KPMG cutting through complexity

KPMG LLP

KPMG's Integrated Funding Framework
for defined benefit pension schemes

The Pensions Regulator released a new Code of Practice on 10 June 2014 calling for a more collaborative approach to funding defined benefit schemes.

The Code of Practice represents an opportunity for trustees and sponsors to refresh the way they work together and has two key messages:

i) Covenant, investment and funding should be integrated into a cohesive scheme funding strategy; and

ii) Scheme cash demands should be balanced with investing in the sustainable growth of sponsors.

An integrated approach to funding where investment strategy and cash contributions are flexed to reflect changes in the sponsor's business and the development of financial markets clearly benefits all parties. However, the length of guidance makes it clear just how difficult it can be for trustees and sponsors to draw together all the complex strands.

We don't think that a 'black-box' model will be sufficiently bespoke to address the complex needs and circumstances of stakeholders.

KPMG's **'Integrated Funding Framework'** follows four simple steps to help trustees and sponsors have the right conversations to build an integrated funding plan which is truly bespoke to their circumstances.

STEP 1 – WHAT IS MY COVENANT WORTH?

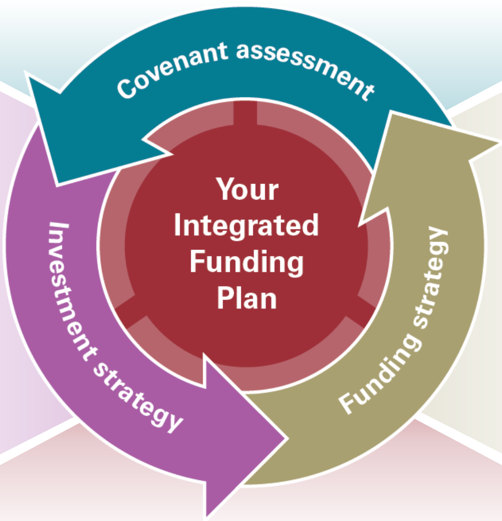
Employer covenant is placed firmly centre stage within the new Code. Sponsors are encouraged to present a 'Plan for Sustainable Growth' in line with the Regulator's new statutory objective to "minimise any adverse impact [of pensions funding] on sustainable growth".

Sponsors who help the trustees thoroughly understand their covenant will be best-placed to collaborate and quickly agree a balanced funding plan.

STEP 2 – HOW MUCH INVESTMENT RISK WILL MY COVENANT SUPPORT?

Sponsors should be able to underwrite the inherent risk in the scheme's investment strategy.

A clear understanding of the cash flow available to support the scheme should be married to your investment strategy's risk profile.



STEP 3 – WHAT DOES THAT MEAN FOR SCHEME FUNDING AND THE VALUATION?

With a clear view on covenant and investment strategy, you will be in a position to determine an integrated funding plan aligned with trustee and sponsor objectives.

This should include any wider strategic factors such as liability management, asset backed funding and secondary funding targets.

STEP 4 – PULL TOGETHER INTO YOUR INTEGRATED FUNDING FRAMEWORK

The new guidance emphasises that a collaborative working relationship between sponsors and trustees is intended to lead to improved funding outcomes. The guidance is clear that trustees and sponsors should engage early and often.

KPMG's 'Integrated Funding Framework' brings together experts in all three areas (covenant, investment and funding) alongside our analysis and monitoring tools to develop an integrated funding plan that delivers value for the trustees and sponsor.

We can assist the development of your integrated funding plan – a clear decision making strategy for your scheme with clear triggers and targets.

The Integrated Funding Framework in practice

The following case study illustrates how KPMG's Integrated Funding Framework helped one client to distil our analysis of the three key areas into a single straightforward matrix.

This allowed the trustees and sponsor to understand the interaction of the various elements and move quickly to a negotiated funding agreement.

Background information:

On the expected funding basis the scheme had liabilities of £390m with assets of £300m resulting in a deficit of £90m. Looking forward three years, on consistent assumptions and allowing for cash contributions, the deficit is expected to reduce to £60m.

However, the investment strategy has downside risks – can the sponsor underwrite this level of risk?

Recovery period in 3 years

Deficit in 3 years' time		5	10	15	20	
	£60m	15	9	6	5	EXPECTED OUTCOME
	£90m	21	12	9	7	
	£120m	27	15	12	9	RISK SCENARIO
	£150m	33	18	15	12	

Affordable
Stretch
Unaffordable

KPMG'S COVENANT ADVISOR:

"The sponsor has a strong market position and believes £9m per annum is an affordable scheme contribution.

However, there is a further £24m of 'free' cash flow currently forecast to fund discretionary capital expenditure and ordinary dividends.

KPMG'S INVESTMENT ADVISOR:

"The investment strategy gives a good chance of positive investment returns over the next three years.

However, there is a one in twenty downside risk that the strategy underperforms by £60m, which would lead to a deficit in three years time of £120m.

KPMG'S ACTUARIAL ADVISOR:

"If the business maintains covenant strength and investments perform as expected, a reasonable length recovery plan will remain affordable in three years time.

However, if the downside investment scenario results in a £120m deficit, a ten year recovery plan would require contributions of £15m per annum.

Your integrated funding plan

By stress testing alternative funding assumptions and investment scenarios within a common understanding of covenant and affordability the trustees and sponsor formulated an integrated funding plan. This scheme-specific strategy included triggers and targets directed by common agreement that:

a) Covenant remained strong;

b) Deficit contributions of £9m per annum were affordable and would be the basis of the recovery plan;

c) Deficit contributions could be sustainably increased to £21m per annum if the investment strategy underperformed; and

d) The sponsor can therefore underwrite the risk inherent in the investment strategy and take the opportunity to clear the deficit from investment returns as well as cash.

How can KPMG help?

KPMG is well placed in the market to provide integrated advice, bringing together people with the strength and depth in all the skill-sets needed alongside our analytical tools to build effective pension scheme solutions. We combine:

- Business analysts and sector specialists who are able to clearly articulate covenant strength and affordability.
- Investment consultants with in-depth knowledge of the financial markets built from a proactive and innovative approach to research and identifying attractive opportunities.
- Strategically focused pensions actuaries who provide expertise on topics as diverse as the technical approach to mortality right through to the most effective way to set your overall funding strategy.
- We believe that 'Scheme Specific' funding should be exactly that – tailored to the needs of an individual pension scheme and sponsor.

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