Setting your corporate DB endgame strategy

Creating your strategy

For a company which sponsors a defined benefit scheme, having an effective pension strategy in place to see the scheme through to its end really matters.

Our latest modelling suggests that an effective strategy can reduce best estimate cash costs by 30% compared to expected Fast Track requirements from the Pensions Regulator (TPR), as well as giving more time to recover from any funding shocks.

So how should a company go about developing its pension strategy? At Hymans Robertson we use a four stage process to support our clients. The third stage is Create.

By this stage the Company has:

- a clearly articulated set of objectives and associated beliefs that the final strategy must support;
- clarity on the range of tools that can realistically help with delivery of the strategy;
- an understanding of what any future governance framework needs to manage and achieve;
- a view on the ultimate exit strategy for the scheme.

Armed with this framework we then develop a small number of solutions that meet the Company's requirements. This involves looking at the optimal pace of funding, investment strategy, the role of non-cash options and different governance models.

1 CLARIFY

What are the key financial metrics of your pension scheme?

How do they interact with your corporate targets?

What objectives does your pension strategy need to achieve?

How will this integrate with your corporate governance?

2 CONSIDER

What is the corporate toolkit for managing DB pension liabilities?

What options are feasible for your Company?

What does a good exit strategy - the endgame - look like?

Do you understand trustee governance and TPR scrutiny?

3 CREATE

Develop a suitable long term funding and investment strategy

Identify what actions to take to maximise the chance of success

Be confident it can be agreed with the trustees and pass TPR oversight

Ensure a robust governance structure

4 CONTROL

Take opportunities tactically as they emerge

Keep tight control on costs

Ensure the strategy remains on track

Alignment of corporate and trustee governance

Testing the solutions

From the Clarify stage we have worked with the company to develop a set of financial metrics and tests that any endgame strategy needs to meet. These will relate to areas such as maximum size of deficit relative to market cap, cash costs as a proportion of EBITDA, P&L costs within certain tolerances, etc.

The candidate strategies will also have been developed with the trustees and TPR oversight in mind and will only be brought forward if we consider it realistic that agreement with the trustees can be reached. This will be heavily influenced by both the Clarify and Consider stages, where the company's views on which tools can be deployed and decisions around endgame versus insurance will quickly shape appropriate strategies.

We can now model the candidate strategies using either deterministic ("what if") scenarios or using asset liability modelling to explore how the strategies perform against the given financial objectives.

This will ensure:

1. A good understanding of median/best estimate outcomes, informing expected development of the funding and accounting metrics over time and more generally the development of the scheme's financial profile as it completes its endgame journey.
2. Critically, that the strategies perform in downside scenarios, whether driven by general economic and demographic experience, or company-specific events. This analysis is essential for ensuring that any strategy under consideration is robust and can be relied upon by the company when building pension costs into long term business planning.
3. That there are no material economic inefficiencies in upside scenarios, for example inefficient use of capital, trapped surpluses or unnecessarily large settlement losses being incurred.

Whilst it would be great if we now had a strategy that ticked all the boxes, at this point it is more realistic that we have a partially successful solution, passing some but not all the tests. Resolving this usually requires a combination of the following:

- relegating some of the company's requirements from essential to "nice to have";
- re-evaluating some of the company's objectives, in terms of cost and/or risk budget or use of non-cash solutions, such as enforceable security;
- re-visiting the use of the wider toolkit and perhaps considering tools from the "amber" list that were rejected for reasons that can now legitimately be re-considered.

Any amendments to the strategy cannot be allowed to make the overall proposal too difficult for the trustees to agree.

Example

A strategy that results in unacceptably high cash contributions in downside scenarios can be amended by use of one or more of the following:

- taking less investment risk;
- increasing short term cash funding;
- greater use of non-cash security;
- extending out the endgame timeframe.

A Pension Increase Exchange (PIE) exercise which was ruled out because the company was not keen on the short-term implementation costs and required management time can perhaps be re-visited, as a PIE would bridge some of the gap which the modelling revealed.

To ensure any proposal is still acceptable to the trustees, a combination of taking less investment risk and offering more security can offset a company request for a longer endgame timeframe and a PIE exercise designed to generate company cost savings.

Scenario analysis also enables a discussion to take place amongst the company's key stakeholders about the range of possible outcomes that can arise from the strategy under development, with a view to ensuring that this really is something that the company can live with across all key corporate teams. It also ensures that the finances of the pension scheme are high on the agenda of the different corporate teams in future business planning cycles.

Preparing the proposal for the Trustees

As part of the development of the short list of strategies, we have already tested that they should be acceptable to the scheme's trustees. However, that does not mean that the trustees are likely to simply accept any proposals with minimal discussion.

Endgame strategies are fundamental to the long-term future management of the scheme and will involve both the company and the trustees agreeing to a framework for funding, investment and risk management that will impact decision making for years to come. In this context it is obvious that any proposals will come under considerable trustee scrutiny, as well as negotiation over the detail.

Hopefully this can be done as part of an ongoing dialogue with the trustees, reflecting a good, open working relationship, often using the triennial actuarial valuation as a springboard for the discussions. If possible, it is far better to keep the trustees informed on evolving company thinking as the endgame strategy is developed, as opposed to simply presenting them with a significant package of proposals with only minimal signposting of what is coming. First, this enables early feedback from the trustees on their objectives and concerns, which can then be built into the company thinking. Secondly, it builds trust that developing an endgame strategy is a collaborative process rather than a "deal" to be negotiated. That collaborative spirit will be critical to the future governance of the strategy and ensuring it remains on track.

After the modelling stage, we have a strategy that works for the company and we believe will be acceptable to the trustees.

The final test is to prepare a detailed proposal for the trustees, setting out:

- details of the strategy;
- the rationale for the proposal, i.e. what the company is trying to achieve and how this has led to the proposed strategy;
- recognition of the trustees' responsibilities and how the company has considered these in developing the proposal;
- ongoing governance, i.e. how the company and trustees will work together going forwards to keep the strategy on track.

In particularly complex situations, we can test this proposal with a separate Hymans team in order to receive independent challenge and to flush out most likely areas of focus for the trustees. These typically include the:

- balance between cash and investment performance;
- design of any proposed member options;
- extent and quality of any security;
- long term funding target and its relationship with the ultimate scheme exit strategy.

As far as possible, this final stage of feedback can be used to refine the presentation to the trustees. Often the presentation needs to be highly nuanced, in that the proposed strategy has only passed the modelling test because the combination of the various components contribute to balance the cost/risk profile. If the trustees challenge too many individual components, even if their counter-proposals look fairly modest, then the whole strategy could start to unwind from the company's perspective.

To mitigate this risk the company needs to be as transparent as possible about what it is seeking to achieve. An effective trustee will use this insight to frame their concerns in a collaborative way, with a view to seeking to amend the proposals but without fundamentally undermining the approach.

Getting the governance right

So far a lot of work has been done to develop a strategy and reach agreement with the trustees. However, the make or break factor for long term success for any endgame strategy will be the governance framework put in place.

It is vital, therefore, that the company develops its thinking on the future governance framework and presents this to the trustees as an integral part of the strategy package. Otherwise, the company may find it difficult to agree any governance changes with the trustees or, at the very least, there will be a delay to the implementation of an appropriate governance framework.

By incorporating a strong governance framework into the strategic proposal, the company will also give the trustees confidence that it is fully committed to the strategy as a long-term endeavour.

From the company's perspective, the governance framework needs to achieve the following:

- maintain trust and open dialogue between the trustees and the company;
- keep everyone focused on the big picture endgame strategy;
- respond to experience, good or bad, so there is appropriate course correction;
- grab opportunities to improve the outcome as and when they arise;
- ensure all advisers are working collaboratively and towards a common set of goals.

Example

A joint company/trustee committee is tasked to meet quarterly to review the endgame strategy, i.e. to monitor progress on funding, investment strategy and tactical projects that will impact the endgame objectives.

Committees of this type have generally responded effectively over the last year to quickly address:

- changes to the RPI index and the implications on investment strategy, member benefits and funding levels;
- strategic decision making in relation to GMP equalisation;
- short term pricing opportunities in the risk transfer market;
- the emergence of the newer risk sharing solutions.

Such an approach typically means there has been timely and consistent communication between company and trustee boards, leading to highly efficient decision-making.

It does not have to be difficult!

At the start of this article we explained why an effective corporate endgame strategy really matters. The problem is that it can sometimes feel bewildering to work through all the angles involved in a new strategy and to consider the ever growing list of solutions available in the market. Companies can be rightly concerned about the possibility of spending a lot of time and money on exploring a seemingly endless combination of ideas, only to end up not being able to see the wood for the trees!

The good news is that it really does not have to be that way. By following a tried and tested process, working methodically through your requirements and using the experience of your advisers to funnel down the universe of solutions, companies can quickly get a handle on a credible endgame strategy. Furthermore, by understanding and respecting the duties and requirements placed on their trustees, the agreement and implementation of a new strategy does not have to be drawn out or frustrating.

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