The challenge of maturity

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Costas Yiasoumi and **John McAleer** discuss the challenges faced by mature defined benefit pension schemes and present a framework for managing their run-off

The growth and now run-off of UK defined benefit (DB) pension schemes touches many of us, whether we work in pensions, investments or insurance. How mature DB schemes are run-off will affect the retirement incomes of millions of people. Given the huge assets and liabilities involved, there is also a significant impact on employers and the wider economy.

There is plenty of material covering various aspects associated with running off mature schemes, but no work that covers the topic as a whole. The Running Off Mature Schemes Working Party therefore decided to pull together various strands of existing analysis and research, where appropriate, reinterpreting it in the context of mature schemes and then presenting it in a coherent way with observations and recommendations in a paper.

To make our work even more topical, the Department for Work & Pensions (DWP) published its long-awaited white paper *Protecting Defined Benefit Pension Schemes* on 19 March 2018. There is current debate within the industry on how accrued pension promises should be delivered and the white paper is perhaps a natural consequence of the challenges faced by the large number of rapidly maturing schemes. It proposes various changes, many of which touch on the findings of the working party.

The good news is that actuaries are perfectly placed to help schemes run-off effectively.

Setting the scene

Depending on how you assess your half-glass, there are only (or as many as) 5,588 DB schemes in the UK (*see Figure 1*). It is uncommon for new DB schemes to be set up; this is a species in long-term decline, with the number decreasing steadily each year; albeit extinction is still some time away.

FIGURE 1: DB schemes in the UK

NUMBER OF MEMBERS	NUMBER OF SCHEMES	AVERAGE LIABILITIES £M	TOTAL LIABILITIES £BN
Less than 100	1,994	10.8	21.6
100 to 999	2,458	81.9	201.4
1,000 to 4,999	759	515.0	390.9
5,000 to 9,999	180	1,594.4	287.0
Over 10,000	197	6,987.3	1,376.5
Total	5,588	N/A	2,277.3

Source: Pension Protection Fund (PPF) Purple Book 2017. Liabilities shown are based on the cost of securing all accrued liabilities with bulk annuities. Working party analysis, charts and figures exclude public-sector schemes.

ILLUSTRATIONS: ISTOCK

Each scheme is in effect a mini insurer, but they were never intended to be run like insurance companies. They do not hold direct risk capital and the regulatory environment in which they operate is entirely different. Other than the largest schemes, the vast majority rely on outsourced services, whether that is member administration, actuarial or investment services. The schemes are run by trustees and, while there are knowledge requirements for trustees, expertise can vary considerably.

The huge number of smaller schemes is of note. For example, the 4,452 schemes with less than 1,000 members represent some 80% of the total by number but only about 10% by liability. One challenge is how these smaller schemes can be run-off effectively and efficiently.

Mature schemes are becoming the norm

The proportion of schemes still open to new members, as represented by the gold part of each bar in *Figure 2*, has diminished rapidly to 12%, for reasons covered in our paper. At 31 March 2017, of the 10.5 million members of DB pension schemes, only 1.3 million were active members earning benefits, the remainder being pensioners or deferred pensioners.

FIGURE 2: UK DB schemes by status

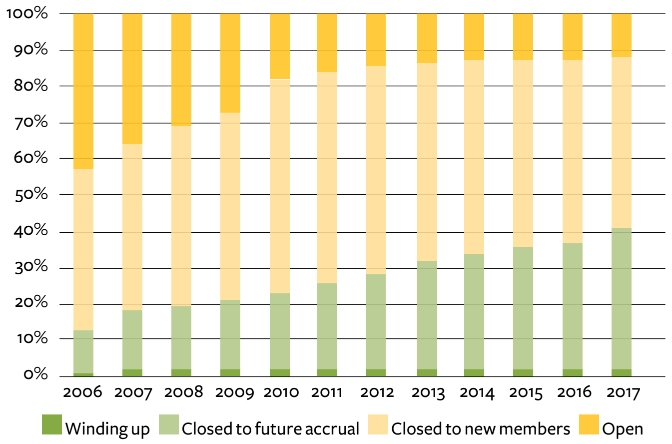


Chart source: PPF Purple Book 2017

Why does it matter that a scheme is mature?

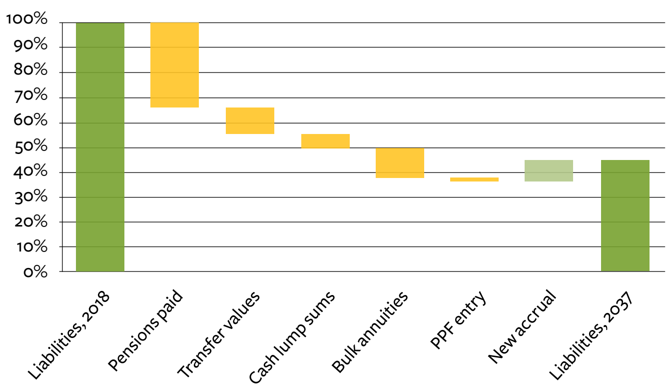
Mature schemes can face very different issues to immature schemes. They tend to be cashflow negative, making cashflow matching far more important in order to avoid the risk of having to sell in depressed market conditions to meet benefit outgoings.

At some point the scheme becomes a 'legacy arrangement' in the sponsor's eyes; a balance sheet liability to be managed away.

From the trustees' perspective, the mindset can change as the scheme becomes increasingly mature. They might take the view that they are the trustee board to lock down the risks and then steer the scheme to its long-term target, which for many schemes will be securing benefits with an insurer. Getting there won't happen overnight, but it may be a realistic prospect over a 15-year period, say.

The landscape will change significantly over the next 20 years. We project that the size of the DB scheme market will more than halve over the next 20 years, from £1,800bn* to £800bn in 2018 value terms; these are huge numbers (see *Figure 3*).

FIGURE 3: Projection of what happens to the same £1,800 billion of pension liabilities in 2018 over 2018-2037 (all amounts presented valued to start 2018)



Projections produced by the working party, using simplified assumptions. *£1,800bn figure is a proxy for best estimate and hence lower than bulk annuity cost shown in figure 1. Percentages based on projected monetary amounts in 2018 value terms.

A large part of that will be down to pension payments (£600bn) and retirement lump sums (£100bn), which will be recycled through the economy by pensioners. We projected £200bn of transfer values to individuals and £200bn of bulk annuity purchases. The projected £200bn of new pension accrual for active members won't do much to dent the massive outflow and maturing effect.

The white paper proposes commercial consolidation vehicles under which a corporate sponsor is no longer linked to the scheme and hence ceases being responsible for funding it. Commercial consolidation vehicles are not factored into the above projection – if they became a significant reality they might easily absorb a large proportion of scheme exposures.

There are great opportunities for organisations to offer advice and solutions to service the change. Some of those solutions exist today, but there will be scope for new ones to meet the evolving needs of schemes and their members.

A framework for mature scheme run-offs

The white paper emphasises the importance of having a clear long-term strategy for scheme run-off. As a working party we went further and recommended that all mature schemes would benefit from a detailed run-off plan and we hope that, as the industry absorbs the white paper, our recommendation is taken up. We've developed a suggested framework (see *Figure 4*):

- Be very clear about the vision.
- Then create a strategy which is based on three components:
  1. The detailed run-off plan.
  2. Ensuring that the employer, trustees, advisers, service providers and members have a common understanding of the objectives and the plan. Identify and manage conflicts and tensions.
  3. Be ready to take opportunities as they arise, so that the scheme can accelerate progress along the plan. This points towards having the right governance and management information in place.
- Detailed implementation of the strategy can then be formulated along the lines of the 12 key areas that the working party explored in its paper (see list in bottom box of *Figure 4*).

FIGURE 4: Framework for mature scheme run-offs

VISION

Meet member benefit expectations as far as possible, while avoiding a disproportionate impact on the sponsoring employer(s) business

STRATEGY

1.The run-off plan
2. Creating and maintaining a shared understanding
3. Taking opportunities

IMPLEMENTATION

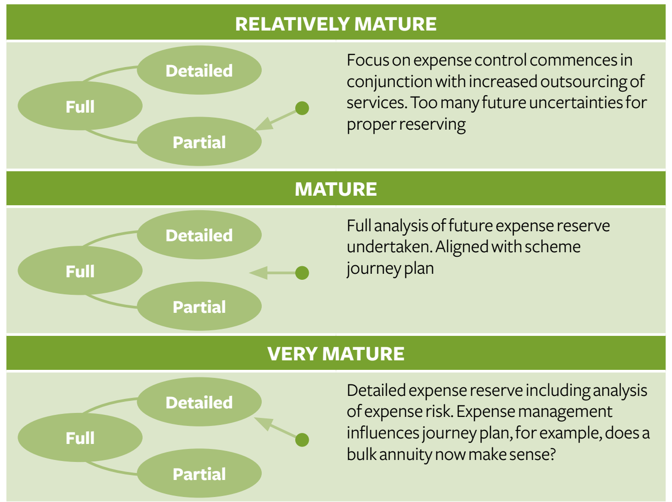
1. Pace of funding
2. Covenant (incl. separation)
3. Contingent assets
4. Liability management
5. Cashflow matching (incl. hedging)
6. Asset allocation
7. Outsourcing
8. Locking down the benefit liabilities
9. Bulk annuities
10. Journey plans
11. Employer relationship/governance
12. Expense management

This differs from integrated risk management, which focuses on getting asset and funding strategies right in light of the sponsor covenant. We propose that schemes go further and also consider other areas like operations and governance.

The formulation of a full plan means that pension schemes become a lot more deliberate in how they run-off and access products and solutions.

A scheme can rate itself against each of the twelve key areas and action accordingly. For example, in relation to expense management, our assessment of expected practice by maturity is illustrated in *Figure 5*.

FIGURE 5: Expected practice by maturity



If a scheme was very mature but its expense management approach aligned with that of a less mature scheme, the trustees could schedule suitable action to bring the scheme in line with what we would expect for that maturity. Or, alternatively, they could make a conscious decision as to why it is not appropriate. The white paper highlights that the DWP will work with The Pensions Regulator so as to enhance trustee and corporate sponsor awareness of their consolidation options – quantifying expected and potential development of scheme expenses is one piece of that analysis of options.

Recommendations

This is a huge topic and so we restricted ourselves to a small number of core recommendations and it is reassuring that a number coincide with the white paper:

WORKING PARTY	WHITE PAPER
Schemes should develop comprehensive run-off plans, mapping out their intended journey.	Focuses on schemes having a clear long-term strategy for running-off.
It would be advantageous for there to be a clear regulatory framework for separation of a scheme from a corporate sponsor, where the covenant is unlikely to support full benefit delivery. There are varying estimates of up to 1,000 schemes being in such a position.	The DWP will work closely with The Pensions Regulator, the Pension Protection Fund and industry to make improvements to the existing Regulated Apportionment Arrangements process. The DWP will consult on consolidation arrangements which allow corporate sponsors to break their link to a scheme.
Professional trustees should become the norm for mature schemes.	Schemes should have an earmarked chair of trustees who'll have some specified responsibilities. This doesn't go as far as the working party.
Schemes in run-off should start to consider reserving for expenses. This would ensure that thought is given to the steps (and associated costs) of running off and aide future trustee decision-making.	The existing Funding Code of Practice should be refined to set out how trustees should set funding objectives in the context of the long term. We would hope the expense reserving point is covered here.
There should be further analysis to support informed decisions on consolidation and scheme run-off strategies. Some of the stated advantages of the most complete forms of consolidation (e.g. superfunds) would diminish if the recommendations and other practices we highlight were adopted.	The DWP is developing proposals for a framework to enable consolidation in which an employer no longer sponsors a scheme. This will be put out for consultation.
Development of industry standard data and benefit structure formats. This would allow the vast majority of scheme benefits to be codified and would help with areas like benefit audits and bulk annuity purchases.	This was not picked up by the white paper. However, it discounted allowing wholesale simplification of benefit structures. Hence, given we now know historic benefit structures remain for the long haul, industry can take the initiative to develop standard data and benefit structure formats. This will also help support scheme consolidation initiatives (see above).

The assets held by both today's mature DB schemes, as well as the mature schemes of the future, are enormous. We hope our work focuses attention on the issues these schemes face and help result in improved outcomes.

The working party's paper, "Mature Pension Schemes – Onwards And Forwards", is close to completion and will be published on the IFoA website shortly. Our members comprise: Costas Yiasoumi (chair, Legal & General Assurance Society), Graham Wardle (Legal & General Investment Management), John McAleer (Aon), Mike Walsh (Legal & General Reinsurance), Nick Sparks (BMO Global Asset Management), Nigel Jones (2020 Trustees and Broadstone Corporate Benefits).