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FM Watch

How well do fiduciary managers address pension schemes' endgame objectives?

The trustees of UK defined benefit (DB) pension schemes are waiting for The Pensions Regulator (TPR) to finalise its DB Funding Code. Previous consultations focused on the importance of trustees setting a long-term target for their schemes – likely to be a stronger target than many schemes' current Technical Provisions – and having a plan in place to reach it. In addition the 2022 gilts crisis has meant many schemes' funding levels have improved and are now closer to buyout.

As a result, now is a good time to follow up our 2021 paper on how fiduciary managers (FMs) de-risk pension schemes throughout their journey plans. This edition of XPS FM Watch examines how UK FMs are helping their clients reach their endgames in a number of key areas.

End-game Planning
June 2021
How do fiduciary managers de-risk as schemes approach their long-term funding targets?

In this report we explore:

- **Whether clients of FMs have set a long-term target;**
- **Where a target is in place, the nature of that target;**
- **FMs' capabilities to help pension schemes approaching buyout; and**
- **FMs' fees as their clients' investment strategies are de-risked.**

Key takeaways for trustees

1. Think about the endgame and have a long-term target in place.
2. Carefully consider the target – low dependency or buyout.
3. If targeting low dependency, make sure you understand the level of inherent risk – is the investment strategy really low dependency?
4. Check what experience and expertise your FM has of buyouts and tailoring investment strategies accordingly.
5. Agree how your FM will set their fees as you de-risk.

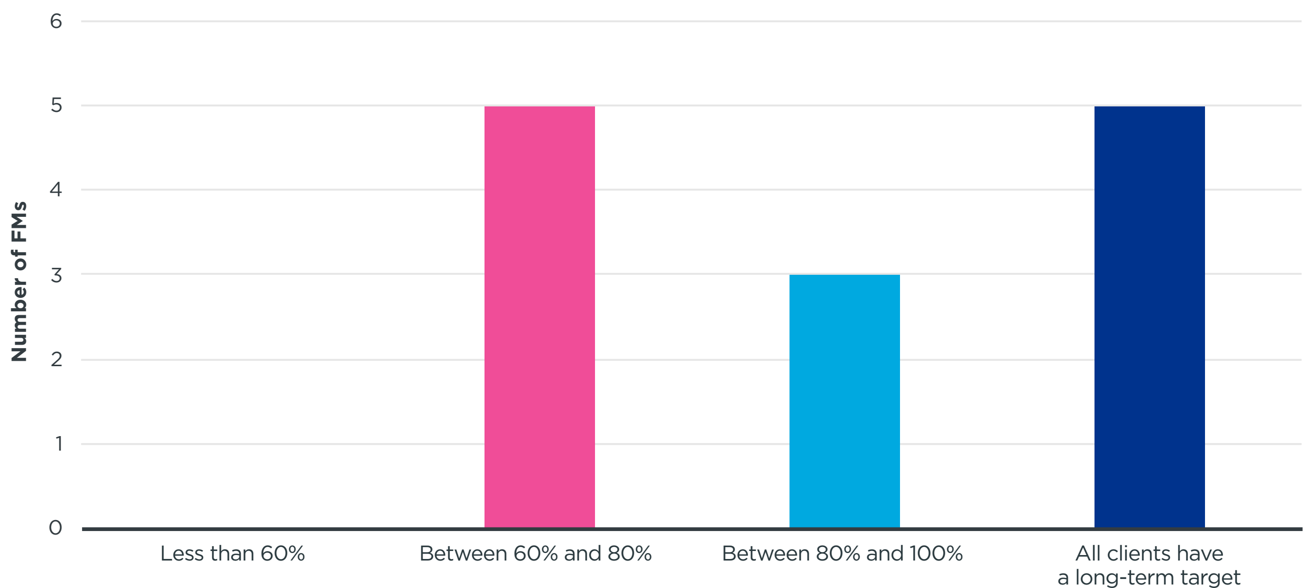
Funding level improvements in recent years and TPR's consultation on the new funding code suggest that FM clients should have a long-term target in place.

Adam Rouledge
Senior Consultant, XPS Investment

How well funded are pension schemes managed by FMs?

Until the volatility and inflationary pressures seen from the start of 2022, investment markets had generally been very favourable for DB pension schemes, particularly those that had high levels of interest rate and inflation hedging, as tends to be the case for FM clients. Our survey from the start of 2022 suggested that most FM clients were 100% funded (or better) on Technical Provisions. Gilt yield rises over 2022 will have reduced the value placed on pension scheme liabilities since then. Given the high levels of liability hedging seen across FM clients, significant improvements in Technical Provisions funding levels following the September gilts crisis are likely to have been unusual. However, we expect most FM-managed pension schemes' buyout funding levels to have improved, given hedges are lower on the buyout basis compared to TPs. As a result we expect most FM-managed schemes are now able to think about a more ambitious long-term target (than TPs) – their 'endgame'.

Chart 1: Proportion of FM clients with a long-term target in place



Source: XPS Pensions Group

The chart above shows that a sizeable minority of FM clients do not have a long-term target in place, beyond being fully funded on a TPs basis. We had expected more schemes using FM to have a long-term target relative to traditional advisory, given the governance assistance that FMs ought to be giving their clients. Also, the concept of a long-term target is not a new one, even if moves to formally bring this into regulations are not yet complete. Where they do not have a long-term target, trustees should look to put one in place, potentially in conjunction with TPR's finalised funding code.

We expected more schemes with FMs to have a long-term target. Where they do not have a long-term target, trustees should look to put one in place.

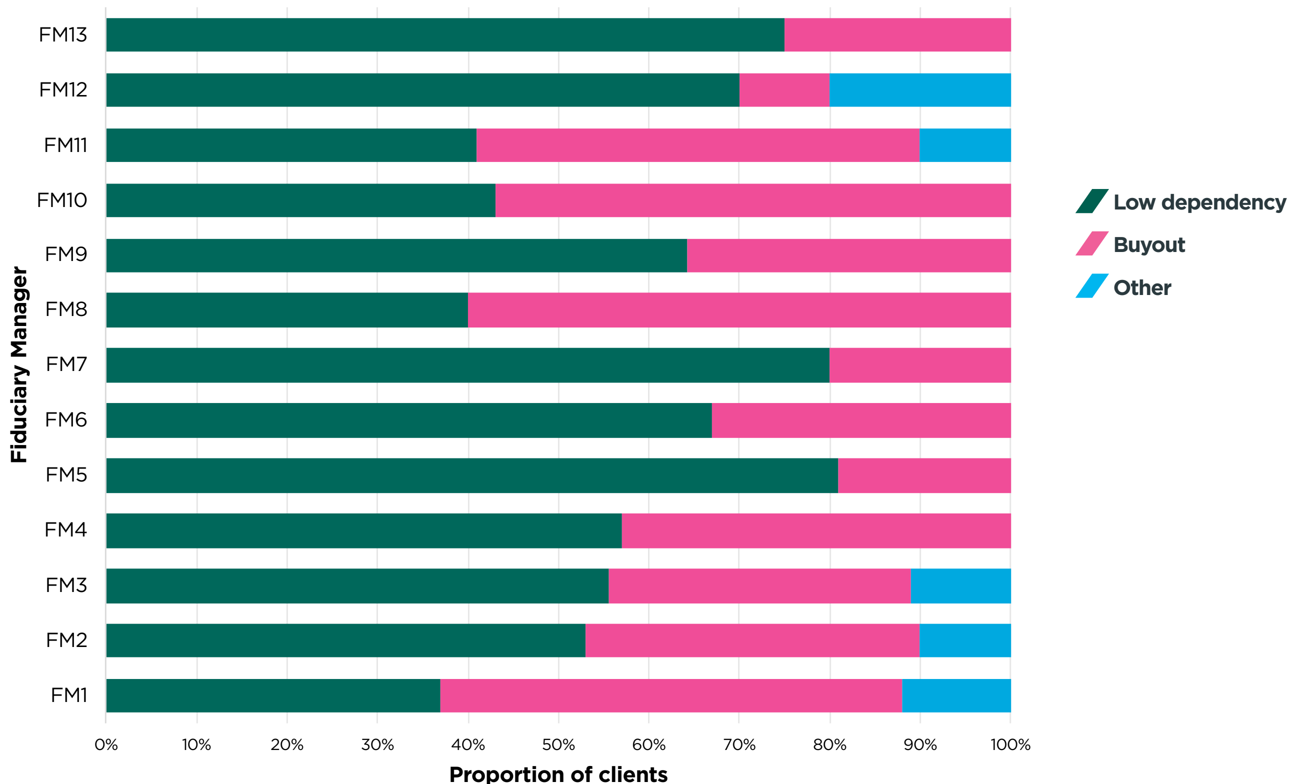
What long-term targets are FM clients setting?

Some trustees target **buyout**, explicitly aiming to secure their liabilities with an insurance company. Advantages include fully completing the trustees' duties (securing members' benefits) and getting pension scheme risk off the employer's books. It's also the costliest option because of having to pay insurers' profit margins and expenses within the buyout premium. Hence reaching buyout often involves targeting a higher amount of assets and hence a review of the balance between expected future investment returns and additional contributions needed to achieve that.

The alternative is targeting '**low dependency**', where trustees target 100% funding on actuarial assumptions that support a low-risk and return investment strategy. The idea is that schemes can be run on over the long-term with a fairly low chance of sponsors having to pay in more contributions because the low-risk investment strategy adopted means the funding level should be reasonably stable.

Our survey shows that low dependency is the most popular target, with buyout a close second. Information was not provided on the drivers behind those targets i.e. whether due to client preference, FM preference or a combination of both. It would be interesting to see if there have been any changes in views following the likely reduction in buyout deficits seen since the gilts crisis.

Chart 2: FM clients' long-term funding targets



Source: XPS Pensions Group, Fiduciary Managers

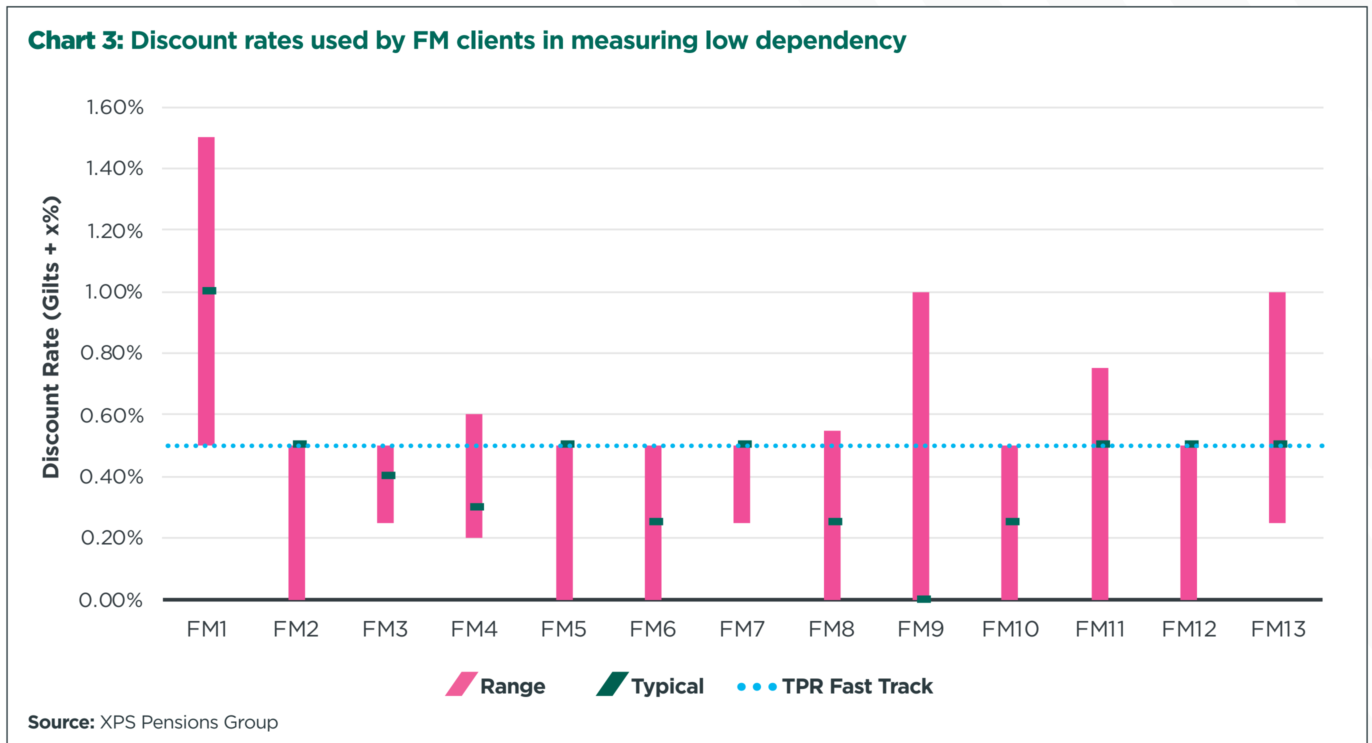
Low dependency can sometimes be an interim target before buyout so could we see the buyout number rising in future?

Our survey then focused on those FM clients targeting low dependency.

One point of debate for those clients adopting a low dependency target is the rate at which they discount the liabilities. The higher the rate, the lower the value placed on the liabilities, and the easier it is to be deemed to be 100% funded. However, a higher discount rate also means higher investment returns are needed for the assets to keep pace with the unwinding of the liability discounting over time. This then means higher risk, a more volatile investment strategy and greater potential for employer contributions to be needed if investment experience is poor.

We asked the FMs about the discount rates their clients use when placing a low dependency value on liabilities – both the 'typical' rate amongst their clients and the 'range' of rates. The results are set out in chart 3.

Chart 3: Discount rates used by FM clients in measuring low dependency



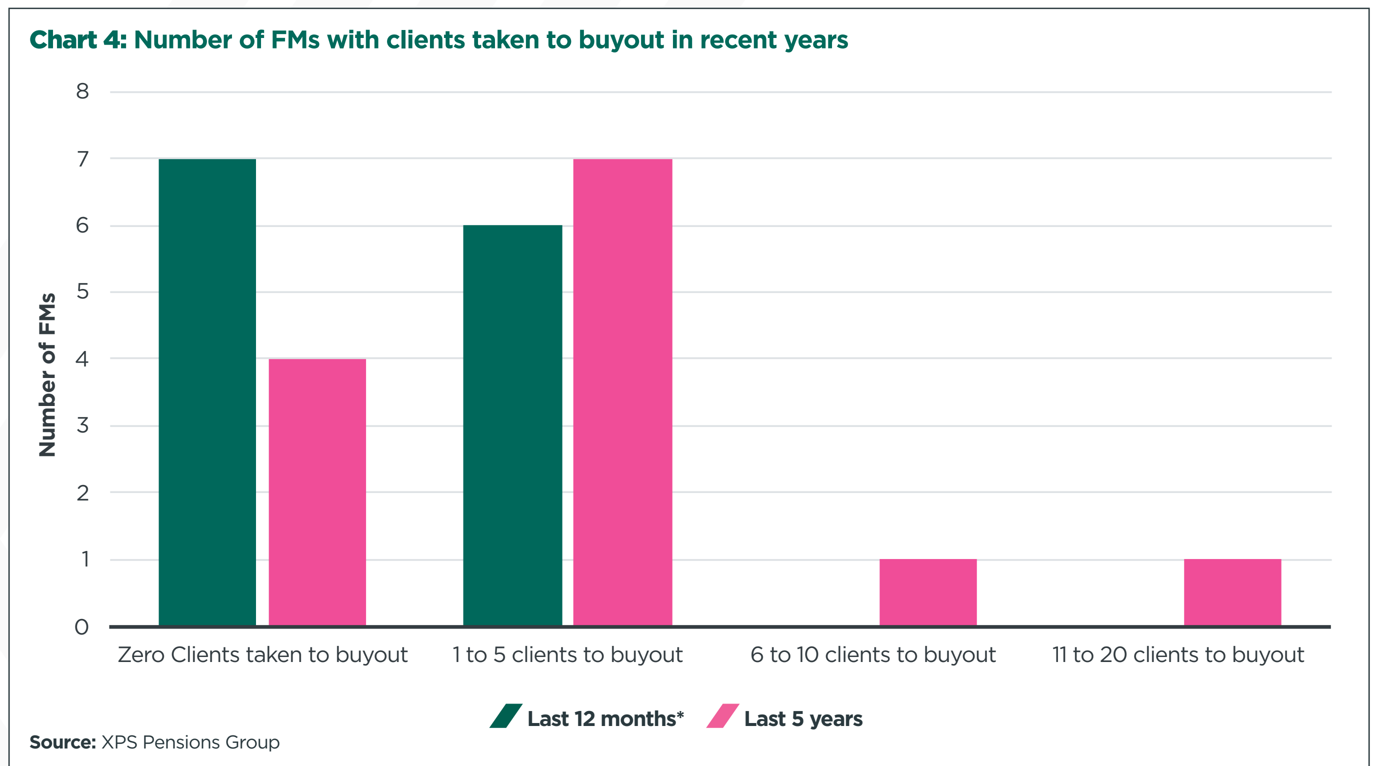
Source: XPS Pensions Group

Key findings from the above:

- There are significant differences between many of the FMs. It's not clear whether this is down to the FMs' own views, clients' views or a combination of the two.
- Gilts + 0.5% p.a. – the top of the range previously put forward by TPR for their potential 'Fast Track' approach – is a popular answer, as we would have expected.
- A number of FMs have low dependency discount rates below the Fast Track level of gilts + 0.5% p.a. In its latest consultation, TPR has confirmed that the Fast Track discount rate will be gilts + 0.5% p.a. (removing the previous range of gilts + 0.25% to gilts +0.5% p.a.), so some FM clients currently have a tougher funding target than required under Fast Track.
- Equally, there are some significant outliers with discount rates well above gilts + 0.5% p.a. In setting themselves a less ambitious target than one consistent with Fast Track, these schemes may be subject to closer scrutiny from TPR.
- Ultimately, it should be noted that TPR's draft Funding Code is not a legal requirement; it is TPR's interpretation of how the new funding and investment strategy regime should be implemented. TPR acknowledges that schemes may take an alternative approach, if appropriate, and still meet the legislative requirements.

The move to buyout

Turning to buyout, we asked the FMs how many schemes they had taken through to the final buyout stage.



Our survey shows that only around a half of FMs completed any buyouts in the previous 12 months for their clients and a third of FMs have not completed a buyout over the last five years. In contrast, a couple of FMs have completed 10 or more. This highlights the importance of asking questions about your FM's expertise and experience in completing buyouts. In particular, we think this is important when appointing an FM – most trustees are likely to benefit from having the reassurance that the selected FM has the capabilities to complete the full journey for the scheme.

Trustees should ask FMs about how they evolve an investment strategy towards buyout over time and how they will help with the annuity broking process. Around a third of FMs have their own annuity broking team with the rest often using a specialist third party. It is important that whoever does this has sufficient experience and credibility with the insurers to be able to secure limited capacity in the insurance market. This need not be anyone with a relationship to the FM, with schemes' administrators and actuarial and investment advisers potentially able to help. Aside from expertise and track record, fees will be an important consideration – FMs may be able to offer an attractive proposition given the revenue they earn from the investment management part of the mandate.

It is also interesting to see how FMs tackle the inherent conflict they have – each client taken to buyout is a client 'lost', so one could argue that FMs may inherently prefer clients to adopt a low dependency target. On the other hand, what better advert for an FM's services than a track record of successful buyouts?

Trustees should review whether an FM has the capability and track-record to convince them that they can successfully manage a buyout. A third of FMs have completed no buyouts in the last five years.

*Note: Data reflects experience to 31 December, 2021

FM fees as clients de-risk

We asked the FMs whether they reduce their fees as clients de-risk. Around half of FMs said that fee reductions do accompany de-risking. 90% of attendees at our recent webinar responded that they thought FM fees should reduce as investment strategies are de-risked.

The argument for lower fees as investment strategies are de-risked is that generally greater resources have to be dedicated to generating higher returns – there is more effort involved in identifying, managing and monitoring growth asset classes. In contrast, lower-risk portfolios are more focused on gilts, LDI and corporate bonds often managed using low-cost index-tracking or buy and maintain approaches. Some FMs may counter that lower-risk strategies are often still sophisticated, needing careful managing and monitoring, particularly cash flow-driven investment strategies.

XPS View

The need for an FM at all in the later stages of the move to endgame, when the vast majority of the assets may be invested in investment grade corporate bonds and LDI, can be questioned. At that point, for some pension schemes, the governance advantages of fiduciary management (including assistance that can be provided with a final move to buyout) can be outweighed by the higher total fees (from underlying managers and the FM). Consistent with this, XPS's view is that FM fees should generally reduce as the investment strategy is de-risked. Ideally this principle should be established at the outset of the relationship when arguably clients have the greatest negotiating power. Absent this, trustees should ask for fee reductions as they de-risk. As ever, having an idea of what the market rate ought to be before starting negotiations is very useful.

> 90% of attendees at our webinar thought that FMs should reduce their fees as their clients de-risk.

André Kerr
Head of Fiduciary Management Oversight, XPS Investment

Actions

Pension scheme funding has improved significantly in recent years. In addition, TPR now has an increasing focus on ensuring that each scheme has a low-risk, long-term target and a plan in place to reach it. The following actions will therefore be increasingly important for trustees and their FMs as they plan their endgame strategies:

- Ensure there is a TPR-compliant **long-term journey plan** in place to progress the scheme beyond a Technical Provisions funding target, whether it be low dependency or buyout;
- Use available **de-risking mechanisms** as funding improves and ensure that a de-risked investment strategy meaningfully reduces, to the desired extent, the likelihood of there needing to be future employer contributions;
- Confirm that **risks of illiquid assets** and within matching portfolios (such as leverage) are understood and managed;
- Ensure **fee arrangements** appropriately reflect the investment strategy being used; and
- Understand where **appropriate expertise** can be accessed to assist with the ultimate move to buyout.

Trustees appointing an FM for the first time should recognise the importance of these factors, even if they are currently poorly funded. For existing FM mandates, trustees may wish to review the arrangement if they do not feel that such factors are sufficiently aligned with their expectations.

A key lesson is that it is important that FMs have the capabilities to support their clients through all stages of their funding journeys.

This involves being able to generate higher returns early in the journey, having mechanisms and expertise in place to de-risk as funding improves, and having experience of dealing with insurers to achieve buyout.

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