XPS Investment

Investment Briefing
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Do all roads still lead to buyout?

Defined benefit (DB) schemes have never been better funded, and buying-out pension scheme liabilities is within reach for many, with record numbers of schemes completing transactions in the bulk annuity market. However, the government is in the midst of looking at how pension schemes can be used as a force for UK economic growth.

With scope for radical changes in policy, the most appropriate long term solution may not be as clear cut as it once was, and running on could create value and upside potential. Just because you can afford to buyout with an insurer, no longer necessarily means you should.

Key highlights

- There is political ambition to boost the UK economy by creating scope for pension schemes to run on and invest their surplus for the benefit of both pension scheme members and scheme sponsors.
- The anticipation of this potential industry revolution introduces additional factors that need to be considered by schemes that might otherwise have chosen buyout to be the obvious end game solution.
- A buy-in or buyout transaction is generally irreversible, and whilst it will continue to be the route for many schemes, it is important to explore all options before you commit.
- All schemes, but particularly those preparing their investment strategy to be ‘buyout ready’, should consider the implications and potential upside of the potential regulatory change.

Buyout is no longer the only end game option in town. With potential for significant political change round the corner, there may be new opportunities for members and sponsors… and the UK economy.

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Endgame checklist

The following actions can be taken by all schemes to establish whether their plan for endgame remains suitable in light of the potential opportunities on the horizon:

1. **Confirm current funding position** – how well funded is the scheme in relation to its technical provisions, low dependency and buyout liabilities.

2. **Engage with sponsor** – to understand their attitude towards mitigating future contribution risk through buyout against the potential upside of a run-on investment strategy.

3. **Review of current funding** – assess the extent that the current surplus or deficit might change and if there are any ways that risk can be better managed or reduced.

4. **Consider liquidity profile** – illiquid assets may present a barrier for buyout, resulting in schemes forfeiting value to the secondary markets where rushing to transact and selling at a discount.

5. **Revisit your long term objectives** – check what key factors and assumptions they are based on and make sure these remain relevant and appropriate.

6. **Consider uses of surplus** – in context of your membership profile and scheme rules. Is the scheme open to new members or accrual? Is there scope for discretionary benefits or defined contribution (DC) contributions under the existing scheme rules?

7. **Understand potential impact of regulatory change** – the recent consultation from the Department for Work and Pensions (DWP) set out a number of proposals which trustees should consider in the context of their own specific circumstances.

8. **Revisit journey plan** – determine the approach that will best meet the objectives of your members and the sponsor in light of the changing regulatory landscape.

Drivers for change

Buyout is a road well-trodden, and for many years has rightly been considered the ultimate 'endgame' solution for most UK defined benefit pension schemes. This method of securing member benefits has naturally been considered to be the 'gold plated' option, where affordable.

- **Buyout eliminates risks relating to the value of the liabilities, including longevity, interest rate and inflation risk, as well as investment risk relating to a scheme's assets.**
- **The insurance contract is backed by additional ring-fenced capital and full protection from the Financial Services Compensation Scheme (FSCS).**

The widespread funding level improvements of the last two years have meant that the affordability barrier to buyout has been overcome for many schemes. But the world is changing and new opportunities might lie around the corner.

Following the Mansion House initiatives first announced in July 2023, the Chancellor of the Exchequer provided a series of updates and responses to ongoing consultations in the 2023 Autumn Statement, expected to significantly reshape the UK DB pensions landscape. Ultimately seeking to incentivise schemes to continue to invest assets for productive means, helping to stimulate the UK economy.

As part of this, the authorised surplus payments charge was reduced from 35% to 25% from April 2024. This is further supported by proposals to provide an override to scheme rules to allow surplus to be paid out, supported by regulatory guidance. If future regulation continues on this trajectory, the upside for running on schemes could be significant.

We challenge trustees and sponsors to consider if the question is no longer **"can I"** buyout, but rather **"should I"** buyout?

Current estimated buyout pricing

Insurance pricing fluctuates over time, which reflects the changing investment returns that are available in the market as well as the insurers' capacity and appetite to take on business from schemes.

We have observed the attractiveness of the available pricing peaking around 12 months ago. It has subsequently dipped, reflecting a range of factors including tightening credit spreads on corporate bonds and increased demand from pension funds due to improved affordability from rising funding levels. The market continues to evolve and pricing opportunities will come and go – not least as new entrants emerge and insurers increase capacity levels.

Chart 1: XPS buyout pricing estimates

Source: XPS Pensioner Buy-in Pricing

Why might schemes choose not to buyout and instead run-on?

'Running-on' refers to an approach whereby schemes simply continue to run their investment strategy beyond the point they could reasonably transact with an insurer.

This relies on a strong sponsor covenant, as the possibility of insolvency has scope to materially undermine any benefit to members.

Under the existing regime, there are a relatively small set of situations where a scheme might have chosen to run on:

- **Schemes that are open to accrual** – by taking some investment risk in the strategy, the cost of future benefits being accrued could be kept affordable to the sponsor, ultimately benefiting members.
- **Schemes offering discretionary benefit increases for members** – the scope for trustees to offer this is very dependent on the specific scheme's rules.

Consequently, historically where buyout has been affordable, run-on has rarely represented an attractive option given that any surplus generated could only be accessed once the scheme has wound up, and at that point would be taxed heavily. On the flip side, any deterioration in the funding position due to financial risks would require near term funding from the sponsor.

However, the landscape is potentially changing markedly.

Potential changes on the horizon

There is a strong political agenda to use pension scheme assets as a source of direct investment in the UK.

Given the recent consultation from the DWP on the Options for DB pension schemes, which covers use of surplus and a possible public sector consolidator, there is considerable scope for a new regime to emerge whereby both members and sponsors have more scope to benefit from schemes running on.

A policy change that encourages schemes to run on could provide advantages such:

1. **Uplift to member benefits** – surplus assets could be used to secure more generous benefits for members.
2. **Supplement DC contributions** – use surplus assets to augment DC contributions, either supplementing or subsidising employer contributions. This could then go some way to alleviate the inequality between DB and DC savers.
3. **Scope for sponsor to extract surplus** – surpluses in pension schemes could be used to support the credit strength of the sponsor. Reducing the surplus tax charge could encourage schemes to be seen as an asset, returning past contributions back to the sponsor for reinvestment back into the business.

We have summarised the current strengths and weakness of buyout and run-on, highlighting areas that may be subject to further change:

	Buyout in near term		Run-on in near term		Potential future regulatory changes
Insolvency	Lowest risk for members in event of insurer failure given uncapped 100% FSCS protection	✓	PPF protection equates to between 70-80% of benefits if sponsor fails	✗	*PPF benefits may be enhanced to provide 100% protection for some or all pension schemes, funded by an additional levy*
Sponsor liability	No downside on sponsor – liability fully discharged to insurer	✓	Risk of deficit re-emerging, requiring cash funding from sponsor	✗	–
Future flexibility	Insurance policy cannot usually be unwound once transacted	✗	Asset portfolio provides flexibility for changes in future approach	✓	–
Maturing scheme	Insurer pricing expected to become cheaper as scheme matures	✗	Scheme has scope to benefit from expected reductions in insurance pricing as membership matures	✓	–
Discretionary increases	No scope for discretionary increases other than those purchased at point of buy-in	✗	Scope for discretionary benefits but only where scheme rules permit and where affordable	?	*Scope for tax rules to be changed to allow one-off payments to be made to members without adverse tax implications*
Access to surplus	Surplus returned to the employer based on surplus after transaction if trustee agrees and rules permit, taxed at 25%	✓	Scope for surplus to grow but cannot be returned to sponsor until scheme bought out, and then taxed at 25%	✗	*Potential for constraints to be relaxed on how surplus is extracted before wind up*
Illiquid assets	Incompatible with holding long term illiquid assets, sometimes forfeiting significant value to secondary markets	✗	Scope to hold long term illiquid assets where beneficial	✓	–
Economies of scale	A natural consolidator of sub scale schemes	✓	Reliant on scheme having sufficient scale to be viable	?	–

As can be seen, there is scope for future policy changes to materially redress the balance of considerations between buyout and run-on.

In addition to these two choices there are other long-term outcomes, such as consolidation through a superfund, or another option being explored by government is the Pension Protection Fund (PPF) playing a role as a consolidator for small schemes. In addition to these end games, there are other approaches that can be utilised along the journey, such as capital backed journey plans, which incorporate insurance underwriting in exchange for shared upside. These alternatives are likely to be of more niche relevance but will nonetheless be important options to consider for schemes they apply to.

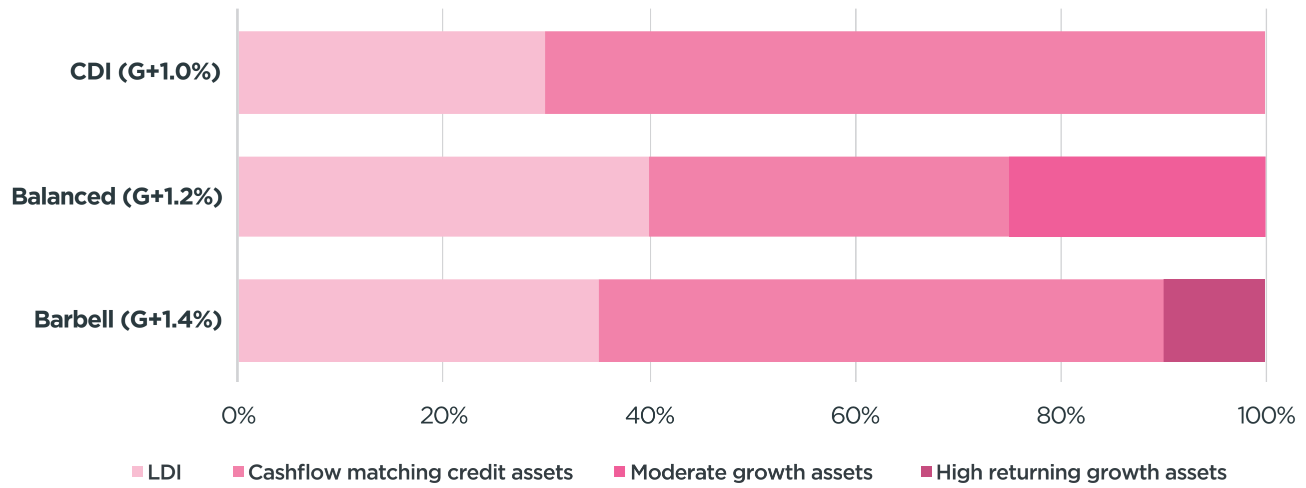
The right decision when setting the long term objective will depend on weighing up these different considerations in the context of the scheme and sponsor's specific circumstances, whilst factoring in the scope for change in these key areas.

Constructing a run-on investment strategy

A run-on objective provides significant flexibility when considering how to construct an appropriate investment portfolio. There are some examples for how a scheme might invest for run-on:

- **Cashflow Driven Investment (CDI)** – a portfolio of high quality contractual assets that seek to generate a fairly predictable stream of cashflows over the long term. These income generating assets can provide a small pick up in return beyond the level required, in a risk balanced way.
- **Balanced portfolio** – constructing an investment strategy that focuses on maximising diversification to make efficient use of the risk budget available. By combining credit and traditional growth assets, such as equities, schemes can extract more upside potential whilst limiting risk to an affordable level supported by the covenant.
- **Barbell investment strategy** – maintaining a low dependency allocation underpinned by a conservative portfolio of gilts and high quality bond assets, where surplus assets are invested in higher octane return generators such as private equity and even venture capital.

Chart 2: Investment approaches to run-on



Source: XPS calculations

The DWP's final draft funding and investment strategy regulations provide schemes with more flexibility than they may have initially anticipated when considering how to invest surplus assets. However, as with any investment strategy decision, this should be considered in the context of scheme funding and covenant support.

There are a range of ways to construct a run on portfolio. The approach that is right for a given scheme will depend on the target return, level of risk and liquidity profile.

But the one thing they will all have in common is a long term time frame.

Case Study

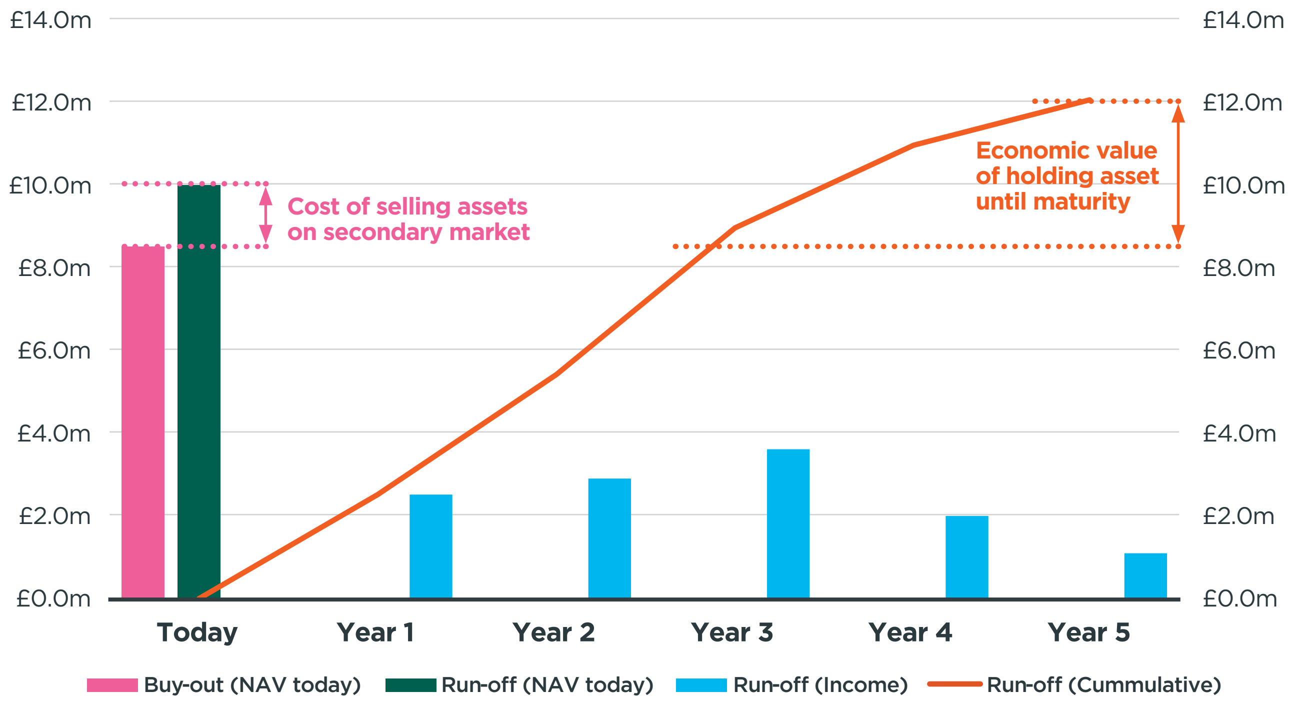
Illiquid assets and secondary market opportunities

Securing benefits with an insurer, can involve incurring loses on asset sales where it leads to sale of assets at a discount. As most buyout transactions are incompatible with illiquid assets, many schemes have chosen to sell their illiquid assets on the secondary market at significant discounts. Here we have historically seen substantial discounts and whilst this has settled somewhat, can still be in the region of 10-25%.

The illustration demonstrates how schemes can extract significantly more value from their illiquid assets by delaying a buyout transaction to realise value that already exists in the investments. We note that other methods are capable of achieving a similar result including sponsor loans and deferred premiums where the insurer effectively lends the scheme money for a period of time.

In this example we assume that a scheme holds a fully deployed illiquid allocation with a remaining life of 5 years. The scheme could sell the allocation to another investor via the secondary market and realise 85% of its value today, ready for a buyout transaction. However, continuing to hold the asset until maturity would allow the scheme to extract 40% more economic value from the holding.

Chart 3: Illiquid asset payoff profile



Source: XPS calculations

Note: Illiquid asset return profile is illustrative only. This assumes the cost of selling assets in the secondary market is 15% and a return of 7.5% per annum. Cashflow profile assumes 25% in year 1, 29% in year 2, 36% in year 3, 20% in year 4 and 11% in year 5.

As well as extracting more value from current holdings, it presents an even greater opportunity for schemes with the capacity to increase their allocation to private market assets. This can provide a number of benefits:

- **Purchasing assets at discounted pricing** can provide a significant pickup in return across the life of the asset.
- **Assets purchased in this way are typically fully deployed** and therefore avoid otherwise lengthy investment periods.
- **Typically the remaining life of these assets** is expected to be <5 years, therefore, may still be appropriate for schemes considering buyout in the medium term.

What can schemes do in the meantime?

For many schemes the mindset needs to be one of being poised for change, rather than necessarily committing to a specific course of action.

Schemes are likely to find themselves in one of three scenarios:

1. **Well-funded on a low dependency position and heading to buyout** – schemes in this situation should check that transacting on a buyout at this point remains the most desirable option. Thought should be given to the magnitude of potential upside and downside of holding off an insurance transaction.

2. **Well-funded on low dependency and already looking to run on** – sense check that the merits of buyout are fully understood so it is not being discounted out of hand, but once confirmed then look at ways to make the most of current opportunities such as investing in illiquid private market assets.

3. **Less well funded on a low dependency position** – for schemes in this position the primary target will initially be achieving either full funding on the scheme funding basis or low dependency funding. However, having a discussion about the longer-term objective is an important step to take now, to avoid the scheme de-risking too soon, or de-risking too late.

For schemes that are close to making key decisions in relation to the long term strategy of their scheme, it's important to consider the full spectrum of possible implications of current regulatory reform. The approach that is going to be most appropriate will depend heavily on a scheme's circumstances. A judgment will need to be be made on the scope for upside versus scope for downside, combined with likely timescales for clarity on the various factors.

Summary

With so much change on the horizon, schemes would benefit from ensuring that they have appropriately considered all the potential upside and downside implications of recent developments.

For further information, please get in touch with **Sian Pringle** or **James Stewart** or speak to your usual XPS Investment contact.

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