Consulting

Mid-market Pensions Review 2019

BUCK

We are delighted to present the Buck Mid-market Pensions Review. Our 2019 review includes around 1,900 UK defined benefit pension schemes in the £10m-£1bn asset size range, using data supplied by Pension Funds Online.

The last year has been incredibly busy for the pensions industry – including The Pensions Regulator getting tougher on 'unscrupulous' companies, a consultation on pensions consolidation, the advent of Collective Defined Contribution (CDC) schemes and the fun and games of GMP equalisation. Meanwhile, Brexit is still looming large, with the increased uncertainty that brings. Among all this, an increasing number of companies are taking a more proactive approach to managing their long-term pensions strategy with a view to reducing risk and costs.

This document sets out the key messages and analysis from our review. If you would like to see how your scheme compares against the data – or if you would like to review your pensions strategy to identify ways to better manage your costs and risks – please let us know.

Mark Williams FIA

Principal and London Retirement Practice Leader

mark.williams@buck.com
+44 (0)207 429 1092

Steve Williams FIA

Head of Corporate Accounting and Senior Consulting Actuary

steven.williams@buck.com
+44 (0)207 429 1356

5M

5 million people could be impacted by GMP equalisation. Depending on the approach taken, this complex project could significantly increase scheme expenses, but it also provides potential opportunities to reduce future costs and risks.

1Yr

1 year reduction in assumed life expectancy at age 50 due to recent trends. This has helped schemes defy challenging market conditions and see improvements in their financial position over the year.

75%

75% of schemes are now paying out more money than they are receiving. This is leading to greater innovation in investment strategy, beyond the traditional asset classes. There has also been an increase in the appetite for de-risking solutions such as member options exercises.

Pension scheme design

The last year has seen another wave of Defined Benefit (DB) scheme closures, as companies look to 'turn the tap off' on the future build-up of cost and risk.

Where companies have more than one DB scheme, consolidating the schemes can provide efficiency savings and reduced governance burden. Following the Government's White Paper on DB schemes, a consultation has taken place on how to enable wider consolidation across the industry. Watch this space...

While Defined Contribution (DC) schemes are now the dominant pensions vehicle, there is innovation in the market – Royal Mail's decision to seek to implement a Collective Defined Contribution (CDC) scheme may well signal a trend towards solutions that provide some element of risk sharing. More broadly, there is a great deal of innovation in the industry, extending to wider long-term savings vehicles and 'financial wellbeing' initiatives.

In total our review covers 1,869 defined benefit pension schemes. The table shows the status of the scheme.

Scheme type	Description	Number in 2019 review
DB – Final salary	Pension based on salary near retirement and number of years' employment. In response to escalating costs, many of these schemes have been closed to new benefits, or re-designed to provide a more sustainable level of benefits	1,803
DB – Career average revalued earnings	Similar to a final salary arrangement, but instead of being linked to salary near retirement, benefits are linked to average earnings over the member's working life	36
DB – Hybrid	Covers a range of scheme designs which include some combination of DB and DC benefits, thereby providing risk sharing between the company and members	29
DB – Mastertrust	A multi-company arrangement which provides economies of scale relative to running individual small pension schemes	1
DC – Contract-based	These all involve scheme members and companies contributing to a savings 'pot'. Under the new pensions freedoms introduced in 2015, members have significant flexibility over how and when they use their pot.	
DC – Trust-based		
DC – Mastertrust	These schemes tend to be much lower cost for companies. However, unlike DB schemes, the members bear most of the risks, and typically have no guaranteed level of retirement pension. This can cause workflow planning issues if members cannot afford to retire	
Alternative savings		

These arrangements are not directly covered by our review but our DC and Wealth team have extensive experience and insight in relation to the design and management of these schemes

Membership profile

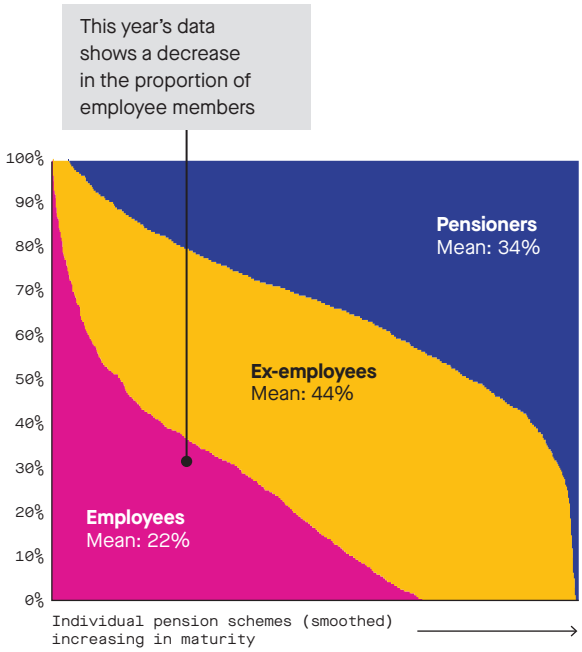
As pension schemes mature and an increasing proportion of the promised benefits become payable, there is an increased focus on data quality. The Pensions Regulator has made this clear, recently expanding their disclosure requirements in this area.

Data quality is especially important in relation to risk-reducing insurance options, for which pricing is more attractive if the data is clean. Therefore, companies may wish to work with pension trustees to complete a 'data cleanse' project.

It is also worth considering a review of scheme practices, to identify if there are any 'hidden' discretions whereby benefits are being paid at a more generous level than strictly required. This can also help to improve insurance pricing and reduce risk.

GMP equalisation adds a new dimension to this issue – good data quality and a thorough understanding of past practice is critical to ensuring a smooth and efficient project.

The distribution of the membership between different groups at the latest census date (smoothed).

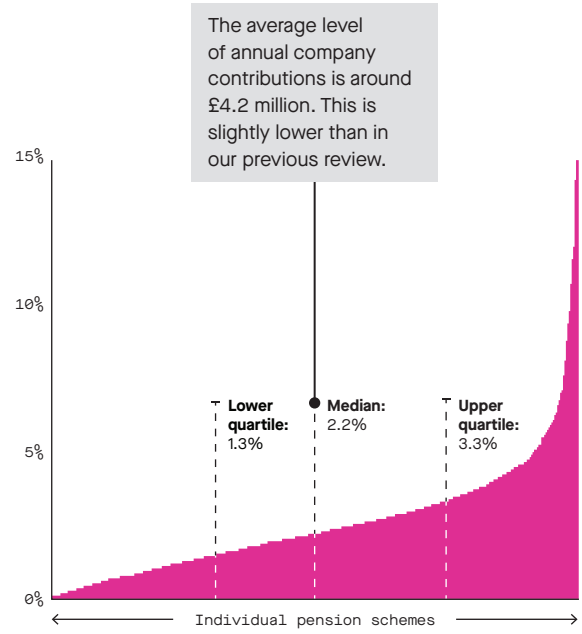


Company contributions

Our 2019 review shows a slight decrease in the typical levels of company contributions. This may reflect improving funding positions, but also that a greater number of companies are finding ways to permanently reduce their liabilities and mitigate the risk of future cost increases (for example through a member options exercise).

However, there was no let up from The Pensions Regulator, who stressed in their 2019 funding statement that they would be getting tough on schemes with long deficit recovery plans (over 7 years for stronger companies). TPR also clarified their position on what they call the "equitable treatment" of the pension scheme, stating that where there is a significant pensions deficit they do not expect dividends paid to shareholders to exceed annual contributions. There is more to come from the Pensions Regulator over the coming year, including their review of the code of practice for scheme funding.

The level of total annual company contributions (where payable). Expressed as a proportion of scheme asset value.



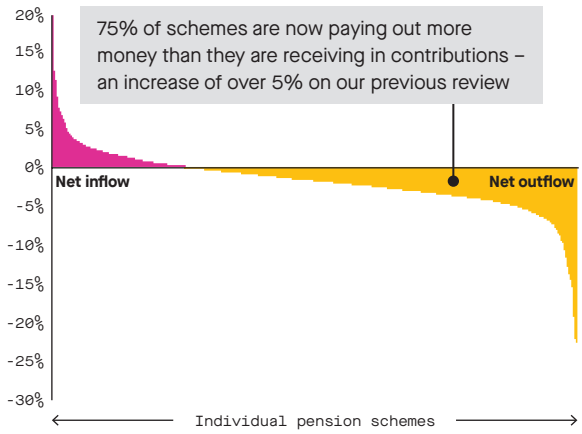
Cash flow

Cash flow is an ever-more important issue as schemes mature. The average scheme in our review has net annual outgoings of c. £3m, meaning that contributions are no longer sufficient to meet regular benefit payments.

In part, this reflects an up-tick in pensions transfer activity, whether through individual voluntary transfer values or one-off exercises. Many schemes are providing greater support to members with transfers – for example by providing quotations on retirement statements or by appointing a 'preferred' independent adviser – which appears to be resulting in a greater number of members taking this option.

As cash flow becomes more important, schemes are increasingly adopting 'cash flow aware' or 'cash flow driven' investment strategies to ensure that they can meet cash flows efficiently and without being a 'forced seller' of assets such as equities when markets are depressed.

Total net cash flow in to (and out of) the scheme. Expressed as a proportion of scheme asset value.



Assets

Our review shows an increase in the allocation of assets outside of 'traditional' pension scheme investments such as bonds and equities. Companies and trustees are looking to more innovative ways to manage their risk exposure.

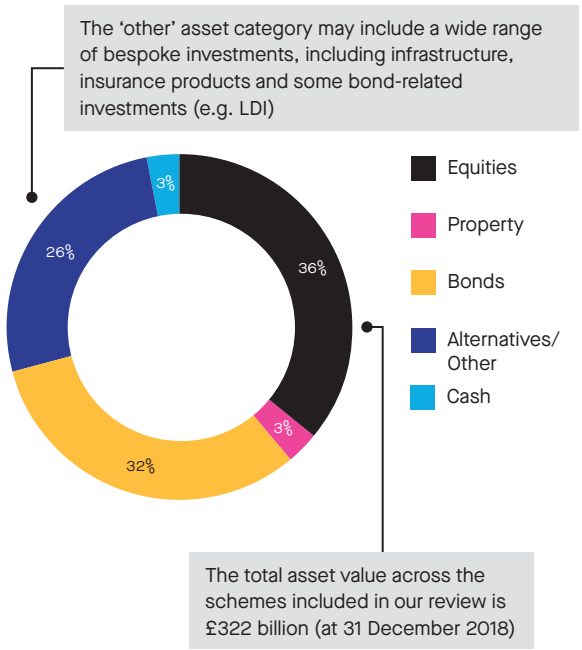
Liability Driven Investment (LDI) has also become a more commonplace option among mid-market schemes. Switching assets into LDI helps to manage interest rate and inflation risks, while potentially maintaining a similar level of expected investment return. Companies and trustees need to consider how much exposure they want to further falls in long-term interest rates.

Pricing for insurance products – e.g. 'buy-in', which remove all risks in relation to part of the liabilities – has become more attractive, making this a viable option for schemes of all sizes as part of their overall investment portfolio.

Some schemes have adopted a structured mechanism for disinvesting from riskier assets such as equities at opportune times. This could be integrated within a wider 'journey plan' which seeks to move schemes towards a sustainable long-term position, with a low level of investment / liquidity risk and a good level of funding.

That all sounds great – but Brexit might be the fly in the ointment, potentially increasing uncertainty in investment markets and making the funding level more volatile. Companies are not always involved in scheme investment strategy reviews (this being traditionally a matter for trustees) – but given the current levels of uncertainty it is critical that companies do have a seat at the table and ensure the scheme is in good shape, robust to whatever the coming years bring.

Average distribution of investments between major asset classes.



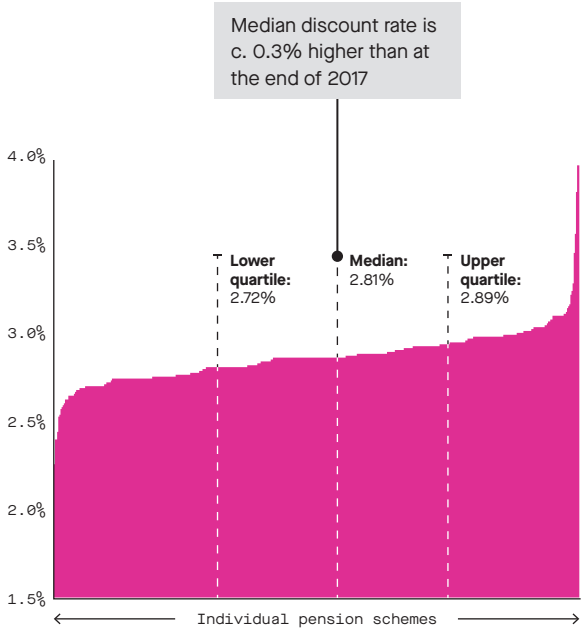
Discount rates

Bond yields remain at or around historical lows. Remember back in 2008 when corporate bond yields were over 7%? The fall in yields since then has resulted in a c. 150% increase in a typical scheme's liability value.

So will a rise in interest rates make the problem go away? It is important to recognise that the market is already pricing in an anticipated rise in interest rates. It is only if rates rise at a faster rate than expected that we will see pensions liabilities contract.

Low yields have driven innovation in the way discount rate assumptions are modelled for pensions accounting. A greater number of companies are taking advantage of the range of 'yield curve' approaches available – some of which are selective over which bonds are included in the analysis and some take a more optimistic view of the future.

The discount rate used for statutory pensions accounting purposes. They are set using the yields available on high quality corporate debt. Discount rates are per year and are as adjusted to 31 December 2018.



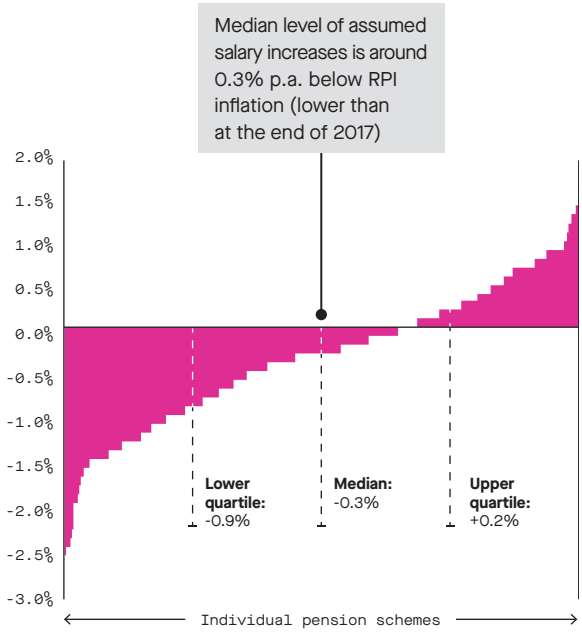
Salary increases

Assumptions for long-term salary increases have tended to be set as a margin above Retail Prices Index (RPI) inflation.

However, in practice many companies do not use RPI as a reference point when setting salary increases – indeed in many cases the rate of inflation is not directly taken into account at all. Moreover, for most DB schemes the employee membership is weighted towards those who are nearer retirement, who may expect to receive a lower level of future salary growth.

For both funding and accounting purposes, companies may wish to re-consider their long-term expectations for the level of salary increases, and whether the assumption is expressed relative to RPI or CPI inflation or something else, or as a fixed percentage (e.g. 2% p.a.).

The assumed rate of long-term future salary increases per year for pensions accounting purposes, in excess of assumed RPI inflation.

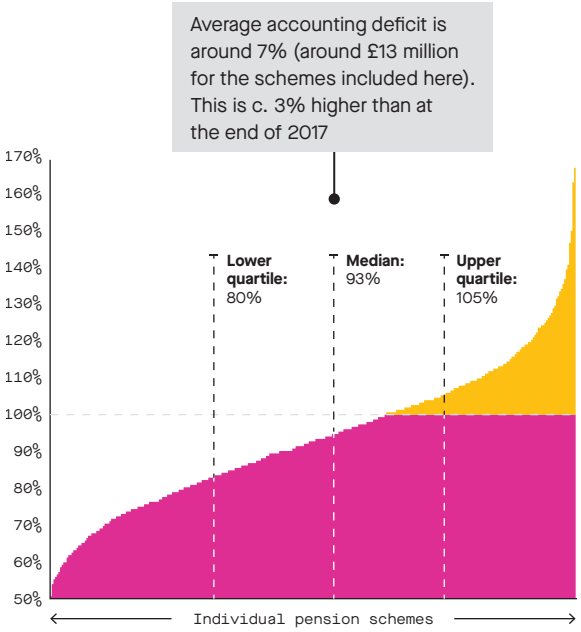


Funding ratio

We have some good news! Accounting positions have improved – indeed, the accounting deficit for a typical scheme in our review has halved over the past two years (as a percentage of assets).

A key reason for improvement in the funding position (though perhaps not such good news from the members' perspective!) is that the rate of improvement in life expectancy has slowed significantly. Reviewing and updating the scheme assumptions can reduce life expectancy at age 50 by as much as a year, and may reduce the value of liabilities by c. 3-5% (depending on when the assumptions were last updated). Companies may wish to commission a review of their life expectancy assumptions, taking into account the latest data and market trends.

The funding ratio (= asset value divided by liability value) for pension scheme accounting. Figures are as adjusted to 31 December 2018.



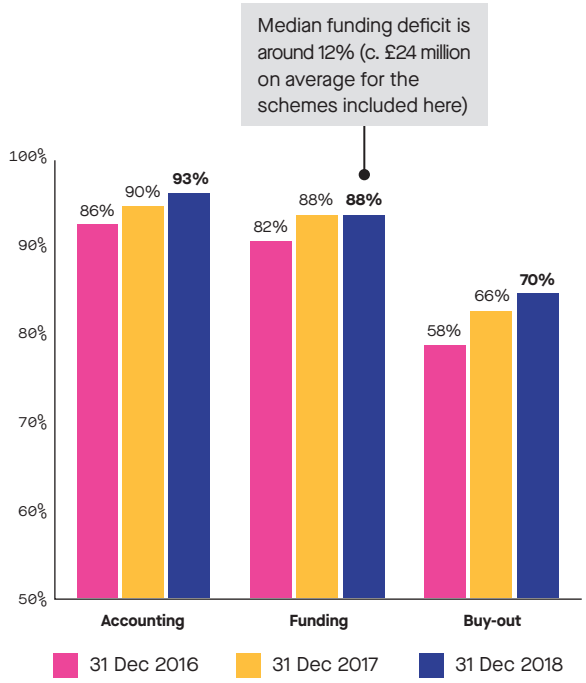
Financial position

The financial position of a typical scheme has improved over the past two years, on all three measures shown in the chart.

The financial positions on the accounting measure, and on the more prudent scheme funding measure (as used to set contribution levels) do not move entirely in tandem. This is because of differences in the movement of gilt yields (which are typically used in setting funding assumptions) and corporate bond yields (which are used for accounting). Credit spreads contracted over 2017, but then widened over 2018.

Estimated insurance pricing (whether 'buy-in' or 'buy-out') has improved recently, reflecting increased market competition and lower life expectancy. Now might be a good time to conduct a feasibility study to review the level of risk reduction that may be achieved through a pensioner buy-in.

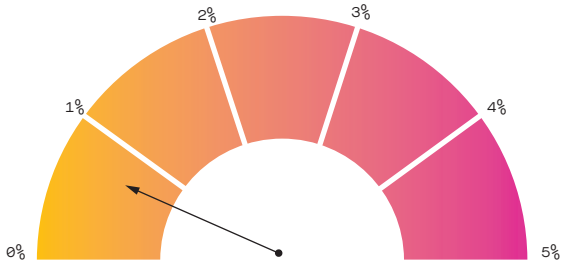
The median funding ratio (= asset value divided by liability value) using accounting assumptions, proxy scheme funding assumptions and 'buy-out' assumptions.



Topical issue: GMP equalisation

A High Court ruling (in relation to Lloyds Bank) was published on 26 October 2018. This ruling related to certain historic pensions (known as GMPs) that were built up in many pension schemes in the 1990s. Importantly, GMPs are not the same for men and women – the ruling held that pension schemes must "equalise" benefits to reflect these differences, adding new liability and costs.

Typical impact on scheme liability value

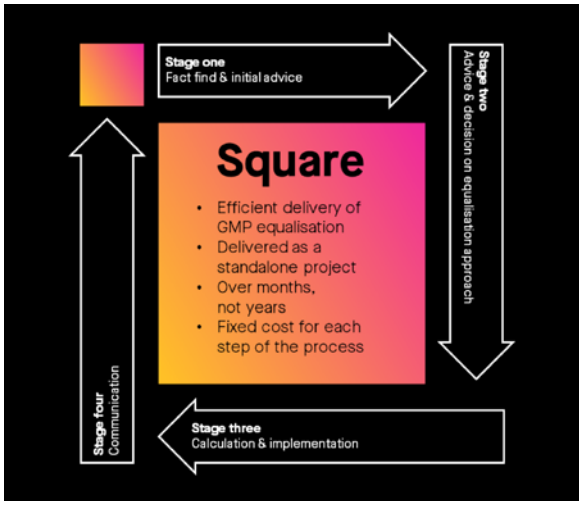


While in some extreme cases the increase to scheme liability values might be 5% or more, in most cases the impact is likely to be relatively small (c. 0.8% for a typical scheme).

Despite the modest liability impact, GMP equalisation will be a large and complex project, perhaps impacting c. 5 million people across the UK.

There are a number of approaches that can be taken to implement GMP equalisation. Companies should be proactive in engaging with trustees to ensure it is done in the most pragmatic and efficient – and hence lowest cost – way possible, for example using our "Square" process.

There are also opportunities to implement GMP equalisation in a way that could reduce future costs and risks, e.g. by achieving improved pricing for insurance solutions (e.g. buy-in) or undertaking a related member option exercise.



Strategy review

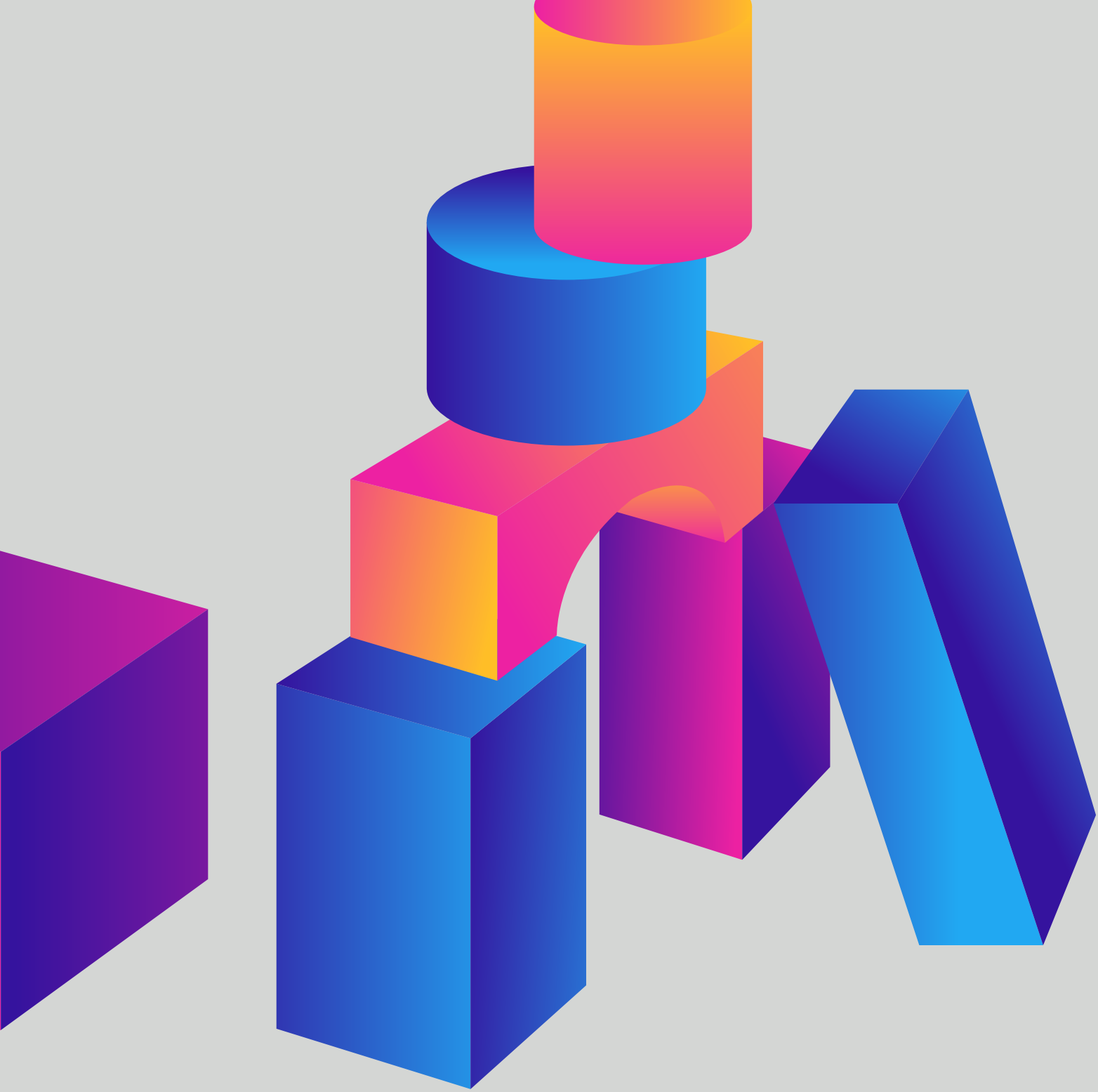
If you have not done so already, we recommend conducting a full strategy review of your company pensions arrangements. This will help you to establish your objectives, and consider the options available for reducing your exposure for future increases in costs. Some possible strategy elements are set out below (figures are illustrative and are for a typical scheme from our review).

There has been a notable increase in companies' and members' appetite for pension transfers, since the introduction of DC pensions freedoms in 2015. Many schemes are now giving more support to members to help them through the process, and increase take-up

	Ease of implementation	Funding level	Annual contribution
Before:		88%*	£4.2 million
Impact of possible strategy element:			
Closure or benefit re-design	Medium	+2%	-£1.0 million
Transfer exercise	Medium	+2%	-£1.0 million
Pension increase exercise	Medium	+1%	-£0.5 million
Small lump sum exercise	Easy	Small improvement in funding position and reduction in contributions; plus administration efficiency savings	
Scheme merger	Hard	Highly dependent on the nature of the merger; but potential for material efficiency savings	
Discretionary practice review	Easy	+1%	-£0.25 million
Life expectancy review	Easy	+3%	-£1.0 million
Pensioner buy-in	Medium	These two options provide significant potential for reduction in risk of future escalation in deficit and contributions	
Investment strategy review	Easy		

* Equivalent to a deficit of c. £24 million on average for the schemes included in this review

Please contact us if you would like to discuss completing a strategy review for your pension arrangements.



About our review

Data

- The data used is provided by Pension Funds Online.
- The data covers 1,869 pension schemes between £10m and £1bn in asset size.
- All the data is taken from publically available sources.
- The data relates to accounting year-ends over the last two years.

Our approach

- We have adjusted the financial data to a common date (31 December 2018) using approximate methods and publically available market indices and bond yields.
- Unless otherwise stated, all figures are effective at 31 December 2018.
- Where appropriate some outliers have been removed from the data (in general the highest and lowest 0.5% values).
- In some cases data for schemes outside of the £10m to £1bn range has been used to inform the analysis.
- The proxy scheme funding position is based on approximate average UK scheme funding assumptions, determined with reference to The Pensions Regulator's latest Scheme Funding Statistics document.
- The proxy buy-out position reflects our knowledge of the current market for buying out pension scheme liabilities with an insurer.
- The GMP equalisation liability impact is based on a survey of Buck clients (as relevant to this review).

Limitations

- This review is for general information purposes only.
- It should not be used by companies, pension scheme trustees or scheme members to make any financial decisions.

Find out more

If you would like to see more detailed analysis, in particular how your scheme compares against the review data – or if you would like to explore options for mitigating your pension scheme deficit – please let us know.

Mark Williams +44 (0)207 429 1092
Steve Williams +44 (0)207 429 1356

Alternatively, contact us on:
0800 066 5433 | talktouk@buck.com

Pension Funds Online

Pension Funds Online is the essential source for detailed financial and contact data on global pension funds and their advisers.

Visit **www.pensionfundsonline.co.uk** for more information.

About Buck

Buck is a premier, global integrated pensions and benefits consulting, administration, and technology services provider. We offer a world-class portfolio of benefits advisory, analytics, administration, engagement and communication solutions powered by best-in-class technology to help fulfil the pensions and benefits needs of you and your scheme members.

At Buck, we're working to redefine the social contract, or two-way relationship, between you and your members, to not only accommodate shifting expectations, but to stay ahead of them. We're exclusively focused on helping our clients and their people succeed together. We work with you to find the right combination of pension consulting, outsourcing, and technology solutions to help drive positive health, wealth, and career outcomes for your members.

www.buck.com

BUCK