Endgame Strategy & Priorities Report 2024.

IN PARTNERSHIP WITH:

WELCOME!

Despite growing capacity amongst insurers, buy-out is no longer the be-all end-all endgame. Last year, we saw the first superfund transaction, as well as the launch of new governance and fiduciary management solutions. DB master trusts and protection for fully funded schemes are also garnering support, as providers are offering more alternatives.

Ally Georgieva,
Head of Insight,
mallowstreet

While the industry mulls over the role of growth assets in the Mansion House reforms and the productive finance agenda, endgame options are diversifying. The new DB funding and investment regulations are less prescriptive on de-risking than their original draft, allowing more leeway for schemes to hold growth assets as they deem appropriate. The government is also consulting on surplus distribution to potentially encourage longer risk-taking at schemes, but this issue is more complex than it first appears.

Ryan Daley,
Senior Researcher,
mallowstreet

With so many moving parts, it is not surprising that many schemes are yet to decide on a long-term objective. To understand their evolving strategy and priorities, **mallowstreet**, in partnership with **Brightwell**, surveyed 27 UK DB schemes over £1bn in January 2024, gathering perspectives on a total of £300bn in assets under management. This report presents our in-depth findings. We hope you find it insightful.

REMAINING OPEN-MINDED IN EVER-SHIFTING CHANGE

The UK DB sector is undergoing a huge period of change. Schemes are having to make some big decisions about their endgame strategy against a backdrop of ever shifting regulatory sands. Our research with mallowstreet shows that larger schemes are more likely to be undecided on their endgames and, with a range of alternative options coming to market, remaining open-minded is probably wise.

Morten Nilsson,
CEO, Brightwell

The research also shines a light on some of the complex old and new issues schemes are having to grapple with, from GMP equalisation to geopolitical instability, stubborn inflation and interest rates, and cybercrime. Running a DB scheme has never been more challenging. Nonetheless, many schemes are questioning whether buy-out is in fact the 'gold standard' – or whether they risk 'selling the family silver' instead.

KEY STATISTICS

27
chairs, trustee directors and heads of pensions from different UK DB schemes over £1bn

£300bn+
of pension assets represented

52%
schemes between £1bn and £5bn

26%
schemes between £5bn and £10bn

7%
schemes between £10bn and £20bn

15%
schemes over £20bn

15
questions

600+
primary data points

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EXECUTIVE SUMMARY

MANY LARGE SCHEMES ARE YET TO SET LONG-TERM OBJECTIVES: faced with a regulatory overload, they feel like they must choose between retaining regulatory and macro risk or transferring value to insurers with a buy-out – but there are other avenues to explore. Alternative long-term objectives like consolidation, capital-backed journey plans (CBJPs) and run-on are gaining popularity, so many large schemes are taking a 'wait and see' approach until the regulatory context becomes clearer.

Schemes backed by strong employers are confident they will deliver value to members in run-off. To them, the insurance path constitutes a transfer of value which comes with a loss of control and discretionary benefits. But given the risks of geopolitical instability and rising rates, it is surprising to see that they are not thinking about fiduciary management or similar solutions.

Meanwhile, schemes targeting buy-out worry about affordability to the sponsoring employer, but this does not deter them from pursuing this strategic objective. But not everyone may get to buy-out while interest rates are advantageous, so they may be underestimating the risk of funding level volatility. At the same time, they seem reluctant to consider other available options.

ILLIQUID ASSETS REMAIN A BARRIER INSTEAD OF OPPORTUNITY: a high allocation to illiquids is the top obstacle to most endgames, including for schemes which are yet to set a long-term target. This may change with the new DB funding code but potentially puts DB schemes at odds with the government's desire to increase investment in productive assets.

SURPLUS GENERATION NEEDS A RETHINK: schemes are run to meet the promised benefits to members and protect their outcomes, not to increase the return to the sponsor. While many schemes are not yet fully funded (especially on a buy-out basis), those in surplus are not doing anything about it – largely because they do not have an objective to do so. However, using the surplus to enhance DB or DC benefits, or as a volatility buffer, can be attractive, but this needs a change in ideology and support in regulatory guidance. At present, it is rarely possible to return the surplus unless at wind-up.

KEY STATISTICS

41%
of schemes over £1bn are either open or have not yet set a long-term objective

86%
of schemes targeting run-off would not buy out because their sponsor is strong

57%
of them are worried about inflation and interest rate volatility

67%
of schemes aiming for buy-out are worried about the regulatory burden

43%
of schemes aiming for run-off say the surplus should be held in case the funding level changes

42%
of all schemes say illiquid assets are the top obstacle to their endgame plans

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[*] Throughout this report, figures may add up to 99% or 101% due to rounding of percentages. Additionally, some questions required multiple answers, so figures in some bar charts will add up to significantly more than 100%. In such charts, dark blue highlights may be used to emphasise key statistics and help the reader follow the analysis.

INDUSTRY RECOMMENDATIONS

FOR OPEN PENSION SCHEMES AND THOSE AIMING FOR RUN-OFF:

- Decide long-term strategy early – run-on and run-off are increasingly an acceptable plan for larger schemes
- Start discussions around surplus treatment early to avoid it getting 'trapped' in the scheme
- Consider accumulating a surplus as a buffer for funding level volatility – interest and inflation rates may change in a macro downturn
- Assess how fiduciary management and capital-backed journey plans can make your endgame more affordable or easier to reach
- Review ways to protect the scheme in case the sponsor covenant deteriorates – this is a long-term risk which is often left unaddressed
- Discuss the role of illiquid assets with peers and providers – they need not be an endgame obstacle, but a return opportunity instead
- Learn best practices from peers – the run-on rule book is yet to be written, so now is the time to exchange expertise with others

FOR PENSION SCHEMES TARGETING BUY-OUT:

- Explore capital-backed journey plans and fiduciary management – they can be a helpful way to address affordability issues for your sponsoring employer and accelerate your endgame timeline, especially if there is a funding gap

FOR SPONSORING EMPLOYERS:

- Engage with pension scheme trustees on endgame plans – this is crucial for the long-term funding and investment strategy of the scheme
- Evaluate all options at hand – seek support and best ideas from various solution providers which can broaden the choices available to you

FOR SOLUTION PROVIDERS:

- Build holistic solutions addressing regulatory complexity, macro and liability risks, as well as managing an illiquid asset allocation
- Strengthen your administration offering with robust cyber-security – this has become a top priority moving forward
- Develop more flexible surplus solutions – it does not automatically go to the sponsoring employer and may need to be shared with members depending on scheme rules on a case-by-case basis
- Help schemes devise a strategy for illiquid assets – and rethink their role in increasing returns, net zero and endgame preparations
- Share your expertise by offering CPD training via industry bodies to establish yourself as a partner to the industry

FOR REGULATORY AUTHORITIES:

- Consider providing guidance on the appropriate uses of scheme surplus, so trustees can feel more comfortable with its accumulation
- Create additional stimuli for investing in growth assets to support the productive finance agenda without getting too prescriptive
- Update the DB funding code of practice, so trustee boards have a better understanding of suitable levels for their growth investments

PART I:

LARGE SCHEMES ARE YET TO SET OBJECTIVES

Faced with a regulatory overload, schemes feel like they must choose between buy-out and retaining regulatory and macro risk – but there are other avenues to explore. Strong schemes are confident they add value to members, so insurance may not be the right path for them.

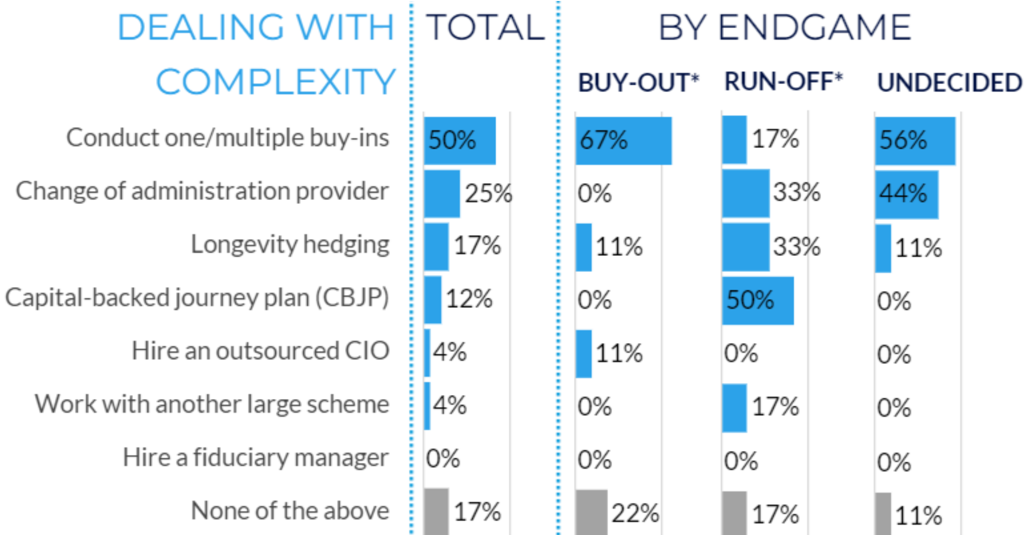
MANY LARGE SCHEMES ARE YET TO SET LONG-TERM OBJECTIVES

Regulatory overload is leaving many UK schemes with the choice to either get to buy-out or conduct a buy-in – but there are other avenues to explore.

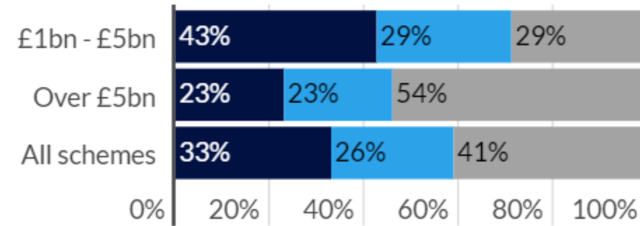
Two in five UK DB schemes over £1bn have not yet set a long-term objective. In particular, 7% are still open, but another 26% are simply undecided on their endgame plans (see charts to the right). This likely reflects uncertainty around a range of issues on the UK pensions agenda, including the DB funding regime, consolidation and surplus treatment. As a result, just 7% are looking to run on – and alternative endgames are gaining popularity.*

At the same time, 67% of schemes aiming for buy-out say they will conduct one or multiple buy-ins to deal with the growing complexity of UK pensions (see chart below). Surprisingly, more than half of schemes with undecided plans are also considering buy-ins. This suggests that the regulatory overload is pushing schemes towards insurers – but there are other avenues to explore.

Capital-backed journey plans (CBJPs) are a new part of the run-off toolkit – but, interestingly, not on the buy-out radar. Along with longevity hedging, they do not extinguish the sponsoring employer's responsibility for the scheme.



ENDGAMES BY SCHEME SIZE



Insurance buy-out
Consolidation (0%)
Run-off with low dependency on sponsor
Open/run-on/undecided

However, CBJPs can help make the endgame more affordable. Against this backdrop, it is puzzling to see that they are not perceived as a good fit for the road to buy-out.

It is also worth noting that a third of schemes in run-off and 44% of those with an undecided long-term objective are confronting the growing complexity in UK pensions by changing their third-party administrator or admin software provider. This is an ongoing concern for those planning to look after their members for a long time and evolve their service offering.

KEY STATISTICS

41% of schemes over £1bn are either open or have not yet decided their long-term objective

56% of schemes with undecided plans may use buy-ins to deal with the growing regulatory complexity in UK pensions – but there are other options

50% of schemes in run-off are thinking about a capital-backed journey plan

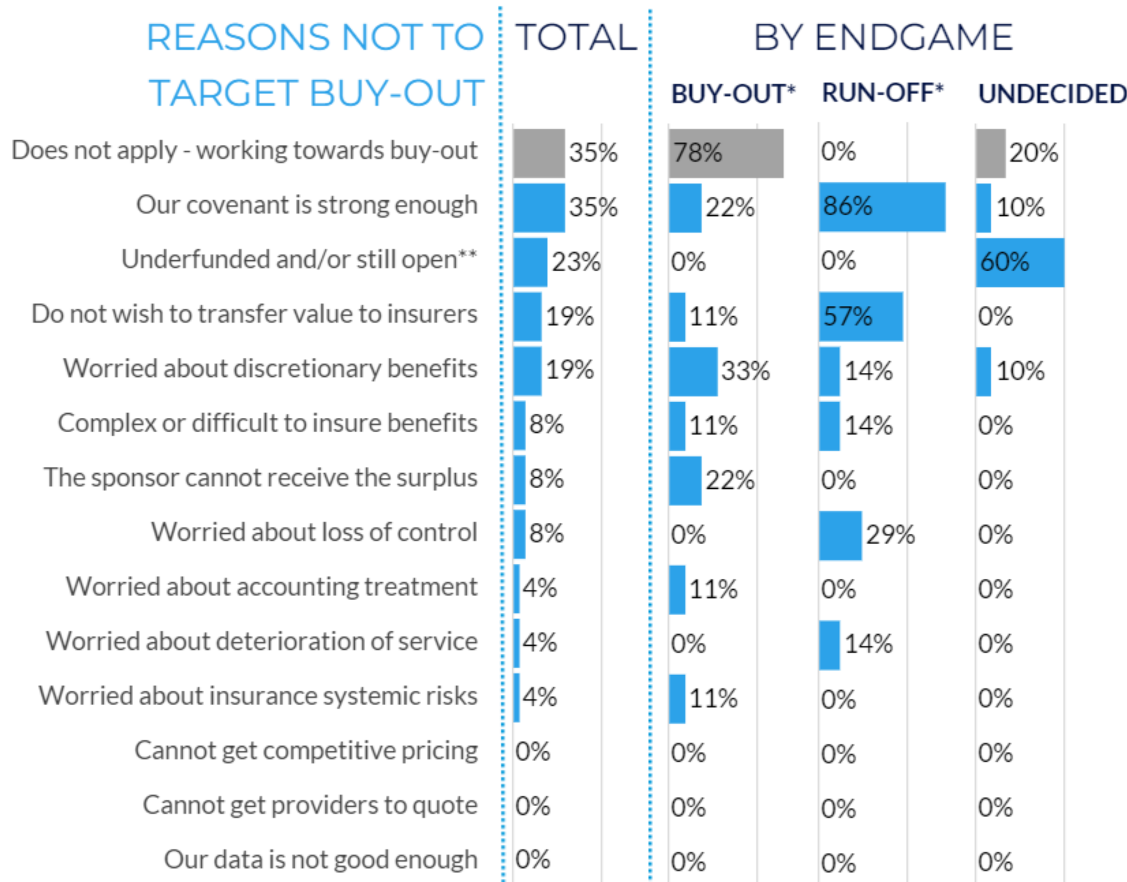
44% of schemes with undecided plans may change their administration provider or software

* Some groups are represented by a small sample, so our analysis is only indicative. For example: schemes aiming for buy-out = 9, run-off = 7.

STRONG SCHEMES CAN CONTINUE GENERATING ADDED VALUE

To them, engaging with insurance firms constitutes a transfer of value – and the loss of control and discretionary benefits are additional concerns.

When asked why their scheme is not targeting buy-out, 86% of those aiming for run-off state it is because their employer covenant is strong enough. More than half clarify that, as a result, they do not wish to transfer value to insurers, and 29% are worried about the loss of control. A deterioration of the service to members can be an additional concern. This means that schemes with strong sponsors feel confident in their employer and want to continue generating added value for their members.



Interestingly, concerns about capacity in the buy-out market are not enough to deter endgame plans: barely any schemes worry about systemic risks if all assets move to insurers, or whether they can obtain competitive pricing.

This shows that the choice of endgame is a strategic decision not impacted by the associated implementation issues. Additionally, 60% of schemes with undecided plans are not targeting buy-out because they are simply too far away from having to make such important decisions.**

Interestingly, 33% of schemes aiming for buy-out are concerned about losing the ability to offer discretionary benefits (e.g., increases) to members. Rising inflation is putting pressure on well-funded schemes to up pensions – but their ability to do so goes away completely in an insurance buy-out.*

KEY STATISTICS

86%
of schemes targeting run-off would not buy out because their sponsor is strong enough

57%
of them add they do not wish to transfer value to insurers

29%
of them are worried about losing control in such a scenario

60%
of schemes with undecided endgames are not targeting buy-out because they are open and/or underfunded

33%
of schemes on a buy-out path are worried about discretionary benefits

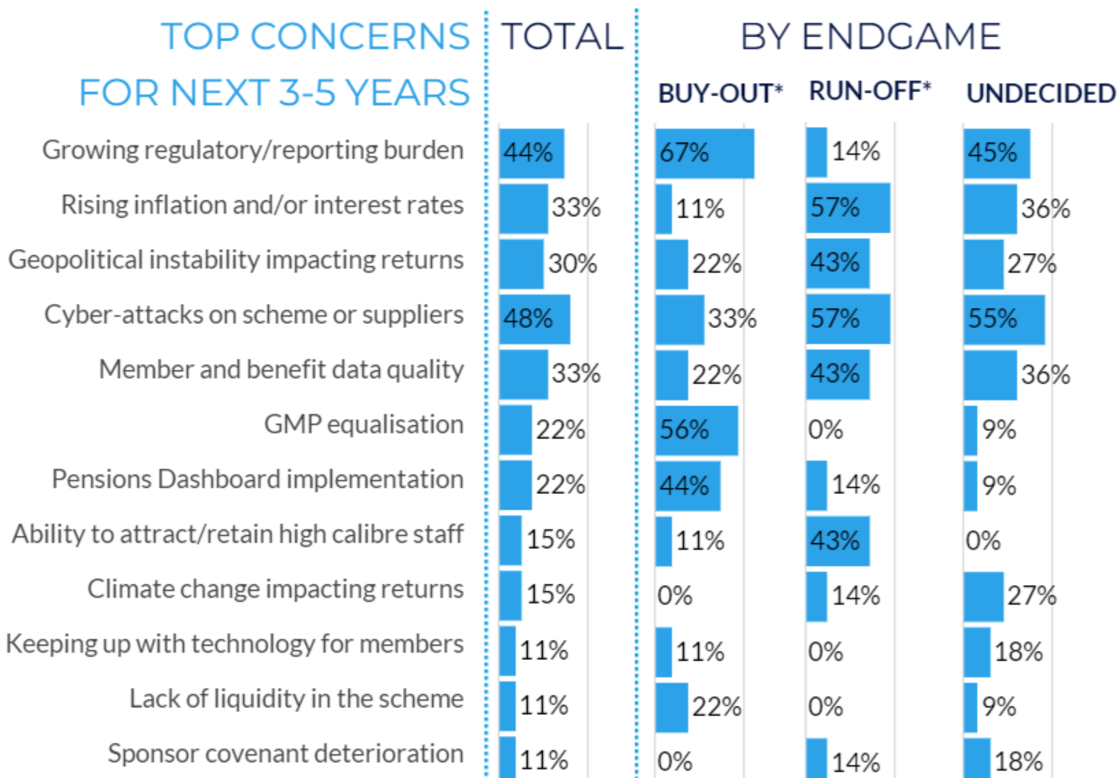
22%
of them cannot return the surplus to the sponsor

* Some groups are represented by a small sample, so our analysis is only indicative. For example: schemes aiming for buy-out = 9, run-off = 7.
** This question contained an option to specify other reasons not to target buy-out. A big number of respondents with undecided endgames chose this answer and wrote that they are either underfunded or far away from needing an endgame plan and, ultimately, being able to consider buy-out.

SCHEMES ARE TORN BETWEEN COMPLEXITY AND BUY-OUT

When deciding endgames, schemes feel like they must choose between buy-out and retaining regulatory and macro risks – but this need not be the case.

Looking at the next three to five years, 67% of schemes targeting buy-out are concerned about the growing regulatory and reporting burden (see chart below and also page 6). In contrast, over half of schemes targeting run-off worry about the impact of rising inflation and interest rates on scheme returns. The risk of geopolitical instability is an additional worry for 43% of them, as well as many schemes with an undecided endgame. This suggests that when choosing a long-term objective, schemes feel they are confronted with the choice to either retain regulatory and macro risk or conduct a buy-out and wind up the scheme. This need not be a binary choice. For example, fiduciary management can combine liability hedging with a return component to enhance funding levels, improving outcomes and freeing up internal trustee resources.



In this context, it is surprising that so few schemes are thinking about an outsourced CIO or a fiduciary manager. This is despite 43% of schemes on the path to run-off worrying that they will not be able to attract high-calibre staff.

Finally, cyber-security is the top concern for schemes targeting run-off or with undecided plans. These two groups are most likely to change administration providers or software, so cyber-security will likely be a major consideration (see page 6).*

KEY STATISTICS

67%
of schemes aiming for buy-out are worried about the regulatory and reporting burden

57%
of schemes targeting run-off are worried about inflation and interest rate volatility

43%
of them also worry about geopolitical risk impacting returns

43%
of schemes in run-off are also worried about hiring and retaining high-calibre staff, yet would not consider outsourced CIOs or fiduciary managers

55%
of schemes with undecided endgame plans are worried about cyber-attacks

* Some groups are represented by a small sample, e.g.: schemes aiming for buy-out = 9, run-off = 7. The full chart about dealing with complexity is available on page 6.

PART II:

SURPLUS GENERATION NEEDS A RETHINK

Schemes are run to meet the promised benefits to members or improve their outcomes, not to increase the return to the sponsoring employer. However, using a surplus as a volatility buffer can be attractive and needs a change in ideology. In this context, it is not surprising that illiquid assets are still seen as an obstacle rather than an opportunity.

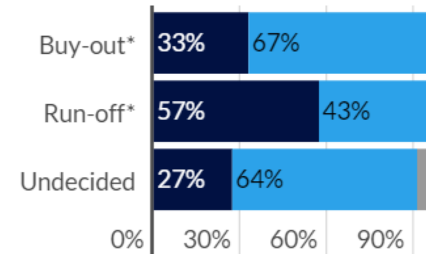
SCHEMES ARE NOT RUN TO GENERATE A SURPLUS

While many schemes are not yet fully funded, those in surplus are not doing anything about it – largely because they do not have such an objective.

One-half of large schemes targeting run-off do not currently have a surplus, compared with just a third of their peers (see chart to the right). For the remainder, the surplus is simply part of their asset portfolio, irrespective of the endgame. Just one scheme is investing its surplus to grow it over time – and, surprisingly, no scheme in our survey is using an escrow account.

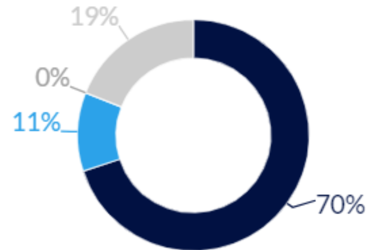
As a result, investment strategy is not driven by surplus accumulation (see chart below). Even if the government change the rules to make the return of surplus to employers easier (e.g. by reducing the 35% tax charge or other measures), 70% of schemes will not change their investment strategy – and just one in ten would stay invested in growth assets for longer.

CURRENT SURPLUS



- No surplus currently
- Simply part of the asset portfolio
- Invested to grow the surplus
- Held in an escrow account (0%)

IMPACT OF 35% TAX CHARGE CHANGE



- No change to investment strategy
- Stay invested in growth/illiquids for longer
- Increase growth/illiquid assets (0%)
- Do not know

A partial explanation is found in when and how the surplus may be distributed – it should be shared with members, but there are no ways to do so before winding up the scheme (see next page). More importantly, trustees emphasise they are not running the scheme in order to generate a surplus.

Whatever the endgame, trustees go on to explain that schemes are run to meet the promised benefits to members and protect their outcomes, not to increase the return to the sponsoring employer. If the endgame objective is low dependency on the sponsor, then an additional goal could be to reduce the need for further sponsor contributions. In both cases, trustees contend that letting prevalent tax rates or employer profit and loss (P&L) drive investment strategy would be a bad idea.

For other schemes, the problem is that they have already conducted a buy-in and are close to buy-out, so they do not have the ability to change the investment strategy. A handful of trustees share they would consider re-risking if faced with full funding on a buy-out basis, but not on technical provisions. It would also help if they were not already locked into buy-ins. Finally, open schemes are simply too far away from a surplus.*

KEY STATISTICS

57%
of schemes aiming for run-off do not have a surplus at present

64%
of schemes with an undecided endgame simply keep it invested with all other assets

0
no schemes are using an escrow account

70%
would not make any changes to investment strategy if tax rates upon surplus return are adjusted

11%
would hold growth assets for longer in such a scenario

* Some groups are represented by a small sample, so our analysis is only indicative. For example: schemes aiming for buy-out = 9, run-off = 7. The opinions expressed on this page come from an open-ended question asking about the reason why schemes would not change their investment strategy in the circumstances explained above.

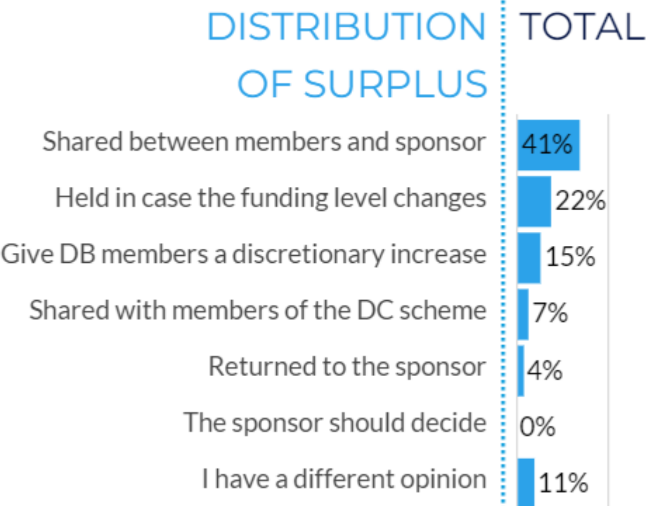
SURPLUS RETURN IS NOT POSSIBLE EXCEPT ON WIND-UP

Trustees believe the surplus should be shared between members and the sponsoring employer – in part to create a buffer for funding level volatility.

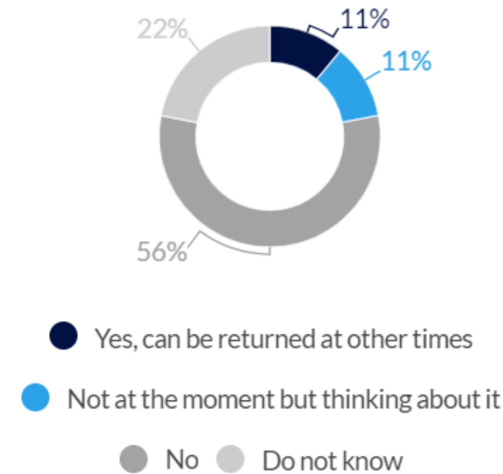
More than half of trustees report that scheme surplus cannot be returned except on wind-up (see chart to the right). Just one in ten have such an ability, and a similar proportion are thinking about making this possible.*

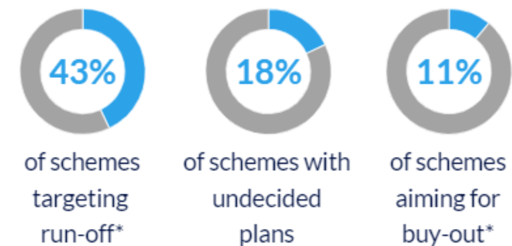
Two in every five schemes say any surplus should be shared between the members and the sponsoring employer (see left chart below). Additionally, some believe it should be given to DB members as a discretionary increase or shared with members of the DC scheme instead. In general, just one scheme thinks the surplus should automatically go to the sponsoring employer. This may be appropriate when the scheme is non-contributory for employees and the surplus is used to reduce employer contributions.

In all cases, the treatment of surplus would depend on the scheme rules. More importantly, 22% of trustees believe the surplus should be held in the scheme in case the funding level changes, as a buffer for asset underperformance or a reserve for a future pension risk transfer transaction.



It is interesting that schemes in run-off particularly favour this option (see chart to the right). As discussed, these schemes are exposed to geopolitical risks and rates volatility but wish to continue generating value for their members (see pages 7 and 8). In this context, running a surplus to create a funding level buffer could be highly desirable, but an ideology change and regulatory support is needed for trustees to feel comfortable with taking this approach.





KEY STATISTICS

43% of schemes aiming for run-off say the surplus should be held in case the funding level changes

56% of all schemes say the surplus cannot be returned at any other point except on scheme wind-up

41% say it should be shared between the members and the sponsoring employer

15% say it should be given to DB members as a discretionary increase

4% of all schemes say the surplus should be returned to the sponsoring employer

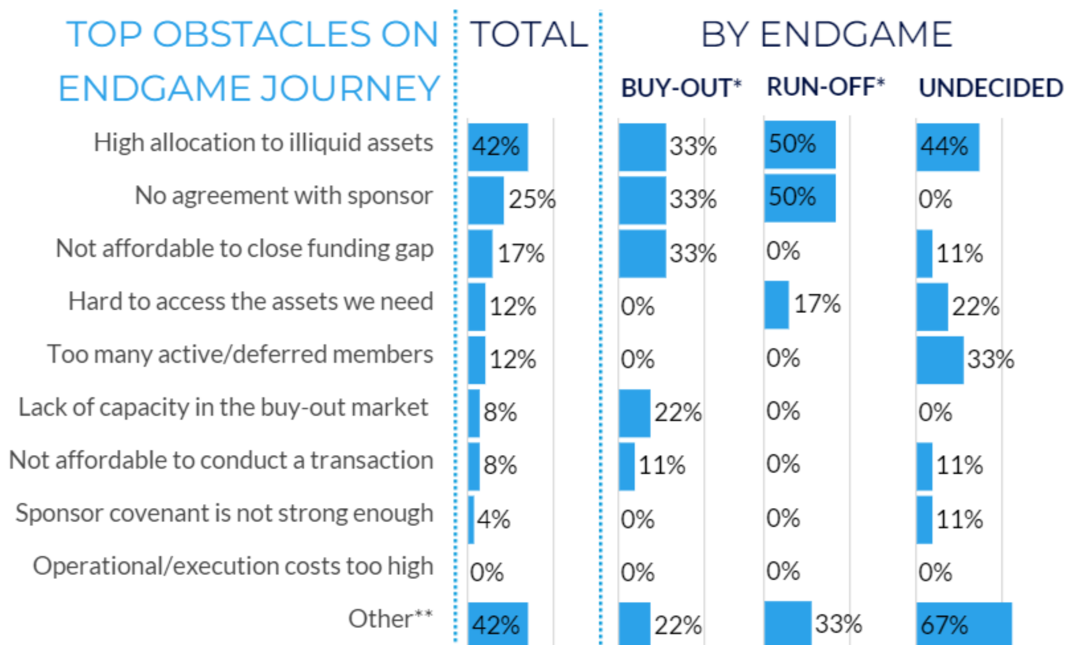
* Some groups are represented by a small sample, so our analysis is only indicative. For example: schemes aiming for buy-out = 9, run-off = 7. Unless shown, there are no significant differences by endgame in this part of the analysis.

ILLIQUID ASSETS REMAIN A BARRIER INSTEAD OF OPPORTUNITY

A high allocation to illiquids is the top obstacle to most endgames – which suggests a need for innovative solutions to support productive capital.

One-half of schemes targeting run-off are hindered by a high allocation to illiquid assets. More surprisingly, this view is shared by many schemes which are open, running on or yet to decide their endgame. This suggests that illiquid assets are still perceived as an obstacle rather than an opportunity in the mid to long-term. This is likely a consequence of the LDI crisis of 2022, which put scheme liquidity to the test but left many overweight such assets. Additionally, the DB funding regime has historically encouraged schemes to de-risk and focus on cashflow matching as they mature. This may change under the new DB funding regime, which was announced in January 2024 and is less prescriptive than its original draft, but it is too early to say.

In addition, a third of schemes targeting buy-out are worried about agreement with the sponsor or whether closing the funding gap faster would be affordable. This is interesting to see, given the reluctance of such schemes to consider capital-backed journey plans (CBJPs) or fiduciary management to improve funding levels (see page 6). With just one in five doubting the capacity in the buy-out market, many schemes aiming for this endgame may be underestimating their exposure to funding level volatility and macro risks.



TOP OBSTACLES ON ENDGAME JOURNEY	TOTAL	BUY-OUT*	RUN-OFF*	UNDECIDED
High allocation to illiquid assets	42%	33%	50%	44%
No agreement with sponsor	25%	33%	50%	0%
Not affordable to close funding gap	17%	33%	0%	11%
Hard to access the assets we need	12%	0%	17%	22%
Too many active/deferred members	12%	0%	0%	33%
Lack of capacity in the buy-out market	8%	22%	0%	0%
Not affordable to conduct a transaction	8%	11%	0%	11%
Sponsor covenant is not strong enough	4%	0%	0%	11%
Operational/execution costs too high	0%	0%	0%	0%
Other**	42%	22%	33%	67%

Schemes aiming for run-off may also struggle reaching agreement with their employer, but not because of the funding gap. Not only are schemes in this position more likely to call upon CBJPs, but they also enjoy the financial backing of a strong sponsor (see pages 6 and 7).

As for open schemes and those with undecided endgames, the obstacle of having too many active and deferred members is causing many to delay setting a long-term objective. While it should not be taken in haste, this decision should also not be delayed unnecessarily, as it will facilitate long-term investments and planning. After all, run-on is a perfectly acceptable choice.*

KEY STATISTICS

50%
of schemes going for run-off say they do not have agreement with their sponsor

50%
of them also state that a high allocation to illiquid assets is an additional challenge

44%
of schemes with an undecided endgame share this concern

33%
of schemes targeting buy-out are worried about agreement with their sponsor, as well as their ability to close the funding gap faster

33%
of schemes without an endgame say they have too many active or deferred members

* Some groups are represented by a small sample, so our analysis is only indicative. For example: schemes aiming for buy-out = 9, run-off = 7.
** Other obstacles include a variety of responses with no clear trend: benefit equalisation and rectification, capacity in the administrator market, dealing with international accounting implications, data and administration shortcomings, and a lack of trust between the trustees and the sponsor.

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