HYMANS ROBERTSON

Adapting to an uncertain world

Trustee Barometer - January 2017

Contents:

A shift in perspective

Once, trustees of defined benefit (DB) schemes were simply required to be prudent stewards of members' assets.

However, unprecedented changes – a decade of low interest rates, political uncertainty and market volatility, pushing pension scheme deficits to new highs - have forced the 21st century trustee to adapt. Trustees are becoming sophisticated risk managers, a trend we've seen emerging in recent years.

Our annual Trustee Barometer seeks to understand current trends in trusteeship and the challenges trustees are grappling with. This year's results show clear areas where trustees need more support, such as how best to truly prioritise and integrate covenant, balance sheet and cashflow risks.

We see two key themes this year:

1. Deficits remain an unwelcome distraction. A longer-term focus is required.

Only 1% of trustees told us they focus on the long-term probability of paying their members' pensions. This highlights that when it comes to strategy, the industry still relies on volatile balance sheet deficits and discount rates. Focusing on these in isolation is clouding the issue of how best to secure members' pensions.

53% of trustees believe their schemes could benefit from a slower and steadier approach, but a short term balance sheet focus has led to strategies that increase the cost and uncertainty of delivering members' pensions, unnecessarily putting £250bn[1] of benefits at risk.

DB is a long-term game. To help them through the course, trustees need strategic advice that's clear, gives them ownership of their strategy and aligns their interests with their scheme sponsor's where possible.

2. The real deficit is strategic leadership. Inclusive, clear and big picture advice is needed.

57% of trustees said that having a fully integrated approach to funding remains one of their biggest challenges. Discussions about technical matters like discount rates and inflation risk premiums is perpetuating the deficit problem. It focusses time and effort in the wrong places, drowning out efforts to embed a fully integrated approach to strategy and risk. Reflecting on our past Barometer surveys and the Financial Conduct Authority's ongoing review into the asset management and investment consulting industry[2] – which questions whether trustees have the confidence to challenge their advisers - is the real pension deficit a dearth of inclusive, big picture advice and leadership?

At the moment, schemes may be unwittingly putting members at risk by failing to take a broader view and strategic approach. We believe that it's our role, as advisers, to make sure that trustees are focusing on the strategy, risks and metrics that matter.

Our definition of strategy is quite simple – it's about how you get from A to B. Done well it requires clear objectives and a measurable plan to achieve them – with an understanding of chances of success balanced against the risks that can knock you off course. As the summary results on the next page show, many schemes are still leaving too much to chance.

The difference in member outcomes between schemes with a strategic approach to risk management and those without a clear, integrated, long-term strategy could be vast. We explore these themes in more detail in this year's report, with a focus on how to build more resilient strategies that deliver better results for your scheme and members.

[1]Hymans Robertson UK DB analysis. See 2016 Hymans Robertson paper 'A better future for DB'.
[2]https://www.fca.org.uk/publications/market-studies/asset-management-market-study

Is too much being left to chance?

don't focus on the probability of paying their members' pensions

Can trustees reach their goal with certainty?

23%

have no measurable plan in place to reach their goal

21%

have no specified timeframe for getting there

Barriers to sucess

say having a fully integrated approach to funding is their biggest challenge

don't have access to formal valuation results within a month

recognise cashflow negativity as an issue for their scheme

As always, a very warm thank you to all the trustees that shared their insights and views this year. We hope you enjoy reading this report. If you'd like to discuss its themes in more detail, please feel free to get in touch.

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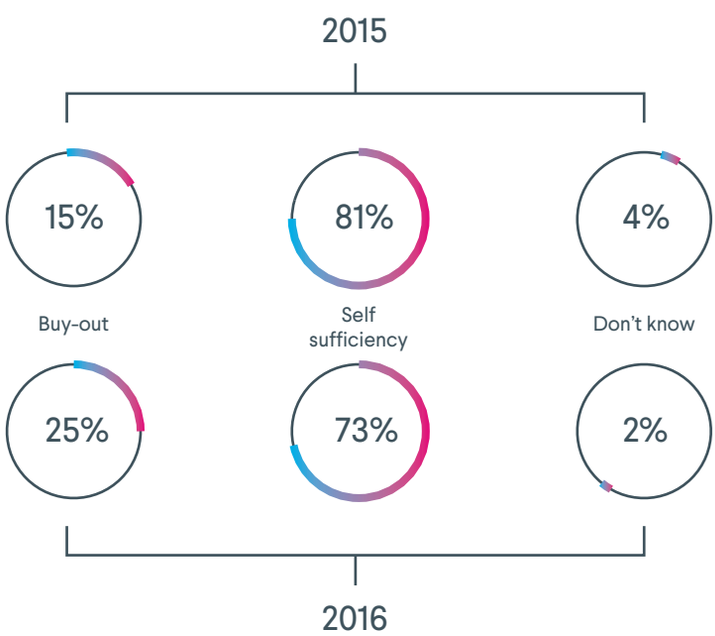
The goal

2/3 increase in number of schemes targeting buy-out since 2015

This year, we've seen a positive shift towards longer-term goal setting. However, more are failing to put in place measureable plans to reach these goals. Whilst the majority are still targeting self-sufficiency, many more trustees are now targeting a buy-out.

We asked trustees what is the ultimate goal for your pension scheme?



The news that more trustees are targeting buy-outs is encouraging. For many schemes, entering a buy-out agreement with an insurance company will be the right choice. A buy-out will give members, sponsors and trustees the secure knowledge that their benefits are protected whilst freeing up corporates to focus on their core business.

This increase could be considered surprising, given the shift has occurred after a year when buy-out is further away for many, with buy-out deficits peaking at c£1trillion[3] in August last year. However, the heightened activity we saw in the buy-in market during 2016 could account for this change. Many more schemes are exploring phased buy-ins on account of them being a natural alternative to holding ultra-low yielding gilts. They provide a more reliable contractual income, as well as being a stepping stone that makes the ultimate goal of buy-out that much more achievable.

[3]Hymans Robertson UK DB Analysis

Mission drift

Number of trustees who said they have no measurable plan to reach their goal:

Number of trustees who said they have no specified timeframe to achieve their goal:

Regardless of their end goal, it's crucial that schemes have a measurable plan and specified timeframe for achieving that goal. Without this there's a very real risk of veering off course. This year we've seen the number of trustees with no measurable plan to reach their goal almost double from 12% to 23%. This may reflect the subtle shift towards targeting buy-out as dicussed on page 4. After all, a new destination warrants a new plan, and great plans rightly take time to form.

We'd therefore expect and hope to see a real positive shift in this area next year. To avoid leaving success to chance, or getting knocked off course by unexpected bumps in the road, trustees need to build up resilience to risk through a measurable and strategic plan of action. Without a plan or a timeframe, we question whether trustees will achieve the best possible outcomes, as these are fundamental pillars of building a successful strategy.

Our view

James Mullins, Partner and Head of Risk Transfer Solutions

It's encouraging to see more trustees targeting full buy-out as their end goal. Whether targeting buy-out or self-sufficiency however, a buy-in, or series of well-planned buy-ins, can help schemes achieve their goal with more certainty.

A question I get asked regularly is, why are buy-ins attractive currently? For the first time, UK DB schemes are holding over 50% of their investments in bonds, with the majority of this in ultra-low yielding government bonds[4]. Schemes are looking for alternative ways to make their capital work harder. Buy-ins offer not only higher yields – transactions we've advised have resulted in scheme assets with a 33% higher yield than government bonds – but also income better suited to meet benefit cashflows whilst also offering longevity protection.

Competitive pricing in the market currently makes this an area schemes can really take advantage of. In our **Risk Transfer Report**, published in August 2016, we found that six of the seven insurers we surveyed were particularly keen to write large volumes of new bulk annuity business and furthermore, new entrants are expected to join this market in the coming months. But as this year's survey results show, demand is on the increase, and we expect that times when demand outstrips supply from insurance companies will become more and more common in the future. As demand grows, those schemes that have already completed a transaction will be at the front of the queue in the eyes of the insurance companies when deciding who should be offered the best pricing.

[4]The Purple Book 2016

The journey

Only 1% of trustees focus on the probability of paying pensions as a key measure

The Pensions Regulator has emphasised the importance of integrated risk management for a few years now. This means weaving together covenant risk, investment risk and funding risks to achieve better member outcomes. From this year's research it's clear that integrated risk management is an area that trustees find difficult.

Trustees acknowledge that evolving into risk managers is a challenge. Understanding risk and knowing when to de-risk (60%) and having a fully integrated and risk based approach to funding (57%) are their biggest challenges this year.

Although there are signs that trustees are thinking about their long-term goals, there are also some hints that integrated risk management is still not a reality for most.

Whilst the response above is encouraging, we'd question the extent to which this is really happening.

Why? Only 1% of trustees say they focus on the probability of paying pensions as a key measure and over half say having a fully integrated approach to funding is one of their biggest challenges this year. Paying members' pensions in full is what trustees care about, so why not focus on that?

As an advisory industry, there's been too much focus on regulatory compliance or short term measurements, with a focus on deficits and discount rates. As a result, that's what trustees hear about in meetings – gilts plus discounting, technical provisions, short term volatility and so on.

The probability of paying pensions, with a decent chance of success and taking no more risk than is required has got lost in the mix. If it ever was in the mix. This needs to be a primary driver of strategy, so that trustees can regularly review their likelihood of ultimate success, i.e. paying pensions, and evolve it accordingly to further enhance the security of members' benefits.

Although the current economic environment is challenging, our analysis of the FTSE350[5] shows that the majority of companies are in a good position to support schemes and pay members' pensions in full over the long-term. But it's time for a new approach. Sticking to the status quo is leaving success down to chance.

[5]2016 Hymans Robertson FTSE350 Pensions Analysis Report

We think it's time for the industry to shake off traditional advisory silos to deliver big picture, 'all avenues explored' advice on how best to deliver members' pensions. Otherwise we face a £250bn[6] reduction in benefit security for UK DB. Advisers need to guide and support trustees to focus on what matters and embrace a truly integrated approach. Equally trustees should push their advisers to get the strategic advice that they need.

Schemes have been too focused on overcoming their deficits via strong investment returns over relatively short time horizons and relying on favourable interest rates – bets which haven't paid off. In fact, by betting on investment returns and interest rates, schemes are risking more adverse outcomes.

A truly integrated approach should incorporate long-term covenant risk. It should explore all reasonable funding and investment strategy combinations to deliver members' benefits with greater certainty and reduced cost. This contrasts with the traditional approach, where appropriate investments are determined after agreeing cash contributions, which in turn significantly reduces the investment strategy options available. Less choice means less secure benefits.

Last year we applied our 3DFunding approach to the UK DB universe, to show that outcomes could be materially improved by taking a different strategy. The full research can be found in our **'Better Future for DB'** report, but a summary of the results are shown below:

UK DB: Current vs alternative strategy at a glance

We extended the existing cash commitment and reduced the growth asset risk, replacing it with a portfolio of diversified income generating assets across the credit and yield spectrum.

Current approach	Key issues	A lower for longer alternative strategy
1 in 3	1 **Chance of success** Chance of reaching buy-out funding by 2036	1 in 2
1 in 4	2 **Level of risk** Chance of no deficit improvement in 20 years' time	1 in 12
c£45,000	3 **Member security** Average loss of benefits per pensioner in the event of sponsor failure	£21,000

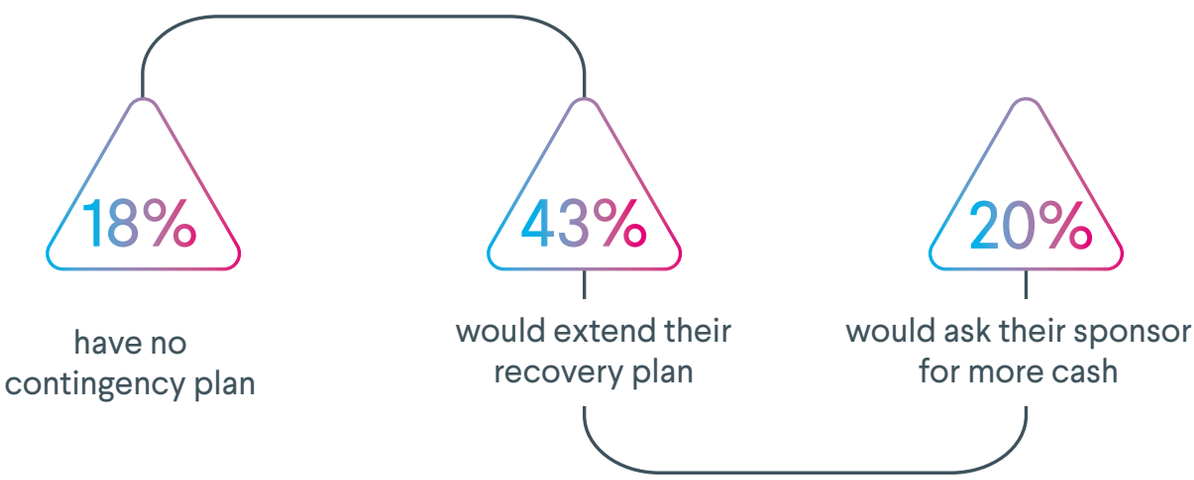
This is just one alternative strategy which we believe could maintain affordability for many sponsors, reduce cash uncertainty and improve outcomes for DB members. Of course, every scheme is different and the optimal strategies for each one will vary.

[6]Hymans Robertson UK DB analysis

53% of trustees believe their scheme could benefit from a slower and steadier approach to achieving their goals

It's encouraging to see trustees are open to a longer-term covenant commitment, even if they've not yet revised their strategy accordingly. Additional benefits of this type of alternative strategy are that cashflow requirements are better managed through a longer term funding commitment, as well as delivering a higher and more certain yield on assets. So cashflow risk – a potential barrier to success (as set out in the next section) – is managed.

We asked trustees what happens if their investments don't deliver what's expected?



"We think it's time for the industry to shake off traditional advisory silos to deliver big picture, 'all avenues explored' advice on how best to deliver members' pensions . Otherwise we face a £250bn reduction in benefit security for UK DB."

While it's a worry one in five trustees have no contingency plan - particularly given recent record deficits - it's refreshing that more trustees are open to extending their recovery plan, rather than simply asking for more cash. In fact, as the figures earlier show – when comparing the current UK DB strategy to an alternative slower & steadier strategy – the chances of success and benefit security can be materially improved by taking more time. This also reduces the risk of further cash calls from the sponsor. Crucially, this is something that many trustees can do now – it needn't be left as a contingency plan. Why treat symptoms when you can have a cure?

Of course, once the exposure to tough times has been reduced, it's still important to plan for the worst. Overall, we'd encourage trustees to think about the circumstances in which their funding could deteriorate and to consider what their sponsors' world would look like in these circumstances. This provides a helpful context for working together to map out how to adapt in the tough times. This is all about taking high stakes decisions in a low pressure environment.

Our View

Susan McIlvogue, Partner and Head of Trustee DB Actuarial and Benefits

It's really concerning that almost a fifth of trustees have no contingency plan if their investments don't deliver what they expect. In such a politically uncertain time, with lower for longer interest rates, there's a very real possibility that trustees will have to revise their investment expectations downwards. Trustees should be wary of remaining wedded to their historic funding approach, particularly if they have been valuing liabilities using gilt yields. They should be open to change and should focus on building resilience to risk and market volatility.

We encourage trustees to embrace a fully integrated, strategic approach. This can lead to longer recovery plans with less investment risk and greater certainty – often the best outcome for trustees, sponsors and members.

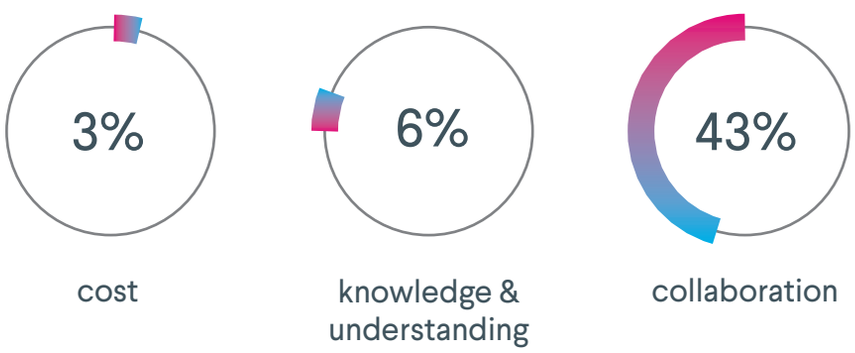
Trustees need more support from collaborative and inclusive advisers, who will help to guide them along the right strategic path for their scheme – helping trustees to really own their strategy.

The roadblocks

Barriers to an integrated approach

We asked trustees to rank the **top three barriers** to adopting a fully integrated approach

We asked Independent Trustees what's the **single biggest barrier** to adopting a fully integrated approach[7]

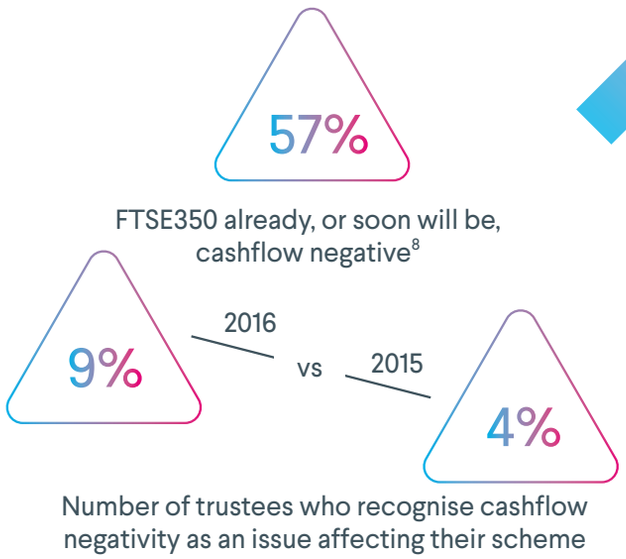


It's interesting that cost was the top barrier for trustees, but was considered relatively unimportant by their independent trustee counterparts. We think this cost issue is an unhelpful industry myth, and it's a concern that many trustees consider it such a barrier. A longer-term, more holistic approach doesn't necessarily have to be more expensive. Smart new technology puts an integrated approach to risk management in the hands of trustees, making it practically self-service.

Using technology, risk management can be both scalable and affordable. Technology has made access to up-to-the-minute risk analytics and valuation results direct from source data a reality for the first time (see page 12 for more on this). Trustees should feel empowered to push their consultants to deliver better value for money by focusing on improvements to strategy and risk. When this happens, concern will diminish over time.

[7]Hymans Robertson Independent Trustee Survey 2016

Dealing with cashflow negativity



Schemes need cash to pay pensions. Yet more and more schemes are becoming cashflow negative (when benefits out exceed contributions in). Our 2016 FTSE350 analysis showed that 57% of schemes are already, or will soon face, cashflow negativity - up from 50% in 2015.

Managing cashflows becomes increasingly important as schemes mature and benefit payments fall due. Additionally, with increasing numbers of members opting to transfer from DB to DC in the wake of Freedom and Choice, disrupted cashflows are becoming more commonplace, and the need to manage your cashflows to ensure you can meet benefits as they fall due is ever more important.

A mere 9% of trustees recognised cashflow negativity as an issue affecting their scheme. Meanwhile, only 5% of trustees, in 2015 and 2016, considered having to sell assets at a depressed price as a key risk. This is concerning given trends show this is a material risk for many schemes. The key risk is becoming a forced seller of assets, which can lock in material losses – effectively you run out of fuel to run your scheme. This is a real barrier to achieving your goal, so it's a risk that needs managing.

Our **Practical Guide to Cashflow Risk** offers some tips on understanding the impact of cashflow risk to your scheme and steps you might take to mitigate it.

Our View

Laura McLaren, Actuary

Cashflow negativity is an issue that still isn't getting the recognition it deserves. This is despite the Pensions Regulator highlighting the importance of cashflow planning as vital to effective scheme management in its 2016 annual funding statement.

Schemes are facing an ever-growing mountain of cash commitments as members retire, more take transfer values and pensions go in to payment. Once benefits in payment exceed contributions coming in, schemes will find themselves in the position of becoming forced sellers of assets. In a market downturn, this could mean substantial losses.

We think that many schemes could benefit from identifying the level of priority this issue merits for your scheme, and adopting a proportionate and practical plan to manage the risk.

[8]2016 Hyman Robertson FTSE350 Pensions Analysis

The route finder

94%

of trustees don't have access to formal triennial valuation results within one month

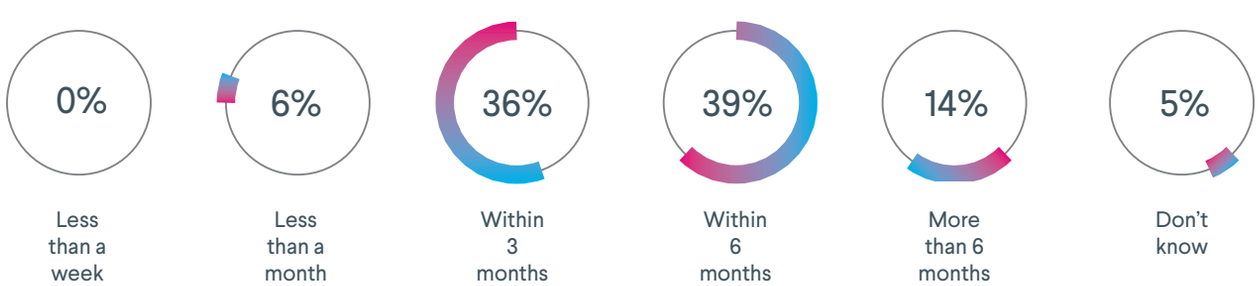
72%

of trustees would welcome more accurate data on funding, risks and scheme cashflows, driven from member-by-member data

As consumers, we're used to banking on our mobile phones, reading our credit statements online and even buying and selling our investments via apps. Why should modern day trustees be given access to their pension schemes' valuation data more than a month - and in many cases much longer - after their triennial valuations, as 94% reported this year?

Whilst 58% of trustees say they already have access to 'on demand' member by member data from their actuaries and administrators, plus the supporting technology, we would question whether this is the case. The vast majority of trustees reported receiving their valuation data not weekly, not monthly, but within three months, six months, or even longer. This doesn't sound 'on demand' and 56% told us getting access to accurate up to date data will be one of their biggest challenges this year.

We asked trustees how long on average it takes to get access to formal triennial valuation results?



56% of trustees told us that having access to accurate and up to date funding data for strategy setting, monitoring and decision making will be one of their biggest challenges this year

The imminent publication of the Government's Green Paper on DB pensions could put this challenge into even starker context, given one area of consideration is the valuation timescale. Were this to be reduced to say 9 or 12 months, the down time between the valuation date and access to formal results – allowing for sensible negotiation time - simply won't be workable. Ensuring access to accurate, bang up to date data and analytics needs to be on trustees' priority list this year.

Do you have access to 'on demand' analytics?

- ✓ Are your cashflow, funding and risk projections based on up to date membership data?
- ✓ Can you track your scheme's chances of success, risk and benefit security in real-time?
- ✓ Can you independently explore different strategies and economic scenarios to see how you could improve outcomes and reduce risk?
- ✓ Can you use these tools in meetings to ensure strategies and advice is fully explored, understood and owned based on up to date financial conditions?
- ✓ Do you incorporate the emerging impact of longevity experience between triennial valuations?

Our view

Richard Shackleton, Partner

In a political and economic environment where seismic changes, like the introduction of freedom and choice, happen with surprising frequency, trustees deserve – and frankly, need – better. The traditional triennial approach doesn't meet the needs of today's trustee. Indeed, for a £500m scheme, over or under-estimating scheme funding can be as significant as £30m over the triennial cycle.

Trustees need to have confidence that the data upon which they are basing their risk management decisions is sound. It's time for trustees to be in the driving seat. Access to strategy and risk analytics driven by the latest membership data is key – and shouldn't be costly to deliver.

The long-term view

Whilst the fast-changing pensions landscape creates challenges for trustees, with the right strategic approach and leadership, we believe trustees can thrive. Building resilient strategies that lead to more certain outcomes for members is within reach.

Taking a long-term view is key. This helps to look past today's noise and focus on what really matters – paying pensions. So here's a checklist of 2017 pension resolutions to help you do this:

- Clarify or re-affirm your long-term goals, including the role insurers could play
- Own your strategy and become confident it's fully integrated
- Appropriately turn down the lights on deficits and discount rates
- Guide your strategic journey with measures that matter - success, risk and security
- Map out clear contingency plans - both on the upside and downside
- Identify and clear any roadblocks to progress, such as unnecessary cost or cashflow risk
- Check you've got the accurate and timely cashflow, funding and risk MI you need to navigate and take action with confidence
- Finally, challenge your advisers to get the strategic advice you need

If you can tick all these boxes in 2017, you can be confident that you're not leaving better outcomes for your members down to chance. This will help as many pensioners as possible to enjoy a more certain and better quality of life in retirement.

We hope you've enjoyed reading this report and wish you a successful 2017. If you'd like to discuss the results in more detail please do get in touch.

If you've any questions or would like to discuss any of the issues raised, please don't hesitate to get in touch with one of us or speak to a member of your Hymans Robertson team.

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About the survey

Hymans Robertson commissioned Opinium Research LLP to conduct our third annual Trustee Barometer in Q3 2016. We surveyed 100 pension fund trustees currently serving corporate defined benefit pension schemes with £50m+ of assets under management.

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