THE SOCIETY OF PENSION PROFESSIONALS

making pensions work

Vision 2030:

The Future for DB Pension Scheme Investment

September 2023

Foreword

The lifecycle of DB pension schemes has reached a critical tipping point. Schemes are, in general, continuing to mature and, following a decades-long battle against deficits, funding levels have improved with many schemes now finding themselves in surplus on a low-risk basis. There has also been a focus on DB strategy across a wide range of the policy agenda, including the consultations regarding a revised DB funding regime and calls for evidence from both the Work and Pensions Select Committee and from the DWP, following on from the Chancellor's Mansion House Reforms. Our Vision 2030 paper therefore takes a well-timed look at the future for DB pension scheme investment. We hope that the issues explored in this paper help move the debate forward in this crucial area.

Steve Hitchiner
SPP President

Back in 2012 the SPP published its Vision 2020 paper. This paper highlighted a problem, namely that the aggregate pension liability was very sizeable in the context of the UK bond market. It noted that as pension schemes sought to better match their liabilities they were going to be 'chasing their tails', with their collective demand driving up liability valuations by driving down yields. That publication noted the problem was particularly acute in index-linked gilts where pension schemes' inflation-linked liabilities swamped the size of the UK inflation-linked gilt market.

We saw the predictions of that paper borne out in practice with yields falling for the best part of a decade. Index-linked gilt yields, at their least attractive, delivered an expected real return of -2.8% per annum[1].

What the publication did not predict was the chaos in gilt markets in September 2022, when pension schemes had to sell gilts due to a collateral squeeze. With yields so low, most other potential investors had little interest in the gilt market, meaning rapid price corrections for trade orders to be met, and ultimately the Bank of England needing to stabilise the market.

These dramatic events spelled the start of a new era of pension scheme investing. I therefore thank my SPP colleagues for helping to draft this paper: Vision 2030 – pension investing in the next decade.

Natalie Winterfrost
Chair of the Investment Committee, SPP

1 *Source: Bloomberg; figure refers to 20-year index-linked gilt yield as at 7 December 2021.*

Vision 2030:
The Future for DB Pension Scheme Investment

UK defined benefit (DB) pension schemes are in excellent health, with many in surplus and able to secure their members' retirement income.

Today, they are at an inflection point, with many on track to achieve their endgame objective of self-sufficiency or insurance buy-out within 10 years.

Pension schemes have become the focus of intense scrutiny over the last 18 months, in the wake of the gilt market volatility of late 2022 and the Mansion House Reforms announced by Chancellor Jeremy Hunt in July 2023. A call for evidence from the Government on options for DB schemes has sharpened the focus on their future.

Against this backdrop, trustees face significant questions about their investment strategy and how to achieve the best outcome for their members.

In this paper, we outline the changed circumstances of DB pension schemes today, the dynamics that will likely define their investment strategy over the next decade, the challenges that will face trustees, and how they might rethink the endgame target ahead of them.

EXECUTIVE SUMMARY

- **DB pension schemes today are in a very different position –** Schemes are in much stronger funding positions and invested in lower-risk portfolios compared to ten years ago.
- **The future of DB scheme investment: a focus on resilience –** Schemes hold much larger collateral buffers following the gilts liquidity crisis, and there is a greater focus on building investment resilience, including avoiding being a forced seller of assets. Assets which offer contractual cashflows and a return over gilts, such as high-quality corporate bonds, are likely to form the core of many DB schemes' investment strategies, although as a result of the crisis there are many schemes that find themselves with higher allocations to illiquid assets than they would have chosen. Resilience is not purely a question of asset allocation, and significant challenges remain that trustees will need to take into account.
- **Deciding on the endgame: ensuring the best outcome for scheme members –** The suitability of a specific endgame target will depend on a scheme's circumstances, but an insurance buy-out is not always the answer, and there may be good reasons to run on a scheme over the long term. Pension schemes can secure their members' retirement income with low reliance on their sponsor, meaning they could potentially invest for the long term, with the possibility of sharing any surplus generated between members and the sponsor.

1 BACKGROUND: DB SCHEMES TODAY ARE IN A VERY DIFFERENT POSITION

The UK DB pensions landscape has shifted dramatically over the last decade, and the last two years have transformed the circumstances of many schemes.

For many years, trustees and sponsors have focused on investing for growth, alongside liability-driven investment (LDI) strategies to minimise funding level volatility. For most, their aim has been to close funding deficits while maximising security for members' retirement income by removing unrewarded risk.

However, trustees are now facing different circumstances for their schemes. The key changes experienced by UK DB schemes include the following:

> **Most are now closed to new benefit accrual:** In 2022, 51% of schemes were closed to new benefit accrual; this compares with 26% of schemes in 2012.[2]

> **Most are now paying out more than they receive:** Most UK DB schemes are no longer accumulating assets, where their assets grow through investment returns and sponsor contributions. In other words, their outflows now exceed their inflows.

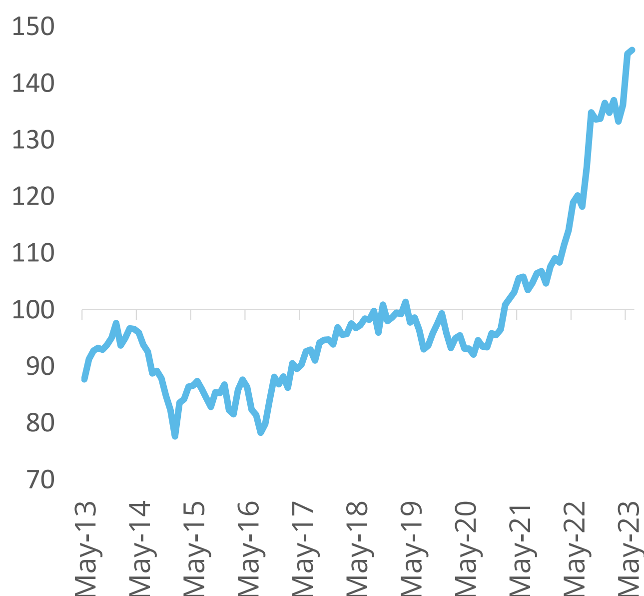
> **The majority of pension scheme allocations are in bonds, not equities:** DB schemes' allocations to equities have almost halved from 53% in 2006 to 27% in 2022. At the same time, the allocation to bonds has more than doubled, from 23% to 59%.[3]

> **Liability hedge ratios have doubled:** Industry surveys and other data suggest the average liability hedge ratio for UK DB schemes has risen from c.40% to over 80%.

> **Funding ratios have improved substantially:** Gilt yields fell between 2012 and 2022, but gilt yields have risen strongly since the beginning of 2022. With the average scheme not fully hedged, this has improved many pension schemes' funding levels. This is clearly illustrated in the funding ratio of schemes eligible for the PPF, which has soared to over 140% on a PPF basis (see Figure 1).

> On a more prudent basis, such as a discount rate of gilts plus 0.5%, the average pension scheme is still in surplus. A recent survey of the SPP membership indicated that c.30% of their schemes are over 100% funded on a gilts-flat basis.

Figure 1: Funding ratio of UK DB schemes (PPF basis)[4]



1.1 The Mansion House Reforms: a new dawn for DB schemes?

In July 2023, Chancellor Jeremy Hunt announced the Mansion House Reforms, which covered a range of topics, including the evolution of DB schemes.

The Chancellor outlined three golden rules guiding the Reforms: to "secure the best possible outcome for pension savers; to always prioritise a strong and diversified gilt market...and to strengthen the UK's position as a leading financial centre to create wealth and fund public services"[5].

A range of consultations opened in the wake of the announcement, including a call for evidence on options for DB schemes – which referred to changes over the last two decades in DB asset allocations, shortening time horizons for investment, and the desire of trustees and sponsors to reduce risk, supported by the regulatory framework. It included questions focusing on the incentives for and ability of trustees and sponsors to manage their pension scheme over time to grow and benefit from a surplus, the development of the consolidation market and questions on investing in 'productive finance' (effectively early stage equity and capital for UK business).

If the legislative, regulatory or tax framework is adjusted in light of this call for evidence, it could have direct implications for how trustees and sponsors view the options before them – both for their pension schemes' long-term investment strategies and endgame options.

2 Source: *The Purple Book: DB pensions universe risk profile 2012* and *The Purple Book 2022: DB pensions universe risk profile*, Pension Protection Fund and The Pensions Regulator. Excludes schemes winding up (2% of schemes in each year).
3 Source: *The Purple Book 2022: DB pensions universe risk profile*, Pension Protection Fund and The Pensions Regulator.
4 Source: PPF 7800 index. On a Section 179 basis. As at 31 May 2023.
5 Source: *Chancellor's Mansion House Reforms to boost typical pension by over £1,000 a year*, 10 July 2023, HM Treasury.

2 THE FUTURE OF DB SCHEME INVESTMENT: A FOCUS ON RESILIENCE

Pension schemes' investment strategies have historically focused on closing deficits by investing for growth alongside LDI strategies. Those pension schemes that hedged interest and inflation rate exposure late suffered funding falls as gilt yields fell to record lows, with real yields on index-linked gilts falling to -2.8%[6]. However, rising gilt yields and the gilt market volatility in late 2022 have changed many pension schemes' circumstances dramatically.

In the wake of the gilt liquidity crisis in late 2022, stakeholders have adjusted their respective approaches to ensure that pension portfolios remain resilient in the face of future volatility. Significant reductions in equity exposure have been implemented as a higher proportion of scheme assets are held within LDI mandates to collateralise hedges. In many cases improvements in funding mean equity exposure is no longer required. For schemes that had a hedge nearer 100%, meaning they have not benefited from the rise in rates, they may instead now be accessing equity exposure synthetically. There is an emphasis on physical investment in gilts and forms of high-quality corporate debt that are likely to form the core of most schemes' investment strategies going forward.

Significant challenges remain for trustees to consider, including:

> **High allocations to illiquid assets:** For many schemes, illiquid assets now represent a much larger allocation, as overall asset values have fallen by 50% or more following decreases in the present valuations of liabilities and LDI portfolios. Given the speed of the move, only liquid assets were sold to meet obligations within LDI portfolios, and there can be challenges disinvesting from illiquids to rebalance allocations.

> **Systemic risks associated with inflation hedging:** The inflation hedge of a scheme is imperfect because an RPI asset is used to hedge an inflation-linked liability, where the inflation linkage of the latter is limited by caps and floors. This means the amount of index-linked gilt exposure needed will change as inflation levels and inflation volatility change; but if pension schemes need to adjust their index-linked gilt allocations at the same time, this will cause problems in an asset with few other natural buyers (more on this in 2.3.2).

> **Continued upward pressure on gilt yields:** This pressure is driven by a number of factors including the Bank of England's shift to quantitative tightening and the UK Government's increased borrowing requirements.

2.1 The gilt liquidity crisis sharpened the focus on resilience

Since the gilt liquidity crisis in late 2022, anecdotal evidence suggests that most UK DB pension schemes have significantly improved their resilience to rising yields, with most now well prepared to tackle a repeat of September 2022.

Regulators, including The Pensions Regulator (TPR), have issued guidance on pension scheme resilience, specifically focused on the use of leverage within LDI strategies.

The TPR guidance[7] outlines what trustees should consider with regard to LDI, including the need for resilience testing, effective governance and resilience standards.

Under its resilience standards, TPR states that schemes' LDI arrangements must operate a minimum 'market stress buffer' to give them resilience against a rise in yields of at least 2.50%, assuming this could be replenished within five days. In addition, schemes must have an additional 'operational buffer' to help keep a scheme from depleting its market stress buffer on a day-to-day basis. A minimum was not set for this additional buffer, with a rise in yields of 1% provided as an example.

The guidance follows similar recommendations from various authorities in the wake of the gilt market volatility in September 2022. These included guidance from the Financial Policy Committee of the Bank of England[8] and a joint statement from the Central Bank of Ireland, Luxembourg regulator CSSF and the European Securities regarding LDI funds[9].

6 *Source: Bloomberg; figure refers to 20-year index-linked gilt yield as at 7 December 2021.*
7 *Using leveraged liability-driven investment, 24 April 2023, TPR.*
8 *Bank staff paper: LDI minimum resilience – recommendation and explainer, 29 March 2023, Bank of England.*
9 *Letter – Re: Liability Driven Investment Funds, 30 November 2022, CSSF.*

The draft Funding and Investment Strategy regime: sharpening the focus on risk

The Pensions Regulator has been working on a revised code of practice to help trustees and employers comply with DWP's draft regulations on DB pension scheme funding. The regulator has effectively put forward two routes for pension schemes, 'fast track' and 'bespoke'. For schemes to qualify for the fast track, they must meet three tests. In broad terms, they must:

1. target a low-dependency level of funding set at no more than gilts plus 0.5% at 'significant maturity',
2. have recovery plans no longer than six years (or three years after reaching significant maturity), and
3. ensure the scheme's funding is more resilient than that implied under a prescribed funding and investment stress (currently in line with the PPF stress test).

The new regime (and the revised funding code) was set to come into force in April 2024. However, since the new regime was first envisaged, positive changes in the circumstances of DB schemes have raised questions as to its applicability and relevance. Most recently, in its report on DB pension schemes and LDI, the Work and Pensions Select Committee asked TPR to postpone the launch of the code until it produced a full impact assessment for the proposals[10]. The timetable before the next general election is also short – potentially raising further doubts about when, or if, the revised code will be implemented in its current form.

2.2 Contractual assets are likely to form the core of resilient investment strategies

For well-funded pension schemes, which now applies to many UK DB schemes, expectations are that the required investment return to pay pensions in full is only a small margin above gilt yields.

This means that contractual assets offering legally binding fixed cashflows, such as corporate bonds and other credit-like assets, appear particularly well-suited for well-funded schemes for two reasons:

> **Contractual assets offer greater certainty of future returns compared to traditional assets where the return is driven by market valuations.** When held to maturity, these assets provide a contractually defined income and return (subject to any defaults).

> **Corporate bond yields are at their highest level in over a decade,** meaning that for many schemes, even allowing for a prudent expected default loss, they will provide sufficient returns, removing the need to adopt higher-risk exposures through traditional growth assets such as equities to achieve their goals.

The return available from investment grade corporate bonds relative to gilts is attractive (see Figure 2), even when accounting for a 95th percentile default outcome (equivalent to a default outcome that occurs once in 20 years). Under such assumptions, as at end June 2023, AAA-rated corporate bonds still paid a premium of 1.2%, and BBB-rated bonds a premium of 1.7%.

Figure 2: Investment grade corporate bonds offer an attractive combination of relative certainty and returns

Credit rating	Spread (over gilts)	95th percentile defaults	Net spread (over gilts)
AAA	1.2%	0.0%	1.2%
AA	1.2%	0.3%	0.9%
A	1.6%	0.7%	1.0%
BBB	2.2%	0.5%	1.7%

Source: Insight Investment and Bloomberg as at 30 June 2023. Credit spreads based on ICE BAML 1-10-year indices Sterling Corporate Indices, and are net of 95th percentile defaults, annualised.

10 Paragraph 149, *Defined benefit pensions with Liability Driven Investments: Seventh Report of Session 2022-23, 23 June 2023, House of Commons Work and Pensions Committee.*

Based on these yields, a portfolio of gilts, AAA-rated and AA-rated corporate bonds could be expected to deliver a return in excess of gilts plus 0.5%. This means that a scheme fully funded on a gilts-plus 0.5% basis, which is equivalent to a low-dependency level of funding according to fast track in TPR's draft DB funding code, could largely use such a portfolio even once it has reached significant maturity.

Under the draft funding code, there is scope for pension schemes to hold a wide variety of assets, including bonds, equities and real assets such as infrastructure. The specific mix of assets will depend on a scheme's specific circumstances.

These portfolios would be highly resilient, with built-in default protection and plenty of collateral, while also offering scope for matching cashflows to a pension scheme's liabilities. While the last crisis showed that in stressed markets, corporate bonds might not be as liquid as anticipated, the capability to repo these bonds to generate short-term cash has been put in place by many large UK bond managers.

For pension schemes with longer-term investment strategies, particularly those targeting run on rather than buy-out, other assets such as infrastructure may also be appropriate. We consider this in the next section.

2.3 Investment challenges that remain

2.3.1 High allocations to illiquid assets reduce flexibility

Many schemes today hold high allocations to illiquid assets. As an example, schemes that previously opted for illiquid allocations in the region of 20% might find themselves with allocations of closer to 40% after the gilts crisis. Such schemes will have used a significant proportion of their liquid assets to shore up their collateral buffers. Schemes that have completed partial buy-ins may have an even larger proportion of illiquid assets (a bulk annuity, once purchased, cannot be cashed in).

Respondents to a focussed survey of SPP membership conducted in July 2023 showed that among recipients, approximately one in four schemes have over 30% of their assets invested in illiquids[11]. Less than 30% of schemes had less than 10% of assets invested in illiquids.

The time horizon of illiquid assets varies. In our survey, over 75% of the illiquid assets in question mature after one year, and almost 50% will not mature until after three years.

These illiquid assets will pose a significant challenge if they need to be sold to increase or replenish collateral buffers, or to pay benefits. There is evidence that pension schemes are trying to replenish their liquidity with open-ended vehicles of illiquid assets, which are 'gating' (limiting redemption requests) as they cannot fulfil the requests being placed on them. In the final quarter of 2022, property markets saw their worst performance on record and property has continued to languish in 2023.

These problems should not spell the end of defined benefit schemes investing into illiquid assets, which could still have a significant role to play for schemes that either have a long-expected timeframe to buy-out or that intend to run on. Many illiquid assets can provide secure income over time, with some providing inflation linkage (even aligned with pension scheme caps and floors), which could help to fulfil future cashflow requirements cost-effectively.

Schemes with high illiquid allocations may wish to consider how to make more use of their liquid assets. For example, arranging for corporate bonds to be eligible as collateral for hedges may help support overall resilience. The cost of doing so over time may compare favourably with the cost of selling illiquid assets at a discount to their net asset value.

2.3.2 Falling inflation expectations could force index-linked gilt sales

Most UK defined benefit pension payments are linked to inflation, subject to caps and floors. Many payments will rise in line with RPI (or CPI) up to a maximum of 5% per annum, with a floor of 0% per annum. This type of inflation linkage is known as Limited Price Indexation (LPI). Other caps and floors are also common, such as a maximum of 2.5% per annum.

To create an investible liability benchmark for hedging purposes, LPI liabilities are typically proxied using a combination of fixed cashflows and RPI-linked cashflows, with the split calibrated to provide the same overall level of inflation sensitivity as the LPI liabilities. Changes in inflation expectations lead to changes in the percentage of index-linked versus conventional gilt exposure that a pension scheme would hold to hedge its inflation risks.

The current high inflation level and inflation volatility mean that caps on pensions are more likely to bite than was expected over the last decade. Initially, as inflation expectations fall, pension schemes could be buyers of index-linked gilts as they expect the cap to bite less, meaning liability valuations would again be more likely to change in line with inflation expectations. However, should UK inflation expectations fall significantly and deflation become a possibility, the inflation sensitivity of LPI-linked liabilities would decrease: with a zero floor to stop pension payments reducing in value in absolute terms, trustees would not want to hold too many index-linked gilts with coupons and capital redemption payments that would fall in a deflationary scenario.

11 For the purposes of the survey, illiquid assets were defined as assets that take over one month to liquidate.

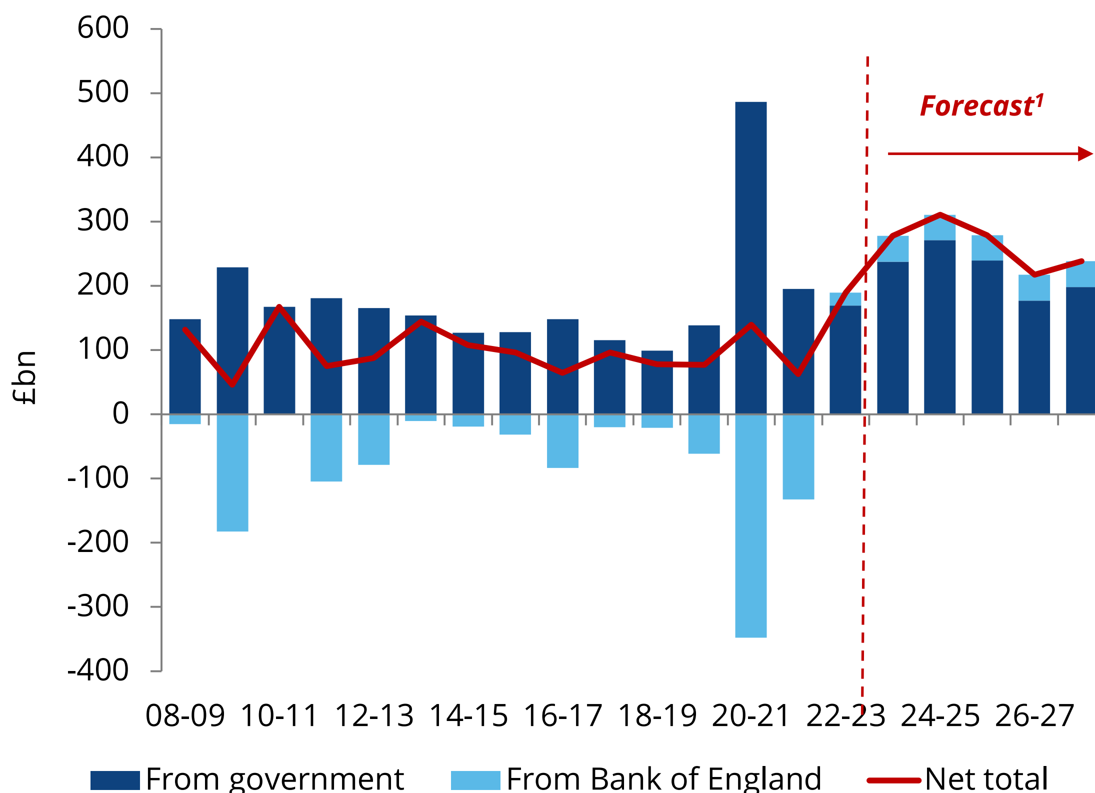
In these circumstances, pension schemes could become mass sellers of index-linked gilts, which would push implied inflation rates lower still – meaning there is the potential for another negative feedback loop akin to that caused by the mass selling to address the collateral squeeze in September 2022. Typically, pension schemes rebalance their portfolios at different times, meaning this loop may be less dramatic than the gilt-selling spiral in September 2022, but the impact could still be significant.

This risk could be mitigated over time via the issuance of Government bonds with an inflation floor at 0% per annum; this would remove the need for pension schemes to sell index-linked gilt holdings as inflation falls, given the inflation sensitivity of the assets would be more closely aligned with pension schemes' liabilities. As inflation allocations were trimmed on rising inflation expectations, pension schemes were selling an asset that had performed well and realising profits. The opposite would be true should expectations be moving closer to the zero floor. Here, pension schemes would be selling an asset they had moved overweight in after it had fallen in value.

2.3.3 The shift to quantitative tightening is putting upward pressure on gilt yields

The Bank of England, a major buyer of gilts for many years, has begun to sell gilts. This comes at a time when the Debt Management Office is forecasting a much higher rate of gilt issuance. The combination of these two factors means that the supply of gilts, net of the Bank of England purchase facility, is forecast to rise sharply. The question is who will buy these gilts? Little further demand from pension schemes, which are already well hedged, is expected. This could put upward pressure on gilt yields (see Figure 3).

Figure 3: Net supply of gilts is set to rise sharply



Source: UK Debt Management Office and Bank of England, as at 21 July 2023. [1] Estimates.

2.4 Improving resilience in pension investment strategy

Reflecting the risks described above, we expect pension investment strategy to focus on managing investments holistically, maintaining or improving their governance and focusing on cashflows.

> **Holistic investment with a united purpose:** All investment decisions will need to be made in the context of the trustees' overall funding objective and endgame target (such as buy-out or run on) to increase the certainty of achieving that goal.

> **Improving governance to enable effective decisions:** The gilts liquidity crisis highlighted the need for trustees and their advisers to agree decision-making processes, including the benefits of clear delegation within set parameters. This delegation might be to sub-committees of the trustee board or to providers (be that implemented consultants, fiduciary managers or investment managers under their Investment Management Agreement). One example is the implementation of collateral top-ups following an agreed asset waterfall or increased use of automatic pre-set processes.

> **Focus on cashflows for transparency and resilience:** Comparing the cashflows contractually secured (such as gilts and corporate bonds) with the value needed to deliver a scheme's desired funding outcome provides greater transparency and certainty in progressing towards the endgame objective, and greater resilience as there is less sensitivity to market movements. The existing regulation of actuarial valuations and, indeed, the draft new funding code both allow for asset-based discounting, which would allow the trustees of a pension scheme to invest in a range of secure income assets without their funding level changing as a result of market noise. Under such an approach, a pension scheme's funding level would only deteriorate if there was an expected or realised change in asset defaults (the former because a larger haircut should be applied to the yield, increasing the liability; the latter because asset values would fall). This approach to setting discount rates by the scheme actuary is referred to as a 'portfolio-minus' approach, compared to the common gilts-plus approach.

3 DECIDING ON THE ENDGAME: ENSURING THE BEST OUTCOME FOR SCHEME MEMBERS

With funding levels at their highest since the surpluses seen in the last century, and most pension funds closed to new members and largely closed to any accrual, trustees are reconsidering their endgame targets. Record-breaking amounts of pension capital are expected to transfer to insurers over the next few years. The systemic risks to which insurers are exposed has been highlighted recently by regulators.

The suitability of a specific endgame target will depend on a scheme's circumstances. For many smaller schemes or those with weak sponsors, insurance will often be the desired solution. However, there are reasons for larger schemes with strong sponsors to consider whether an insurance buy-out would increase or reduce the expected outcome for members, relative to running on the scheme over the long term.

It is not just a question of run on or buy-out. Various forms of consolidation provide alternative endgame targets to consider, though consolidation vehicles have yet to make significant progress. Options include:

> **Defined benefit mastertrusts:** These seek efficiencies through economies of scale by merging investments and operations. The potential to call on the original sponsor for deficit repair contributions remains.

> **Superfund consolidators:** Replacing an employer covenant with a 'superfund' which contributes a capital buffer might be appealing for trustees of scheme with a weak sponsor which is yet to reach a buy-out level of funding. As consolidators still require a minimum level of funding, the proportion of schemes suitable for such an approach is limited. At this time, there are two known superfund models – one is a 'bridge to buy-out', which extracts a profit only after the members' benefits are secured with an insurance company; the other is a run-on model. At the time of writing, no superfund consolidators have secured any pension scheme transfers, with the latter model yet to get the support of The Pensions Regulator.

> **Capital-backed journey plans:** This is not strictly a consolidation approach, but another option to progress towards a buy-out. A provider of a capital buffer invests a pension scheme's assets over an agreed timeframe, with the intention of achieving a funding level sufficient to achieve a buy-out and generate an attractive return on their capital.

However, these options have been available for some years with limited take-up, so it appears the rules or incentives governing these alternatives need further development before their adoption becomes widespread. Ultimately, these are typically a step in the journey to buy-out.

3.1 Insurers' systemic risks

3.1.1 Demand for insurance buy-outs is surging and capacity may not meet demand

Over the last 10 years, insurance buy-outs amounted to £67.5bn in total and buy-ins amounted to £142.9bn. Given the strong funding of many pension schemes, demand for insurance transactions is expected to surge. One estimate is of growth in coming years to over £50bn every year, and even over £70bn in some years[12]; another estimate predicts similar levels of activity to arrive at £600bn of pension risk transfers over the next 10 years[13]. This is dramatic expected growth.

Such growth could be challenging for UK insurers to manage. Charlotte Gerken, the Prudential Regulation Authority (PRA) Executive Director for Insurance Supervision, has called for "moderation" in the insurance sector – saying in a recent speech that insurers "need to balance the short-term financial and reputational incentives to grow rapidly, with long-term and enduring financial strength, to meet the long-term needs of policyholders and the economy"[14].

3.1.2 Insurance backing versus corporate sponsor backing

There has been a shift in relative risks between the strategy of pension schemes and the strategy of insurers. At the turn of the century, pension schemes ran significant investment risk; it was typical for a scheme to only back pensioner liabilities using bonds, with active and deferred liabilities 'matched' with equity investments. Even a decade ago, a 60/40 model was common, with the bulk of a portfolio invested in equity-like assets. But with many pension funds now able to pursue an investment strategy suitable for a gilts plus 0.5% discount rate, pension schemes may take little or no equity risk and invest in secure income assets.

We are now in a position where the investment strategy of insurers, as guided by Solvency II, is less conservative than that adopted by many pension schemes – with pension schemes today typically having a high weighting to gilt investments, while insurers typically invest a much higher proportion in credit-based assets.

Insurers offer insurance buy-outs to generate a profit for shareholders, meaning that an insurance transaction typically leads to capital leaving the pension system, rather than being retained to maximise security for pensioners or increase their benefits.

In the case of a pension scheme backed by a strong corporate sponsor, the level of insurance capital held against pension scheme liabilities is low relative to the equivalent capital represented by the larger corporate sponsors' market capitalisation. The power of trustees to maintain their access to this capital has also increased, with limitations on how sponsors might endanger the security of a pension fund (e.g., through corporate activity, the issuance of higher-priority debt or distribution to equity).

Once pension liabilities are passed to an insurer, there is no scope for future improvements to benefits (such as discretionary pension increases in a time of high inflation or improvements to factors). This compares unfavourably with pension schemes, where a material proportion of any excess surplus may be distributed to members through benefit enhancements, depending, of course, on the terms of the deed.

12 Source: *Buyouts, buy-ins and longevity hedging – H2 2022: Managing pension scheme risk, April 2023, Hymans Robertson.*
13 Source: *JPMorgan.*
14 Source: *Moderation in all things – speech by Charlotte Gerken: Given at Westminster and City's 20th Annual Conference on Bulk Annuities, 27 April 2023, Bank of England.*

How do insurers invest?

There are currently nine bulk annuity insurers in the market, although this number may increase as other players look to take advantage of greater demand for risk-transfer solutions from DB pension schemes. These insurers differ in what they offer, such as in the transaction size they might accept and the ability to accept deferred pension liabilities.

Although these insurers invest in a range of different investments to back these annuity liabilities, they are subject to much more stringent regulations than DB pension schemes, with all of them investing and managing their investments in accordance with Solvency II's Matching Adjustment (MA). Bonds and other credit assets are the asset class of choice.

To obtain the capital benefits associated with the MA, insurers' asset portfolios need to meet an array of detailed and complex requirements, taking account a range of different factors including the overall matching of asset with liability cash flows, the level of certainty of the cash flow expected from a particular bond and its credit rating. It should be noted that following the departure of the UK from the EU, these rules are currently being reviewed with a view to relax some of the criteria for the MA-eligibility of assets in order to facilitate greater investment in the UK economy, particularly infrastructure.

Insurers' investment strategies differ, with each choosing a particular mix of bonds to meet their specific internal objectives. Structures that typically feature in these portfolios include traditional investment grade corporate bonds, gilts, infrastructure debt, equity release mortgages and commercial mortgages, as well as private placements and structured finance. Many of these insurers will source their own investments directly, specifying the requirements to the issuer to ensure compliance with the MA. Insurers are also integrating ESG considerations in their investment selection driven by both regulatory direction and client demand.

The differences between insurers' investment portfolios mean it is not straightforward for a DB scheme to adapt its investment portfolio to be 'insurance-company ready' in advance of an insurer selection exercise, although gilts and investment grade credit are usually deemed a sensible mix of assets for broad price matching (and readily accepted as part of an in-specie transfer).

Today, some DB schemes have relatively high allocations to illiquid assets such as private credit. While insurers also allocate to these assets, unfortunately, it is not straightforward to transfer these assets, especially when they are held as part of a pooled fund or the private credit is not MA-compliant.

3.1.3 Insurers bear potential for significant systemic risks

The risks to which insurers are exposed could affect the whole sector – in other words, these risks could put pensions, and the wider market, at risk. We outline some of these risks below.

> **Default risk:** Insurers invest the majority of their assets in corporate debt, meaning they are more exposed to default risk relative to pension schemes which emphasise gilt investments.

How insurers invest is guided by the Solvency II regulation. Under current rules, insurers can hold a range of assets – including investment grade corporate bonds (as well as private debt and illiquid assets) – against their liabilities, with the additional spread on those assets (relative to Government bonds) effectively meaning an insurer can hold fewer assets against those liabilities. Most pension funds measure their liabilities with reference to the gilt market, whereas there is no such 'mark-to-market' mechanism within insurance regulation.

If corporate bond default rates rise by more than expected and reserved for, this could have a significant impact on insurers' ability to fund their liabilities. As credit spreads increase within a pension scheme portfolio, the reported funding level would decline, triggering deficit repair contributions at a valuation if this decline is material enough.

Current proposals to adjust the Solvency II regulation in the UK are likely to further reduce the capital insurers are required to hold against their liabilities. The Bank of England has estimated that the proposals would lead to a 20% increase in the annual probability of life insurer failure if a firm met just the minimum regulatory standard[15].

15 *Letter from Andrew Bailey, Governor of the Bank of England, to Harriett Baldwin MP, Chair of the Treasury Committee, 22 February 2023.*

- **Longevity risk**: Insurers are collectively exposed to pensioners living longer than expected, meaning they would be required to pay pensions for longer. However, this risk is diversified beyond those in the buy-out market to the reinsurance market. This risk is also present for pension schemes, but is unlikely to be positively correlated with other business risks. If needed, pension funds can access the reinsurance markets through longevity swaps.
- **Falling inflation:** Insurers can hedge inflation-linked pensions using inflation-linked assets, but they are exposed to the risk of falling inflation, prompting sales of inflation-linked assets – which could, in turn, lead to further sales and a vicious cycle of asset sales. Sponsor may also face this risk, but only in relation to their own specific schemes.
- **Liquidity risk:** Insurers are users of derivatives, meaning it is possible that a liquidity crisis, similar to that experienced in September 2022 in the gilts market, plays out in the insurance sector. So-called 'dirty CSAs' (derivative documentation that allows the posting of credit as collateral, rather than only cash or gilts) are now more common for insurers than pension funds, which will have provided assistance in the last crisis, but equally it means they might receive credit that they do not want.
- **Counterparty risk:** Much of the risk outlined above, such as longevity risk, might be passed on to reinsurers – but the potential for systemic risk in the reinsurance sector, specifically as a result of taking on more risk from pension schemes as the buy-out market booms, has itself become a source of concern. For example, UK insurers often pass risk to reinsurers outside the UK, which are subject to different and potentially less stringent regulations; this could potentially increase underlying risk exposures.

The potential for systemic risk has been raised by Andrew Bailey, Governor of the Bank of England: "If a future [insurer] failure occurs, it would be difficult to predict the quantum of losses, nor is it certain that it would be limited to a single firm. **For example, as corporate pension schemes continue to transfer their pension liabilities into the life insurance industry, the insurance sector might in future have larger and more concentrated exposures to similar types of risks**. This could impact the capacity of surviving insurers to take on significant additional liabilities of a failed annuity writer."[16]

Assuming an insurance covenant will always be stronger than that of a strong corporate might be imprudent. It is not beyond the realms of possibility that the next black swan event is an insurance crisis.

3.1.4 Insurer failure would lead to FSCS support for pensioners – but systemic risks still raise concerns

Pensions paid by insurers are backed in full by the Financial Services Compensation Scheme (FSCS), but it may not be appropriate to assume these will be paid out in full in a worst-case scenario. We note the following key characteristics of FSCS support:

- **Support from the FSCS is subject to change:** The FSCS previously covered 90% of payments related to long-term insurance policies, including pensions. This increased to 100% in 2015. There is no limit applied to the amount covered (unlike, for example, bank deposits which are covered up to £85,000).
- **The FSCS is unfunded:** Levies are charged, and support is offered, on a sector-by-sector basis. In other words, insurance-related claims are covered by levies on insurers. If insurance failure were systemic rather than insurer-specific, the FSCS would need to turn to other funding sources.
- **A crisis scenario would mean FSCS support is dependent on political will:** The FSCS is independent of Government and regulators; however, in the wake of the global financial crisis in 2008, the UK Treasury granted the FSCS a loan of over £20bn to enable it to fulfil shortfalls. This loan has since been repaid, largely through recoveries from failed banks.

FSCS protection is contingent on future policy and political appetite. Coverage could fall back from 100% if circumstances change; if insurers fail, the FSCS may not be able to charge sufficient levies on the sector to cover the level of funding required to support pensioners. Depending on the wider political and socioeconomic context, taking into account intergenerational inequality, it could be very difficult for a future Government to bail out pensioners through financial support to the FSCS.

16 *Letter from Andrew Bailey, Governor of the Bank of England, to Harriett Baldwin MP, Chair of the Treasury Committee (PDF), 22 February 2023. Emphasis ours.*

3.2 Pension schemes' resilience to run on

Many pension schemes today have reached, or are close to reaching, a 'low dependency' or 'self-sufficiency' state. They are funded well enough that they are expected to be able to pay all future benefits and expenses without recourse to their sponsor and without taking much investment risk. Schemes with sufficient funding are able to invest in enough secure income assets, even taking a prudent haircut for credit losses, such that those investments will generate contractually defined cashflows to pay benefits and expenses as they arise.

Prudence in the expected return versus the required return can provide a buffer against adverse events, such as higher credit losses than expected or an improvement in longevity – without compromising the security of members' future retirement income. If such events do not occur, a scheme will generate additional surpluses that can be used for the benefit of members or the sponsor.

However, low dependency is not the same as no dependency. Insurance companies are providing a guarantee to provide the promised level of member benefits, and are required to maintain significant solvency capital against their annuity book, resulting in an effective funding level that far exceeds the low-dependency targets adopted by pension schemes. For smaller schemes or for those with weaker covenants, the security this provides to members is likely to be attractive.

Where the sponsor covenant is strong, the security of members' retirement income may be as good as, or even better, than the security provided by the insurance regime, although sponsors may not be willing to continue to underwrite these risks for the long term. Additionally, trustees and their advisers need to consider the visibility of the covenant, i.e. how certain they can be that the sponsor covenant will remain strong.

An insurance company transaction is, therefore, likely to be the favoured option in many cases. Nevertheless, there are arguments against this. Pension schemes are now well placed to provide a high level of security without insurance.

3.2.1 Ensuring security for members' retirement income

Pension schemes have access to three valuable lines of defence to ensure the ongoing security of their members' future retirement income:

1. **Over-collateralisation using the assets of the scheme:** When a pension scheme is well funded on a buy-out basis, its assets are generally able to support pension payments with a level of return close to that offered by gilts.

   However, the returns available from high-quality bonds are higher (see previous section), meaning that as pension schemes' bond holdings mature they can support pension payments while also funding increased surpluses over time. This could be held as a reserve for tail risks (such as dramatic improvements in life expectancy) or distributed if the sponsor is strong enough.

2. **Sponsor covenant:** If funding shortfalls arise and a scheme's assets are not sufficient to pay pensions, corporate sponsors act as the next line of defence. Although current high funding levels, a prudent regulatory regime and appropriate investment strategies will limit the need for sponsors to offer such support, it remains an important part of the solvency structure.

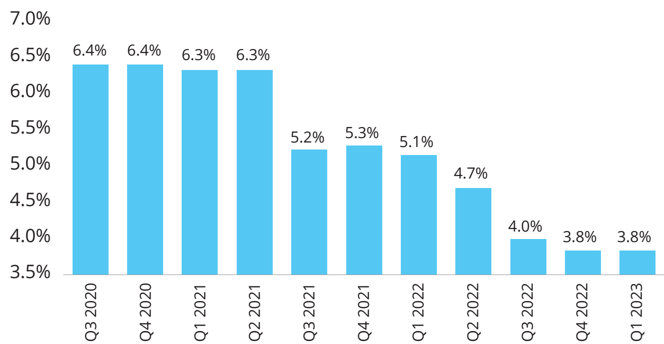
3. **Pension Protection Fund (PPF):** From a member perspective, the PPF offers a final lifeboat. Recourse to the PPF should be limited in schemes funded to self-sufficiency.

3.2.2 Longevity risk can be managed efficiently

For many pension schemes that have derisked their investment strategy, there remains a large, unhedged risk in the form of longevity. This is not in itself a reason to move to buy-in – it can be managed either through a prudent buffer or by hedging using a longevity swap contract (where a scheme is large enough for this to be feasible). This, in effect, gives a pension scheme access to the reinsurance market that insurance companies use, and is regularly collateralised, limiting the exposure to counterparty failure.

The cost of longevity protection has declined substantially over recent years (see Figure 4), driven by a combination of new entrants coming into the market and rising interest rates. Further declines may materialise in the future as reinsurers reassess their underlying longevity assumptions.

Figure 4: Longevity risk fee (pensioner only)



These estimates are based on the indicative longevity swap pricing methodology used by Club Vita LLP in its reporting to pension schemes. Club Vita's indicative longevity swap pricing methodology uses a combination of market pricing data, information received from longevity reinsurers and survey responses from 25+ insurers and reinsurers representing the vast majority of the longevity risk transfer market. The estimates are indicative only and they make no allowance for intermediary fees.

3.2.3 Use of pension surpluses

Beyond providing for members' retirement income, DB schemes could also enhance benefits to the people who helped grow them over preceding decades – members and sponsors – and society more broadly, through:

> enhancing benefits for members, including potentially increases above the 5% inflation-linked cap during periods of high inflation;

> reimbursing capital to sponsors (although this comes with tax implications);

> providing additional support to defined contribution (DC) benefits, which is tax efficient if held within the same scheme; and

> invest capital in support of wider economic growth.

Importantly, if the sponsor is strong enough, these benefits could potentially be achieved without compromising the security of the benefits that need to be delivered. However, incentives and possible new protections would have to be introduced to encourage many trustees and sponsors down this route.

The role of the PPF in providing pension security – and more

The PPF today is in a strong position as there is less risk that pension schemes will need assistance in future. This has a number of implications which could enable DB pension schemes to unlock the value which has now been established.

> **The PPF could help support economic growth:** To the extent that the PPF has excess security (in other words, assets in excess of those required to safely secure the benefits promised), this could be deployed to support UK growth.

> **The PPF is in a better position to support the schemes that need it:** With many pension schemes now in surplus, fewer are likely to fail and prompt support from the PPF. The PPF itself is also in a better funding position, enabling it to play its role more effectively when pension schemes do fail.

> **The PPF could uplift benefits for both current and future members:** When a scheme falls into the PPF, the benefits provided are lower than those promised under the original pension scheme obligations. An improvement in the PPF's funding level could mean that benefits are uplifted for beneficiaries being supported by the PPF, to a level closer to that originally promised by their schemes.

If the benefits provided by the PPF were increased to scheme levels, from a member perspective, the difference between a buy-out and PPF protection is removed. While this would take away the concern of trustees that sponsor insolvency could lead to reduced member benefits, it could introduce moral hazard. The draft TPR guidance on investment in relation to the proposed DB funding code may mitigate this moral hazard to some extent. An alternative would be optional higher levies, providing access to a higher benefit section of the PPF.

3.2.4 Incentives are set for realignment

The current regulatory, legislative and tax framework incentivises trustees and sponsors to transfer DB pension assets and liabilities to an insurer, rather than to run on a pension scheme.

However, the current focus on options for DB schemes – illustrated by the Government's call for evidence on the topic – shows that policymakers are open to changing this.

Adjustments to the framework could maintain security for pensioners' future retirement income while also providing incentives for pension scheme trustees and sponsors to continue investing over the longer term, reflecting their liabilities, which may extend over many decades.

For example, to incentivise trustees and/or companies to run on pension schemes, discretionary increases of members' benefits from excess surplus could be made easier to grant (this is not always a power that sits with trustees under the rules of the scheme) and there could be clarification around trustees' roles and responsibilities (e.g. on the security of accrued benefits versus enhancing benefits, which currently encourages them towards buy-out). Another idea might be tax exemptions if returns of pension fund surpluses are used for particular purposes.

Ultimately, changes such as these could align with the Chancellor's three golden rules set out in the Mansion House Reforms.

1. **Secure the best possible outcome for pension savers:** Enabling DB schemes to run on could lead to better outcomes for pension savers both within and outside DB schemes.

2. **Prioritise a strong and diversified gilt market:** DB portfolios today focus on gilts, the most secure source of future cashflows. Allowing DB schemes to run on would enable DB schemes to maintain their substantial existing gilt holdings, while a transfer of pension scheme capital to insurers could lead to material sales of gilts over time.

3. **Strengthen the UK's position as a leading financial centre to create wealth and fund public services:** Once members' retirement income is secured, pension schemes' excess surplus could be deployed over time, and its scope for investing in riskier markets – such as the UK equity market and productive finance – can be expected to grow.

The Society of Pension Professionals (SPP)

SPP is the representative body for a wide range of pension advisers and service providers. The breadth of our membership profile is a unique strength for the SPP and includes actuaries, lawyers, investment managers, administrators, professional trustees, covenant assessors, consultants and specialists.

Harnessing the expertise of its broad membership, the SPP strives to deliver value to its members and improve how pensions work, positively impacting outcomes for pension scheme members, the pensions industry and its stakeholders.

The SPP Vision

A secure retirement for all, supported by a thriving and diverse pensions industry, operating within clear and trusted regulation.

The SPP Mission

To deliver value to our members through education, experience and opportunity to influence. To support the wider pensions industry, Government and associated bodies in delivering an effective operating and regulatory environment.

For more information on the SPP, please visit our website or email info@the-spp.co.uk

Credits

Thanks to those who contributed to this guide, Emily Tann, Jos Vermeulen, Natalie Winterfrost, Adam Gillespie, Anil Shenoy, Phil Craig, Steve Hitchiner, Jonathan Gilmour.

NOTICE: This document is provided for information only. You may not rely on any part, or all, of this document in deciding whether to take any action or to refrain from action. You may not use this document in part or in whole, or reproduce any statement it contains, without the prior consent of The Society of Pension Professionals. No liability (other than any liability which cannot be excluded by law) arising from your failure to comply with this Notice rests with The Society of Pension Professionals or with any individual or organisation referred to in this document. Liability is not excluded for personal injury or death resulting from The Society of Pension Professionals' (or any other party's) negligence, for fraud or for any matter which it would be illegal to exclude, or to attempt to exclude, liability.

THE SOCIETY OF PENSION PROFESSIONALS

making pensions work

The Society of Pension Professionals
124 City Road, London, EC1V 2NX
T: 020 7353 1688 E: info@the-spp.co.uk www.the-spp.co.uk
A company limited by guarantee. Registered in England and Wales No. 3095982