BlackRock

A roadmap to a resilient retirement: Key trends shaping the pensions landscape

The intricate interplay between global ageing populations, high interest rates and the risk of market turbulence will shape UK pension investments. What could this mean for 2024 and beyond?

Pensions are at the intersection of powerful forces

With the economic, political and social environment seemingly in flux, BlackRock believes there are several key issues that are set to influence the future of retirement. For Gavin Lewis, Head of UK Institutional Client Business at BlackRock, three forces in particular are having a big impact on UK pensions: demographics, consolidation and the new macroeconomic regime.

Demographic change will start to play a more noticeable role, he says. Although it has long been acknowledged, the fact that we are living longer remains a crucial issue for defined benefit (DB) pension funds. They must provide pension benefits over longer periods – and, of course, fund them.

But it is not the only problem they face. “The other real impact has been this issue of consolidation and affordability,” Lewis adds.

Almost all types of pension schemes – defined contribution (DC), private sector DB and Local Government Pension Scheme (LGPS) funds – are consolidating or expected to do so, even if the mechanics and the speed are not yet entirely clear in each case.

In July, the Department for Levelling Up, Housing and Communities consulted on accelerating asset pooling in the LGPS, proposing that all listed assets must be pooled by March 2025.[1] In its response in November, the government said that by 2040, all local government pension funds should be invested in pools of £200bn or more.[2]

In addition, the government recently responded to a consultation on private sector DB consolidators, and a first transaction was complete in early November. In July, the government also proposed that the Pension Protection Fund should run a consolidator, which would in effect be publicly backed.

On the DC side, tightened governance regulations – including a requirement to demonstrate value for money or wind up – mean that companies are increasingly outsourcing their DC schemes to master trust providers or group personal pension plans.[3]

Alongside demographics and consolidation, the economic environment is another major driver of change for pension schemes. Schemes’ assets are not just exposed to it, but also their liabilities and sponsor covenant, while the economic backdrop itself is very dependent on population growth.

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“We've got to wake up and recognise the powerful impact that an ageing and declining workforce has on growth,” warns Peter Fisher, BlackRock’s Head of Global Retirement Initiative.

Economic growth is directly linked with demographics – and governments presiding over ageing populations need to come up with a solution if they want to avert economic decline, he says.

Can demographic divergence offer opportunities?

The challenge will be to find the returns that will allow us to fund retirements, that now last longer than was previously expected in the past, Fisher says. Most of the 20th century saw rapidly rising populations that powered economic growth, but ageing populations mean there is potentially less income to capture.

However, demographics can be used to identify economies with better or worse growth prospects. Increasing demographic divergence – with some countries’ populations ageing while others see theirs rise rapidly – may need to be factored in when making investment decisions.

Demographic decline “becomes a retardant to growth and influences the returns we can capture when we invest on behalf of the beneficiaries”, says Fisher. “That's a major challenge we all face.”

However, it is also a relative value opportunity for investors who are aware of this, he believes, adding: “We want to look at countries that may be adapting better.”

For example, the UK population is still rising slightly, mostly through immigration. Fisher says understanding the drivers of population change is important. “When we go around looking for returns, we've got to see this and see through it. Countries adapt differently, and companies will adapt differently – some will be more successful than others at generating the economic income we need to pay for people's benefits,” he argues.

Some governments have already sought to tackle the issue by increasing workforce participation – the Netherlands and Japan have made efforts to increase the proportion of women in paid work, for example.

Longevity risk might be with DB schemes for longer

While pension funds have long had to manage increasing longevity, in our view, typically companies have typically tended to look at the issue as a temporary one, assuming they would get the scheme to full funding and transfer the risk to an insurer at some point.

However, this long-standing perception is changing, says Lewis. As DB liabilities have fallen because of high government bond yields, there are now a considerable number of pension schemes that are fully funded or in surplus. Consultancy LCP estimates that 1,000 DB pension funds, about a fifth of the DB universe, are now fully funded on a buyout measure.[4] Even where they are not, the cost to sponsors to bringing them to full funding with extra contributions is now typically lower than it has been in years because deficits are smaller, and many employers are using this opportunity. But once full funding has been achieved, the question of what to do with the scheme becomes much more real for sponsors and trustees.

The choice might not always be theirs, suggests Lewis: “The reality is that not all pension schemes in the UK will be able to transact and remove that risk from the sponsor’s balance sheet. The insurance market might not have the capacity to cater for all, certainly in the near term.”

The DB universe currently stands at about £1.5tn according to LCP, while the market’s total capacity is generally estimated to be roughly £50bn per year, showing a wide discrepancy between supply and potential demand.[3]

“So suddenly the role of savers and trustees has changed. It's no longer just about deficit, recovery, and risk management, it's, ‘How do we manage the pension scheme so that it doesn't go back into deficit?’”

Trustees and employers are having to face up to the fact that they may be the ones responsible for paying pensions to members for the foreseeable future, perhaps for longer than they anticipated. This means making assets work harder and smarter to provide for longer lives or diverting cash from the sponsor.

Ultimately, longevity is a problem that affects governments and the private sector equally. “The longevity puzzle is going to end up on someone's balance sheet," says Fisher. It could end up on the balance sheets of pension schemes and their sponsors, or if they transfer the DB liabilities to an insurer, on that of an insurance company or reinsurer. For those with DC benefits – who carry their own longevity risk – it will affect households, unless it comes back to the taxpayer via higher state pensions or welfare payments.

“And so one way or another, we have to see how long we can make these assets live and pay off,” says Fisher. “That's what leads to pension trustees thinking about the asset composition – when you realise how much longer people are living and for how much longer we need the payouts.”

And just as UK schemes face this dilemma, schemes in other countries do as well, he observes. “Pension investors across the globe therefore look to infrastructure and other long-dated assets that provide continuous, preferably inflation-linked, income streams to help them solve the longevity conundrum” says Fisher in his opinion.

What will 2024 bring?

With high levels of activity in the bulk annuity market, Lewis expects to see more and much larger pension risk transactions next year.

However, more employers will face the prospect of managing pension assets and liabilities for longer amid an insurance capacity crunch, which he says could ultimately drive the pensions market to become more inventive.

"There's still going to be this gap, and we're going to have to see some innovation in the industry around actually managing pension schemes that are ongoing,” he thinks.

The fact that many well-funded schemes will need to continue on a low dependency basis could throw up questions around consolidation, such as: is bigger always better?

“I think that question has yet to be answered,” says Lewis. “However, I do think we'll probably see some experiments or initiatives to try and pool or consolidate assets to a much greater degree."

Innovation could also be seen in the DC market next year. First allocations will likely be made to the recently introduced Long-Term Asset Fund vehicles, designed to give DC members access to private markets.

In DC as in DB, increasing longevity makes finding assets to maximise returns for individuals imperative. In addition, DC savers’ pension incomes are particularly affected by social issues such as the cost-of-living crisis and the gender and ethnicity pension gaps.

“I think these will remain and will certainly come to the fore in the next year or so. It's incumbent upon the industry to help find solutions to these,” says Lewis.

While social and demographic challenges, along with consolidation, will affect pensions in the long term, Fisher says that in 2024, trustees and pension schemes will be confronted with continuing high interest rates.

The resulting high gilt yields make DB pension schemes look better funded but, although beneficial in liability terms, this backdrop has downsides on the asset side: it can make markets more volatile and harder to navigate, he warns. This environment means getting the investments right is harder, but even more important.

Trustees will therefore need to keep their eyes on the ball, carefully watching the Bank of England, market volatility and returns, along with the deeper structural features of an ageing population and pension fund consolidation.

Sources:

1. GOV.UK, 11 July 2023

2. GOV.UK, 22 November 2023

3. The Pensions Regulator, 30 June 2022

4. LCP De-risking Report, 2023

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