100 HYMANS # ROBERTSON

Setting your corporate DB endgame strategy

Clarifying your company objectives

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 first stage is Clarify. Like any good strategy, the company needs to start by articulating the problem that needs to be solved.

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

Why are clear objectives so important?

On the face of it this is a rhetorical question, it's obvious why clear objectives are so important! But if that's true, why do so few companies have a clear vision for how to manage their pension scheme and why do companies with a strategy seem to change it frequently?

In part, the answer lies in the reality that many companies react to what is happening with their pension scheme, including issues that arise from economic or regulatory events. This means that any articulation of a corporate objective is often through the lens of the specific issue that has triggered the company's engagement. A very common example is a trustee request for higher cash funding. Often the Company will frame their thinking and response purely in terms of the affordable or target level of cash, i.e. "we need a solution that keeps annual contributions below £x million".

However, an effective endgame strategy is about thinking through all the factors that matter to the company, both now and in the future. Possible strategies can then be robustly tested against those factors and the strategy adjusted accordingly.

At their most fundamental level, well defined objectives inform the risk/reward debate and enable a framework to be developed to help the company understand its ability and appetite to take risk in the expectation of reducing future costs.

At this point, having an effective governance framework becomes all important. Strong governance will ensure focus is not lost on the key objectives and future monitoring and decision making is made in a logical and consistent way over the scheme journey.

Possible objectives

Cash contributions

This is the most obvious area for a company facing pension issues to focus upon. However, to develop an effective and robust long-term strategy, a range of cash parameters need to be explored:

- the optimal level of cash funding
- the corridor of "acceptable" levels of cash contributions, reflecting a less than ideal cash commitment but still at a level that does not fundamentally affect corporate planning
- the absolute worst-case maximum level of cash contributions that the company could manage.

Ideally, these contribution levels should be quantified for both a short and medium term timeframe, for example if there is a short term focus on retaining cash to pay down debt or invest heavily, whilst over the medium term free cashflow is projected to improve.

Size of pension deficit

Whether linked to credit ratings, views of lenders or, for financial institutions, some form of capital solvency test, most companies care about the size of their pension deficit (above and beyond how that drives cash contributions). This may be the deficit on an accounting or solvency (section 75 debt) basis.

Again, it is important to understand the company's tolerance in terms of manageable deficit levels and any absolute levels that the deficit must not exceed.

Use of non-cash security

The use of company assets to provide security to the scheme as an alternative to simple cash funding has been a powerful tool in the company pension toolkit for a number of years. It also forms an important component of the Regulator's new funding code.

Whilst not really an objective, it is important to understand the extent and the appetite of the company to use assets to provide security. It is also important to understand how this may change in future downside scenarios, for example the ability to always access letters of credit at an acceptable price if the company covenant weakens or how the value of corporate assets changes in a downside scenario.

Links to broader corporate strategy

Increasingly, pensions is a significant consideration for companies when planning corporate activity, whether use of cash, restructuring or M&A activity. In the light of the Pensions Act 2021, trustees are expected/required to have a seat at the table, and to look to be treated equitably relative to other stakeholders in corporate transactions. It is important that the provision of appropriate mitigation for any detriment to the security of members' benefits does not de-rail the company's plans.

This is beginning to influence how companies view their medium to long term pension planning. In some cases, it has already led to a desire to accelerate the de-risking, funding and settlement of pension plans, so that broader company planning is not impacted by pensions. It is important that any such broader objectives are captured in the Clarify stage, as they can materially impact the range of solutions worth exploring.

Understanding company beliefs

Corporate decisions are often driven not just by hard analysis but by the inherent beliefs of senior management. Beliefs are rarely something that can be concluded to be "right" or "wrong", but they can underpin entire corporate strategies. Company pension decisions are no different, although here the underlying beliefs are generally less well articulated and understood.

To develop a robust endgame strategy, these beliefs needs to be clarified and appropriately challenged. Otherwise, the rationale for the strategy will only ever be partially understood, which can be particularly unhelpful as circumstances change and the strategy needs re-visiting.

So what do we mean by company beliefs? A few important pension examples are below:

- the value of running investment risk within the pension scheme, as compared with taking that risk in the core business
- the extent to which business risks provide a hedge to pension scheme risks (for example inflation could increase pension liabilities but be offset by higher corporate earnings)
- comfort levels in being an outlier against peers and facing regulatory scrutiny
- the appetite to be exposed to longevity risk
- the attractiveness of using insurance to provide a risk transfer solution, as compared with running off the liabilities and
- the appetite for being an early mover with new solutions, compared to moving with the market.

Corporate beliefs can have a profound impact on the development of pension strategy, so it is vital that they are considered on the basis of the best evidence. This is a key part of the Clarify stage. It means the company makes pension decisions with a clear understanding of where its beliefs are leading to judgement calls that may, or may not, be backed by empirical evidence.

Maintaining focus

A mistake too often made is to develop and implement a strategy, based on a set of objectives, and then lose sight of those objectives and the underlying thought-process as time passes and experience unfolds. Used properly, the work put into the Clarify stage can bring value for many years into the future as strategies are monitored and managed in the Control stage, by ensuring future decision-making maintains the discipline of retesting actions against the company's core objectives.

Conversely, company objectives can and often do change over time. It is important in the Control stage that the original objectives are regularly revisited and the strategy is tested to ensure its ongoing alignment with the aims of the company.

All of this points to the need for ongoing and robust governance (both at the corporate reporting level and how the company and trustee works together).

Final thoughts

It is important that the right 'customised' endgame strategy is developed to meet each company's specific objectives. The Clarify stage is essential for ensuring those objectives are correctly identified and fully understood.

Just as importantly, those objectives need to be kept in focus as time passes and retested as appropriate, to ensure the endgame strategy remains on track and that future opportunities are taken as they emerge.

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