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What's been happening and what's on the Horizon in the world of pensions

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With the inexorable rise of Defined Contribution (DC) schemes and the continued closure of Defined Benefit (DB) schemes to new members and future accrual, suggestions that DB is dead are ever present. However, with funded DB schemes accounting for around 80% of UK pension assets, most of which are not going to buyout just yet, DB is very much alive and kicking. DB also provides the foundation for many millions of retirement outcomes. Given this, here we examine the current DB landscape and what it might look like three to five years from now.

The UK's Defined Benefit landscape

As the world's fourth largest funded pension system by assets, the UK is still very much defined by the relative size of its Defined Benefit (DB) assets. Despite the average split of pension assets for the world's top seven pension systems being 55% Defined Contribution (DC)/45% DB, for the UK the split has long been around 80/20 in favour of DB. Indeed, only Japan and the Netherlands have a greater concentration of DB assets.[1] Despite this, the number of private sector (corporate) and funded public sector DB schemes,[2] and the number of active members, are overshadowed by the UK's 26,990 DC schemes and their 16 million active members.[3] Additionally, the size distribution of funded DB schemes is much less skewed than DC: UK DB being characterised by a high concentration of mega schemes, a cluster of large schemes and a long tail of small schemes.[4]

The most recent data suggests that there are 5,131 corporate DB schemes, with assets of £1.67 trillion, of which 89% are closed to new members and 51% closed to the future accrual of benefits. Of these schemes' 9.65 million members, pensioners account for around 43%, deferred members 47%, and only 10% comprising active members.[5] Funded public sector DB schemes, numbering around 200, are dominated in terms of size of assets and membership numbers by the eight Local Government Pension Scheme (LGPS) pools - comprising 86 administering authorities - with collective assets of £342 billion,[6] and the mighty Universities Superannuation Scheme (USS), the UK's largest funded DB scheme at £88.9 billion.[7] Of the LGPS' 6.2 million members, there are around 2 million actives, 2.3 million who are deferred and 1.8 million pensioners,[8] while of the USS's 500,000 or so members, 212,000 are actives with 207,000 deferred and 81,000 pensioners.

[1] Global Pensions Assets Study 2023. Thinking Ahead Institute. 16 February 2023.
[2] Public sector DB is dominated by unfunded, or pay-as-you-go (PAYG), schemes for the uniformed services, health workers, civil service workers and teachers. Gross pensions in payment from these schemes are estimated to account for 2.1% of GDP per annum. See: Pensions in the national accounts, a fuller picture of the UK's funded and unfunded pension obligations: 2018. ONS. 8 February 2021. Also see: Public Service Pensions: facts and figures. Briefing paper number 8478. House of Commons Library. 11 May 2021. p.16.
[3] DC trust: scheme return data 2022 to 2023. The Pensions Regulator. Data as at 1 January 2023.
[4] By contrast, UK DC has a cluster of large master trusts (master trusts account for 23.7 million of the UK's 26.4 million DC memberships) and single sponsor trust-based DC schemes and a very long tail of micro schemes (fewer than 12 members) which, at 25,700 schemes, account for the bulk of the UK's 26,990 DC schemes. See: DC trust: scheme return data 2022 to 2023. The Pensions Regulator. Data as at 1 January 2023.
[5] The Purple Book 2022. Pension Protection Fund. December 2022.
[6] See: Scheme annual report 2021. LGPS Advisory Board – England and Wales. 13 June 2022. The eight LGPS pools comprise: Access, Border to Coast, Brunel Pensions Partnership, LGPS Central, Local Pensions Partnership Investment, London CIV, Northern LGPS Pool, Wales Pensions Partnership. The 31 March 2022 LGPS triennial valuation is due to be published by 31 March 2023. Early insights of the results are available at https://www.hymans.co.uk/insights/research-and-publications/publication/sixty-second-summary-2022-valuation-results-early-insights/
[7] Report and accounts for the year ended 31 March 2022. Universities Superannuation Scheme.
[8] Scheme annual report 2021. LGPS Advisory Board – England and Wales. 13 June 2022.

Is UK DB in rude health?

The health of funded DB, whether in general or at a scheme-specific level, has traditionally been measured by funding levels (or ratios) on a range of liability bases, some more prudent than others. In 2022, scheme funding ratios were principally determined by individual schemes' sensitivity to rising yields and inflation expectations - a theme magnified by the gilt market turmoil of last autumn, which ensued in the aftermath of the government's disastrous mini-budget of 23 September. Sparking the most violent mean reversion of yields ever seen and culminating in the most volatile period that both sides of DB scheme balance sheets have had to contend with since the global financial crisis (GFC) of 2008/09, the resulting diffusion of scheme funding ratios came into sharp focus.[9]

This sensitivity to violent moves in nominal yields, in particular, and to rising inflation expectations, hence also real yields, was determined by the level of each scheme's liability driven investment (LDI) hedge ratios. That is, the extent to which each had hedged its liabilities' exposure to long-run unrewarded interest rate and inflation risk.[10] This, in turn, determined whether a scheme's funding ratio materially improved or markedly deteriorated both in the run up to and, more notably, in the aftermath of this turbulent period. Typically, a scheme with a low hedge ratio, say one that hedged 50% or less of its liabilities against rates and inflation risk throughout the year, would have ended the year with a considerably higher funding level than it started with. That is, as gilt yields rose, the scheme's liabilities would have fallen by more than its assets. This would have been typical of a funded public sector DB scheme.[11] By contrast, a scheme targeting something close to a 100% of assets, or funding level, hedge - one that typifies many corporate DB schemes - would have, asset allocation notwithstanding, seen its assets fall at the same rate as its liabilities. After all, the majority of its liabilities would have been hedged. Moreover, the absolute value of the scheme deficit would have fallen.[12]

Interestingly, despite this dichotomy in outcomes, higher gilt yields and wider credit spreads meant the buyout deficit, the premium charged by an insurer to take on a scheme's assets and liabilities, of both these illustrative schemes, now with smaller asset portfolios and diminished liabilities, would have fallen quite considerably from the start of the year – albeit by a greater amount for the 50% hedged scheme. Moreover, continued market stability throughout January, has meant that both schemes would have exhibited small improvements in funding levels and buyout deficits.[13]

So, despite cries that DB is dead, funded DB remains in comparatively rude health. Not only that, with well over 16 million pensions to pay – some potentially stretching into 22nd century – for now at least it remains the cornerstone of a great many retirement outcomes.[14]

Where is the DB landscape prospectively heading?

So where is DB prospectively heading over the next three to five years? Well, in the main, there's likely to be continued evolution rather than revolution, with every prospect of there being declining numbers of corporate DB schemes, with little, if any, change to the number of funded public sector schemes.[15] Additionally, almost all private sector DB schemes will be closed to new members, with ever increasing numbers closed to future benefit accrual. Coupled with the inexorable march of asset gathering within DC, notably by master trusts, the DB/DC asset split will also likely start materially gravitating south of the current 80/20 split. Of course, there will be other contributory factors to the rationalisation of DB scheme numbers and assets under management in absolute and relative terms. DB actives and deferreds will increasingly become pensioners, as second wave baby boomers and early Generation Xers begin to take their benefits or opt to exercise freedom and choice by transferring their accumulated DB entitlements to DC. Additionally, those with smaller pots may take advantage of trivial commutation exercises.

There is also likely to be a considerable amount of corporate DB risk transfer activity, comprising buy-ins, longevity swaps and buyouts – the latter further denting scheme numbers and assets.

[9] To provide a context, at 31 March 2022, the aggregate proportion of corporate DB scheme assets invested in listed equities was 15.3%, of which 87.1% was invested in overseas equities, whereas 71.6% was invested in bonds. Of this, 22% was invested in nominal gilts, 47.8% in index-linked bonds and 30.2% in corporate bonds. See: PPF (December 2022). op.cit. By 28 September 2022, at the height of the gilt market turmoil, the MSCI All World Index (in USD terms) had fallen 25% year to date, while two representative gilts, employed within many LDI portfolios, the Treasury 4.25% 2046 and the Treasury 0.75% index-linked 2047, had respectively lost an eye watering 53% and 59%. In fact, the latter lost an unprecedented 50% of its value between 22 and 28 September. At the year end, the MSCI All World Index was down 19.8%, while the conventional gilt, whose yield had moved from 1.2% at the start of the year, to 5.15% on 28 September and then to 4% at the year end, had lost 42%. The index linked gilt, which moved from a real yield of -2.35% at the start of the year to +2.45% on 28 September, lost 43% over the year as a whole.

[10] For a fuller explanation of what LDI is, its raison d'etre and operation, please see: Pensions Watch, edition 17 at https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-issue-17/ . Also note that, by contrast, in 2008/09, LDI was in its infancy and hadn't been widely adopted.

[11] Given their strong covenants, positive cash flow (as a result of being open to new members) and no share price to protect against mark-to-market deficit accounting, public sector DB schemes typically have low, sub-50% of liabilities, hedge ratios.

[12] For example, take a DB scheme with £100 of liabilities, £80 of assets – both with a duration of 20 years (or a 20% sensitivity to a 1% change in yields) – and a funding ratio of 80%. If market yields rise by 1%, then for a 100% assets-level hedge, the funding ratio remains at 80% (liabilities at £80, assets at £64) but the deficit falls to £16. Please see: Pensions Watch, edition 17 at https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-issue-17/ However, it should be noted that the funding level of many DB schemes during the yield spike of autumn 2022 would have been impacted by a considerable number of other related factors and moving parts. These include: 1. The type of LDI mandate employed, i.e. whether a segregated, bespoke or multi-client pooled mandate; 2. The governance applied to that mandate, i.e. whether run by an in-house team with fully delegated powers, a FM/OCIO with or without full in-house operational access to the mandate, or an investment consultant acting in an advisory capacity; 3. The amount of leverage employed within the mandate relative to collateral headroom and 4. Whether the LDI manager sold hedges when gilt yields peaked/prices troughed, then re-establishing the positions as soon as there was adequate collateral to do so, i.e. when gilt yields had fallen substantially/prices had risen.

[13] Rising assets keep DB funds in surplus during January. Jonathan Stapleton. Professional Pensions. 6 February 2023.

[14] This comprises corporate DB schemes' 9.65 million members, LGPS' 6.2 million members and USS' 500,000 members. See: The Purple Book 2022. Pension Protection Fund. December 2022, Scheme annual report 2021. LGPS Advisory Board – England and Wales. 13 June 2022, and Report and accounts for the year ended 31 March 2022. Universities Superannuation Scheme.

[15] Though some housing associations who are part of LGPS but are now facing lower cessation (s75) debts may, in time, leave LGPS.

Indeed, the Broadstone Sirius buyout index has continued to show that on average corporate DB schemes have sufficient assets to buyout their pension promises with insurance companies, with a collective surplus on a buyout basis of £165 million.[16] Of course, at an individual scheme level the picture is much more diverse. Additionally, there are limits to the number and size of deals that can be accommodated. In fact, professional services firm PwC notes that, based on recent annual deal flow, it would take over 25 years to buyout the entirety of corporate DB.[17]

While all corporate DB schemes will eventually go to buyout,[18] on a three-to-five-year timeline the chances are that it will principally be those well-funded (larger, if not the very biggest) schemes with well sorted member data, clear benefit specification and appropriate asset allocations who, in targeting settlement as their long-term objective (LTO), will progress to buyout. Assuming, of course, sufficient market capacity exists.[19]

Meanwhile, those others targeting buyout, including the less well funded and/or not so well administratively prepared,[20] will progressively make and execute their buyout transition plans – while formulating an appropriate investment strategy in the interim. Progressively is the operative word here as, with higher yields leading to lower scheme liability values, some schemes can now afford to target lower levels of return by adopting a lower risk holding strategy ahead of buyout. Indeed, not all will want to run to buyout, especially if this entails assuming a level of investment risk unsupported by the sponsor covenant. Instead, to enhance the certainty and stability of the scheme's investment journey, many might prefer to walk - or perhaps take a purposeful stride - to buyout.[21] Some may even employ buy-ins for pensioner cohorts, and perhaps deferred members, along the way, assuming they have sufficient collateral assets, principally gilts, to exchange for an insurance-backed on-balance sheet annuity.

Not that buyout is the default for all of corporate DB. There will be those schemes who, in targeting self-sufficiency as their LTO, will transition from return seeking to low/no covenant dependency, low risk, life company-type portfolios, perhaps adopting, collateral-lite, longevity hedging in the interim.[22]

Moreover, those not yet going to buyout for a while and those for whom buyout isn't their LTO, may be well positioned (liquidity requirements notwithstanding) to keep hold of some or all of their illiquid assets, depending, of course, on what each contributes to the portfolio. Some may even add to their illiquids allocation. More on this shortly.

Meanwhile at the other end of the corporate DB health spectrum, we may see a greater number of weaker schemes transfer to DB consolidators, or superfunds, subject to market capacity and meeting the Pension Regulator's (TPR) superfund transaction gateway principles.[23] Even further along the spectrum, those schemes contending with failed covenants will, of course, continue to be subsumed within the Pension Protection Fund. Again, hopefully not too many surprises there, just more evolution. However, evolution could well morph into revolution if, with favourable legislative and regulatory tail winds - and the Royal Mail making a success of its transition from DB - Collective Defined Contribution (CDC), which is effectively DB without the expensive guarantees, starts substituting for DC, not least in becoming the default for other DB schemes closing to future accrual. You never know, it may even become a potential candidate for substituting for public sector funded DB, if a fundamental review of public sector pension benefits was to resurface.[24]

[16] See: Professional Pensions. 6 February 2023. op.cit.
[17] See: Professional Pensions. 6 February 2023. op.cit.
[18] Ultimately, all corporate DB schemes, regardless of long-term objective, will be too expensive and cumbersome to administer when their membership becomes a fraction of what it is today. There's also the visibility of an insurance company covenant.
[19] According to investment consultancy Aon, "These bigger deals will, of course, consume large portions of capital and assets at both insurers and reinsurers. But with increasing use of new sources of capacity, such as funded reinsurance and capital market money - and with potentially more flexibility within the Solvency II framework to come (relaxation of capital through amendments to insurers' risk margin requirements) - expect to see a greater volume of mega deals in 2023 and future years." The UK Risk Settlement Market. A Review of 2022 and looking ahead into 2023. Aon. 16 December 2022.
[20] The key barriers to transacting for most well-funded schemes comprise member data not being up to scratch, the benefits to be insured not being clearly specified, the scheme's asset allocation not being sufficiently liquid for the life assurer, or an asset transition plan not having been prepared, and trustees and sponsor views not being aligned.
[21] See: Navigating the key issues facing schemes in 2023. Pensions Management Institute, in association with Schroder Solutions. Third annual issue. February 2023. Additionally, two-thirds of the 130 DB trustees surveyed said their schemes will favour targeting a lower return objective for longer to reach their endgame. The scheme size and investment governance model breakdown of the 130 schemes surveyed can be found on p.23 of the report.
[22] That said, if reduced life expectancy assumptions result from excess deaths remaining persistently high, this may well lessen the appetite for longevity risk transfer. Accepting, of course, that member longevity is very scheme specific and is often the biggest contributor to a scheme's value at risk (VaR), once interest rate and inflation risks have been nailed down. However, as an aside, few schemes have yet to take their climate VaR into account, which could potentially overwhelm longevity VaR.
[23] See: https://www.thepensionsregulator.gov.uk/en/trustees/wind-up-or-transfer-your-scheme/db-superfunds/superfund-guidance-for-prospective-ceding-trustees-and-employers
[24] The last formal review of public sector pensions was conducted by Lord Hutton of Furness in 2010/11.
See: Independent Public Service Pensions Commission: Final Report. 10 March 2011.

So, is this the beginning of the end for DB?

Despite its increasing maturity, with prospectively reducing numbers and assets, funded DB will continue to play a central role in underpinning a considerable number of pension outcomes for some time yet. However, as a complex exercise in multi-faceted risk management, with an ever-expanding list of quantifiable and less quantifiable risk factors to address,[25] maintaining DB's rude health will continue to necessitate not only exceptional risk management, but also bigger operational and investment governance budgets.

First up, the evaluation and management of environmental, social and governance (ESG) risk factors. As it truly enters the mainstream and becomes embedded in all aspects of portfolio management, ESG will likely become front and centre of everything DB scheme fiduciaries do. Moreover, as the notion of retiring into a world worth living in gathers momentum, and the definition of fiduciary duty widens, the management of and opportunities pertaining to climate and social risks in particular, should gain greater prominence. For instance, as more schemes progress towards halving portfolio emissions by 2030, there will inevitably be a heavier regulatory burden entailing greater associated disclosures and scrutiny around fiduciaries' climate actions and the increased prominence of Paris-aligned portfolios - through a combination of backing climate leaders[26] and investing in climate solutions - perhaps resulting in the widespread adoption of low carbon benchmarks. Additionally, the ever-greater focus on social risk factors and social impact investment, particularly that which aligns with a just transition,[27] will undoubtedly be accompanied by schemes being required to disclose their impact objectives and the extent to which these are being met. LGPS is already instrumental in this process, with a number of funds heavily focused on advancing urban regeneration at a local level, particularly on levelling up projects that are also climate-friendly.

Then there is liability driven investment (LDI), which has been the pre-eminent DB risk management exercise post-GFC – albeit unseated by the events following the mini-budget of 23 September 2022. However, even in - indeed especially in - a higher yield and above-target inflation environment, nailing down long-term under rewarded, interest rate and inflation risks will remain a key risk management tool.[28] That said, from hereon this will be via evolving and increasingly inventive strategies with far less leverage[29] and more collateral headroom.[30] In fact, in whatever form it ultimately takes, LDI 2.0 will not only seek to employ those assets and methodologies that avoid being embroiled in systemic risk events, but will apply ever greater scrutiny to the ESG credentials of hedging instruments, strategies and counterparties - a process that has already started. This process might even result in LDI strategies employing an element of illiquid, non-collateralised, unleveraged, uncorrelated, duration assets, to maintain both hedge levels and expected returns and even advance sustainability and net zero objectives.

Moreover, this process will coincide with, and become complicated by, almost all corporate DB schemes becoming cash flow negative as sponsors switch off deficit repair contributions (DRCs) for those schemes with much improved funding ratios and pensioners become a rapidly increasing percentage of scheme memberships.[31] This could also affect some funded public sector DB schemes as well.[32] Consequently, cash generative strategies, with secure long-term implicit or explicit index-linked cash flows, and formalised cashflow driven investment (CDI) strategies, each with ever stronger ESG credentials, will become increasingly popular.

We should also see and in fact are already seeing an increase in the level and sophistication of tail risk hedging, if funding ratios are to be better protected against myriad known unknowns and those black swans that occur with ever greater regularity and equally unpredictable tipping points. This, in turn, will necessitate a greater use of scenario and stress testing. Indeed, it remains absolutely critical for pension fiduciaries to not only expect the unexpected but to be in the best possible position to identify and nimbly respond to any emerging black swan events lurking on the horizon.[33] Add in the need to keep a keen eye on the most important risk of all – covenant risk – and you have a highly governance-intensive set of risks to monitor, manage and occasionally mitigate.

There will also continue to be ever more data cleansing and remediation exercises to contend with. This will be the case even once guaranteed minimum pension equalisation has been consigned to the history books and the pensions dashboard is up and running as schemes prepare for and variously conduct liability management, longevity hedging and bulk annuity exercises. And, of course, there will be plenty of new legislation and regulation to become familiar and compliant with, not least The Pensions Regulator's (TRP) forthcoming new DB funding code of practice and single code of practice.

[25] See Pensions Watch edition 22 at https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-22/
[26] Climate leaders are not necessarily those that currently have low carbon footprints, indeed some are carbon heavy. However, as they are ultimately an integral part of the transition to net zero emissions, Paris-aligning portfolios in the short term isn't that simple.
[27] See: Pensions Watch edition 20 at https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-issue-20/
[28] It is noteworthy to mention that LDI is not only a means by which to stabilise funding levels (by hedging to 100% of assets) or deficits (by hedging to 100% of liabilities) but also to hedge insurer buyout pricing.
[29] Leverage is employed via gilt repo, or sale and repurchase agreements, and through interest rate, inflation and gilt total return swaps.
[30] On 30 November 2022, TPR issued comply or explain guidance on collateral headroom, following the lead of the regulatory authorities in Ireland and Luxembourg (where many LDI funds are domiciled). This requires collateral headroom (taking the convexity of the hedge into account) to be set at 300-400bps. This is considerably higher than the 150-200 bps levels typically seen pre-September 2022. See: Maintaining liability-driven investment resilience. The Pensions Regulator. 30 November 2022. This may coincide with a widening of acceptable collateral assets, which for many schemes currently only comprises gilts, with some also accepting investment grade corporate bonds.
[31] See Pensions Watch edition 23 at https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-issue-23/
[32] The 31 March 2022 LGPS triennial valuation, due by 31 March 2023, will set employer contribution levels for the financial years 2023/24, 2024/25 and 2025/26.
[33] See: Pensions Watch edition 22 at https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-22/

Plugging the governance gap

As noted, deploying this ever-expanding and evolving multi-faceted risk management, and to be in a position to nimbly respond to any emerging risks, will require a much greater level of operational and investment governance. After all, without good governance, the wheels can come off a pension scheme very quickly – a point not lost on TPR in drafting its single code of practice. Indeed, the code requires almost all schemes to have in place an effective system of governance (ESOG) and to rigorously conduct an own risk assessment (ORA).[34] Not only that, it is well established that employing an advanced level of investment governance can potentially add more than 1% per annum to long-run investment returns.[35]

Part of the solution lies in the more widespread appointment of independent trustees. Although more than half of DB schemes currently employ professional trustees, TPR makes no secret of its desire for all schemes to have at least one independent on the board. Indeed, it may well mandate this over the next three-to-five-years, assuming there are enough professional trustees to go round, which there currently aren't.[36] Equally, with many schemes becoming all too aware of the limits of their operational and investment governance, especially in the aftermath of the gilt yield spike of September 2022, it is perfectly conceivable that there will be a greater move to fiduciary management (FM), or Outsourced Chief Investment Officer (OCIO) mandates[37] – particularly to those FMs/OCIOs with full delegation over those capabilities with the biggest operational governance demands, such as LDI.

Additionally, with the increased policy focus on value of money, there is every possibility that something akin to the annual DC value for money/members (VFM) assessment and the recently announced VFM framework are applied to DB, likewise with a focus on enhancing levels of scheme governance.

Why does this matter?

As we approach the point of peak pension income, especially with potentially higher structural price inflation, and with DC very much in the ascendency and reliance on inadequate DC pots in retirement ever increasing, index-linked DB benefits will become ever more valuable. While considerably more prevalent in the public sector, DB benefits are still accruing within select pockets of the private sector, with deferred benefits significantly more widespread.

Of course, the DB pensions promise, or member security, is only as good as the sponsor covenant that underpins it and the integrated risk management applied to the covenant, funding and investment strategy and those myriad risks that impact each of these three pillars. Central to the efficacy of this risk management is employing an advanced level of operational and investment governance which, given the extraordinary demands on pension fiduciaries finite governance budgets, may see even more schemes delegating their day-to-day investment, risk and cashflow management to a FM or OCIO. Indeed, this potential trend is reinforced by the fact that most corporate DB schemes won't be going to buyout yet, while others will continue to target self-sufficiency.

In short, all of this illustrates that if DB is to continue to form the foundation of a comfortable, rather than just a modest, retirement for many millions of people for some time yet, it must evolve and adapt and be effectively managed to meet the challenges of the ever-changing ecosystem in which it operates. In all likelihood, it will.

[34] See: https://www.thepensionsregulator.gov.uk/en/document-library/consultations/new-code-of-practice
[35] See: Keith Ambachtsheer, Ronald Capelle, and Hubert Lum. Pension fund governance today: strengths, weaknesses and opportunities for improvement. Working paper submitted to the Financial Analysts Journal. October 2006. Also see: Gordon L. Clark and Roger Urwin. Best-Practice Investment Management: Lessons for Asset Owners From the Oxford-Watson Wyatt Project on Governance. September 2007.
[36] Of course, when considering the advice of their investment consultant, those independents with a background in asset and risk management should be the best prepared for this increasingly demanding aspect of scheme management.
[37] See: Pensions Watch edition 19 at https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-issue-19/

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