

DB end games:

Understanding your DB destination

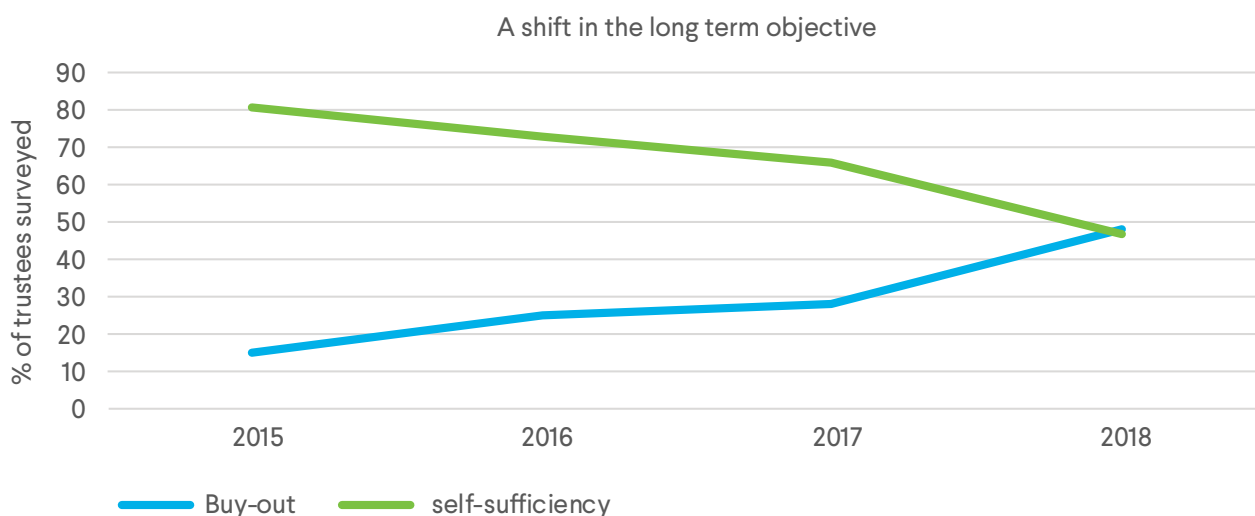
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Introduction

As The Pensions Regulator (TPR) continues to emphasise the importance of setting an appropriate Long Term Objective (LTO), the majority of trustees either plan to, or have already, reviewed the end goal for their DB pension scheme.¹

As a result of this increased focus on the end game, we're seeing a shift in trustee behaviours. Buy-out has now caught up with self-sufficiency in terms of preferred LTO:



But are trustees properly considering all of the end game options available to them? And do they fully understand what they're aiming for? With 95% of trustees still aiming towards traditional routes, it's clear more education and awareness is needed around the alternative opportunities now available.

“Examples of a suitable long-term objective could be to:

- **run-on** with employer support (for open schemes);
- reach for **self-sufficiency** with low-risk investment strategy and run-off with minimal call on the sponsoring employer;
- **buy-out** by a set-time; or
- enter a **consolidator vehicle** within an agreed timeframe”

DWP White Paper

Looking at the main options available, this paper will help you understand which end game is appropriate in different circumstances. For each option, we explore the key differentiators in terms of required funding position, investment portfolio and covenant strength, to help you set an appropriate target and understand exactly what you're aiming for.



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¹ Hymans Robertson's Trustee Barometer research 2019 – 70% of Trustees have reviewed their LTO in the past 12 months.

The changing landscape

As schemes carry on reducing investment risk, many trustees now see long term covenant support as their key risk:²

20% of trustees believe **sponsor failure** is the biggest risk to their scheme's financial health
The number of trustees looking to pass the running of their scheme over to an **insurer** has **tripled in 4 years**

In response to this, the DB landscape is expanding with new opportunities. Buy-out is now far closer for many schemes, and other new solutions are coming to market that provide an alternative end game option.

Traditional LTOs

Self-sufficiency* – trustees retain responsibility for the scheme until the last pension is paid. The scheme can either be run-off (i.e. where benefits are paid from within the current pension arrangements) conservatively, or more aggressively to optimise return, depending on the needs of the scheme and strength of covenant support.

Buy-out – responsibility of the scheme is transferred to an insurance company. Members leave the pensions regime and join the insurance regime.

Alternative end game options

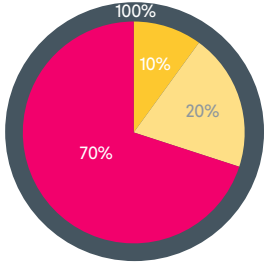
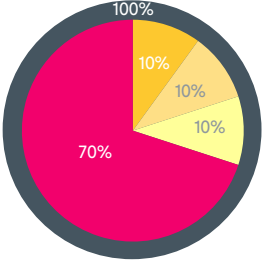
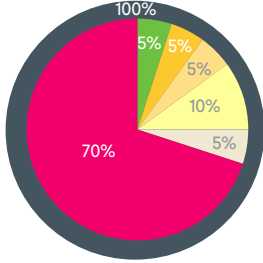
Commercial consolidators – sponsor covenant is swapped for a financial covenant provided by a capital buffer sitting outside the pension scheme. The consolidators are not insurers, and operate in the pensions regime. The cost may therefore be lower than insurance but the member security is also lower.

²Hymans Robertson's Trustee Barometer research 2019

*Please note: TPR are moving towards using 'low dependency' to describe this approach.

Traditional LTOs: Understanding the target

In order to hit your target, you need to know what you're aiming for. Here we compare an illustrative funding target, investment portfolio and covenant strength for each of the traditional LTO's highlighted on the previous page.

| | Buy-out | Self-sufficiency | |
|--|---|---|---|
| | | Conservative run-off (low risk, low return) | Optimised run-off (to generate higher return) |
| Illustrative funding target* | <p>Gilts + 0.25% p.a.</p> <p>This target is predicated on an average duration scheme buying out when all members are pensioners, rather than being sufficient to complete an immediate buy-out now.</p> | <p>Gilts + 0.5% p.a.</p> <p>This is a low dependency target with a high degree of confidence that the investment strategy will meet the ongoing benefit payments over time. The need for additional employer contributions is low.</p> | <p>Gilts + 0.75% p.a.</p> <p>This is a run-off target, with a reasonable degree of confidence that the investment strategy will ensure that the scheme's assets will be sufficient to meet the ongoing benefits over time. However, there is more risk in the investment strategy, and therefore the ongoing reliance on employer covenant is higher.</p> |
| Target end game investment portfolio** |  <ul style="list-style-type: none"> Asset Backed Securities Investment Grades Corporates Hedging assets |  <ul style="list-style-type: none"> Asset Backed Securities Investment Grades Corporates Liquid Multi-Asset Credit Hedging assets |  <ul style="list-style-type: none"> Equities Long Lease Property Investment Grade Corporates Liquid Multi-Asset Credit Private Lending/Real Estate Debt Hedging assets |
| | <ul style="list-style-type: none"> Growth assets Income assets Protection assets Interest Rate / Inflation Hedging | | |

*The gilts + targets shown are illustrative. In practice these should be kept under review and will change over time as market conditions and insurance pricing changes and as schemes mature.

**The investment strategies shown are illustrative based on market conditions at the time of writing. The choice of strategy may vary from scheme to scheme depending on scheme size, expertise of trustees, governance budget of trustees and trustees' investment beliefs towards e.g. leverage.

| Buy-out | | Self-sufficiency | |
|---|---|--|---|
| | | Conservative run-off (low risk, low return) | Optimised run-off (to generate higher return) |
| Investment considerations | <p>The investment strategy will aim to replicate buy-out pricing to allow the funding level to move in tandem with insurer pricing. The assets need to be held for some years in the end game portfolio to wait for the liabilities to mature and insurance pricing to come down to the funding target. The assets need to return above the funding target to give confidence of remaining fully funded and to meet ongoing and buy-out expenses.</p> | <p>The investment strategy will aim to have lower risk than the optimised run-off equivalent strategy and be fully hedged to interest rate and inflation to reflect the short, medium and long term risks facing the scheme.</p> <p>Assets need to generate a sufficient return to meet expenses, actual experience differing from expected, and second order risks.</p> | <p>The investment strategy will focus on income-generating assets which will deliver the return required to ensure that pensions can be paid as they fall due. The assets will often be structured to produce income in the same profile as the scheme's pension payments (both in terms of timing and amount). This is often called Cashflow Driven Investment (CDI). For an optimised run-off strategy, the income is often higher yielding albeit with somewhat higher risk of default. This higher risk of default can have a negative impact on the ability to pay pensions.</p> |
| <p>The strategy should provide liquidity to enable benefit payments and other scheme outgo to be met without being a forced seller of assets. Additional liquidity is needed for a buy-out target unless the insurer is willing to take assets in specie.</p> | | | |
| Covenant strength | <p>The obvious covenant scenario for this LTO is where the covenant is currently strong but there are concerns around longer term covenant support. The covenant can therefore support more risk taking now to reach a lower risk buy-out ready portfolio (similar to that shown above) sooner.</p> <p>However, this LTO works for other covenant scenarios too, and if the employer is supportive of ultimate buy-out then this LTO works in most circumstances. It may not be appropriate however if the current covenant cannot support the level of investment risk or cash contributions required to reach this LTO.</p> | <p>This LTO can be a good fit when the current covenant cannot support the level of risk or cash required now for a buy-out LTO. In these situations it can lead to better member outcomes to have a lower funding target e.g. gilts +0.5% rather than gilts +0.25%, and take less risk now, i.e. a "lower risk for longer" strategy. This is preferable to taking an unsupportable level of investment risk now to try and buy-out too soon.</p> <p>Once fully funded on this LTO, schemes can either run-off in a low dependency way with little reliance on employer covenant, or carry on taking some more investment risk to reach a buy-out LTO.</p> | <p>This LTO is a good fit for stronger employer covenants. For it to be viable, the scheme needs to have confidence that the covenant support is there for the long term in case the investment strategy does not deliver the required income (for example if default rates are higher than expected).</p> |

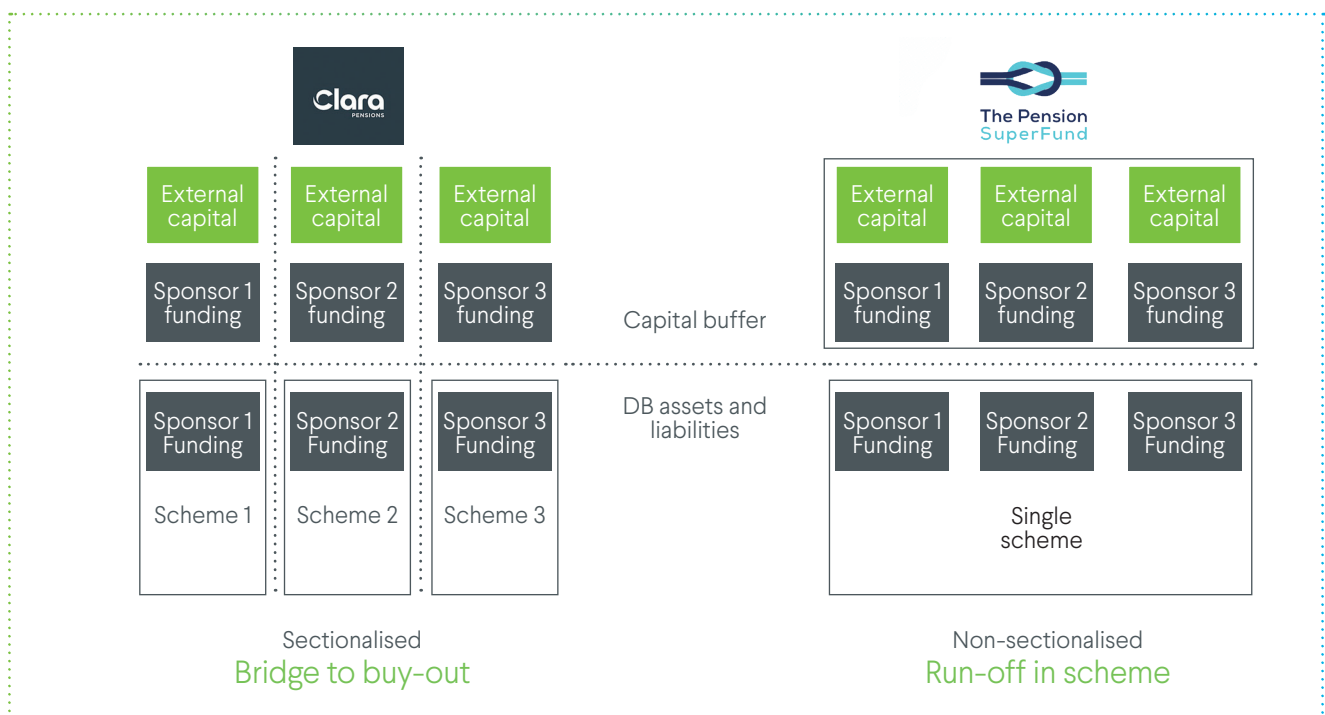
Where does commercial consolidation fit?

Commercial consolidators are now active in the pensions market, and can be a way to reach the LTO sooner. This becomes a viable option if circumstances change on route to your LTO, for example:

- 1 **Concerns arise over the long term viability of the sponsor's covenant** – commercial consolidators present an opportunity to replace sponsor covenant with a financial covenant. This improves member security in cases where this financial covenant is stronger than the covenant from the employer.
- 2 **Cash becomes available** – if an upfront cash injection, or even additional capital outside of the scheme's legal reach, becomes accessible, and this is sufficient to transfer to a consolidator but not to buy-out or move to one of the run-off investment strategies, then this may be worth considering. Accepting this capital and accelerating the pace at which the gap between the current strategy and LTO is closed, may be preferable to retaining a link to the current covenant to try and reach buy-out or a run-off strategy over time.

There are currently two consolidators in the market – Clara-Pensions and the Pension SuperFund. Both vehicles involve the transfer of the scheme's assets and liabilities into a new DB pension scheme backed by additional capital from external investors. However, the vehicles themselves have different LTOs.

Clara-Pensions has a buy-out LTO and plans to transfer incoming assets and liabilities to the insurance regime within 5-10 years. Conversely the Pension SuperFund has a self-sufficiency LTO akin to the optimised run-off model in our table.

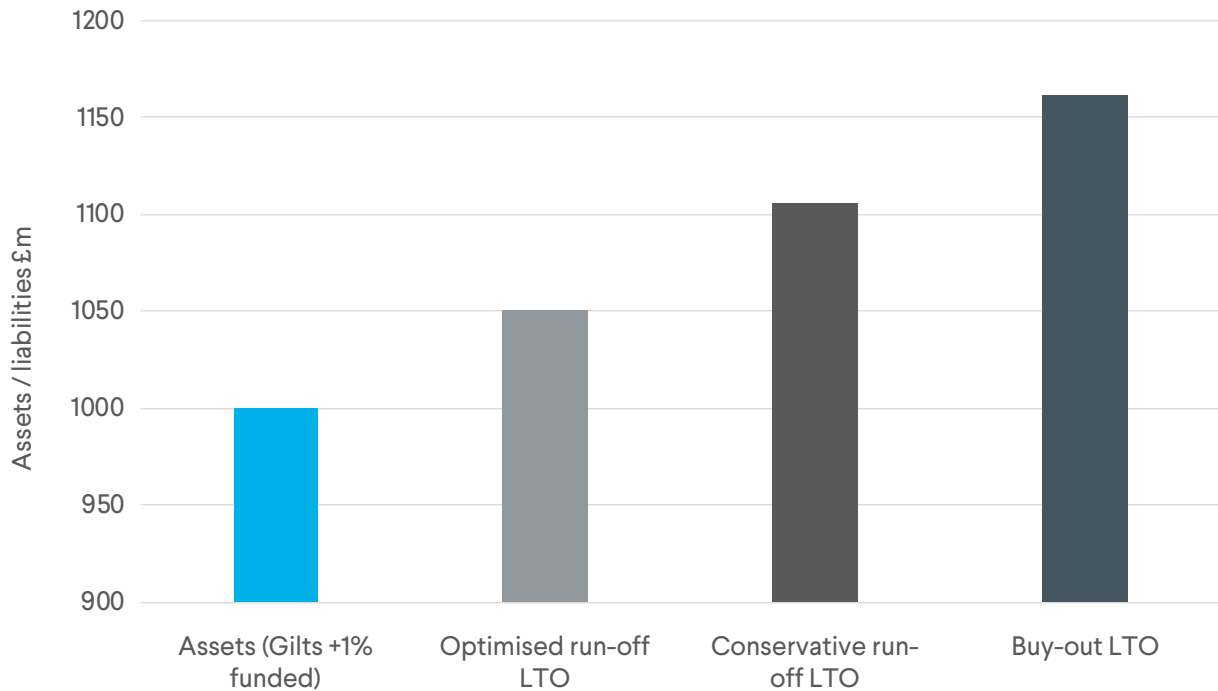


Despite the potential benefits of commercial consolidation, 75% of trustees still wouldn't ever consider moving to one of these vehicles.³ Trustees need to keep an open mind. As the market develops and momentum continues to build, we hope to see a shared and common understanding emerge of what commercial consolidators have to offer, and when they are in the best interests of members.

³Hymans Robertson's Trustee Barometer research 2019

What this means in practice

Here's an example of what different LTOs might look like in practice for a £1bn scheme, fully funded on a gilts + 1% basis that is trying to reach its LTO within 15 years.



| LTO | Optimised run-off | Conservative run-on | Buy-out |
|--|--------------------|---------------------|--------------------|
| Deficit | £50m | £100m | £150m |
| Required cash contributions to reach the LTO through cash alone | £3.3m p.a. | £6.7m p.a. | £10m p.a. |
| Required investment return to reach the LTO through investment returns alone | Gilts + 1.05% p.a. | Gilts + 1.15% p.a. | Gilts + 1.25% p.a. |

Actions for trustees and sponsors

As TPR continues to toughen its stance around LTOs, there are three key actions you should take:

- 1 Review your LTO** – Consider all the options available and factor-in both funding position and covenant strength.
- 2 Understand your target** – Ensure you understand what you are aiming for, in terms of funding position, investment portfolio and covenant strength.
- 3 Regularly assess** – Covenant strength can change over time. It's important to review your LTO on a regular basis to ensure it is still appropriate, and your strategy is aligned and on track. If something changes along the way, commercial consolidation may be a viable option to improve member security, and ultimately still achieve the LTO.

Get in touch to find out how we can help you with each of these areas, and ultimately achieve better outcomes for your scheme and members.

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