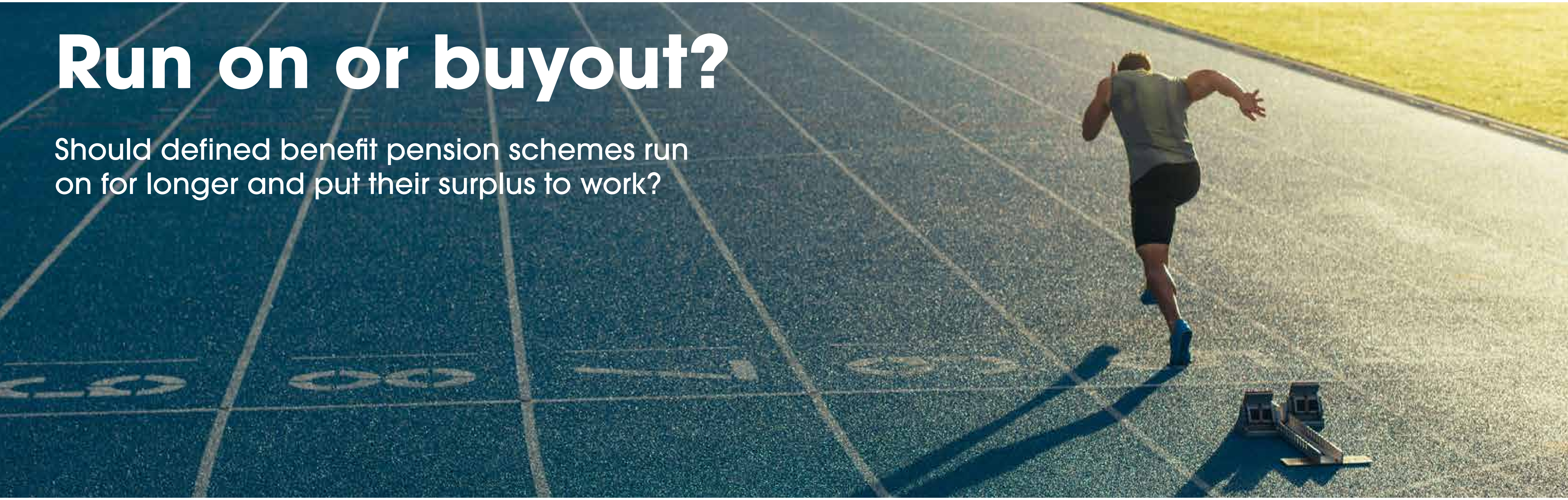
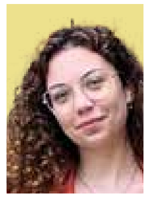
All-member event blog



Run on or buyout?

Should defined benefit pension schemes run on for longer and put their surplus to work?

By Bruna Bauer



With approximately 5,300 schemes managing £1.4 trillion in assets, the private sector defined benefit (DB) market holds immense significance. In addition to this substantial capital market investment, important changes, including the *Mansion House* reforms, were announced and consulted on in 2023. This process has continued into 2024.

David Brown, Senior Director & Training Lead at *Pensions for Purpose*, invited David Fairs, Partner at *LCP*, Douglas Clark, Head of Research and Solutions at *Brightwell*, and William McGrath, Founder of *C-Suite Pension Strategies*, to shed light on these developments.

How have we arrived at this position?

Fairs reflected on the origins of the productive finance initiative, launched after the pandemic, aiming to boost the economy and support a green transition. Initially focused on defined contribution (DC) schemes, the challenge of scale shifted the attention to DB schemes, particularly the small ones lacking investment capacity – since several large schemes already had investments in the areas the government wanted them to focus on.

The September 2022 fiscal event was a game changer, given it drastically improved pension scheme funding levels, making buyout more feasible in the immediate future.

What does productive finance mean?

David Fairs explained, although various definitions of 'productive finance' can be found across a range of different documents issued by the government, productive finance mainly refers to investment in infrastructure, green technology and startups trying to green the economy.

What are options being considered by government?

Two consolidation ideas have emerged. One involves utilising the *Pension Protection Fund (PPF)* as a public consolidator. Even though consolidating the smallest schemes fails to create a substantial asset pool, there are merits to the *PPF* taking on this role, given it offers efficiency and regulatory advantages. Yet, it's unlikely to generate the significant sums required to reshape the investment landscape. Another proposal under consideration focuses on larger, well-funded schemes, encouraging them to increase their investments in productive finance.

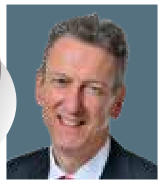
If a *PPF* opt-in regime were established, giving schemes or sponsoring employers the option to procure full protection for members, trustees would have the flexibility to diversify investments for growth. However, this places the burden of risk on the sponsoring employer. One proposal is to facilitate surplus extraction from pension schemes, ensuring benefits for both employers and members. As these ideas evolve, a winter consultation promised by the government will provide further clarity.

What are the potential implications of a change in government?

Fairs does not believe such plans would be ignored in the event of political changes post-election. This is because the overarching goal of leveraging pension schemes to stimulate economic growth is expected to persist regardless of the government in place. Although some details may change, the basic premise of the *PPF* as a public consolidator and the encouragement for large schemes to contribute to economic expansion are likely to continue.

Navigating strategic options in the UK DB market: run on or buyout?

David Brown to William McGrath



Brown asked McGrath whether there is a compelling argument for allowing DB schemes to continue operating without immediately pursuing a buyout.

McGrath believes, if we can convince companies to see the potential benefits of keeping these schemes running rather than just focusing on risk avoidance as they have been in recent years, we could see a significant shift in attitude.

Although finance is one factor, he believes the real motivation could be found in environmental, social and governance (ESG) considerations. When we think about a company's reputation and its commitment to sustainability and its workforce, pensions provide a unique opportunity to invest in the long-term future of current and former employees.

What is really needed is support from the top levels of corporate leadership – it is the executives who can truly make a difference. By getting shareholders and stakeholders focused on ESG issues to prioritise long-term investment returns, companies can reshape their pension strategies. If they aim for sustainable returns above the usual benchmarks, they stand to improve their corporate image and financial outcomes. In this sense, McGrath highlighted it is important for our industry to keep pushing corporate boards and executives to explore how pension schemes can align with broader objectives.

Douglas Clark argued while buyout is often viewed as the gold standard, running on is a viable option for many schemes. It allows for surplus sharing, benefits sponsors and members, and avoids the long-term costs associated with insurance. Running on keeps options open, embraces innovation and change and enables adaptation to evolving market dynamics.

Member-nominated trustees and scheme members

McGrath believes it is essential for pensioners and current employees to ask questions about the surplus. Everyone should be part of this discussion, not just past employees. Member-nominated trustees have a significant opportunity to represent the needs of all pension scheme members. In recent years, higher inflation has caught many by surprise, highlighting the importance of exercising discretion. Trustees should engage with this topic and negotiate with corporations to ensure they are willing to make necessary top-up payments. While regulations pose challenges, the industry has yet to fully explore the potential for improving payments to past and present employees. The missing piece of the puzzle is corporate engagement. It is up to all of us to approach them and invite them to join the debate.

Sustainability

Clark stressed pension schemes and insurance companies operate under different regulations, leading to distinct portfolio compositions. Even now, pension schemes with relatively low-risk portfolios have significantly different asset allocations compared to insurance companies, with notable investments in private equity and infrastructure.

Opting for the run-on approach offers greater flexibility to invest across various sectors of the economy, presenting opportunities, especially from a sustainability perspective, considering the UK's capital needs for the transition.

Discretions

Brown asked McGrath to elaborate on how discretions, particularly in pension increases, can be leveraged within the context of a run-on approach and surplus generation.

McGrath highlighted a common misconception that increasing pensions will inevitably burden the company, noting strategic increases can effectively address inflationary concerns without significant cost. He suggests this is an opportune time for schemes to assess their discretionary powers and consider modifications to ensure alignment with future objectives.

He also emphasised the importance of a strategic review, encouraged by the government, which should include an examination of discretionary powers within scheme rules to ensure future relevance and effectiveness. He advocates a proactive approach to discretion, highlighting its potential benefits for trustees and corporations, including the possibility of surplus funds being reinvested for the benefit of current employees.

McGrath concluded the panel session by saying discretion should be a focal point in pension discussions, with its optimal utilisation expected to emerge from ongoing collaborative dialogue among all stakeholders.

Time for a Q&A...

1 An audience member mentioned concern about the widespread de-risking trend in DB pension schemes. This approach has led to significant under-investment in the economy over the past two decades. They highlighted the need to leave a legacy of investment for future generations, despite challenges posed by regulatory language promoting de-risking. They questioned how their generation can leave a legacy of investment rather than disinvestment.

David Fairs: The regulator operates independently from the government, enforcing rules rather than creating them. It is conceivable to adopt a different funding regime for DB pension schemes, such as funding on a best estimate basis, which would alter the risk transferred to the *PPF* and then impact levy rates. Any change must be considered holistically, as adjustments to one aspect can ripple throughout the system.

In the UK, the government sets the funding framework for DB schemes and the regulator ensures compliance. While the idea of a different regime allowing for greater investment in growth assets is valid, concern should be directed at the government's framework rather than solely at the regulator. Different countries employ varied regimes but this is the one established in the UK.

William McGrath: There has been a notable shift in government mindset, evident through initiatives like the Autumn Statement and the evolving stance of *The Pensions Regulator (TPR)*. McGrath considers de-risking is now seen as a policy error leading to substantial under-investment. With this recognition, there is an opportunity to reconsider strategies.

2 In discussions among pension fund chairs, legality and alignment with fiduciary duty have been key concerns. Specifically, we're grappling with the purpose of discretion: is it solely to protect accrued benefits or to provide additional benefits? How can this be legally defined and aligned with fiduciary duty? Impact investing raises similar challenges in terms of compliance with investment regulations and ensuring financial viability. How can trustees reconcile impact investing with fiduciary duty? What further measures are needed to ensure trustee comfort in exercising discretion?

William McGrath: I believe embracing impact investing is a visionary approach, yet the challenge lies in combining it with legal requirements and fiduciary duty. There is a need for further clarity and guidance to enhance trustee confidence in exercising discretion. The traditional narrow interpretation of trustee responsibility doesn't suffice, particularly in dynamic economic conditions. There is a need for a broader perspective and proactive measures from corporates to facilitate trustees in making informed decisions. By covering downside risks, corporates can empower trustees to pursue more positive investment strategies.

All-member event blog

Insights from the audience: breakout rooms

Postive reasons to run on

During the breakout session the audience formed into groups to discuss the positive reasons why shareholders, management, trustees and advisers should consider running DB schemes on for longer, alongside other end-game strategies.

Larger schemes, benefiting from economies of scale, could reap significant advantages from continuing operations, including financial gains for all stakeholders. However, for smaller schemes, the complexities and management burdens might outweigh the benefits.

There was a collective sense of regret regarding the closure of DB schemes, with some participants suggesting that a shift towards defined ambition and less stringent regulation could have sustained their viability. Understanding members' needs is another reason to continue, with emphasis placed on the importance of financial education and retirement planning.

Additionally, participants expressed optimism about potential improvements in the future, such as the role of public consolidators like the *PPF* in mitigating insolvency risks. Overall, there was a strong consensus favouring the continuation of schemes over exploring alternative strategies.

Barriers

What were the barriers preventing this group from considering running on for longer.

Perception is the primary barrier identified, particularly the perception that opting for a buyout is the easier solution after years of financial contributions. Education emerged as a potential remedy for this, with the consensus being that advisory services could play a role in providing the necessary guidance.

However, the government or regulatory bodies like the *TPR* have not been direct sources of such education. Drawing parallels with the evolution of perception around impact investing since 2017, participants speculated on the future trajectory of running on, suggesting that collaborative efforts and educational initiatives, similar to those undertaken by *Pensions for Purpose*, could shape its understanding in the coming years.

Looking forward

There's no singular solution or entity responsible for driving this initiative forward, rather, it requires collaborative efforts from various stakeholders – trustees, regulators, government bodies and members themselves.

There is genuine interest among trustees to gain a deeper understanding of running on, which is a positive sign. Additionally, involving banks and other third-party capital providers in the discussion could increase support available to corporates considering running on. Also, there is a need to improve communication with members to convey the significance of running on and its benefits to them; to date this has been challenging due to the diverse nature of pension communication.

Finally, there is optimism that focusing on discretions and utilising surplus for the members' benefit, whether from DC or DB generations, will encourage greater engagement.

About our Pensions for Purpose Community

Our goal is to accelerate institutional investors into investments that are good for people and the planet. The *Pensions for Purpose* Community allows members to learn from leaders in the impact investment industry.

We provide a trusted environment for Community members to interact, collaborate and share knowledge. They can engage in a programme of activities to shape their strategy in ESG, sustainable and impact investments.

Our Community Partners

AXA Investment Managers, Downing, EY, Federated Hermes Limited, J.P.Morgan Asset Management, Jupiter Asset Management, LCP Insight Clarity Advice, Nephila, Quinbrook Infrastructure Partners, Stewart Investors, Tikehau Capital, WHEB

Impact Lens

Our research includes published and commissioned reports. Through engagement with diverse stakeholders, from pension funds to their advisers and asset managers, we gather insights into the challenges of sustainable and impact investment. Impact Lens seeks to offer solutions and informed decisions on governance and investments. See our **Impact Lens** page.

More information

If you are interested in a conversation on this topic, please e-mail Karen Shackleton.

Click to watch the video, or read the synopsis of the event.

Help for asset owners

Pensions for Purpose offers asset owners bespoke pension committee training and facilitated workshops to help funds clarify their priorities, goals and how to achieve them. Our Knowledge Centre contains a huge collection of Thought Leadership articles from our members, with over 300 on Paris Alignment alone, as well as our own content.

PENSIONS FOR PURPOSE

Bruna Bauer is an Intern at Pensions for Purpose and a graduate of the University of Glasgow