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INVESTMENT MANAGEMENT

Strategies for Winning the Endgame

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Capital at risk

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Executive summary

For decades, defined benefit (DB) pension scheme trustees and sponsors have strived to reach the Holy Grail of endgames – Buyout. The security that comes with transferring scheme liabilities to well-capitalised, strictly regulated insurance companies has resulted in this particular 'endgame option' being recognised as the 'Gold Standard' across the pensions industry.

In recent years, the pensions landscape has changed drastically. Particularly relevant has been the rise in gilt yields that was experienced over the past two years, which has significantly accelerated the time to reach buyout for many schemes. However, does being 100% funded on a buyout basis automatically mean that a scheme should complete a buyout of scheme liabilities? This paper aims to broaden the thinking around the pensions endgame, acknowledging that buyout is the Gold Standard, but simultaneously raising the question "is it the be-all and end-all?"

Key considerations for trustees and sponsors

- Despite the sizeable improvement in scheme funding positions across the UK DB pensions market, we expect many schemes will encounter difficulties securing benefits with an insurer due to capacity constraints across the market.

- Beyond this, we believe that a number critical developments will prompt trustees and sponsors to consider alternative endgame options. For example, the completion of the first two DB Superfund transactions has given proof of a concept to an idea that has been in development for years, and one that could help many schemes in difficult positions ensure that they deliver full member benefits by acting as a bridge to buyout.

- Furthermore, the development of legislation that focuses on expanding the way scheme surpluses can be used will be enticing to both trustees and sponsors alike, who may be interested in the prospect of enhancing member benefits, be that defined contribution or defined benefit members or extracting surplus after decades of deficit contributions.

- In December 2023 the Financial Reporting Council (FRC) published version 2.0 of Technical Actuarial Standard 300: Pensions (TAS 300), stating that "practitioners providing advice to trustees and employers, must consider credible alternatives to the potential transaction for the long term provision of members' benefits."

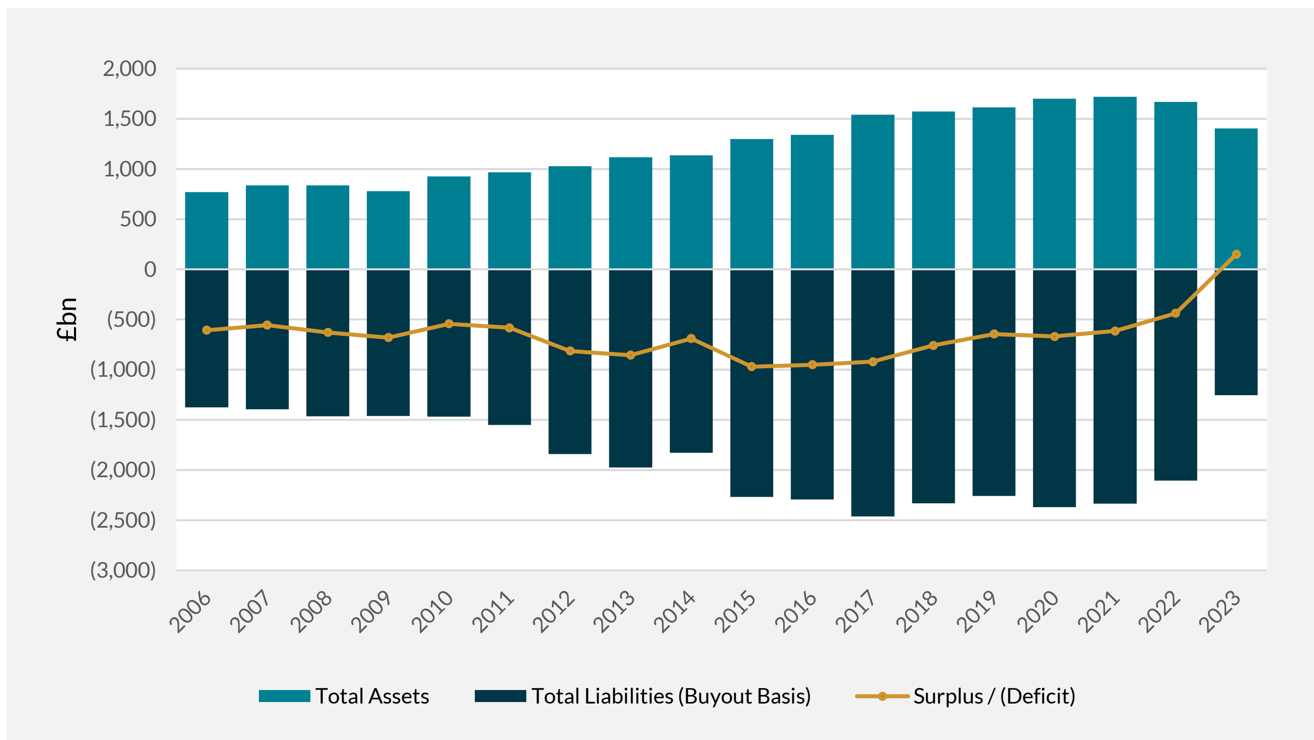
This paper discusses these considerations in greater detail, and highlights some of the potential benefits (and risks) that come with alternative endgame strategies such as Superfunds, Capital Backed Journey Plans (CBJPs) and scheme run-on.

Introduction

Over the past two years, the UK defined benefit pensions market has undergone significant structural changes – from the major changes in the design of the Liability Driven Investment (LDI) market, driven by the 2022 UK Gilts crisis, to various pensions policies outlined in the Chancellor of the Exchequer's Statements and the 2023 Mansion House speech. Amidst all of this, there has also been significant volatility across financial markets, with the most important (for the UK pensions market) being the sharp rise in gilt yields over the period.

This rise in yields has drastically improved the funding positions of many DB pension schemes. According to data from the Pension Protection Fund's (PPF) 2023 Purple Book, (The Purple Book 2023 – ppf.co.uk) the aggregate buyout funding level of the UK pensions market was roughly 112% as at 31 March 2023, equating to a surplus of c.£150 billion.

Chart 1: PPF aggregate buyout funding position estimate



Source: PPF Purple Book (2023 Edition)

This improvement in scheme funding positions has led to trustees, sponsors and advisers engaging in earlier conversations on potential endgame options for their schemes, with the landscape now including a number of options that aim to capture different segments of the pensions market. This paper explores these different options and aims to highlight some of the key considerations trustees and sponsors should keep in mind when thinking about the right endgame for their schemes.

Insurance buyout – the industry's 'gold standard' endgame option

Endgame planning is a key part of a DB pension scheme's journey, with trustees seeking the assistance of their advisers and support of their sponsoring employers to determine the most effective means of securing the long-term benefits of their schemes' members.

For over a decade, transferring a scheme's liabilities to an insurance provider (i.e. an insurance buyout) has been viewed as the 'gold standard' approach for securing members' benefits. This is largely due to the strict capital adequacy requirements that insurers are required to adhere to, requirements that aim to provide purchasers of insurance policies with a greater sense of security and maintain the stability of the market. However, the significant rise in gilt yields over recent years has resulted in a large fall in the value of DB pension scheme liabilities, which, on average, has resulted in a drastic shrinking of schemes' (buyout) funding deficits.

With significantly lower deficits, many schemes find themselves much closer to buyout. However, two crucial questions then arise:

1) Does the current insurance market possess sufficient capacity to handle this sudden spike in demand for bulk annuity policies?
2) With surpluses, and ongoing covenants, are insurers always the better option than running-on outside of the insurance regime in all cases?

According to a 2024 report published Hymans Robertson (Risk Transfer – Buy In, Buy Out, Longevity Swaps – Hymans Robertson) insurers have been bolstering their businesses through new hires and greater technological innovation to cater to this increased demand. However, we believe the sheer number of schemes looking to secure a buyout is likely to put a strain on the bulk annuity market for the next five years.

Furthermore, there has been some concern voiced by the UK's Prudential Regulation Authority (PRA) around the increased use of funded reinsurance and some of the potential risks this poses to the market. When annuity providers insure liability risk, they often repackage this risk to a range of reinsurers. The PRA have identified a structural shift in the global life insurance sector, with insurers increasingly making use of cross-border funded reinsurance arrangements. Newer counterparties are more focussed on returns, with investment in private markets and limited appetite for insurance risks.

Additionally, trustees and sponsors may also choose to not to buyout immediately to allow their schemes to mature and continue to build up surpluses, thereby making the prospect of buyout more affordable. We believe this together with the previously mentioned constraints will trigger trustees to consider alternative endgame options. Vehicles such as Superfunds offer trustees a cost-effective route to secure member benefits.

Superfunds[1]: Clara Pensions – bridging the gap to buyout

Clara Pensions ('Clara') is currently the only regulated DB Superfund in the UK. Clara offers an opportunity for trustees and sponsors to ensure that scheme members are paid their full benefits at retirement, without having to meet the relatively higher cost of securing scheme benefits with an insurer. Clara is then responsible for running the scheme and ensuring that members' benefits are paid as they fall due. Once the scheme is sufficiently mature and it is no longer practical to continue running the scheme, the liabilities and assets are transferred to an insurer, at which point the cost of securing a buyout would be much cheaper.

Clara would typically be considered as a viable endgame option for schemes that possess the following characteristics:

– **5–10 year time horizon to reaching buyout:** The Pensions Regulator (tPR) would typically recommend schemes that are within 5 years of reaching buyout to continue running on instead of transferring to a Superfund (tPR's second 'gateway principle').
– **Relatively weak employer covenant:** sponsoring employers with a weak covenant carry greater insolvency risk. In the event of the sponsoring employer becoming insolvent, the scheme would be required to wind up. In the event that the assets are still insufficient to secure a buyout following the addition of any capital following the completion of solvency proceedings, the scheme would enter the PPF and members would not receive their full benefits. Additional capital is posted as buffer assets to replace the sponsor covenant.

As Clara continues to grow and establish itself as a robust risk transfer vehicle, we expect to see a greater range in the types of schemes looking to use this vehicle. For example, trustees and sponsors of smaller schemes with relatively strong covenants might use Clara as a means of achieving the dual objective of benefiting from Clara's scale and also alleviating pressure on the corporate sponsor's balance sheet. This ability to provide the benefit of economies of scale is also consistent with the UK government's desire to have greater consolidation within the UK DB pensions market (i.e. having a smaller number of more efficiently run schemes).

We believe that this push towards greater consolidation of the pensions market will act as a tailwind for Superfunds such as Clara. Furthermore, the previously mentioned supply-demand constraints within the bulk annuity market will also encourage more schemes to consider alternative risk transfer options to buyout. That being said however, we also believe that there are certain schemes that might still consider other endgame options outside of Superfunds or buyouts (at least in the immediate term) and we will discuss these in the next section.

Superfund transactions completed to date

	Sears Retail Pension Scheme	Debenhams Pension Scheme
Size	£590m	£600m
Number of members	9,600	10,400
Additional capital injection	£33m	£34m
Type of transaction	Weak Employer covenant case	PPF+ assessment case
Member benefits	Member benefits met in full backed by capital injection	Member benefits restored to 100% with back payments made for period spent in the Pension Protection Fund

1 When discussing Superfunds within this paper, we are mainly referring to the Clara-Pensions Superfund, which is currently the only Superfund to have passed the Pension Regulator's (tPR) assessment.

Alternative capital-backed risk transfer options

Despite the significant improvement in scheme funding positions, there are still a number of schemes that find themselves falling short of being able to achieve a full insurance buyout. Trustees of schemes that fall into this category might therefore explore alternative risk transfer options such as Capital Backed Journey Plans (CBJPs).

CBJPs and Superfunds help schemes meet their long-term funding objectives (e.g. reaching buyout, or effectively running on to maturity) by providing third party capital that is used to protect against any adverse funding experience (thereby mitigating sponsor covenant risk). Although both risk transfer approaches are similar in that they utilise third party capital to support scheme funding, there are a number of differences, such as governance terms, regulation and overall structure. The table below outlines some of these differences:

	CBJPS	Superfunds*
Time-horizon (before aiming for buyout)	10+ years	5-10 years
Regulation	None (Although tPR** may consider oversight if further deals are transacted)	tPR** Legislation
Link to sponsor retained	Yes	No
Trustee board retained	Yes	No
Typical sponsor covenant	Likely to be Weak / tending to weak	Weak / tending to weak
Provision of external capital	External capital provider injects capital at outset to support additional investment risk. Capital can be provided either directly or via an alternative means, e.g. a surety bond	Clara provide a capital injection at outset (has been in the range of 5-10% of liabilities for deals written to date) to act as a buffer in case of adverse funding experience
Investment return target (gross of fees)	Gilts + 5% to 7% p.a. (gross)	Gilts + 1.5% to 2.5% p.a. (gross)
Investment risk***	No explicit risk target, but is considered over the entire investment period	Less than 1% chance of funding level being below 100% in 5 years

*We have used Clara, which is currently the only Superfund to have passed tPR assessment, to illustrate the characteristics of a Superfund in this paper
**The Pension's Regulator
*** For Superfunds, this is the TPR requirement for the test of funding when agreeing the buffer amount

A key difference between CBJPs and Superfunds is the structure of the risk transfer vehicle. The decision to use a CBJP is often viewed as an investment decision. Third party capital providers work directly with trustees and their advisers to set a new, typically more aggressive, investment strategy that aligns with their goal of helping the scheme reach full funding on the agreed long-term funding basis, whilst simultaneously generating a profit for the external capital provider. In the case of a CBJP, the link to the sponsoring employer remains intact and the sponsor is not usually required to inject any further capital into the scheme.

The trustees also retain their stewardship responsibilities over the scheme's assets. We would note, we understand only one capital backed journey plan transaction has been completed to date, in 2020 ('First of its kind' capital-backed journey plan transaction completed by UK scheme – Pensions Age Magazine). With Superfunds, sponsoring employers are required to provide additional capital alongside the capital provided by external investors. However, upon completion of the transaction, the links between the scheme, the sponsoring employer and trustees are severed.

Trustees and sponsors will need to be aware of these differences when deciding which capital-backed risk transfer approach is better for their scheme, making sure that they are well-informed of the various risks and operational considerations associated with each of them. Of note is the less stringent regulation of CBJP providers – although CBJPs may come with a

slightly lower operational burden and cost than a Superfund, trustees and sponsors might obtain greater comfort from the stricter capital adequacy and broader regulatory requirements that Superfunds comply with under the tPR.

Does full funding mean you have reached the end?

We previously discussed how the large rise in yields has led to more schemes now being able to afford an insurance buyout. We also noted the capacity constraints that have arisen within the bulk annuity market as a result of this greater demand. Due to this occurrence, there are likely a number of schemes that are fully funded on a buyout basis, but are still finding it difficult to obtain a buyout quote. Schemes that find themselves in this position might consider running on, by maintaining a suitable level of risk, but generating a return that will build up a funding surplus within the scheme.

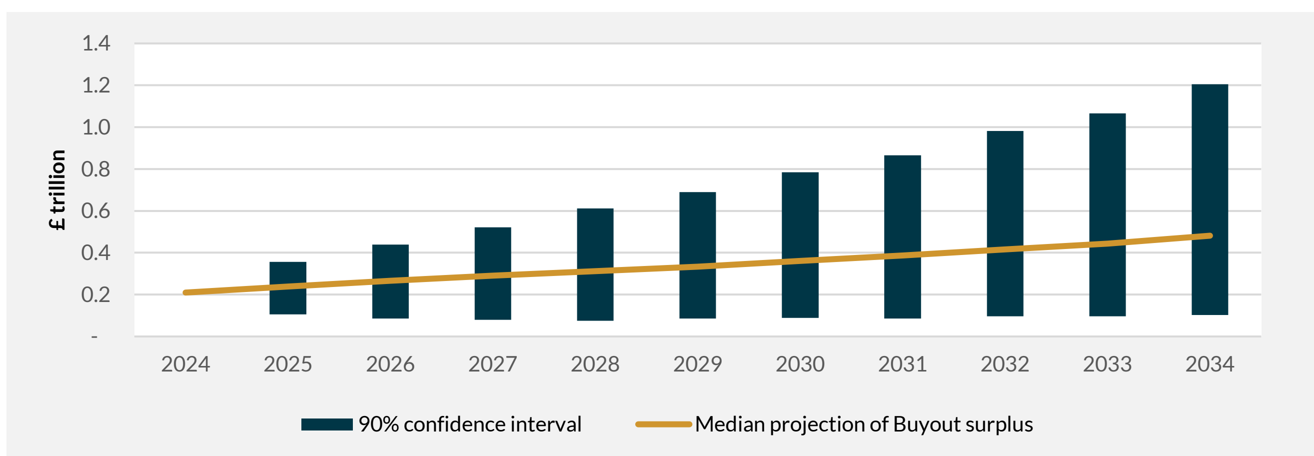
When preparing for a buyout transaction, trustees will typically transition their scheme's investment strategy to a portfolio comprising gilts and investment grade credit matching their specific circumstances. A primary purpose of this exercise is to invest schemes' assets in a portfolio that closely matches insurance pricing, thereby mitigating the risk of the insurance price 'moving away' from the scheme.

In the event that schemes choose not to target buyout and continue running on, they can remain invested in return-seeking growth assets. This approach has the following potential benefits:

- **Buyout cost saving:** by choosing to run on, trustees and sponsors can avoid having to incur the various costs associated with a buyout transaction, e.g. the sponsoring employer making up any shortfall between the scheme assets and buyout price and trustees not having to incur the numerous advisory costs (legal, actuarial and investment advice). This of course must be measured against the ongoing cost of running the scheme, as the trustees will be responsible for obtaining the necessary administrative, actuarial, legal and investment support required to ensure that their schemes are run as effectively as possible.
- **Ability to generate surplus:** retaining exposure to return-seeking growth assets enables schemes' portfolios to potentially deliver greater long-term returns and, in turn, generate surpluses.
- **Greater scope to invest in 'productive assets':** instead of solely investing in gilts and credit, schemes would be able to continue allocating to more productive, long-terms assets such as infrastructure and farmland. Pension schemes have the ability to help drive long-term impact by continuing to invest in assets such as infrastructure, which will play a key role in the transition towards a greener society.

The second bullet point around surplus generation has been one that has been discussed quite heavily across the industry and one that we believe will continue to attract a lot of attention going forward given the significant impact a surplus can have on enhanced member benefits, sponsoring employers and the broader UK economy as a whole. How this surplus might evolve under a number of different scenarios is showcased below.

Chart 2: Evolution of UK DB Pensions (Buyout) Surplus[2]



Source: VLK, Moody's Analytics

2 Assumed an investment return of Gilts+1.5% p.a. Modelling is hypothetical and illustrative, based on a number of assumptions regarding financial markets and relationships between them. A model is necessarily a simplified representation of the real world, with simplifying assumptions made in order to be usable

The chart above shows the distribution of potential outcomes, focusing specifically on the evolution of the buyout surplus. We've assumed that, on average, schemes will adopt relatively conservative investment strategies (i.e. not take on an excessive amount of investment risk), given the overall improvement in funding positions. In the (median) base case, which is shown by the solid yellow line, we believe there is an opportunity to generate a surplus of around £0.5 trillion over the next 10 years, and in an extremely optimistic scenario (shown by the top of the blue bar on the right) up to £1.2 trillion over 10 years. The key takeaway here is that there is great potential to generate a large amount of surplus within the UK DB pensions market, even after allowing for a continuation in the significant buyout activity of £50 billion per year. This opportunity is overwhelmingly anchored by larger schemes (£500m+).

This dilemma of looking to continue generating surplus whilst effectively managing the risk of a deterioration in schemes' funding positions is one that many participants in the industry now increasingly find themselves trying to address. In light of this, there are a number of interesting run-on solutions that aim to allow schemes to keep some investment risk on the table whilst managing funding risk through the use of different guarantee mechanisms to protect the Scheme from funding level shocks or covenant default.

Solutions such as these come with some extra complexity but will likely be well-suited to large schemes with more sophisticated governance frameworks and strong sponsor covenants.

Potential benefits of generating a surplus

DB Members	Sponsor	DC	DC
Top-up inflation proofing for DB members Improved life insurance and medical benefits Inflation protection	Increased cashflow from lower DB contributions Increased cashflow from lower DC contributions Overall increase in shareholder value	Additional contributions for DC members to address intra-generational issues Ability to target certain member groups	Worse-off members looked after Impact investing Support Mansion House reforms

Facilitating other forms of running-on: Asset-led discounting and dynamic discount rates

Asset-led discounting is an alternative approach to deriving a pension scheme's discount rate, which is typically set as the yield on fixed interest gilts at the valuation date plus some margin that is set in accordance with the level of investment risk (i.e. the riskier the investment strategy, the greater the margin and vice versa). Under the asset-led discount rate approach, the discount rate is usually set as the best-estimate long-term expected return of the investment strategy backing the scheme's liabilities, with a 'haircut' for prudence.

The aim of this discounting approach is to reduce the funding level volatility by valuing the liabilities using a discount rate that reflects the long-term expected returns of the assets. This in turn allows schemes to continue investing in a broader range of assets whilst managing the risk of a severe divergence in the value of the assets and the liabilities over the long-term.

When considering adopting an asset-led discounting approach, trustees should keep in mind the following potential benefits and drawbacks:

Benefits

- More stable liability value between actuarial valuations.
- Less constraints on the assets (and returns) that can be generated.
- Investments made on fundamental 'investment-worthiness' of assets rather than investing in assets that solely aim to match the movement in liabilities.
- Potential to generate greater scheme surplus over the long-term.

Drawbacks

- Introduces an extra layer of complexity – for example, calculating and agreeing on the discount rate, transfer values, etc.
- Not widely used in the pensions market and actuarial models are often calibrated to gilts (though there are a number of precedents).
- Likely to result in 'riskier' investment strategies.
- If expected returns are not realised, the scheme can incur large deficits.
- Any shortfall ultimately needs to be covered by the sponsoring employer, who must be able to tolerate the potential for large contributions in 'bad' scenarios.

This concept of asset-led discounting would be well suited for schemes which choose to run on.

Conclusion

The industry finds itself in unique situation which very few would have predicted at the height of the COVID pandemic in 2020. We estimate the surplus as at February 2024 (on a proxy buyout basis) to be in the region of £210bn. Even allowing for a blockbuster decade of buyout activity at £50bn p.a., aggregate surpluses could reach half a trillion pounds across the industry over the next 10 years.

The endgame decision is therefore hugely important and has wide-ranging implications for different stakeholders across the pensions market. This decision will affect the way in which pension assets are invested over the long-term, which will have significant implications for broader society as a whole given the sheer size of the UK pensions market. As such, it is extremely important that trustees, sponsors and advisers alike think deeply about where their schemes are going and how they are going to get there.

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Appendix

Endgame options explained

	BUYOUT	SUPERFUNDS	CBJPS	RUN-ON
How does it work?	Pension scheme liabilities are fully insured by insurance company. Scheme pays insurer single lump sum premium at outset in exchange for transferring liabilities to insurer.	Similar to a buyout, schemes transfer liabilities to the Superfund, but would typically pay a lower premium, together with a capital buffer as cover for sponsor covenant replacement. The current single UK Superfund, Clara, operates a "bridge to buyout" model, where Clara runs the schemes for 5 – 10 years before transferring liabilities to an insurer.	An injection of capital is provided by an external third party to support greater investment risk, which is required to close the buyout deficit and thereby accelerate the journey to buyout.	Schemes continue to take investment risk. Schemes may also choose to use various run-on solutions that allow them to generate surplus over the long term whilst managing funding risk through the use of guarantee mechanisms.
Type of schemes that typically consider this	Well-funded schemes with a sponsor who is looking to transfer the scheme's liabilities off of it's balance sheet.	Relatively well-funded schemes with weak sponsor covenants	Schemes looking to expedite their journeys to buyout and with sufficient capacity to accommodate greater (capital-backed) investment risk.	Usually larger schemes with relatively strong sponsor covenants and an appetite to retain investment risk in order to generate surplus. Schemes typically won't be looking to buyout in the near-term.
Size of schemes that typically consider this	Any size	Potentially any size	Potentially any size	Typically larger schemes (£300m+)
Typical required (buyout) funding level	100%	c.80%+	80% - 90%	95%+
Link to sponsor retained?	No	No	Yes	Yes
Link to trustees retained?	No	No	Yes	Yes

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The usefulness of the models in this analysis or others should therefore be considered in the context of the limitations of any model, particularly with respect to key aspects including but not limited to: i) the amount of weight that should be given to recent levels of market volatility compared to long term historic averages, ii) should future volatility levels be determined by the markets, through observation of derivative prices, iii) past performance should not be a guide, and iv) should the expectation of default risk and recovery rates for debt instruments be based on past data.

Output from any model will vary based on the approach taken around these key assumptions and others. Any modelling assumptions may prove to be incorrect and actual results will differ from the results of the model. The results between different models will also differ, potentially substantially, from that shown in our analysis. As such, recommendations, decisions and advice based on modelling by their nature contain associated (model) risks. We do not make any claims to accuracy and we acknowledge that there are a wide range of alternative underlying assumptions that may be just as valid as those we use. Any modelling assumptions (and the resulting analyses and forecasts) may require modification as additional information becomes available and as economic and market developments warrant. Nothing contained herein may be relied upon as a guarantee, promise, assurance or a representation as to the future.

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