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Setting your corporate DB endgame strategy

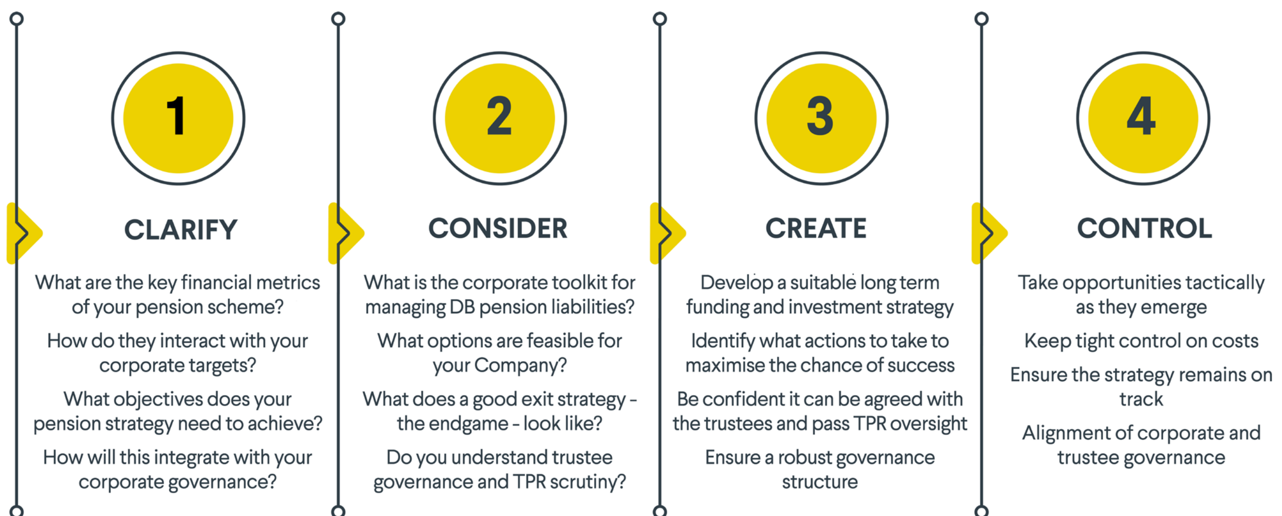
Staying in control of the journey

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 fourth stage is Control.

In this stage we help the company to implement a sensible and proportionate monitoring framework, along with a suitable governance structure. The latter ensures that the company and trustees have good lines of communication and a common understanding of how to manage the pension strategy, and that the company's running costs 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.



Pensions – a vital area of your corporate governance

Companies with defined benefit (DB) schemes are responsible for managing funding shortfalls that can often be 20% (or greater) of the company's market cap. Defined contribution (DC) arrangements can cost 5-10% of the salary payroll, with millions (or even billions) of assets under investment. For many companies no one part of their operations carries as much financial clout as their pension commitments.

In addition, the UK has one of the most developed legal and regulatory frameworks for the management of pensions. There is a track record of huge reputational damage when a company hits a serious pension problem, with executives and key advisers appearing before Parliament to justify their actions. This has led to the recent increase in regulatory powers to crack down hard on companies who are perceived as avoiding their duty to support pension obligations.

Despite this context, it has only been a recent development for companies to consider how to integrate pension monitoring and decision making into their ongoing corporate governance framework. Many companies have still not properly engaged with the need for this. Why might this be the case?

There are a number of factors at play:

- The UK trustee model puts a lot of power and responsibility on the trustees, particularly for DB schemes. Companies have limited control/influence over the day-to-day operation of their schemes and often can only influence, not dictate, major strategic policy decisions, such as investment and funding strategies. This means that companies have been able to sit back and focus their attention on their core business. After all, why throw time and resource at something you can only partially control?
- Companies have traditionally seen pensions as an issue to engage with only when a "big ticket" decision is required, for example, for DB schemes, three yearly funding valuations, investment strategy consultations or risk transfer proposals. For DC arrangements, the review of contribution levels or the selection of pension provider are of equivalent importance and focus.
- Pensions is a large and complex topic which is not core to most companies' businesses. In practice, securing enough time to brief senior management in detail on the issues and stay on top of emerging developments is not straightforward. It raises the question of whether there is enough value to make the investment of management time worthwhile.

Another way to put this is "if it ain't broke, don't fix it". However, given that the potential success or failure of the pension strategy has profound cost and risk implications for the company, we would suggest it is only right that companies takes a measure of control over the strategy.

It is also worth remembering that the trustees are there, first and foremost, 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, nor whether the implementation of the strategy is aligned to any broader corporate objectives. That is the job of the company.

“The end is nigh”

Developing and implementing an endgame strategy requires a wide-ranging dialogue that covers funding, investment, risk transfer and operational project management.

These strategies will have profound implications on the operation of schemes for years to come. It is essential that companies properly engage and, ideally, drive these discussions. A passive approach will lead to sub-optimal corporate outcomes in most cases.

This points to the need for ongoing company engagement in the monitoring of any endgame strategy, to ensure:

- a robust and long-term governance framework that will make sure 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.

Broader benefits from the Control stage

Socially responsible corporate governance

The need for companies to demonstrate they are responsible corporate citizens has never been higher. The move to much greater shareholder activism and the greater role for non-executive directors to provide independent challenge to the executive has led to much greater scrutiny of the operations of companies and the impact on ethical areas are matters of increasing concern to society - a very immediate and high profile example being climate change and how we globally respond to the emerging risks.

Well run companies are working hard to ensure these issues are central to all corporate decision making and that there is a clear audit trail to show how company actions and investments have been considered against the impact on our society. But what about the company pension schemes?

The sheer scale of a pension scheme, and hence the impact of its investment policy, can lead to hard questions for sponsoring employers if the ESG principles of company and scheme are not aligned.

Increased regulatory compliance and penalties

We do not believe that good governance should be driven by the fear of negative outcomes, but there is no getting away from the fact that an effective governance framework protects companies from non-compliance risks, the consequences of which have never been more serious.

The Pensions Act 2021 created new powers for the Pensions Regulator and, in tandem with this, a range of new sanctions.

Companies simply cannot afford to make mistakes in this area and company boards are becoming concerned about that risk. To properly mitigate against this, companies need new reporting frameworks to ensure that all significant corporate activity is considered through a pensions lens before action is taken. There needs to be a strong audit trail in order to prove that the right issues have been considered at the right level in the business.
If this were not sufficient, trustees and corporates alike will soon be subject to a new DB funding regime, which will be the biggest shake-up in funding since scheme-specific funding was introduced in the mid-2000s.

How the trustees respond to the huge challenges posed by these requirements on their own governance framework is something which the company should care about. Trustees will be very focused on their governance and strategy over the next few years, as they respond to these changes, and it is an excellent (and essential) time for sponsors to ensure company and trustee governance are well aligned.

What does good corporate governance look like?

As with any other type of corporate governance, the framework will be bespoke to the circumstances and style of the company. But there are some key features a successful framework will need to include.

Frequent and transparent trustee and company communication

In order for the company to influence the pension agenda, it is vital the trustees understand the company's thinking and have a regular opportunity to explain to the company their concerns and to share adviser thinking. There is tremendous value in building trust and a common understanding of the different stakeholders' perspectives. This increases the chance of finding ways forward that balance all parties' requirements. This cannot be achieved by company/trustee communication being limited to major events, such as three yearly valuations.

Additionally, regular dialogue that has built up trust maximises the chance of making quick, appropriate decisions if things go off track or short-term opportunities emerge.

Clear terms of reference for any committees/decision making groups

Whether it is a joint trustee/company working group or a company pension committee, absolute clarity of the role of any such group is vital, i.e. its scope of discussion and decision making powers and, just as importantly, when and what decisions need escalating.

Regular reporting to senior management and signposting of how the pension strategy is proceeding

Any governance framework will need to support the ability to make quick company decisions in response to emerging circumstances. That requires two things:

1. Enough regular discussion at executive board level of the pension strategy and technical aspects so that company decision makers are confident they have an appropriate level of understanding to make the decisions asked of them.
2. Clearly articulated and well understood corporate objectives, so that recommendations from advisers can be framed in the context of meeting the corporate objectives already approved by the company.

With this in place, there can be effective delegation of day-day to pension discussions with only big-ticket decisions being referred to the board.

Implementing change

Strong, effective corporate governance is not a mystery to well-run companies. Pension governance has never been more important, but companies have the skills and experience to put this in place. The two possible missing ingredients to success are companies recognising the need for this and then ensuring the right specialist support is in place.

In the Create stage we use our specialist and market leading governance experience to map out the governance requirements of the identified endgame strategy, for example by identifying any skill set gaps and whether the current decision making structures are fit for supporting the nature and timing of likely pension decisions needed in the future.

These governance recommendations form an integral part of the endgame strategy. Implementation runs parallel with the introduction of the new strategy, i.e. any governance changes will need to be discussed with the trustees and signed off by senior company management as part of the approval process for the new strategy. Senior buy in from all parties is essential for any new governance structure to get off the ground and be effective over the longer term.

The prize for getting this stage right is huge - more efficient decision making, greater influence over strategy, improved relationships with important stakeholders and more effective risk management. These are all ingredients for long-term corporate success and an endgame strategy that effectively delivers with minimal pain along the way.

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