CASHFLOW-DRIVEN FINANCING

INVESTING INTELLIGENTLY
EXECUTIVE SUMMARY

With uncertainties about global economic growth and the prospect of interest rates remaining low for longer, there is substantial risk that high defined benefit (DB) pension costs and volatile deficits will continue. This is significant — not just for trustees, but also for sponsors, and for years to come, if they continue to pursue the conventional approach to pension scheme financing.

Additionally, nearly 50% of UK DB pension schemes surveyed in Mercer’s latest European Asset Allocation Survey are cashflow-negative. So the shortfall of investment income and sponsor contributions relative to benefit payments for these DB schemes is a challenge. According to the survey, the proportion of DB schemes in this situation is expected to rise to 80% within the next 10 years.

The issues above are big concerns. Volatile financial markets could drive up pension costs unless trustees and sponsors approach DB scheme financing in a different way. And trustees of DB schemes that are cashflow-negative face the risk of needing to sell investments at a time when asset values are depressed. For small cashflows, this is unlikely to be an issue. But over a period of time, this can have a material impact, particularly as the size of the cashflow calls increases.

This article looks at an innovative way to solve the above challenges — Mercer’s cashflow-driven financing (CDF) solution.

CALM IN THE MIDST OF THE STORM

UK DB pension scheme trustees and sponsors have endured years of increasing pension contributions and stubbornly high and volatile accounting and funding deficits in their DB pension schemes, as illustrated in Figure 1.

FIGURE 1. HISTORIC PENSION SCHEME FUNDING VOLATILITY FOR FTSE 350 COMPANIES
Furthermore, schemes are facing approximately £2 trillion of UK defined benefit (DB) pension liabilities, nearly £0.5 trillion of index-linked gilts in free circulation, oversubscription for gilt auctions, and around £15 billion annual market capacity for annuity buy-ins. This makes it impractical for most sponsors to transfer pension risk from their balance sheets using bulk annuities. However, an annuity buyout is a suitable and realistic goal for some schemes; for example, those that hold sufficient funds to do so or whose sponsors are willing to make available the required contributions. But many sponsors will be unwilling or unable to allocate the resources to finance the substantial premium needed to secure members’ benefits with an annuity provider compared to the underlying cost of providing pensions within the scheme.

An intelligent solution is to continue the DB scheme but with funding and investments managed like an insurer — on a CDF basis — without the additional costs. CDF is a flexible, capital-efficient approach for managing pension financing and corporate balance sheet volatility without the higher contributions associated with traditional investment de-risking (focused on gilts) and annuity buy-in strategies. This approach focuses on the true objective of all pension schemes: to have cash available to pay members’ benefits without unnecessarily constraining the sustained growth of sponsors. And for sponsors with a high risk of insolvency, this approach helps minimise the impact on members, and the sponsor, of downside investment risks.

For trustees of DB pension schemes supported by a strong employer covenant, CDF can be phased in over an appropriate timescale. For example, to address the cashflow challenges facing many pension schemes with increasing payments to retired members, trustees could match pensioners first. This allows an orderly transition from return-seeking to income-generating assets when a scheme’s finances permit, allowing the sponsor to invest in its sustainable growth.

A balanced CDF solution is ideal for managing pension obligations and transitioning efficiently to a risk-contained funding and investment strategy compatible with the sponsor’s covenant and risk appetite.
If someone told you that you could cut pension risk by 80%, reduce investment costs, and stabilise cash contributions, all without increasing your existing deficit cash commitments, would you be sceptical?

It may sound too good to be true, but that’s exactly what an award-winning investment strategy implemented by Mercer achieved.

**Background**

A £500 million DB pension scheme was following a reasonably traditional funding and investment strategy. This included defined allocations to both growth assets (equities, property, and diversified growth funds) and liability hedging assets, and supported a discount rate 1% per annum above gilt yields.

The sponsor and the trustees were both keen to reduce risk, but only at the right price — funding requirements couldn’t increase from current levels.

**An Integrated Approach**

We worked closely with the sponsor and trustees to develop an integrated funding and investment strategy supported by the sponsor’s covenant.

Critically, the strategy moved away from the traditional approach towards one modelled on meeting the scheme’s cashflow requirements. Hence, the designation “cashflow-driven financing”.

**Investment Arrangements**

The investment strategy now focuses on income-generating assets. Long-term buy-and-maintain corporate bonds form the bedrock of the strategy. Other key investment areas are property, alternative credit investments, and liability-driven investment (LDI) to manage risks associated with longer-term cashflows.

The strategy was designed to provide a reasonably high cashflow match for the curved black line in Figure 2, which represents the present value of the scheme’s expected liability outflows.
The coloured lines represent expected cashflows from the scheme’s assets, using a prudent assumption for potential defaults.

Over time, any excess cashflows in the earlier years of the strategy will be reinvested to provide a fuller long-term physical cashflow match (with initial reinvestment expectations shown in pink).

Because the credit is held on a buy-and-maintain basis, the strategy should be resilient to fluctuations in market value. As long as the credit income is received and defaults do not exceed the prudent risk margin held, the strategy will achieve its objective.

**Link to Funding**

On day one, the portfolio supported a discount rate consistent with the gilts-plus-1%-per-annum level used in the past. The cashflow-driven nature of the strategy has enabled the trustees to use a dynamic funding approach; that is, linking the discount rate used in their funding strategy to the yield on the buy-and-maintain bonds held rather than to gilt yields plus a fixed margin. The scheme actuary reassesses the risk-adjusted discount rate on a monthly basis in light of market conditions.
The Outcome

Figure 3 demonstrates the outcome secured by the scheme’s move to the CDF approach for their entire portfolio.

The effect of the new strategy is represented by the solid navy-blue line (which assumes the discount rate is updated daily; albeit, in practice, this is done on a monthly basis). The scheme’s previous strategy (with a more traditional investment policy and a funding approach tied to gilts) is represented by the dotted blue line.

The trustees implemented a CDF strategy in June 2015. As shown in Figure 3, over the 10 months to April 2016, the scheme’s funding position was approximately 4%-5% higher than it would have been under the previous strategy. In addition, adopting the new strategy has led to materially lower funding volatility to date. The scheme’s funding position is largely unaffected by changes in gilt yields or credit spreads (and, in particular, is unaffected by equity market falls in August 2015 and January 2016).

Thinking about the future, Figures 4 and 5 (produced in 2015) highlight the impact of the scheme’s shift to a cashflow-matching investment strategy versus their previous approach. The range of funding outcomes is significantly narrower, even though the median expected outcome is broadly the same (that is, full funding on the agreed basis). The modelling does not allow for the dynamic-funding approach, which might be expected to reduce funding-level volatility by at least another 50%.
The above case study shows how a particular scheme has benefited from this approach, but we think there are wider-reaching advantages that many UK DB trustees and sponsors could tap into:

- **Ability to invest like an insurer.** If integrated with longevity protection (which is now possible even for smaller schemes), pension risk management is consistent with the way in which insurers manage their annuity buyout business. More importantly, it is a lower cost than a bulk annuity purchase, because there is no need to pay a premium to an insurance company. Because insurers typically invest in cashflow-matching credit assets, the CDF approach removes most of the insurer’s role (and their profit) from the risk management process — while reducing most of the key risks. However, adopting a CDF strategy means there’s still a risk of sponsor insolvency while the pension scheme is in deficit.

- **Adaptable.** Flexibility exists within the CDF approach to align the funding and investment strategy to the sponsor’s covenant and to evolve the strategy over time to a fully de-risked annuity buy-in position, if desired. The strategy is flexible enough to be implemented for just a portion of the investments. Indeed, several schemes are now considering CDF as their long-term “self-sufficient” objective, even if it’s not an affordable option today. In these cases, one option could be to use a cashflow-matching approach now to mitigate risks associated with some of a scheme’s liabilities (whether all pensioners or just a proportion), and then have a plan in place to move to a full CDF approach as and when this becomes affordable. This might involve a dynamic de-risking approach, with pre-agreed funding-level triggers for building up the cashflow-matching portfolio.

- **Closer to sponsor balance sheet approach.** The credit linkage of the funding and investment strategy removes the tension most sponsors see between the trustees’ view of risk and their own (credit-based) balance sheet. A CDF approach therefore reduces the volatility of the sponsor’s pension accounting disclosures.

- **More protection for members and sponsors.** A CDF approach affords significant protection against funding deterioration, maintaining the security of members’ benefits while delivering a reliable improvement in funding over time. All without the substantial downside risks associated with conventional financial strategies.

- **Integrated risk management.** A CDF approach truly links funding and investment strategies together based on the sponsor’s covenant. Taking this into account, the discount rate used by the scheme actuary to value liabilities is derived from a prudent estimate of a reliable default-adjusted yield on the underlying income-generating assets. The prudent risk margin between the yield on assets and the discount rate is monitored with regard to default risks on both the assets and the sponsor. Transparency of the risk margins included in the discount rate avoids both excessive prudence and optimism in financing the pension scheme.

- **Support for members’ flexibility and choices.** Consistent with Government policy, members’ options, such as transfer values and cash at retirement under a CDF approach, are all calculated using assumptions that are both consistent and cost-neutral to the strategy.
SUMMARY
Although the CDF approach is not a panacea, it is a suitable strategy for DB pension schemes that want to address their liquidity, funding, and investment challenges in a way that’s both innovative and compatible with the strength of the sponsor’s covenant. There are risks associated with this strategy, such as: the need to reinvest investment income, manage collateral, and find suitable long-dated inflation-linked assets to match the relevant liabilities. But intelligent and well-designed investment strategies can overcome these risks. The important thing is to ensure that trustees and sponsors of DB pension funds stay focused on the big issues — covenant, funding, and investment — and manage the key risks that keep rearing their ugly heads in this new economic and financial environment.

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