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Setting your corporate DB endgame strategy

Consider the corporate "toolkit"

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 second stage is Consider. Once a company has clarified the objectives for its endgame strategy, it needs to understand the "tools" available that might help deliver those objectives and therefore form part of the endgame plan.

The good news for companies is that the range of tools available to help manage DB schemes has never been greater. The bad news is that this can become quite bewildering! Without a smart consulting process, there is a risk that something that can really help ends up being overlooked.

It is also worth remembering that different tools work best at different times in the lifecycle of the scheme. So it is not just about understanding what you can do but when to do it. For example, an insurance buy-in can be a very powerful tool in managing your long term pension risks, but the best time to do a transaction depends upon the maturity of the scheme's liabilities, its funding position and the company's ultimate objectives.

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

Where to begin

We start by reviewing, at a high level, the different areas under which the tools fall, namely:

- Investment strategy
- Member options
- Risk transfer/risk-sharing
- Non-cash solutions

This broad categorisation can help the company consider who needs to be involved, so as to ensure the right experience and company context can be brought to bear early in the project, for example interaction with reward policy in the case of benefit change or treasury priorities when looking at non-cash solutions.

A lot of time and money can be wasted at this stage, looking at a wide spectrum of solutions that in reality will not work in the given situation.

To manage this risk, we "triage" the universe of ideas through three tests:

1. The company objectives and beliefs that were established at stage 1, Clarify.
2. The high-level metrics of the scheme in terms of funding, trustee powers and company strength.
3. The likely views of the trustees and TPR.

This results in the following ratings for each specific tool or solution as seen in table below.

By walking the company through this analysis we can review in an efficient way the entire universe of solutions, agree which tools are not worth any further investigation and quickly home in on a small subset of ideas that are worth taking to the next stage.

Another benefit of this process is that it provides a valuable test of the conclusions reached at the Clarify stage. By discussing which options are worth exploring through the lens of the agreed company objectives and beliefs, we re-test with the company at an early stage the practical implications of the conclusions drawn from the Clarify stage.

Reject	Does not fit with objectives/beliefs and/or highly unlikely to be acceptable to the trustees or TPR. **This is unlikely to change over the next 3-5 years.**
Maybe	Not a perfect fit with objectives/beliefs and/or not obvious that implementation will be straightforward BUT enough value if idea could work not to reject at this stage. **Might not work now, but plausible within 3-5 years.**
Worth exploring	In theory, compatible with objectives/beliefs and realistic to implement. **Worth considering for implementation within 2 years.**

Example

A company believes that traditional risk transfer solutions do not represent good value when compared with the risk/reward profile of running off the scheme's liabilities. Whilst that belief may change in the future, spending time on the viability of risk transfer solutions as part of the scheme's strategy for the next 5 years is of limited value, unless the trustees are likely to explore risk transfer despite the company's reservations.

However, if the scheme unexpectedly moves into a strong funding position relative to insurer pricing, the company may want to revisit its belief-driven objections given that insurance solutions are now credible in the short term without significant company contributions.

More detailed investigations

With an agreed small set of tools for further investigation, we work with the company to help it understand in detail the design decisions that need to be made for each such tool and what they might achieve in terms of cost/risk management. A key part of this investigation is to establish what implementation would involve, including time, cost, governance requirements and areas of trustee focus/concern.

Often this can lead to two key conclusions:

1. a particular tool or solution may be worth taking forward but only within a narrow range of designs, otherwise it is not worth the implementation overhead;
2. there can be important interrelationships between different tools so that, whilst in isolation a solution may add minimal value, the synergy when it is combined with other tools can be material.

Example

Detailed modelling has shown that a pension increase exchange (PIE) exercise could be of material value to some members, whilst helping to reduce the company's longer term funding costs. However, the trustees are likely to focus on the more generous end of the design spectrum in order to benefit members taking up the option.

The company is keen to use the PIE as a way of accelerating the endgame timetable and therefore decides to offer a package of proposals, including a specific PIE design but also improved security for the scheme. When considering the cost of this security, the company compares this against the value of getting the PIE design agreed as well as the additional risk that can then be run in the scheme's investment strategy. By combining these two "tools" of PIE and security a win/win solution can be developed for the company and the trustees.

The big question – what is the endgame?

Fundamental to the development of an endgame strategy is the role of risk transfer solutions, as compared with running off a scheme's liabilities backed by the company's covenant over an extended period of time. This is a simplification, as "do-it-yourself" insurance solutions are also possible, but we start with the more fundamental question, "to insure or not to insure?".

There are multiple aspects to answering this question:

- ability and appetite of the company to manage downside outcomes;
- scale of potential "regret" risk, if hindsight shows insuring to have been the better option (this has been the case over certain periods in the past and almost certainly will be at points in the future);
- comparing the cost of insurance with other strategies that potentially free up company resources in the short term for other investment opportunities;
- fundamental company beliefs about handing over (at a perceived price) responsibility for the scheme to a commercial provider, as opposed to using internal company resources to manage the endgame;
- if not the insurance route, how does the company give the trustees confidence about the ongoing company covenant when the plan involves running the scheme off over decades?

As part of this discussion it is important that the company really understands what is behind insurance pricing and what the company is getting for that price, rather than approaching the question through the lens of insurer profit margin.

There also needs to be a honest discussion about how much time and resource the company wishes to invest over the next 20-30 years in running down the pension scheme when it is not, for most, a core skill set of the company. Does a manufacturer really want to run a multi-billion financial arrangement for decades to come if there is an alternative option?

On the other hand, time can be a company's friend. If a pension scheme remains manageable and the company covenant remains sound, then over time a scheme will discharge its liabilities and the membership become older. This reduces both the size of the pension scheme and its risk profile, as future experience becomes less unpredictable (for example, medical improvements are more likely to significantly impact scheme liabilities if members are on average aged 50 as compared with 70).

From a company perspective, it may well make sense to run the scheme on for a period of time before looking at insurance and incurring a risk transfer premium. But this depends on the company understanding, and being able to live with, the risks it will be running up to that point.

For companies with weaker covenants and the potential ability to accelerate funding into their scheme, superfunds should be considered. They give the company a clean break at a lower cost than insurance buy-out (particularly for less mature schemes), and from a trustee perspective might give better long term covenant support than the employer's covenant.

In the Consider stage, we explore these concepts with the company and develop an understanding of where the company's thinking is. This high-level understanding is then taken into the Create stage, where we develop our short list of possible endgame strategies.

The role of governance

Whilst we look at governance design in detail in the Create stage, it is important that the company has a working understanding of the governance/oversight requirements of the various tools. There is no point in exploring an idea in any detail if the company will not support the infrastructure required to maintain it.

This ties in with a broader discussion we start to have with the company at this point around the future governance model for managing the scheme and how the agreed endgame strategy will be kept on track. It is important we agree with the company some high-level principles in respect of future governance models at the Consider stage, to support the triage of the wider toolkit and establish what is plausible and worthy of further investigation.

Bringing it all together

By this point in the Consider stage we have arrived at a small set of tools which have been tested to ensure that the company:

- understands the concept and why the tools may have a role to play in their situation, given the agreed objectives and beliefs from the Clarify stage;
- knows how the tools might interact to generate a more powerful impact;
- appreciates what implementation would involve and has taken an initial, high level decision that this is not a barrier to exploring further with the trustees;
- has a degree of confidence that trustee agreement should be achievable.

This means that we now have clearly articulated company objectives and beliefs, as well as a focused set of tools/solutions to help us build and develop the endgame strategy as we move into the Create stage.

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