HYMANS # ROBERTSON

Setting your corporate DB endgame strategy

Analysis: Assessing effective endgame strategies

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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.

Companies underwrite the (sometimes substantial) risks presented by their pension schemes and therefore ought to have a strategic vision for the appropriate level of pension cost and risk supported by the business. This may, and indeed probably will, change over time as the scheme matures and the business evolves. Where and when the scheme's trustees are navigating to can have material implications for the sponsor.

The new funding regime being introduced by The Pensions Regulator (TPR) in 2022/23 gives added impetus for corporates to develop their endgame strategy, rather than waiting for their trustees to set it. The Covid-19 pandemic may also mean that businesses are re-sizing. Such activity may bring strategic endgame planning to the fore with substantial sums being available from sales or, conversely, significant capex required. In these cases, it's important to consider the equitable treatment of the scheme relative to other stakeholders and to ensure any detriment to the scheme is mitigated.

In this analysis we therefore assess effective endgame strategies for a range of illustrative companies. We'll flow this analysis through to the FTSE350 companies, when we assess them later in the year in our annual FTSE350 report.

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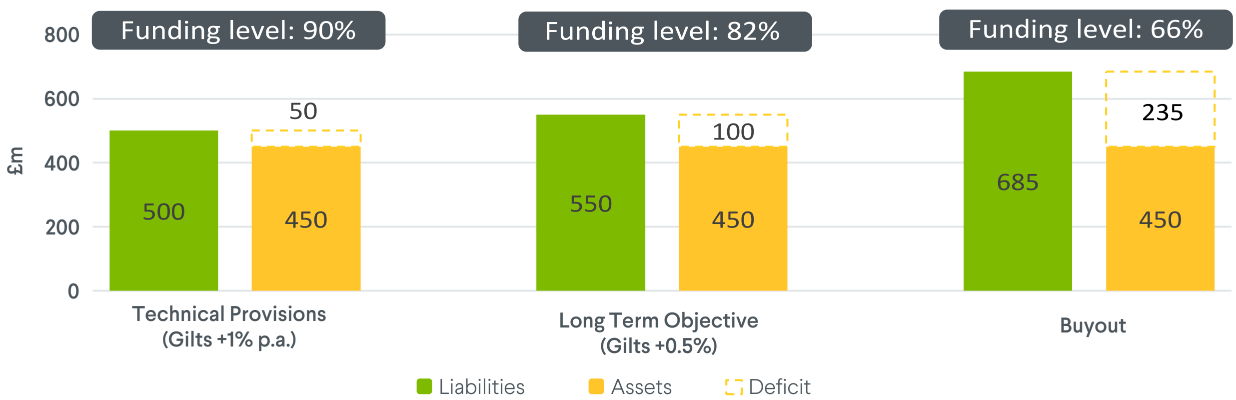
Setting the scene

The table below sets out the 3 illustrative covenants considered in this analysis.

	Weaker covenant	Medium covenant	Stronger covenant
Company metrics:			
Market capitalisation	£400m	£1,200m	£3,200m
EBITDA	£80m pa	£160m pa	£320m pa
Pension contributions	£8m pa for 6 years	£8m pa for 6 years	£8m pa for 6 years
Contributions / EBITDA	10%	5%	2.5%
Buyout deficit / Market cap	55%	18%	7%

The pension scheme is the same in each situation, with a funding position on different bases as set out below (this funding level is around the average in the UK at the moment).

Scheme metrics



Corporate objectives

What ultimately matters for a company is the cash cost of running off the pension scheme – an effective endgame strategy will minimise these cash costs. Retaining investment risk in the scheme reduces best estimate cash costs, but also increases the risk of having to pay additional contributions if the assumed level of returns do not materialise. Companies need to assess this trade-off and be able to support the downside risk that comes with running a higher level of investment risk.

Typical corporate objectives will therefore be a maximum level of cash costs and an acceptable level of deficit risk. Bringing these points together, our illustrative companies have the corporate objectives set out in the table below. These objectives intentionally have headroom in them against the current metrics, in order to reflect the risk associated with funding a DB scheme and the risk of covenant deterioration in the future:

Corporate objectives	Weaker covenant	Medium covenant	Stronger covenant
Maximum cash costs	20% of EBITDA	20% of EBITDA	20% of EBITDA
Maximum buyout deficit	100% of market cap	35% of market cap	15% of market cap
NPV preference	Where two strategies have the same current cash costs vs EBITDA, the strategy with the lower NPV will be preferred		

Endgame options

It is likely that most DB schemes will eventually be transferred to the insurance or superfund markets. When the capitalised value of the future running costs exceeds the premium payment required for insurance, then it must make sense to insure. But this position is usually over 20 years away. Over the next 15 years, corporates have a choice to 'run-off' the scheme or to aim to achieve or be close to an insurance buyout, and this is the fundamental choice we analyse here. We have fixed the timescale for full funding on a low dependency basis at 15 years, as most DB schemes will be significantly mature within this timescale and having to pay out a significant proportion of the asset base each year to pay pensions – it is simply not in the interests of the company to be running an underfunded scheme beyond this point. Within 'run-off', there is a decision on whether to run-off at the 'Fast Track' level expected to be required under the new funding regime or to run-off at a cheaper but less secure level. This therefore gives the following 3 end game strategies considered in this analysis:

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.
3 **Trustee default**	Gilts + 0.5% pa in 15 years' time to set initial contributions, which continue until a 90% buy-out 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 annual contributions that continue until 90% funded on insurance buy-out.

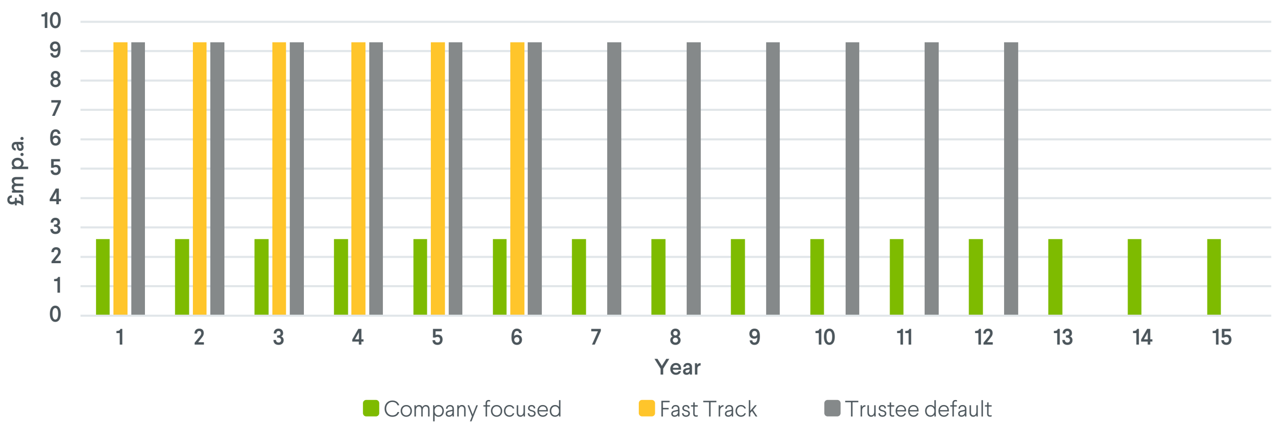
Base case funding and investment strategies

The 3 endgame options give rise to the following base case funding and investment strategies. In practice the relative contributions from cash and investment returns will vary and the balance shown here is intended to be sensible, rather than particularly aggressive or prudent.

Funding strategies

Option	Cash contributions	Total cash commitment	Explanation
1 Company focused	£2.6m pa for 15 years.	£39m	With an unfettered position, the company spreads contributions over the full period to endgame 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.

Cash contributions



Insight 1

Even before we worry about managing risk, these central projections provide us with some significant insights.

Unsurprisingly the company focused strategy results in the most efficient use of cash. However, this strategy is only an option if the company can offer robust security to enhance the covenant and the cost of that security will come with an opportunity cost.

Companies with medium and weaker covenants will not have this option and will therefore be looking at something in the range of Fast Track to a Trustee default strategy. Here the cost differences on the face of it look dramatic, which leads to three observations:

1. A trustee driven strategy will land somewhere in this wide cost range. It is therefore key that the company seeks to influence the development of the strategy as the difference in contribution extremes could be 100%.
2. On the face of it, Fast Track is clearly the way to go. However, as we see below this creates considerable short-term funding risk, i.e. any downside events will need to be made good over short timeframes. Furthermore, funding in line with Fast Track does not discharge the company of its commitments and the company is still exposed to the risk that full funding on a Fast Track basis ends up not being enough over the longer term.
3. Targeting an insurance solution looks expensive but, unless the company has a strong covenant, it can valuably reduce exposure to downside risks and support longer timeframes for redressing adverse experience.

Before we look at risk, we already have a number of issues for the company to consider:

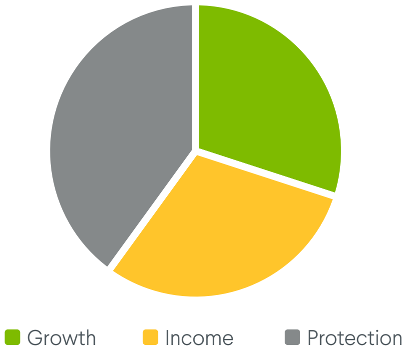
1. Access and appetite to use non-cash security to support longer but lower cost funding strategies.
2. Ability to absorb short term funding shocks, a particular issue with Fast Track funding.
3. Willingness to retain long-term funding risk, versus paying a premium to an insurer and having certainty of cost.

These questions will not have black and white answers, there will be ranges of tolerance that will drive the company towards certain strategies.

Investment strategies

The following base case investment strategy is assumed. It is intentionally structured with sufficient assets in LDI to hedge the funded liabilities at a reasonable level of leverage, with the remaining assets then generating the asset returns over the liability discount rate to help close the funding gap. For the 'Trustee default' option, a pensioner buy-in is conducted immediately and the investment strategy below is adopted on the remaining uninsured assets.

Asset allocation



Asset class	Allocation
Growth	30%
Income	30%
Protection	40%
Prudent asset return assumption	Gilts + 1.3% pa
Hedging	100% of funded (TPs) liabilities
1 year VaR 95 (buyout)	15% reduction in funding level

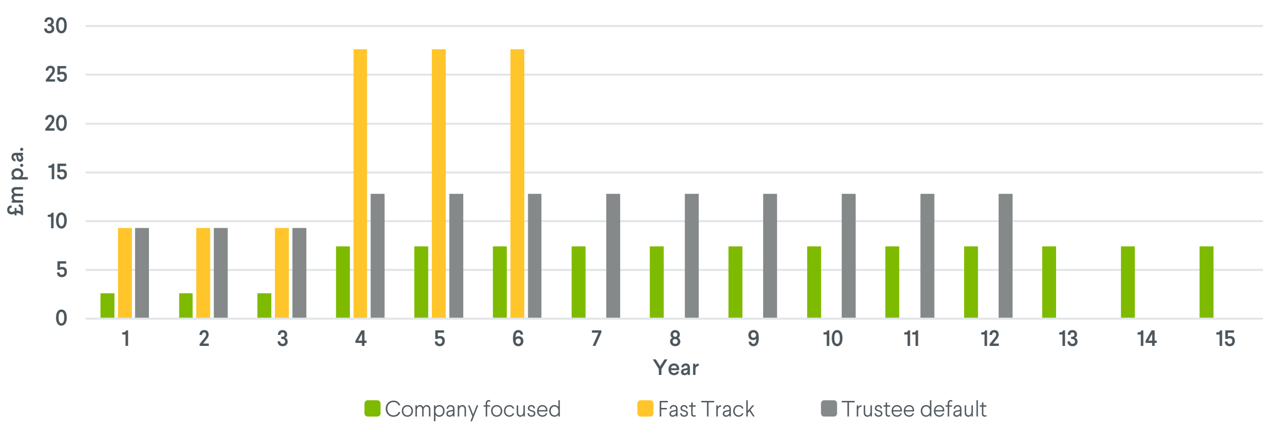
Understanding the risk / reward trade-off in an economic downturn

Whilst the company focused strategy delivers lower cash costs, the question is whether the company is willing and able to support the risk inherent within this strategy? We have therefore applied a shock to each strategy 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 is a 20% fall in equities (including the sponsor's market cap) and a 5% increase in liabilities from a mortality shock. Both of these events are broadly equivalent to 1-in-20 downside events. The resulting increase in deficit is then funded over the remaining cash recovery plan length for each strategy.

The chart below shows the resulting cash requirements, with the higher shocked contributions commencing in year 4.

Cash contributions (shocked)



Insight 2
The shocked annual contributions under the company focused strategy remain lower than the base case cash contributions under the other options. This is because the company focused strategy allows more time for funding to recover from the shock.

Linking it back to the corporate objectives

As well as the pure cash cost impact, the company needs to understand how each of the strategies fits with its own objectives and how willing and able it is to support the associated risk. The table below shows how the shocked positions stack up against their objectives, using the following green / amber / red rules:

Status	Rule
🟢	More than 5% headroom up to the corporate threshold
🟡	Within 5% of the corporate threshold
🔴	Equal to or exceeds the corporate threshold

Covenant strength	Weaker covenant	Medium covenant	Stronger covenant
Corporate objectives:			
Maximum cash costs	20% of EBITDA	20% of EBITDA	20% of EBITDA
Maximum buy-out deficit	100% of market cap	35% of market cap	15% of market cap
NPV preference	Where two strategies have the same current cash costs vs EBITDA, the strategy with the lower NPV will be preferred		
Shocked cash:			
Company focused	🟢	🟢	🟢
Fast Track	🔴	🟡	🟢
Trustee default	🟡	🟢	🟢
Shocked buy-out deficit*:			
Company focused	🟢	🟢	🟢
Fast Track	🟢	🟢	🟢
Trustee default	🟢	🟢	🟢

* the shocked buy-out deficit is calculated in year 3 and allows for the buy-out deficit trending down over time as the liabilities mature.

What about a downturn for the company?

The company's capacity to support risk in the pension scheme relies on maintaining its own covenant position. In practice this is not certain and the company will want to ensure that the pension scheme does not prevent it from reacting in an unconstrained way in the event of a corporate downturn.

We have therefore considered a second shock to the corporate sponsor, whereby the market cap and EBITDA of the company shrinks by 50% in year 3, at the same time as the economic shock to the pension scheme already explained above.

The table below shows how this corporate downturn shocked position stacks up against the corporate objectives.

Covenant strength	Weaker covenant	Medium covenant	Stronger covenant
Corporate objectives:			
Maximum cash costs	20% of EBITDA	20% of EBITDA	20% of EBITDA
Maximum buyout deficit	100% of market cap	35% of market cap	15% of market cap
Shocked cash:			
Company focused	🟢	🟢	🟢
Fast Track	🔴	🔴	🟡
Trustee default	🔴	🟡	🟢
Shocked buy-out deficit*:			
Company focused	🔴	🔴	🔴
Fast Track	🔴	🟡	🟡
Trustee default	🔴	🔴	🟡

* the shocked buy-out deficit is calculated in year 3 and allows for the buy-out deficit trending down over time as the liabilities mature.

Insight 3

It is the shocked events, and in particular the corporate downturn shock, which hit the corporate thresholds and highlight powerfully the need for the company to engage early in the decision making process.

It's no surprise that the company focused strategy delivers the lowest cash costs in a base case. Interestingly this remains the case with an economic and corporate shock because there is more time to recover funding after the shock, so the impact on annual cash costs is less severe than for the other options. However, in the real world the ability of the trustees to agree to the company focused 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 impending funding regime, this means providing legally enforceable covenant support to the scheme for the trustees to be able to support the strategy. This 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 are challenging because the available corporate headroom to support the impact of a funding shock is limited. Of the remaining two options, the 'Trustee default' looks the preferred strategy, as it stacks up better against the corporate objectives in a shocked position. 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.

Bringing it all together

Even ignoring a strong covenant-backed company focused strategy, the range of solutions a typical trustee board might look at could impact cash contributions by 100% and the impact of downside risks by 100%.

Interestingly Fast Track looks the least attractive option in most cases. This is largely driven by the need for cash recovery plans to be no more than 6 years for stronger covenants. This reinforces the need for corporates to drive their endgame planning, rather than leaving it to their trustees who understandably might start by looking to follow Fast Track. If longer cash recovery plans are permissible under the final Fast Track structure (which may be possible particularly for weaker covenants), then this option may start to look more attractive relative to the other options, but it still does little to manage more extreme risks or longevity.

Insurance is expensive and easy to dismiss for that reason but it provides the best protection in downside scenarios and is the only route to discharge the company from tail risks.

The company focused strategy looks very attractive from a cash perspective but under the new funding regime will require the provision of legally enforceable support (i.e. security) to the pension scheme. Companies with the ability to provide this support should assess the cash savings this strategy brings against the opportunity cost of pledging the security.

There is a significant difference in outcomes in all cases depending on whether or not the economic downturn happens in conjunction with a corporate downturn. This highlights the importance of considering the correlation of corporate performance and that of the general market and will be highly dependent on the company in question. Integrated scenario analysis where scheme and company outcomes are considered together is therefore an important tool for long-term planning.

A possible framework for setting the strategy

The table below sets out a potential framework for setting corporate pensions strategy, dependent on the covenant strength.

	Weaker covenant	Medium covenant	Stronger covenant
Ability to offer non-cash security	No	Limited	Significant
Ability to absorb downside costs	No	Limited	Significant
Possible strategies	Low investment risk plus insurance when affordable	Fast Track or insurance	Bespoke strategy, targeting runoff

For companies with medium covenant, the question of insurance is finely balanced. The right decision will be driven by the exact levels of tolerance for downside risk and the longer-term outlook for the covenant.

Economically there is a limited justification for insurance for companies with strong covenant, unless the company has broader rationale for risk transfer, such as reducing management time on pensions or concerns over pensions complicating future corporate restructuring plans.

Speak with one of our team

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