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.
Pension scheme liabilities are often viewed as a single number at a snapshot in time, such as an actuarial valuation. Today’s liability figure, however, does not determine the actual cost of your pension scheme, rather it is part of an ongoing budgeting exercise.

Understanding not only what your liabilities look like today, but also how they could change over time is key to building a robust journey plan and strategic decision-making framework.

### Liability measures

There is a wide range of liability measures which might be relevant to your scheme, including the accounting basis and the Pension Protection Fund basis. However, in this note we focus on three bases which form part of the long-term planning for many schemes:

- **Funding** – a prudent basis used in scheme funding valuations and termed ‘technical provisions’. Where the scheme is fully funded you expect existing assets with investment returns to be sufficient to meet liability cashflows, however you are exposed to ongoing risk and rely on the sponsor continuing to support the scheme if needed.

- **Low dependency** – a low-risk basis, where there is a low probability of needing to call on the sponsor for further cash, and if there are any cash calls they would be expected to be comfortably affordable. Often interchanged with ‘self sufficiency’ which unhelpfully implies no further need for additional support which is not achievable in practice without buy-out or some form of consolidation vehicle.

- **Buy-out** – the target level of assets needed to be able to transfer the liabilities to an insurance company, hence removing any future obligation on the sponsor.
Factors affecting the liabilities

**Your liabilities are unique** – the single liability figure quoted at a valuation date can conceal a wealth of important information. We set out a summary of considerations below:

### Maturity

The maturity of your scheme helps determine your time horizon and is an important aspect for consideration flagged by TPR in its 2019 annual funding statement. It will inform whether your scheme is getting bigger or smaller and how much risk is appropriate to take, given the amount of time you have left to recover from any losses.

### Assumptions

**Assumptions that determine your cash flows:**

- **Mortality** – generally the most significant assumption in determining the projected future cash flows from a scheme.
- **Inflation** – often impacting on revaluation of benefits before retirement and increases in payment.
- **Retirement age** – the age that members draw their benefits.
- **Dependants** – proportion of members who have a spouse or dependant eligible for a benefit and the age of a spouse or dependant.
- **Salary increases** – how active members’ salaries will increase and how likely members are to remain in service up to retirement.
- **Cash lump sum** – level of cash lump sum taken at retirement.

### Demographic experience

Most low-dependency or buy-out bases have prudent demographic assumptions but, in projecting forward liabilities, you might expect actual experience to be favourable relative to this conservative estimate. This means that the buy-out pricing should typically become cheaper as your scheme matures.

### Significant individuals

For smaller schemes, or schemes where a small number of members make up a significant portion of the liabilities, the actual experience of individual members can alter the course of your journey significantly. Insurance can be useful to hedge this kind of idiosyncratic risk.

### Member choices

Understanding how members’ choices can alter the expected progression of your liabilities can help to shape your journey. For example a greater take-up of transfer values can change the shape of your future cash flows and hence the evolution of your liabilities.

Once you understand your scheme’s cash flows you can consider what an appropriate liability target looks like for your long-term strategy.

### Buy-out: the ultimate end game?

Even if your scheme has no intention of buying out at the moment, there will ultimately come a point when the scheme is not practical to continue to run due to diminishing economies of scale (i.e. with fewer members) and buy-out becomes the most cost-effective option.

Therefore, buy-out is the likely ultimate end game for most schemes. However, this does not lead to a natural conclusion that all schemes should target buy-out as their Long Term Funding Target, nor that all schemes should necessarily seek to insure members in tranches (generally known as a partial buy-in) as a stepping stone to this eventual destination.

For many schemes buy-out will take place many years from now when the scheme is unrecognisable from today’s arrangements, and the current pensioner population will represent a small portion of the residual scheme. Therefore insuring current pensioners now does not necessarily aid the pursuit of reaching buy-out in 20 or 30 years’ time where those members may have died by that point.

A low-dependency strategy can therefore have a substantial role in getting schemes from where they are today to the ultimate destination of buy-out.
Case study: A tale of two schemes

In the example below, the Mature Scheme is based on a genuine XPS client. The Immature Scheme is a fictional scheme with the same liability value as the Mature Scheme, but a very different profile. Below we look beyond the single liability figure and see that these apparently subtle differences can significantly influence the strategic decision-making.

### Initial trustee perspective

The trustees of the Mature Scheme had previously ruled out consideration of a longer-term low-risk target, and in particular buyout, as being too far away. They were sceptical about buy-out due to the £55m gap between the funding and buy-out liabilities at the current date.

<table>
<thead>
<tr>
<th></th>
<th>Mature Scheme</th>
<th>Immature Scheme</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td>£90m</td>
<td>£90m</td>
</tr>
<tr>
<td><strong>Funding liabilities</strong></td>
<td>£105m</td>
<td>£105m</td>
</tr>
<tr>
<td><strong>Deficit</strong></td>
<td>£15m</td>
<td>£15m</td>
</tr>
<tr>
<td><strong>Funding level</strong></td>
<td>86%</td>
<td>86%</td>
</tr>
<tr>
<td><strong>Duration</strong></td>
<td>15 years</td>
<td>25 years</td>
</tr>
<tr>
<td><strong>% of funding liability in respect of pensioners</strong></td>
<td>60% (mature in TPR's classification)</td>
<td>30% (immature in TPR's classification)</td>
</tr>
</tbody>
</table>

The chart shows the cash flow profile of the two schemes.

The Mature Scheme has already broadly reached its peak expected cash flow. The Immature Scheme on the other hand is not expected to reach its peak cash flow for around 20 years.

This chart shows the expected future progression of liabilities for the two schemes, with very different expectations for the future sizes of the schemes.

The Mature Scheme is expected to reduce in size more quickly than the Immature Scheme, which has implications for the extent of the future reliance on the sponsor.
How close is buy-out?

The chart below shows the liabilities of the two schemes both today and in 20 years’ time building up from the funding liability to the low-dependency and buy-out liabilities.

![Chart showing liabilities]

**Buy-out is currently much more expensive for the Immature Scheme highlighting a key difference between the schemes.**

In addition, for the Mature Scheme the buy-out cost converges with the low-dependency basis much more quickly than the Immature Scheme.

Why does buy-out get relatively cheaper over time?

There are two key reasons:

1. Pensioner members are priced relatively more cheaply than deferreds within the insurance market. Therefore, as more members retire, a scheme becomes relatively cheaper to insure.

2. The buy-out cost today will incorporate conservative demographic assumptions in relation to the life expectancy of existing pensioners etc. As time passes you would expect the actual experience to be in favour of the scheme which will then reduce future buy-out pricing.

Case study outcome: Action taken

Following initial scepticism, on seeing the speed at which the gap was expected to close, the trustees constructed a journey plan to get to a low-dependency target of gilts +0.5% over the medium term, with the intention to jump to buy-out if and when conditions where favourable.

The trustees have also started to put in place a programme of member options exercises, such as enhanced transfer values and pension increase exchange. These exercises give members additional flexibility and when taken up they accelerate the closing of the gap to buy-out.

How to manage your liabilities

To build your journey plan you need to understand your target and how that target will evolve over time.

- Seek to understand your scheme liabilities not just defining their current value.
- Hone your demographic assumptions to understand the factors that could significantly affect your cash flows.
- Consider steps you can take to reduce the uncertainty around your liabilities such as liability management, interest rate and inflation hedging, and use of partial buy-in.
- Work with your sponsor to establish sufficient cash support and security to meet the scheme’s current needs, and how this will evolve.
- Understand the buy-out cost and how this will change over time. This is likely to be your ultimate end-game even if you don’t currently have aspirations to get there.
- Consider the role of a low-dependency target as a medium-term safe haven until buy-out pricing comes into view.
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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