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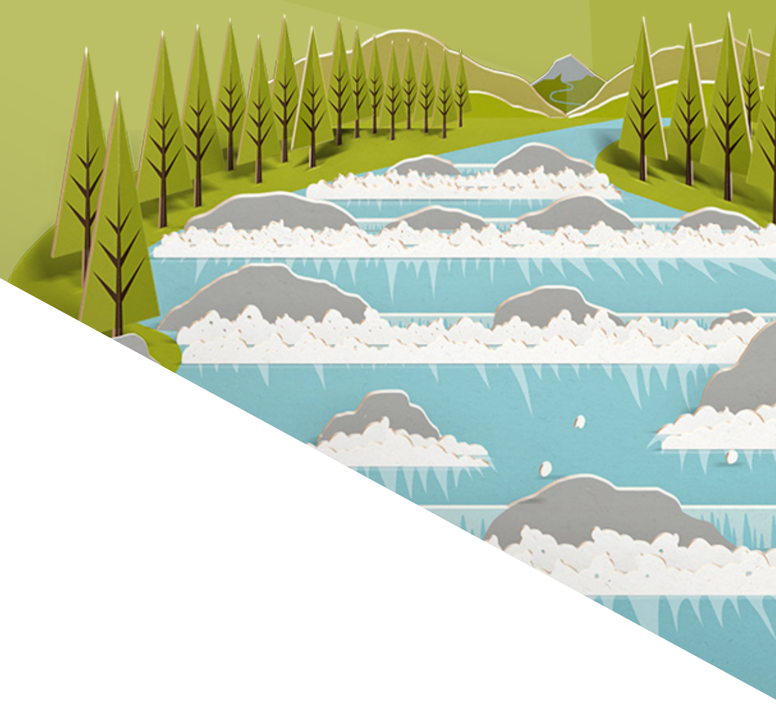
beyond the expected



FTSE350 PENSIONS

Covid-19 delays the endgame

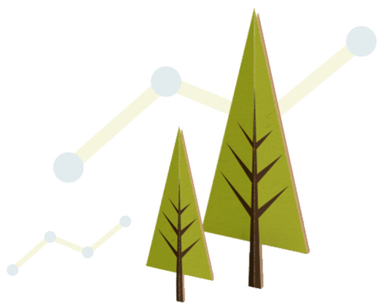
As the defined benefit (DB) pension landscape has matured, the focus of companies and trustees has naturally shifted to the endgame. If a long-term plan to reach endgame is not already in place, regulation will soon make this a necessity. From a funding perspective, The Pensions Regulator's (TPR) review of the funding regime is arriving at a difficult time.

Covid-19 has put unprecedented strain on businesses, while at the same time putting downward pressure on DB scheme funding levels. Reaching the DB pension endgame will now undoubtedly be a more demanding target for many schemes.

In this analysis of the FTSE350 companies with DB pension obligations, we quantify how the economic turmoil of Covid-19 has impacted on the path to endgame.

The calm before the storm

At the beginning of the year, with the world unwittingly on the edge of a precipice, the outlook for the UK's DB schemes looked fairly clear. While government bond yields had fallen during 2019, strong equity market performance and falling inflation expectations provided a relatively benign backdrop for DB scheme funding. In early March, TPR published its consultation on a revised DB funding code of practice, setting out its intentions for the future regulation of DB scheme funding, and broadly committing to paper the messages that it had been communicating over the previous couple of years.

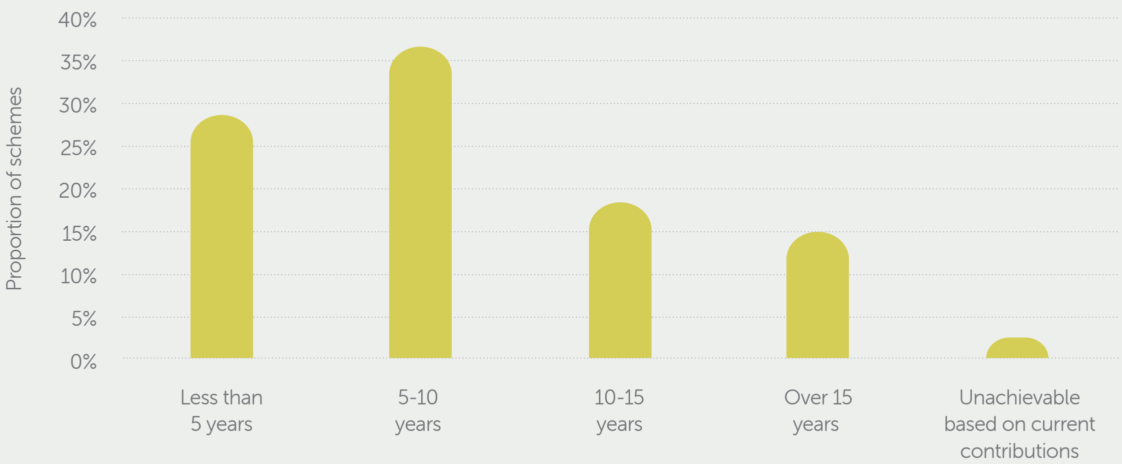


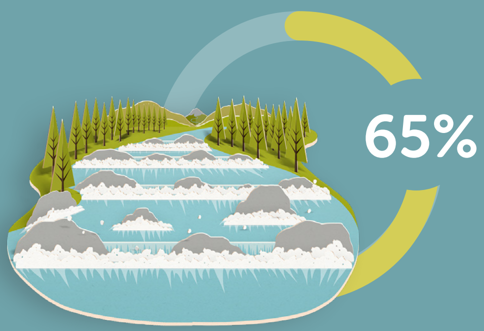
The key focus of the consultation was for each DB scheme to put in place a long-term funding plan for reaching the endgame, at which point the scheme should have a low level of dependency on the sponsoring employer.

In the analysis that follows, we consider the time expected for the FTSE350 DB schemes to reach full funding on a buyout basis. This is intended to approximate the time to reach the DB pensions endgame, though this will not be the ultimate objective for all schemes. Achieving some form of self-sufficiency or transferring to a consolidator may also be valid endgame targets - the chosen target should reflect the specific circumstances of the scheme and its employer.

The chart below shows the expected time to buyout for the FTSE350 DB schemes as at 31 December 2019. This is based on the deficit contributions being paid over 2019 continuing until full funding on a buyout basis is achieved.

TIME TO BUYOUT





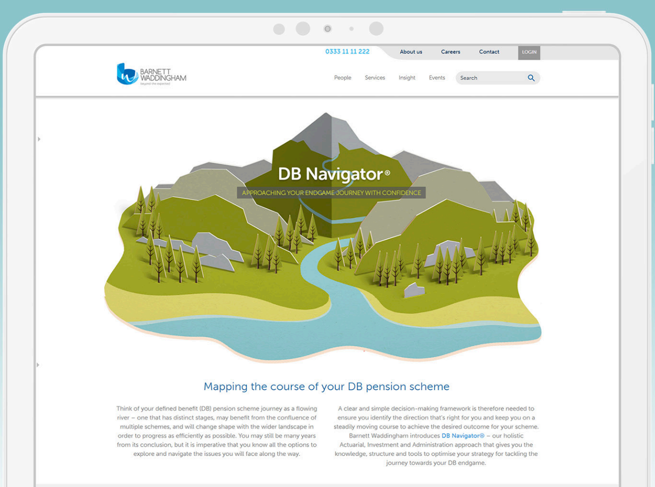
At **31 December 2019**, our calculations suggest that around **65%** of the FTSE350 DB schemes would have been in a position to **buyout** within **10 years**, with around **28%** potentially able to **buyout** within **5 years**. The **average time to buyout**[1] was around **8 years** and **2 months**.

[1] Note the average time to buyout calculation excludes schemes where time to buyout exceeds 30 years

What is an endgame?

We believe that an endgame consists of the following elements:

- An achievable endgame target for securing members' benefits given the strength of the covenant of the sponsor.
- Considering the options available to settle benefits for some or all of the members before the final endgame is reached.
- An associated contribution and investment strategy that enables the endgame to be reached within an appropriate timeframe and acceptable cost and risk constraints given the strength of the sponsor's covenant. This will include a clear plan for de-risking the investment strategy over time.
- A real-time monitoring process that enables progress along the journey plan to be measured and for the strategy to be reviewed and potentially adjusted according to actual experience.



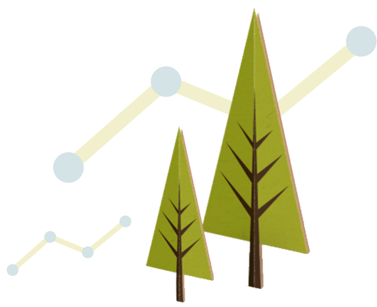
Discover more about your endgame:

https://www.barnett-waddingham.co.uk/db-navigator-end-game-journey/

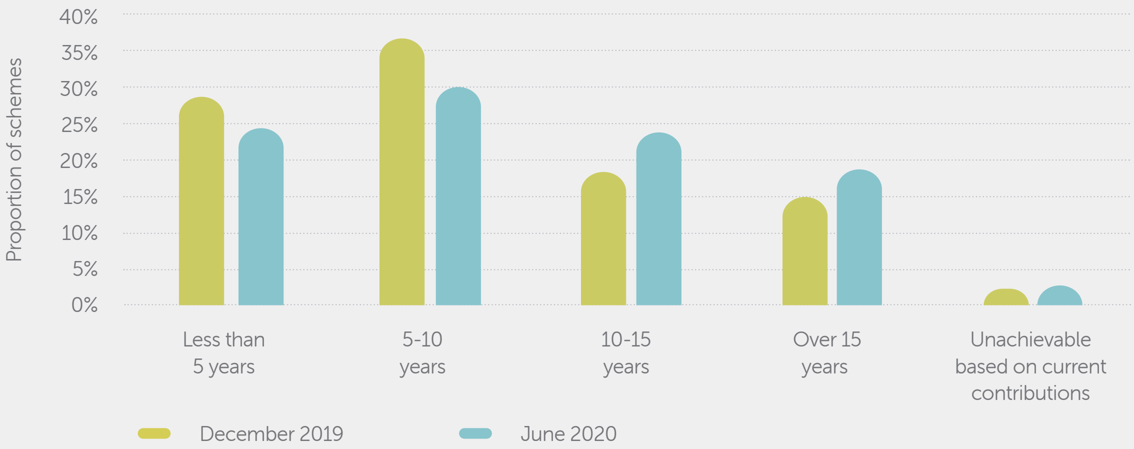
The Covid-19 setback

The extreme measures taken to contain the Covid-19 pandemic have had a severe impact on the UK economy. At the start of the UK lockdown, the FTSE All Share index fell by over 25%, causing a steep fall in funding levels for any schemes with a material equity allocation. While equity markets have started to recover since the lows at the end of March, yields on index-linked bond yields remain around 0.5% lower than they were at the start of the year, putting strain on funding levels for any schemes with unhedged liabilities.

Overall, the disruption to financial markets has been a stumbling block for DB schemes on the path to the endgame. The chart below shows the impact that this has had on the expected time to buyout for the FTSE350 DB schemes, comparing the position at 30 June 2020 to the position at the start of the year.



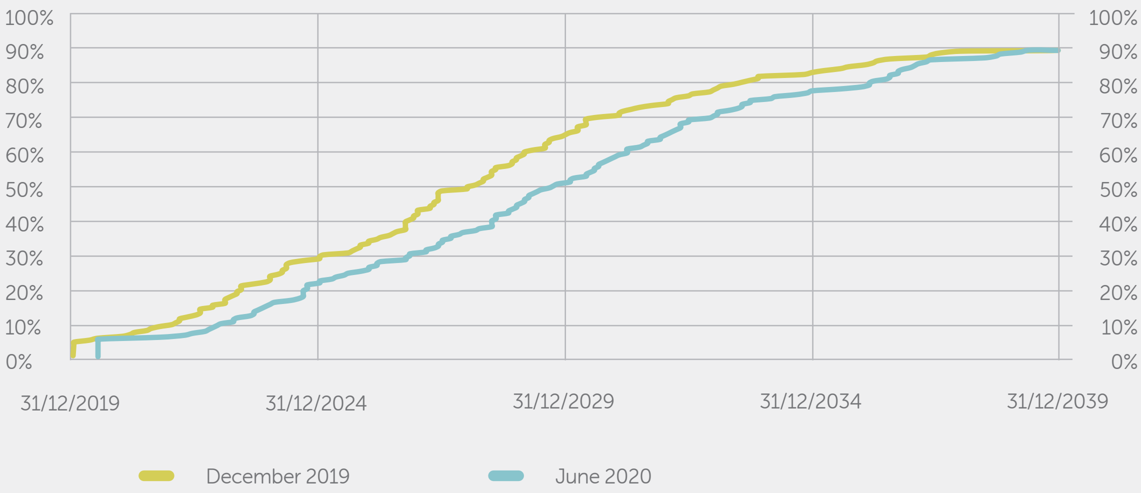
TIME TO BUYOUT



Based on the position at the end of June, around **55%** of the FTSE350 DB schemes can now expect to be in a position to buyout within 10 years, down from **65%** at the start of the year.

The average time to buyout is now around 9 years and 2 months. Allowing for the 6 months that have elapsed, this means that Covid-19 has pushed back the DB pensions endgame by around a year and a half for the FTSE350 companies. For the average time to buyout to return to the position at the start of the year, the FTSE350 companies would need to step up their deficit contributions by around a third relative to current levels.

PROPORTION OF SCHEMES ACHIEVING FULL FUNDING ON BUYOUT BASIS



The chart above shows the projection of the proportion of the FTSE350 schemes reaching full funding on a buyout basis in the future. These calculations assume that the contributions paid during 2019 remain unchanged. Given the strain that many employers have been under, and the steps taken by a number of organisations to defer deficit contributions, this might be an overly optimistic view. Striking a balance between an appropriate level of deficit contributions and the recovery of business to a stronger standpoint will be a key challenge for companies and trustees alike over the coming months.

TIME TO BUYOUT

The importance of deficit contributions to the long-term health of DB schemes is illustrated by the chart above, which shows the impact on the DB endgame for the FTSE350 at the end of June if future deficit contributions are half those paid during 2019.

> A 50% reduction in deficit contributions would reduce the proportion of FTSE350 schemes able to buyout within 10 years to around 40%. The average time to buyout for the FTSE350 would increase significantly to 11 years and 3 months – over a 3-year increase from the position at the start of the year.

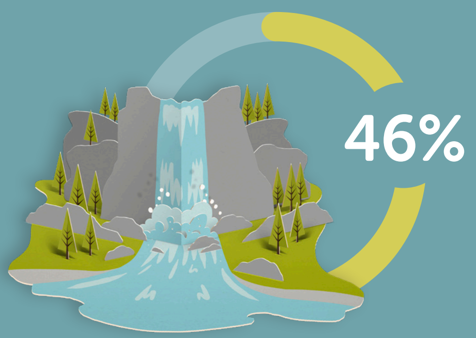
At the extreme, if contributions ceased completely, fewer than half of schemes would be in a position to buyout within 15 years. This is clearly not a plausible scenario, but demonstrates how reliant DB schemes are on their employers to complete the journey to endgame within a reasonable timeframe. Some employers will get an unwelcome reminder of this point when full funding is achieved on a technical provisions basis. In a number of cases, achieving this goal will simply be a checkpoint on the journey to the endgame, rather than an opportunity to cease contributions.

Another way out?

TPR has recently published details of an interim regulatory regime for capital-backed consolidators or "superfunds". Established as a potential alternative to the insurance market, these vehicles could provide a compelling endgame target for companies looking to relinquish responsibility for the management of their DB scheme. While transferring a DB scheme to one of the superfunds will require a specific set of circumstances, the attractive pricing of these arrangements relative to the insurance market will undoubtedly draw the attention of a lot of companies.

Based on our understanding of the current pricing of the superfunds, the chart overleaf sets out the time expected for the FTSE350 schemes to be in a position to transfer to a superfund at 30 June 2020. This is compared to the time expected to buyout with an insurance company.

TIME TO ENDGAME



Our calculations suggest that, based on current contributions, around **46% of FTSE350 schemes** might be in a position to transfer to a **superfund within 5 years**.

This compares to 24% that might be in a position to buyout with an insurance company in the same timeframe. The proportion of schemes potentially in a position to transfer to a superfund within 10 years is around 78% - an increase of 23% relative to the 55% of schemes potentially able to buyout in the same period.

Clearly, these vehicles could provide an opportunity for companies to reach the endgame sooner than anticipated if buyout is the current target. However, careful thought will be required to determine whether this is the best solution for the scheme's members, taking into account the particular circumstances of the scheme and the sponsoring company.

A delicate balance

At the beginning of the year, nobody could have predicted the extraordinary events that we have seen. The economic impact of Covid-19 has pushed back the time to endgame for most schemes. Now that the peak of the crisis appears to have passed, the challenge for the pensions industry will be to decide how the funding of DB schemes fits into the picture of an economy in recovery.

While TPR's review of the funding regime might formalise existing practice for a number of schemes, for others a thorough and clear-headed assessment will be needed to agree a plan to reach a low dependency funding position. A delicate balance will be needed to ensure that this plan does not jeopardise the company's ability to rebuild its business, whilst at the same time ensuring that the security of member benefits is not compromised.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

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