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Mature pension schemes – onwards and forwards

Running Off Mature Schemes Working Party

Mike Walsh FIA

SAI Annual Convention, 18 May 2018

Working party's deliverables

- A paper, that is easily accessible for all stakeholders across the pensions industry
- A strategic framework for the management of mature schemes
- Identify areas for future focus and recommendations

Running Off Mature Schemes Working Party members

- Costas Yiasoumi (Chair), Legal & General Assurance Society
- Graham Wardle, Legal & General Investment Mgt.
- John McAleer, Aon Hewitt
- Mike Walsh, Legal & General Reinsurance
- Nick Sparks, BMO Global Asset Mgt.
- Nigel Jones, 2020 Trustees and Broadstone

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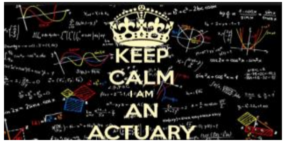

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- **Trustees:** Unenviable task of overseeing transition of schemes into increasingly mature schemes that, often, have lower margins for error. Require advice and services tailored to these new circumstances
- **Actuaries:** A situation in which schemes are on a relentless path to maturing introduces challenges and opportunities. Actuaries well placed to deliver successful outcomes to all stakeholders

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Setting the scene – the UK defined benefit pension environment

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**

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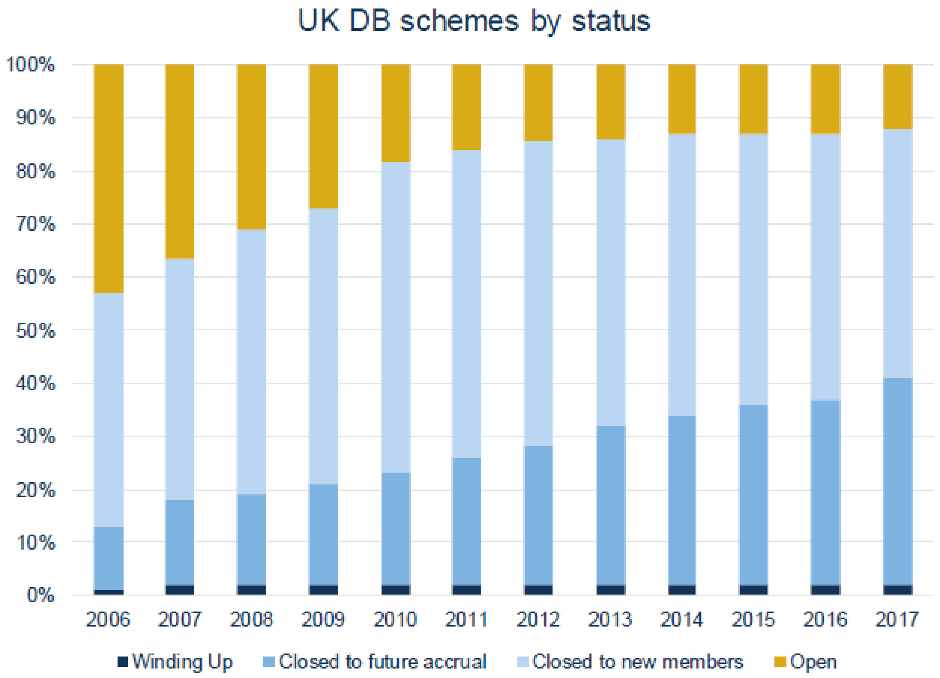
Table source: PPF Purple Book 2017. Liabilities shown are based on the cost of securing all accrued liabilities with bulk annuities

Mature schemes are becoming the norm in the UK



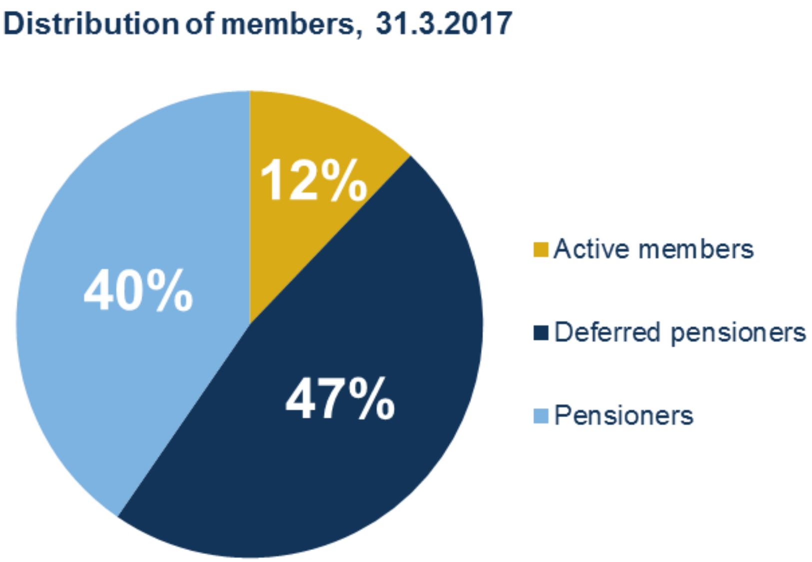


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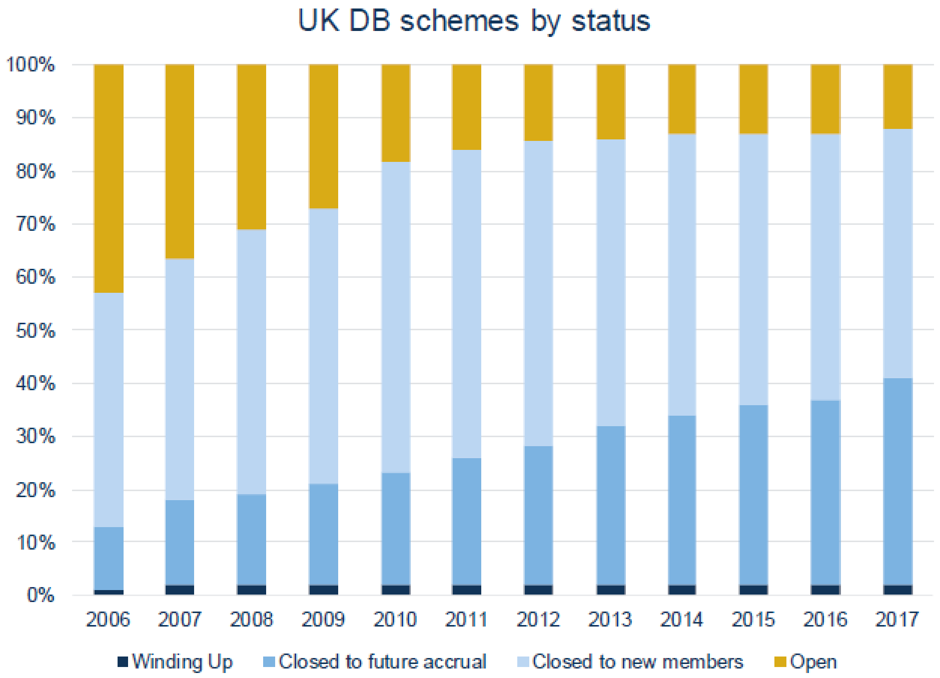
Chart sources: PPF Purple Book 2017

Mature schemes are becoming the norm in the UK



Few of these schemes in scope

Many of these schemes are in scope today. Most will be in scope within the next 10 years

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Chart sources: PPF Purple Book 2017

Key behavioural characteristics driving management of a mature scheme

1. There is a real end point

2. Benefit cashflows are known

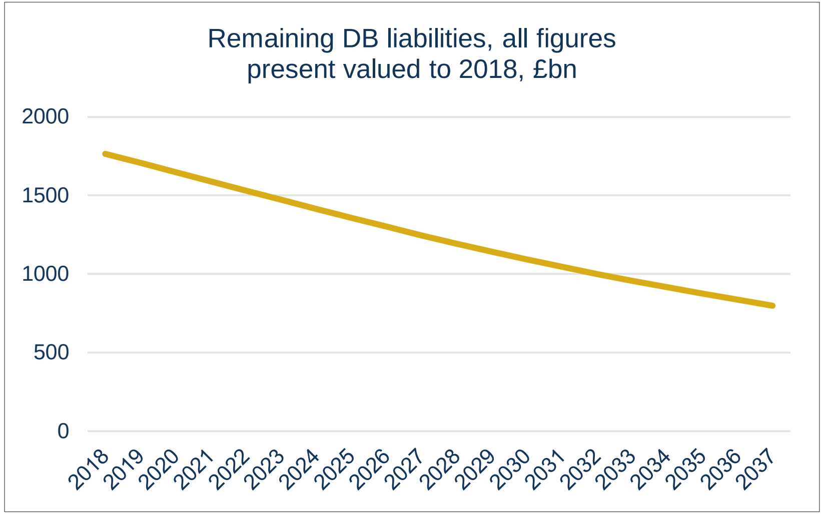
3. Plausible time horizon to which to work towards

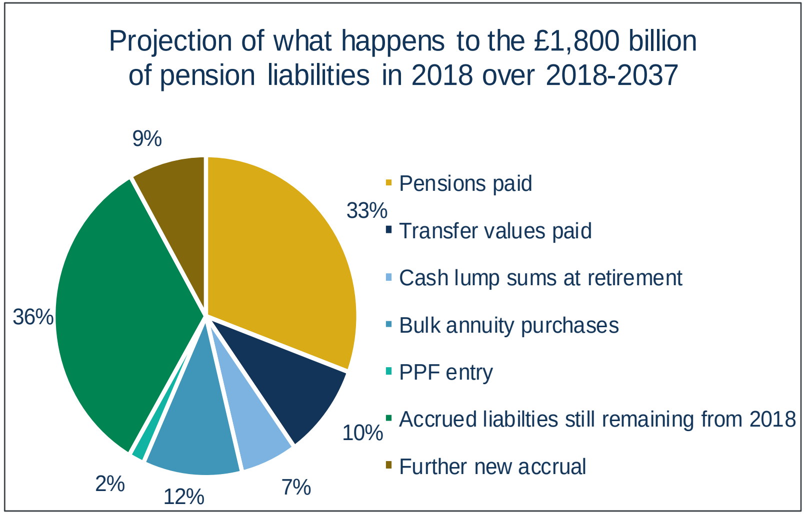
4. Key financial and operational risks could be locked down within a decade

5. Cashflow becomes king

6. Scheme becomes irrelevant to employer

The shape of the UK defined benefit pension market will change significantly over the next 20 years





A huge opportunity (and challenge!) for service and product providers

Projections produced by the Working Party, using simplified assumptions. Liabilities are a proxy for best estimate

The Working Party assessed 12 different areas of pension practice

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

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1. *Pace of funding*
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Let’s take a look at some of these

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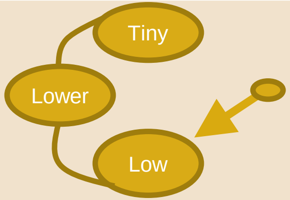
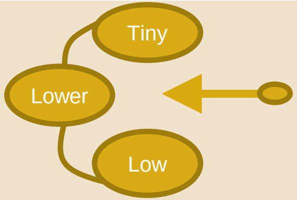
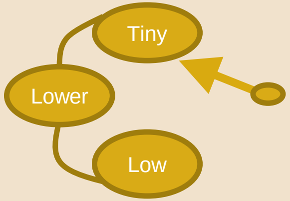
Asset allocation

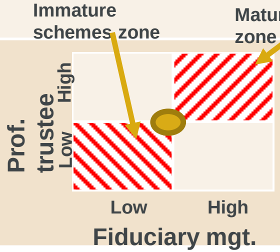
Dashboard – what we'd expect		
Relatively mature	**Mature**	**Very mature**
 Return seeking is the smallest asset class but still nevertheless sufficiently large to make a material impact to expected returns	 Return seeking allocation significantly lower. Funding triggers to reduce the allocation further are common.	 Return seeking either nil or very small with a definite plan in place to reduce to nil.

- **What we found:** More mature schemes have lower return seeking assets – but not a lot lower (40/60 vs 60/40)
- **In future:**
  - Increased focus on short recovery horizon
  - Increased focus on cashflow matching
  - Increased focus on synthetic solutions and liquidity management

Outsourcing

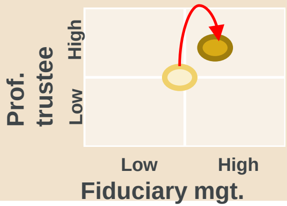
Dashboard – what we'd expect (professional trustees and fiduciary mgt.)

Relatively mature



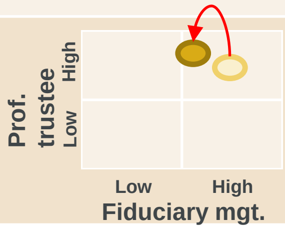
Not uncommon to see prof. trustees, but many still only company and MNTs. Fiduciary mgt. getting traction

Mature



Prof. trustees more common. Increased prevalence of sole prof. trustees. Fiduciary management peaks

Very mature



Trustee boards typically made up of prof. trustees / sole trustee. Reduced usage of fiduciary mgt. as strategies less active, more "set and maintain"

- **What we found:** Increasing take-up of fiduciary management (550 schemes with "full" version) and c20% of schemes now with professional trustees
- **In future:**
  - Member experience philosophy shifts from "excellent service" to "sufficient service"
  - Professional trustee or sole trustee the norm
  - Outsourcing of non-exec operations continues eg fiduciary mgt.

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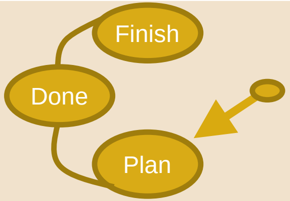
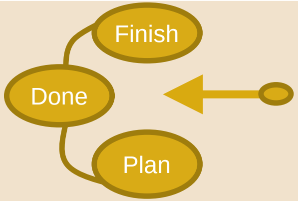
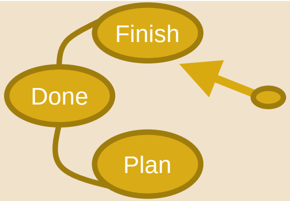
Locking down the benefits

Dashboard – what we'd expect

Relatively mature	Mature	Very mature
 If data and benefits haven't yet been validated / audited then it is within the scheme's calendar of future activities	 Data and benefits have been validated and audited. However, proportionality will apply so scope may have been restricted	 Data and benefits fully validated including resolving how to deal with "known unknowns"

- **What we found:** No correlation found between maturity and data quality. But an apparent correlation between proximity to de-risking and data quality
- **In future:**
  - The norm for mature schemes to have locked down their full detailed benefit provisions and data as a matter of course
  - Industry standards for recording that information will be an ingredient for future "soft" or "hard" consolidation

Bulk annuities

Dashboard – what we'd expect		
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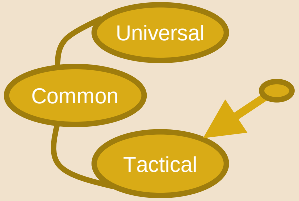
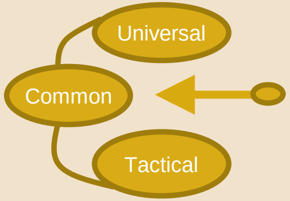
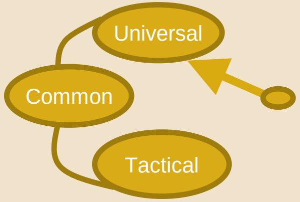
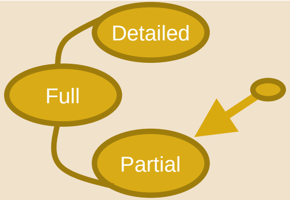
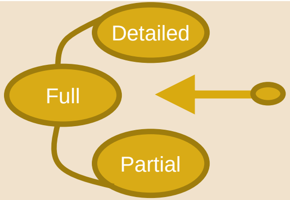
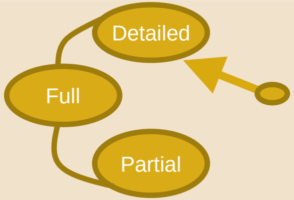
 Bulk annuities not uncommon. Generally purchased as seen as offering good value vs alternative asset opportunities	 Bulk annuities common as part of a deliberate strategy to de-risk with scheme termination in say 10 years being targeted	 Trapped surplus issues greater. Longevity highly uncertain except for large schemes. Bulk annuity usage universal – most trustees have an objective to wind up via a buy-out

- **What we found:** No data linking maturity with bulk annuity purchase. Anecdotal evidence is that buyout prevalence not strongly linked to maturity
- **In future:**
  - Lack of economies of scale will encourage all smaller schemes to aim for buyout or for DB master trusts or other non-insured consolidation vehicles
  - Continued use of bulk annuities and longevity insurance to manage risks

Expense management

Dashboard – what we'd expect

Relatively mature	Mature	Very mature
 Focus on expense control commences in conjunction with increased outsourcing of services. Too many future uncertainties for proper reserving	 Full analysis of future expense reserve undertaken. Aligned with scheme journey plan	 Detailed expense reserve including analysis of expense risk. Expense mgt. influences journey plan eg does a bulk annuity now make sense?

- **What we found:** Remains normal to exclude an expenses reserve in TPs. Yet expenses are c3% to c7% of TPs for schemes of 100 to 5,000 members
- **In future:**
  - Expenses reserving will become prevalent with increasing maturity
  - Schemes will also start looking at expenses risk eg plausible stress
  - Visibility of expenses will inform journey planning

A framework for mature scheme run-offs

VISION

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

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A framework for mature scheme run-offs

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STRATEGY

1. **Develop the journey plan**
2. **Create and maintain a shared understanding**
3. **Take opportunities**

A framework for mature scheme run-offs

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IMPLEMENTATION

1. Pace of funding
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Example: Assessing + managing maturity
Matching behaviours to metrics

Operation area	Current state	Change target	Comment
1. Pace of funding	Immature	2030	End of recovery plan
2. Covenant (incl separation)	Mature	N/A	Direct topco covenant already in place
3. Contingent assets	Immature	2030	Security to buyout level to be added
4. Liability management	Mature	N/A	Exercise completed 2014. Ongoing program in place
5. Cashflow matching (incl hedging)	Rel. mature	2020-25	Derivative overlay covering 70% liabilities
6. Asset allocation	Immature	2020-25	Current 60% return seeking with de-risk triggers in place
7. Outsourcing	Mature	2034	TPA in place – viable down to 100 members
…	…	…	…
12. Expense management	Immature	2025	Target switch from employer PAYG to a funded reserve

Metric	Current	Maturity gate	Date at gate	Comment
Duration	18 yrs	14 yrs	2028	
Number of members	267	100	2034	No longer viable below 100 members
% deferred pensioners in TPs	51%	25%	2032	
Covenant	CG2	CG3	2023	Sponsor in long term decline
Benefit cashflow % liabilities	2.6%	5.0%	2027	

Potential game changer – White Paper on DB pension schemes

1. Strengthen the Regulator’s powers

2. Scheme Funding

3. Consolidation – including “superfunds”

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Recommendations we've already touched on…

1. Schemes should develop comprehensive **journey plans** mapping out intended run-off approach

2. Most mature schemes would benefit from having a **professional trustee** appointed

3. Industry standardised member **data and benefit formats** should be developed

4. Schemes should focus resources to lock down their benefits (ie **data and benefit cleansing**)

5. **Reserving for future expenses** should be a norm for mature schemes

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Recommendations – the rest

1. **Standard measures of maturity** should be adopted by industry to facilitate communication and analytics

2. **Legislation** should be adapted to more easily accommodate the needs of mature schemes

3. Advantageous for a framework for **separation** of schemes and employers, in some circumstances

4. Key industry bodies should identify **skills and expertise** needed to service scheme run-offs

5. Adoption of highlighted practices improves scheme run-offs and **diminishes advantages of extreme consolidation** eg superfunds

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Questions

Comments

The Working Party will publish its analysis by end Q2 2018

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