A journey plan towards the ultimate destination

Trustees will be aware that The Pensions Regulator (TPR) is busy working on a more prescriptive DB code of practice on scheme funding[1]. We expect a shake-up across the industry, as TPR aims to implement measures which will "optimise" scheme funding in the wake of several high profile corporate failures, and provide itself with new and improved regulatory powers to intervene when expectations are not met. These include:

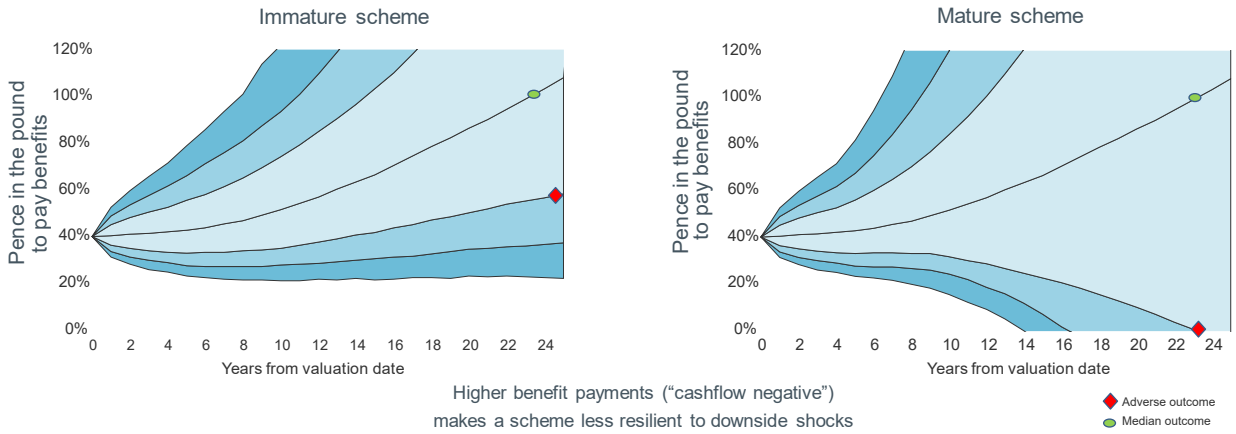
1. **A more directive approach for setting funding strategy** – either "comply" or "explain";
2. **A focus on risk management** – a further push for integrated risk management (IRM) to become standard industry practice;
3. **More regulatory scrutiny** – with serious penalties;
4. **More governance reporting** – via a DB Chair's Statement; and
5. **Setting of long-term funding objectives** – trustees and sponsors will need to consider their ultimate long-term goal and set a clear plan for getting there within a realistic timescale.

With that in mind, trustees and sponsors should not fall into the trap of considering scheme funding in isolation from the investment strategy being run. In a "comply or explain" world, many of the flexibilities on funding could be locked down, and investment is the area we see with the greatest potential to add value. Rather like determining how and where to take your summer holiday, we see the following factors as being critical to the success:

- Understanding your maturity – a key driver of ending up at the right destination;
- The journey plan – focus on how you're going to get there; and
- Resources at your disposal – these need to be managed and spent wisely.

Understanding your maturity

Chart 5



Higher benefit payments ("cashflow negative") makes a scheme less resilient to downside shocks

[1] Last year's White Paper from TPR (**Protecting DB Pension Schemes)** and our update on this (**Hymans Robertson - A stronger pensions regulator**) provides further context. We have also provided a further update related to this year's Annual Funding Statement (**Hymans Robertson - Summary of 2019 DB Annual Funding Statement**).

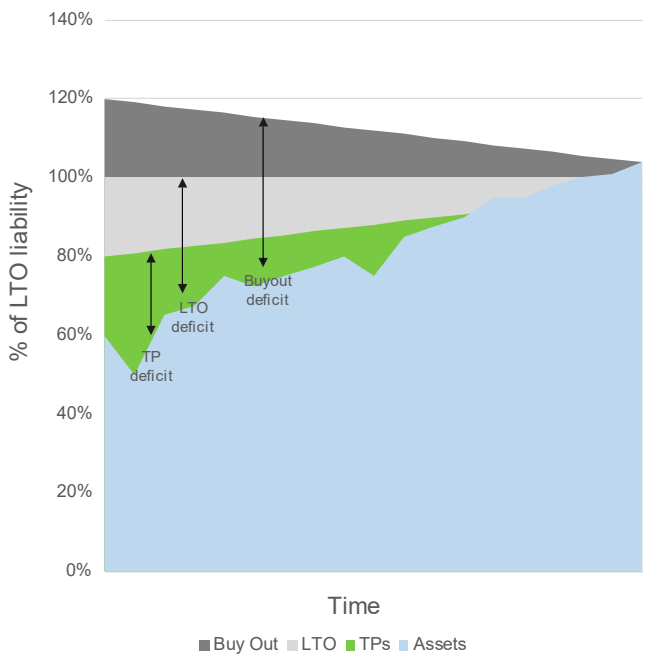
The implications from adding 'maturity' into the mix shows TPR are serious about schemes quickly reducing their deficits and the investment risks being run – the more mature the scheme, the more amplified is the level of downside risk within a scheme's investment strategy. In Chart 5 on the previous page, two schemes which are identical in every way except for maturity, are projected over a 20-year period giving a 'funnel of doubt'. Both medians reach a similar outcome (the green dots in each chart), but the more mature scheme is less resilient to the downside shocks – this scheme is paying out more in benefits when these asset shocks occur and has less time to recover. In an extreme scenario, the more mature scheme essentially runs out of money (the red dot on the right hand chart). Therefore, it's vital for schemes to consider how their maturity profile fits alongside the investment considerations.

Journey plan

Most DB schemes will have articulated, in some shape or form, when and on what basis they are targeting full funding. This is often thought of as the "destination" for the funding plan, and the route there on, often known as "journey planning".

With the performance of assets over the last few years, and often with a favourable impact from longevity, we have seen many schemes achieve their primary target – full funding on a technical provisions (TP) basis. However, it isn't 'job done', merely that the focus just changes to a stronger funding target – whether that's a buyout target, 'gilts plus a margin', LTO (long-term objective) target or a self-sufficiency asset-based target. Many trustees recognise that the cost of a full buyout could still be out of reach just now and that allowing time (for the Scheme to mature) can reduce that cost. Chart 6 to the right provides a simple illustration of the interaction of bases and the asset portfolio.

Chart 6: Interaction of different funding bases and asset portfolio



Beyond the point where the green and blue shaded areas intersect, we believe that many trustees have not given enough thought to the most appropriate investment strategy. Identifying what a 'run-off' portfolio would look like is helpful. There are a variety of approaches to derive this – ranging from more approximate to more precision engineering, including consideration of how to deal with longevity risk over time.

Setting a run-off portfolio, and time horizon to reach that target, helps:

- To create a clearer measure of performance against the objectives;
- Decision-making as there is a clearer rationale for running less risk/more risk – and understanding the impact of the different levers; and
- To compare the portfolio you have and what the terminal portfolio might look like eventually.

Managing your spending and resources

Schemes' investment strategies have evolved and will continue to do so, from heavily dependent on 'growth', to more focus on income-generating strategies (to deliver benefit outgo) with a more predictable return stream and increased protection against unrewarded risks. Clearly, a 'cashflow driven investment' (CDI) / run-off approach would focus predominantly on income assets with a balance between liquidity and illiquidity (this is discussed in more detail in a later article). More mature schemes targeting buyout may prefer more liquid, higher quality income assets.

In summary, we expect the new funding regime will have far reaching consequences for trustees and sponsors that are likely to restrict the scheme's flexibility. Therefore, focusing on the investment strategy both now and in the future will be critical to ensure that you are able to achieve the best outcome for your scheme in the future.

Ross Fleming
Senior Investment Consultant
ross.fleming@hymans.co.uk
0141 566 7693

Russell Chapman
Partner
russell.chapman@hymans.co.uk
0207 082 6134