Broadstone

# Settlement options for pension schemes

August 2024

# Introduction

Trustees and sponsors are keen to find the optimal solution for the long-term future of their schemes, balancing time and cost, risk and opportunity. In this report, we summarise the expanded range of options now open to them.

Following sustained bond yield increases, a significant portion of defined benefit (DB) pension schemes are now fully funded. This major shift has placed end-game planning further into the spotlight.

The new Funding Code from the Regulator, with its focus on planning and documenting a more detailed long-term funding and investment strategy, only adds to this impetus.

We therefore examine here the various approaches available from the traditional to the newer, more innovative solutions on offer.

# Insurance

## The traditional route for securing pension scheme liabilities – tried, tested, but potentially expensive.

**Outline:** Trustees purchase an insurance policy from an insurer which covers their scheme's liabilities. Ultimately, policies are written in each member's name and the scheme can then be wound up so it ceases to exist. FSCS protection exists for insurance policies.

Trustees should not underestimate the time, cost and effort required to effect an insurance transfer. Detailed preparation, and advice across legal, actuarial, investment and administration are critical to a successful transaction, and there is then still a material project post transaction to manage the scheme through to wind-up.

**Comment:** Pension schemes have been securing liabilities with insurance companies for decades, but the market has really taken off in the past ten to fifteen years. More importantly, demand continues to rise in response to the improved funding position of many schemes and the growing costs, governance requirements and regulatory risks associated with running a scheme.

In response, we have seen existing insurers expanding their capacity and recent new entrants. In a sign of a healthy market, with pressure on existing capacity, this is all welcome news.

However, there are signs of market failure at the smaller end of the market, with limited competition and with some quotes for smaller schemes either experiencing significant lead times and/or carrying a material premium compared to the prices offered to larger schemes. Many insurers have shown signs of limited capacity over the remainder of 2024, ahead of what is usually a busy final quarter of the year as insurers look to finalise deals inside of the calendar year.

Ultimately, insurance is still seen as the gold standard. It should remove all risk from the trustees and sponsor, with member benefits being secured in the capital intensive and prudently regulated insurance regime. Countering this, it remains the most expensive route in the short term, not least as all future expenses are paid up front. Also, future pricing can be hard to forecast, particularly if looking to target a transaction in five to ten years' time.

# Scheme run-on: Low risk state

## Allowing a scheme to continue, potentially until the last pensioner dies, in a low-dependency state.

**Outline:** Trustees and sponsors agree that the scheme should simply be allowed to run on over time. Benefits continue to be paid from the scheme and the scheme continues to exist, almost certainly in a state of low dependency on the sponsor covenant.

**Comment:** In order to do this effectively, the trustees and sponsor must be clear that the advantages outweigh the risks. Although the scheme is likely to be in a low-dependency state with, particularly, investment risk diminished as far as possible, some risk will continue to exist. For example, mortality risk exposure is likely to be retained, as solutions to deal with such a risk remain closed to all but the largest of schemes.

Funding to this low dependency level is also likely to be a higher target than many have traditionally aimed for, albeit one that is encouraged by the new funding regime as schemes approach their end game.

Crucially, the sponsor will still be on the hook for any residual risks that come to pass. If targeting this route, the trustees must be clear that the sponsor covenant is sufficiently strong and able to meet any unexpected extra liabilities or costs that may arise, potentially over the very long-term.

The expenses of maintaining a scheme will also need to be met and these are likely to make low-risk run-on an unattractive solution for schemes with only a small number of remaining members.

# Scheme run-on: Higher risk state

## Allowing a scheme to continue for a defined period of time in order that an insurance transaction is cheaper. Could also be used to improve benefits or provide surplus to sponsors.

**Outline:** Trustees and sponsors agree that the scheme should be allowed to run on for a defined period of time, with a target of having sufficient funds for an insurance transaction at the end of this period.

The investment strategy is set in a balanced way, designed to produce additional return to help pay for the insurance transaction and, possibly, either provide a return of surplus to the sponsor or provide an improvement to member benefits as well. (Insurance transactions, all else being equal, get cheaper over time, as retired members are cheaper to insure than non-retired members.)

**Comment:** This is likely to be an attractive lower cost route for sponsors of medium to large schemes who are reluctant to pay the current premium for insurance or to lock in a low-risk position with limited opportunity for upside.

However, trustees must be confident in the covenant of the sponsor and measure the degree of risk to ensure it is justified. Trustees may also wish to take some form of security over sponsor assets in order to contemplate extra investment risk, as ultimately, they will wish to be clear that the additional risk being taken is covered in some way.

Running on a scheme purely to generate sponsor surplus is unlikely to be in the interests of members. There are also no guarantees regarding future availability or pricing of an insurance transaction, so Trustees need to be confident the solution is appropriate.

Beyond this, the other scheme run-on risks are still present, including those which cannot easily be mitigated, such as mortality risk. The trustees should have contingency plans for dealing with these should they arise; and again, the expenses of continuing to run the scheme should be factored into the decision-making process.

# Commercial consolidators

## Passing a scheme over to a commercial consolidator, enabling risk to be removed in an alternative way from the traditional insurance route.

**Outline:** Commercial consolidators exist, essentially, to aggregate schemes together and take a pooled approach to the higher-risk scheme run-on scenario. They offer a total risk reduction approach at a lower cost than the traditional insurance route, allowing sponsors to close off their liabilities, but the gateway into this route is relatively narrow.

**Comment:** At the time of writing, Clara is the only commercial consolidator which has been successfully assessed by the Pensions Regulator. Other firms hoping to participate in this market have come and gone, illustrating the difficulty in getting this type of solution off the ground. Clara itself had a long journey to approval. However, it is now open for business and has taken on two schemes, one of which is administered by Broadstone on Clara's behalf.

Clara is required to hold defined capital buffers and its scope for writing business is likely to be restricted depending on its investors' appetite for doing so. As such, and due to economies of scale, Clara is initially focused on larger schemes.

The Regulator has also set out three 'gateway tests' which must be met before a transfer to a consolidator can be contemplated and clearance must be obtained from the Regulator before a transfer can take place.

Under the gateway tests, a transfer should only be considered if:

- the scheme cannot access an insurance transaction now; and
- the scheme has no realistic prospect of an insurance transaction in the foreseeable future, given potential employer cash contributions and the insolvency risk of the employer; and
- the transfer will improve the likelihood of members receiving full benefits.

This all means that, whilst the advent of the commercial consolidator is a welcome new addition to the endgame options available to schemes, the range of schemes for which a consolidator transfer has a realistic prospect of success is, for now, relatively limited.
It is also unlikely to be a viable endgame target when setting long-term funding and investment strategy.

# Public sector consolidator

## Passing a scheme over to a public sector consolidator enabling risk to be removed in an alternative way from the traditional insurance route. Not yet in operation but being considered by the Government.

**Outline:** A public sector consolidator is one of the options previously announced by the Conservative Government to meet its agenda of improving investment in UK productive finance vehicles as well as, potentially, accelerating consolidation of the pensions market and improving access to insurance-type solutions for schemes at the smaller end of the market.

It could require benefits to be transformed into one of a number of different standard benefit structures before a transfer could take place but could provide a cheaper and quicker end game solution for relevant schemes.

**Comment:** It is important to note that this option is not operational at present, and the new Government have yet to reaffirm the previous commitments on its introduction by 2026, although we understand that the PPF – who would run the consolidator – have done significant preparatory work alongside central Government.

The PPF already provides a working blueprint for how a public sector consolidator could be delivered at scale: they have an established track record, having already consolidated over 1,000 schemes. A public sector consolidator would be an entirely separate arrangement and would have different entry and administration requirements but the infrastructure appears to be already available. In addition, the size of the PPF would allow for significant economies of scale, potentially leading to more competitive insurance pricing across the board.

Some commentators have focused on the negative aspects of these proposals: citing concerns about nationalising DB pensions through the back door and about distorting what is a well-established insurance market. Whilst it is true that there are still questions to be answered about the detailed functioning of a public sector consolidator, we feel that these objections can be overcome with well thought through and sensible proposals.

Ultimately, a further addition to the range of options open to schemes must be worthy of consideration, particularly if it allows better outcomes for members. The backing of the PPF would appear to make a public sector consolidator an attractive option.

# A brief word on choosing

Trustees and sponsors should turn their minds towards the selection of a long-term plan if they have not already. Whilst it will be a requirement of the new funding regime, doing this now can set the strategic context for many other decisions faced by trustees. For example, if an insurance transaction is likely in the next three years, that may produce a different approach to proportionate compliance with the General Code than if a run-on for the next fifteen years is the chosen solution.

There are many considerations to the selection of such a plan, including funding strategy, investment strategy, sponsor covenant (visibility and longevity), member expectations, expenses and the size of the scheme.

A project to select a plan should be undertaken ideally on a joint basis, in order to maximise buy-in across trustee and sponsor representatives. A better outcome is more likely if all parties are pulling in the same direction.

The long-term plan can then point forwards towards the various actions required to execute that plan and appropriate prioritisation of tasks.

# A dynamic long-term plan

There might be a temptation for trustees and sponsors to go through a project to select the most appropriate long-term plan for their current needs and then not review it: a 'one-and-done' approach.

We would instead advocate the concept of a **dynamic long-term plan** which bends and flexes in response to changes in:

- Scheme and sponsor circumstances
- Pricing and availability for various options in the market
- The legal and regulatory context

A regular review process, even If relatively light touch, will help to ensure that decisions made previously continue to make sense as time goes by. This will allow refinement of timelines or a re-positioning of approach, as needed, or simply re-affirm to all parties that they are on the right track.

# Conclusion

This is an exciting time for the pensions industry. With endgames now within touching distance for many, innovation continues apace across the board to provide an ever-wider range of opportunities for schemes. This allows trustees and sponsors to proactively consider alternative options and make long-term plans which make sense in their own particular contexts.

We would encourage trustees and sponsors to sit down together and really get to grips with the issues involved, ensuring that appropriate plans are made that provide clear actions and can deliver better outcomes for all.

## Find out more

**For more information on how Broadstone can help you, please contact your usual Broadstone consultant, or:**

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