Case study

Assessing the endgame

Our corporate client, a leading financial institution, supported by a well-funded defined benefit pension scheme, wanted to review their endgame objectives.

Background

Our client was at least a few years away from reaching buy-out and so wanted to understand what their endgame objective should be and the actions required to align to meeting that objective. The client had not considered the optimal endgame objective relative to their risk appetite and their own institutional financial objectives.

We helped them to consider whether to target buy-out or to run-off their pension scheme, with a view to economic value being shared back to the company. As the process went on, the pension scheme became fully funded against buy-out (due to rising yields) and so the need for this review and beginning this process became even more urgent. Fortunately, the company was now well placed to act quickly.

The analysis

By going through this process with the company, we illustrated the financial benefits and costs of the different objectives and helped the company understand:

- The potential financial benefits and risks from pursuing a buy-out or run-off objective
- How the company could extract value from the pension scheme under the run-off objective
- The impact of low likelihood but high adverse cost events (i.e. black swan events)
- The practical and legal considerations of following either strategy.

The table on the next page illustrates a projection of a scheme which is 90% funded with buy-out liabilities in the order of £500 million at September 2022 (i.e. prior to the pension scheme becoming fully funded against buy-out in October 2022). The three sensitivities we have shown are:

- **Poor returns, and downside risk event in 2040 –** this reflects if returns were 1% p.a. less than best estimate returns, with a downside risk event equivalent to a 15-20% fall in funding and a 10% worsening in insurer pricing
- **Best estimate –** in line with the pension scheme's current expected return
- **Positive returns –** if returns were 1% p.a. greater than best estimate returns.

Where the figures have been discounted above, we have used a rate of 5% p.a. to illustrate potential present values under the different scenarios.

Sensitivity	Value from company contributions £m	Surplus in 2040 (discounted value, after sharing 15% with members and if positive, net of tax) £m	Optimised value for the company in today's terms (net of tax) £m
SCENARIO: company continues to meet expenses and future accrual			
Poor investment returns, and downside risk event taking place in 2040	-	-15	-15
Best estimate investment returns	-	50	50
Positive investment returns	-	80	80
SCENARIO: Expenses, future accrual are met by the scheme assets after reaching full buy-out funding *			
Poor investment returns, and downside risk event taking place in 2040	30	-35	-5
Best estimate investment returns	35	35	70
Positive investment returns	40	60	100

* *The timeframe to being fully funded on buy-out changes by around 1-2 years for each sensitivity when compared to the best estimate scenario.*

It was clear that material surpluses could be paid back to the company however, there remains the risk of significant adverse movements in funding. The regret risk of a significant downside event could mean further contributions become necessary in the future.

By using the surplus to meet expenses and future accrual after the pension scheme is fully funded on a buy-out basis, economic value from the surplus could be released sooner, reducing the tax due from taking the surplus at the point of buy-out and materially improving the net present value (NPV) of the optimised value.

Practical considerations

As a part of the different endgame objectives, we highlighted how key practical issues would need to be considered when aligning to a particular objective. For instance:

- Understanding the legal constraints
- Dealing with trustee negotiations
- Aligning the investment strategy to optimally meet the objective
- Interactions with the new funding code
- The extent to which additional risk reserves are needed under run-off
- Having the right governance model.

Conclusion

By going through this process with the company, it became clear what appetite they had for risk and the practical issues that would need to be addressed for their preferred strategy. For instance, the potential financial benefits under run-off were not significant enough for that objective to automatically be the preferred route, given the risks.

However, the company decided that if a strategy could be put in place (particularly around investments) to minimise the potential impact of downside events, it could be a viable choice.

Get in touch

If you'd like to discuss your approach in more detail, then please get in touch.

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