Commentary
Liability-Driven Investing

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Demystifying the DB End Game

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Plug the words 'defined benefit end game' into Google and you'll be faced with a multitude of results featuring links to articles covering a range of topics including 'pension solutions', 'DB consolidation', 'Pensions Superfunds', 'buy-out' and 'buy-in'.

This complex array reflects the increasing desire of trustees and corporate sponsors to explore ways of closing down the risks of DB pension schemes. Drivers include increasing regulatory pressure, for example with The Pensions Regulator's proposed new approach to scheme funding. Financial markets are also challenging, with low interest rates and high levels of volatility sparked by the COVID-19 pandemic. In the very short term, funding levels have deteriorated and the 'end game' may have been pushed off, but the market turmoil will underline the need for scheme sponsors to find a sustainable solution.

This paper examines the different routes available and offers some thoughts on what might work for schemes facing different circumstances:

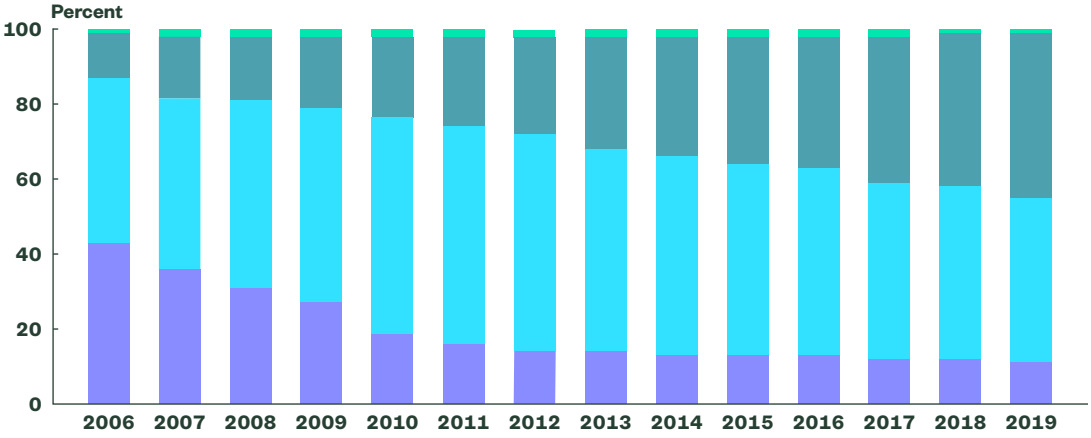
- In **Heading for the Exit** we look at the various flavours of 'exit' options open to schemes, offering our thoughts on the advantages and disadvantages of each.
- In **Working the Assets Harder** we consider how the key risks can be managed efficiently with a view to achieving the different exit options.

UK Defined Benefit Market

DB schemes have been diminishing — whether by consolidation or going into the PPF — with the number of scheme numbers falling by around 25% in the past decade. But their demise is over-egged as there are still around 5,400 pension schemes in the UK. Of these, 44% are closed to new members and benefit accrual, and only 11% are open to new members (with 1% in the process of being wound up).

As Figure 1 shows, there has been a consistent trend of scheme closures since the early 2000s, with the number of active members declining from 3.6 million in 2006 to 1.1 million in 2019. Total assets invested on behalf of UK DB schemes total around £1.7 trillion, while the estimated liability of those schemes is around £1.9 trillion.[1]

Figure 1
Trend Towards UK Defined Benefit Scheme Closures



Source: PPF Purple Book 2019, data as at 31 March 2019.

Heading for the Exit

So, what does the DB end game look like? For some schemes, it will be a case of a long-term run-off with support from the corporate sponsor, and there are a range of options available to help in that journey. For other scheme sponsors, the desire will be for a clean break, passing on the assets and liabilities of the scheme and allowing management to focus on running the company.

According to Aon's Global Pensions Risk Survey 2019, buy-out and self-sufficiency are the most popular long-term solutions so we have outlined more details here.

Figure 2
Which Endgame?

Source: Aon Global Pension Risk Survey, data as at 31 October 2019.

Self-Sufficiency

To reach self-sufficiency in general means that a scheme can run until its last member has died without a need for further contributions from the sponsoring employer. This can mean that once the scheme has reached a suitable funding level that it runs a low-risk investment strategy with a focus on regular cash flow requirements.

On the journey to self-sufficiency, schemes can have more flexibility in their asset allocation as they don't have to worry about long lock-up periods, provided the future cash-flows or upside can be quantified. Some may also consider longevity swaps to manage longevity risk, otherwise the risk remains with the scheme and may undermine the self-sufficiency.

Buy-Out

Buy-out has traditionally been the key method of removing the ongoing governance, risk and administration of DB pension schemes from the sponsoring employer. Individual scheme members become policy-holders of the insurance company and receive pension benefits from that organisation.

Due to scale, investment efficiency and regulatory oversight, insurance companies are well placed to manage the process on an on-going basis. The buy-out market has been running at around £10bn a year and 2019 was a record year with over £40bn transacted. However, when faced with a £2 trillion pool of liability, the buy-out market is unlikely to be able to meet the demand that exists.

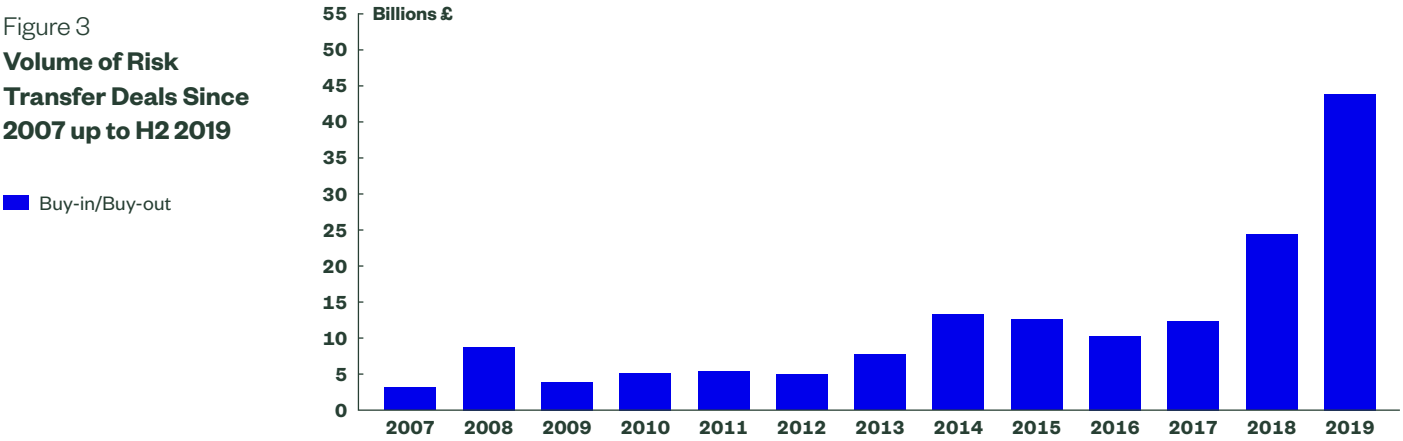
The market is being fueled by deals for multi-billion schemes, meaning transactions are lumpy and smaller schemes may not attract so much interest from insurers. From an investment perspective, schemes with this as an endgame need to make sure their investment strategy is consistent with their end game approach, including avoiding locking up assets for time frames longer than their planned buyout.

Buy-In

In a buy-in, the scheme buys a bulk annuity contract in respect of individual members which guarantees those pensions for the rest of their lives (and any death benefits, such as dependants' pensions). The contract becomes an asset of the scheme and the scheme receives the pension payments to distribute to the member. As such, the buy-in can be considered an asset that hedges the liability risk — including longevity risk — of those covered.

A full buy-in will provide cover for all of the scheme's liabilities and be the sole asset of the scheme. A partial buy-in will only cover some of the liabilities. The trustees will only be able to change the allocation of assets excluding the buy-in policy, which may create a challenge in working the assets hard enough to meet the remaining liabilities.

Figure 3
Volume of Risk Transfer Deals Since 2007 up to H2 2019



Source: Hymans Robertson, 2019.

DB Master Trusts

Although fast becoming the vehicle of choice for defined contribution schemes, master trusts have not been as significant in the DB market. As regulators encourage debate around consolidation — particularly for small schemes — it will be interesting to see if the DB master trusts option develops further. The key benefit of DB master trusts lies in economies of scale: as smaller schemes aggregate assets, the collective buying power can reduce the fees of investment management and administration.

In addition, the governance oversight provided by the master trusts should provide members with greater comfort about the efficient management and operations of the pensions arrangements. Whilst the investment options open for individuals schemes to utilise will be constrained by what the master trusts offers, this has to be balanced with the additional governance support.

There is no risk transfer — the scheme remains liable and the membership remain exposed to the covenant of the employer.

DB Consolidators

Non-insured DB consolidators are a relatively new concept and the market is not yet active. To date, two organisations have been founded to offer consolidation options to the DB market: the Pension SuperFund and Clara-Pensions. There is not yet a clear regulatory framework for these vehicles, which may make trustees wary of transacting.

The objective of the *Pension SuperFund* is to improve the probability of benefits being paid in full via:

- The injection of additional funds from the employer or its parent group
- The capital buffer provided by the Superfund's investors
- The efficiencies of scale offered by a consolidation vehicle
- The absence of potential future sponsoring employer insolvency

If a scheme chose to use the SuperFund, all assets and liabilities would be transferred, with the covenant of the sponsor replaced by a capital buffer (15% of the assets of the scheme — 10% from external investors; 5% from ceding employers). Unlike Clara-Pensions (see below), the SuperFund operates as a run-off vehicle, providing and administering pension payments for the duration of the pension scheme's liabilities. In addition to full pension payments, there is also the potential for upside to the member — each year 1/3 of any improvement in the funding is paid to the SuperFund Trustee who can provide this as a bonus or build a reserve for future use.

Clara-Pensions to a large extent operates on a similar basis to the Pension SuperFund — there is a transfer of assets and liabilities and the sponsoring employer will provide a cash injection which, alongside investors' capital, will form a buffer to replace the covenant. Unlike the Pension SuperFund, however, Clara-Pensions operates each pension scheme as an individual section, managing them separately with a view to getting the funding to a level where a bulk annuity purchase can take place with an insurance company.

Fiduciary Management

Whether the scheme is on a journey to one of the consolidation options, or aiming for self-sufficiency, the trustees may wish to improve the effectiveness of investment decision making. Fiduciary management involves delegating the design and implementation of the investment strategy to a specialist — usually an asset manager or consultancy — with the aim of harnessing greater investment expertise and more nimble decision making and implementation. The recent market turmoil as a result of the COVID-19 pandemic is a good case study for the potential need for timely reaction to changing circumstances.

Sole Trustee

For pension schemes where governance is the key concern, changing the trustee arrangements may be a preferable solution to risk transfer. This option replaces the trustee board with a single trustee — usually a corporate entity — to oversee the ongoing management of the scheme. Although the focus is on improved governance, greater efficiency can lead to improved cost control and provides schemes access to a depth of experience in pensions that may not be achievable with traditional trustee models.

So, Which Model for Your Scheme?

The table below summarises the main end game options and approaches that can be used on the journey and what they mean for sponsors and members.

The choice for each scheme will depend on multiple factors, such as the maturity of the scheme, the strength of the sponsoring company's covenant and funding level. Well-funded schemes will have the choice of the full range of options. Those with weaker funding may need to focus on the investment efficiency and governance improvements in order to get to the point where the end game options are feasible.

In the second section of this paper, **Working the Assets Harder**, we set out some thoughts on what are the key risks, what trustees can do to manage these within existing arrangements and what longer-term solutions may be appropriate for consideration.

Figure 4
End Game Options

	Option	What Does It Mean for the Sponsor?	What Does It Mean for the Member?	Is It the 'Endgame'?
Insurance	**Buy-Out**	The liability is transferred, together with the assets to purchase the buy-out.	The risk of non-payment moves from the corporate sponsor to the insurance company providing the contract.	Yes, for the sponsoring employer and the scheme — which will be wound up. Pensions payments made by the insurance company.
	Buy-In	Certainty of benefit payments for those members bought in. Continued liability for those members not bought in.	From the member's perspective there is little difference — the ultimate risk of payment remains with the scheme.	No, although the cashflows for the members under the buy-in are secured, the scheme continues. Investment flexibility or remaining assets constrained.
Consolidation	**DB Mastertrust**	No risk transfer. Economies of scale. Cheaper administration.	Additional governance oversight. Economies of scale should lead to improved probability of payment.	No, the scheme continues albeit in a different form.
	DB Consolidators	Effective risk transfer.	Capital buffer should improve probability of pensions payments. **Pension SuperFund** Payments made in run-off by the SuperFund. **Clara** Transfer to insurance company once at buy-out level.	Yes, for the sponsor. Some concern that regulatory framework is yet to be settled.
Increased Outsourcing	**Fiduciary Management**	No risk transfer. Economies of scale. Access to investment opportunities otherwise out of scope.	Potential improvement in governance could lead to improved probability of payments.	No, simply a change in the oversight arrangements.
	Sole Trustee	Removes need for company and member nominated trustees. Quicker decision making. Professional oversight.	Potential improvement in governance could lead to improved probability of payments.	No, simply a change in the oversight arrangements.
The Very Last Resort	**Pension Protection Fund**	PPF is to protect schemes of insolvent employers.	Pension payments capped.	Potential that PPF tries to pursue the scheme sponsor or related parties for additional assets.

Working the Assets Harder

Given the desire of schemes to reach their long-term objective, whether it is self-sufficiency, buy-out or one of the newer consolidation alternatives, there is a need to assess their investments with this long-term lens. To recap, the key risk for a scheme is a mismatch between their assets and liabilities. Looking at the liability side, it is driven by changes in interest rates, inflation and longevity risks.

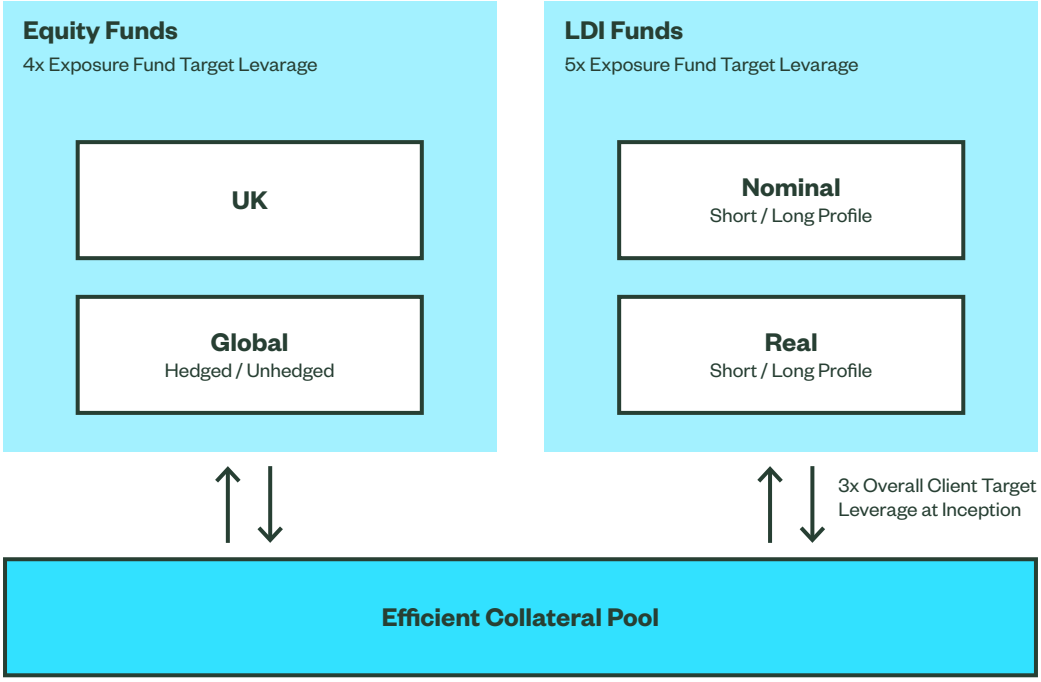
Since so many schemes have the double whammy of being in deficit and (now or soon to be) cashflow negative, they need to maintain the delicate balance between liquidity and generating returns in a low return environment.

Sweating Your Traditional Assets

Large schemes have historically taken an approach of using leverage in their traditional asset classes, freeing up assets to invest in more illiquid or higher-yielding solutions. In those large schemes they make the most efficient use of their assets by using segregated accounts with a single pool of cash to cover collateral calls. Recent times have seen development of solutions for smaller schemes which allow them to be more flexible and efficient.

Our Target Leverage Fund range provides a pooled solution which allows schemes to use leverage in their equity and LDI assets and free up cash to invest in alternative strategies. The pooled fund approach with both equities and bonds sharing collateral means that the schemes should have a smaller number of collateral calls and therefore can plan their cashflow needs better.

Figure 5
Target Leverage Funds



Source: State Street Global Advisors, data as at 31 March 2020.

Cashflow Driven Investment

Cashflow driven investment, or CDI, is investing with an awareness and focus on the liabilities and payments to pensioners. Our view is that the best way to do this is matching short to medium-term cashflows where there is more certainty. Given schemes' long-term targets and circumstances may change, focusing on the foreseeable future minimises risk and produces cashflows to smooth distribution schedules. Our view is that the characteristics of a robust CDI approach are:

1. Buy and maintain credit portfolio, with systematic and transparent screening of credit quality.
2. Global universe to create the widest opportunity set, currency hedged as required.
3. Incorporating ESG screens to further increase sustainability of cash flows.

We expect CDI approaches to see increasing take up as more and more schemes become cashflow negative.

Conclusion

Schemes need to maintain their focus on their long-term funding objectives and plan accordingly. Risk management is critical to ensure that the assets are considered in light of the liabilities. Schemes will need to continually revisit their thinking as their long-term options increase. While fiduciary management was a new concept a few years ago with £10bn in assets, it is now increasingly mature with £150bn and growing. Consolidation may be right for some schemes whether through master trusts or super funds but these are still in their nascent phase so time will tell how successful the model is. Improving the funding level of schemes remains paramount in any scenario so making sure the assets work efficiently and smoothing the path to the end game are key.

Endnotes

1 PPF 7800 Index, April 2020.

About State Street Global Advisors

For four decades, State Street Global Advisors has served the world's governments, institutions and financial advisors. With a rigorous, risk-aware approach built on research, analysis and market-tested experience, we build from a breadth of active and index strategies to create cost-effective solutions. As stewards, we help portfolio companies see that what is fair for people and sustainable for the planet can deliver long-term performance. And, as pioneers in index, ETF, and ESG investing, we are always inventing new ways to invest. As a result, we have become the world's third-largest asset manager with US $2.69 trillion* under our care.

* AUM reflects approximately $50.01 billion USD (as of March 31, 2020), with respect to which State Street Global Advisors Funds Distributors, LLC (SSGA FD) serves as marketing agent; SSGA FD and State Street Global Advisors are affiliated.