BARNETT WADDINGHAM
beyond the expected

Beyond "low dependency" - Time for a New Journey Plan

Executing the endgame

The New Funding Code will seek to steer all schemes towards a low dependency funding target by the time they are significantly mature. There is a lot of debate yet to come on how flexible or prescriptive that requirement will be, but the reality is that many closed schemes are already near to or beyond this low dependency target.

For these schemes - for whom low dependency is now the present, not the future - a new type of journey plan is needed which now hones in on that next phase of the journey. This means it is less about managing potentially high levels of funding volatility and more about effective implementation.

With recent increases in interest rates moving many schemes closer to endgame sooner than expected, how should trustees adjust their plans? **In this paper, we set out our ten-point plan for executing an endgame journey as reliably and cost efficiently as possible.**

When should you start?

Being fully funded on a gilts + 0.5% pa discount rate is not a bad yardstick for deciding when that focus needs to switch to executing the endgame. This has historically been a common "self-sufficiency" measure not because it is truly self-sufficient but because it is roughly the point at which most employers may reasonably consider they should not be required to pay any more money into the scheme. It is also the point at which an investment portfolio can be structured that can provide reliable returns/cashflows with suitable risk buffers and margins of prudence.

At this point, the focus should switch to managing outcomes for members and employers.

For members +

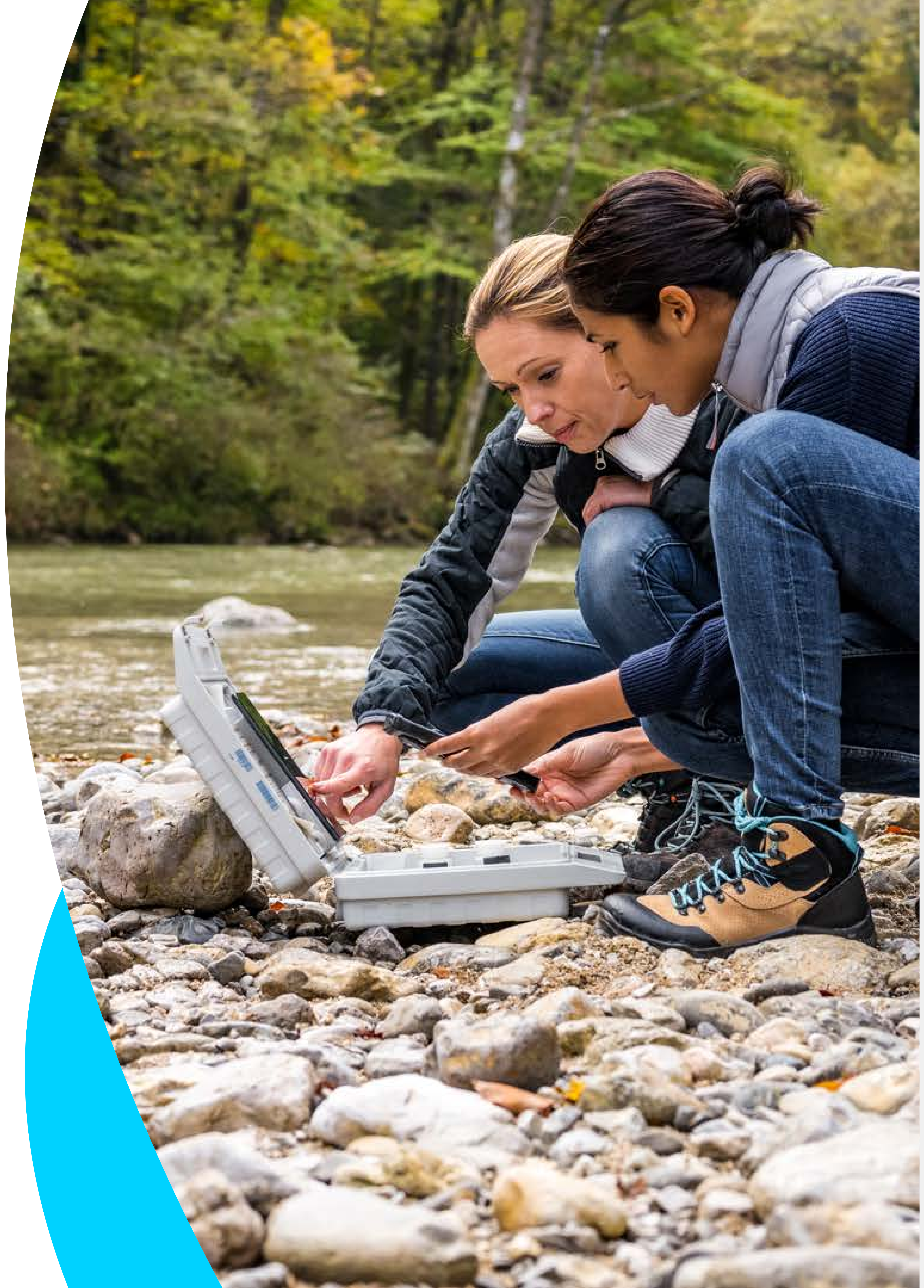
For employers +

01 - Work out the endgame you are in

Most schemes that are broadly in a low-dependency position could probably identify one of the following three options as their "central plan":

- Targeting buyout in the next three to five years (ish)
- Targeting buyout with a timeframe of seven to ten years (ish)
- Run-on for the foreseeable future

There are lots of reasons why circumstances may change and options need to be kept open, but without a good idea of the fundamental differences in approach between these three scenarios, there is a risk you may be spending your time, money or risk budget on the wrong thing at the wrong time. Which of these three broad categories the scheme sees itself in will then determine the course of action in many of the subsequent areas noted below.



02 - Understanding the employer's flexibility and crunch points

It will be important to understand the employer's business and the needs of its stakeholders so that the way forward can take these into account - more collaboration and understanding should enable trustees to meet their own requirements as well as the employer's.

There are a few key areas where an early and open dialogue is needed between the trustees and the employer as these can significantly impact the direction of travel, identifying opportunities which may not have been apparent or represent unwelcome barriers to progress late in the day:

- What is the employer's appetite to make additional contributions to facilitate buyout (now commonly referred to as the "cheque writing distance")?
- What level of risk on membership data and benefit uncertainty is the employer prepared to indemnify the trustees on post buyout? The management of this "residual risk" is one of the big differences between what lots of schemes have already done (buy-ins) and what many schemes may now want to do (buyouts). Getting timely legal input on this aspect is an important part of the process.
- What will be the approach to discretionary benefits in the buyout and on-going scenarios respectively?
- How, if at all, could the employer benefit from the surplus whilst the scheme remains on-going?

03 - Focus on the important strategic investment decisions

Irrespective of your endgame, what's crucial is having an investment strategy that works for you – not your investment consultant, fiduciary manager or asset managers.

The gilt-crisis highlighted the importance of focussing on getting the big strategic risk management decisions right. Having an over-engineered strategy with too many managers, insufficient liquidity and an insufficient buffer to deal with collateral has created issues for schemes.

In situations where we have been asked to come in and fix these issues, we've focussed not just on solving the short-term challenges but also setting a long-term plan that meets the objectives of all the key stakeholders (members, trustees, employers). This means understanding the three key phases of the journey plan (set out on the right), identifying which phase your scheme is in, and having a strong governance and decision-making process in place to ensure smooth transition to the next phase.

+ Growth phase

+ Consolidation phase

+ Insurance phase

As schemes move towards consolidation and insurance phases, streamlining the investment arrangements is vital. Appointing a single risk-management asset manager – covering collateral management, credit exposure, and LDI and derivatives – offers a more efficient structure for many schemes. You can then partner with your risk management asset manager and investment consultant to tailor your portfolio to your scheme circumstances (timeframe, cashflow needs, return requirement, risk tolerances, liquidity management etc).

04 - Clarity on the trigger for re-starting employer contributions

Whether schemes are targeting buyout or run-off, the base case will be to build up a gradually increasing surplus on a low-dependency basis with an investment strategy which targets a modest level of expected investment out-performance. Nevertheless in the shorter term there may be the possibility that the scheme falls modestly below 100% at valuation dates and the legitimate question from the employer would be whether this automatically requires additional contributions or whether the trustees can accept some tolerance around this.

For an employer which expects to provide an additional top-up contribution to support buyout via some additional contributions, this might not be a contentious issue. In contrast, an employer looking at long term run-off may be more concerned that additional contributions will just increase any "trapped surplus" that it cannot access.

Agreeing how much flexibility trustees will accept when the scheme falls below 100%, and how this will be delivered under the New Funding Code will be important. For example the latest consultation on the New Funding Code potentially allows for more flexibility in the way the discount rate is determined from time to time and less on the recovery plan for any deficit.

05 - Getting a reliable indication of proximity to buyout

Given insurers' resource constraints, the likelihood of getting regular and reliable scheme-specific pricing updates from insurers will generally be low. The better plan will be:

1. getting ready to go (for the buyout process);
2. knowing when to go; and
3. deploying an efficient insurer selection process at the end.

Knowing when to go does still require a reliable indication of the possible buyout cost and an acceptance of a reasonable but not excessive margin of error around that. Are the trustees and the employer for example going to start the process at an estimated buyout funding level of:

95% - based on a cheque writing distance

100% - no expectation of additional employer contributions but employer open to the possibility of a modest further injection if needed

105% - unlikely that any additional contributions will be needed

Getting a reliable indication of buyout cost requires your actuary, risk transfer and admin teams to work as one – how are you going to make that happen? You might not be able to predict the commercial drivers which swing a particular insurer's quote but a lot can be done to package the data, understand the demographic experience, and re-set the scheme's actuarial factors to get as close as possible to the way an insurer will look at things and thereby minimise the uncertainty premium that might be included by insurers.

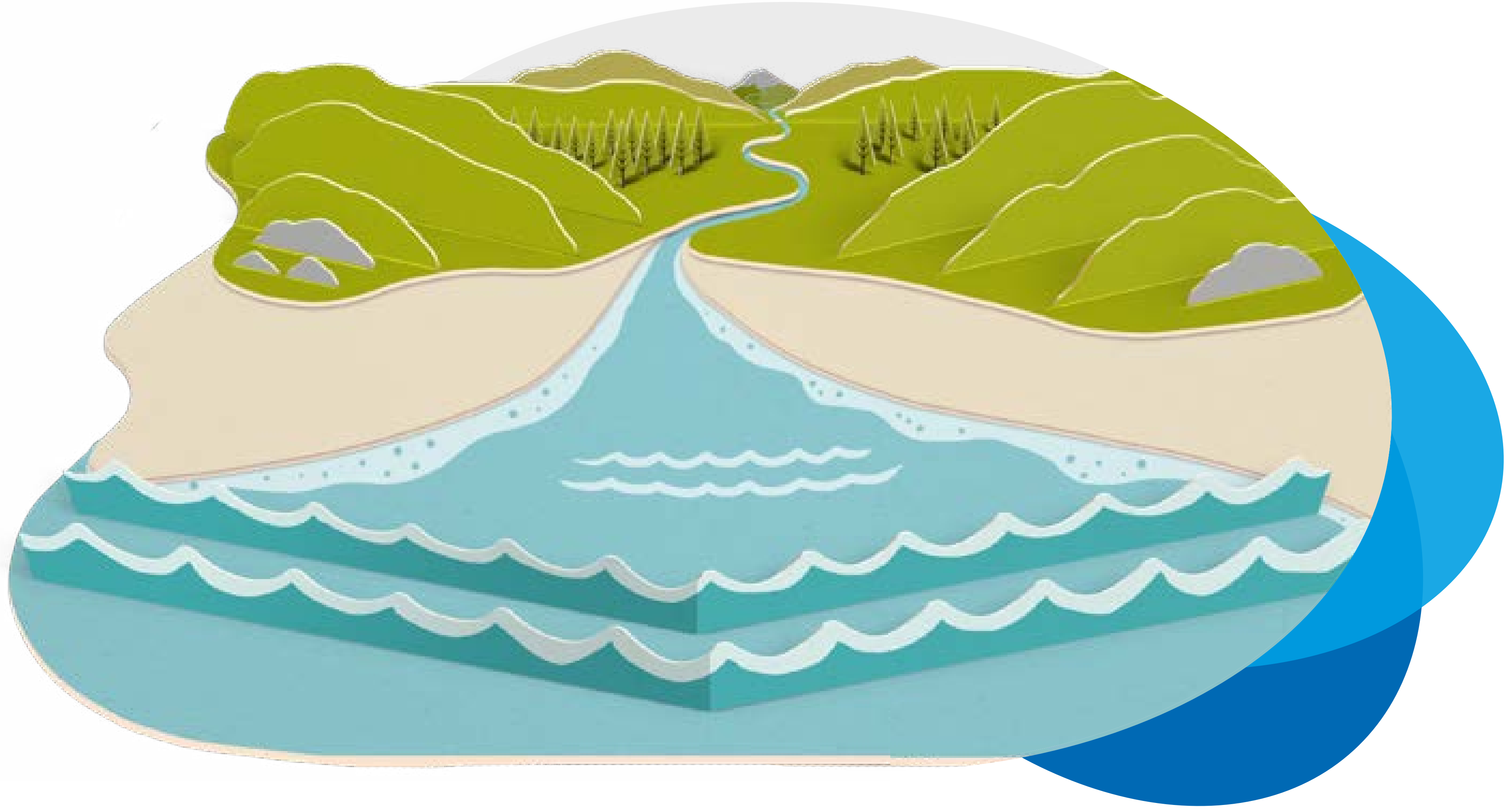
06 - Navigating the latest mortality trends

As recent headlines have identified, the second half of 2022 and 2023 so far have seen a significant increase in death rates compared to the pre-pandemic period. Understanding the likely impact of this will require proactive engagement on the issue.

For schemes close to buyout the real question is how this latest experience will impact insurer pricing three to five years from now. The range of possibilities in that regard is much wider than it has been for some time but probably with some downward pressure on pricing likely as insurers (slowly) begin to take on board recent experience. For schemes not relying on employer contributions, timescales could be shortened materially. For schemes relying on a final employer top-up payment, employers may begin to weigh up the potential benefit of delaying the process if they expect the cost could be substantially lower.

The key is to tackle this question early to understand how this added layer of uncertainty might affect the scheme-specific plans and stay close to the market, especially how longevity reinsurers may be looking at this for their pricing. Our risk transfer team has longevity specialists that can help with this, and we keep regular engagement with reinsurers so we can understand how changes in their approach may affect buyout pricing.

For schemes targeting run-off there is a longer-term horizon to allow time for greater clarity to emerge. However even these schemes will need to keep on top of developments more regularly and perhaps in a way which is more tailored to the scheme's particular demographic profile to ensure, for example, that cash-flow hedging strategies remain robust. The latest mortality trends could also be material for schemes which have funding level related de-risking triggers in place and such schemes might want to question whether some adjustment should be made to their mortality assumptions now, rather than wait until the completion of their next valuation.



07 - A member focused role for member options

Introducing new member options (such as enhanced transfer values, pension increase exchange and bridging pensions) first started off in an environment where employers were attracted to these as a way of managing their sizeable pension scheme risks and deficits. As schemes move beyond self-sufficiency, and with the administration capabilities to support members having improved, there is a range of different propositions for trustees to consider around member options.

A well thought through member options strategy will both enhance your members' experience and accelerate your journey to buyout or reduce risks when running on the scheme. It should focus on what options are available to members, and on what terms; the communication and support provided to members; and the administration impact of offering them.

Focus where buyout is close +

Focus where buyout is further away +

Either way, member options need not just be about introducing new options. For example, simply encouraging members to consider early retirement before a buy-out could lower the cost due to the difference in insurer pricing of non-pensioners and pensioners.

08 - Cost efficient operating model

The scheme's on-going costs will gradually become a greater proportion of, for example, the targeted out-performance from the investment strategy. Due attention will therefore need to be paid to proportionately reducing investment management costs but also the annual running costs across the range of support the trustees rely on.

A critical aspect of this is the effective working together of the actuarial and administration teams. When the scheme actuary's advice and the administrator's systems are not aligned, the various practical limitations and historic complexities can lead to an approach which is not only more blunt but also more costly. A classic example of the need for effective working together was the high inflation experienced last year which required widespread interventions ("temporary fixes") on early retirement factors, and the increase in interest rates which required a revisit of cash commutation factors.

A move to a market-related approach to actuarial factors would reduce the potential need for more regular interventions in a volatile market environment, be demonstrably fairer, and help move along the path of alignment to an insurer's approach.

09 - Prioritising projects to meet your timescales

Two of the key projects which most schemes will still need to complete prior to completing a buyout are GMP equalisation and data cleansing. Both of these are typically big projects and are going to be subject to the general industry-wide resource constraints. Trustees should engage with their administrator early on to understand when these projects should be done with the long-term endgame in mind because it will not be possible to rush them at the end of the journey plan.

Equally, given the number of projects on the go, advisers will have a "queue", in particular for GMP projects. So the key is to understand precisely where the scheme fits in the administrator's queue and ensure the project is efficiently completed in that period. Just looking for "continuous progress" may be one of those things that makes everyone feel a bit better but is not the most efficient approach for anyone. In most cases a scheme's place in the relevant queue will still fit comfortably within the scheme's endgame timetable, but trustees should engage with their advisers to make sure that this is the case.

10 - Aligning your governance structure with your objectives

Finally, getting in a position to glide efficiently towards the endgame requires great co-ordination of activity. Some of the "mechanical" connections such as between the actuarial and administration input referred to earlier are an important element of that, but so is an alignment of ambitions across all the advisers on ultimate objectives and key metrics for success.

How far away from that alignment are you at the current time? Does the complexity of the existing arrangements around trusteeship and advisers match your needs, and if not how are you going to bring the two closer together? A scheme in a holding pattern over the next several years doesn't need a large trustee board, whereas a scheme nearing buy-out may need some additional / professional expertise - do you need extra support or do you need to reduce the complexity? What are your key person risks at this critical time and is that an opportunity to change things up more significantly to future-proof the structure in place?

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