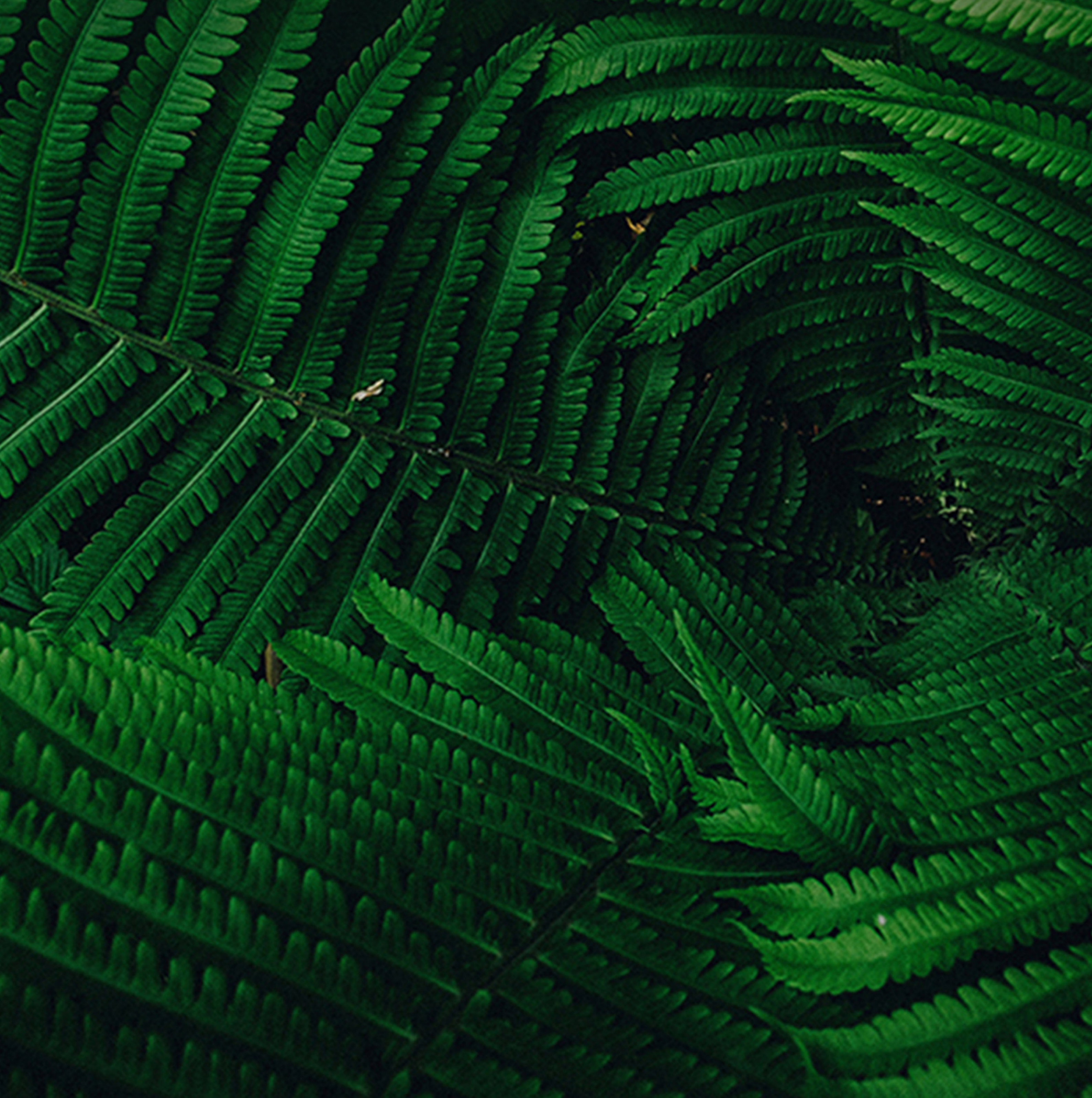
Setting your corporate DB endgame strategy

The importance of companies planning for the endgame

September 2021



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 - more on this later. But what do we actually mean by having an "endgame strategy"?

Journey plans or glide paths have been around for many years but there has recently been an increased focus from companies and trustees due to the emerging views of the Pensions Regulator on how schemes should be funded.

Whilst the Covid-19 pandemic may have slowed down the formal implementation of the new funding code, it seems inevitable that long term funding objectives will be enshrined in future funding standards now that the Pensions Scheme Act 2021 has received Royal Assent. So, does this mean all companies will have an endgame strategy? The short answer is no, in fact most companies won't.

This document sets out why having an endgame strategy is essential, the economic value it can bring and the process you should follow to put an effective strategy in place.

Leonard Bowman
Head of Corporate DB Endgame Strategy
leonard.bowman@hymans.co.uk
020 7082 6388

The need for an endgame strategy

An endgame strategy means the company can clearly articulate the following:

- Its expectation for how the scheme's liabilities will ultimately be discharged, i.e. run-off, insurance buy-out or possibly one of the evolving solutions.
- What that means for the scheme's current investment strategy and how that strategy should evolve over the remaining life of the scheme.
- Both a short term and longer term understanding of the expected cash and accounting implications, together with the risk profile of facing higher costs in downside scenarios.
- A plan for how downside risk events will be managed to avoid damage to the company's covenant or its wider business plans.
- A governance framework that aligns with the company's governance philosophy and effectively integrates with that of the trustees.
- A preferred delivery model for the scheme that meets the cost and governance objectives of the company.
- How it will monitor changing circumstances and new pension solutions to take timely action to keep its strategic aims on track or to improve them over time.

Simply having a long-term funding objective is not enough if the company is to intelligently manage its pension costs and risks over the lifetime of the scheme. A holistic strategy, which is carefully monitored with robust governance, needs to be put in place - the long-term funding target is only one piece of the jigsaw.

Finally, the strategy needs to be tested through the dual lens of how the trustees will respond and how the strategy will be viewed by the Pensions Regulator.

An optimal corporate strategy is of no practical use, if it cannot pass these tests.

At this point, senior management will probably be asking whether all this is really necessary? After all, the scheme has been running along fine up to this point and "if it is not broke"...

We would suggest an endgame strategy is very necessary, for four reasons:

1. *"We have not needed this in the past"* is often not true, it's just that some companies do not realise the opportunities that have been missed.

2. As our latest research shows, the impact of an effective strategy can be financially significant.

3. Trustees and their advisers are taking endgame planning increasingly seriously. If the company does not drive this, then it will struggle to influence the agenda and to stay on top of emerging opportunities.

4. Management of pensions is moving up the corporate governance agenda, as a result of

   a. the Pensions Act 2021 giving trustees a "seat at the table" for corporate activity
   b. ethical and socially responsible governance requiring companies and pension schemes to be aligned – many companies are receiving investor questions about how their scheme is invested
   c. as noted under point 3, companies need to manage the pension agenda and that is far easier if there is a common governance

The economic value of an effective strategy

Our detailed model scheme analysis is available upon request, but we provide an overview of the analysis below.

We started by considering the following model scheme. This is funded at around the average level in the UK at the moment.

Funding basis	Technical Provisions (Gilts + 1.0%)	Long Term Objective (Gilts + 0.5%)	Buy-out
Assets	£450m	£450m	£450m
(Liabilities)	(£500m)	(£550m)	(£685m)
(Deficit)	(£50m)	(£100m)	(£235m)
Funding level	90%	82%	66%

We then considered the following 3 potential endgame options:

Option	Funding target	Explanation
1 Company focused	Gilts + 1.0% pa in 15 years' time	This enables a Cashflow Driven Investment strategy that meets the benefit payments with a reasonable degree of confidence, whilst still placing reliance on the employer covenant.
2 Fast Track	Gilts + 0.5% pa in 15 years' time	The Long Term Objective (LTO) basis under Fast Track is yet to be finalised, but given Covid-19 and TPR's funding basis for superfunds, we have assumed that the Fast Track LTO will be at the lower Gilts + 0.5% pa end of the range proposed by TPR in its first consultation.
2 Trustee default	Gilts + 0.5% pa in 15 years to set initial contributions, which continue until a 90% buyout funding level is reached	Given possible concerns around long term covenant visibility, we have assumed that the trustees' default strategy, in the absence of anything from the company, would be to do an immediate pensioner buy-in, and have a fast track level of contributions that continue beyond 6 years until 90% funded on insurance buy-out.

These options give the following base case contribution requirements.

Option	Cash contributions	Total cash commitment	Explanation
1 Company focused	£2.6m pa for 15 years.	£39m	An unfettered position, the company spreads contributions over the full period to end game funding.
2 Fast Track	£9.3m pa for 6 years	£56m	Under Fast Track the expectation is that cash recovery plans will be no longer than 6 years for stronger covenants.
3 Trustee default	£9.3m pa for 12 years	£112m	The trustee default strategy would be to set contributions at a Fast Track level, but for these to then continue until 90% of buyout is reached, which is after 12 years. In this scenario, full buyout is likely to be achieved between 20 and 25 years.

The Company focused option gives 30% lower cash costs than those expected under Fast Track. However, crucially it also gives more time to recover funding in the event of a shock. To assess the resilience of each strategy, we have applied a shock in year 3 to understand the impact on required cash contribution levels at the next triennial valuation and therefore the risk within each strategy.

The shock represents a general economic downturn and involves a 20% fall in equities and a 5% increase in liabilities from a mortality shock. Both of these events are broadly equivalent to 1-in-20 downside events. The table below shows the impact on cash contributions of the shock. The shocked annual cash contributions under the Company focused approach remain lower than the base case annual contributions under the other options.

Option	Cash contributions from year 4 prior to shock	Increase in deficit from shock	Cash contributions from year 4 after shock	Increase in cash commitment from the shock
1 Company focused	£2.6m pa for 12 years.	£50m	£7.4m pa for 12 years	185%
2 Fast Track	£9.3m pa for 3 years	£54m	£27.6m pa for 3 years	197%
3 Trustee default	£9.3m pa for 9 years	£30m	£12.8m pa for 9 years	38%

The Company focused strategy looks attractive in a base case and shocked environment. However, in the real world the ability of the trustees to agree to this strategy is constrained and heavily dependent on covenant visibility. This strategy therefore only works for companies that offer stronger covenants to their schemes. In practice, with the new funding regime, this means providing legally enforceable covenant support to the scheme so that the trustees are able to agree the strategy. It really demonstrates the value from providing security or contingent assets to the scheme when compared against the alternative Fast Track option that does not require security but has significantly higher cash costs.

For weaker covenants where security is not available, the Company focused option is not achievable in practice, and indeed all the options may be challenging because the available corporate headroom to support the impact of a funding shock could be limited. Of the remaining two options, the 'Trustee default' looks the better strategy, as it is more resilient in a shocked scenario.

This is because completing a pensioner buy-in reduces the magnitude of those funding shocks and starts to tackle what is now the main unhedged risk for some pension schemes – longevity risk.

However, the trustee default/insurance route comes at a high price in median or good economic outcomes compared to run-off. The question is how much downside risk the company is able or willing to underwrite to support an efficient cash strategy.

So how should a company go about developing its pension strategy? At Hymans Robertson we use a four stage process to support our clients. Below is a brief overview of each stage with more detail on the following pages.

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

1

CLARIFY

Like any good strategy, the company needs to start by articulating the problem that needs to be solved. Usually this is achieved by considering some or all of the following:

- Desired level of cash contributions into the scheme
- Maximum level of affordable cash contributions in the event of negative experience, to drive the level of risk to take in the scheme
- The availability of "non-cash" security, for example other company assets or external security solutions
- From an accounting perspective, any P&L or balance sheet targets or limitations
- Running costs for managing the scheme
- Ensuring an effective governance framework is in place.

Agreeing some parameters within which the strategy needs to operate means we have an initial range of ideas to be developed and tested, allowing optimal solutions to be identified fairly early on in the process.

This is also the stage where we work with the company to understand the more subjective beliefs of senior management, in areas such as investment and longevity risk and the role of external risk transfer providers. Whilst these beliefs are often not clearly articulated when solutions are being developed, they can still drive decision-making, sometimes leading to lack of clarity as to why the company is taking a certain action. This can become particularly unhelpful as circumstances change and the strategy needs re-visiting.

2

CONSIDER

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 ultimate company targets.

In this stage we explore with the company the choice of relevant tools. Using the information gathered in the Clarify stage, we triage the full range of options to ensure we only discuss the tools that might be of use.

For those which are relevant, we walk the company through what they involve, best practice for how they should be used and how to decide which options are worth exploring in more detail. Some solutions require much more governance if they are to work effectively and this needs to be understood at an early stage when shortlisting which ideas to look at more closely.

At this stage we also help the company identify the optimum exit strategy, i.e. whether that be running the liabilities off or targeting some form of transaction (either a bulk annuity or possibly one of the evolving solutions). If some form of transaction is contemplated, we identify over what sort of timeframe this works best.

3

CREATE

By this point 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.

Our short list of solutions is tested against a range of economic and demographic scenarios, in order to evaluate their robustness against the stated company objectives. This testing answers two key questions:

1. How likely is it that the strategy will deliver against the objectives?
2. Can the company live with downside risk events, and therefore how much risk should be taken in the scheme?

Finally, we look at how the best strategies stack up from the perspective of the trustees and the Regulator's new funding code.

The output from this analysis means that we present the company with a realistic assessment of the options most likely to meet its objectives, whilst at the same time being acceptable to the trustees. In the real world this stage usually involves some trade-offs! However, the company can then take those decisions with a deep understanding of the pros and cons of any particular trade-off.

Once the core strategy has been settled, we look in more detail at the other tools that, as agreed at the Consider stage, are worthy of further investigation. This can include the role of member options, fiduciary investment management, buy-ins or indeed newer risk transfer solutions, to name a few. By doing this, we identify any quick wins which immediately strengthen the scheme's financial position, as well as those options which are worth keeping a close eye on because they may help in the future.

4

CONTROL

As all companies know, no strategy works perfectly. Yet many companies have been surprised in the past when, having implemented an agreed pension strategy with their trustees, things have gone quickly off track. In no area of business would a company set in motion a complex financial strategy and then sit back and not manage its delivery, so why should pensions be any different?

In part, of course, the reason lies in the role of trustees and the trust structure of UK DB pensions. Often this has meant that the company has left it to the trustees and their advisers to manage the scheme on a day to day basis. In some circumstances this has worked very well - after all, trustees have a legal duty (and a range of powers) to ensure their scheme is well run. However, given that the potential success or failure of the pension strategy has profound cost implications for the company, we would suggest it is only right that the company takes a measure of control over this strategy.

It is also worth remembering that the trustees are, first and foremost, there to ensure members receive their benefit entitlements. They are not going to focus on how this can be achieved in the most optimal way for the company, or whether the implementation of the strategy is aligned to any broader corporate objectives. That is the job of the company.

All of this points to the need for ongoing company engagement in monitoring of the strategy. This stage is designed to make sure:

- there is a robust and long-term governance framework that will ensure the strategy remains on track
- or if not, that corrective action is taken promptly
- opportunities to outperform are not missed, for example investment market movements, new risk transfer opportunities or the sudden attractiveness of a member options exercise.

At this stage we help the company develop and implement a sensible and proportionate monitoring framework, along with a suitable governance structure to ensure the company and trustees have good lines of communication, a common understanding of how to manage the pension strategy, and that the company's running cost and governance objectives are met. This can be critically important if short term market opportunities are to be taken, or if any emerging problems are to be corrected quickly. Effective monitoring is not much use if you cannot act in time on what your monitoring framework has flagged up!

London | Birmingham | Glasgow | Edinburgh

T 020 7082 6000 | www.hymans.co.uk