Taking control of your pension scheme’s future

An XPS Guide to funding and journey planning

In brief

Our **four-part guide** will give you insight into how you can form a coherent strategic plan tailored to your unique circumstances.

Read Part 1 today and look out for parts 2, 3 and 4 over the next 3 months.

The Pensions Regulator (TPR) has raised the bar and now expects all pension schemes to set a Long Term Funding Target and document their journey plan to get there. But what does this mean exactly and how can a scheme go about fulfilling these requirements?

At XPS we believe a successful journey plan is more than a de-risking flightpath. It should capture all strategic decisions and culminate in a clear action plan to get your scheme from where it is today to its end-game.

In this four-part series we have grouped the various considerations into four key areas of strategic decision-making, highlighting the main issues that need to be considered and acted upon by all DB pension schemes.

Together this represents an Integrated Risk Management approach.

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**Part 1 | Sponsor**

We will look at what you need to know about your sponsor’s business, financial health, prospects, and the strength of support available to the scheme.

**Part 2 | Liabilities**

Every pension scheme is unique: your members and your cashflows are unlike any other. Therefore any strategic decision-making needs to build from an understanding of your scheme’s liabilities and how they will evolve over time.

**Part 3 | Assets**

We will explore how you determine the right Long Term Funding Target and the right level of risk to get there.

**Part 4 | Members**

Members sit at the centre of your scheme. We will highlight how making the most of your membership can materially improve the prospects for your scheme and improve their experience at the same time.

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The Pensions Regulator has been clear that having an overall strategic plan that takes direct account of the strength of the employer covenant is now a fundamental expectation of all schemes.

### Why
understanding your sponsor is crucial:

- Every DB scheme is reliant on the support from its sponsor to some extent
- The sponsor has to fund any shortfall and it underwrites all the risks the scheme is exposed to
- The Pensions Regulator expects trustees to understand the strength of the covenant and categorise their scheme accordingly
- Decisions made based on the covenant now will influence the scheme’s future financial position

### What
action you can take:

- Take steps to understand your current risk tolerance
- Build this assessment into investment and funding strategies
- Set a plan to preserve and improve security either immediately or over time
- Monitor the covenant regularly and act promptly if needed
- Be vigilant for any covenant leakage and be ready to protect the scheme

The Pensions Regulator (TPR) now expects trustees and employers to develop a Long Term Funding Target (LTFT) for their schemes (beyond becoming fully funded on the technical provisions basis) and to put in place a journey plan to achieve that target reflecting the strength of the employer covenant. The wider framework mapped out by TPR for balancing key risks faced by pension schemes is built on a new categorisation of schemes determined by several key characteristics.

### Which Regulator category applies to your scheme?

**Step 1:** Determine your letter

<table>
<thead>
<tr>
<th>Covenant</th>
<th>Strong or tending or strong</th>
<th>Weaker with limited affordability</th>
<th>Weak and unable to provide support</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Strong funding basis and short recovery plan</td>
<td></td>
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</tr>
<tr>
<td>B</td>
<td>Weak funding basis and/or long recovery plan</td>
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<td>E</td>
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**Step 2:** Determine your number

1. Immature scheme (fewer pensioners).
2. Mature scheme (more pensioners).

Trustees will need to have a solid understanding of the employer covenant characteristics of their scheme. This will be important to determine in which category their scheme fits in TPR’s new framework and more importantly what expected actions follow from that.
5 key covenant questions that trustees should be able to answer

1. How much can the company “comfortably afford” to pay in ongoing annual cash contributions?
   - This is the amount that the company could, if required, pay out in cash on an annual basis without undermining day to day operations, capital expenditure, future business growth opportunities and a reasonable dividend policy.
   - This is a key input when it comes to cash funding negotiations and understanding the desired long-term risk tolerance of the scheme. It is an essential input in the process of setting the Long Term Funding Target – which will be covered in detail in Parts 2 and 3.

2. What is the “upper threshold” in terms of annual cash affordability?
   - This is the upper limit that the company could pay out in cash on an annual basis without pushing the company into insolvency, it is likely to compromise future growth opportunities and have material implications for other stakeholders including the dividend policy.
   - This will inform the maximum level of risk that can be taken in the journey to get to the Long Term Funding Target, which will be covered in part 3.

3. How might affordability change in the future?
   - This includes understanding the company’s prospects and the uncertainties surrounding this, which will be a combined picture of factors specific to the business, the wider industry, sector, geographic and political environment.
   - This ultimately affects both the comfortable level and upper threshold of cash affordability in the future. It therefore affects the choice of long-term target and the amount of risk that can be taken on the journey to get there.

4. What is the existing level of security?
   - This includes understanding the strict legal recourse of the scheme in an insolvency event based on the corporate structure, borrowing arrangements and security provisions as well as the balance sheet of the sponsor.
   - Understanding this element highlights the key factors that are of greatest relevance to the scheme’s security and how this security can be positively and negatively impacted by corporate actions.

5. What options are available to improve the security of members’ benefits?
   - There are often ways that a scheme’s security can be improved either immediately or over time.
   - By having a clear understanding of the current position and available options, the scheme can set on a path to preserve or indeed improve security over time.
Assessing covenant strength in practice

The covenant strength will be determined by a host of factors, including:

- profitability and cash generation of the underlying business
- balance sheet strength of the employer
- wider group context and borrowing arrangements
- security provisions and guarantees provided by the employer and its wider group
- company's industry position and the longer term prospects of that industry

Developing a good robust understanding of all these areas and bringing them together to form an objective view about the covenant strength can be challenging. The following case studies illustrate how conclusions can hinge on small but significant details:

**CASE STUDY 1**

### “Profitable business with strong prospects”

The business was profitable with a strong pipeline of new business. However on investigation two issues affected how this translated to strength of covenant.

Firstly the new opportunities involved considerable capital expenditure meaning that little cash was available to the scheme in the near term. Further, as a result of historic business disposals where liabilities had been retained, the scheme had become large relative to the organisation. Despite the relatively moderate deficit the level of ongoing risk was therefore substantial.

**Action taken**

The trustees pursued a more moderate investment return target, such that the downside risk was controlled, whilst agreeing a recovery plan with lower initial cash contributions rising over time with increases linked to strong business performance.

The long-term target was focused on getting the scheme to a high level of funding so the scheme would ultimately not represent an ongoing risk to the company.

**CASE STUDY 2**

### “Large strong business, well known to trustees”

The business was large relative to the pension scheme and the trustees all previously worked there and knew the business.

However, assessing group structure and intra-group arrangements was a key initial step in the trustees’ covenant assessment which uncovered a few key details. The perceived strength of covenant was based on the overall group but in fact it was one of the smaller subsidiaries within the group that had formal legal obligation to support the scheme. This wholly undermined the perceived security as the wider group had no obligation to fund the scheme.

**Action taken**

The trustees were in a better position to negotiate a parent company guarantee as part of the forthcoming actuarial valuation in exchange for pursuing the company’s desired level of investment return.

The Long Term Funding Target was set taking into account the ongoing parent company guarantee which could support a higher risk investment strategy. Higher expected returns were anticipated to get to the target within a reasonable timeframe.
Balancing needs of different stakeholders

Sponsor free cash flow can be directed to a number of places:

<table>
<thead>
<tr>
<th>Free Cash Flow</th>
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<tbody>
<tr>
<td>Reinvest in business</td>
</tr>
<tr>
<td>Payment to lenders</td>
</tr>
<tr>
<td>Payment to scheme</td>
</tr>
<tr>
<td>Payment to shareholders</td>
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</tbody>
</table>

TPR has reiterated its concerns regarding the relatively high level of dividend payments compared to pension contributions and the recent divergence between these. Trustees need to ensure an equitable treatment of the scheme relative to other stakeholders and restore the balance if needed. Similarly, any material leakage of value from the covenant net should not go unnoticed and these may need rectification in the form of mitigation. In relation to these issues trustees are expected to become more active stakeholders.

How to manage the employer covenant

Trustees often have more scope than they realise to manage the risks to which their scheme is exposed. Specifically they can:

- Maintain a collaborative relationship with the sponsor
- Be an active stakeholder, not afraid of asking difficult questions
- Understand the level of risk the sponsor can underwrite and manage the scheme within this
- Seek contingent assets and non-cash support
- Be alert to covenant leakage and ensure fair treatment of the scheme
- Monitor the covenant regularly and consider the impact of one-off events
- Review the journey plan in light of the changing covenant and realign it if needed
XPS Pensions Group is the largest pure pensions consultancy in the UK, specialising in actuarial, covenant, investment consulting and administration. The XPS Pensions Group business combines expertise, insight and technology to address the needs of over 1,000 pension schemes and their sponsoring employers on an ongoing and project basis. We undertake pensions administration for over 870,000 members and provide advisory services to schemes of all sizes including 25 with over £1bn of assets.

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