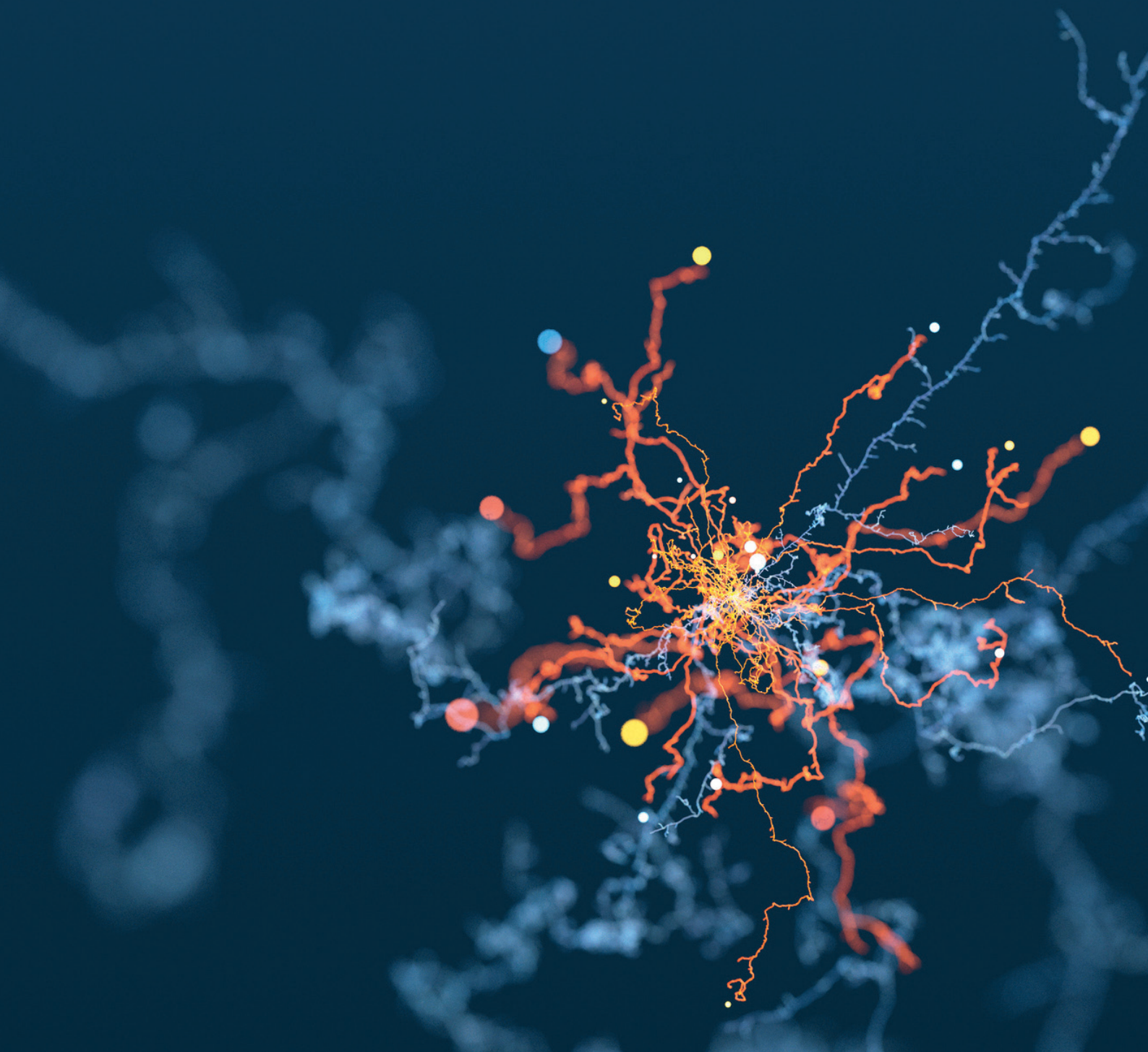
HYMANS ROBERTSON

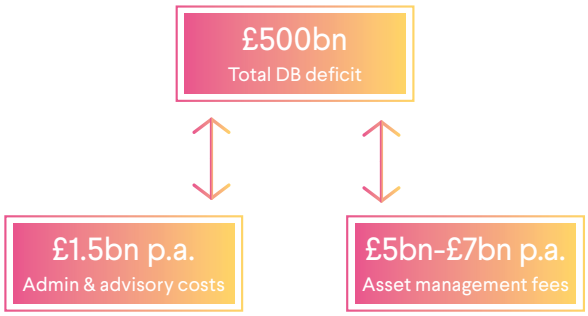
Maximising Value in DB

Securing a better future for schemes and members



‘Value for money’ is an established concept in the DC world and not-for-profit sector, and with it expected to feature in the imminent DB Chair’s Statement, it is now gaining momentum in the DB landscape.

Value is often associated with reducing costs. In reality, value creation goes far beyond this. With running costs across UK DB schemes totalling £6.5bn-£8.5bn per annum compared to a collective shortfall of £500bn, it’s clear that while cost savings will help, it won’t make a significant dent if this is our only focus. To secure a better future for DB, we must look at broader ways to create value.



The 3 pillars of value creation

Throughout this paper we explore opportunities to create £billions of additional value across UK DB, looking across each of the 3 pillars of value creation:

1

Long term objective

Pages 5-7

With attractive insurance pricing and new consolidators emerging, are schemes aiming higher than they need to?

Reducing the collective DB shortfall by £100bn

2

Efficient strategy

Pages 8-11

How can schemes bridge the funding gap and make capital work harder?

Chipping away at the £500bn shortfall across UK DB

3

Operational effectiveness

Pages 12-13

Are schemes operating effectively to achieve optimum value?

Potential to reduce running costs by up to 50%

Alistair Russell-Smith

Partner and Head of
Corporate Consulting

Susan McIlvogue

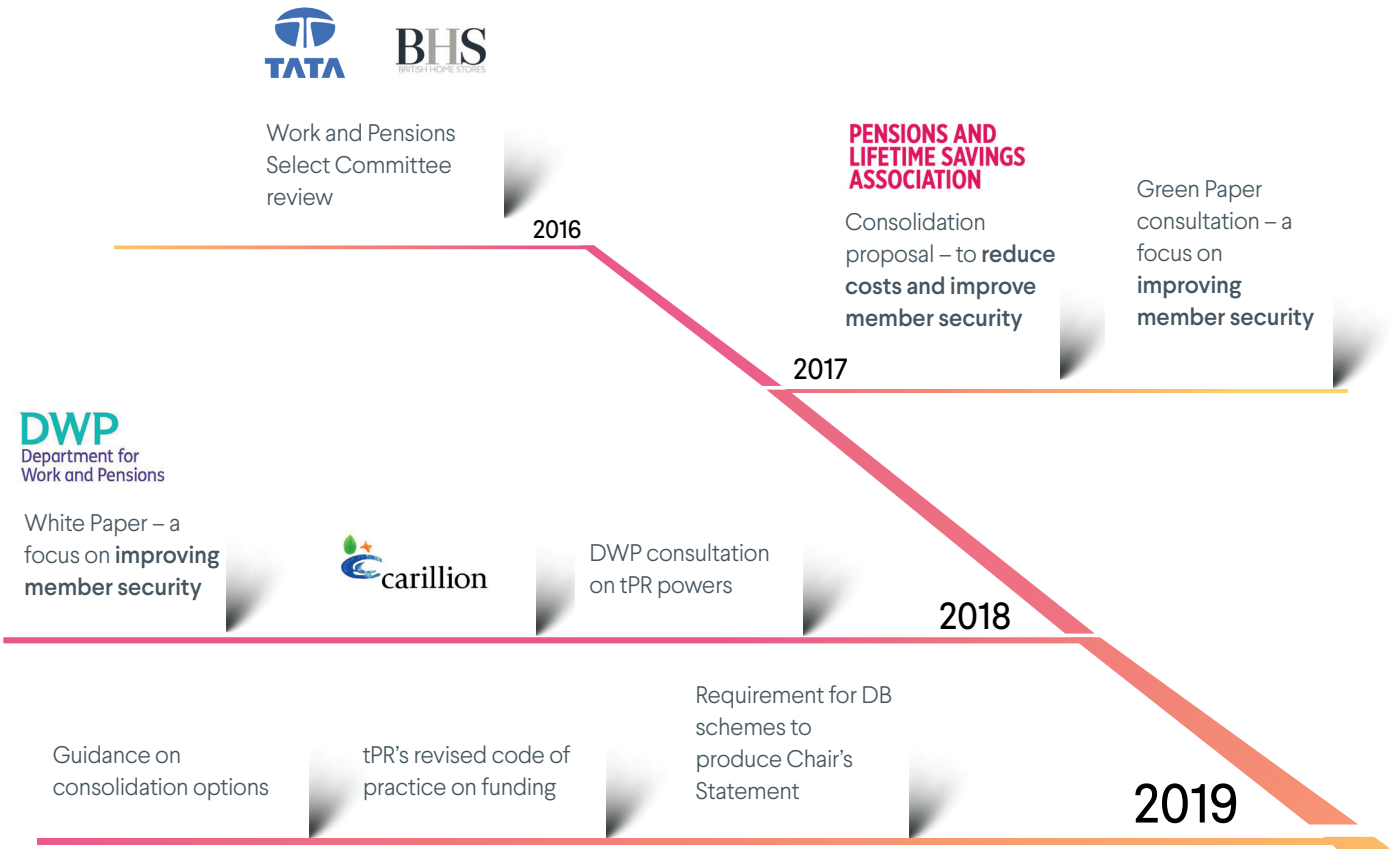
Partner and Head of
Trustee Consulting

Market context

DB pension schemes are coming under pressure to achieve value:

1. £500bn shortfall – despite £billions being paid into DB schemes, we're still faced with a huge collective shortfall
2. Scheme maturity – with 75% of schemes already cashflow negative[1], there's an urgent need to fill the funding gap
3. Member security – high profile sponsor failures are a stark reminder that benefits aren't guaranteed

In a bid to restore confidence in the DB system, we've seen a stronger stance from policymakers over recent years, with various proposals designed to improve member security. Ensuring schemes maximise value on behalf of their members is key to achieving this.



[1]Hymans Robertson's 2017 FTSE 350 analysis

Long Term Objective

The first pillar of value creation is setting the right Long Term Objective. For the majority of schemes, the finish line still feels like a long way off. Indeed, our Trustee research suggests almost 50% are targeting a timeframe of over 10 years to reach their end goal.

But the finish line may be closer than many schemes think. The increasingly competitive landscape in the insurance market is currently creating very attractive pricing opportunities, and new consolidation options are emerging. These developments are providing opportunities to improve member security at lower cost than in the past, reducing the collective shortfall across UK DB by £100bn. Trustees and sponsors should consider the impact on their own scheme, starting with a review of their Long Term Objective.

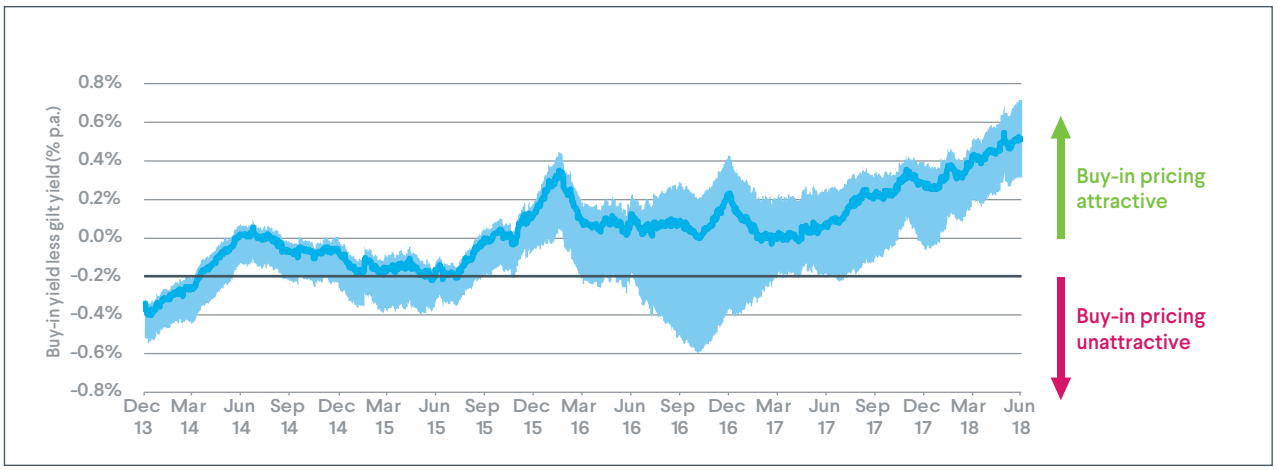
Over the next three pages we will explore how these developments can impact a scheme's Long Term Objective.

Attractive insurance pricing

Pricing for both pensioner buy-ins and whole scheme buy-outs is currently as attractive as we've seen in recent years. The chart below shows the improvement in pricing since 2013 compared to gilt yields. In particular, schemes are currently able to achieve a 0.5% p.a. uplift in asset return on gilts exchanged for a pensioner buy-in, as well as addressing demographic risks.

Insurance for deferred members is more expensive than for pensioners which means that buy-out becomes more affordable as schemes mature. However, even with this dynamic, schemes with at least 50% of pensioners may be able to achieve full buy-out for a cost equal to the value of the equivalent gilt liabilities.

Buy-in yield relative to gilt yields



Future pricing dynamics

Demand from pension schemes wishing to transfer risk to an insurer is greater than ever and we expect this trend will continue. Despite this, we believe that the current pricing opportunities will persist, although trustees and sponsors will need to be smarter and more patient to get the best outcome for their schemes as insurers become more selective.

Insurers continue to be able to offer attractive pricing but are limited in volume by the investment opportunities they can source. Well prepared schemes with an understanding of insurers' investment processes and a clear target in mind will be able to get to the top of insurer lists and gain the best deals. £25bn could be saved across UK DB over the next 10 years if schemes execute a series of well planned buy-ins.

Emerging end-game solutions

The consolidation drive in DB means that new end-game solutions are emerging which can enable risk transfer at a lower cost than traditional buy-out. Two emerging examples include:

1) Non-insured risk transfer

Non-insured risk transfer involves transferring all scheme assets and liabilities into a new DB master trust backed by additional capital provided by external investors. The sponsor support is replaced by the financial covenant of the external investors. Two new DB consolidators are already working on coming to market in 2018:

- Clara-Pensions manages the assets and liabilities in individual sections in the master trust, and then transfers them to the insurance market when sufficiently well funded.
- The Pension SuperFund combines all incoming assets and liabilities and runs them off in the master trust.

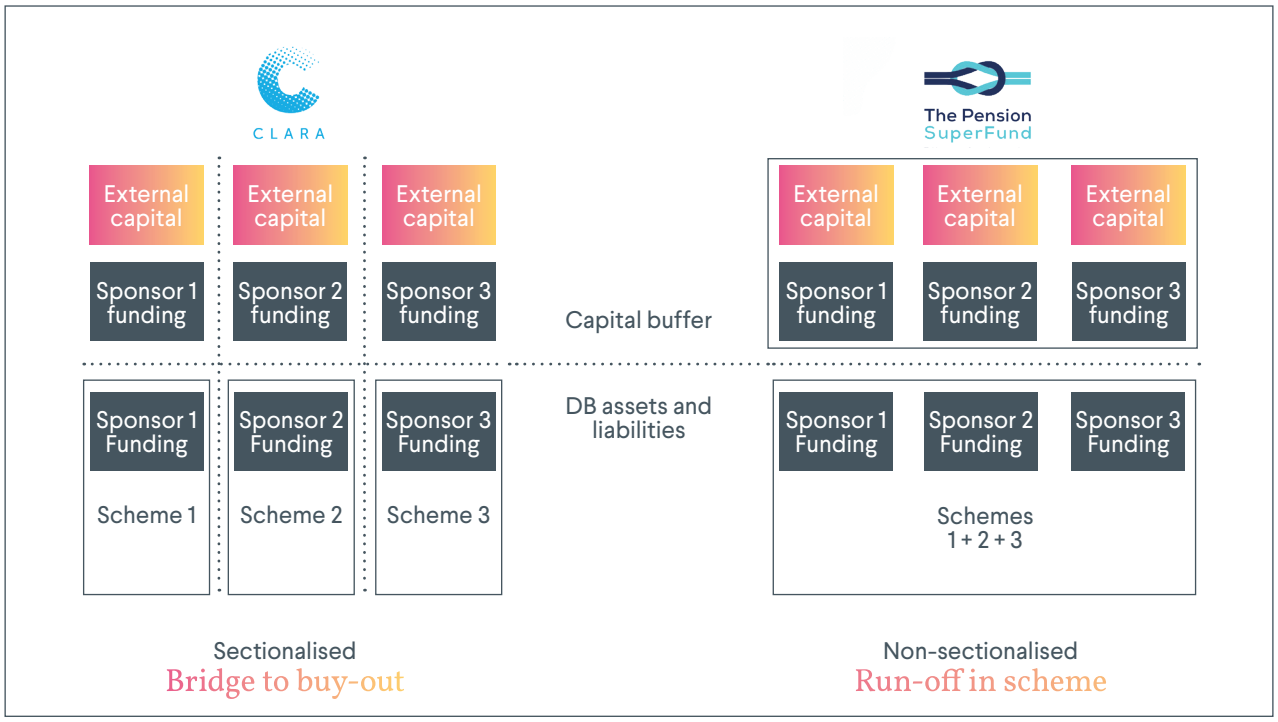
These solutions give a clean break for employers at a lower cost than buy-out and, in certain circumstances, member security can be improved.

"Non-insured risk transfer can improve member security for schemes with all but the strongest levels of covenant support. Upfront funding and the permanent support of capital puts members in a better position today; and gives sponsors certainty that they have fulfilled their obligation to members."

Adam Saron, CEO of Clara-Pensions Limited.

2) Insured self-sufficiency

Another emerging solution is insured self-sufficiency. This is where an insurer works closely with the scheme to manage some, or all, of the assets and liabilities as if these were part of its book of annuity business. The insurer invests the assets to reach buy-out over time. This approach can create efficiencies in transitioning to buy-out and the insurer may provide a level of certainty over the investment performance. The funding level required for this solution is lower than a full buy-out and involves the sponsoring employer sharing the downside risk with the insurer in certain scenarios on the path to buy-out.

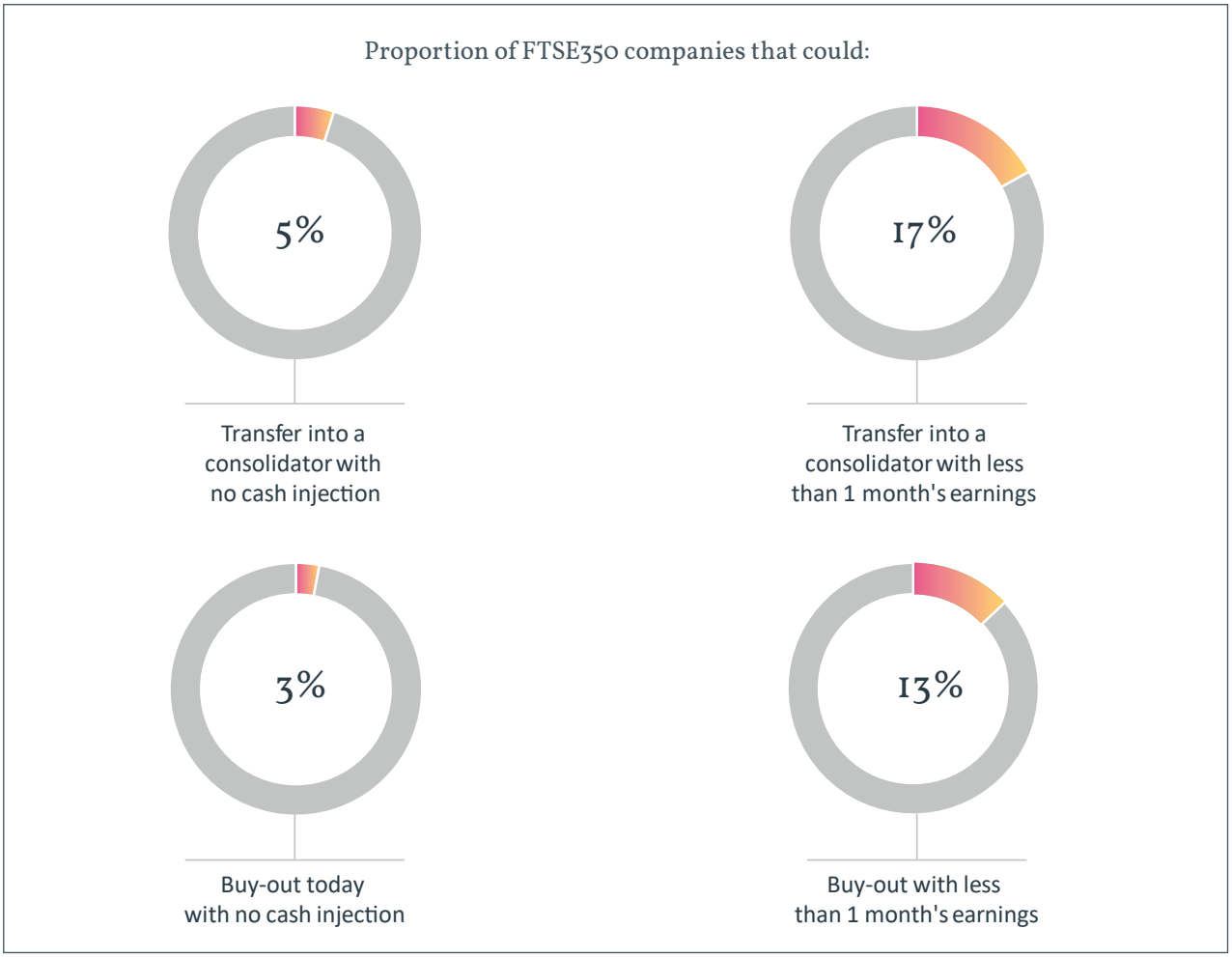


Impact on the Long Term Objective

The decision to transfer DB risk to the insurance or non-insurance market is scheme-specific. One thing is certain – the DB landscape is set to change. Schemes should consider the full range of settlement options within the context of their long term strategy and assess which route will provide maximum value for the scheme and its members.

Restating the Long Term Objective to take account of attractive insurance pricing and new consolidation options reduces the collective shortfall across UK DB by £100bn.

FTSE350 analysis

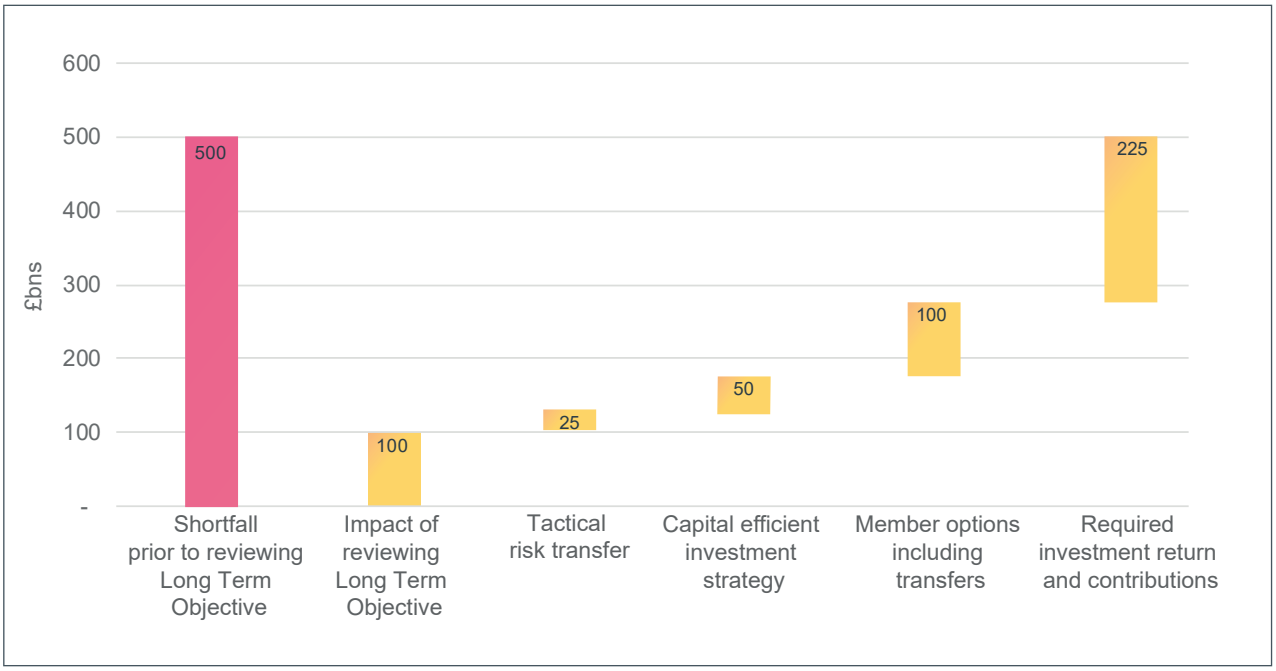


Efficient strategy

We've explored how attractive insurer pricing and new emerging end game solutions can bring the finish line closer than many schemes think. Indeed, allowing for these developments reduces the UK DB shortfall by £100bn, with a further £25bn reduction from a proactive, tactical approach to risk transfer.

However, despite these reductions, there remains a shortfall of £375bn. The second pillar of value creation is therefore adopting an efficient strategy to bridge the gap. The diagram below shows how this can be achieved across UK DB.

Bridging the funding gap over the next ten years



Schemes should consider all the tactics available to them to help bridge the funding gap. Without doing so, we're at risk of a shortfall remaining. An efficient strategy is one which maximises value at each stage of the journey and ensures the scheme is in a position to grasp every opportunity to create additional value and improve member security.

Capital efficient investment strategy

One of the ways in which schemes can bridge the funding gap more effectively is through adopting an alternative, more capital efficient investment strategy.

Implemented well, a capital efficient investment strategy has the potential to increase schemes' resilience to risk and achieve a stable income more affordably. There are two key drivers for this:

1. In the worst one year in 20, UK DB may need to find an extra £400bn of cash to pay pensions[2]. This simply wouldn't be sustainable. In order to be more resilient to future shocks, schemes need to rely less on volatile return-seeking assets and more on less volatile, income orientated assets that deliver more stable and predictable returns.

2. 75% of schemes are now materially cashflow negative, meaning benefit outflows exceed the amount of cash coming into the scheme. As such, achieving a stable income is more important than ever in order to avoid becoming a forced seller of assets to pay pensions. Despite this, our Trustee research suggests only 5% of schemes are targeting income generation as a key driver for their investment strategy.

The investment market has evolved beyond investing in physical assets. New capital efficient investment strategies are now emerging, making it possible for schemes to achieve the same investment returns for less upfront capital. The table below shows how to replicate traditional asset classes with capital efficient asset classes.

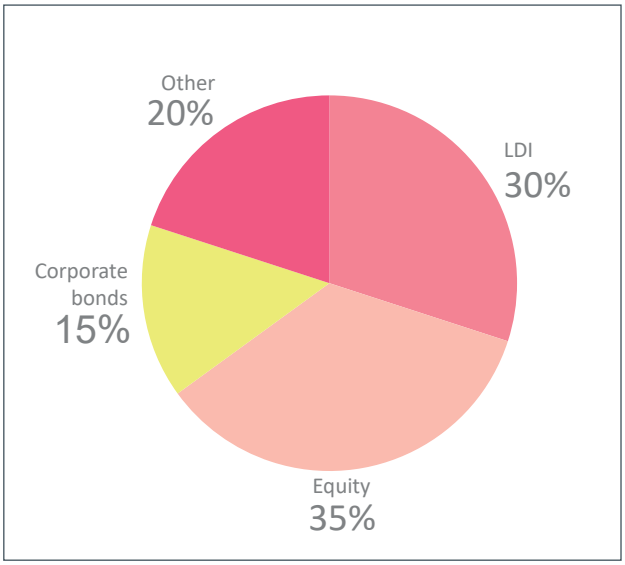
	Traditional strategy	Capital efficient strategy
Growth To fill the funding gap	Physical equity holdings	Synthetic equities
Income To meet your cashflow needs	Physical investment grade credit	Synthetic investment grade credit
Protection To manage risks effectively	Physical gilts	Leveraged LDI

[2]Hymans Robertson's response to DWP green paper "Defined Benefit pension schemes: security and sustainability

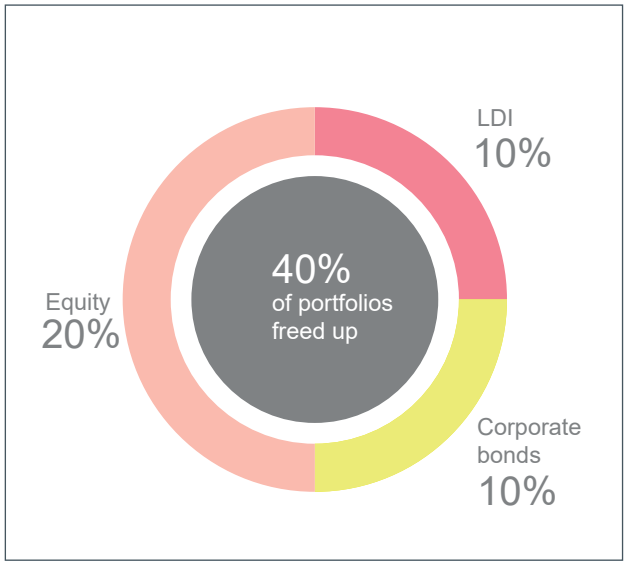
As shown below, applying a capital efficient strategy to a typical scheme can free up as much as 40% of its total capital. This extra capital can be used to create value in a variety of different ways, such as targeting higher returns to reach the finish line sooner, or reducing risk to reach the finish line with more certainty.

For example, freeing up this capital could allow schemes to invest in a way which earns an additional return of 1% p.a, collectively generating a further £50bn across UK DB to help bridge the funding gap.

Typical current asset allocation



% of portfolio freed up with a capital efficient strategy



"As schemes face the pressure of ever shortening time frames to reach full funding in a market environment characterised by low yield, improved capital efficiency and getting assets to work harder is a key area of interest. The now familiar use of leverage within traditional LDI mandates, allowing more capital efficient investment in gilts, is now evolving to encompass other asset classes e.g. equities and investment grade credit. The natural extension of this activity is to bring these types of assets together into a single solution, providing schemes with even greater capital efficiency, increased investment flexibility, and a portfolio which is more robust under a wide range of market conditions."

Alistair Byrne, Head of EMEA Pensions and Retirement Strategy, State Street Global Advisors

Member options

Enabling DB to DC pension transfers can be a win:win for schemes and members. Members receive valuable choice over how they access their benefits, and schemes reduce risk by settling liabilities at a cost lower than buy-out. Additionally, Pension Increase Exchange (PIE) exercises give pensioners the option to swap future increases for a higher non-increasing pension. This can better suit the income needs of some pensioners and reduces liabilities and inflation risk for schemes.

These flexibilities are becoming ever more popular with members, with around £50bn of transfers being paid across UK DB since the freedoms were introduced. Since 2015, we're seeing treble the amount of transfer value quotation requests and quadruple the number of transfers being paid[3]. Based on these trends, we predict that proactive access to member options could reduce the end goal across UK DB by as much as £100bn.

Ensuring members have access to clear, engaging information and advice is critical, both to facilitate member options for interested members and to protect all stakeholders by ensuring members make the right decisions for them. Schemes should consider proactively putting in place access to a reputable IFA for scheme members as part of their business-as-usual retirement process. This will address concerns raised by the FCA in their last review of DB transfer advice where they found only 48% of financial advice was appropriate.

"Enabling member options like DB transfers and PIEs is a win:win which gives members the right choices and helps bridge the gap to ultimate settlement of the DB liabilities. It's critical that the member education and engagement is done in the right way to ensure members make the right decisions for them and schemes are protected. One of my schemes ran a PIE advised by Hymans Robertson earlier this year, which had a 50% take-up, resulting in more engaged pensioners and leaving us able to consider settling our liabilities with a pensioner buy-in."

Steve Southern, Professional Independent Trustee

Halving the shortfall

These opportunities in the consolidation, risk transfer and investment markets, together with member options, reduce the overall shortfall by a significant £275bn.

While a £225bn gap still remains, this is a much more realistic target for schemes to achieve through contributions and investment returns.

Reducing the UK DB shortfall by over 50% will therefore allow schemes to reach the finish line with more certainty, improving overall security of DB pensions.

[3]Transfer figures across Hymans Robertson's client base.

Operational effectiveness

The last pillar of value creation is operational effectiveness, including running costs, governance models and effective use of technology.

Effective trustee boards

Schemes should review their current governance arrangements to ensure they are achieving maximum effectiveness from their trustee board. A governance review can help with this assessment, covering a range of areas including:

1. Trustee board culture
2. Relationship with sponsor
3. Effectiveness of delegations
4. Knowledge, skills & diversity of board
5. Approach to IRM
6. Quality of policies & documentation

Using technology

In this digital age, schemes should embrace technology to achieve more for less. Just some of the technology solutions which can help improve efficiency include:

- Online administration to help members self-serve, underpinned by the automated calculation and processing of transfer values and other member options. This gives members a better experience and can reduce running costs.
- Online governance, funding and risk analytics to enable better, faster decisions and capture opportunities to close the funding gap sooner or with more certainty. With relevant, up-to-date analytics at our fingertips, schemes can shift away from a culture of day-long trustee meetings towards exception reporting, freeing up time to focus on actions which will create the most value for the scheme and its members.

Technology is key to bringing the management of pension schemes into the 21st Century. By embracing the solutions available to them, schemes can make more accurate decisions and free up time to focus on what matters most - improving the security of members' benefits.

Alternative governance structures

While savings can be made through maximising trustee board effectiveness and embracing technology, schemes should look broader than this when considering operational effectiveness.

As shown below, there are a range of alternative governance structures which can potentially enhance operational effectiveness. These are explained in further detail on the next page.

	Governance	Operational costs	Investment	Member security	Cost certainty
Sole trusteeship	🟢	🟡	🟡	🟡	🟡
Investment platform	🟡	🟡	🟢	🟡	🟡
Merger and simplification	🟢	🔴 upfront 🟢 ongoing	🟢	🟡	🟡
Master trust	🟢	🟢	🟢	🟡	🟡

Sole trusteeship

A sole trustee replaces a full trustee board with a single person or company. Typically, it is a professional independent trustee company that acts as a sole trustee, and there are now hundreds of examples of this approach to governance in the UK.

Moving to a sole trusteeship arrangement can add value in a number of ways, including more streamlined decision making, reduced management time and removing the need to find company and member nominated trustees. While it may not be suitable for all schemes, the number of schemes shifting towards this arrangement is on the rise.

Investment platforms

A platform offers investors a "one stop shop" to access a wide range of pooled funds run by different asset managers. Value can be achieved through simplicity of operations, reporting and transitions.

Effective asset pooling can also lead to lower management fees through economies of scale – we've seen some examples where fees have halved as a result of appointing a platform provider. Given the CMA investigation into investment consultancy and fiduciary management services, investment platforms are well aligned with the industry's direction of travel.

Merger and simplification

Many schemes still have different firms providing actuarial, investment and administration services. Bundling these services with one provider is on the increase, and can lead to lower costs and improved service. Integrated teams, processes and technology can streamline governance, reduce operational risk and improve member experience.

For companies with more than one DB scheme, further value can be created by aligning service providers and trustee boards across the schemes, or even by merging schemes together. A full merger may need an injection of cash or security to mitigate against differences in funding levels or covenant support.

Our analysis of the FTSE350 shows that 47% of companies have more than one DB scheme and could benefit from merging schemes or consolidating service providers.

DB master trusts

A move to a DB master trust can enhance value, particularly for smaller schemes, through a combination of the above solutions. Moving to a master trust arrangement involves the transfer of all the scheme's assets and liabilities to a section of a larger DB trust, and then closing down the old scheme.

Through cost-sharing and accessing economies of scale, moving to a master trust can halve running costs compared to single-trust arrangements.

Master trusts also provide access to wider investment opportunities and lower fund management charges, as well as outsourcing much of the governance structure.

The crucial consideration for a transfer to a master trust is whether the new scheme provides better value overall, taking into account the 3 pillars outlined in this paper.

Our analysis of the FTSE350 shows that 14% of companies have at least one scheme which could benefit from moving to a master trust arrangement.

Closing remarks

As demonstrated, there is potential to create £275bn of value across UK DB. To take advantage of this, schemes should review their current practices with the following key questions in mind:

- Is our Long Term Objective still appropriate, and could we be closer than we think?
- Are we taking advantage of all the opportunities available to close the funding gap?
- Are we making efficient use of capital to achieve more for less?
- Could our governance and operational structure be more effective?

As member security continues to rise up policymakers' agendas, we should expect more pressure to be placed on schemes to demonstrably achieve value for money. The wheels are already in motion to create a tougher Regulator, and we expect the forthcoming Chair's Statement will need to include a value assessment, requiring trustees and sponsors to evidence the actions they're taking to achieve value on behalf of their members.

We urge schemes to take action now and unlock the potential. By considering the 3 pillars of value creation explored throughout this paper, we can achieve better outcomes and ultimately improve security for members.

Our experts

Alistair Russell-Smith
Partner and Head of Corporate Consulting
T: 020 7082 6222
E: alistair.russell-smith@hymans.co.uk

Susan McIlvogue
Partner and Head of Trustee Consulting
T: 0141 566 7672
E: susan.mcilvogue@hymans.co.uk

James Mullins
Partner and Head of Risk Transfer Solutions
T: 0121 210 4379
E: james.mullins@hymans.co.uk

David Morton
Partner and Head of Trustee DB Investment
T: 020 7082 6347
E: david.morton@hymans.co.uk

Laura Andrikopoulos
Senior Consultant and Head of Governance
T: 0212 210 4308
E: laura.andrikopoulos@hymans.co.uk

Appendix – Technical notes

The methodology we have used for the analysis in this paper is as follows:

UK DB liabilities and deficit

Our analysis starts from aggregate solvency liabilities quoted by TPR and the PPF in the Purple Book 2017, which in turn comes from information provided in annual scheme returns to TPR. We have then restated and rolled forward aggregate UK DB assets and liabilities, allowing for index investment returns, contributions, benefit payments, interest on the liabilities and the impact of changing yields and inflation expectation on the liabilities.

Impact of reviewing the Long Term Objective

Our analysis assumes that, on average, schemes can increase the discount rate on their Long Term Objective by 0.25% pa to reflect improved insurance pricing and the emergence of new consolidator options.

FTSE350 analysis

Our FTSE350 analysis is based on data used for our 2017 FTSE350 report available at http://hymans.co/FTSE350-2017.

The capacity and pricing of the consolidator market is currently evolving, and depends upon the provider and scheme specifics including the maturity of the liabilities. For this analysis we have assumed that a c.20% uplift to IAS19 liabilities is required to fund a transfer to a consolidator, and that a 30% uplift to IAS19 liabilities is required for a full buy-out. These uplifts are broadly consistent with other published indications on pricing, particularly the indication that the consolidator pricing is expected to be of the order of 10% cheaper than buy-out pricing.

For the analysis on the proportion of companies that have more than 1 DB scheme (and therefore may be suitable for mergers), we have simply looked at which companies in the FTSE350 have multiple UK DB schemes.

For assessing the proportion of companies that could transfer into a master trust we have looked at schemes under £200m which would need more than 3 months' earnings to be sufficiently well funded to transfer to a consolidator (i.e. allowing for a 20% uplift to IAS19 liabilities). An immediate switch into a consolidator or buy-out is therefore not readily affordable, meaning a switch to a master trust as an initial action could reduce running costs and access wider investment opportunities, helping bridge the gap to the Long Term Objective.

Bridging the funding gap

Our analysis assumes that facilitating DB member transfers across UK DB would reduce the Long Term Objective deficit by c£50bn. On top of this, we have assumed that other member options such as Pension Increase Exchange and commutation at retirement will reduce the Long Term Objective deficit by a further c£50bn during the same period. We have also allowed for schemes securing tactical buy-in policies locking in a 20bps pa saving on full buy-out pricing, equating to a £25bn saving across UK DB.

Capital efficient investment strategy

The analysis for adopting a capital efficient investment strategy assumes an average scheme holds 30% equities, 10% investment grade corporate bonds, 30% leveraged LDI and 30% other assets.

If we assume that UK DB schemes collectively freed up, conservatively, 30% of their total assets by applying a capital efficient strategy, and that capital is invested in a way which earns an additional return of just 1% pa, that would contribute around £5bn pa. Applying this over a 10 year timeframe generates £50bn across UK DB.

HYMANS ROBERTSON
CLUB VITA

London | Birmingham | Glasgow | Edinburgh T 020 7082 6000 | www.hymans.co.uk | www.clubvita.co.uk