Pensions Policy Institute

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Approaching the endgame: The future of Defined Benefit pension schemes in the UK

Executive Summary

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Mark Baker joined the PPI in November 2018, as the Senior Policy Researcher. Prior to joining the PPI, Mark earned a PhD in Sociology from the University of Exeter before working for RNIB and RNID in senior research and policy roles, authoring a number of influential research reports as well as chairing the Disability Benefits Consortium and ACEVO's welfare to work special interest group.

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John has been the PPI's Senior Policy Analyst since 2008. In his time at the PPI John has worked in a lead role in the modelling of a wide range of pension policy project number of PPI modelling projects including a number of projects looking at public sector pensions and pension related tax-relief.

At the PPI, John is responsible for the PPI's Pension Facts and has authored briefing notes and reports on subjects such as how housing wealth can support retirement, tax policy on pension schemes, harnessing pension savings for debt alleviation, public sector pension reforms.

John joined the PPI in 2008 from Hewitt Associates. At Hewitt he worked primarily on modelling of standard and non-standard Defined Benefit pension scheme calculations for the consultants to present to the clients.

Prior to joining Hewitt John worked for the Government Actuary's Department for 8 years in the Occupational Pensions directorate, during which time he calculated public sector pension scheme valuations, bulk transfer values, and designed models for the use of other Government departments.

John has a BSc in Actuarial Mathematics and Statistics from Heriot Watt and a Post Graduate Diploma in Actuarial Management from Cass Business School.

The Pensions Policy Institute (PPI)

The PPI is an educational, independent research organisation with a charitable objective to inform the policy debate on pensions and retirement income provision. The PPI's aim is to improve information and understanding about pensions and retirement provision through research and analysis, discussion and publication. It does not lobby for any particular issue or reform solution but works to make the pensions and retirement policy debate better informed.

Pensions affect everyone. But too few people understand them and what is needed for the provision of an adequate retirement income. The PPI wants to change that. We believe that better information and understanding will lead to a better policy framework and a better provision of retirement income for all. The PPI aims to be an authoritative voice on policy on pensions and the provision of retirement income in the UK.

The PPI has specific objectives to:

- Provide relevant and accessible information on the extent and nature of retirement provision
- Contribute fact-based analysis and commentary to the policy-making process
- Extend and encourage research and debate on policy on pensions and retirement provision
- Be a helpful sounding board for providers, policy makers and opinion formers
- Inform the public debate on policy on pensions and retirement provision.

We believe that the PPI is unique in the study of pensions and retirement provision, as it is:

- Independent, with no political bias or vested interest
- Led by experts focused on pensions and retirement provision
- Considering the whole pension framework: state, private, and the interaction between them
- Pursuing both academically rigorous analysis and practical policy commentary
- Taking a long-term perspective on policy outcomes on pensions and retirement income
- Encouraging dialogue and debate with multiple constituencies

A Pensions Policy Institute report

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Executive Summary

Private sector Defined Benefit (DB) pension schemes have been in decline for a number of years, in terms of the number of schemes and members. The vast majority of schemes are either closed to new members or to new accrual, and most are cash-flow negative, payments to pensioners exceed contributions from members and the sponsoring employer. Against this background, many pension schemes are turning their attention to how they can ensure that they continue to provide the benefits to members while minimising the costs and risks to the sponsor. Traditional approaches to this 'endgame' scenario have been insurance solutions, such as bulk annuity purchase. However, there is growing interest in the use of alternative consolidation mechanisms; either merging schemes or transferring liabilities to a third party.

The endgame market is evolving, and it is predicted that the number of schemes considering at their options will continue to grow. The number of private sector DB schemes that will be in a position over the next ten years to enter an endgame scenario – whether that be through an insurance solution, investment or administration merger or consolidations – is anticipated (although not guaranteed) to grow as funding levels improve.

However, the shape of the future market will depend on a number of factors, the impact of which are currently difficult to predict. These factors include:

- Sponsor appetite for specific approaches, particularly the extent to which the employer covenant is compromised.
- The availability of greater consolidation and the potential emergence of 'Superfunds'.
- The capacity of the insurance sector to meet increased demand for bulk annuity solutions and the effect on pricing.

If scheme funding improves as anticipated, sponsors will have more endgame and de-risking options available

PPI modelling suggests that under scenarios where future changes are similar to past experience, funding levels for private sector DB pensions will continue to improve, resulting in more schemes to be in a position to meet their future liabilities.

Additional PPI modelling of these scenarios projects that by 2030 the number of schemes in surplus is expected to rise, with the proportion of schemes in a position to secure full buy-out can be expected to rise from a current level of 6% to 72% by 2030. As assets exceed liabilities, more schemes will also be in a position to become self-sufficient or be able to enter into consolidation vehicles, allowing for potentially greater security for scheme members. In these scenarios there is a potential buy-out market of £770 billion over the next decade.

The choice of endgame strategy will depend partly on the financial situation of the scheme, and also on the appetite of the sponsor to maintain a strong covenant or to cede partial or total management of the scheme to third parties.

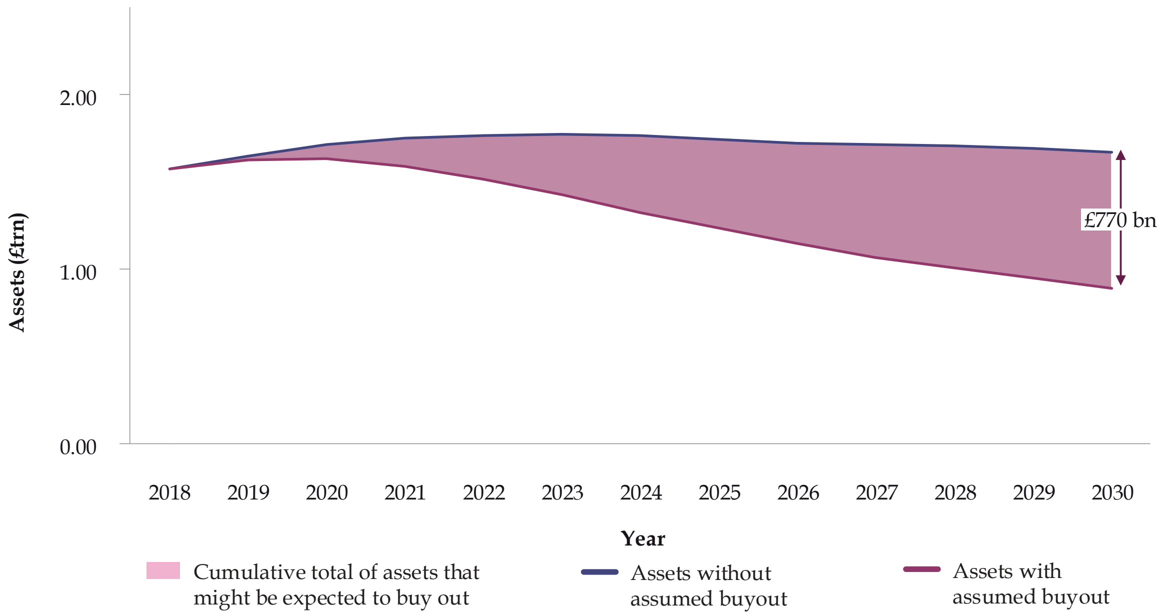
PPI modelling suggests that there is a potential buy-out market of £770 billion over the next decade

Buy-outs have traditionally been seen as the most secure way of ensuring that benefits are paid to members, because the entire scheme is bought out by an insurer that assumes responsibility for all future liabilities. Many sponsors will aim towards achieving a full buy-out of the scheme as their final destination.

As funding levels increase, more schemes might be in a position to achieve buy-out. Total DB assets, as modelled by the PPI, are projected to reach £1.67 trillion by 2030. When the assets assumed to be capable of full buy-out are removed, total assets fall to £900 billion, suggesting that there is a potential buy-out market of £770 billion over the time period (Chart Ex1).

Chart Ex1[1]
The buy-out market is projected to reach £770 billion by 2030

Total assets with and without assumed buy-out, 2018-2030 (current earnings terms)



Some schemes may not reach a position for full buy-out, or may have sponsors that do not wish to cede control of the scheme, particularly if the scheme is still open to new members or new accrual. Options available for schemes in these positions include buy-ins and longevity hedging that insure specific groups within the scheme, or adopting specific investment strategies to meet future expected liabilities and cash-flow. These may be undertaken as ends in themselves, or as stages on a journey to buy-out.

With more schemes looking towards their endgame, multi-scheme strategies are increasingly being seen as a viable option.

1 PPI modelling

Current options available include;

- Administrative mergers
- Asset mergers
- Scheme consolidation

Mergers and consolidation of schemes can mitigate against risk through economies of scale and different opportunities for investment

The choice of whether and how to consolidate or merge will depend on the appetite of scheme sponsors for ceding control over key aspects of the scheme. This may be of particular value to smaller schemes where costs are disproportionately high and pooling elements of the scheme with others can drive these costs down.

Another multi-scheme strategy, though not one that is currently in widespread operation, is the 'Superfund' which could potentially have a significant effect on the future DB landscape.

Superfunds would see entire schemes transferred into a single large scheme, and could provide a cheaper and more readily accessible endgame option, especially for smaller schemes. This could for some types of Superfund, reduce the numbers of pension schemes aiming for self-sufficiency or insurance solutions. However, Superfunds are not yet specifically regulated in their own right, and their potential impact for members, schemes and the wider endgame market is difficult to predict. If Superfunds do become more prevalent, this could limit demand for bulk annuity purchases.

A rise in the number of schemes finding themselves able to achieve full buy-out may be expected to increase pricing as appropriate assets become more sparse and more expensive. However, the introduction of Superfunds as a cheaper alternative for some schemes may mean that this situation may not arise, as schemes may opt to enter a superfund as their endgame.

For many schemes, the endgame could prove to be a long game.

Although DB pension schemes are preparing for their endgame scenarios, PPI modelling suggests that even those schemes that are closed for further accrual will likely be in existence for another 26 years, rising to 35 years for the few open to new entrants. For many schemes, sponsors and members, the DB endgame could be a long journey (Table Ex1).

Table Ex1:[2] Expected longevity of pension scheme by current status

Scheme Status	Expected time in current status (years)	Expected time until scheme is wound up (years)
Open to new entrants	9.7	35.5
Closed to new entrants, open to accrual	7.3	30.8
Closed to further accrual	25.4	26.1
Winding up	2.2	2.2

2 PPI modelling