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RESEARCH

Big Schemes Survey: £1bn+

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Introduction

Many pension innovations stem from big schemes and work their way through to smaller schemes as the strategies become more refined and accessible.

For example, asset backed contributions, pension increase exchanges, and normal pension ages linked to longevity improvements. The last year has seen a number of the schemes covered by our survey undertaking bulk annuity or longevity transactions. Our analysis shows how these schemes are maturing quickly which should prompt greater activity in this area in future. But what are the other basic features of the big schemes in terms of scheme type and investment allocation; and how are they doing currently in terms of investment returns and funding position?

This is our third annual survey on private sector defined benefit (DB) schemes in the UK with assets of over £1bn. It is based on publically available data up to 31 October 2014 and focuses on scheme type, asset allocation, investment performance, deficit contributions, and adviser fees. The survey covers 170 schemes, but not all schemes are included within each section.

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75% of schemes have a deficit on their company accounting basis, unchanged from last year.

Some of the highlights from our analysis include:

- 57% of final salary schemes in our survey are closed to new members and a further 24% are also closed to future accrual, leaving just 19% open to new members. Career Average Revalued Earnings (CARE) schemes are not far behind, with 21% open to new members. The Pensions Regulator's and Pension Protection Fund's 2014 Purple Book shows 53%, a slightly lower proportion of schemes, closed to new members and 32%, a slightly higher proportion closed to future accrual.
- 75% of schemes have a deficit on their company accounting basis, unchanged from last year.
- The average annual employer deficit contribution was £94m, but ranged from £7m to £400m.
- A significant proportion (18%) of assets have been classed as 'other' i.e. hedge funds and derivatives, or funds where the allocation between equities, gilts, property, etc could not easily be determined. There appears to be a steady decline in the use of such investment vehicles as this has actually reduced from 22% last year and 25% the year before that.
- The average 3-year investment return was about 8.5% per year (for end dates ranging between March 2013 and March 2014), and the 5-year return was about 9.5% per year. These returns were significantly larger than the 1-year return which was around 5.5%.
- The average PPF levy paid was £3.2m.
- The average annual investment management fee was around 0.2% of assets, which is unchanged from last year.

Please contact me for further information on the results of our research.

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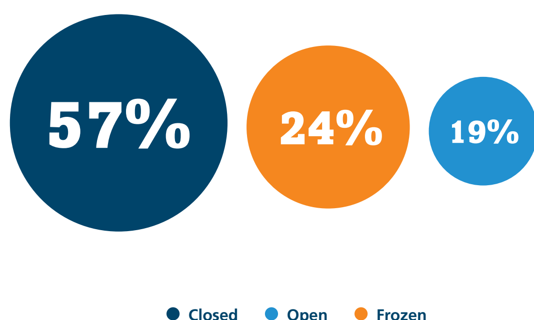
The decline of defined benefit

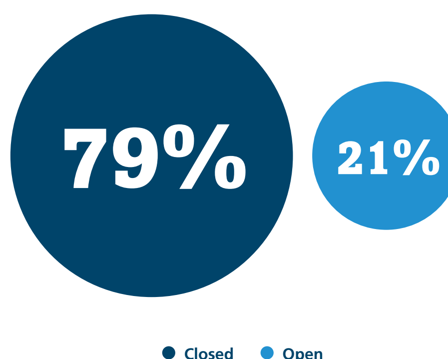
Not all final salary scheme closures result in a move to defined contribution – many of the big schemes have moved to CARE schemes. A number of those CARE schemes are now closed to new members themselves, but generally remain open to accrual. We have analysed the status of final salary (119 schemes) and CARE (14 schemes) separately below.

Final salary scheme status



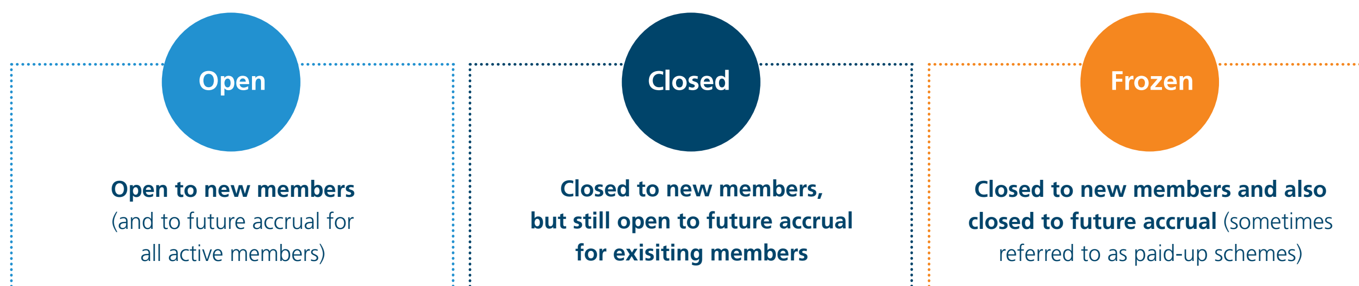
Closed Open Frozen

CARE scheme status



Closed Open

Source: Scheme data downloaded from Pension Funds Online and individual scheme accounts



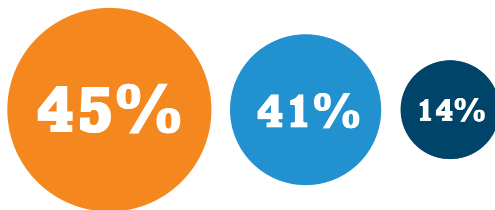
The charts show that although only 24% of final salary schemes are frozen, the great majority (81%) are closed to new members. CARE schemes are generally much younger than final salary schemes, so it is perhaps surprising that such a large portion of these are already closed to new members (79% compared to 72% last year). However, quite a number would have been established as closed schemes from the outset, at the point of closing a final salary scheme to accrual and offering the CARE structure to existing members only, with a DC structure for new employees.

These figures can be compared against those published by The Pensions Regulator and Pension Protection Fund in their 2014 Purple Book. The Purple Book looks at the universe of PPF eligible schemes, and is based on information submitted to the Regulator via Scheme Returns as at 31 March 2014. The Purple Book shows 53%, a slightly lower proportion of schemes, across the universe closed to new members and 32%, a slightly higher proportion closed to future accrual.

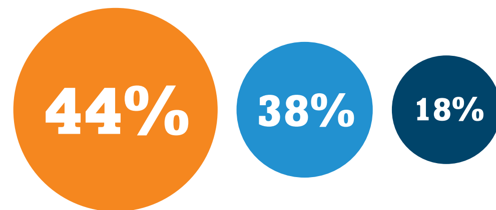
Scheme maturity

One key factor in identifying appropriate de-risking strategies is the maturity of the scheme, i.e. the proportion of pensions that are in payment and the age distribution of all members. For example, buy-ins and buy-outs are often most cost effective in relation to pensioners, whereas transfer and early retirement exercises are only appropriate in relation to deferred or active members. The following charts illustrate the membership profile of the schemes included in our survey, split between those with and without a CARE section.

Schemes with a CARE section



Schemes without a CARE section

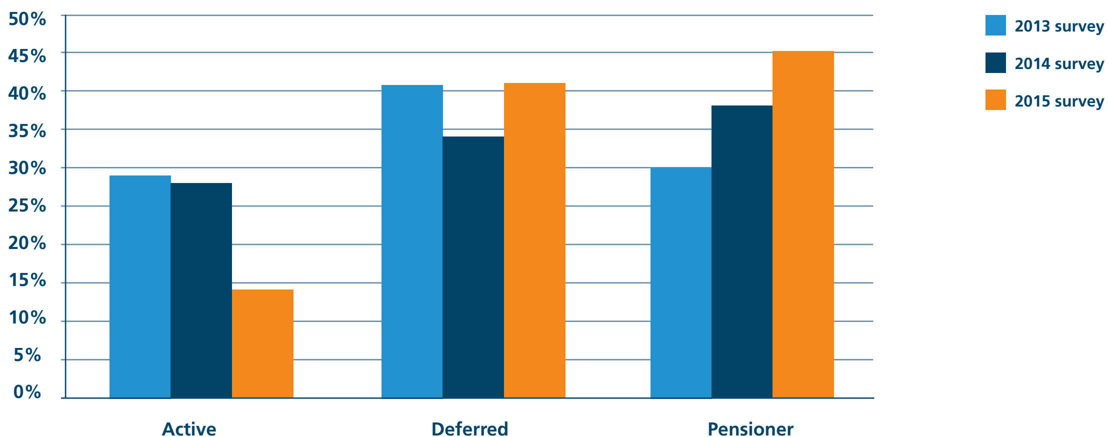


Pensioner · Deferred · Active

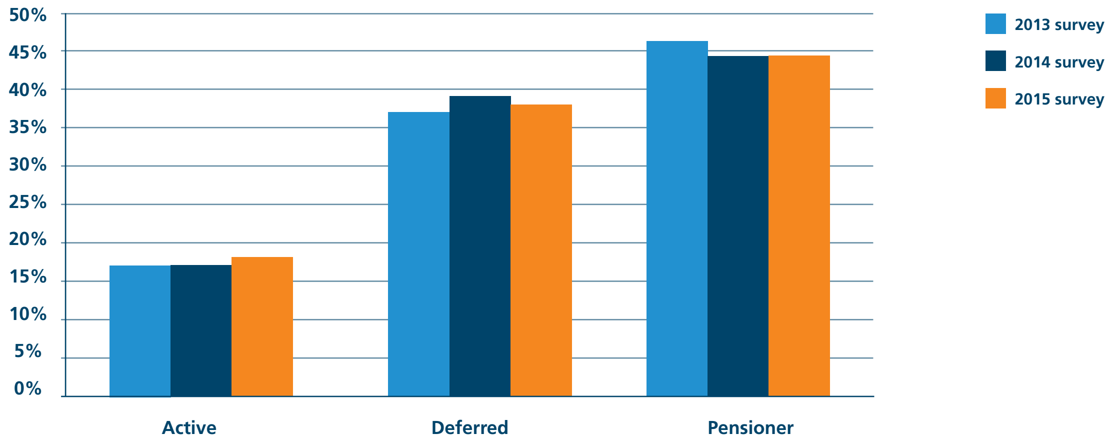
Source: Scheme data downloaded from Pension Funds Online and individual scheme accounts

As can be seen, the two sets of schemes have a similar member profile. When compared to last year's data, the average profile for schemes without a CARE section has not changed whereas the profile for schemes with a CARE section has seen a significant increase in pensioner members and a corresponding decrease in the proportion of active members.

Scheme with a CARE section



Source: Scheme data downloaded from Pension Funds Online and individual scheme accounts



Source: Scheme data downloaded from Pension Funds Online and individual scheme accounts

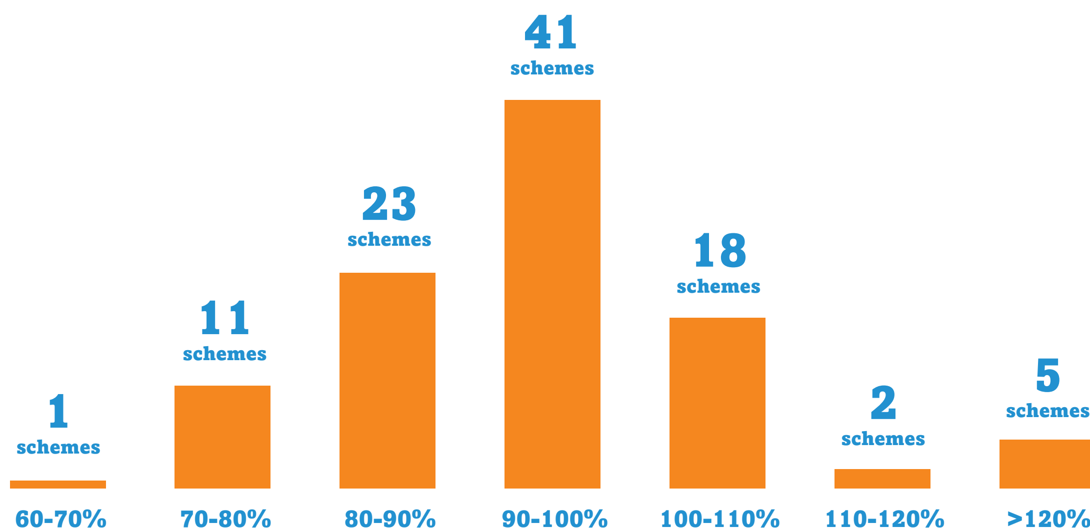
Assets and liabilities

All of the schemes analysed had total assets exceeding £1bn. In around 80% of schemes by number, total assets were below £5bn and the mean average across all schemes was £4.35bn – an increase of £0.15bn compared with the previous year's data. The largest scheme had assets of approximately £40bn.

The liability values were available for 101 schemes, of which 76 (around 75%) had a deficit on the company accounting basis, with the remainder showing a surplus or zero balance. The average funding level across these schemes was 94%. Anecdotally, the proportion of DB schemes across the UK as a whole with an accounting deficit at the relevant dates would have been much higher than 80%. The data shows that the average funding level is unchanged since the previous Big Scheme Survey.

The profile for schemes with a CARE section has seen a significant increase in pensioner members.

Summary of funding level information



Source: Scheme data downloaded from Pension Funds Online, individual scheme accounts and member newsletters

The size of deficit is another key factor in determining the range of appropriate exercises for consideration. With a deficit of 20%, for example, a full buy-in or buy-out is unlikely to be attractive and transfer exercises may require more cash from the employer than it has available. Leveraged interest rate or inflation hedges, on the other hand, might be appropriate, as could be a PPF-compliant group guarantee (to help reduce the PPF levy) or an asset-backed contribution - see explanation below - (to improve the disclosed funding position without requiring substantial cash contributions).

Employer contributions

The average annual contribution made by sponsoring employers to fund their scheme deficits was £94m. As would be expected, the variation in deficit contributions was substantial, ranging from around £7m to around £400m.

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***What is an asset backed contribution?**: This is where the expected proceeds from an income-generating asset owned by the sponsoring employer are formally assigned to the scheme, so that the scheme's balance sheet benefits immediately from the capitalised value of the future income.*

Asset allocation

The following chart summarises the asset allocations of the schemes within our survey. The split between growth assets (e.g. equities) and matching assets (e.g. gilts) is a fundamental decision and traditionally a typical growth/matching split has been 60/40. However, the allocation has swung the other way during the last few years (i.e. to around 40/60) and our analysis shows that the big schemes are in line with this trend. The average allocation to equities was about 31%, with an average of 51% allocated to bonds, property, and cash.

Average asset allocation

Source: Scheme data downloaded from Pension Funds Online and individual scheme accounts

The observed move towards matching assets is partly a consequence of maturing schemes – as more schemes are closed to new members the average age increases and so matching assets become more appropriate.

It should be noted, though, that the 'other' category is substantial at 18% and it is likely to include more growth assets than matching. A large proportion of the 'other' category is accounted for by pooled investment vehicles. The asset allocations in these pooled funds vary, but often contain a higher proportion of growth assets than matching assets. The 'other' category also includes alternative asset types such as derivatives, emerging market currencies and hedge funds.

Investment performance

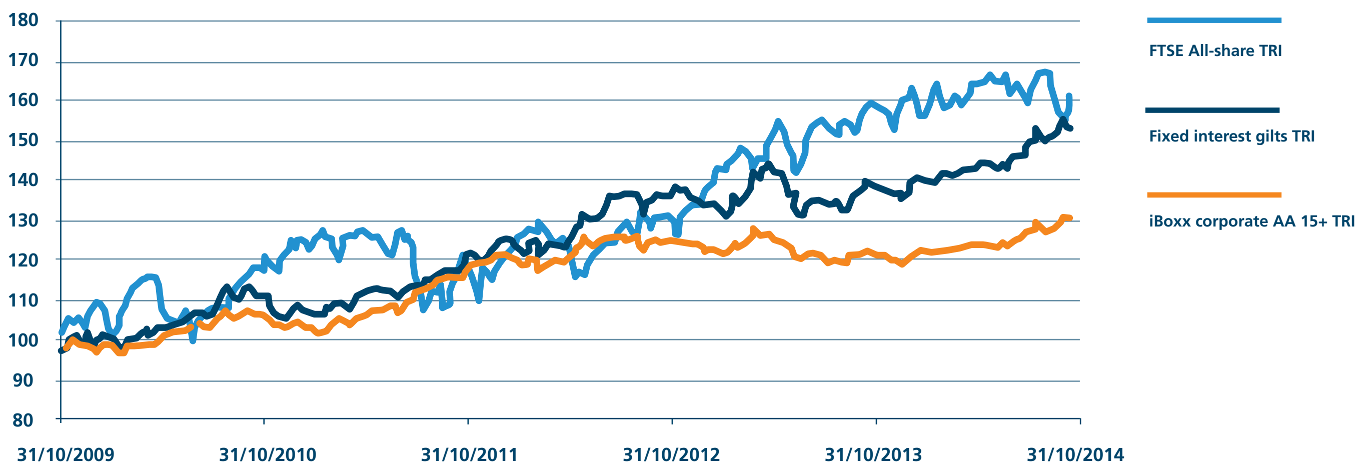
The following chart summarises the investment performance of schemes included in our survey over 1-year, 3-year, and 5-year periods ending between March 2013 and March 2014:

Average annualised investment performance

Source: Individual scheme accounts and member newsletters

The 1-year performance is significantly lower than for the 3-year and 5-year periods. This reflects the levelling off of gilt and corporate bond returns over the period since October 2012. The graph shows equity, gilt, and corporate bond total return indices over the 5-year period from 31 October 2009 to 31 October 2014.

Market returns

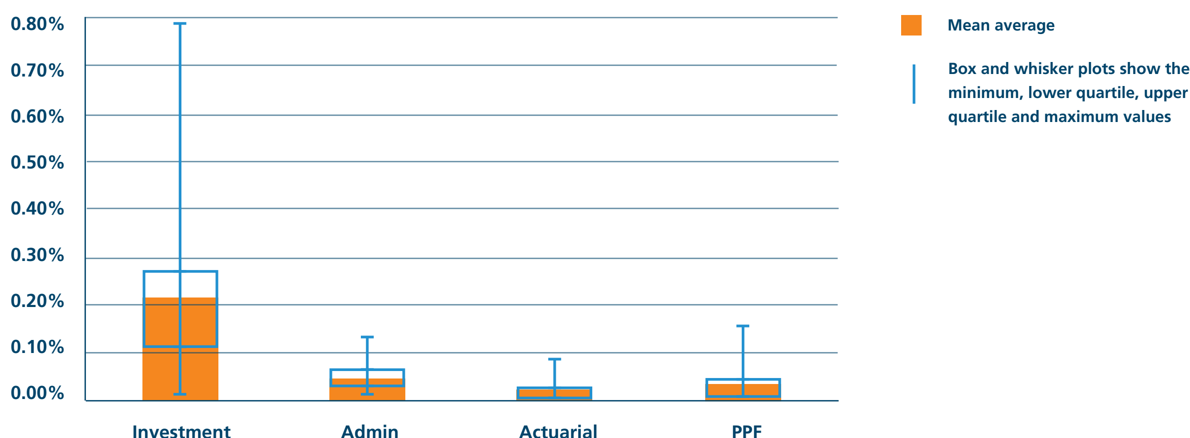


Source: FTSE and iBoxx market statistics

Scheme expenses

The rising cost of running DB pension schemes (due to regulatory complexity and the PPF levy) is often quoted as a contributory factor in the demise of such schemes. Careful monitoring and governance is required to keep costs under control. For large schemes, economies of scale should help to keep costs down, but in practice even tighter control is required to prevent costs from escalating.

The following chart shows the spread of annual fees, as a percentage of scheme assets, paid by schemes included in our survey:



Source: Individual scheme accounts and member newsletters

The average PPF levy was approximately £3.2m, corresponding to 0.03% of scheme assets. For these big schemes it is clearly worth paying for professional advice to ensure that the levy is kept as low as possible. Smaller schemes should take steps to avoid picking up an undue share of the total levy after the big schemes have optimised their position.

Investment fees are the largest outlay by a substantial margin, at around 0.2% of the average total scheme assets. The big schemes are more inclined to hold segregated assets and employ complex investment structures in the hope of achieving out-performance. As such, their absolute spend on investment fees may be higher than for a typical smaller scheme although as a percentage of the scheme assets you would expect the costs to be lower. Between the schemes included in our survey, though, weighting the average investment fees by scheme assets has no impact, so beyond £1bn of assets there is no evidence that extra scale reduces investment fees as a percentage of assets.

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Case study - Tate & Lyle

As part of their most recent actuarial valuation, Tate & Lyle were seeking to continue to de-risk their £1 billion legacy DB pension scheme, but without a significant increase in deficit recovery contributions.

As the company's advisers, we helped them agree a funding plan that achieved the company's objective of keeping cash contributions at their target level, while also delivering sufficient ancillary security for the trustees to remain comfortable with the pace of contributions, the level of investment risk being run, and the 2026 target for full funding on a self-sufficiency basis.

Prior to the scheme's 2013 actuarial valuation, the company and the trustees had put in place a framework for future investment de-risking, which aims to reach a fully matched position within 15 years. In conjunction with this planned de-risking, and in the lead up to the valuation, the company and trustees also purchased a buy-in policy for a significant proportion of the scheme's pensioner members.

We helped the company to align the scheme's actuarial valuation method and assumptions to the existing de-risking framework, including a simplified technical provisions basis and an allowance for best-estimate investment out-performance within the recovery plan. This meant that the headline level of deficit reduction contributions being paid into the scheme could be maintained at the level set at the previous actuarial valuation (£12 million per year). At the same time, the company had also achieved significant progress towards de-risking the scheme over this period. The new aligned funding and investment target is to reach full funding on a self-sufficiency basis by 2026.

In conjunction with the committed deficit reduction contributions of £12 million per year, the company also set up a secured funding account, funded through annual payments of £6 million per year (for six years). The company and trustees have agreed a number of trigger events which may result in the release of some or all of the funds in the secured funding account into the scheme at various points over the lifetime of the structure. These trigger events include under-performance of the scheme's assets and a deterioration in the employer covenant, thereby ensuring that the agreement with the trustees forms a complete financial management plan for the remaining lifetime of the scheme. This innovative and integrated approach to risk management also ensures full compliance with the key principles set out in The Pensions Regulator's new code of practice on 'funding defined benefits'.

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Liability management and risk reduction

For some employers, a large defined benefit pension scheme can represent a volatile accounting expense and substantial business risk.

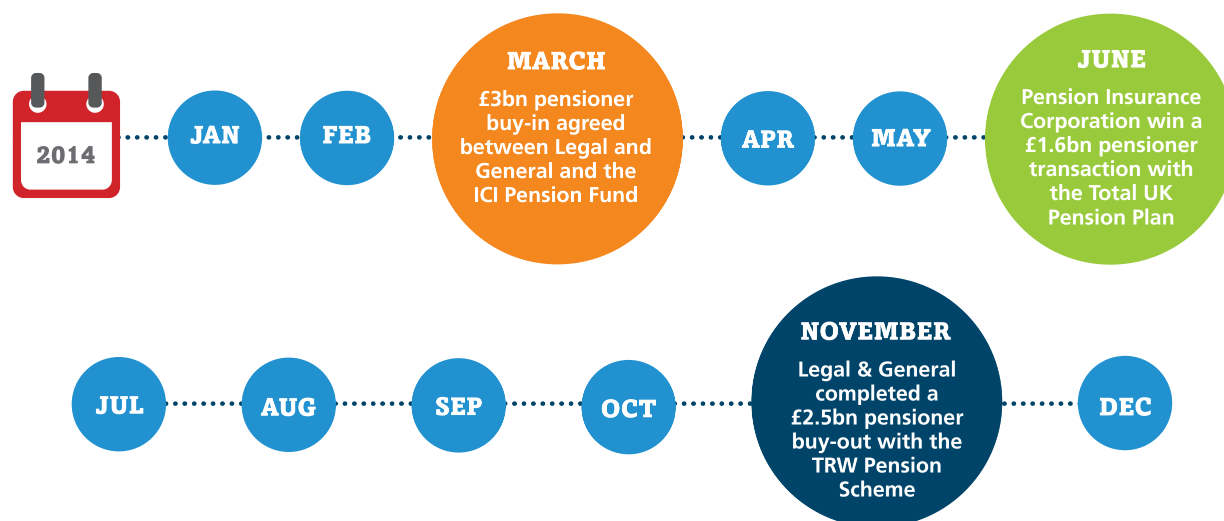
Many employers have taken the first step to containing the growth of future pension liabilities by closing their scheme to new entrants, changing the benefits being accrued or even closing to future accrual altogether.

However this still leaves employers with a legacy past service liability which should be managed. Over the last few years, bulk annuity contracts have increased in popularity as a means of removing all investment, inflation and longevity risks associated with a group of members or the whole scheme. Legacy liabilities can also be reduced and re-shaped using a variety of techniques (so called liability reduction exercises) with the effect of improving the scheme's funding level.

Activity in the bulk annuity market

A number of 'big schemes' have been active in the bulk annuity market throughout 2014, with the following notable transactions taking place:

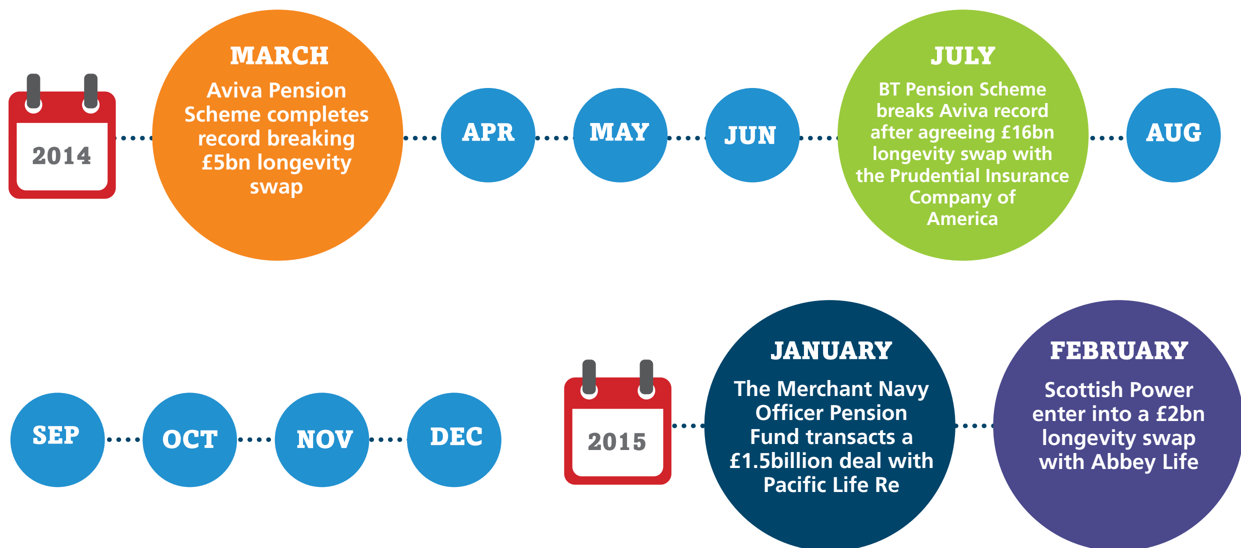
- The record for the largest bulk annuity transaction in the UK was broken in March 2014 by the £3bn pensioner buy-in agreed between Legal and General and the ICI Pension Fund. Prior to that transaction the record had been held by the £1.5bn deal Pension Insurance Corporation completed with the EMI Group Pension Fund in 2013.
- June 2014 saw Pension Insurance Corporation win a £1.6bn pensioner transaction with the Total UK Pension Plan.
- In November 2014 Legal & General completed a £2.5bn pensioner buy-out with the TRW Pension Scheme. This is the second largest bulk annuity transaction completed by a UK insurer and followed a sequence of liability management actions, including both a pension increase exchange and an enhanced transfer value exercise.



Managing longevity risk

The risk that people live longer than expected is one of the key risks that pension schemes are exposed to. It has become ever-more high profile in recent years, partly due to rapid rises in life expectancy and partly due to the current low interest rate environment. Recent notable transactions amongst the 'big scheme's' include:

- The Aviva Pension Scheme completed a record breaking £5bn longevity swap in March 2014, with 3 of the world largest re-insurers Munich Re, Scor and Swiss Re. The transaction covered the pension liabilities of around 19,000 members of the Scheme,
- The record set by the Aviva transaction was broken in July 2014 when the BT Pension Scheme announced that they had completed a £16bn longevity swap with the Prudential Insurance Company of America. This was over three times the size of the Aviva transaction and covered 25% of the scheme's longevity exposure. The pension scheme created its own insurance company to engage with the re-insurers.
- January 2015 saw the Trustee of the Merchant Navy Officer Pension Fund announce that it had hedged the longevity risk of 16,000 members of the Fund, in a £1.5billion deal. Pacific Life Re assumed ultimate liability for the risk.
- Scottish Power entered into a £2bn longevity swap with Abbey Life in February 2015. The deal transferred the risk of nearly 9,000 pensioner members living longer than expected to three different re-insurers.



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Contact information

If you would like to discuss any of the matters raised in this survey then please contact Andrew Vaughan FIA, who is a corporate actuary based in our London office, on:

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