LCP INSIGHT CLARITY ADVICE

Chart your own course

Navigating the pensions journey

July 2019

Your scheme, your journey

DB pensions have changed course. With funding levels buoyed by investment returns and contributions, and new mortality assumptions trimming back liability valuations, many DB schemes that are closed or maturing have got to a point where they are able to focus on the final stretch of their journey to securing members' benefits. But this journey is often far from over and there can be many important choices for DB trustees to make as they navigate their way.

Much has been made in the industry of the end-game of the journey and indeed Regulation is set to change with a long-term funding target likely to become enshrined in the new funding code. Of course, it is essential to know where you're heading, but the journey can matter just as much, and that is the focus of this report.

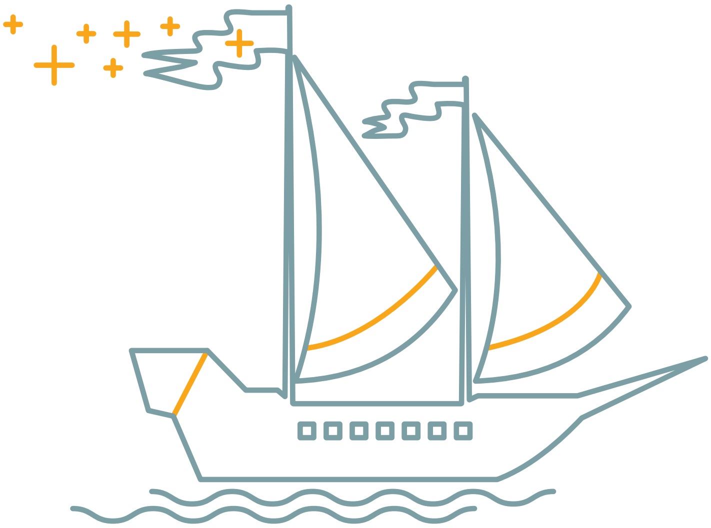
From working with our clients, it is clear that each journey is unique, and rightly so as the dynamics of each scheme can be so different. This report sets out our blueprint for a successful journey as well as sharing case studies and data from other pension schemes, to help trustees consider whether they are navigating their journeys, and tackling the risks they face, as effectively as they can. Our checklist on page 23 will help trustees to consider what further actions they could take.

Much of the content of our report is relevant to sponsors too, who may also want to see the scheme reach its end-game. However, their priorities and appetite to risk can be different, leading to a different approach to tackling the journey.

This report is the first in our "Chart your own course" series. Watch out in the coming months for further LCP material which will include how to navigate the new guidance awaited from the Pensions Regulator.

Our risk management steering group which draws on expertise from our covenant, investment and funding specialists.

> *What's needed more than ever is clear advice joined up across covenant, investment and funding. We support trustees to confidently make the decisions that are right for their members.*



Journey planning blueprint

As set out in our report:

1. **Determine the destination**
2. **Understand the risks**
3. **Assess the covenant strength**
4. **Set a suitable investment strategy**
5. **Plan to fund the liabilities**
6. **Develop the governance framework**

In this report we set out our latest thinking on the practical steps that trustees can take to manage the scheme's journey and the risks it runs. A successful journey is built on the following principles:

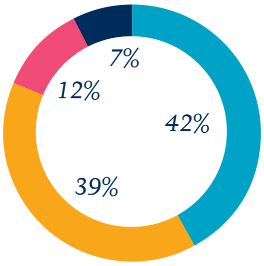
- A full understanding of the covenant, and how able it is to support the risks the scheme faces over the short and longer term, is crucial to all funding and investment decisions.
- In a volatile world, plan for uncertainty. Together with the sponsor, trustees should develop their long-term target and journey plan dynamically, to ensure they remain appropriate.
- Measure what matters: keep the focus on key risks – which will change over time. Don't over-engineer how those risks are managed but do plan for what happens if they emerge.
- Things won't move in straight lines. In anticipation of change, be aware of the options and adopt governance structures that support nimble decision-making; this will maximise the scheme's chance of success.
- Be prepared for changes in the UK regulatory regime and make sure that the chosen approach will be fit for purpose in the new world.

Jill Ampleford
Scheme Actuary

Before starting on a journey, it is essential to know where you want to go. This will help frame all decisions until you reach your destination.

1. Determine the destination

Most schemes already have a longer-term destination in mind (as shown in the chart below) and this is a key first step in planning any journey.



What is your long-term objective for your pension scheme(s)?

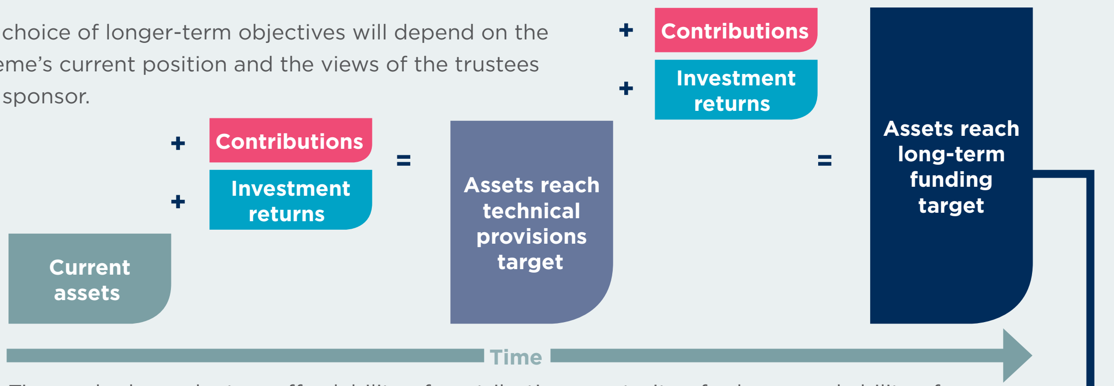
- To fund and run-off the scheme on a "self-sufficiency" basis
- To buy-out with an insurer when affordable
- We don't currently have an agreed long-term objective
- Other

Source: LCP De-risking report survey, 2018

Furthermore, having a long-term funding target will most likely soon become a regulatory requirement. The Pensions Regulator's 2019 annual statement has paved the way, encouraging trustees to think beyond technical provisions, to identify a longer-term objective and, over time, to reduce the reliance on the sponsor.

The journey to your long-term objective

The choice of longer-term objectives will depend on the scheme's current position and the views of the trustees and sponsor.



Timescale dependent on affordability of contributions, maturity of scheme and ability of covenant to underwrite risks.

Target	What does this mean?	Find out more
Buyout	Secure all members benefits with an insurance company	See our latest de-risking report
Consolidator	Transfer to a pensions consolidator, which takes on assets and liabilities of a number of schemes, aiming to pay (or secure) all members' benefits in due course	See our podcast to find out more
Self-sufficiency (or "low-dependancy")	Run the scheme on with a low-risk investment strategy, paying benefits as they fall due, with low ongoing covenant reliance	Look out for our blog on this

Trustees have three key levers to pull when establishing and managing their long-term plan:

- the level of contributions;
- how much to rely on investment returns; and
- how long until the target is achieved.

How trustees choose to pull these levers will be unique to each scheme and sponsor, and will inevitably involve some compromise.

The original plan does not have to be set in stone – the levers can be adjusted dynamically, and contingency plans should be agreed with the sponsor in advance, to manage risks.

The Pensions Regulator is clear that both investment strategy and technical provisions should be aligned with the scheme's long-term objectives and strength of the sponsor covenant. Trustees need to determine how this is done in practice.

2. Understand the risks

At LCP we have developed a risk framework that can easily be used to classify and consider the key risks facing a scheme as set out below. This framework helps trustees identify and navigate the risks they face and put in place an effective framework to monitor, manage and mitigate those risks.

Covenant risks

Sponsor failure

The sponsor fails, the scheme's section 75 debt is triggered and there are insufficient asset realisations to secure members' benefits in full.

Balance sheet strength

Pension scheme large in the context of the sponsor's overall resources, putting a strain on its ability to underwrite scheme risks.

Affordability

Sponsor unwilling or unable to fund the scheme to an appropriate level.

Investment risks

Investment underperformance

The funding position worsens because the investments underperform.

Reinvestment risk

Low future returns make it harder to deliver the investment returns.

Disinvesting to pay benefits

Increasing needs for cash to pay pensions as more members retire causes the scheme to become a forced seller.

Funding risks

Inflation

Estimated benefit payments are too low due to inflation being higher than expected.

Longevity

Estimated benefit payments are too low due to members living longer than expected.

Member options

Members take options that result in different cashflow pattern to assumed.

Governance risks

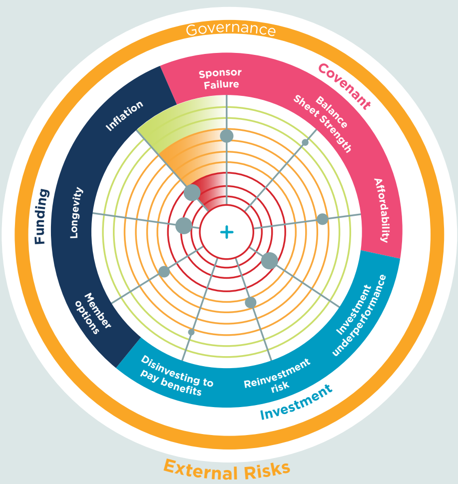
In the coming pages, we set out some practical ways in which you can manage these covenant, investment and funding risks.

Bringing risk management to life

A first step could be to undertake a high-level benchmarking exercise to identify the keys risks for your scheme, using a tool like LCP Sonar. Subsequent work can then be focussed where it will add the most value.

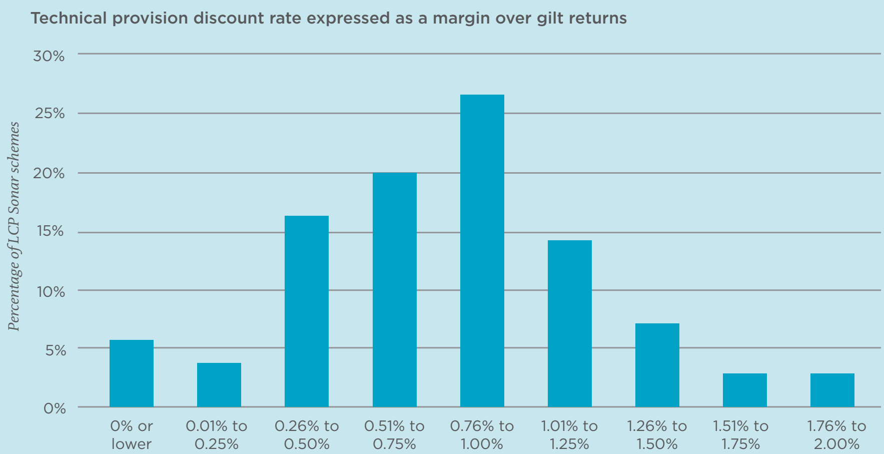
LCP Sonar is our risk profiling tool which shows how a scheme stacks up against most of our pension scheme clients using our key risk framework (above). The dots show how this scheme stacks up against LCP Sonar schemes, in each key risk area, using metrics we have developed.

Depending on the risks most relevant to each scheme, the way trustees measure and react to risk events will vary materially, as will their measures of success.



The scheme's risk profile drives ultimate objectives and the journey plan

Understanding the key risks is crucial when trustees are deciding on an ultimate funding objective, planning the journey to get there, and managing risk along the way. At present, the Pensions Regulator would consider that few schemes have technical provisions at what we may expect they consider a suitable long-term funding target.



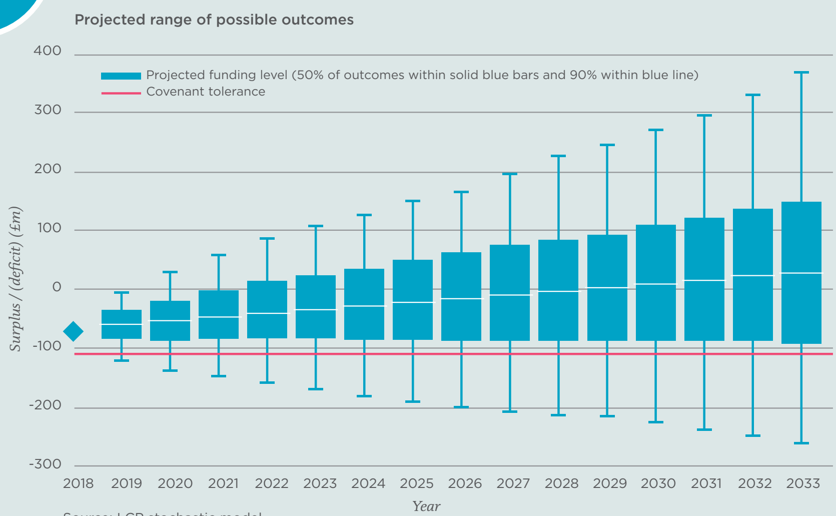
Our LCP Sonar scheme data shows that expressing the discount rate used in the technical provisions as a flat premium above gilt yields gives the spread shown opposite. This implies that many trustees expect to continue taking risk when they reach full technical provisions funding and it's important to think about the types of risks they will be willing to take.

Mary Spencer
Investment Adviser

Projecting your assets and liabilities isn't enough; you should understand the range of outcomes for both the pension scheme and sponsor, and, crucially, what you would do if a risk materialises.

Case Study

Ability of covenant to support scheme's future journey



Source: LCP stochastic model

In this example, the trustees have determined that if the deficit exceeds £110m – the red line on the chart - at any point on the journey, this would put a significant strain on the covenant, and would be a trigger for them to de-risk the investments. In confirming the appropriateness of decisions on contributions and investments, they look at the chance of the deficit increasing to that level or more. Each year the trustees review the covenant and consider if the £110m trigger level should be adjusted.

3. Assess the covenant strength

The greatest risk facing most defined benefit schemes

If the sponsor continues successfully then members will ultimately receive all their benefits. However, if the sponsor fails, members' benefits will often be reduced. For example, the scheme may fall into the PPF, or a level between PPF benefits and full benefits may be secured with an insurance company. The Consolidator market may provide a third way for some schemes.

The extent of the risk of failure can be materially underestimated. In part, this is because traditional ways of measuring risk – including value at risk and stochastic simulations – do not allow for the potential deterioration in covenant support over time.

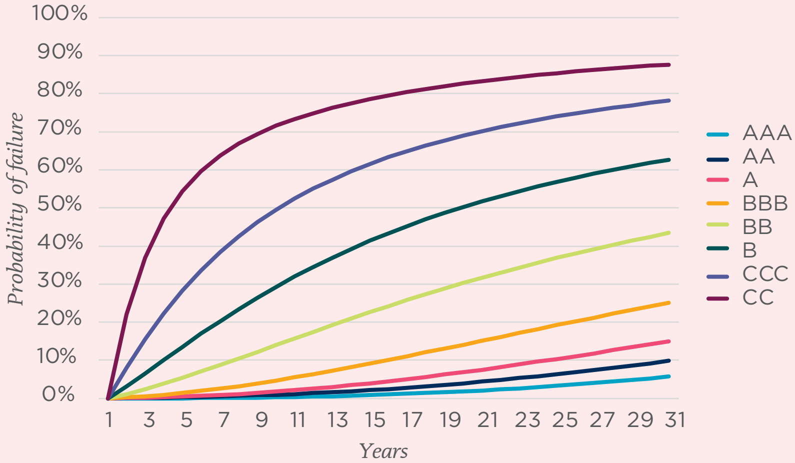
High-profile failures like BHS and Carillion highlight that sponsors both can and do fail. The chart below demonstrates that over the long-term the risk of failure can become material, even for the sponsors that appear relatively strong today.

Assess your covenant

Have you considered:

- **Contingency plans to support the journey?**
- **How dividends compare to deficit contributions?**
- **Looking at the chance of paying benefits in full?**

Cumulative chance of default over time



Source: Moody's default and downgrade data, 1920 to 2017.

The chart shows the cumulative likelihood of default as time passes for different credit ratings.

A company rated BBB may well gain a "tending to strong" covenant rating today, but over a 15-year period there's more than a 10% chance that the sponsor fails.

Schemes are already required to assess their covenant with an increasing number carrying out an independent review. It is key that this understanding of the covenant is embedded into your journey plan.

Fran Bailey
Covenant Specialist

A thorough understanding of the sponsor covenant is key in making decisions on contributions, investments and the desired timeframe to get to a low covenant reliance position.

If disaster strikes, and the sponsor does fail, trustees should know the consequences for their members. There are various ways this risk could be analysed, for example considering the percentage of members' benefits that might be secured in that scenario, or the chance of members' benefits being paid in full if the scheme was to run on with no sponsor (see our example on page 15).

The potential outcome will depend on things like the balance sheet of the sponsor at the point it fails, the scale and priority ranking of other creditors competing against the scheme for recovery of assets on insolvency, any contingent support provided to the scheme, the contributions paid up to the point of sponsor failure and the risk and returns generated by the investment strategy.

Mitigating covenant risk

It's hard to fundamentally change the sponsor you have. However, the most effective action you can take to reduce covenant risk is to work towards a well-funded, low risk position. The Pensions Regulator is keen to encourage schemes to do this.

It is important to manage the exposure to covenant risk along this journey and this is best done by implementing an integrated covenant monitoring framework, comparing key financial metrics with measures of funding and investment risk. Within this framework, trustees need to also carefully consider the scale of any covenant leakage, eg dividends, shareholder buybacks or management remuneration, and assess whether the scheme is being treated fairly.

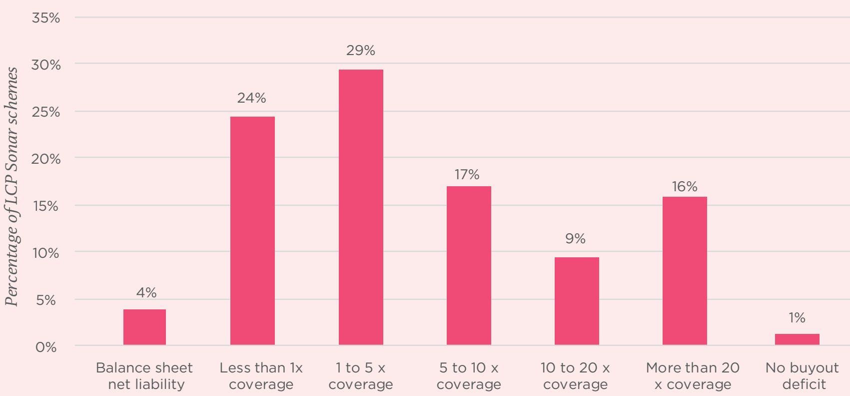
Ongoing engagement and collaboration with the sponsor is crucial for trustees. This will give them full visibility of sponsor developments, allowing them to act early to protect members should that become necessary. In scenarios where trustees have significant powers, eg to demand contributions or to trigger a wind-up, then they should think carefully about the extent of those powers and when it would be appropriate to use them.

Jonathan Wolff
Covenant Specialist

The sponsor's covenant to the scheme underwrites any deficit and all the other risks to which a pension scheme is exposed. For all but the best funded schemes, the greatest risk may be the level of covenant support available over the longer term.

The LCP Sonar schemes are on average 76% funded on a gilts basis; remaining firmly reliant on sponsor strength at the current time.

Level of balance sheet support



LCP Sonar scheme data highlights that just over a quarter of entities providing covenant support to LCP schemes had net assets (excluding pensions asset or liabilities) which were smaller in scale than the associated scheme buy-out deficits that they support. Trustees need to ask themselves the question – if your sponsor became insolvent today, how much would members receive? And how can you collaborate with the sponsor to improve this support, if needed?

Case Study

Managing balance sheet strength risk with a secured account

The trustees and sponsor were both keen to reduce levels of risk associated with the pension scheme and agreed to target a self-sufficiency level of funding over a 10-year period.

The sponsor was concerned that the trustees' assumptions, particularly around investment returns, were too prudent, and that paying scheme contributions might result in a trapped surplus.

It was therefore agreed that all future contributions would be paid into a separate account.

The trustees were granted security over this account, so that in the event of sponsor failure over the 10-year period they could be confident that this value would end up in the pension scheme. After 10 years, the secured account is paid into the scheme to the extent needed to achieve full funding against the self-sufficiency target, and any remainder returned to the sponsor.

This agreement gave the trustees comfort that the sponsor was underwriting investment risks being run, allowing more risk to be taken in the early years, with the expectation that they would reduce risk over the 10-year period. The Scheme Actuary, covenant and investment advisers worked closely together on this exercise to give joined-up advice and enable the trustees to make a decision based on the full picture.

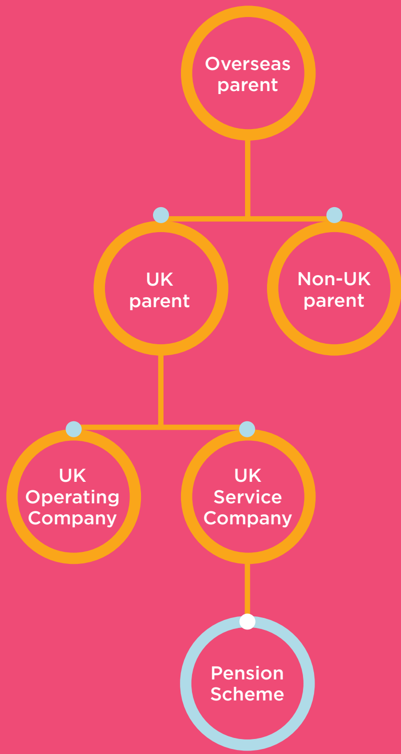
33%

of LCP Scheme Actuary clients have a contingent asset, of which 72% are in the form of a parental guarantee.

Case Study

Managing sponsor failure risk with a parent company guarantee

- In this example, a UK pension scheme's only sponsor was a service company with a weak covenant.
- The trustees reflected their views of the covenant by adopting a cautious funding target and low risk investment strategy.
- The sponsor provided a parent company guarantee which gave the pension scheme legally enforceable access to the value of the whole group in the event of an insolvency of the participating employer. This resulted in the covenant being assessed as strong.
- In exchange, the trustees agreed to aim for higher investment returns, and to give credit for these returns in the technical provisions and long-term journey plan. The trustees were supported by their advisers collaborating to make sure that the overall package was appropriate.
- This reduced the level of contributions required from the sponsor by over 50% in return for the extra security provided to members.



Linking contributions to dividends

Recent cases such as Carillion and BHS involved companies that had historically paid significant dividends to shareholders before subsequently failing, leaving behind underfunded and unsupported pension schemes. The Pensions Regulator's 2019 funding statement addresses this risk, by emphasising that where dividends and other forms of shareholder distributions exceed contributions, it expects a strong funding target and short recovery plans.

This has focussed trustees' attention on the level of dividends being paid by sponsors, and how these compare to the level of deficit contributions. Trustees (and the Regulator) could argue that if a sponsor is doing well, and increasing dividends, that is the time to pay additional contributions into the scheme.

One way we have helped trustees and sponsors to navigate this issue is to link pension contributions and dividends, so for example, if dividends exceed a certain trigger level, then an additional contribution will be paid into the scheme. This additional contribution might be set as a percentage of the dividends paid above the trigger level, subject to a fixed cap.

LCP's accounting for pensions report showed FTSE100 companies paid out

\+ 7 times more

in dividends than deficit contributions over the last year. For LCP Sonar schemes where both dividends and contributions were paid, over 10 times more was paid out as dividends than in deficit contributions.

4. Set a suitable investment strategy

Strive for success instead of going for glory

In most cases, investment returns are the engine driving the assets towards meeting the liabilities and therefore form a vital component of the journey plan. For our latest innovative investment ideas, check out LCP Vista, our bi-annual investment magazine. But of course, when investing to generate returns, it is essential to ensure that the covenant strength is able to underwrite such risks, and to reduce risk if this is not the case.

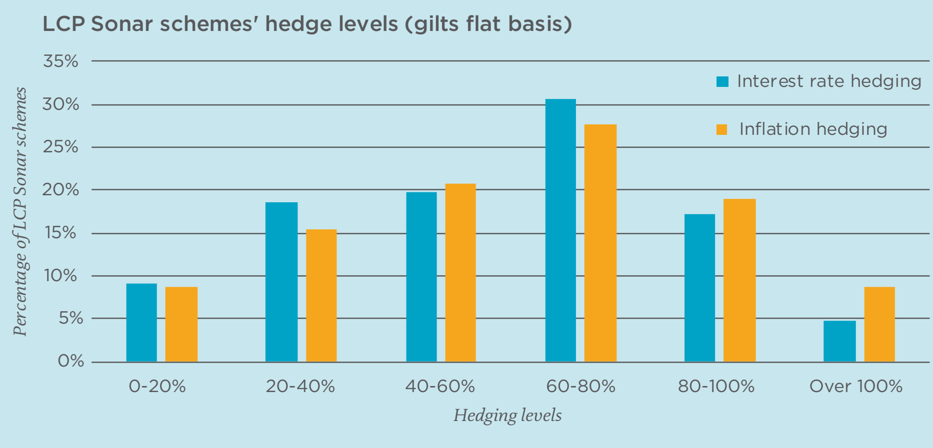
It can be difficult to avoid the temptation to aim for perfection (especially if you are an actuary!) but, as Warren Buffet has said, "You don't have to do extraordinary things to get extraordinary results". We recommend that trustees focus on the risks that really make a difference to the success of the scheme, easing governance requirements (and costs) and encouraging prompt action when it's required.

Perhaps one of the biggest challenges to pragmatism that we see, is when setting an approach to matching portfolios.

Set investment strategy

Have you considered:

- **Whether you can generate the returns you need within the risk capacity your covenant provides?**
- **Which risks to prioritise managing first?**
- **How to manage your cashflows?**



We view interest rate and inflation risks as unrewarded, so normally we encourage trustees to reduce these as far as possible. Schemes with low levels of hedging in the chart may hold liability matching assets, such as buy-ins, separately, or they may have a high level of required return. Those with very high levels of hedging may be aiming for a stronger target, such as buy-out.

> *On average LCP Sonar schemes hedge 60% of their gilt-based liabilities in relation to changing interest rates and 65% in relation to changing inflation expectations. But how accurate are these figures? And does it matter whether it's 60%, or 63%, or 65%?*

Be pragmatic when hedging interest rate and inflation risks

Understandably, when designing matching portfolios, the focus is on holding investments to better match "the liabilities". But which measure of liabilities are we talking about? Is it technical provisions, self-sufficiency, buy-out, or something else?

Many trustees will be familiar with thinking about "the value of the liabilities" being sensitive to interest rates and inflation – and with designing asset portfolios that match these sensitivities. Many trustees will also be familiar with a sensitivity to members living longer and have started to think about protecting this risk via insurance solutions. But there are other factors to consider which drive changes in the cashflow shape such as:

- changes in the age at which members typically retire, what benefits they take including commutation and the terms on which they do so; and
- the extent to which members take transfer values.

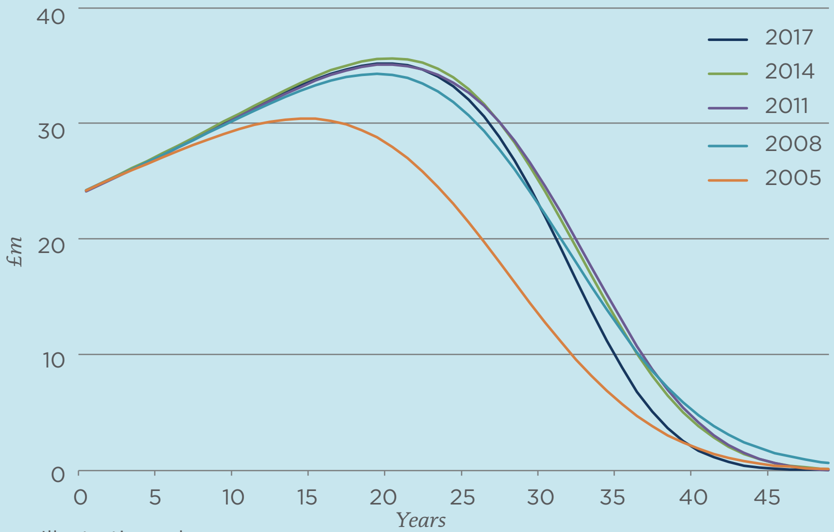
Dan Mikulskis
Investment Adviser

Don't let perfect be the enemy of good - there are too many unknowns.

One thing is for certain: members won't do what you assume they will

We back tested the impact of changing demographic assumptions on the expected cashflows for a scheme. We used the same membership data and assumed the same financial conditions at all five valuation points, varying only the demographic assumptions.

Cashflow projections at different valuation dates



Illustrative scheme

The chart shows that the cashflow profile for each of five actuarial valuations for an example scheme. In the space of just a decade, the cashflows vary by up to 26%.

This means a liability matching portfolio built based on 2005 cashflows could leave the scheme up to 26% under water in time.

In practice, we suggest trustees look to align their hedging target with their long term funding target and to review the portfolio when new information is available.

Be cashflow aware not necessarily cashflow driven

Meeting scheme cashflows is a challenge that will only get bigger as schemes get more mature. In this context, we support strategies that help tackle this issue. However, we believe over-engineering could lead to sub-optimal outcomes.

A pragmatic approach is to hold cashflow aware, diverse and suitably liquid assets: typically a portfolio of asset classes providing high levels of stable (ideally contractual) income. Awareness of the expected cash outflows enables trustees to decide on an initial portfolio, but flexibility is also important. We recommend investing in a range of investments, so the scheme isn't too exposed to any one illiquid asset type, and make sure that the portfolio can be re-shaped if the cashflows change.

LCP Sonar scheme data shows that, currently, 62% of schemes are in a net cash outflow position.

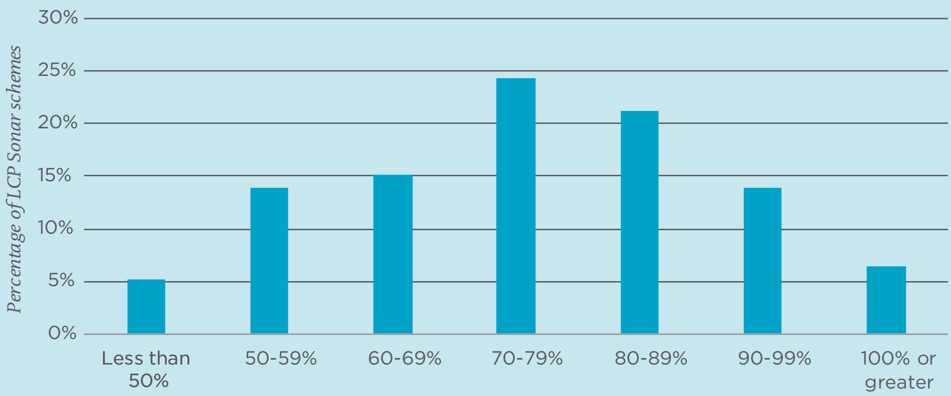
On average, LCP Sonar schemes will need to use 2% of their assets to meet next year's expected benefit payments – if investment income doesn't achieve this, they will need to disinvest.

Manage the risk of investment underperformance: chase only the returns you need

Roll back a decade and most pension scheme trustees were playing the investment game. The goal was to maximise returns and hope the sponsor could underwrite the risk being taken. Today we look back on a decade of rising markets, where schemes experienced significant asset growth.

As we all know, it's not just about the assets – the last decade has also seen material increases in the values placed on scheme liabilities (primarily because gilt yields have fallen). But despite that, and helped by a slowing rate of longevity improvement, schemes might be closer than they think to the finish line.

Funding level against a 'gilts flat' measure



'Gilts flat' means a measure of the liabilities where the discount rate is set in line with prevailing gilt yields.

Many schemes are closer to a long-term funding target than they may realise, but others have a long-way to go.

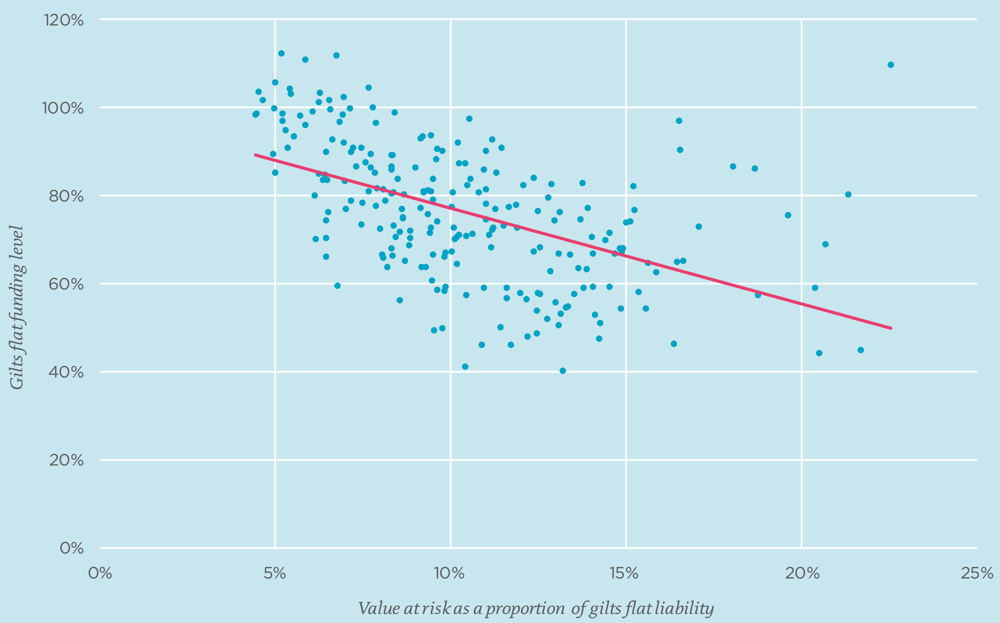
LCP Sonar scheme data shows the average gilts flat funding level as 76% with around 20% of schemes being at least 90% funded on this measure.

In some cases it might be appropriate to "go for glory" by continuing to run a higher risk, higher return approach and reducing the period over which it is hoped the scheme reaches the target funding level. This might apply when the scheme is backed by a strong sponsor and has robust contingency plans in place.

> *Trustees need to determine the amount of investment risk they take in the context of their assessment of the covenant and its ability to underwrite this risk.*

It is often appropriate to bank investment good news by dynamically reducing the return sought from the assets, as this will reduce the overall level of risk. One way to do this is by regularly assessing progress against the long-term funding target and the returns needed to get there in the desired time-frame in order to assess whether there is any scope to de-risk whilst remaining on track. This helps move toward the chosen target more smoothly within the desired timescale, reducing the impact of downside events in the future, and hence reliance on the covenant.

Funding level against value at risk (each dot is a scheme from the LCP Sonar scheme data)



The chart shows that better funded schemes are generally taking less investment risk – but it is a very individual decision as can be seen from the range of outcomes shown on the chart. Trustees need to decide what the best position is for them depending on many variables including risk appetite and covenant strength.

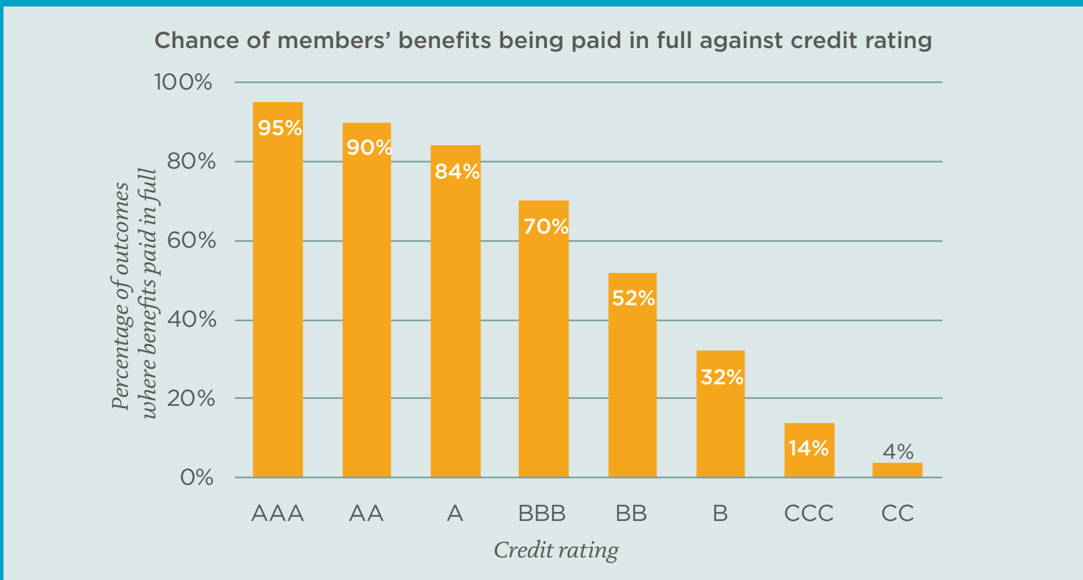
Case Study

Managing investment risk to support an ongoing company

This scheme was supported by a small cash-constrained company but contributions were needed to progress towards their longer-term target. Conscious that the risk in the scheme could materially impact the sponsor's future ability to make contributions, the trustees were focussed on minimising contribution volatility and downside risk. We used our integrated stochastic tool to help the trustees understand the trade off between covenant and other risks.

Results of LCP's integrated stochastic tool

The chart illustrates that there is a reasonable chance that not all benefits are paid, even where the sponsor currently appears strong, as there is a chance the sponsor fails before the scheme gets to a secure position.



The trustees accepted that there was a reasonable chance that not all benefits would be paid, so focused instead on maximising the proportion of benefits expected to be paid.

In this example, accepting a higher risk investment strategy today in order to achieve a lower risk investment strategy later may undermine members' security and the overall viability of the scheme. Adopting a more moderate approach to risk-taking today, in the knowledge that this would need to be maintained for a longer period into the future, was the approach that maximised their measures of success as outlined in the table.

Target return from investment strategy	*Probability of paying benefits in full*	*Mean proportion of benefits paid*
Gilts + 2% pa	52%	88%
Gilts + 1.5% pa	60%	91%

Although the result pushed out the timeframe under which the scheme would be exposed to the covenant strength, the trustees were comfortable this was the most appropriate conclusion.

5. Funding the liabilities

Keep your eye on the long-term prize when setting your funding plan

The Pensions Regulator's 2019 annual funding statement encouraged trustees to set a long-term funding target, establish a plan to progress from their current technical provisions to this long-term target and to agree technical provisions that are consistent with this journey plan. It seems likely that new funding legislation and regulation will require all of this in the future.

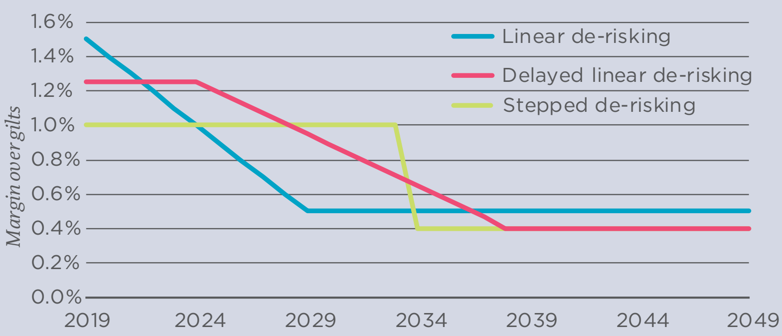
Many trustees will need to think hard about what this might mean for their investment strategy, technical provisions and sponsor contributions as part of their next valuation. This might include amending the model behind the technical provisions to allow for future de-risking to the chosen long-term target in a more transparent way. There are different ways this can be done, depending on the starting investment strategy, the target investment strategy, the way in which the scheme is expected to transition between them, and the time scale over which this is expected to happen. The decisions made on each will depend on the covenant and the concerns and objectives of the trustees and the sponsor.

Funding the liabilities

Have you considered:

- **How to reflect the long-term funding target in the technical provisions?**
- **How the scheme's membership profile shapes decisions on options and communications?**
- **The impact of topical issues such as mortality, GMP equalisation or RPI reform?**

Illustrative discount rate models to use in technical provisions for an example scheme



The chart shows several potential models for discount rates that are set with reference to gilts and of course there are many other options too. In each case, the assumption blends to the chosen long-term target have gilts +0.5% pa for "linear-derisking" and gilt +0.4% pa for the two others.

Case Study

Reflecting a long-term funding target in a valuation

The trustees' discount rate model was set with reference to their long-term funding rate of gilts +0.25% pa in respect of pensioners and a higher rate in respect of non-pensioners. This model takes 25 years for all members to retire and therefore to get their long-term funding target. Furthermore, there was no planned future de-risking of the assets.

The trustees agreed with the sponsor that this was unrealistic and instead both parties wanted to get to their long-term funding target within 10 years. The covenant adviser gave a view of how much investment risk the covenant could support and the affordability of contributions and the Scheme Actuary calculated Technical Provisions allowing for this new structure. Working with the investment adviser, they put together some possible contribution plans, allowing for differing levels of investment returns in the Recovery Plan. The trustees ultimately agreed with the sponsor's (higher) proposed reliance on investment returns, in return for security over a contingent asset (should these returns not materialise) and planned de-risking should the actual returns put them ahead of plan.

The scheme now has a joined-up funding and investment strategy which both parties are confident has increased the chance of getting to their long-term funding target within 10 years.

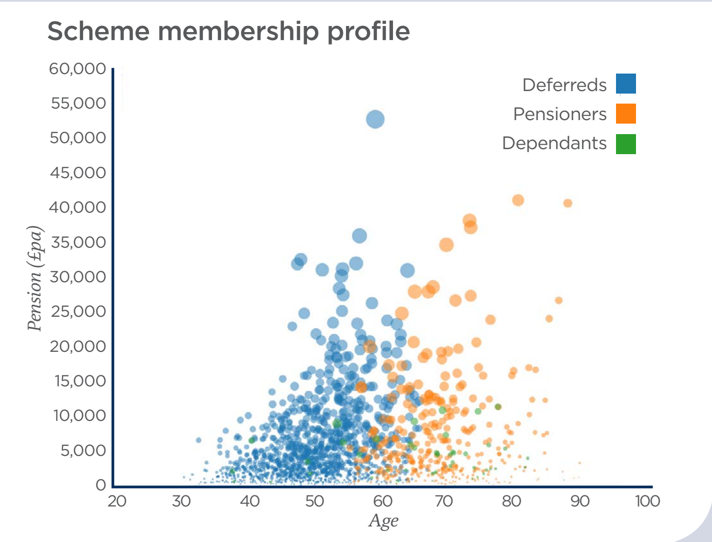
Is a gilts-based measure the right approach for all schemes? When your long-term target involves holding lots of gilts (perhaps on a journey to ultimately pass these to an insurer), gilts makes sense, but others adopt an alternative strategy. We have worked with a number of schemes to agree a funding measure set with reference to their actual asset strategy rather than pegged to gilts.

Understand your membership

It is important that members understand their benefits and the options they have, and that trustees communicate these in a clear and balanced way. As those options affect future cashflows from the scheme, it is also important for trustees to understand them when considering journey planning and risk management.

As well as options being potentially attractive to members, they can also help the scheme progress towards its long-term funding target and reduce pension scheme risk and uncertainty.

LCP Sonar data shows that on average 55% of a scheme's liability is in respect of members who have not yet retired.



When considering your member option strategy, it is key to understand the profile of your membership. This is particularly relevant for members who have not yet retired, who will have more options available to them. This chart shows the distribution of members by age and pension size, with every dot being an individual member of this example scheme.

Understanding the membership profile allows trustees to consider questions such as:

- Are there many members who would value a partial transfer value?
- Should there be a proactive communication strategy to engage with members regularly and not just when they approach normal retirement age?
- Should members be offered access to financial advice in line with an increasing number of pension schemes?
- Would offering enhanced transfer values potentially be attractive to a significant proportion of members if the sponsor proposed this? In considering this it may also be useful to consider how your transfer values compare to the new test introduced by the FCA – further detail is set out in our joint report with Royal London.
- What might be the impact of offering pensioners the ability to exchange increasing pension for a higher pension that does not increase (a Pension Increase Exchange, or PIE), and how does this interact with inflation hedging?

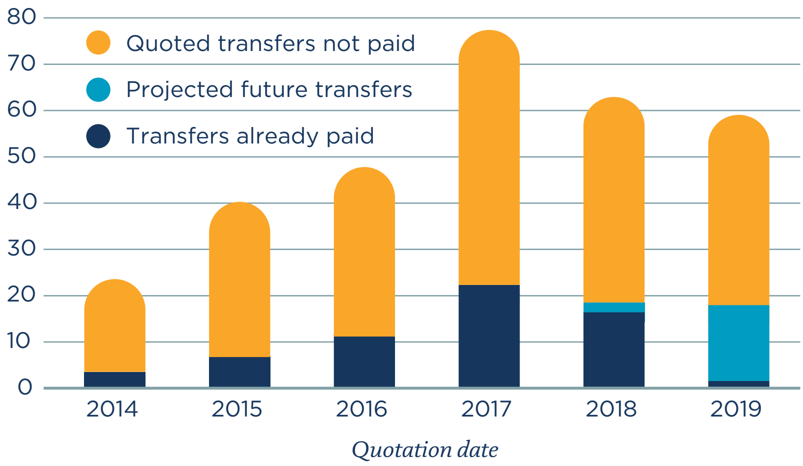
Manage member option risk

As discussed on page 12 the future cashflow profile of a scheme is unpredictable and could be very different to that assumed. This risk should be managed so that any future surprises don't throw you off course.

Monitor transfer value experience

The increase in members taking transfer values in recent years, due to the introduction of pensions flexibilities, is one example of how a cashflow profile can change. Whilst activity is still much higher than before the pensions flexibilities were introduced, there are early signs of it slowing down. Activity also continues to vary significantly from scheme to scheme with some still seeing very little activity and some seeing a lot.

Annualised quotation rate per 1,000 deferred members



15%

of LCP Scheme Actuary clients allow members to take partial transfer values.

Keep track of transfer value experience. This ensures that you know how transfer payments affect expected future cashflows, hedging, liquidity, funding levels and perhaps how you stack up against a de-risking trigger.

Further information is available in our quarterly update on transfer value experience.

Make sure you have a dynamic plan

The best managed journeys are those where trustees know exactly where they are on their journey and frame their decisions accordingly. We can track funding positions and dynamic metrics in real time, giving our clients the latest information at their fingertips. This helps answer questions like:

- Am I ahead or behind of where I planned to be?
- If I'm behind, what extra contributions and / or investment returns would I need to get back on track, or how much longer would I need to wait?
- If I'm ahead, could I bank some of this good news and reduce risk?
- What does all this mean in the context of the covenant?

7 Years is the average recovery plan length for LCP Scheme Actuary clients.

Is GMP equalisation an opportunity for a spring clean?

Following the Lloyds case in 2018, the majority of pension schemes will be taking steps to equalise benefits for the effects of GMPs ("GMP equalisation").

The expected financial impact of GMP equalisation is generally relatively small, typically less than 1% of the technical provisions. However, often GMP equalisation affects a large proportion of the members.

The process of equalising GMPs may also lead to a deeper understanding of what historic data is available and any nuances in the benefits. We expect that many schemes, particularly those whose aim is to ultimately buy-out, will use this exercise to create a full specification of the benefits for this purpose, that could be provided to an insurer in due course.

Bringing data and benefit issues to light and resolving them now, in conjunction with a GMP equalisation process, will lessen the risk of unexpected issues coming out of the woodwork in the future.

It is also possible that GMP equalisation presents an opportunity to consider if there are aspects of the benefit design that could be simplified. This could reduce both administrative cost, and potentially risk, in the future, and enhance member understanding and appreciation of their benefits.

Click here to read our view on the publication of GMP conversion guidance by the Department for Work and Pensions.

Manage your risk

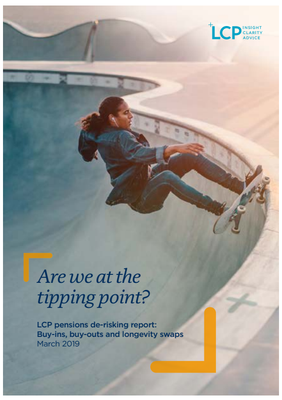
As schemes move along a de-risking journey and reduce the investment risk they face, their longevity risk – ie the risk their members live longer than expected – becomes relatively more significant.

In recent years, we have seen a slow-down in the rates of increase in life expectancy. This has caused a downwards revision in the assumed future rate of longevity improvements, reducing the value placed on liabilities.

While this now appears to be an established trend, the drivers for it are still unclear. It is quite possible that it could accelerate, or reverse. Therefore, longevity risk continues to be an uncertain issue.

In recent years, the way in which pension schemes look at longevity risk has evolved. Mortality tables are now more flexible than previously, with different parameters that can be used to model different patterns of future improvements.

Of course, understanding longevity risk is only the first step. There is now a wider range of options than ever before for mitigating longevity risk. More details can be found in our latest LCP pensions de-risking report.



RIP RPI?

The measure of inflation used to increase benefits can vary between schemes, and even within a single scheme it is not uncommon to revalue benefits in deferment based on CPI, and increase them in payment based on RPI.

There is an ongoing debate about whether RPI is fit for purpose as a measure of inflation. A House of Lords report recently recommended making immediate changes to the way RPI is calculated and, over the longer-term, converging RPI and CPI into a single recognised measure of UK inflation.

Quick facts:

- A small change in the way RPI is calculated could have a big impact on levels of benefits. After 20 years a 0.25% pa reduction in pension increases would lead to pensions in payment being c5% lower than they would otherwise have been.
- Using RPI instruments to hedge CPI increases could have unwelcome consequences if changes are made to RPI but not CPI, or if the two measures of inflation are combined.
- Where pension scheme rules give trustees or sponsors flexibility as to the measure of inflation then it would be appropriate to review the basis currently used and to monitor developments.

At a LCP seminar in June 2019, **69%** of the audience thought RPI needs to change from its current form in the next 2 years.

6. Develop the governance framework

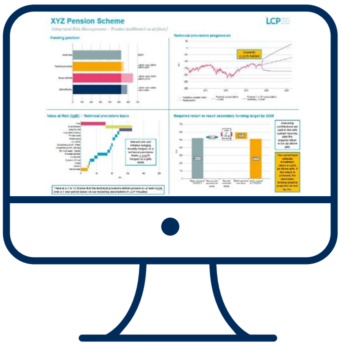
Pulling together covenant, investment and funding for the most effective journey plan

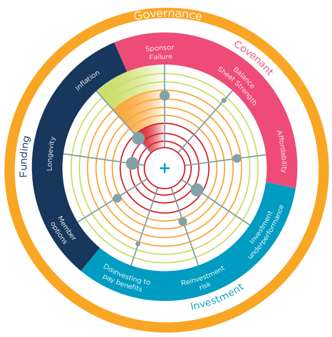
Risk management is crucial to a well navigated journey

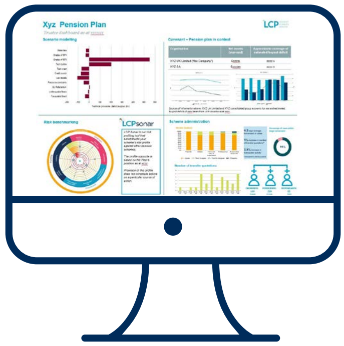
Robust governance is central to executing an effective journey plan. We share our tips for a good risk monitoring framework below:

- **Start with covenant** as this is often the key risk a scheme faces. Its ideal to use existing management information, rather than trying to reinvent the wheel, working with the sponsor on the right measures to use, and to consider the long-term covenant, as well as short term.
- **Combine covenant with funding and investment in key integrated metrics** specific to the scheme. For example, if the performance of the business stays constant, but the pension scheme deficit doubles, then the relative strength of the covenant may have deteriorated.
- **Metrics should be relevant to your end-game and planned journey.** For example, if you want to get to buy-out ultimately and expect you'll do some partial buy-ins along the way, pick metrics related to what needs to happen to make that first buy-in feasible.
- **Consider how far metrics would need to move for them to warrant action.** For bad news, this could include; engaging with management to understand the drivers for the change, considering the implications for investment and funding strategies, and additional support for the scheme. Good news could trigger an investment de-risking step.
- **Monitor those metrics closely to capture opportunities** and pre-agree the actions so you can move fast when they arrive. Our online tool, LCP Visualise, can be used to monitor integrated covenant, investment and funding metrics.
- **Create a "live" risk document** that tabulates your key risks, how they are currently being monitored and managed, and current actions in progress in relation to those risks. This document should include the intended long-term funding target and journey plan so progress against this is also tracked. Maintaining and continuously updating such a document and tabling it at each trustee meeting, with a risk dashboard capturing the current position, can be powerful and effective.

> *LCP Sonar is built around key metrics in each financial risk area. Some of our schemes now track the change in their own position using these metrics. Others have evolved this structure into something bespoke that more closely reflects their unique circumstances.*





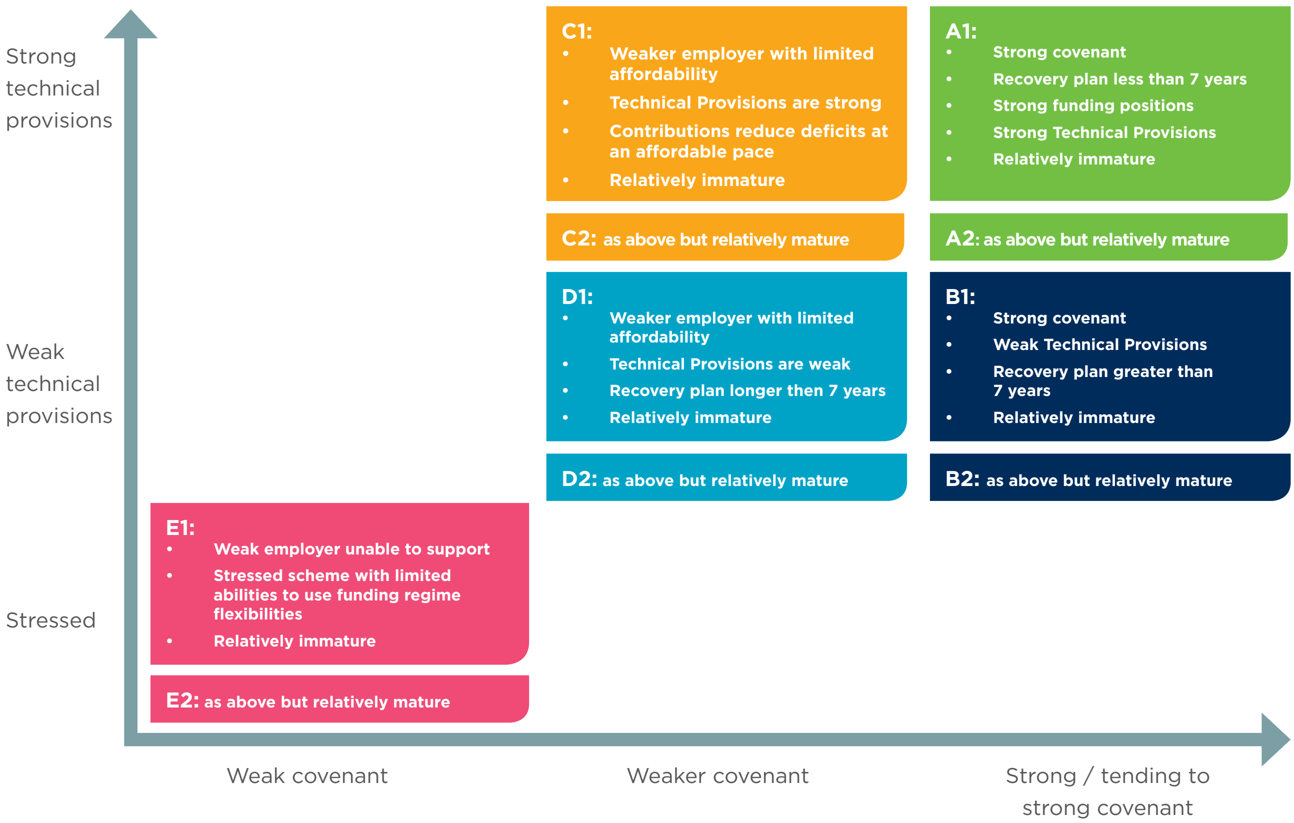


The future of funding: everything changes or nothing really changes?

Following the Government's 2018 White Paper, the Pensions Regulator has been ramping up its guidance on how schemes should be funded and managed – the Annual Funding statements of 2018 and 2019, as well as more recent TPR blogs, have clearly signalled a direction of travel toward a new world of DB pensions regulation and oversight.

In its latest corporate plan, the Regulator sets out new KPIs: to increase deficit contributions and to reduce the length of recovery plans. And it's not just about funding. Views on contributions are intertwined with how investment strategy should be set, as well as how views on the sponsor's covenant underpin all key decisions.

The 2019 Annual Funding Statement set out the Regulator's expectations of trustees, and highlights circumstances where the Pensions Regulator may intervene. The first step in working out what this means for your scheme is to consider which of the Regulator's 10 classifications your scheme fits into - as shown below.



The Statement then sets out what the Regulator expects for each category. Read our blog to find out more for what this might mean for trustees currently undertaking a valuation.

Details are not yet clear, but it seems likely that the future funding regime will have the following features

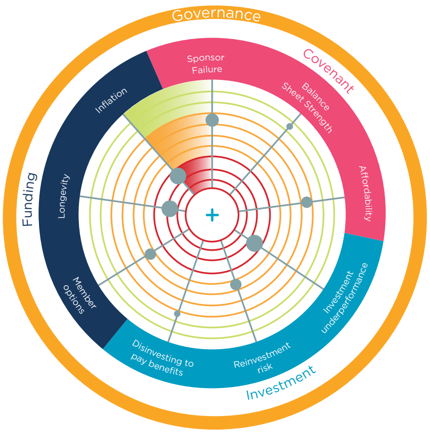
- A requirement to set a long-term funding target and to focus funding and investment strategies on getting there, based on a robust understanding of the covenant to the scheme.
- More emphasis on funding deficits over a shorter period, over which trustees can have confidence in the covenant support available.
- Requirements to document the approach taken to integrated risk management, potentially through a regular statement by the Chair of Trustees.

What should trustees do next?

Each scheme is in a unique position and what's needed more than ever are informed decisions and clear advice, joining up investment, funding and covenant aspects to empower each set of trustees to confidently make the decisions that are right for their scheme.

Could you weather a pension storm?

To assess your current approach to managing risk, you could complete the detailed checklist on the next page, or you can ask your LCP contacts, or one of our risk management experts to show you how your scheme stacks up on LCP Sonar.



How LCP can help

There are a number of areas where we can help, including:

- Setting your long-term funding target and designing your journey plan, perhaps at a joint trustee and sponsor workshop
- Understanding your covenant
- Providing practical insights from long-term modelling
- Agreeing contingent funding solutions
- Planning a dynamic investment strategy to deliver your needs
- Setting up and managing an integrated risk management framework
- Providing a roadmap for using bulk annuities or longevity swaps along your journey to securing benefits
- Advising whether a pension consolidator may be appropriate for the scheme
- Putting robust governance structures in place

More and more, we see trustees expecting their advice in each area to come with the perspective of the broader context, and for one adviser to pull it together, combining covenant, investment and funding advice and presenting a unified picture.

We are an independent consultancy firm with award winning funding, de-risking, investment and covenant teams all working together for our clients under one roof. We believe this puts us in an ideal position to support with this role.

Michelle Wright
Scheme Actuary

For all schemes, the Regulator asks trustees to set a long-term funding objective, for trustees and sponsors to agree a clear strategy for achieving it and for risks to be properly managed along the way.

How do your risks stack up?

Checklist: can you answer these key questions?

	Actions to consider	✓
Have you chosen your ultimate destination?	• Receive training on options including insurance solutions and consolidators • Understand the views and priorities of the sponsor and trustees • Compare the costs and benefits of each option, taking into account future scheme expenses	
What are the key features of the covenant?	• Obtain independent professional covenant advice • Consider what is an affordable level of contributions, both now and in the future • Consider the extent to which the covenant can support investment risk now and in future • Understand the extent to which members benefits would be exposed in a sponsor insolvency • Consider ways in which the covenant might be strengthened, and engage with the sponsor	
What is an appropriate timeframe for reaching your objective?	• Consider the longevity of the sponsor covenant • Quantify what is achievable based on affordable contributions and supportable levels of risk • Consider the risk that members' benefits are not paid in full based on different scenarios • Consider your cashflow profile and how fast the scheme matures	
What should your investment strategy be now and how do you expect it to change over time?	• Understand the total returns that you need to generate over the period until you reach your goal • Consider when the covenant is best able to support the risk required to target those returns – use this to decide on how investment risk and target return should vary over time • Consider liquidity requirements and how they are expected to develop • Consider all available asset classes and how best to deliver the required returns in a risk-controlled manner • Based on all the above, consider supportable levels of hedging and how best to achieve them • Make sure the ultimate strategy is consistent with your goal eg make sure assets can be sold or transferred to an insurer, if that is your objective	
Does your funding strategy reflect the above?	• At your next valuation make sure the technical provisions reflect the expected future changes in the investment strategy	
What are the key risks that you face en route to your ultimate objective?	• Use LCP Sonar to help identify key areas of risk • Consider any risks specific to your sponsor and/or scheme • Consider the external risk environment (eg climate change) and the potential impact upon covenant, investment and funding risks • Capture the key risks in a working risk document	
How are those key risks being managed?	• Add current controls to the working risk document • Consider holding a risk workshop to identify any additional ways to manage risk • Track resulting actions and update the risk document on a continuous basis • Agree and document a clear contingency planning policy in the event of downside risks materialising	
How are those key risks being monitored?	• Capture key metrics in an easy to read risk dashboard • Agree an information sharing protocol between the trustee and sponsor • Implement an integrated covenant, investment and funding monitoring framework	
Are you confident in your data and benefits?	• Identify areas where data is incomplete • Prepare a benefit specification and agree it with your administrators, actuaries and lawyers • Commission a benefit calculation audit • Complete GMP reconciliation, rectification and equalisation processes	
Do you have robust and nimble governance structures in place?	• Consider how frequently the Trustee board should meet • Review lines of communication with the sponsor, and the level of participation of sponsor representatives in Trustee business • Review the scope and composition of any Trustee sub-committees • Consider diversity of board and implications of group think	

Contact us

At LCP, we have joined up experience across covenant, funding and investment.
For further information, please contact one of us or your usual LCP contact.

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At LCP, our experts provide clear, concise advice focused on your needs. We use innovative technology to give you real time insight & control. Our experts work in pensions, investment, insurance, energy and employee benefits.

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