



Risk Management Insights

DB Scheme Funding

Where do we go from here?

Good risk management by trustees and sponsors of defined benefit (DB) pension schemes is becoming increasingly important as those schemes mature. The Pensions Regulator (TPR) has also emphasised this, in particular since its guidance on Integrated Risk Management was released in December 2015.

Our recent in-depth survey of the approach taken by trustees to risk management suggested that trustees are engaged with TPR guidance, but are still getting to grips with exactly how to implement it in practice. We set out our thoughts on the state of the DB pension scheme universe, some of the key challenges that schemes face and how good risk management can help meet those challenges.

The state of the DB universe

The introduction of the Scheme Funding regime in 2006 coincided with the start of a challenging financial environment for pension scheme funding.

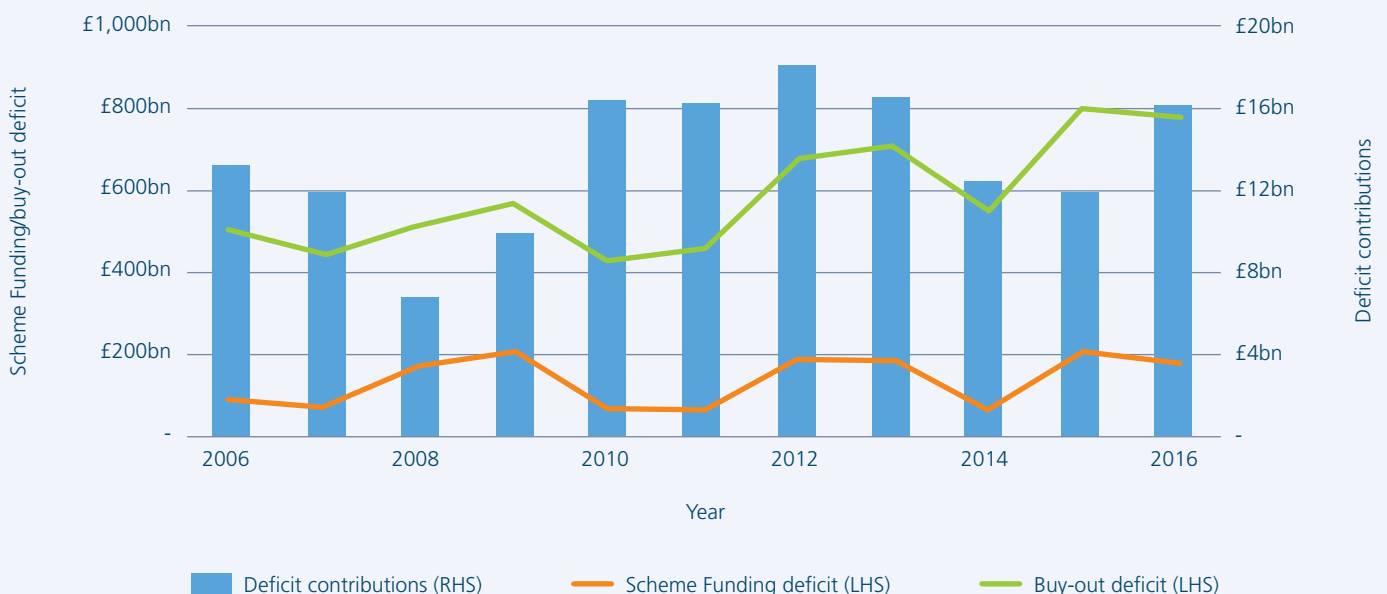
The financial crisis, austerity and Brexit have all played a part in a relaxing of monetary policy by the Bank of England – reductions in interest rates and quantitative easing have significantly reduced the cost of borrowing and pushed gilt yields lower.

Whilst this may have been a good thing for the economy as a whole, including asset values, it has not been good news for most of the UK DB pension scheme market.

As the chart below shows, **Scheme Funding deficits are almost double what they were when the Scheme Funding regime started**, despite £150bn of deficit contributions being paid in by sponsors over that time. Also, the shortfall of schemes against **the cost of buying-out with an insurer is around £300bn higher than in 2006**.

Over the same period schemes have invested more into protection assets, such as government bonds, as they mature. This means these schemes are less able to invest their way out of the problem than in 2006 and so they will need greater support from their sponsors in future if their plans go off track.

Funding position of DB universe



Source: Office for National Statistics, The Pension Protection Fund

But not all schemes were made equal...

This overall analysis hides a great deal of variability between schemes. The chart below shows **the average scheme is now about 60% funded on a buy-out basis**, but many schemes are much better or much worse funded than that. In the past many trustee boards had assumed that they would buy-out at some point in the future, around the time the scheme largely comprised pensioner members. That is now looking ambitious for many schemes.

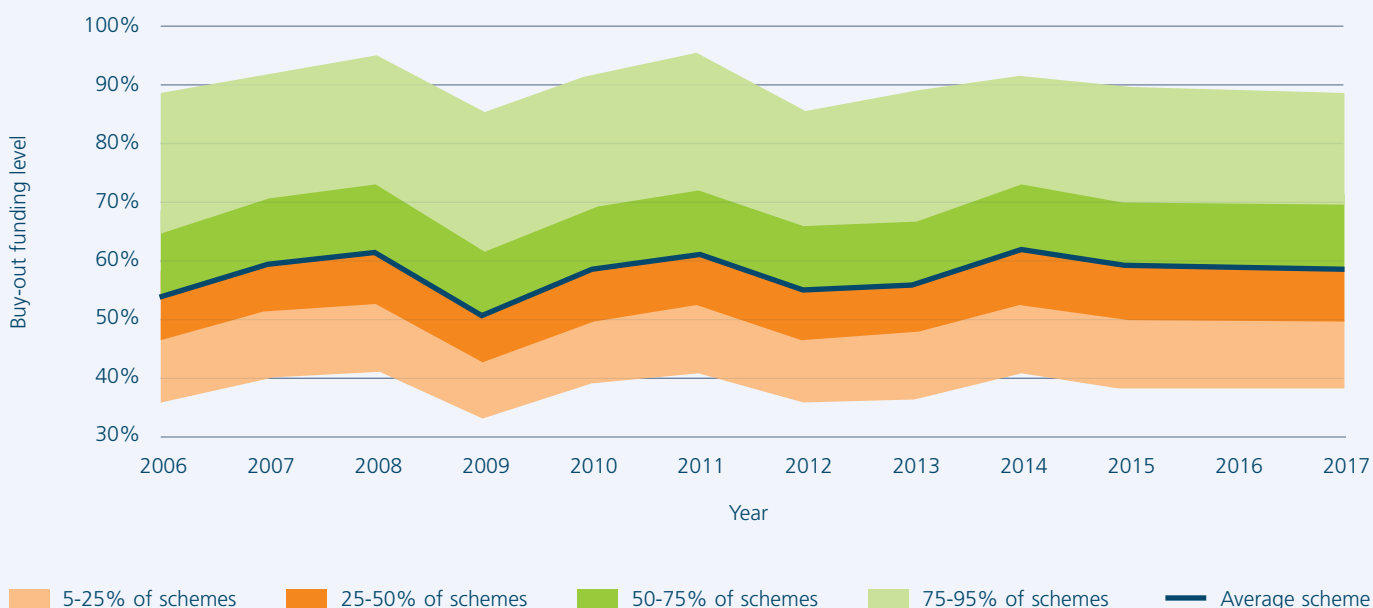
Some schemes can see their path to buy-out, but it will take them longer than they would have liked. Others are so underfunded that realistically they are very unlikely to get there without a significant improvement in market conditions or a big increase in employer contributions.

Trustees of these more challenged schemes need to change their focus to start thinking about how they will manage the very long term risks they face. For example, many trustees view their employer as strong today – but how sure are they that it will still be able to support the scheme in 30 or 40 years time. We live in a time of disruptive technologies, where whole sectors are increasingly challenged by innovation and so taking a 30-year view on many covenants requires a considerable leap of faith.



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Funding position of DB universe



Source: The Pensions Regulator, Barnett Waddingham

Time is running out for underfunded schemes

As schemes become more mature, being reliant on equity investment returns without adequate covenant support will become riskier.

Over time schemes are going to become increasingly cashflow negative. The chart below shows how the total size of the DB universe might change over time. We are not expecting the size of the DB universe to peak for a decade or so, but after that it will start to shrink quite quickly.

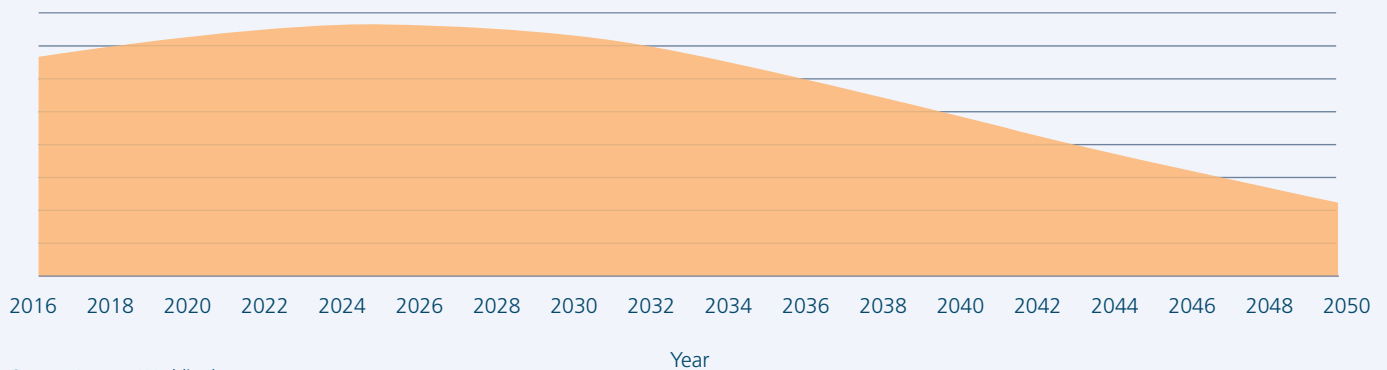
As schemes start to shrink investing in equities becomes riskier as there is less time to make up any short term losses since assets need to be sold to pay benefits.

Time is running out for schemes relying heavily on good equity returns to improve their funding. Alternative solutions are needed, albeit equities will likely remain part of the answer.

TPR's analysis suggests that **there are already 5% of schemes with valuations in the current year who may struggle to produce a viable long-term funding plan based on current market conditions.** Their worry will be that a number of schemes are slowly running out of money to pay benefits, and with employers unable to plug the black hole. If we have a similar next decade to the last, this could be a significant number of schemes.

It is going to become increasingly important for trustees and employers of underfunded schemes to embed sound risk management techniques into their decision making over the next few years as they battle with these difficult circumstances. Options to reduce risk within assets or liabilities without reducing expected returns may be increasingly important for trustees, as well as sponsors, to consider.

Total DB universe asset size projection example



Source: Barnett Waddingham

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What about schemes that are de-risking?

Schemes that are better funded have a different issue to consider. The demand for assets that provide steady, low risk long-term income is going to increase considerably as schemes mature. The problem is the conventional supply is not there to meet that demand.

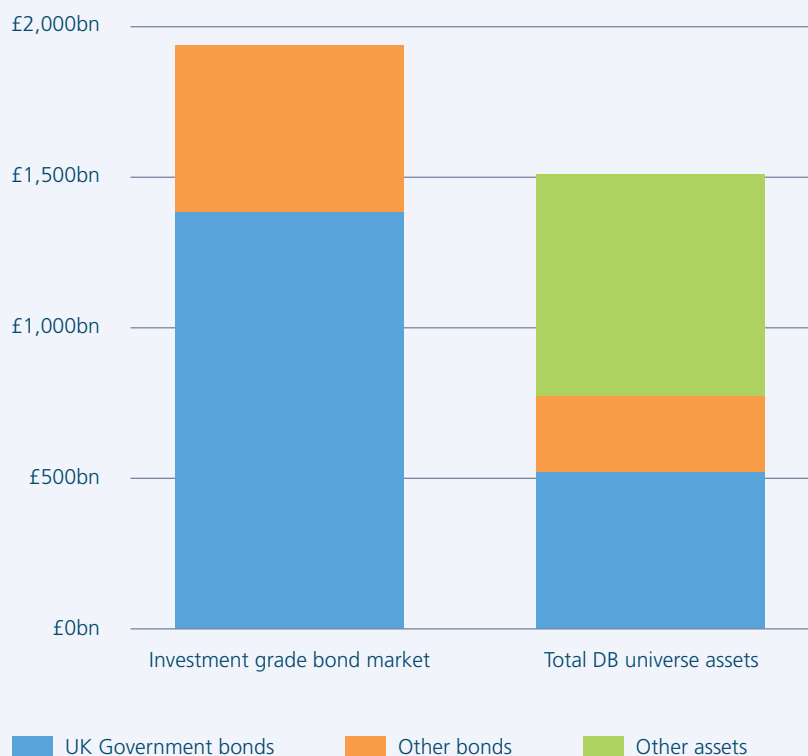
The chart below shows that **DB pension schemes currently hold around 40% of all sterling denominated bonds**. This could increase considerably as more pension schemes de-risk. This is against a backdrop of the UK government promising to cut the national debt, which may further reduce the supply of bonds.

If demand outstrips supply the price of traditional low risk assets is going to continue increasing, making de-risking more challenging to achieve.

Those that do want to de-risk are likely to need alternative methods, such as: investing more globally, considering alternative types of debt instruments and alternative asset classes such as infrastructure.

Schemes that are lucky enough to be within reach of buy-out have a very similar problem. Insurers also rely on protection assets. If the price of these assets is forced up then insurance premiums will also need to increase to compensate. Furthermore, if insurers invest in riskier assets then they are likely to need to hold additional capital to mitigate against potential asset losses, again increasing the cost of buy-out. Ideally pension schemes would be buying assets today that they were reasonably confident about could be passed to an insurer in future as part of a transfer of liabilities, but in reality the competition for these assets is high.

Trustees of schemes in a good financial position need to think about their long term objectives, plan accordingly, and carefully monitor the opportunities available for de-risking and buy-out so that they are in position to take advantage of favourable market conditions if they arise.



Source: iBoxx, The Pension Protection Fund



What does good risk management look like?

Trustees need good risk management plans to deal with an uncertain future. What this looks like will differ between schemes – there is no ‘right’ answer. However, there are common themes.

When deciding on an appropriate investment and funding strategy trustees should be asking themselves:



What are we trying to achieve and by when?



What risks threaten our likelihood of getting there and can we mitigate them?



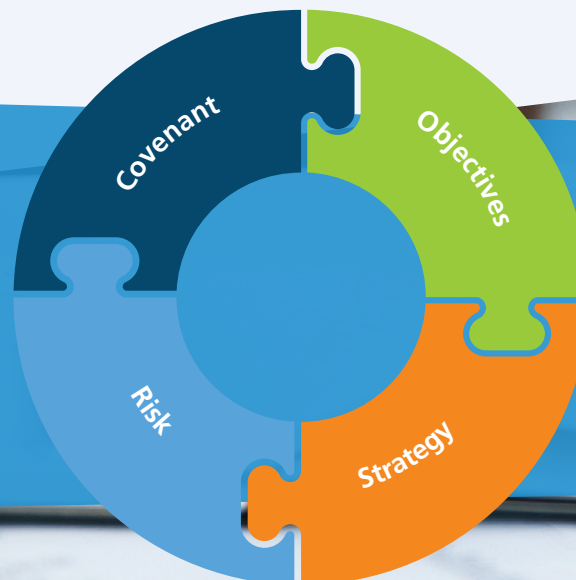
Can our scheme’s employer(s) afford to fund the scheme if the risks we are taking do not pay off?



What are the risks to our employer’s financial position?

For example, if a scheme is not targeting buy-out then its funding and investment strategy should be consistent with running the scheme on in the long term. Trustees need to think about how much risk they can afford to take, both now and in the future, and how quickly they should be de-risking. This should take account of the employer’s ability to underwrite the risks that the trustees are taking.

In summary, the key to good risk management is to take an integrated approach to your key financial decisions.





The importance of monitoring

A crucial part of effective risk management is monitoring how your strategy is progressing in light of experience. We believe that effective monitoring has to be done in an integrated way – considering funding, investment, covenant and their interactions. Our Illuminate:Monitor system is an online tool for trustees designed to meet this need in a proportionate manner.

To find out more about Illuminate please visit our website:

www.barnett-waddingham.co.uk/illuminate



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Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact Chris Ramsey via the following:

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