulators alike."

Redmayne shares a similar opinion that "DB consolidation could be far harder to put into practice than envisaged in the absence of direct government intervention".

While acknowledging the intended improvements that the consolidation of DB schemes could bring, the industry is still critical of the hindrances and obstacles that it may bring to the DB system.

Hodgson concludes: "Our fear is that the wider sector is sleep-walking into exactly what they should be avoiding: correlated returns with little downside protection at the exact time it should be protecting itself."

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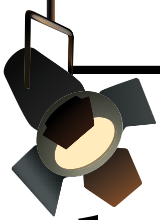

DB sustainability - holding strong

With political and financial uncertainties, large firms falling into administration and funding shortfalls, the future and sustainability of DB pension schemes can be brought into question. Talya Misiri explores the sustainability of DB schemes

With political and financial uncertainties, large firms falling into administration and funding shortfalls, the future and sustainability of DB pension schemes can be brought into question.

Where DB schemes were historically the preferred choice to guarantee an income for life once departing from the workforce, employers and some savers become more in favour of defined contribution schemes.

Recent insolvencies such as the BHS scandal, as well as proposed closures of the British Steel Pension Scheme and the Royal Mail's pension scheme have emphasised the well-known concern that the gold-plated pensions of the past are becoming increasingly unaffordable.

JLT Employee Benefits director Charles Cowling boldly states: "DB schemes as we know them are not sustainable."

Cowling explains that looking back, "a lot more should have been done to move liabilities out of pension schemes as soon as members left employment or retired. Pension schemes would not then be full of legacy liabilities, which have become too big for employers to manage".

It is also agreed that the current funding levels of DB schemes are an issue. Despite recent PPF funding valuations showing an improvement in aggregate funding levels, this is not the case for all schemes. PLSA policy lead for investment and DB Caroline Escott points out: "Some schemes continue to face significant underfunding challenges."

Aegon head of pensions Kate Smith agrees: "We shouldn't be surprised if more high-profile cases such as Toys R Us with large funding deficits and weak sponsoring employers hit the headlines. Although a small upturn in DB funding levels was reported at the end of 2017, DB schemes will continue to be under pressure, particularly due to turbulent economic times as a result of Brexit leading to both corporate uncertainty and investment volatility."

Escott predicts that: "While some schemes will be heading towards buyout or buy-in, others will not be able to do so" and it is expected that there will be further thinking and action taken regarding potential changes to governance or administration to tackle the funding gap.

Nonetheless, Escott is not completely doubtful about the future of DB. "With £1.8 trillion in assets and covering 10.9 million members, DB schemes are not going anywhere," she says.

On the opposing end of the spectrum, however, Cowling and former Pensions Minister and Royal London director of policy Steve Webb are not convinced that DB schemes are sustainable in the long term.

Webb notes: "In some ways it is quite surprising that the 'death of DB' has still not quite happened." He observes that while there continues to be a steady fall in the number of active DB members, there is still around 1.3 million people accruing DB rights and suggests that: "gradual attrition rather than a spate of mass closures is more likely".

Cowling shares a similar opinion that "ongoing DB benefits for current employees are also, sadly, no longer viable."

"They *[DB benefits]* are far too expensive as an employee benefit, given the current UK legislation and the guarantees that are required in legislation for all DB pensions, and not suitable for a 21st century working environment in which most people will have many different jobs and employers in the course of their career."

Another area that suggests the unsustainability of DB schemes in the long term is DB to DC transfer growth. Smith comments: "The flow from DB to DC is likely to continue as members transfer their DB benefits to take advantage of the pension freedom flexibilities."

Smith explains that the increasing demand for these transfers has led to an imbalance, whereby the demand for DB transfer advice outstrips the supply of specialist financial advisers. Nonetheless: "This could change once the FCA introduces its new pension transfer advice rules in the spring, giving confidence to advisers to enter this market. This will not only increase administration costs for DB schemes, but also potentially affect investment strategies due to increased cash flows," she says.

Adding to these arguments, Escott and Smith both note that the Department for Work and Pensions' DB White Paper, due to be published in February, could change the position of DB schemes through consolidation or amendments to governance and liabilities.

Written by Talya Misiri

The future of DB – drawing to a close?

Increasing risks, the possibility of consolidation and questions about the sustainability of defined benefit pension schemes could present a bleak outlook for the future of the once commended gold-plated pensions. Talya Misiri investigates how long DB pensions have got left in the retirement income space

Increasing risks, the possibility of consolidation and questions about the sustainability of defined benefit pension schemes could present a bleak outlook for the future of the once commended gold-plated pensions.

There were 7,800 DB schemes when the PPF came into existence in 2005; there is now a much lesser 5,600 schemes operating today. As a result of these figures, one cannot help but question how long DB pensions have got left.

Looking at the future of this type of scheme, former Pensions Minister Baroness Ros Altmann expects that: "Within the next 10 years, traditional DB schemes will only exist in the public sector but will be gone from the private sector."

Altmann continues to suggest that once DB schemes no longer exist in the private sector, "sooner or later, I expect the public sector will follow".

JLT Employee Benefits director Charles Cowling also isn't hopeful for the future longevity of DB schemes. He says: "We are losing around 200 schemes per year and the rate of attrition is showing no signals of slowing. Indeed it may speed up if conditions improve and scheme wind-ups become more affordable."

Looking specifically at the private sector, Cowling shares a similar opinion to Altmann, suggesting that in the next 10 years at least all DB schemes are "likely to cease" and "will have all but disappeared within 20 years".

Another key area that is somewhat expected to be in the pipeline for DB schemes is consolidation. Following its proposal in the Department for Work and Pensions' White Paper last year, consolidation is slowly becoming a reality for some DB schemes and disputed by others.

Altmann predicts that there will be "significant moves to consolidate smaller schemes with larger ones, whether that is just the administration, or just the assets is yet to be seen".

In comparison, former Pensions Minister and Royal London director of policy Steve Webb believes that schemes may see "some gentle encouragement for consolidation, but probably nothing very radical." He explains that by the time a new act is passed, (potentially following on from the DWP's White Paper proposals) and followed by detailed regulations, "it is likely to be several years before scheme members would see any difference on the ground".

Furthermore, Webb comments on the surge of DB to DC transfers that are showing "little sign of the demand slowing down". As a result, "schemes may have to gear up for having to process higher volumes of transfer requests as part of 'business as usual'. Ideally this will mean automating the process of providing transfer value quotes, providing standardised 'template' information to advisers to help speed up the process etc; funding projections and investment strategies will have to be reviewed on the basis of new assumptions about transfers out; it may even bring more schemes closer to buyout earlier than they expected," he says.

With the rate of change involving DB schemes increasing, the pensions industry must ensure it is prepared for all possible options and decide whether, and for how long this type of scheme should be continued.

Written by Talya Misiri