A smoother journey to the endgame

Simon Partridge
Head of Fiduciary Management Solutions

After years of seemingly always being at least 10 years from full funding, UK Defined Benefit (DB) pension schemes appear to be moving closer to the end of their journey. But what is their destination, what is the plan for getting there and how can fiduciary management help?

The Objective

In 2020, the Pensions Regulator (tPR) started a consultation on its latest Defined Benefit (DB) Funding Code. In the consultation, tPR proposed that all schemes set a long-term funding target (LTFT), followed by a plan for how to get there. They proposed two options for schemes to achieve their LTFT – Fast Track (which was expected to fall into a standard framework) and Bespoke. Additionally, they suggested some prudent long-term objectives, including targeting full funding on a prudent gilts +0.25-0.50% basis over 15-20 years for the average scheme.

In February this year, the 2021 Pensions Act was passed, with a requirement on trustees to agree a long-term funding and investment strategy. Despite tPR's consultation still being in progress, it was given enhanced powers to enforce standards and regulation, particularly around investment strategies. In summary, the message from the Government is clear: if they haven't already, trustees now need to define their long-term objective, or endgame, and establish a plan to get there.

So, what options are available to trustees today in order to meet this objective? Briefly, self-sufficiency (running off the scheme with a low-risk investment strategy), buyout (transferring the liabilities to an insurance company), consolidation (transferring into a master trust or new DB superfund) or applying to the Pension Protection Fund (the safety net for schemes whose sponsors collapse). We take a closer look at self-sufficiency and buyout options.

Self-sufficiency: What does it look like?

A self-sufficient investment strategy will typically invest in low-risk assets which are expected to provide a steady stream of cashflows. These strategies typically invest in UK government bonds, investment grade credit and potentially some income-generating unlisted assets, including infrastructure and private debt. For many schemes, self-sufficiency is seen as a stepping stone to full buyout. This may be because the scheme is relatively immature, with a high proportion of non-pensioners making it unattractive to insurers. Alternatively, it may be that there is a low appetite from the trustees or sponsor to pay a premium for someone else to take on the liabilities.

What about buyout?

This is where a pension scheme transfers all risk and responsibility for paying the future pension obligations to an insurance company. There is no set price for this, insurers will quote for the business. As a general rule of thumb, it is typically more expensive than self-sufficiency (particularly when looking to insure younger members who are yet to retire).

Establishing the appropriate journey to the endgame

The first step for trustees to consider is where they are now – what is their scheme's funding position today? Trustees and sponsors should then discuss and, most importantly, agree on how much risk they are willing and able to take now and in the future. Is it realistic to target buyout now, or is self-sufficiency a more appropriate near-term target?

How can fiduciary management smooth the journey?

In contrast to a traditional investment adviser working on a time-cost basis, a fiduciary management arrangement typically uses an 'all-in' service model. This should include all of the training sessions and meetings required to identify an appropriate long-term objective, designing the journey plan to get there and then implementing and monitoring the strategy through time. The fiduciary manager will also liaise with the scheme actuary and other key stakeholders.

At every stage of the journey, it's important that the scheme's strategy is appropriate, risks are carefully managed and the asset allocation is nimble enough to capture upside opportunities and manage downside risks. A fiduciary manager can take care of the day-to-day management of the portfolio, including managing any derivative exposures, ensuring the necessary income is generated to meet pension payments as they fall due and, if needed, making swift and decisive investment decisions. This significantly reduces the governance burden on trustee boards.

Furthermore, if a scheme is targeting buyout, your fiduciary manager should be able to monitor pricing levels and ensure that the investment portfolio is positioned similar to how insurers invest.

Whatever a scheme's chosen endgame, a fiduciary manager like Russell Investments will be here to make the journey a smooth one.

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