Opportunity in the endgame

What's next for DB pension schemes?

As UK defined benefit (DB) pension schemes mature, trustees face a pivotal moment: securing members' futures in a dynamic market. With new pathways like superfunds and an increasing focus on liability-driven investing (LDI), fresh endgame approaches are clearly emerging.

The past two years have transformed the UK's 5,000 DB schemes. Trustees face changing funding, rising interest rates, and macroeconomic uncertainties. However, amid these challenges there are some strong, new opportunities.

State Street Global Advisors, in partnership with Van Lanschot Kempen Investment Management and Clara-Pensions, surveyed 100 UK corporate DB scheme trustees in Q3 2024 to understand these dynamics and what schemes really want. All schemes were closed to new members; 52 per cent were also closed to accrual, and 52 per cent were 90 per cent funded or higher.

Finding the right strategy

The survey revealed no single dominant endgame path. Indeed, while traditional strategies like buyout (43 per cent) and run-on (38 per cent) remain popular, newer options, such as superfunds (10 per cent) and capital-backed journey plans (7 per cent), are fast gaining traction. Run-on strategies – which allow schemes to operate independently using robust funding and investment strategies – are challenging buyout's long-held gold standard perception.

Trustees identified three main challenges in setting an endgame strategy:

1. **Volatility and macroeconomic uncertainty (23 per cent)**
2. **Balancing stakeholder and member expectations (19 per cent)**
3. **Risk management and timing (18 per cent)**

While trustees generally feel well-informed about buyout (89 per cent) and run-on (91 per cent) options, they report knowledge gaps for less conventional strategies like superfunds (74 per cent) and capital-backed plans (55 per cent). A small but significant minority of trustees are targeting consolidation (10 per cent) and capital-backed journey plans (7 per cent) as their endgame strategy.

The role of scheme sponsors adds complexity. Nearly half (45 per cent) of trustees report shared influence between sponsors and themselves, while 17 per cent believe sponsors are more influential. External advisers are often brought in for endgame planning (68 per cent). This negotiation between sponsors and trustees requires careful balancing of multiple perspectives, often relying on third-party advice.

The growing role of superfunds
Superfunds have emerged as a compelling alternative endgame for schemes seeking to enhance member outcomes while lowering sponsor costs compared to buyouts. By consolidating multiple schemes under one trust, superfunds pool resources to create stronger financial foundations, improve governance, and potentially replace weaker sponsor covenants.

The appeal of superfunds lies in:
1. **Improved member outcomes (66 per cent)** – resource pooling and governance can secure or enhance benefits.
2. **Lower cost to sponsors (52 per cent)** – economies of scale free up resources compared to buyouts.
3. **Replacing weak covenants (31 per cent)** – particularly relevant for schemes with weaker financial backing.
4. **Access to additional funding (27 per cent)** – supporting the scheme in the short term.
5. **Governance improvements (24 per cent)** – consolidated governance offers robust oversight.

Trustees see superfunds as particularly advantageous for schemes with weak sponsor covenants, with 50 per cent citing this as a key factor. However, for schemes with strong covenants, only 27 per cent view superfunds as appealing.

Despite growing interest, participants cited: Financial stability and risk management (17 per cent), protecting member outcomes and choice (17 per cent), regulatory uncertainty (12 per cent) and lack of trust and familiarity (12 per cent) amongst the obstacles faced.

Addressing these concerns will be critical for broader adoption. Many trustees worry about the newness of superfunds and cite regulatory uncertainty as a challenge.

Nonetheless, 55 per cent of trustees expect a rise in schemes transferring to superfunds within the next two years, with 61 per cent believing superfunds could deliver better outcomes than insurers for schemes exiting Pension Protection Fund assessments.

Liability-driven investing (LDI): A cornerstone of endgame planning
For DB schemes nearing their endgame, LDI plays a pivotal role in aligning assets with liabilities. LDI mitigates risks from interest rate changes and inflation, and an estimated 60 per cent of DB scheme portfolios being LDI-aligned.

However, recent events have also highlighted vulnerabilities in LDI strategies. The 2022 UK gilts crisis exposed liquidity risks, prompting many schemes to review their LDI managers. But, while 77 per cent of trustees have reviewed providers, only 23 per cent switched, citing concerns such as institutional knowledge loss (45 per cent) and governance disruption (39 per cent).

Trustees are starting to expect more from their LDI
LDI provider concentration is strongly on trustees' minds: With a few players dominating the market, 81 per cent of trustees are concerned that this lack of competition weakens service quality. Additionally, 80 per cent believe limited competition drives up fees, while 78 per cent worry the high concentration of providers may lead to inadequate servicing in a future market crisis.

Evidently, schemes are traditionally underserved by their LDI managers, and many are beginning to expect more. Risk management is the key area where trustees want their LDI managers to improve, such as through more bespoke hedging, robust stress testing and liquidity management, with 31 per cent saying this is the key change they wish to see in the LDI market. Nearly one-fifth (18 per cent) also want to see better communication and reporting.

A technology-led approach to LDI portfolio management may help providers alleviate these pain points. Integrating real-time analytics into portfolio management can give schemes greater portfolio visibility, allowing their status to be viewed as needed. This technological approach could also address the gaps in service delivery and communication, streamlining regular reporting and thus increasing the capacity of LDI portfolio managers to respond to specific client needs.

Conclusion: Opportunities amid transformation
The current environment presents an important opportunity for the trustees of DB pension schemes to reconsider and redefine their strategies. From buyouts and run-on strategies to newer pathways like superfunds and capital-backed journey plans, trustees must leverage this expanded market to make informed, member-focused decisions that balance sponsor and stakeholder interests.

At the same time, trustees should push for higher standards from LDI providers, particularly since market concentration is perceived to impact service quality. Real-time analytics, improved risk management, and streamlined reporting can strengthen LDI portfolios, enhancing trustees' ability to meet endgame goals.

By embracing a proactive, technology-driven approach, trustees can secure a more resilient future for members. The endgame market is evolving rapidly, and trustees have the opportunity to shape its direction, ensuring that member benefits remain squarely at the heart of their strategies.