A methodical approach to determining the alternative strategic options for a DB scheme

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Introduction

Much market commentary has highlighted that the universe of potential strategic options for DB schemes beyond the traditional alternatives of “run off as is” or “buyout” has grown markedly in recent years – but take-up on a number of these has anecdotally been limited.

Part of this limited take-up may reflect a recent focus on navigating the pandemic – but it may also reflect a lack of familiarity with the available options and an instinctive nervousness amongst trustees about considering structures which might, for example, sever the longstanding employer/scheme relationship.

But in circumstances where sponsor longevity may call the success of an organic run-off into doubt; and a buyout seems unaffordable in any but the most extended timescales, we see a strong case for a methodical and proportionate assessment and evaluation of alternatives so as to ensure that opportunities are not missed; trustees and sponsors are prepared for any chosen option(s); and, as a consequence, the chances of members receiving their expected benefits are maximised.

This paper sets out a suggested methodical, multi-disciplinary and efficient approach to defining realistic possible options; understanding when they might be achievable and at what cost; and then forming a structured plan for tracking towards a chosen option(s) without unnecessarily shutting down others.

The paper acknowledges the considerable market commentary around various strategic and “endgame” options and approaches to them from a range of market participants.

It emphasises that any approach should be cost-effective and proportionate; and commensurate with sponsor and scheme circumstances. The suggested approach is designed to build upon existing information and knowledge – rather than initiating extensive “greenfield” analysis.

At the point of execution of a preferred option, trustees will wish to be confident that they have considered the various alternatives; and that their choice reflects a robust analysis of both the circumstances of their scheme and its sponsor.

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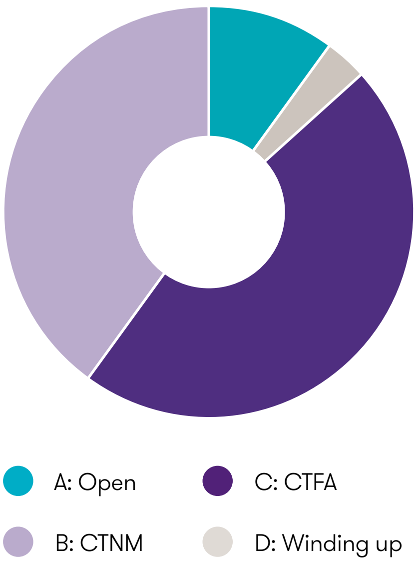
Market backdrop

Statistics from the Pensions Regulator illustrate the progressive increase in the combined number of DB pension schemes closed both to new members and to future accrual[1]. This trend has led to a growing universe of "closed schemes".

The proportion of schemes closed to new members ("CTNM") and to future accrual ("CTFA") as at 31 March 2020 is illustrated in the diagram from the Pensions Regulator reproduced below[2]:

Schemes by status

Figure 1: Distribution of schemes by status



Closed schemes: sponsor and trustee dynamics

Schemes which are closed both to new members and future accrual may be seen by their sponsors as "legacy liabilities", to be managed and contained in a financially efficient way – but of no obvious value as a reward or motivational tool to current generations of employees.

Indeed, the cost and risk associated with funding a (relatively) substantial DB scheme can be seen as a source of strategic competitive disadvantage when compared to newer competitors unencumbered by these liabilities.

Although there are inevitable tensions between scheme trustees and sponsors around the funding of legacy DB schemes – in particular around levels of cash contributions – there are underlying goals which are perhaps more aligned than might otherwise be apparent: the sponsor may well wish to be decoupled from the scheme – or at least to know that the scheme was, figuratively, safely "in a box" with little, if any, further funding needs; and the trustees will equally like to see it safely positioned so as to deliver its members' promised benefits in full.

In cases of potential sponsor fragility, although logically it may seem that trustees should be unconcerned as to whether the scheme remains connected to the sponsor or not provided the chances of their fiduciary obligations to members to meet their benefits are maximised, in practice trustees may find agreeing to a separation challenging: this may either reflect a long term sponsor/scheme relationship; or a "fear of the unknown" and any associated regret risk.

1 DB defined benefit annual report | The Pensions Regulator
2 DB defined benefit annual report | The Pensions Regulator – Table 1

Closed schemes: emerging strategic options

Recent regulatory consultation around a new DB funding code explored the option of a "fast track" assessment of scheme valuations where they are funded on a "low dependency" basis[3]. The Pension Schemes Act 2021 has introduced a further statutory requirement for schemes to have a funding and investment strategy with specific targets[4].

A number of potential strategic alternatives for running off closed schemes outside the traditional bilateral sponsor/trustee "runoff" model or scheme buyout have emerged. These include DB Master Trusts; other forms of pension scheme consolidator; and various types of "capital backed" solutions. Certain of these models involve sponsor separation; others cost scale economies and/or investment enhancements.

A regulatory framework for the "superfund" option was consulted on by the DWP in 2018[5] – although the draft legislative framework for scheme consolidators is, at the time of writing, yet to be published. The Pensions Regulator has, however, published a range of guidance both for trustees and consolidators themselves[6].

Although a number of alternative models and structures have come to market within the past 2-3 years – in response both to perceived market need and opportunity – the use of these alternatives has anecdotally been slow to develop. This may in part be due, for example, to ongoing regulatory approval processes for some providers; to trustees (and sponsors) wishing to see "others go first"; to pricing gaps; to a clear and present focus on getting through the Covid-19 pandemic; or simply to inertia given that so many alternatives seem to have arisen within the space of 2-3 years and it is taking time for trustees and sponsors to appreciate what might be available.

The case for evaluating strategic options for schemes

Although the market for alternative scheme strategic options still seems to be settling, the need for trustees and sponsors to ensure that they are finding the appropriate alternative for a scheme remains.

For sponsors with a progressively atrophying covenant, simply running the scheme on organically whilst ignoring available alternatives could be regarded as a poor strategy: even a "self-sufficient" or low dependency level of scheme funding still requires a sponsor to survive for a long period to meet members' benefits in full. It is not necessarily a reliable "endgame" unless the sponsor can survive until the last benefit is paid or the scheme can afford a buyout, both of which may be a number of decades away.

In reality, many schemes and sponsors may not be able to afford an alternative to the status quo – now. But some may be able to in relatively short order, or in the medium term. And for those who cannot afford an alternative to the status quo, knowing that they have explored other options – albeit at a high level – may provide comfort that their ongoing strategy is the best option available.

The need for a plan

Given the clear case for finding appropriate strategic options for schemes in order to deliver members' benefits securely, we see a strong argument for trustees and sponsors to consider their options in a robust and methodical way; evaluate and potentially plan for those which might be realistically available; and have a strategic plan against which they track dynamically – being ready to evaluate in detail, and if appropriate execute, affordable options when these offer better security for members' benefits than the status quo or other options.

Against this backcloth – and building on our own experience of advising on the systematic evaluation of a range of strategic and endgame options – we outline below a robust and rigorous method for analysing the options available to a scheme; and for developing a robust strategic plan which can be progressed in a systematic and dynamic way over time.

3 Defined Benefit funding code of practice consultation | The Pensions Regulator
4 Schedule 10, Pension Schemes Act 2021.
5 Defined benefit pension scheme consolidation - GOV.UK (www.gov.uk)
6 See, for example, Guidance for DB superfunds | The Pensions Regulator

Current strategic options – a synopsis

The table below summarises a range of categories of existing strategic options. The table illustrates that some of the options involve sponsor separation whereas others do not; and that the range of counterparties to different options is very wide – with a variety of business models and propositions.

Given this broad range of options, how can trustees and sponsors evaluate them and determine which might be right for their circumstances?

Category of option	Comment
"Organic run-off"	The success of this option in delivering members' benefits intrinsically depends on a scheme's funding position and required sponsor longevity.
Bulk annuity transactions – buy-ins and buyouts	Fully insures benefits – although there are structural differences between buy-ins and buy-outs. Pricing reflects insurance-based product and market conditions.
Capital-backed solutions – no employer separation	Products vary depending on provider. Usually assume sponsor continuity.
Consolidator solutions – no employer separation	Can offer administration and investment scale economies – but sponsor continuity assumed.
Consolidator solutions – employer separation	These involve sponsor separation at a reduced price compared to buyout. Regulatory regime evolving.

Getting started

We believe that strategic options evaluation should be approached strategically and methodically; and be underpinned by robust project management.

Whatever approach is adopted needs to be proportionate and realistic given sponsor and scheme circumstances.

Depending on progress and stages reached, the process might involve multi-disciplinary teams to support both trustees and sponsor. The teams are likely to include covenant, actuarial, investment and legal advisers – albeit, for smaller schemes, these advisers may only play specific roles at specific times.

It is essential that there is a clear understanding of objectives and context from the outset; that the chosen approach is commensurate with circumstances; and that good project discipline is established from the outset with clearly agreed deliverables, timetables and budgets. Depending on the nature of the scheme and the potential range of options available, Trustee boards may wish to set up a delegated sub-committee to oversee the project, reporting back to the full board when appropriate.

For the reasons described below, the outcome(s) of the project are likely to be very uncertain in the first instance. But approaching the analysis in a structured, methodical manner with sound governance should improve both the likelihood of success; optimise decision-making; and contain both costs and time spent.

From a timing perspective, it may make sense to initiate the project alongside, or at the conclusion of, an actuarial valuation, leveraging the "baseline" work already undertaken.

Defining the key boundaries and setting aside apparently unviable options

Before embarking on a detailed evaluation of individual strategic options, we believe that there are some key boundaries to the decision-making which need to be understood and defined – all of which are capable of evaluation. These boundaries can be evaluated building on recent valuation, monitoring and IRM work: they do not necessarily require "greenfield" analysis at high expense.

Knowing where options sit relative to these boundaries will be informative in determining (i) whether they should be pursued at all; and (ii) if they are to be pursued, over what time horizon(s). These boundaries are:

Boundary	Analysis
Sponsor longevity	Understanding realistic timeframes over which a sponsor might remain in existence is a central element of decision-making: targeting a buyout in, say, 15 years when sponsor survival may be under threat within, say, 3-5 years may be a high-risk strategy for meeting members' benefits in full. There are a range of tools and techniques for undertaking sponsor longevity analysis[7].
The realistic availability and timing of further cash funding from the sponsor	Unless a scheme is sufficiently well funded to be bought out or enter a consolidator without a further level of funding, most alternatives to an organic run-off "have a price". Understanding how much cash could be available, from whom and when is a key boundary for the evaluation of potential options. This may be nuanced: a parent company may be willing, for example, to finance a transaction with a consolidator in order to achieve scheme separation from its subsidiary – but otherwise be reluctant to fund a buyout or pay additional contributions into a scheme absent legal obligation. Trustees may wish to engage with sponsors and parents about the availability of additional cash to finance options once they have undertaken their preliminary assessment.
The potential funding evolution of the scheme	Measures of deficits at actuarial valuations – such as technical provisions; self-sufficiency or buyout are helpful points of reference. Stochastic modelling and investment VaR analysis can provide an overlay of how the scheme's funding position might evolve for a given investment strategy and, therefore, help scale any likely additional funding need to finance an alternative strategic option compared to an "organic" run-off baseline option.

7 See the ECPA paper regarding sponsor longevity – accessible at: ECPA paper emphasises the importance of professional judgement in evaluating sponsor longevity – ECPA (Employer Covenant Practitioners Association)

An assessment of a scheme's position relative to these boundaries provides a framework around which various options can be evaluated. This assessment can be documented in a straightforward way as a precursor to more detailed options evaluation. A simplified example template for a hypothetical scheme is set out below:

XYZ scheme: endgame planning boundary evaluation template as at [ ] 2021

Boundary	Analysis	Comment and next steps
Sponsor longevity	Based on advice, we estimate that longevity in the range 3-5 years is reasonably secure, but competitive analysis suggests that the sponsor may atrophy markedly after that given the capital needed to remain competitive.	Agreed working assumption of five years for endgame options assessment – to be monitored dynamically.
Cash availability	Discussions with the CFO, triangulated with our advisers, indicate affordability of a maximum of £[ ]m per annum for five years, with a deeply uncertain position thereafter. This is the amount reflected in the recovery plan. The parent has indicated that they might provide additional support of £[ ]m if this achieved employer separation.	Agreed working assumption of cash of £[ ]m for the next five years to meet recovery plan payments and possible injection of £[ ]m to facilitate scheme separation.
Funding evolution	The Scheme Actuary estimates that there is an [ ] % probability of achieving a funding position based on Gilts plus 25bps within three years, with that probability rising to [ ]% by the end of five years. The estimated one year VaR using the current investment strategy if £[ ]m.	Agreed not to adjust the investment strategy at this stage – but to derisk dynamically once the funding position is fully funded on a Gilts plus 50bps basis.

With this boundary framework in place, the preliminary analysis of options can commence – with a view to discounting options which are unlikely to be viable.

Using the case study above, the Trustees might conclude that unviable options include:

XYZ scheme: summary of high risk or apparently unreliable "endgame" options – [ ] 2021

Option	Analysis	Comment and next steps
Organic run-off to meet members' benefits	Sponsor longevity analysis suggests that this option is very high risk.	Continue our covenant monitoring but evaluate feasible alternatives. Whilst this option is the "default", seems unlikely to deliver members' benefits in full.
Transfer to a DB Master Trust	Scale economies and efficiencies do result in cost savings – but the scheme is still reliant upon the sponsor (see longevity problem above).	Not a preferred option at this stage.
Buyout	Sponsor longevity analysis and funding position suggest that this option is highly unlikely.	Discount for the time being.

Preliminary analysis of potentially viable options

Based on this analysis, the trustees and/or sponsor can consider the universe of remaining options with their advisers and determine whether to seek pricing from the relevant providers; and to receive presentations from them as to how any transaction might work.

This will involve initial contact and discussion with the providers; considering whether each option could be viable; and the agreement of datafiles to be provided for preliminary pricing.

Pricing alone is by no means "the answer" – there is a very broad range of other factors to consider – but obtaining indicative pricing is an obvious key next step in evaluating which option may or may not be workable.

As independent advisers, in this paper we do not wish to imply any position or pricing by any individual provider – for example, consolidator or capital-backed solution provider. On this basis, the paper continues by assuming that there are four possible providers of strategic options which the trustees may wish to evaluate – referred to simply as "A, B, C and D". These are purely illustrative but, as shown below, are assumed to have certain different aspects to their business model.

On the assumption that the hypothetical scheme trustees referred to in the example templates above seek pricing from A, B, C and D, the core financial and strategic aspects of possible transactions with these counterparties might be summarised as follows:

XYZ scheme: synopsis of key financial and strategic dynamics of potential transactions with A, B, C and D

Provider	Employer separation	Day one cost – using data as at [ ] 2021	Comment
A	Y	£[ ]m	Day one cost exceeds parent and sponsor current financial capacity – but this is a credible option to keep monitoring. It may become possible, depending on the scheme's funding, in 1-2 years' time
B	Possibly – but will require a new vehicle	£[ ]m	Position around sponsor separation needs further evaluation. Overall structure attractive. There is a possible separation structure to facilitate this option which is being investigated further.
C	Y	£[ ]m	A "possible" in 2-3 years' time but will require parental support and necessary regulatory clearances etc.
D	N – clarified sponsor needs to remain	No additional cash needed	This is essentially an investment-related option and does not solve the challenge around sponsor longevity within our working longevity time horizon of five years.

The illustrative table above shows how – notwithstanding the problems in this case associated with an organic scheme run-off (due to sponsor longevity issues) and with a buyout – a number of potential options are available, albeit with some key points of clarification in some cases.

Option D does not seem to be feasible. Options A, B and C are potentially capable of execution (subject to further analysis) – and can be taken forward to an initial planning stage.

Developing a dynamic plan before selecting a preferred option at the appropriate time

The analysis set out above has identified a number of potential options for further investigation – certain of which seem potentially viable downstream.

No option needs to be cut off at this stage: indeed, the picture may change over time. For example, the sponsor may be acquired in circumstances where its longevity is extended due to investment by the purchaser.

However, the analysis and pricing work mean that elements of a potential plan have emerged which can be refined as further information becomes available and circumstances develop.

Given the number of uncertainties and points still to be clarified around the identified options – some of which are highlighted below – the developing plan is likely to be dynamic, being periodically updated both as further and better information is made available and the scheme's and sponsor's position evolves.

Beyond the financial analysis

The analysis has shown a strong emphasis on the financial achievability of options and the central issue (in this case) of employer separation.

However, before deciding on the attractiveness of any option, further analysis around a range of other factors will need to be undertaken – in particular around counterparty strength, robustness of business model and overall perceived suitability; and execution issues such as any necessary regulatory clearances.

The elements of this analysis will be varied – but important – and will ultimately include issues such as how comfortable the trustees and sponsor feel about the option prior to committing to further work (mindful of the scope for any downstream "regret risk"); how straightforward execution of any transaction seems to be; and the extent of any regulatory or other clearances required for it to take place.

In practice, the analysis and due diligence required prior to any actual transaction is likely to be very substantial – albeit that the regulatory guidance in this area is evolving[8]: at this stage, however, for initial planning purposes, the analysis should be sufficient to determine whether the option is feasible "in principle" – subject to further downstream work.

From the preliminary analysis, the identified possible options – in this case Providers A, B and C – might be ranked as set out below, with, of course, considerable supporting documentation sitting behind this summary:

XYZ scheme: preliminary synopsis of possible strategic/"endgame" options

Provider	Indicative Day one cost – using data as at [ ] 2021	Has the counterparty achieved regulatory approval?	Indicative attractiveness ranking (5 = very attractive; 1 unattractive)	Estimated timescale – years	Next steps
A	£[ ]m	Y	4	1-2	Nothing further at this stage – monitor
B	£[ ]m	Y	5	TBC	Consider sponsor separation issues further following analysis
C	£[ ]m	N	4	2-3	Nothing further at this stage – await regulatory position

8 See, for example, DB superfunds list and assessment | The Pensions Regulator

Getting ready for a decision and preparing for execution

The work described above has sought to identify – in a robust and systematic way – realistic potential strategic options for a DB scheme.

In this stylised example, the analysis has identified potential options which seem more likely to deliver members' benefits than a long-term run-off under the existing sponsor – or a buyout which may be simply unaffordable.

Under the example, it is envisaged that the Trustee sub-committee dynamically progress the evaluation of options and situational monitoring, engaging with the sponsor as appropriate.

At some stage, circumstances may be such that the criteria for executing an actual "endgame" option can be met.

The dynamic planning process described in this paper will have prepared both trustees and sponsor for that point. Once that point is approaching, there will be a need to:

1. Refresh the options analysis and confirm that the position remains as anticipated – or consider the implications of any change. This is likely to involve updated advice around, for example, the sponsor's likely longevity and ability to fund the scheme.

2. Confirm whether the most deliverable option is the preferred option, bearing in mind any alternatives.

3. Update option pricing and commence the process towards arriving at detailed transaction terms for the preferred option(s).

4. Initiate any necessary regulatory or other dialogue and clearances.

5. Pursue appropriate contractual and governance arrangements, including all necessary advice to support a "go/no go" decision: it will be crucial to evidence the thought process and analysis undertaken prior to the execution of a preferred option.

In summary

The emergence of multiple strategic and “endgame” options, together with the lack of certainty facing many sponsors of closed DB schemes, points to the need for a robust, methodical approach to options identification, evaluation and – ultimately – execution.

We believe that this approach will require a multi-disciplinary team to support both trustees and sponsors using robust project management to approach this key strategic issue in a systematic and effective way.

This note sets out the framework for such a rigorous approach – mindful of trustee fiduciary responsibilities; the broad range of possible options; and the reality that progressing towards one or more options will require a dynamic approach, being ready to adapt as pricing or other circumstances change.

In summary, the identified steps are:

Decide on the objectives from any evaluation – and consider an overall approach which is proportionate and cost-effective relative to the circumstances.

Set up and resource a proportionate project team and, potentially, trustee sub-committee – agreeing objectives, deliverables, timelines and budgets.

Define the key “boundaries” – sponsor longevity; cash availability; and potential funding needs.

Consider non-financial factors around options which may be realistic.

Seek preliminary discussions and indicative pricing around possible feasible options to see how large any financial gap might be; and form a view around possible timelines when these options may be realistic.

Identify and “park” options which are unlikely to be viable – these do not need to be discarded but are options which are, at the time of preliminary evaluation, considered to be unlikely to deliver members’ benefits in full.

Document the possible options and plans for ongoing monitoring – identify the triggers for possible moves to further evaluation or execution.

Track the position dynamically and be ready to move forward if circumstances suggest an option may be capable of execution.

If an option(s) does become capable of execution, decide whether and how to pursue it at that time – and under what terms.

How can we help?

We have a range of experience in advising on various strategic options and have contacts at a wide range of market participants.

We can provide a broad range of advice in relation to strategic option reviews, including:

Strategic options reviews
As highlighted in this paper

Advice on bulk annuity transactions
Including sourcing quotes and advising on transactional selection and execution

Project management
Including working with other advisers such as legal and actuarial advisers

Advice on interaction with the Pensions Regulator

Sponsor longevity advice
Linked to our employer covenant offering; and illustrated using our "IRM Gateway" software tool

Advice on commercial negotiations
Including the structuring of "endgame" options

Contact us

For an informal discussion around possible strategic options analysis and evaluation, or around the market generally, please contact:

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