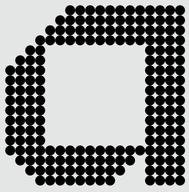


Can consolidation help DB schemes under the UK's new funding regime?

August 2022

For professional investors only – Not for use by retail investors or advisers.

We welcome the publication of draft regulations for the UK's new pension funding regime for DB schemes.[1] Reassuringly, there are no big surprises in the draft regulations which are very much principles-based. The real headlines remain on hold until The Pensions Regulator (TPR) publishes its draft code (expected sometime in the autumn) which should provide information to enable a more detailed impact assessment.

However, there is some new information in the consultation document. In particular, schemes will be required to be fully funded and invested on a low dependency basis by the time their remaining duration is 12 years (clearing up how "significantly mature" will be defined under the regime). For a typical scheme which has a current duration of 18 years, this might mean a period of 12 – 15 years until the low dependency funding and investment requirement kicks in.

That doesn't mean that it can be kicked into the long grass though – the new regulations require an assessment of when the scheme is expected to become significantly mature at each triennial actuarial valuation "check point".

Statement of strategy

Importantly, there will be a requirement to submit a "Statement of Strategy" to TPR providing a rationale for the low dependency assumptions and the plan for moving from the current funding position to this low dependency target over the required timeframe.

Whilst the consultation provides no mention of "fast-track" or "bespoke", it is reasonable to expect the Statement of Strategy to be a simple statement of compliance under a fast-track approach. Bespoke will be a more involved process.

> "What is becoming apparent is that the new regime will mean smaller pension schemes will need to spend a higher proportion of their budgets on developing and documenting their funding and investment strategies in order to comply."

What is becoming apparent is that the new regime will mean smaller pension schemes will need to spend a higher proportion of their budgets on developing and documenting their funding and investment strategies in order to comply. Indeed, DWP's impact assessment that was published alongside the draft funding regulations identified that smaller schemes typically lag behind larger schemes when it comes to setting a journey plan to a low dependency target, and went on to expressly state that "the proposed changes are expected to have a disproportionate impact on small schemes".

A twin-track regime with "standardised bespoke" available through DB master trusts

Although we await details of TPR's second consultation in response to DWP's draft funding regulations, a key feature of TPR's first consultation back in 2020 was that schemes could either meet the requirement to move towards a low dependency target in a prescribed way (the "fast-track approach") or through a "bespoke approach". Clearly there is some detail still to be confirmed in TPR's second consultation, but assuming these two key principles broadly remain then in general we expect:

- fast-track to mean a lower cost of compliance but higher overall funding cost; and
- bespoke to provide the opportunity to lower funding cost but the expenses associated with implementing and demonstrating regulatory compliance will be higher.

Smaller schemes with fewer resources could be more likely to opt for fast-track and face a significant increase in funding cost as they simply do not have the resources to implement a compliant bespoke strategy.

This is where DB consolidation has an important role to play in reducing the escalating costs and risks associated with managing legacy DB pension obligations.

[1] DWP launches consultation on DB funding rules - GOV.UK (www.gov.uk).

How can DB master trusts help?

DB master trusts open up the investment universe and efficiencies readily available to large schemes to their smaller counterparts.

Through efficient implementation of a sophisticated but streamlined investment approach targeting a long-term portfolio that is largely fixed income based (more on this later), we believe a lower long-term funding target is entirely justifiable and indeed preferable in order to control over-funding risk. This is not about avoiding the new fast-track/bespoke regime, which we think has significant merit, but is about using the additional sophistication and capital efficiency that small schemes can potentially access through a master trust to make sure the scheme's investments are working as hard as they can whilst still delivering on the principles of the new funding regime.

Lowering the funding target by, say, 4%, which may be entirely justifiable based on a sophisticated integrated investment and funding plan within a DB master trust, could have a material impact on funding costs.

A sample scheme

Consider a pension scheme that has fast-track liabilities of £50m which aims to target a low dependency target based on a discount rate of 0.5% p.a. above gilts. This scheme has assets of £44m and has a resulting shortfall of £6m. Let's assume that annual contributions of £1m for the next 6 years would be payable under a fast-track approach.

Through careful integration of funding and investment strategies, the same scheme could justify a bespoke liability valuation of £48m (a 4% reduction) based on a discount rate that is slightly higher than the anticipated fast-track level but still very much consistent with a journey towards a low dependency investment strategy. The deficit would be 33% lower at £4m rather than £6m and annual contributions may be reduced by £333k each year to £667k.

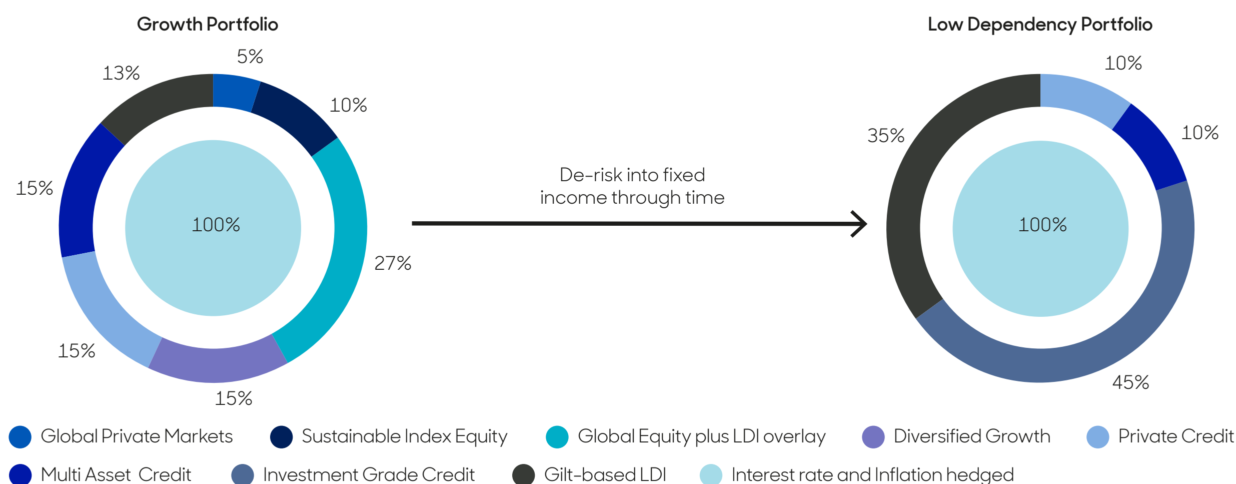
What is the investment approach within the abrdn pensions master trust?

Through close collaboration with XPS Pensions Group, abrdn has developed model investment portfolios appropriate for each stage in a scheme's journey to its long-term objective. The principle is simple and not a new one (i.e. as a scheme matures and its funding level increases, the reliance on contractual yield increases which provides a match for underlying benefit cashflows).

However, what is different is the operational efficiency in delivering this principle en masse within a DB master trust framework, and passing the resulting efficiencies onto the underlying sections.

"What is different is the operational efficiency in delivering this principle en masse within a DB master trust framework, and passing the resulting efficiencies onto the underlying sections."

The charts below show typical "growth" and "low dependency" investment strategies that exist within our master trust.



Source: abrdn.

The low dependency model solution is predicated on a belief that assets which provide a contractual return give the best chance of being able to pay all member benefits without the need for any new contributions. Both solutions are well-diversified – initially with a material allocation to growth asset classes but with an increasing allocation to "low turnover fixed-income" assets across private as well as public markets.

At the point of low dependency, the expected yield is largely contractual and expected to be around 1% in excess of gilts (net of charges). Key residual risks will be default of issuer and liquidity; the latter can be managed through cash flow modelling and the former through a prudent margin being deducted in the funding discount rate. Allowing for these risks, a prudent discount rate could be in the range 0.7% p.a. to 0.8% p.a. above gilts based on spreads[2] between gilts and other fixed income assets. It will be important to keep such a premium under review and not necessarily default to an approach which retains a fixed assumption over gilt yields.

This approach seems to be consistent with the new draft regulation (5) which defines a low dependency investment allocation as one where "the assets of the scheme are invested in such a way that the cash flow from the investments is broadly matched with the payment of pensions…" and "the assets…relative to the value of the scheme's liabilities is highly resilient to short term adverse changes in market conditions"

What about the other expense and cost savings of a DB master trust?

A typical pension scheme could save around 30% in running costs as a result of DB consolidation. Sticking with our £50m example scheme from earlier:

- let's assume total expenses (including investment management – often the "hidden cost") are around £200k.
- Consolidation within a DB master trust could easily take this figure down by around £60k per year (or a total of £1m over the future lifetime of the scheme).

Coupled with the funding savings above, a DB master trust like the abrdn pensions master trust might provide total[3] savings of c. £0.4m per year over the deficit recovery period (or around £3m over the lifetime of the scheme).

Is it prudent to avoid over-funding?

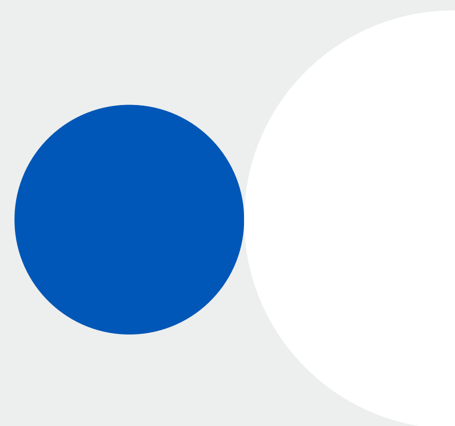
Over-funding of pension schemes is a real concern for scheme sponsors and trustees. Sponsors might view this as a poor use of resources and trustees could be faced with a dilemma in terms of how best to use any surplus. With a competitive insurance market, more risk transfer solutions in the offing and uncertainty over ownership and use of surplus, a gradual journey to buyout rather than overshooting the target might be more preferable.

Conclusion

We welcome the publication of the draft regulations for the new DB funding regime and support the principles underlying this. However, the new regime may present smaller schemes with some challenges that they may struggle to overcome on their own.

Consolidating within a DB master trust could help smaller schemes achieve compliance more easily, but more importantly it could also help those schemes work towards a low dependency position in a more efficient manner, which benefits trustees, sponsors and members alike.

We eagerly await the detail of the TPR's draft funding code in the autumn. In the meantime, if you would like to find out more please contact one of our specialists below.



[2] At 31 March 2022.

[3] Combined funding and expense savings.

Contact us

If you would like to find out more to help decide whether transferring your defined benefit pension scheme to a master trust could help your business, please contact one of our pension solutions specialists at **DBmastertrust@abrdn.com**. Email is not a secure form of communication so please do not send any personal or sensitive information.

Brian Denyer
Senior Solutions Director – Pensions

Mark Foster
Head of Pension Solutions

Toby Rockingham
Director, UK Institutional

Important Information

The value of investments, and the income from them, can go down as well as up and an investor may get back less than the amount invested. Past performance is not a guide to future results.

The above marketing document is strictly for information purposes only and should not be considered as an offer, investment recommendation, or solicitation, to deal in any of the investments mentioned herein and does not constitute investment research.

abrdn does not warrant the accuracy, adequacy or completeness of the information and materials contained in this document and expressly disclaims liability for errors or omissions in such information and materials. Any research or analysis used in the preparation of this document has been procured by abrdn for its own use and may have been acted on for its own purpose. The results thus obtained are made available only coincidentally and the information is not guaranteed as to its accuracy. Some of the information in this document may contain projections or other forward looking statements regarding future events or future financial performance of countries, markets or companies. These statements are only predictions and actual events or results may differ materially. The reader must make their own assessment of the relevance, accuracy and adequacy of the information contained in this document and make such independent investigations, as they may consider necessary or appropriate for the purpose of such assessment.

This material serves to provide general information and is not meant to be investment, legal or tax advice for any particular investor. No warranty whatsoever is given and no liability whatsoever is accepted for any loss arising whether directly or indirectly as a result of the reader, any person or group of persons acting on any information, opinion or estimate contained in this document. abrdn reserves the right to make changes and corrections to any information in this document at any time, without notice. This material is not to be reproduced in whole or in part without the prior written consent of abrdn.

abrdn is a global business providing a range of services to help clients and customers plan, save and invest. abrdn group uses different legal entities to meet different client and customer needs. Some elements of the abrdn client experience may contain previous brand names until all brand name changes have completed.

United Kingdom (UK): abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh, EH2 2LL. Authorised and regulated in the UK by the Financial Conduct Authority.

For more information visit abrdn.com

GB-280722-178393-1