Evaluating the need for alternative DB endgames

Chloe Whelan explores the full range of endgame options for DB schemes

Summary
- The DB pensions landscape is evolving as many schemes reach maturity.
- The government has flagged impending regulatory change, with a focus on alternative endgame options, including commercial consolidation, public sector consolidation and capital-backed journey plans (CBJPs).
- This may also include greater support for schemes to run on and generate surpluses.

The defined benefit pensions landscape is experiencing a seismic shift. The vast majority of schemes are closed to new members and an increasing number are also closing to future accrual. High interest rates have led to drastically improved scheme funding levels. According to The Pensions Regulator's latest industry report, more than two-thirds of schemes are fully funded.[1]

As a result, more eyes than ever before are focused on the endgame – including those of regulators.

The UK government has flagged its intention to funnel more pension investment into UK companies, putting pressure on schemes to consider alternatives to an insured buyout, including several exciting innovations. Similarly, Labour has said if it's successful at the next election, changes will be warranted to tackle "cultural and regulation-induced risk aversion"[2] in the pensions landscape.

With regulatory changes almost certainly on the horizon, trustees and sponsors ought to evaluate the full spectrum of endgame options. As alternatives appear, it is imperative that opportunities are not missed to deliver the best possible outcome for members.

The evolution of DB endgame options

For at least a decade, buyout has long been considered the ultimate DB pension endgame strategy.

"We believe that buyout is the most reliable way to secure members' benefits, in that insurers have to be backed by capital," explains LGIM head of pooled solutions, Lisa Purdy.

"For that reason, it has always been viewed in the marketplace as the gold standard for pension schemes."

The UK pension risk transfer (PRT) market has boomed in recent years. LGIM estimated £50 billion of UK pension liabilities were secured with insurers in 2023 alone, making for a record-breaking year.[3]

Buyout offers significant advantages, including a high level of benefit security for members. However, it also comes with limitations and challenges. Entry costs can be prohibitive, especially for schemes with assets of less than £50 million, and permanent decisions must be made about the treatment of discretionary benefits.

Additionally, the PRT market has become increasingly crowded as more schemes reach maturity. Just nine insurers are active in the UK bulk annuity market, aiming to serve more than 5,000 schemes. Insurers are unable to quote on all transactions and prioritise those that are most likely to be successful. LGIM estimated, in 2021, it was unable to quote on one-third of PRT requests.[4]

"It's a competitive fight to get the attention of insurers, who are looking to spend their time strategically," says Barnett Waddingham partner, Richard Gibson.

"Buyout has long been held as the gold standard in terms of security, but it is relatively expensive as a result. Not every scheme can afford it. At the other end of the spectrum, very large, well-funded and well-diversified schemes may find the benefits of buyout less relevant. These very large schemes can afford to *[access those benefits]* themselves."

Diversification of endgame strategies

Against this backdrop, demand is growing for alternative endgame strategies.

Commericial consolidation

In commercial consolidation, a premium is paid to a consolidator, which becomes responsible for providing future benefits to members. This option offers sponsors and trustees a full risk transfer, generally at a lower price than a bulk annuity purchase.

Consolidators exist within the DB pensions regulatory framework, which carries lower reserving requirements and allows for more flexibility in investment strategy compared to insurance. As a result, while consolidation is more affordable, its protections for members are weaker.

"The difference between the consolidator and buyout models is around the security provided," explains J.P. Morgan Asset Management head of international institutional strategy and analytics, Gareth Haslip.

"A consolidator model sits somewhere between an insurance company's and a DB scheme's level of security. They'll hold some capital but not to the same level of an insurance company."

There is only one commercial consolidator currently operating in the UK market, Clara Pensions, which closed its first transaction in November last year.

Gibson, whose Barnett Waddingham team advised Sears Retail Pension Scheme in that transaction, says Clara was "well placed" to deal with schemes that can't afford to buyout within the next five years but are still quite well funded, with more than £50 million in assets.

"We have other clients that we're actively working with, with Clara, so more precedents may be set for that option," Gibson says.

Public sector consolidation

On 23 February, the Department for Work and Pensions announced its intention to set up a public sector consolidator to make consolidation more accessible to smaller schemes.

The public sector consolidator will be administered by the Pension Protection Fund and is projected to be up and running by 2026. The government expects it will be more affordable compared to commercial consolidators, giving smaller schemes access to economies of scale and their associated benefits, including reduced expenses, greater security and a more flexible asset pool.

Capital-backed journey plans

A third alternative endgame option has emerged for schemes that can't immediately fund a buyout: Capital-backed journey plans (CBJP). Under a CBJP, a third-party loans funds to a DB scheme, allowing the scheme to invest in higher risk assets and thus improve its funding position. Once fully funded, the scheme is then in a better position to access buyout.

The case for running on

Although the endgame market is increasingly dynamic, some schemes may not wish to capitalise on any of these options and instead run on in perpetuity. Running on allows schemes to take advantage of surpluses, which can be used to enhance member benefits or fund an associated defined contribution scheme.

Running on may also allow schemes to 'wait and see' how the endgame market and associated regulatory environment continues to evolve – and whether the insurance market will expand to take on more volume.

"There is an element of capacity in the buyout market," says Purdy.

"Pension schemes need to get their data ready, they may have illiquids in their portfolio, so there are a number of factors to consider.

"It's really important, in our view, for pension schemes to consider that they may pursue buyout in the future, and in the meantime they may get their data ready, get their benefits ready, target a surplus and make use of it. Buyouts are definitely still on the table, but it doesn't have to be today."

Insight Investment head of solution design, Jos Vermeulen, says, in his opinion, the case for running on has "never been stronger".

"Pension schemes are better funded and largely de-risked and, on top of that, the government is looking to make changes that will make run-on more attractive," he says.

"I expect there to be more positive tales about the advantages of run-on, so pension funds become more comfortable with doing exactly that."

Preparing for your chosen endgame

No matter the endgame, it's imperative that trustees and sponsors prioritise the secure delivery of members' benefits. Be prepared to evaluate and, if necessary, implement options that enhance this security.

As Aon head of UK retirement policy, Matthew Arends, notes: "The key here is ensuring the alignment of views among sponsors, trustees and members. That is truly fundamental."

Gibson compares the current DB landscape to that of nuclear decommissioning: "The nuclear decommissioning industry didn't start when the first nuclear powerplants were built; it started 20 years later when they were being taken down. We're facing a similar scenario here. There is a lot of work to do."

Written by Chloe Whelan, a freelance journalist

[1] https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/occupational-defined-benefit-landscape-in-the-uk-2023#:~:text=of%20this%20publication.-,Key%20findings,from%2070%25%20to%2072%25.
[2] https://labour.org.uk/wp-content/uploads/2024/01/Financing-Growth.pdf
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[4] https://www.legalandgeneral.com/institutional/pension-risk-transfer/knowledge-centre/articles/a-badge/