HYMANS # ROBERTSON

Setting your corporate DB endgame strategy

Case Study

ABC plc sponsored a defined benefit scheme which had been closed to future accrual for a number of years.

The company had a very strong covenant but the trustees had a range of powers, including the ability to set contributions without the company's agreement. There was a very good relationship between the company and the trustees, with the trustees respecting the company's views and wanting to work with them wherever possible.

Likewise, the company understood that the trustees wanted to move towards funding the scheme on a low risk basis and were not prepared to take investment risk that could put the timings of that journey at risk.

The trustees also faced challenges over certain discretionary benefits, which had been frequently awarded in the past but were by no means certain to be awarded in the future without company agreement.

The process in practice

Working with company management over several meetings, we identified the following objectives:

- a corridor for "acceptable" deficit contributions
- an absolute level of contributions that any strategy should mitigate against
- P&L and balance sheet targets for both statutory and group accounts
- scope to offer non-cash security via a parent company guarantee and/or letter of credit
- a desire to maintain the discretionary benefits into the future, if affordable
- to reduce management time spent on trustee negotiations
- greater company influence over the trustees' powers.

The company also shared some strong beliefs:

- a desire to take investment risk over the longer term, which the company was prepared to underwrite if it failed to pay off (because the company expected it to pay off)
- that insurance risk transfer solutions were not attractively priced and would be unlikely to be attractive for some time, but if the scheme were to naturally get close to buy-in pricing this would be a sensible step to take
- a concern that the company's lack of influence put the trustees in a position where the most cautious approach would naturally be the default outcome, given the fiduciary duties placed on trustees.

The strategy

The following strategy was agreed with the trustees:

- a weakened technical provisions basis that better reflected the strength of the company covenant
- a contractual commitment to a long term, low risk funding objective (LTO), with a deficit recovery period reflecting the cashflow profile of the scheme and the expected role of asset outperformance
- a flexible recovery period for the LTO, which could absorb some adverse experience before deficit contributions needed to increase
- a parent company guarantee which covered the Section 75 debt and agreement to award discretionary increases for a set number of years into the future, provided
  - future deficit contributions were in line with the LTO framework
  - the investment strategy was in line with a pre-agreed, principles-based framework
  - both of these conditions could be over-ridden by joint company and trustee agreement.
- an automatic switch on of funding into an escrow, or equivalent solution, when full funding on the LTO was close, in order to avoid the risk of trapped surplus.

What has happened in practice?

The following three triennial valuation cycles were completed with no negotiation around the resulting deficit contributions (the level simply dropped out from the agreed strategy). P&L and balance sheet objectives were all achieved.

Almost a decade later, the company started to consider some significant corporate restructuring plans and it became clear that the pension scheme would be a material consideration for these plans. At the same time insurer pricing (which was being monitored as part of the Control stage) had improved significantly.

In a "business as usual" context, an insurance solution would still not have met the company's objectives. However, in the context of the significant mitigation costs the company was facing to achieve its restructuring aims, an insurance solution had become attractive. This led to a risk transfer solution being implemented with the mitigation provided to the pension scheme to cover the impact of the restructuring.

What mattered was that at every stage the company had a clearly defined set of objectives, a strategy it could map to those objectives and a good understanding from the senior management of why and how that strategy needed to change as company requirements evolved. The joint working group provided a well established and effective forum for the company and trustees to work together as the pension strategy evolved.