Summary
• DB pension glidepaths frequently have a bumpy ride, with lower than expected investment returns and changes to a scheme's liabilities.
• Most glidepaths have a trigger for action to get back on course or lock in profits.
• The trigger should be reviewed every time it is exercised.
• Liability reduction exercises have an important part to play.
• The scheme administrator should be involved throughout the process.

Not quite turbo charged?

Why are DB pensions' journeys to wind up often delayed? Stephanie Hawthorne reports

Passengers using Southern Rail over the past two years will know that timetables are not always adhered too. It is just the same for pension schemes aiming for wind up and buyout or going into run off, with glidepaths or journey plans that are often overly optimistic.

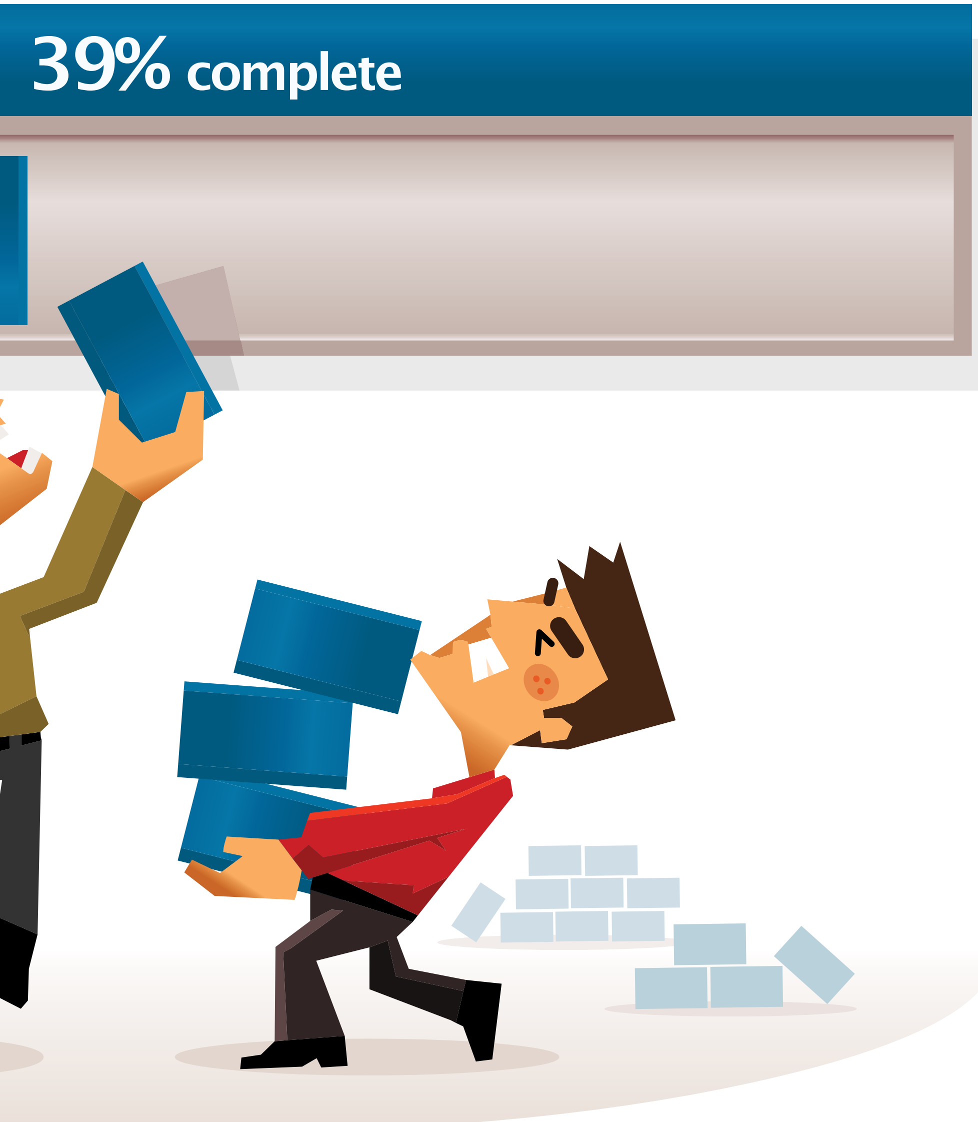
Lincoln Pensions actuary and senior adviser, Francis Fernandes, explains: "Like all plans, things happen to take you off track. And DB pension scheme journey plans are no different – 'stuff' happens! The assumptions underlying some journey plans may not have been borne out in practice. For example: long-dated interest rates may have stayed lower for longer than expected; running expenses might have been much higher than expected; actual sponsor contributions over the period may not have been in line with those expected under the journey plan; assets may have underperformed the returns assumed under the plan; changes in legislation may have added to the scheme's liabilities or running costs."

No avoiding turbulence

KPMG partner David Fairs says: "Trustees often imagine a glidepath, not dissimilar to a plane coming gently into land with the plane smoothly arriving at the destination. The reality might be a little more bumpy. The first element is the strength of the covenant of the employer, both now and in the short to medium term, and its ability to underwrite investment risk and funding risk. A rock solid covenant might well facilitate a less conservative investment strategy or a lower margin for prudence in funding assumptions, resulting in lower recovery plan contributions. Although the annual funding statement from The Pensions Regulator now steers trustees to getting the money when they can and as soon as they can."

Turbulent international financial markets have undeniably made achieving buyout for many schemes more challenging. Plans laid out 10 years ago have had to adapt to an unpredictable economic and political outlook. Trafalgar House director, Daniel Taylor, points out: "For some schemes, this has meant that achieving full-funding on a targeted 10-year buyout trajectory has not been achievable."

However, there is wide variability across the piste. PLSA head of investment and governance Joe Dabrowski says: "On the whole, the average length of a recovery plan – the agreed time (with TPR) by which trustees and employers seek to fund schemes to Technical Provisions *[a measure that is much weaker than buyout]* – has remained about the same, at eight years. Across the same period scheme funding has on the whole remained at about the same level, despite close to £400 billion being put into schemes, £120 billion of which has been special contributions."



"It has become increasingly common for glidepaths to have a 'dynamic' overlay where the pace of derisking is varied from the central glidepath to react to changes in the scheme's funding level or investment market conditions"

A 'classic' glidepath typically targets a reduction in the level of investment risk/return over a period of 10-15 years, say, possibly with an initial period during which investment risk is held constant before derisking starts. Willis Towers Watson consulting actuary Graham McLean says: "A range of structures are used – some schemes have a higher level of initial risk that reduces relatively quickly, whereas others take a lower initial level of risk, but run that on for longer, and the timeframe for reaching the target level of risk can vary quite significantly from scheme to scheme. It's important to find a structure that fits the trustees' funding and investment beliefs and their view of the sponsor's covenant and the extent to which they wish to rely on it."

He adds: "Over recent years it has become increasingly common for glidepaths to have a 'dynamic' overlay where the pace of derisking is varied from the central glidepath to react to changes in the scheme's funding level or investment market conditions."

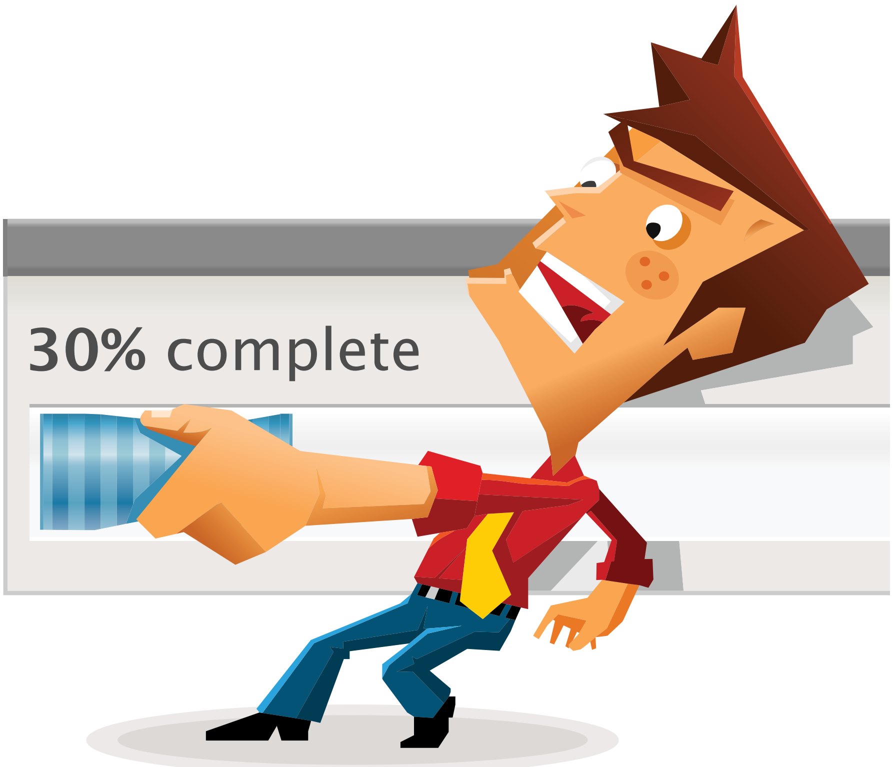
Trigger for action

Most schemes have trigger points for action to get back on course or lock in profits. Fairs says: "We are now seeing trustees put in place contingent mechanisms that are triggered if the scheme experience deviates too far from the desired position. Critically, the scheme needs to monitor covenant, investment and funding and react to significant adverse experience, whether that is collective or just in relation to one of those items."

Schemes might have multiple triggers around covenant strength such as free cashflow of the business, profitability, credit rating etc. There could be triggers around funding position (which can reflect actual scheme experience), length of recovery plans to funding of technical provisions or self-sufficiency and there can be investment triggers such as VaR. There might also be contribution triggers relating to corporate performance or dividend payments. These triggers can be both for upside and downside experience.

Monitoring software is now affordable for the majority of schemes.

Fairs adds: "Where monitoring software is in place, it is easy to get real-time information on these factors, although it would be unrealistic to react to changes on a daily basis. It would be more common to put in place monitoring on a monthly or quarterly



basis and less frequently only in extremis – the challenge is one of not wanting to take action due to a particular short-term spike in experience."

Capturing growth

Hymans Robertson head of investment consultancy John Walbaum explains more on the trigger process: "In relation to growth assets, the aim will be to reduce exposure when the assets have outperformed expectations, the aim being to capture that growth and reduce the risk of adverse market movements leading to slipping back. There may be triggers in place to increase exposure if assets fall, the aim being to capture any rebound in asset values thereafter. In the hedging area triggers will seek to prompt increases in interest rate or inflation protection if interest rates increase to agreed levels where the funding position has improved due to a lower value being placed on the liabilities. Increasing the hedge again captures some of that value and reduces the risk of rates moving against the scheme, and the same logic applies in the case of inflation (ie. triggers will seek to capture lower inflation and protect against future rises)."

Most schemes will carry out an annual review to check the triggers remain fit for purpose, perhaps with a more formal review triennial valuations. LCP partner Clive Wellsteed says: "It also makes sense to informally review the trigger levels each time a trigger is hit."

Don't forget the liabilities

Many schemes have glidepaths that only look at one side of the problem – the assets. They put in place investment strategies that seek to de-risk the assets. But JLT Employee Benefits director Rob Dales says: "Glidepaths should also include strategies that de-risk the liabilities, such as member option exercises, including transfer values at retirement and pension increases exchange. With the introduction of freedom and choice, many members are transferring their benefits out of the scheme at retirement. In our experience, based on 16,500 members taking benefits at retirement in the first half of 2017, 16 per cent transferred their benefits out of the scheme. A transfer out settles the liability in full and moves the scheme closer to ultimate buyout."

"Glidepaths should also include strategies that de-risk the liabilities"

Dales also suggests trivial commutation exercises, whereby small benefits that are expensive to administer and pay are settled in full again, moving the scheme closer to buyout and benefit conversions.

"Most schemes have very complex benefit structures, including elements that are expensive to buy out, but which have little or no value to the member. By simplifying the benefit structure to one that members understand and an insurer can price without excessive margins, buyout becomes more affordable," he says.

Leave no stone unturned

Buyout is a goal for many closed DB schemes, but the ones most likely to achieve it are those with realistic plans and clean data. Schemes with good scheme and member data have greater certainty and are therefore more attractive to insurers. They are also better able to act quickly to transact when the time is right, thus wasting less time and money on abortive exercises. As a postscript, PASA deputy chair Kim Gubler, concludes: "It is important to involve the scheme administrator at an early stage as they can help ensure a smooth process. Too often they are brought it at the last minute with no chance to positively influence the outcome."

Written by Stephanie Hawthorne, a freelance journalist