In the shadows

Zombies. Zombies everywhere. In all corners of the pensions industry. We find out where they're lurking within DB, DC and even within drawdown

DB

There are a number of underfunded DB schemes supported by 'zombie firms' unable to afford the contributions required for these schemes to ultimately pay full benefits to their members. But, lacking any clear mechanism to accelerate a resolution, they 'limp on' without any realistic prospect of recovery.

According to Quantum Advisory principal consultant Julian Fox, in this scenario, the management's long-term strategy is hope for the best, but "definitely don't think about or plan for the worst". This 'head in the sand' syndrome can lead to inappropriate investment strategies and over-optimistic discount rates, he warns.

Estimates as to the extent of the problem vary significantly, Lincoln Pensions managing director Alex Hutton-Mills warns. "For instance," he says, "The Pensions Regulator has classified c.10 per cent of DB pension liabilities as relating to schemes in its weakest covenant category, but expects that only c.5 per cent will ultimately fail. By contrast, recent analysis performed by the PLSA concluded that potentially c.20 per cent of DB obligations may not be paid. Either way, given the size of the DB landscape, the size of unpaid pensions will be significant."

According to recent research by KPMG, of the circa 21,000 UK private companies that it analysed, up to one in 12 (8 per cent) currently display three of more zombie-like symptoms of the companies being under sustained financial strain.

Out of this population KPMG estimates that a fifth (or around 350 companies) will have DB pension schemes. In many of these cases,adequately funding the pension scheme and turning round the business would be a significant challenge.

'Zombie' firms may struggle to attract other companies to take it over, due its DB pension liabilities, and these zombies also pose a risk for the PPF and its levy payers, KPMG explains.

Where buyout is not possible, DB consolidation may prise the schemes away from its zombie. However, this option may still be too expensive.

Instead, Hutton-Mills recommends more flexibility within DB schemes to reduce benefits to help get the company's pension debt to the 'right' size'

"Alternatively, a clear and widely-accepted resolution process is required, which includes swifter identification of 'zombie' schemes and accelerated transfer to the PPF. Coupled with fresh investment, this may give sponsors weighed down by their schemes the best chance of being able to avoid insolvency, whilst providing greater certainty for members and protecting PPF levy payers," he adds.

However, there is the question of whether monsters exist at all.

"We do not find the term 'zombie scheme' helpful, Mercer UK Wealth partner Deborah Cooper says. "Our understanding is that it is intended to indicate that a scheme is failing. In a DB context it seems to be used for many schemes that have a reasonable chance of continuing to operate and pay out benefits to members, without necessarily needing regulatory intervention."

As the pensions environment is more heavily regulated than it was when many employers first established their occupational pension schemes, it's understandable that employers may resent the distraction this can create, she adds.

"However, in most cases their schemes are still warm bodies that, given access to strong governance, controls and oversight, can produce good outcomes for their members."

DC

Within DC, there is a risk that closed 'zombie' funds are being eaten away by fees, PensionBee CEO Romi Savova warns.

A zombie pension fund is a closed or dormant fund that stops issuing new policies but typically holds on to the money invested until the existing policies mature. The structure of zombie pension funds is typically designed to generate as much cashflow from the existing policies as possible, and therefore may not generate a good return for savers.

According to Savova, in the world of DC pensions, zombies can come about when any pension provider decides that they no longer wish to keep attracting new customers. The 'book' of customers and their future expected cashflow is then sold to another company, and there are many companies whose primary focus is to acquire these 'books' of customers.

One of the main problems with zombie pension funds is that savers are often not explicitly told they are invested in one, nor told of the impact that this can have on their pension savings over time, Savova warns.

"With zombie pensions, savers are often unaware how much they're paying in fees and can be tied into costly and poor performing plans, so one of the easiest ways to avoid this is for members to regularly consolidate pension pots," she recommends.

Drawdown

In January, Zurich estimated that more than 115,000 savers risk a savings shortfall in later life due to neglecting their remaining pension pot after taking a tax-free cash lump sum.

After turning 55, savers can withdraw their pension savings, the first 25 per cent of which would be tax-free. They would typically put any remaining cash into drawdown or buy an annuity, even if they continue to work.

Zurich and YouGov's research found that 44 per cent of people who had gone into drawdown to access tax-free cash but had not retired, would leave their remaining balance 'untouched and unchanged' until they start taking a pension income, which could be many years later.

Experts have warned that after moving their savings into drawdown, people need to actively manage their pot, or it could veer off track.

Zurich head of retail platform strategy, Alistair Wilson, comments: "After triggering drawdown, consumers need to monitor and adjust their portfolio to ensure market movements don't leave them exposed to too little, or too much investment risk – yet many are planning to leave their pot dormant until they retire.

"Drawdown gives people much greater freedom and flexibility in retirement, but it doesn't run on autopilot. With no one at the controls, there is a danger tens of thousands of people could see their pensions veer off course."

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