Rothesay life

BUYOUTS:
HOW SCHEMES CAN SECURE MEMBER BENEFITS

THE TRUSTEE MAGAZINE
ENGAGED INVESTOR

BOOMING BUYOUTS

This past year has shown us the damaging impact a defined benefit scheme can have on a company. Insolvencies at BHS and Tata Steel put pensions in the national headlines, and caused trustees and companies to stand up and take a hard look at the risks schemes posed to sponsors' businesses.

The operational costs, financial risks and strain on management resources mean that many sponsors are turning to insurers to secure their scheme's benefits. But, although £25bn of liabilities were insured over the past two years, many schemes are just starting out on this path.

We at *Engaged Investor*, in association with Rothesay Life, surveyed more than 40 UK defined benefit trustees and sponsors to understand the issues they are facing in the buyout market. In this report, we examine the journey from exploring the market and preparing to transact, to execution and implementation.

Half of respondents said that a buyout was their sponsor's long-term objective, but they reported facing significant barriers, including ultra-low interest rates and a lack of funds at the employer.

This report presents our findings, and together with case studies and expert comment examines some of the issues raised in greater depth.

I hope you will find the results as thought provoking as I have. ■

SPONSORS ARE TURNING TO INSURERS TO SECURE THEIR SCHEME'S BENEFITS

JENNA GADHAVI
Special projects editor

A BUYOUT IS A WELL-TRODDEN PATH FOR THE EXPERTS

Many pension fund sponsors have a full buyout and wind-up as the end game for their pension funds but only a small number of schemes have enough fund assets to achieve the desired outcome today.

So should trustees and pension managers spend time understanding what is involved in buyouts? We think they should.

Having been involved in more than 50% of the top 20 buyouts in the past 10 years our experience tells us that full buyouts can sometimes be driven by corporate activity or change, and the sudden change in timing can surprise a trustee that is unprepared. Solvency levels are also volatile for those with low hedge ratios, which may lead to sudden and short windows of opportunities to buyout.

Securing a bulk annuity is now a routine activity when specialist advisers are involved. Securing a bulk annuity that fits with the plan to complete a buyout however requires a lot more careful work and attention to detail in order to stabilise the economics for the sponsor.

We are delighted to have been sponsors of this publication that looks into the details of reaching the end goal of completing a buyout and providing the long-term security to members.

There are also a significant number of stressed schemes where paying full benefits seems highly unlikely and members face uncertainty in the level of their benefits.

This report also looks into the area of providing certainty and better value to the members of such schemes by separating the fund and employer. This approach brings buyout to the fore albeit for benefits in excess of PPF compensation rather than full benefits. ■

GUY FREEMAN
Co-head, business development,
Rothesay Life

SHOULD TRUSTEES AND PENSION MANAGERS SPEND MORE TIME UNDERSTANDING WHAT'S INVOLVED? WE THINK THEY SHOULD

1. MAKING DECISIONS ON BUYOUT

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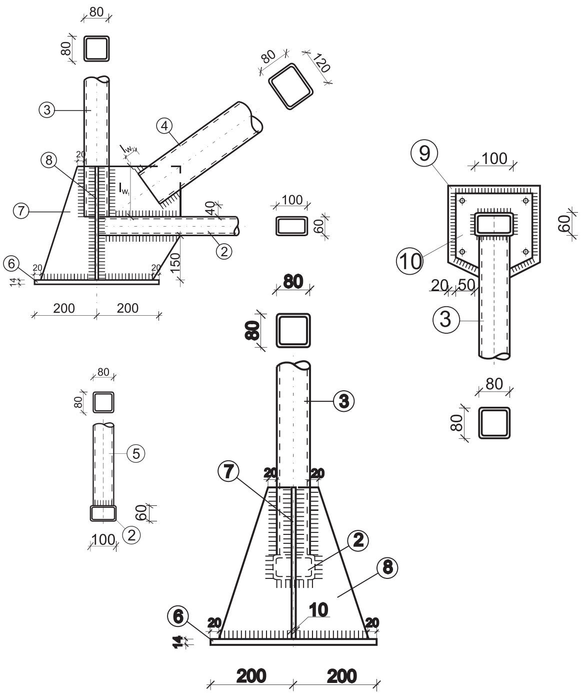
READY, STEADY, GO

OUR SURVEY ASKED WHY PENSION SCHEMES WERE CONSIDERING TAKING THE BUYOUT ROUTE, FROM THE UNDERLYING FUNDING ISSUES, TO RESPONDENTS' VIEWS ON PREPARATION AND IMPLEMENTATION

MAKING DECISIONS ON BUYOUT

- Just over half (51%) of respondents said that a buyout was their plan sponsor's long-term objective
- For 27% of respondents, the level of long-term interest rates was the most significant barrier to achieving the sponsor's end goal, closely followed by the employer not being able to afford it (25%)
- For those that decide to go ahead, transaction experience was the most important factor to consider when selecting an adviser for 31% of those surveyed
- A huge 93% of respondents expect to de-risk in steps rather than in a single bulk annuity transaction when it is affordable. This could be because trustees don't have the funds for a single step buyout



PREPARING FOR AND ANALYSING A TRANSACTION

- Pre April 2015, the largest number of respondents (28%) ran a trivial commutation exercise. Post-April 2015 this dropped to 20%
- In terms of preparation for de-risking, specifically with data preparation, 29% of respondents said that they had started guaranteed minimum pension (GMP) reconciliation. Next highest was the 18% that had checked historical legal documentation for problems
- If the company indicated that a buyout might soon be viable, 31% of respondents said that preparing data on the liabilities so that bulk annuity quotes can be requested would be their top priority, closely followed by educating the trustees on bulk annuities (22%)

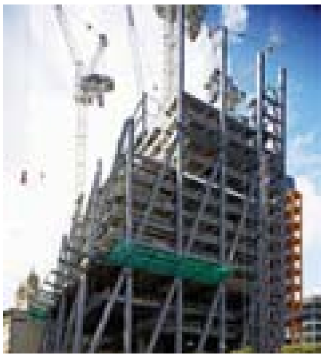
STRESSED SCHEMES: WHAT ARE THE OPTIONS?

TRUSTEES

- The majority of trustees (77%) said that covenant strength was very important, with a further 18% saying it was important
- Despite this, although 68% said that their employer's covenant strength was strong or tending to be strong, almost a third (32%) said it was on the weak side
- Encouragingly, 68% of trustees said that they expected full benefits to be paid to members because their sponsor was strong
- Just under half (44%) felt that if their sponsor became insolvent, enough of the section 75 claim for the buyout shortfall would be recovered to secure benefits above Pension Protection Fund compensation levels, when combined with fund assets
- If the company made an offer of a large, final one-off payment with no further contributions or support that would enable the members to escape the PPF by insuring the benefits, 31% of trustees would consider taking the offer, even if they couldn't provide full benefits.
- Seventy-seven per cent of trustees don't intend to push their employer harder for contributions at the next funding review, despite recent problem cases such as BHS

COMPANIES

- Of the companies surveyed, 42% do not feel obliged to put more money in to their pension schemes in response to events such as the BHS scandal
- Sixty per cent believed that the existence of a pension fund is affecting the company's ability to grow or to finance itself
- Only 42% expect to provide full benefits to their members at retirement
- If the companies surveyed had cash available, 60% would buy out now rather than later
- If there were a buyout shortfall, and the company could crystallise its commitment by putting up only some of that shortfall (without any further payment), only 10% of companies said this would be of interest to them; 87.5% were unsure
- Three-quarters of companies said that 30-50% of the buyout shortfall would, from the company's perspective, make the discussion worth having
- Forty per cent of companies said that they believed the trustees would accept the offer if there were no regulatory hurdles in doing so, and it was viewed as a safe decision for them to make



EXECUTION AND IMPLEMENTATION

- Ensuring the correct benefits are being secured, and contract drafting and negotiation with the insurer were ranked as the top two key complexities involved in completing a buyout/wind-up.

- When considering what benefits to secure under the buyout policy, over half (54%) were most likely to put in place a company indemnity for additional liabilities that may result from incorrect data ■

MAKING DECISIONS
ON BUYOUT

WHY CHOOSE A BUYOUT?
IN NUMBERS

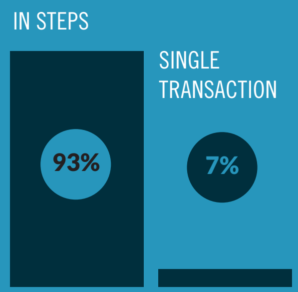
There are a number of factors behind a pension scheme's decision to take the buyout route, with the situation and long-term objectives of the sponsor among the most critical, as our survey respondents showed

WHAT ARE THE PLAN SPONSOR'S LONG-TERM OBJECTIVES FOR THE SCHEME?

Self-sufficiency: 39% / Not sure: 10% / Buyout:

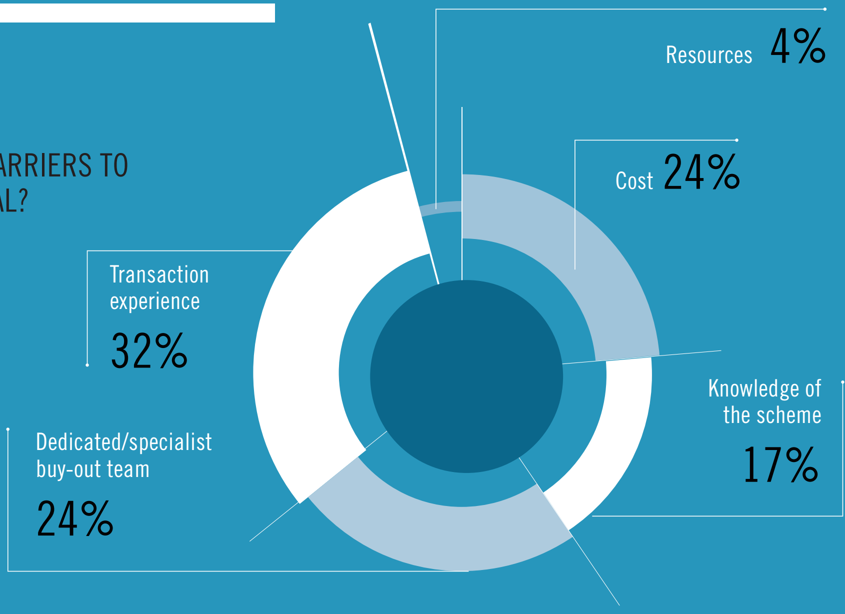
51%

DO YOU INTEND TO DE-RISK IN A SINGLE BULK ANNUITY BUYOUT TRANSACTION WHEN AFFORDABLE OR WOULD YOU EXPECT TO DE-RISK IN STEPS



WHAT ARE THE MOST SIGNIFICANT BARRIERS TO ACHIEVING THE SPONSOR'S END GOAL?

Employer can't afford it	25%
Lack of expertise	1%
Trustee and employer aren't reaching agreement	3%
Insurance market capacity	7%
Company has better use for limited resources	23%
Current level of long-term interest rates	27%
Potential impact on company's share price	3%
Consider insurance is uncompetitively priced	12%



IF YOU DECIDE TO OPT FOR A BUYOUT, WHAT IS THE MOST IMPORTANT FACTOR YOU WOULD CONSIDER WHEN SELECTING AN ADVISER?

WHY BUYOUT IS COMING OF AGE

What was originally an important employee hiring and retention tool has, for most employers, become a legacy issue. Operating pension funds carries large financial risks, involves significant operational costs and uses up valuable management time that could be better spent running the business. So it is not surprising that the aim of most sponsors is to move to a position where the company no longer has any financial commitment to the pension fund.

Many have started to remove the pension funds by purchasing bulk annuities to match the commitment made by the employers to pay pensions. However, only a small minority of pension funds have achieved their end game of completing a pension fund buyout, passing responsibility for pension payments to an insurance company and winding up the trust for good.

PENSION FUND LIABILITIES TYPICALLY HAVE DURATIONS OVER 20 YEARS

Since 2007, UK pension funds have secured around £64bn of bulk annuities. Of this we estimate that around 45% is in respect of buyouts where funds have secured benefits for all of their members and will soon be completing or have already completed a wind-up.

The top 20 buyouts completed in the past 10 years show a range of pension funds and sponsors, including both UK and non-UK parent companies. Publicly listed companies, privately owned companies and participants in multi-employer schemes have all reached full buyout (see table, p14).

In the vast majority of cases these pension funds have reached buyout in a single step. At 11 of these funds, no extra funding has been required from the employer and in six of these cases members have been awarded benefit improvements from surplus assets. The remainder have required a final contribution from the sponsor.

Pension fund liabilities typically have durations over 20 years and the contribution from the sponsor required to bridge the shortfall in the fund's assets can be quite sensitive to movements in interest rates, inflation expectations and asset values, as well as the insurer's buyout premium.

The transactions therefore usually involve significant risk transfers and company boards will often have a budget for their contribution to fund a buyout.

Seventeen of the top 20 have secured full benefits for their members, with the remaining three securing something between Pension Protection Fund compensation and full benefits reflecting the plan sponsor's inability to fund the full benefits. It seems likely that this final category will grow and Chapter 3 in this report is dedicated to this area.

Four of the top 20 started with pensioner-only bulk annuities as initial steps and then moved to securing the remainder of their liabilities in a full buyout. Two more have completed pensioner-only buyouts, separating the non-pensioners from the pensioners and leaving them for later.

AVERAGE SOLVENCY LEVELS ARE DOWN

With the falls in interest rates buyout deficits for the average pension fund have risen, making a buyout unpalatable for most shareholders. As a result the market for investing in bulk annuities and holding them as investments of the pension fund has developed.

In the search for secure income, bulk annuities provide cash flow matching for pensioner benefits and deliver embedded returns that typically exceed gilt yields.

For transactions of sizes above £100m, there have been more than 80 such investments and the process of investing has become routine, while still benefiting from specialist advice outside of the normal investment consulting. ▼

HOW DOES A BUYOUT DIFFER FROM A BUY-IN?

***ON THE FACE OF IT**, they are very similar, as both involve purchasing a bulk annuity contract from the insurer. Indeed, bulk annuity buyouts always start life as buy-ins. Under a buyout, after a transitional period of typically around two years, the bulk annuity contract is broken into a collection of individual insurance policies which are issued to each of the pension fund members. From the member's perspective this means their pension is coming from a different source and involves a change of administrator.*

Once the individual policies have been issued, the trustees have no further obligations to pay any pension benefits. The pension scheme can then complete its wind-up and the employer can return its full attention to running their business.

The primary difference relates to the move from a bulk annuity buy-in to individual policies under a buyout. There are other differences too, although that necessitate consideration in advance of transacting a bulk annuity that is intended for buyout.

MAKING DECISIONS ON BUYOUT: THE STORY SO FAR

TOP 20 BUYOUTS COMPLETED SINCE 2006 *(AS AT THE END OF OCTOBER 2016. SOURCE: LCP PENSIONS DE-RISKING 2015 & ROTHESAY LIFE)*

RANK	CORPORATE/FUND	INSURER	TRANSACTION SIZE £M	COVERAGE	DATE	ANNUITY ADVISERS
1	Philips	PIC, Rothesay Life & Prudential	3,500*	Full Scheme	Nov-15	Mercer/LCP
2	TRW	L&G	2,500	Pensioner Only	Nov-14	Mercer
3	EMI	PIC	1,500	Full Scheme	Jul-13	Citi/Mercer
4	MNOPF	Rothesay Life & L&G	1,300*	Full Scheme	Dec-12	WTW
5	Turner & Newall	L&G	1,100	PPF +	Oct-11	Mercer
6	Thorn	PIC	1,100	Full Scheme	Dec-08	Mercer
7	Uniq	Rothesay Life	830	PPF +	Dec-11	LCP
8	Rank	Rothesay Life	700	Full Scheme	Feb-08	Mercer
9	Lehman Brothers	Rothesay Life	675	Full Scheme	Apr-15	PwC/Aon Hewitt
10	NCR	PIC	670	Full Scheme	Nov-13	WTW
11	Not disclosed	PIC	535	Full Scheme	Apr-15	LCP
12	Western United	Rothesay Life	500*	Full Scheme	Jun-14	KPMG/LCP
13	Delta	PIC	450	Pensioner Only	Jun-08	PwC
14	InterContinental Hotels	Rothesay Life	440	Full Scheme	Aug-13	PwC/Mercer
15	Powell Duffryn	Rothesay Life	400	Full Scheme	Mar-08	Citi/Aon Hewitt
16	Not disclosed	Rothesay Life	370	PPF +	Dec-14	Mercer
17	Inchcape	Aviva	330	Full Scheme	Nov-15	Citi/Barnett Waddingham
18	Law Society	Rothesay Life	320*	Full Scheme	Jul-11	Mercer
19	Alliance Boots	PIC	320	Full Scheme	Jun-10	WTW
20	General Motors	Rothesay Life	230	Full Scheme	Oct-12	LCP

** MULTIPLE TRANCHES ARE AGGREGATED*

Bulk annuity buyouts remain significantly different though from the simpler buy-ins and require more detailed preparation. More than half of the top 20 were driven by some kind of corporate activity which may give trustees little time to prepare. There is merit in planning ahead to be ready to approach the market.

WHAT BENEFITS ARE INSURED?

The benefits insured by a buy-in do not necessarily need to match the benefits paid to the scheme members. However, in a buyout the bulk annuity will need to cover exactly the benefits promised to the scheme members.

This means significant legal due diligence is required to give the trustees confidence that they have secured the true legal benefits of the scheme, that all beneficiaries of the scheme have been identified and secured under the bulk annuity contract, and that the trustees can then obtain discharge on wind-up.

DEALING WITH UNCERTAINTIES

In completing a buyout, pension funds will need to address scheme-specific benefit quirks and characteristics, as well as the uncertainties in the data, benefit calculations and legal provisions. A common example of this uncertainty relates to gender equalisation of benefits and how this was addressed after the Barber case in 1990. It is often not clear what the liabilities are due to these uncertainties.

In larger deals the insurance companies often purchase additional insurance to cover any exposure to these uncertainties, or data risks as they are typically called. Buyouts are therefore often bespoke insurance transactions that fit the circumstance of each pension fund.

Data risk, or 'all risks' insurance as it is often called, is more common in larger transactions, and 80% of the top 20 included some form of data risk transfer to the insurer.

TERMS FOR MEMBER OPTIONS

Unlike buy-ins, buyouts usually include deferred pensioners and consideration will need to be given to the terms for member options.

Once wind-up is completed and the individual policies have been issued these terms will be set by the insurer. A step change from the factors used by the trustees is highly likely. The trustees may need to adopt the insurer's factors for the period while the trustees hold the bulk annuity as a buy-in, before issuance. This makes these factors an important consideration in preparing for a transaction.

TRANSACTION STRUCTURING

Where corporate sponsors are providing additional funding to facilitate a buyout, they will usually wish to avoid having money left in the pension scheme trust after the promised benefits have been secured – a 'trapped surplus'.

On the other hand, some sponsors also wish to avoid the risk of having to put forward extra funding in the event that there were any errors or omissions when determining the benefits to be insured. Structuring the buyout premium payment to achieve the company's and the trustee's aims is vital. Specialist advisers are needed to guide the process and help find solutions to the issues in order to chart a path, not just to execution of a bulk annuity but also through to completion of a wind-up.

GUY FREEMAN
Co Head , Business Development Manager

THIS REPORT

Bulk annuity buy-ins have been covered widely in pension industry publications.
In sponsoring this report we have sought to focus on the issues faced by trustees and their sponsors in moving to a buyout covering

- ***Making decisions on buyouts (this chapter)***
- ***Preparing for and analysing a transaction (chapter 2)***
- ***Stressed schemes (chapter 3)***
- ***Executing and Implementation (chapter 4)***

While average solvency levels do not facilitate appetite for buyouts from many sponsors at the moment, market conditions can occasionally change rapidly and dramatically.
A change in long-term interest rates could suddenly make many buyouts viable and funds that are ready at that time will have an advantage over others that have not prepared.
The content of this report is inevitably technical in places, but the issues are fairly common and are generally faced by all schemes on their journey to buyout

WE'VE MADE THE CHOICE – WHERE DO WE GO FROM HERE?

EMPLOYERS LOOKING TO SECURE THEIR PENSION LIABILITIES FACE MULTIPLE CHALLENGES. **JACK JONES** REPORTS

After another year in which defined benefit deficits have hit the headlines, it is not surprising that many schemes are exploring the buy-in and buyout market. Unsustainable deficits were implicated in the difficulties at BHS and Tata Steel UK, leading to two inquiries by MPs into the issue.

In the wider market, deficits hit record levels over the summer after the Brexit vote and the Bank of England's decision to cut interest rates further and boost its quantitative easing programme.

Consultancy Hymans Robertson estimated the shortfall hit £1trn in August, while scheme funding levels at the UK's biggest companies dropped from 89% to 77% over the past 12 months.

TARGETS

So it is encouraging that the vast majority of respondents have a long-term plan to de-risk their scheme. Half of our respondents were targeting a buyout, with four in ten looking to continue running their scheme themselves on a low-risk basis. Just one in ten were uncertain about their scheme's long-term plan.

For many employers this intention to de-risk their scheme is driven by worries over the impact of volatile deficits on the sponsor's balance sheet. In earlier research carried out by *Engaged Investor* in association with Rothesay Life, one in three respondents said the accounting treatment of the scheme was either critical or very important for employers' de-risking decisions. Just one in six said this was unimportant or somewhat unimportant.

Almost all of those respondents who intend to complete a buyout plan to de-risk their scheme in stages. This approach allows schemes to secure chunks of liabilities as and when the pricing is attractive, or sponsoring employers have the resources to act.

This staged approach is becoming common, with the Vestey Group (see p21), ICI, Philips and Smiths Group concluding multiple transactions in recent years.

HURDLES

Employers looking to secure their pension liabilities face multiple challenges, most of which relate to affordability. The rising deficits explain why the percentage of respondents who thought affordability was a challenge rose from 17% to 25% over the past year. There has been a similar increase in the number of respondents who said sponsors had better uses for limited resources – from 16% to 23%.

The top concern though, is rock-bottom interest rates. This was already troubling schemes and sponsors before the Bank's latest move – 19% of respondents said this was a significant barrier last year – and the further post-referendum cut exacerbated this. Some 27% of survey respondents said the level of long-term rates was a concern.

For well-hedged schemes this actually presents an opportunity. The gap between returns on gilts, high-quality corporate bonds and other long-term investments insurers use to back their commitments has allowed many schemes to insure pensioner benefits at or below their technical provisions.

But clearly for many employers the impact of historically low gilt yields has been to widen deficits, pushing back de-risking plans.

Lesser concerns include a lack of capacity in the market, cited by 7% of respondents, and a belief that insurers are not pricing competitively, cited by 12%.

GETTING HELP

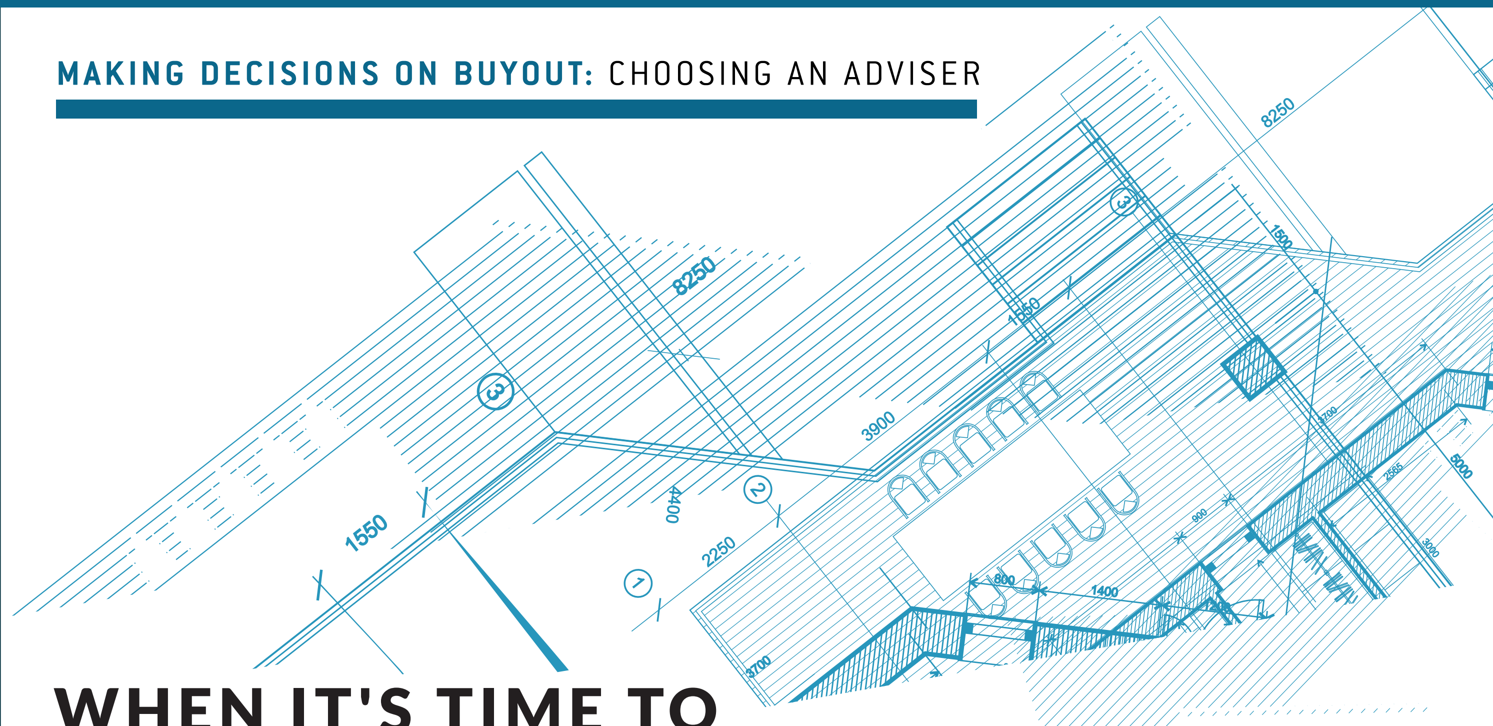
For most schemes the first step is to appoint an adviser.

One in six said knowledge of the scheme was the most important factor when hiring an adviser, suggesting they would rather work with their incumbent consultant. But a quarter of survey participants said a specialist de-risking team was key, while almost a third prioritised transaction experience.

And, with fees coming under scrutiny across the pensions sector, a quarter of respondents said the main issue was the price of advice.

ENDGAME

An increasing number of schemes are consider their endgames. The vast majority intend to de-risk their liabilities in stages and, in a period of low rates and high deficits, see meeting the cost of securing their benefits as the biggest challenge. ■



WHEN IT'S TIME TO CALL IN THE SPECIALISTS

MICHAEL CHATTERTON EXPLAINS WHY A SCHEME CONSIDERING A BUYOUT NEEDS A DIFFERENT TYPE OF EXPERTISE

MICHAEL CHATTERTON
MA FIA
Managing director
LawDeb Pension Trustees
-
Trustee experience spanning 20+ years
-
Established and lead Watsons buyout advisory practice
-
Member of industry wide work parties on liability management exercises and medically underwritten annuities
-
Completed 10+ bulk annuity transactions in past 3 years

Securing all of the commitments made to members of a pension fund via individual annuity contracts requires both expert advice and collaboration between the sponsoring employer and the trustees of the fund.

In my experience, a specialist adviser or deal manager is required. This is someone who can pull together a multi-disciplinary team to build the necessary knowledge and governance (both for the employer and the trustee group) and who has the requisite technical, investment, administration and commercial knowledge, together with project management expertise.

Each of the leading employee benefit consulting firms have dedicated teams set up to support these types of transaction.

A buyout is a substantial project that will require considerable planning and many months to execute and is very different from day-to-day fund management. A specialist deal manager will have the necessary experience to work effectively with the fund's other advisers to supplement them and fill any advisory gaps.

Many trustee boards worry about professional disagreements and duplication of work. However, an appropriate specialist is used to working within set parameters and is effective at avoiding and/or managing these issues.

The specialist adviser should also be able to provide a different perspective on whether a bulk annuity transaction is the best option for the fund in terms of value and risk management and compare this with the many colours of alternative self-sufficiency strategies. However, trustees should be aware of potential conflicts of interest with these advisers – an incumbent investment adviser or scheme actuary may have an implicit desire to see the fund continue on, whereas the deal manager is potentially incentivised to progress towards buying out.

The deal manager should have substantial market knowledge and be able to co-ordinate a detailed understanding of pension fund design (for example of member options at retirement) with the impact of insurance company regulation. For example, they will advise on whether to retain the existing fund factors (commutation, transfer value or early retirement) or whether these are likely to feed into pricing.

Equally, they will be able to advise on how to codify any trustee discretions (such as whether to pay a pension to an unmarried dependant) within a fund's rules that will not be sustainable under a buyout structure.

It can be very cost effective to have completed the preparatory work, including forming a strong view of the desired price to be paid – and then to wait. Market condition changes will dominate all other factors in determining the final price and may cause a change of up to 5%. The deal manager will be able to collate up-to-date market pricing and let you know when a selected counter party has achieved the trustee price target.

The deal manager will help generate interest with insurers at the outset of a project and then achieve engagement with top-level decision makers at the preferred insurer.

Insurers will often only refine their price to reflect the fact that they have purchased a high-yielding asset when they believe there is a high chance of transacting – and this in turn can also influence price in the region of 5%.

A deal manager with experience from a range of successfully completed transactions will enable the trustee to foresee key issues and to deal creatively with these challenges. For example, if the sponsor wants a single final payment, it is important to understand what issues could emerge after signing the bulk annuity agreement that could cause the need for additional payments, or even a premium refund that could become a trapped surplus in scheme being wound up.

Equally, it often makes sense to consider the assets that will be used to pay the premium and whether any transition of these will speed execution or improve pricing.

As the project nears completion there is likely to be a requirement for significant amounts of resource, and an experienced and flexible deal manager should be able to ensure that quality is maintained and timescales are met. ■

COMPARE AND CONTRAST

Every year many pension schemes are bought out. Not because they have to be, but for other reasons: perhaps because the organisation can or because it wants to tidy up, or to transform or sell the business, and so on.

Whatever the reason, there is almost always a big decision being taken by the sponsor to divert money that could be invested elsewhere and use it instead to remove forever the risks and costs associated with the scheme. The sponsor is purchasing certainty.

Like any other big purchase in business, there are three key factors to consider: What do I have to pay? What do I get in return? How do the best alternatives compare?

Let's go through what these questions might look like in the context of a buyout transaction.

WHAT DO I HAVE TO PAY?
All pension schemes will have had an assessment of their solvency position – an estimate from the scheme actuary of what it might cost to insure the known benefits. This is a starting point, but it could be misleading.

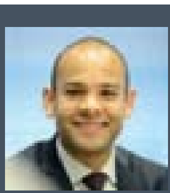
• **Start with the right numbers –** How up to date is the scheme actuary's estimate? How good a reflection of the market is it? It could be materially different to the true cost.

• **Hidden liabilities –** If the solvency estimate covers known benefits, what might the cost be for the unknown benefits? Have the contracted-out benefits been reconciled with HM Revenue & Customs' records? What is the cost of equalising guaranteed minimum pensions (GMP)? Has a lawyer confirmed the current benefits being paid are in accordance with the scheme rules? Is any data incorrect or missing?

• **Member options –** Are there more cost-effective ways to pay members their benefits than insuring them? For example, winding-up lump sums or paying transfer values? Could the benefits be put in a more efficient form through a pension increase exchange?

• **Market timing –** If buying out the scheme is not an urgent priority, could you instead position the scheme to act quickly when market opportunities arise? How much might it save to transact when market conditions are good or when an insurer is in a position to offer a better-than-market price? All these elements should be taken into account as part of a 'balance sheet' style approach that gives ▼

A BUYOUT IS A BUSINESS DECISION LIKE ANY OTHER, AND NEEDS THE SAME HOMEWORK



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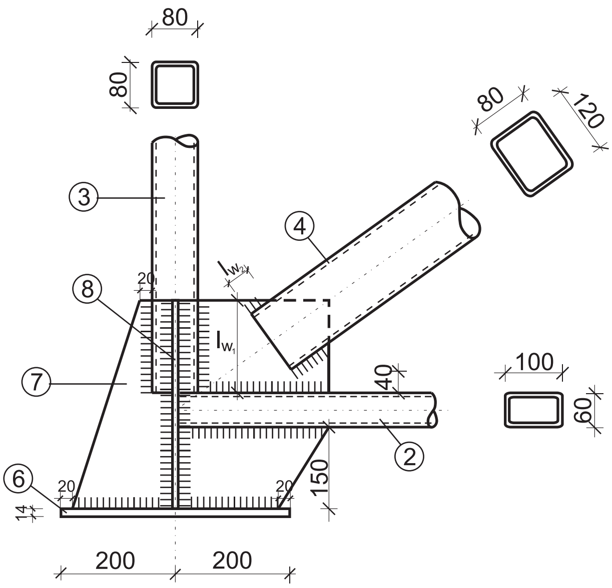
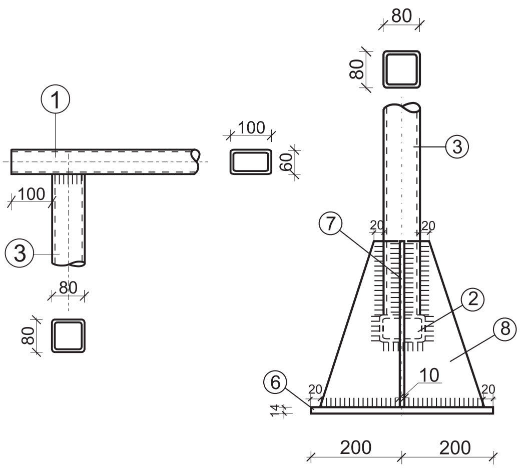
Director, pensions insurance, KPMG



LIKE ANY OTHER BIG PURCHASE, THERE ARE THREE KEY FACTORS TO CONSIDER



THE FINAL PART OF THE DECISION IS TO CONSIDER MY ALTERNATIVES

a much better indication of what you would need to pay to buy out the liabilities.

Let's say I've done the above and can afford it. What do I get in return?

• **Impact on costs –** Savings from eliminating various running costs, management expenses, statutory levies, etc, should be quantified and also added to the balance sheet.

• **Impact on business flexibility –** Additional time, freedom and flexibility to manage and structure the business without having to consider the impact on the pension scheme.

• **Impact on risk –** The major motivation for most buyouts is the wish to fully eliminate the considerable financial and demographic risks that are inherent in running what amounts to a life insurance company within the business. Often this is taken into account only in an abstract sense ("I've had enough of the risk in this scheme, how much would it cost me to get rid of it?").

For a proper business decision, it is necessary to do better than this. This is done by fully quantifying the investment, interest rate, inflation, mortality, longevity and other demographic risks that are faced, and answering the question: "This pension scheme is too risky at present, how much should I be willing to pay to reduce this risk?"

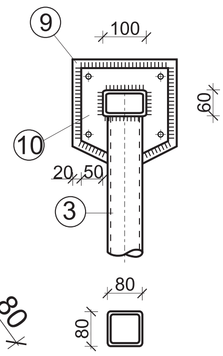
HOW WOULD THE ALTERNATIVES COMPARE?

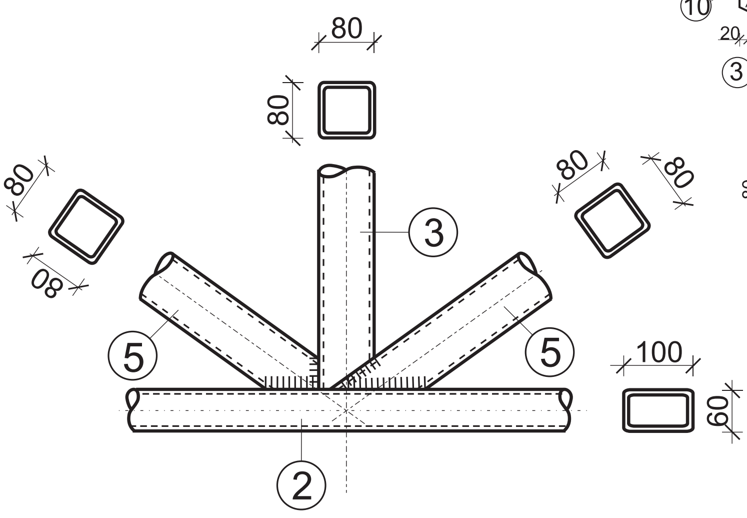
Now that I know what a buyout will truly cost and what it gives me in return, the final part of the decision is to consider my alternatives and what they offer:

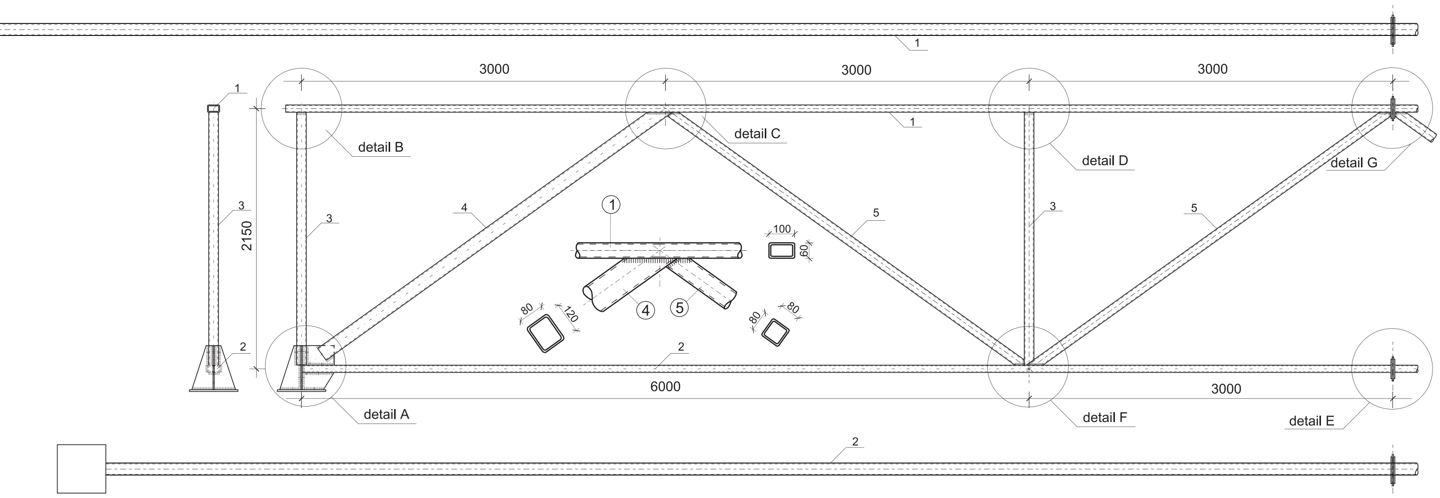
What costs and risks do I have if I spend nothing? Will the funding and investment strategy really stay as it is forever or should the analysis allow for it to drift to a more prudent (and expensive) position over time? Is there a middle road or interim step that is less expensive but still reduces risk considerably? Would that approach give me more or less bang for my business's buck?

The analysis described above will provide a businesslike framework and rationale on which to base the decision. However, as with any major investment decision a business will face, the numbers can only take the decision so far.

In the end, the sponsor must decide what its priority is. Where the sponsor's money is going to facilitate the transaction, this is not a decision that can be taken by trustees alone. ■







THE DERISKING ROUTE OF A FAMILY-RUN FIRM

Family-owned food and farming business Vestey Group de-risked its £500m 14,000 member Western United Group Pension Scheme over the course of three bulk annuity purchases, culminating in a buyout.

Two pensioner buy-ins, one for £115m in 2011 and one for £111m in 2014, were combined with the remaining £280m of scheme liabilities to complete a full buyout in June 2014.

Prior to de-risking, the scheme's £500m assets vastly outstripped the company's £100m value. While the scheme was well-funded and prudently run, both the sponsor and the trustee board could see the risks posed by such a disparity, particularly in the aftermath of market turbulence in 2008.

The buyout was the final phase of a long-term de-risking process in which the scheme had converted its growth assets to protective ones such as gilts, cash and liability-driven investment (LDI) strategies whenever trigger levels were hit.

By May 2013, almost all of the assets had been converted and the scheme was in an almost fully funded position on a gilts-matched basis. Ben Fowler, group head of reward at Vestey Group, says: "That gave us the platform to look at further de-risking options."

Once the scheme started carrying out its pensioner buy-ins, this opened up other opportunities. Fowler says: "We found that once you are in the process of completing buy-ins, you are then in the market for other de-risking activity."

On paper, the scheme was around five to 10 years away from being able to complete a full buyout, but favourable solvency levels combined with suitable annuity prices enabled the company to transact in June 2014.

Having carried out its first two buy-ins with Rothesay Life, Vestey Group knew the company well.

The decision to de-risk meant bringing together a diverse range of views from within the trustee board and the family-owned company.

"However, in the end everyone came to the view that it was not in the interests of the company to have such a big disparity between the company value and scheme deficit and that it wasn't healthy for the scheme to be relying on a sponsor that is one-fifth of its size," explains Fowler.

"It's easy to underestimate the number of steps involved in completing a buyout – we are just completing wind-up now. No matter how much work you accomplish in advance, there'll still be a lot to do."

However, all the hard work has been worth it, with Fowler reporting a positive response from members. "As a family business, we were concerned about that."

The close-knit family structure supported the ability to transact quickly. Fowler says: "We could decide within minutes on what we would do – that might not be the case elsewhere. There was good preparation, a good counterparty and we knew we'd follow through."

Vestey Group and Rothesay Life's thorough approach meant that the scheme is unlikely to encounter problems during the wind-up. "We went through all risks so there would be no lingering liabilities. The due diligence is very intense. Whatever prep you've done, there'll still be more scrutiny. I'd advise anyone considering a buyout to find out as much as they can in advance, so that the process doesn't derail or disappoint."

One of the many positives to come out of Vestey Group's experience has been the establishment of Western Pension Solutions. This consultancy firm – owned by the Vestey Group – specialises in helping family businesses to work through the same processes that the Western United scheme has undergone.

"Family businesses – especially multi-generational families – have a long-term focus. But they don't want to pass down legacy challenges like a pension scheme to their children. We can help them to work through that".

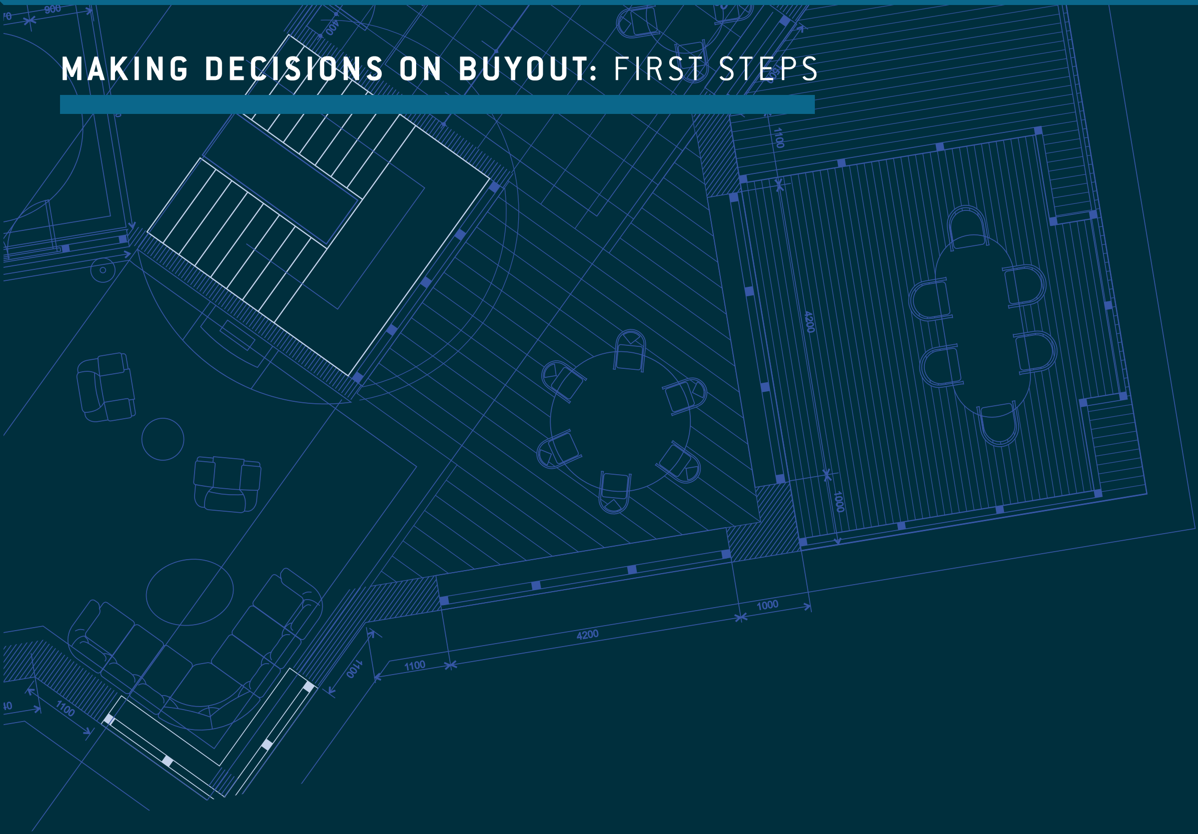
"The really important thing was that everyone was happy at the end," concludes Fowler. "There was surplus revenue, so members even got a discretionary one-off increase. Shareholders are delighted, and the company is unshackled by its pension scheme." ■

A BUYOUT WAS THE CULMINATION OF A LONG-TERM STRATEGY FOR THE VESTEY GROUP

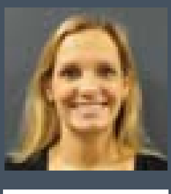
COMPANY:
Vestey Group – Western United Group Pension Scheme

SIZE OF BUYOUT:
£500m

DATE OF BUYOUT:
mid-2014



WHY IT MAKES SENSE TO CLEAN UP YOUR DATA



VERITY HASTIE
Business development

While most full buyouts start as buy-ins (with a clear intention that individual policies will be issued), there are some key differences in the way they are structured. One of the key areas where they differ is the management of member and benefit data. Because a buy-in is held as an investment of the pension fund, there is no immediate need for the insurance to match the individual members' benefits precisely. However, when a pension fund is fully bought out, the liability to provide pensions to its members is transferred in full to the insurer.

It therefore becomes vital that the correct benefits are insured for each member, and this requires significant extra work to ensure that the liability data is correct. While many pension funds have been working over recent years to cleanse their data, there will always be potential for errors to remain uncorrected and for eligible members to be missing from the data set.

Guaranteed minimum pensions (GMPs), if not yet reconciled, will also lead to benefit changes. There is, of course, the thorny topic of GMP equalisation; two time-consuming and costly issues to fix.

This can all lead to uncertainty in the pension fund's liabilities and, when those liabilities are being handed in full to an insurer, the question arises as to who will cover the cost of any corrections that might be required after the bulk annuity has been secured.

In the context of a full buyout, some trustees will rely on a legal argument to avoid any requirement to make corrections after completion of the wind-up. However, the wind-up process and converting the bulk annuity into individual policies can take years, leaving residual liabilities for all that time. Trustees of larger funds (at least) aspire to ensure that errors in benefits are corrected, irrespective of when they emerge.

THE NEED FOR COST CERTAINTY

Uncertainty in liabilities can create difficulty in securing appropriate insurance. Three different examples come to mind:

1 It is usually the case that the corporate sponsor must make a contribution for the full cost of a buyout to be afforded. It is understandable that the corporate and its board would like certainty of this amount. While future injections are not attractive, similarly, there is often a strong wish to avoid putting in too much money up front only to trap surplus as a result of data changes that emerge post transaction.

2 Trustees who are lucky enough to have a surplus in their pension fund will want to spend at least part of it on benefit augmentations; they will therefore want to be sure that they have fully secured the current liabilities before spending any of that surplus on increasing the liabilities further.

3 Similarly, trustees who are trying to prevent their pension fund tipping into the Pension Protection Fund by insuring liabilities instead, will want to know with absolute certainty that they have secured benefits at least equal to PPF compensation.

Increasingly, pension fund trustees and corporates have sought to insure the risks associated with data errors and other risks such as GMP equalisation methodology (referred to collectively as 'data risk'). This can be seen by the fact that 80% of the top 20 buyouts (see table, p14) have included an element of data risk insurance.

80% OF THE TOP 20 BUYOUTS HAVE INCLUDED AN ELEMENT OF DATA RISK INSURANCE

UNDERWRITING DATA RISK

For an insurance company to underwrite data risk, pre-transaction due diligence is key. This is carried out through detailed analysis of the pension fund's governing documentation, the data held on its administration systems and the practices adopted in paying benefits historically. Further, the insurer will review how legislation has been applied to determine whether there might be any issues that could materialise in the future.

The most common cause of problems is failure to affect gender equalisation in a legally-robust fashion following the 1990 Barber judgment. Another key consideration for insurers is whether trust documentation has been executed correctly.

Following the due diligence process, the insurance company will assess the cost of providing cover against data risk. The components of this premium will be:

1. The cost of making corrections that would normally be picked up by a post-transaction, pre-assignment data cleanse (i.e. pre-identified data and benefit issues); and

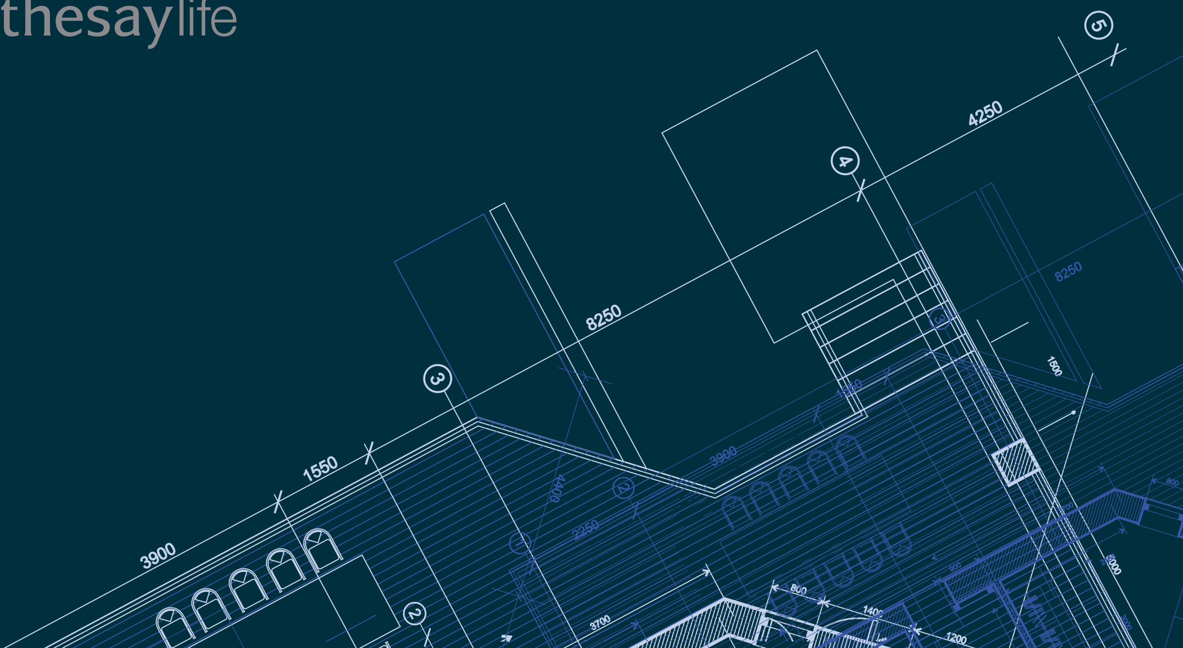
2. A premium for the issues that may emerge in the future but cannot be corrected in a data cleanse (i.e. unknown data and benefit issues).

If insurance is bought for both of these components then the trustees and corporate can achieve certainty on the liability costs. This approach mitigates problems that would arise if an unexpected cost emerges after the trustees have put the bulk annuity in place. Having this certainty makes it much easier to execute the bulk annuity and then in completing a buyout.

For corporates wanting a quick and full settlement of liabilities, this additional insurance has an interesting by-product. The management time and costs taken to completely wind up a trust can be disproportionate, even after a full buy-in has been put in place.

Purchasing cover for data risk can enable a much quicker and simpler move to assignment: removing the liabilities from the corporate pension accounting balance sheet at an earlier stage. ■

Rothesay life



SINCE **2007**, UK PENSION FUNDS HAVE SECURED AROUND **£64BN** OF BULK ANNUITIES. OF THIS WE ESTIMATE THAT AROUND **45%** IS IN RESPECT OF BUYOUTS WHERE FUNDS HAVE SECURED BENEFITS FOR ALL OF THEIR MEMBERS AND WILL SOON BE COMPLETING, OR HAVE ALREADY COMPLETED, A WIND-UP

Guy Freeman
Co-head, business development
Rothesay Life

PREPARING FOR AND ANALYSING A TRANSACTION

EARLY PLANNING

Some straightforward steps can help ensure a straightforward journey to buyout

PAGE 26

ENTITLEMENTS

Knowing exactly what pension scheme members are entitled to are a key part of the picture

PAGE 27

SOLVENCY II

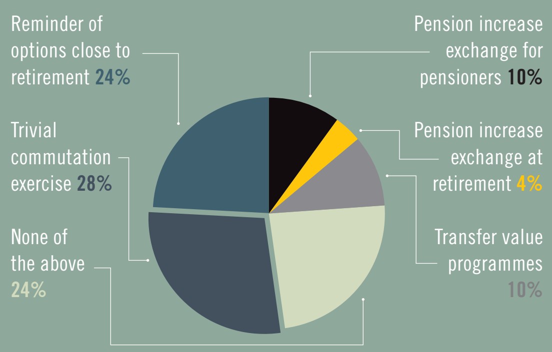
How insurers' approach to risk has changed since the changes to the regulatory landscape

PAGE 30

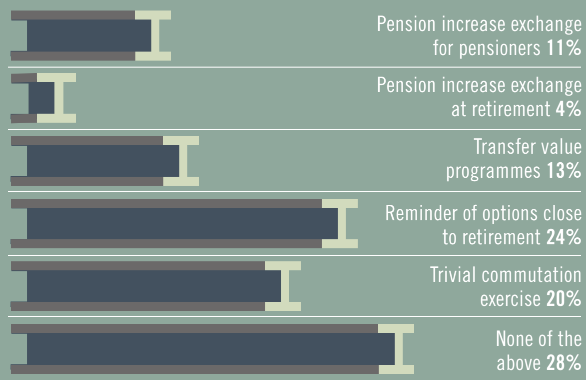
DE-RISKING STEPS

With the majority of respondents expecting to de-risk in steps rather than waiting to carry out a single transaction when affordable, this chapter looks at just what they are doing to prepare for eventual buyouts, how they are prioritising those steps, and specifics on data preparation. It also highlights the differences in liability management and communication exercises, pre- and post-April 2015

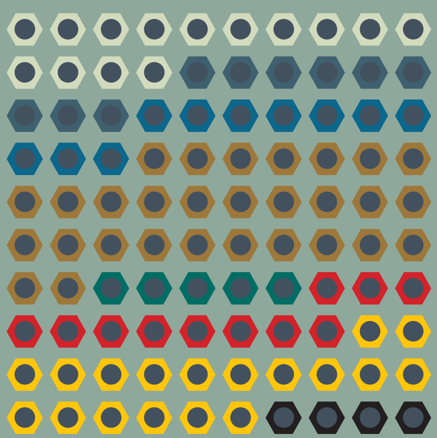
WHAT LIABILITY MANAGEMENT OR COMMUNICATION EXERCISES HAVE YOU RUN PRE-APRIL 2015?



WHAT LIABILITY MANAGEMENT EXERCISES OR COMMUNICATION HAVE YOU RUN POST-APRIL 2015?

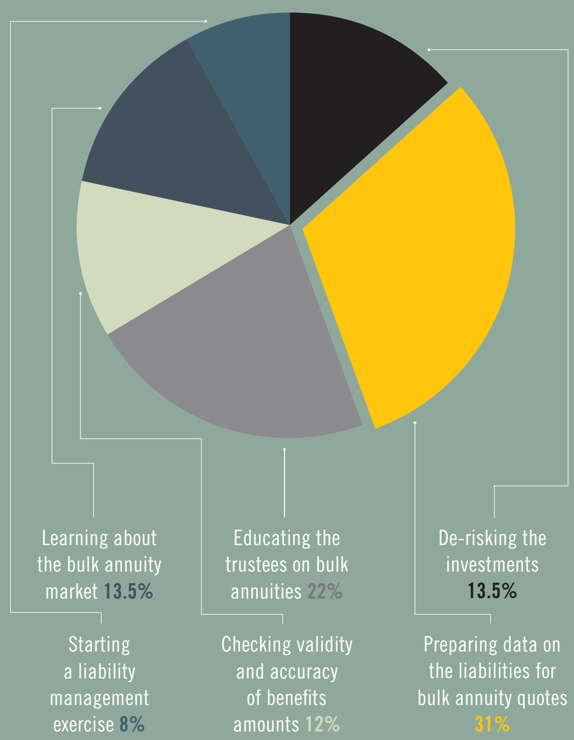


WHAT PREPARATIONS HAVE YOU MADE FOR DE-RISKING, IN TERMS OF DATA PREPARATION?



- Collected marital status and spouse's date of birth data from pensioners 14%
- Collected marital status and spouse's date of birth data from pensioners and deferreds 9%
- Completed electronic records for spouses pensions 10%
- Started GMP reconciliation 29%
- Completed GMP reconciliation 5%
- Checked implementation of sex equalisation of benefits 11%
- Checked historical legal documentation for problems 18%
- None of the above 4%

IF THE COMPANY INDICATED THAT A BUYOUT MIGHT SOON BE VIABLE, WHAT WOULD BE YOUR PRIORITIES BE?



THE DEVIL IS IN THE DETAIL

LIABILITY MANAGEMENT EXERCISES AND DATA EXERCISES ARE KEY TO MOVING TOWARDS A BUYOUT, REPORTS **JENNA GADHAVI**

Driven by maturing defined benefit schemes and volatile funding levels, buyouts are expected to become increasingly common in the future. Indeed half of respondents surveyed cited buyouts as their plan sponsor's long-term objective for the scheme.

RESHAPING LIABILITIES

Schemes with this goal should be thinking about reshaping their liabilities now, so that insurers prioritise their scheme when the time comes. Insurers like simplicity and predictability, so removing smaller liabilities through a trivial commutation exercise, or reducing the inflation risk exposure through pension increase exchanges could make a scheme a more attractive proposition.

This certainly rang true with our survey respondents, with many carrying out liability management exercises both before and after the introduction of freedom and choice. The most common option was a trivial commutation exercise – 28% of respondents had completed an exercise before April 2015 and 20% had done so since that data.

Many schemes have also taken the relatively simple step of reminding members of their options as they approach retirement. One in five schemes took this approach, and the extra flexibilities introduced in April will have made the chance to transfer out more attractive to some members.

Less common options included pension increase exchanges, which give members the chance to swap an inflation-linked benefit for a higher starting income that doesn't increase. One in ten respondents had conducted an exercise among pensioner members pre-April 2015, and a similar proportion had done so over the last year and a half. Just 4% offered pension increase exchanges as standard at retirement.

TIDYING DATA

The other area in which schemes can act to make their benefits more attractive to insurers is data quality. Again, insurers like certainty, and the more information they have on members – and the more confidence they have in that data – the more competitively they will price.

While most schemes have undertaken some action to get their data in shape – just 4% of respondents had carried out none of the exercises on our list – many recognised they had some way still to go. Almost a third said preparing their data would be their priority if their sponsor indicated a de-risking deal was on the cards.

Actions taken to tidy up scheme data include guaranteed minimum pension exercises. Although just 5% of schemes had completed GMP reconciliation, 29% had started the process. Some 18% had gone over their legal documents to check for historic problems.

A number of schemes had also begun collecting data on members' spouses. This is an area that many schemes have traditionally turned a blind eye to, but could make a material difference to the value of liabilities. Some 14% of schemes had collected data on pensioners' partners while 9% had done the same for pensioners and deferred members.

So schemes have certainly started acting to make their schemes easier to insure. With so many targeting an eventual buyout, though trustees cannot afford to be complacent. If capacity in the market gets squeezed, those schemes with the cleanest data, and the simplest benefits will find themselves at the head of the queue.

Pre-April 2015, 76% had run a liability management exercise of some description.

LIABILITY MANAGEMENT

Despite the pensions freedoms introduced in April 2015, the liability management exercises that survey respondents carried out pre and post freedom and choice remained largely the same. The only type of liability management that reduced was trivial commutation exercises (from 28% to 20%), although this could simply be down to the fact that once they are done, they don't need to be done again.

DATA

The more data preparation a scheme does, the cheaper it could be to insure their liabilities.

PRIORITIES

Thirty one per cent of respondents cited 'preparing data on the liabilities so that bulk annuity quotes can be requested' as their main priority, should the company indicate that a buyout might soon be viable.

Interestingly, very few respondents cited starting a liability management exercise as their main priority, but this could well be because many of them had done so already, as the survey results show. ■

WAYS TO OPTIMISE PRICE AND TERMS IN A BUYOUT

SOME SIMPLE STEPS CAN HELP PUT PENSION SCHEMES AT THE FRONT OF THE DE-RISKING QUEUE

According to recent market surveys, demand for insurance buyouts – as the preferred endgame in a pension scheme's de-risking journey – is expected to grow significantly over the next decade, driven by the maturing of defined benefit pension schemes, many of which closed nearly a decade ago. The recent collapse in long-term yields appears to have arrested this growth for the time being, but any rise in yields from today's record lows would bring about demand growth sooner.

Importantly, because pension schemes all closed at a similar time, those demanding buyout will tend to demand it together.

When faced with strong demand for 'gilts for buy-in' transactions and strategic insurance back-book transfers, insurers have a choice. They will naturally prioritise cases that are easier to price keenly (i.e. lower risk) and come to market with a higher degree of execution certainty.

Some pension schemes are brought to market with a simplified benefit specification document and data that is known to be incomplete or inaccurate. Their reason for doing this is based on a wish to avoid the cost of data cleansing or document-drafting until after an initial quotation is received. This is a false economy.

So how can pension schemes ensure they receive attention in what is likely to become an ever-more crowded market?

Cleanse data and provide a detailed benefit specification document. Of course, the trustees will want to ensure the correct benefits are insured for all their members, but that could be dealt with in the post-transaction cleanse and true-up process as the pension scheme is wound-up.

It is important to ensure completeness and consistency of data before approaching buyout providers for a quotation. This is because these drive the amount of prudence built into insurance pricing, and once that has been built in, it is hard to remove it in practice when data is later updated.

A subjective view on data and how it is presented to insurers has a direct impact on the price they quote for any additional insurance against data risk if that is required. A similar rationale applies to why detailed preparation of the benefit specification document is important.

Clarify the contractual terms that matter. Many contractual terms in buyout policies drive pricing. These include member option terms for deferred pensioners or provisions governing the discovery and/or correction of data errors. Trustees and corporate sponsors should agree their position before approaching insurers to ensure their preferences are priced in during the competitive phase of the process, and the scope for the insurer's quotation to change during subsequent exclusive negotiations, is limited.

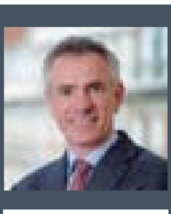
Governance and project management. A pension scheme's ability to react quickly to pricing opportunities requires effective governance and an organised approach to the transaction. Effective governance is founded on ensuring that key decision makers have the appropriate information and advice in a timely fashion and that no one is left behind in the process. By focusing on governance and preparation, the Philips Pension Fund, advised by LCP, was able to seize attractive pricing opportunities in three successive buy-ins and build the experience to respond to an offer from the company to buy out the residual liabilities within a tight timeframe.

In LCP's experience of running processes, where significant emphasis is placed on this up-front preparation and planning, insurers will quote more competitive pricing and prioritise such cases over less well-prepared pension schemes. As well as the impact on underwriting referred to above, if a pension scheme and its corporate sponsor are prepared to invest time and fees in effective preparation and governance, insurers gain comfort that they are serious.

In a buyout it is important to demonstrate to insurers that the trustees and corporate sponsor are working together and have realistic price expectations.

Experience among advisers is, of course, central to minimising execution risk for both pension schemes and insurers in buyout transactions. Increasingly, we see insurers prioritising buyout cases where trustee boards have experience of purchasing annuities in the past. An effective way of building this experience is for trustees to purchase one or more buy-in policies on the de-risking journey towards full buyout.

Optimising the price and terms of a buyout and minimising execution risk is a matter of pension schemes understanding the insurance they are seeking to buy, and insurers pricing this keenly by understanding as much as possible about the risk they are insuring. ■



MYLES PINK
Partner,
Lane, Clark & Peacock

AUDIT YOUR BENEFITS TO SECURE THE BEST PRICING

A KEY STEP TO BUYOUT IS HAVING ACCURATE INFORMATION ABOUT WHAT SCHEME MEMBERS ARE ENTITLED TO

Good-quality preparation for buyout goes further than data checking. The fact is that administrative practice does not always reflect the real legal entitlements under scheme rules. Members are unlikely to be aware if they are being underpaid, but that could change. On a more positive note, trustees and sponsors get a clean break on buyout by securing the correct legal entitlements, as best they can.

They can also enhance comparability, predictability and speed of pricing, which should produce a more competitive price. The due diligence needed to achieve this can be done proportionately, recognising areas of uncertainty without losing control of the agenda, as long as the project is carefully scoped.

VENDOR DUE DILIGENCE

At the buy-in phase benefits can be deliberately under- or over-insured for practical or commercial reasons. But at buyout, mismatches should be removed so that members' entitlements are delivered once the scheme drops out of the picture.

In corporate terms, buyout transactions are comparable to the sale of a loss-making operation (with a reverse premium). Vendors may carry out their own 'due diligence' to package the business for sale in a way that is attractive to a buyer. Corporate sponsors are used to this as an approach even though it front-loads cost.

In pensions, clean-up work tends to be done in relation to data but often does not go as far as checking the underlying legal entitlements. This is a gap in the process.

Reconstructing current benefits in payment from first principles may not be practical or even possible. But as a minimum it seems worthwhile establishing what rights members have in relation to future events (such as retirement, if deferreds are involved; pension increases; hitting state pension age; deaths of members and survivors).

WHAT IS INVOLVED?

There are two parts to this legal due diligence process:

- establishing the legal entitlements under the scheme and
- deciding what to insure.

Establishing the legal entitlements

In a simple single employer scheme this isn't too challenging, but where different documents have applied to different categories of members and different generations of leavers it requires:

- collating all governing documents, including from legacy schemes that still apply to transferred-in members;
- mapping the classes of members, according to joining, leaving or retiring dates;
- producing a working copy of each applicable set of rules; and
- identifying material undocumented terms such as early and late retirement rights, rates of revaluation, and permitted franking.

Some of this information will not be available. For past members there may be limited data beyond the member's pension and/or the deferred pension at the date of leaving.

Specifying what to insure

Once a full set of documentation exists, the trustees will be well placed to draw up a specification of they want the insurer to provide. Traditionally, benefit specifications are supplied in a descriptive format, effectively summarising scheme rules. Discretions will be codified but otherwise the insurer is left to interpret what those rules mean in practice.

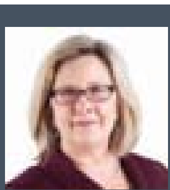
In our experience, drawing up a clear and precise benefit specification in a 'matrix' format for insurers to quote on has real advantages for trustees. A more precise specification gives trustees access to favourable pricing, as insurers have confidence in the thorough benefit audit process that has been followed.

The trustees can have confidence in the comparability of quotes, because they are not based on differing interpretations of benefits by insurers, resulting in further adjustments to price during the verification process.

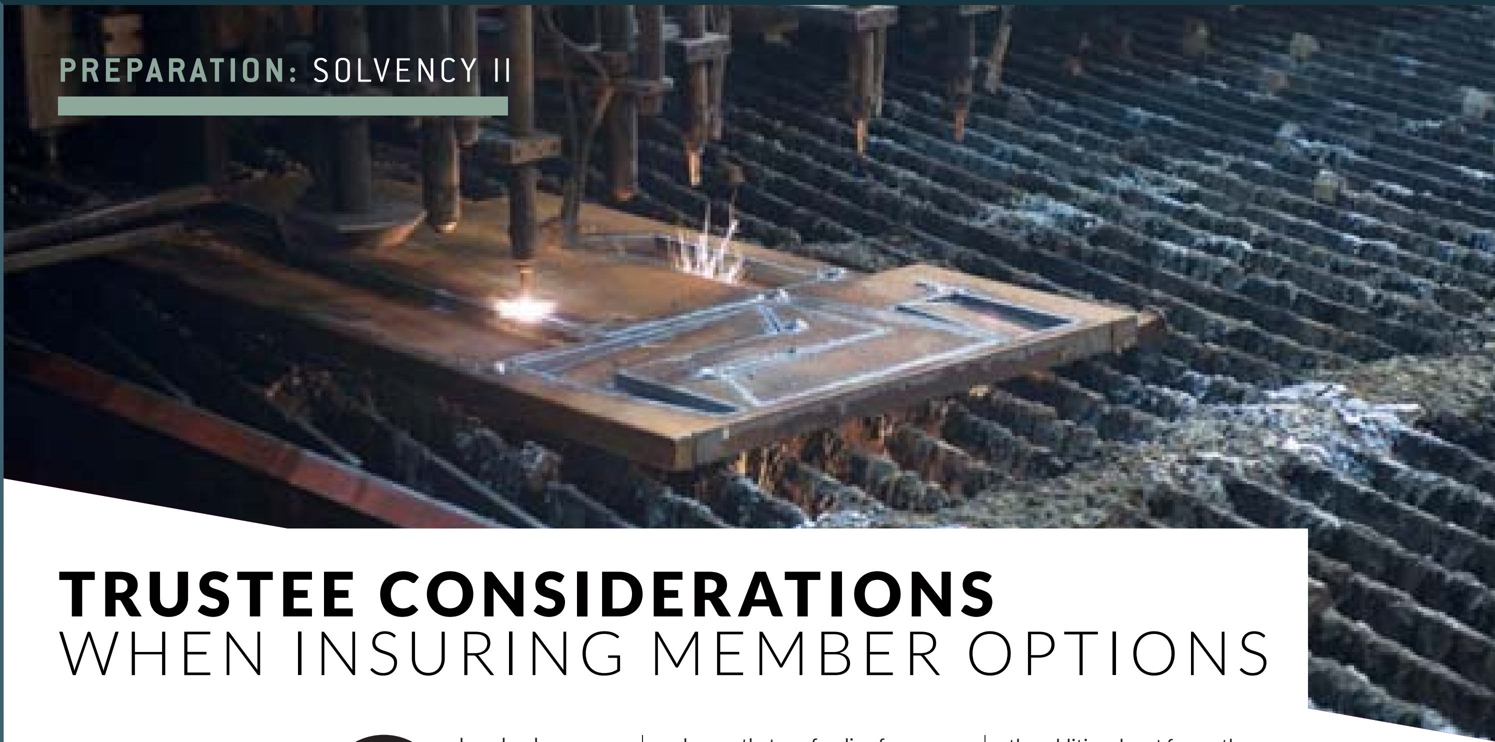
Not doing this exercise seems to represent unrewarded risk taking. Trustees are not required to operate in a vacuum. The law requires them to do their best, but no more than that. Trustees cannot be more exposed by asking the right questions than by not asking at all.

Techniques exist to gain certainty, or a greater degree of confidence, or just to enhance the paper trail (including augmentation and amendment). Retrospective ratification can work as long as there is no evidence to prove that the practice is wrong.

What this amounts to is a process of conscious decision-making. If it improves pricing the exercise may pay for itself. It may even put buyout within reach for the first time. ■



ANNA RODGERS
Senior partner,
ARC Pensions Law



TRUSTEE CONSIDERATIONS WHEN INSURING MEMBER OPTIONS

THE 2016 CHANGES TO THE REGULATORY LANDSCAPE HAVE HAD A MAJOR EFFECT ON INSURERS' APPROACH TO RISK

There has been widespread coverage on the impact of the European Union's Solvency II regulatory regime on the pricing of bulk annuity transactions. However, there has been less focus on the practical consequences Solvency II has had for insuring member options, such as transfer values, the commutation of pension for a cash lump sum and early retirement factors.

These factors are a key concern for trustees as they determine the benefits members actually receive. Insurer 'standard factors' can vary widely, so trustees should carry out a detailed value analysis of member option factors as part of any insurer selection process.

WHAT CHALLENGES DOES SOLVENCY II CREATE?

Insurers' standard terms will typically be different to the terms offered by pension schemes, and can be more or less generous. In some cases, member option factors are hardcoded in scheme rules which limits trustees' flexibility on what they can insure.

In the past, it has usually been possible to insure more or less generous factors than an insurer's standard terms for a reasonable cost.

In the new Solvency II world this simply may not be economic – if not structured in the right way, this could increase the cost by around 20%-30%.

TAKE CARE WITH YOUR TRANSFER VALUE BASIS

A particular issue arises with transfer values for pension schemes that are funding for buyout.

Pensions legislation requires schemes to pay transfer values that are the "expected cost of providing the benefits under the scheme". This means that transfer values are linked to a scheme's investment strategy, and for a scheme with very low risk assets this could be interpreted to mean a 'gilts flat' basis or the buyout cost.

An insurer's transfer values will be materially lower than the buyout premium.

As well as allowing for disinvestment costs, cost of capital and expenses, insurers are constrained by the new Solvency II rules.

Members may therefore experience a reduction in transfer values after a buyout transaction.

This can create a win-win situation where a well-structured transfer value exercise prior to buyout can provide members with higher transfer values than they might expect after a buyout, while reducing the overall buyout cost.

WHAT CAN TRUSTEES DO IF THEIR OPTION TERMS ARE DIFFICULT TO INSURE?

For many schemes the trustees will be able to align their option factors with the insurer's standard terms.

Where this is not possible, particularly for schemes with generous or fixed option terms, we have seen a number of insurance solutions. For example:

- While the policy remains a buy-in, trustees could pay their members benefits based on the existing scheme option factors and cover the additional cost from other scheme assets.
- On move to buyout, insure, basing it on the insurer's standard option terms, but with benefit uplifts in other areas.

BALANCING TRUSTEE AND COMPANY PRIORITIES

Trustee and company objectives are largely aligned in most areas of a buyout transactions – everyone wants to get the best deal! Member options is one area where there can be competing priorities; better options means higher benefits for members, but at a greater cost.

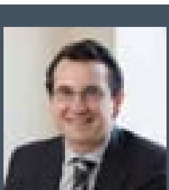
Strong governance processes, up-front engagement and communication between the trustees and the company are all critical to ensuring that you find a solution that works for all parties.

WHAT SHOULD TRUSTEES DO NOW?

Any trustees targeting buyout should consider member options as part of their preparatory work:

- Understand what your member option terms are, and in particular whether there are any constraints in the scheme rules.
- Ensure that you analyse different insurers' member option terms and include this in your insurer selection criteria.
- Consider the interaction of your transfer value factors with any investment de-risking strategy and future buyout.
- Identify and address any issues early, including liaising with the scheme sponsor.

An experienced adviser will help you address these issues at an early stage of any buyout process. ■



KEN HARDMAN
Partner,
Lane, Clark & Peacock

SOLVENCY II
IN A BUYOUT

STRINGENT NEW RULES AROUND CASH FLOW MATCHING ARE HAVING AN AFFECT ON THE COST OF BUYOUTS

Solvency II introduced new reserving rules for UK and European insurers at the start of the year. The new requirements apply to annuity writers and have an impact on how buyouts are structured and on how much they cost.

REGIME CHANGE

A key part of the new regime is some strict rules around cash flow matching of the insured benefits. Insurers need to be able to provide evidence to the Prudential Regulation Authority that they have closely matched their liability cash flows with assets which generate matching cash flows, and the cash flows will continue to match each other under a range of future market stresses.

If the insurer cannot show that there is close matching then it will need to hold additional capital, potentially leading to an increase of as much as 20–30% in the reserves that have to be held. The extra capital will need to earn a return and this will have a dramatic impact on the bulk annuity price, making many transactions unaffordable.

This is therefore a key issue for buyouts that was not present before Solvency II.

MATCHING FOR DEFERREDS

While relatively simple for pensioners, cash flow matching is much harder to do with deferred pensions. The long duration of these pension payments alone presents significant issues, but the harder issue is how the cash flows are affected by member options – namely the precise timing of retirement, the amount of a retirement lump sum and, although rarely used, the possibility of transfers out.

Insurers set up reserves called technical provisions that are primarily based on the portfolio of assets set aside to match the projected cash flows for the pension payments. If the exercise of the option could result in a payment that is larger than these reserves, then it will be not able to claim that it has matched its cash flows and will not be able to offer the better pricing level.

The key aspect of the test is that it is not just applied at the outset. The insurer has to consider a range of future market conditions to pass the test in the first place including, for example, scenarios with much higher yields.

In order to achieve matching and therefore to benefit from the preferred capital treatment, insurers will set a standard approach for member options.

LONGEVITY HEDGING

A new reserving component introduced within the solvency II regime is the Risk Margin. This is an additional capital component which is to protect insurers against "unhedgeable" risks. This is in large part longevity risk.

As a result insurers are doubly incentivised to reinsure longevity risk as they are holding capital against it in their solvency capital requirement and in their Risk Margin. This increased demand has brought a slight capacity crunch with reinsurers being asked to supply more capacity than ever before. As such it is imperative that schemes are able to articulate certainty of trading so as to attract the attention of the reinsurance community.

IMPACT ON BUYOUTS

When considering a buyout, trustees will naturally prefer that the terms for member options after a buyout are similar or better than those currently being offered by their fund. As a result, in the past year we have seen situations where the matching test has failed on each of the commutation, early retirement and Cash Equivalent Transfer Value (CETV) factors.

The most common area of difficulty is likely to be in respect of CETVs close to retirement where low post-retirement discount rates are being used. Perversely, schemes that have de-risked significantly in preparation for a buyout are the ones most exposed to this.

Market competition will mean that insurers will try to deliver what trustees want, but the rules of Solvency II are fairly rigid.

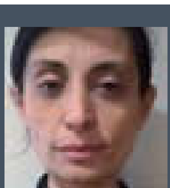
As a result, trustees may not be able to insure their current factors at a price their plan sponsor is willing to fund. However, what is the better outcome for these scheme members? Security for the promised benefits or retaining the existing terms for member options?

In summary, for those that are planning a buyout, there is now good reason to review factors and an extra task for advisers to complete in their feasibility studies. ■

CASH FLOW MATCHING IS MUCH HARDER TO DO WITH DEFERRED PENSIONS

START EARLY IF YOU WANT TO BUY OUT

GOOD PREPARATION IS KEY WHEN TAKING THE PATH TO A SUCCESSFUL BUYOUT



TIZIANA PERRELLA
Principal Consultant in Aon Hewitt's Risk Settlement Group

It would not make sense, from a financial perspective, to keep a defined benefit (DB) pension scheme going until the last beneficiary dies. So, the implication is that each set of scheme trustees will need to complete a buyout at some point (the exception to this being for schemes accepted into the Pension Protection Fund). The key variables are the likely timescales and the process to be followed (i.e. will the benefits be secured in full in a single transaction or in tranches?).

Appropriate preparation for a buyout will result in better outcomes for all stakeholders. This process will require a thorough understanding of the bulk annuity market and the ability of the trustees and sponsor to complete a transaction quickly and efficiently when the time is right.

WHAT DOES IT MEAN TO BE 'BUYOUT READY'?

The data and benefits to be secured will need to be complete and correct before a buyout is completed, as there is limited scope to make corrections post buyout, and no scope at all after the scheme has wound up.

In my experience, a scheme may be very well run and still not hold items of data (such as current contingent spouse pension data) that are not required for ongoing administration purposes but are needed by an insurer to carry out their calculations. The additional data will need to be collected and calculated and kept up to date.

A detailed benefit specification should be drafted and signed off by the scheme lawyers. This will confirm to the trustees that the scheme is being administered properly and will also simplify the broking process once the trustees are ready to approach the market.

Good-quality member data and an agreed specification is likely to result in more insurers being willing to provide a quotation than would otherwise be the case.

This is particularly relevant to smaller schemes, as these tend to be less attractive to insurers. In addition, the initial quotation price will be closer to the final premium earlier on in the process, and may be especially competitive as insurers can be more confident that a transaction will happen quickly.

However, it should be noted that the number of data and benefit specification items that have a major impact on the premium is relatively small. Delaying a transaction because of items which are unlikely to have an impact on price may be detrimental if it results in the loss of pricing opportunities.

WHAT IS THE RIGHT PRICE?

In order to assess whether a quotation price is competitive, trustees and sponsors will need a broad understanding of the pricing approach used by insurers, the regulations they are subject to and their commercial environment. Insurers are required to invest prudently and to hold substantial reserves – this means a bulk annuity is potentially a low-yielding asset.

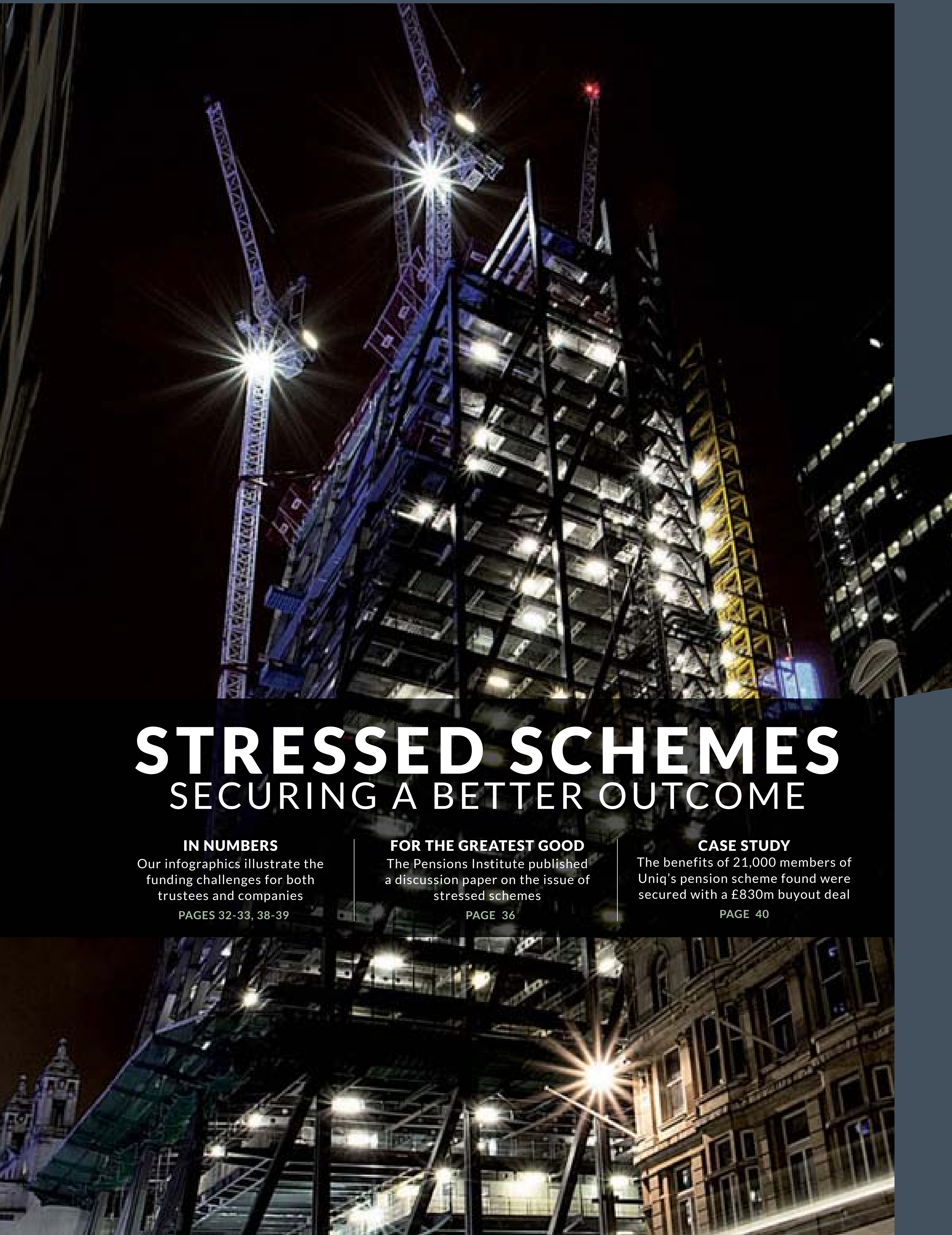
The yield can be improved if an insurer can source low risk / higher yield assets that also match a scheme's liabilities. Schemes which are already engaged with the market at the time these assets become available are able to benefit from this improved pricing.

There is a difference between cost and affordability. If a good price is on offer, but affordability is an issue, contract structures can be put in place so that the premium is paid over an extended period. The extra payments are equivalent to those due under a recovery plan which will not need to be revised at the next valuation date.

The assessment of the quotation price for a buyout should take into account the annual costs of keeping the scheme running, including Pension Protection Fund levies and extra accounting costs for the sponsor. A buyout premium which may have initially been assessed as expensive will look a lot more attractive once the ongoing costs for the next 10-15 years are allowed for. The 'savings' relating to the management time spent dealing with scheme-related issues are harder to assess but could be substantial.

WHAT SHOULD TRUSTEES AND SPONSORS DO?

For some, the first step may be to acknowledge that they are on a path towards buyout. The next step involves understanding data gaps and fixing them, and reviewing the scheme rules and procedure to produce a robust benefit specification. At the same time, trustees should come to consider bulk annuities as an investment class and as a possible investment option whenever changes in investment strategy are considered. Finally, each scheme should engage with the market as soon as it is reasonable to do so. ■



STRESSED SCHEMES
SECURING A BETTER OUTCOME

IN NUMBERS
Our infographics illustrate the funding challenges for both trustees and companies
PAGES 32-33, 38-39

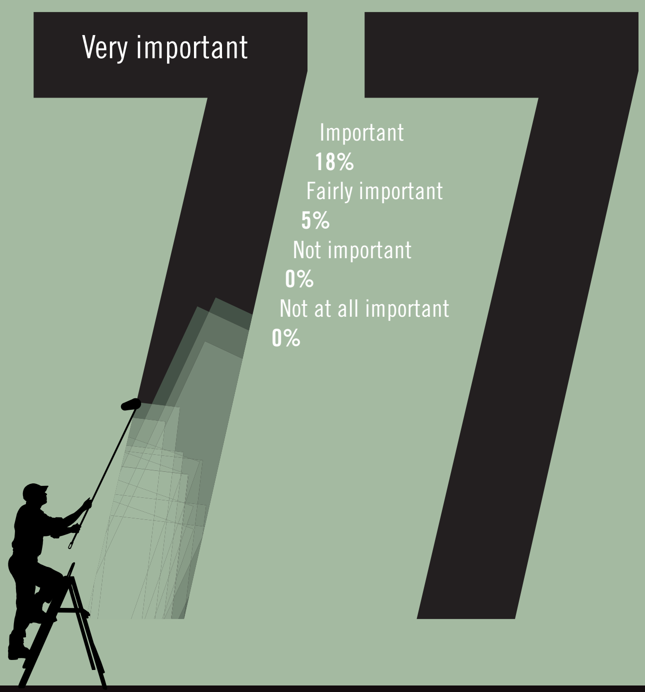
FOR THE GREATEST GOOD
The Pensions Institute published a discussion paper on the issue of stressed schemes
PAGE 36

CASE STUDY
The benefits of 21,000 members of Uniq's pension scheme found were secured with a £830m buyout deal
PAGE 40

TRUSTEES IN NUMBERS

Publicity surrounding high-profile cases such as BHS coming to the forefront this year, what importance do trustees place on covenant strength, how do they rate their own employer's covenant and what are their expectations around full benefits payouts? Despite the recent focus on stressed schemes, our survey found that the majority of trustees still wouldn't push their employer harder for contributions

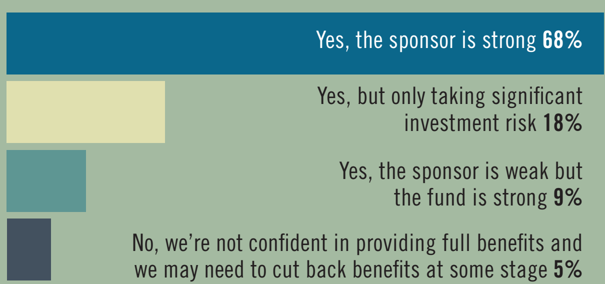
HOW IMPORTANT IS COVENANT STRENGTH?



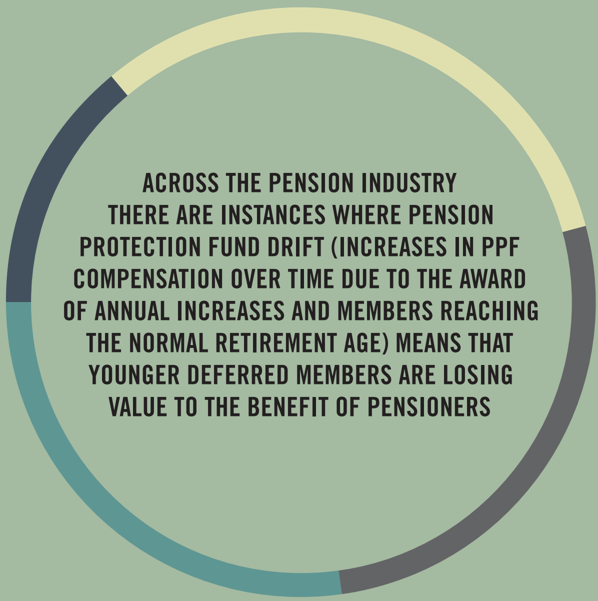
WOULD YOU CATEGORISE YOUR EMPLOYER'S COVENANT STRENGTH AS BROADLY:

Strong 27% Tending to strong 41% Tending to weak 32% Weak 0%

IS IT THE TRUSTEES' EXPECTATION THAT FULL BENEFITS WILL BE PROVIDED TO ALL MEMBERS?

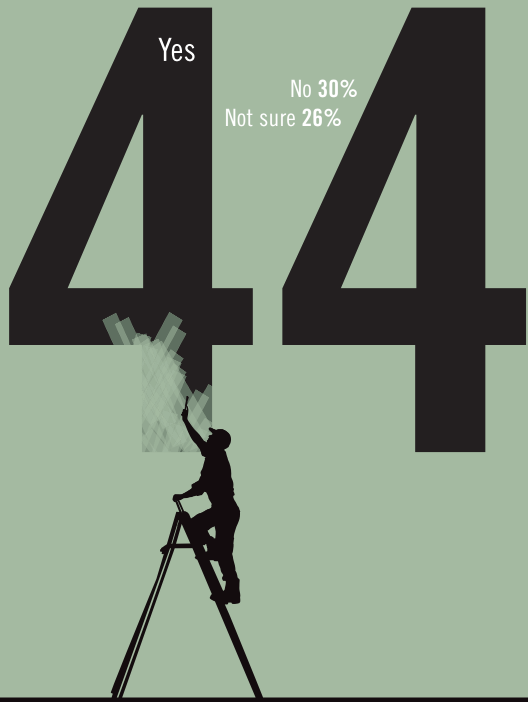


ACROSS THE PENSION INDUSTRY THERE ARE INSTANCES WHERE PENSION PROTECTION FUND DRIFT (INCREASES IN PPF COMPENSATION OVER TIME DUE TO THE AWARD OF ANNUAL INCREASES AND MEMBERS REACHING THE NORMAL RETIREMENT AGE) MEANS THAT YOUNGER DEFERRED MEMBERS ARE LOSING VALUE TO THE BENEFIT OF PENSIONERS



This statement is not true **14%**
This might be true, but there is nothing we can do **32%**
This might be true, but life has its ups and downs **27%**
No idea, never had to think about it **27%**

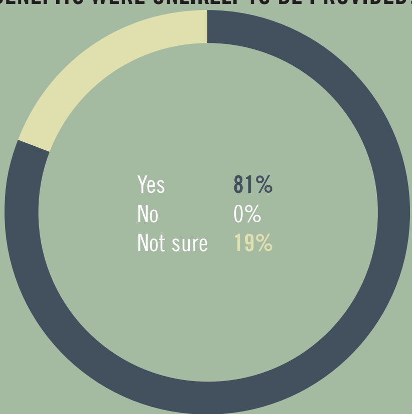
IF YOUR PLAN SPONSOR BECAME INSOLVENT TOMORROW, DO YOU BELIEVE THAT ENOUGH OF THE SECTION 75 CLAIM FOR THE BUYOUT SHORTFALL WOULD BE RECOVERED TO SECURE BENEFITS ABOVE PPF COMPENSATION LEVELS, WHEN COMBINED WITH THE FUND ASSETS ALREADY HELD?



IF THE COMPANY MADE AN OFFER OF A LARGE, FINAL ONE-OFF PAYMENT WITH NO FURTHER CONTRIBUTIONS OR SUPPORT, THAT WOULD ENABLE THE MEMBERS TO ESCAPE THE PENSION PROTECTION FUND BY INSURING THE BENEFITS, WHAT LEVEL OF BUYOUT BENEFITS WOULD BE ENOUGH TO MAKE IT WORTH THE TRUSTEES CONSIDERING (ASSUMING NO REGULATORY BLOCKAGES)?

Full benefits because the sponsor is strong enough **69%** / PPF compensation with Retail Prices Index increases instead of Consumer Prices Index **4%** / 110% of PPF compensation on average **9%** / Anything more than 10% short of the cost of full benefits **9%** / PPF compensation **9%**

(ONLY FOR THOSE WHO BELIEVE THE SPONSOR COVENANT IS STRONG AND/OR THAT BENEFITS WOULD BE PAID IN FULL) WOULD YOUR ANSWER BE DIFFERENT IF YOU BELIEVED THE SPONSOR COVENANT WAS WEAK/WEAKENING AND FULL BENEFITS WERE UNLIKELY TO BE PROVIDED?



Yes 81%
No 0%
Not sure 19%

ARE YOU GOING TO PUSH THE EMPLOYER HARDER FOR MORE CONTRIBUTIONS AT THE NEXT FUNDING REVIEW IN THE LIGHT OF RECENT CASES SUCH AS BHS? (%)

No 77%

COVENANT IS KING

THE IMPORTANCE OF COVENANT IS RISING UP TRUSTEES' AGENDAS, REPORTS **JENNA GADHAVI**

No one can deny that covenant assessment is becoming increasingly important, especially since the launch of the Pension Regulator's Integrated Risk Management guidance in December 2015.

In the integrated funding environment that the Pensions Regulator is promoting, the strength of the covenant is one of three key risks trustees must manage, alongside funding levels and investment strategy. The theory is that the stronger the employer, the more flexibility trustees have over investment and funding decisions.

MESSAGE RECEIVED

Our survey results show the regulator's message is getting through, with 77% of trustees citing covenant strength as 'very important', and a further 18% saying 'important'.

When asked how they'd categorise their covenant strength, 68% of trustees surveyed said it was strong or tending to strong. Not one respondent said they had a weak covenant. However, the Pensions Regulator classes around one in six schemes as having a weak covenant, which suggests that although trustees recognise the importance of employer support, they may not necessarily have an accurate view of covenant strength.

If this is the case, then many trustees are underestimating the most important risk of all – the chance that their scheme might not be able to deliver the benefits it has promised to members.

The vast majority of trustee respondents – 95% – said they did expect full benefits to be provided to members. Sixty-eight per cent said this was because their sponsor would continue to support the scheme (reflecting the proportion who judged their covenant to be strong or tending to strong).

A further 18% expected full benefits to be paid, but only by taking significant investment risk; 9% said they had a weak sponsor, but were sufficiently well funded to make good on all their liabilities.

Sponsors seem to have a more pessimistic view of the situation. Only 42% of companies surveyed expect to provide full benefits to their members at retirement. This disparity between the views of sponsors and trustees on the security of members' benefits is a potential cause for concern.

PAINFUL DEFICITS

Trustees are painfully aware of the shortfalls in their schemes, though. Just 44% said that their scheme would stay out of the Pension Protection Fund if their sponsor went into administration tomorrow. Three in ten said their scheme would fall into the lifeboat fund and a third were unsure.

The publicity around the BHS scheme – which had a 23-year recovery plan in place when its sponsor entered administration – has clearly raised the profile of this issue. Twenty-three per cent of scheme would push their employers for more recovery contributions as a result of the BHS case.

But this awareness of shortfalls does not necessarily mean trustees would compromise on benefits for more security. More than two-thirds would not accept a deal that reduced member benefits in exchange for insuring the scheme, even if there were no regulatory hurdles. Again, this reflects the number of respondents who believe their covenant is strong or tending to strong.

THE CASE FOR COMPROMISE

The third of trustees who believe their covenant is tending to weak said they would be willing to contemplate a range of options to compromise benefits if it meant members were more secure.

One in 11 would even consider cutting a deal with their sponsor that released them from their obligations if it secured PPF-level benefits with no uplift.

And four out of five of those respondents who said they had a strong covenant, added that they would be willing to compromise benefits if they thought their covenant had weakened.

So an increased focus on covenant could lead to a growing appetite for these types of compromise deals, if it turns out trustees have been over-confident in assessing their sponsors' strength. ■

ADOPTING THE RIGHT STRATEGY WHEN THE GOING GETS TOUGH

Markets have continued to be unkind to pension schemes. The persistence of low interest rates and the continuing storm clouds around the world's economy have driven up deficits.

Aggregate Pension Protection Fund deficits increased by £226bn between August 2015 and August 2016. The proportion of schemes in PPF deficit (84%) and the aggregate deficit of those schemes are both about as high as they have ever been.

This has unfortunately highlighted the risks of delaying solving distressed pension funds.

In the past, schemes have, with careful consideration, sought to delay the inevitable. With hindsight this has not worked out. In 2011 the HMV pension scheme supported letting go of Waterstone's to buy time – only to fall into the PPF in 2013. And as far back as 2006 the Polestar scheme was separated from its employer, but ultimately fell into the PPF in 2011.

The chance of providing all benefits was at the heart of these agreements. But it raises the question of whether members would be better off if time is called on a pension scheme sooner.

To date, waiting seems to tie to increasing costs. Over 2011 and 2012, by the time the HMV scheme entered PPF, assessment insurance costs had increased by 20%.

A MORE CONSIDERED, COLLABORATIVE APPROACH

It is possible to save a business by passing on pension liabilities to the PPF. Currently the PPF and the Pensions Regulator require the insolvency of an employer to be inevitable and imminent to agree to this.

By then, however, there is often less flexibility and available funds to support a good outcome for the scheme. If there were a critical examination on the sustainability of a pension scheme earlier on, a better outcome could be achieved.

Settling pension liabilities earlier can support more investment in a business. This can lead to better outcomes for members, the PPF and the economy in terms of saving businesses and jobs.

SECURING A BETTER OUTCOME

If addressing the pension situation earlier may allow more money to be available for the scheme, is it also possible to make that money go further?

Traditionally, if a scheme has more than is needed to cover PPF benefits then it is compelled to buy out. During this process members' pension rights are transformed into whatever pension benefits the assets can buy in the insurance market. With a finite pot of money, securing benefits in such an expensive way can lead to lower benefits for the member.

Why do it, then? This is the only way to provide members with a high degree of certainty that they won't be facing another reduction in their pension in the future. The certainty provided by an insurance company is being prioritised over getting a higher pension.

However, schemes and trustees do not need to be passive bystanders in this process. It is possible to materially reduce the price you pay for certainty and, therefore, materially increase the benefits for all members by carefully choosing the form of benefits to purchase.

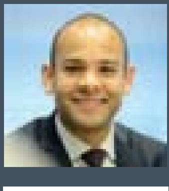
For example, while, the 'certainty' premium for some common forms of pension benefits can be as much as 40% (meaning members pay 40p in the pound for certain and can expect 60p in the pound back as benefits), for other forms of pension benefit it is less than 20% (meaning the member gets more than 80p in the pound).

Choosing to reshape benefits to the latter form can materially improve member outcomes without needing to spend a single extra penny.

To illustrate the impact for the 16% of schemes still lucky enough to be in PPF surplus, that's around £35,000 of value per member – which is not bad. ■

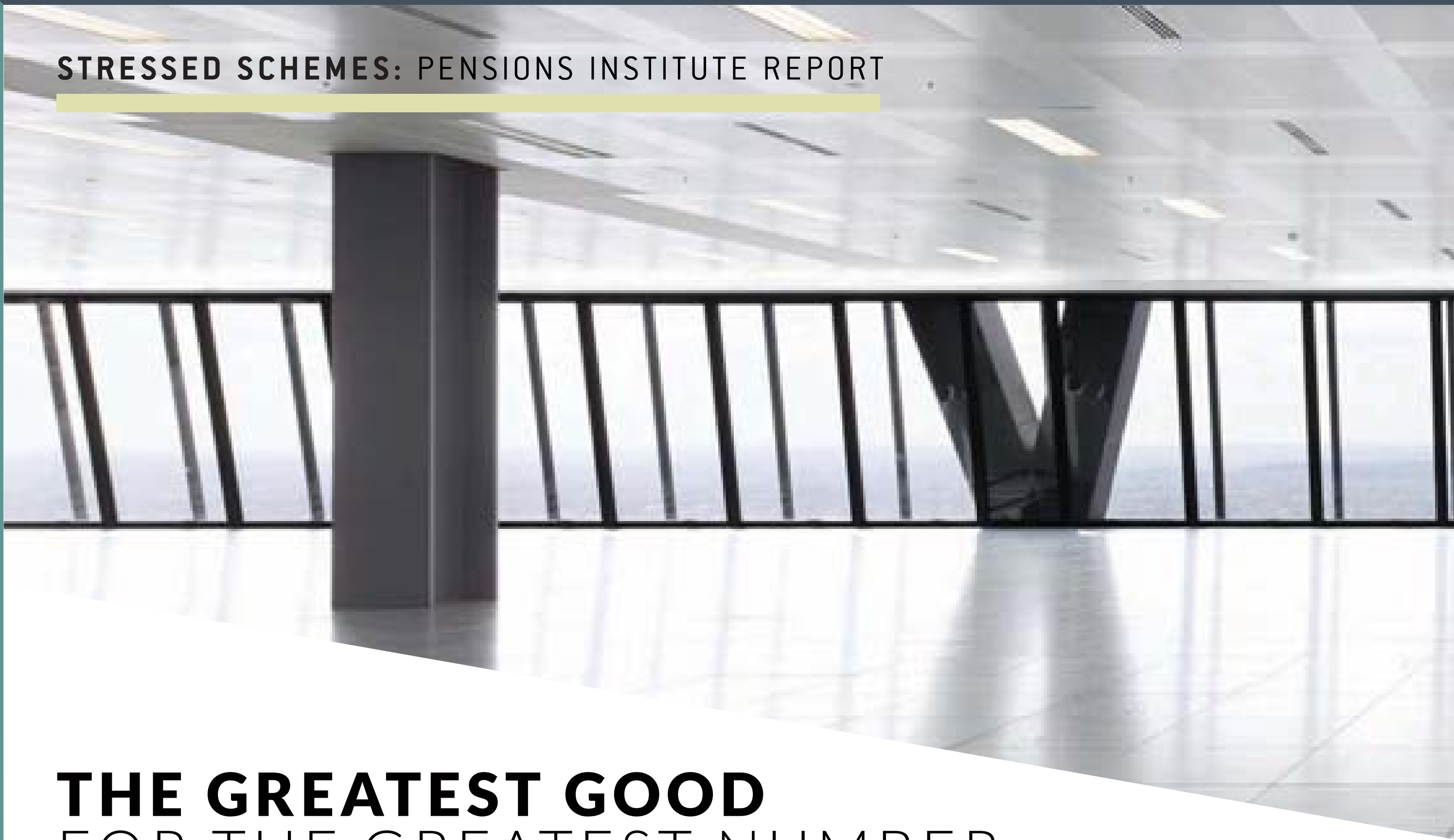
COMING TO TERMS WITH THE INEVITABLE SOONER RATHER THAN LATER CAN BE BETTER IN THE LONG RUN

IT IS POSSIBLE TO MATERIALLY REDUCE THE PRICE YOU PAY FOR CERTAINTY



TOM SEECHARAN
Director, pensions insurance, KPMG

WAYNE SEGARS
Director, pensions, KPMG



THE GREATEST GOOD FOR THE GREATEST NUMBER

THE PENSIONS INSTITUTE LOOKED AT WHY SCHEMES BECOME STRESSED IN THE FIRST PLACE AND OUTLINED SOME STRATEGIES TO TACKLE THE PROBLEM

They often suffer in silence, but stressed schemes – those with a weak covenant and poor funding position – represent a huge risk to the Pension Protection Fund (PPF).

A recent discussion paper, *The Greatest Good for the Greatest Number* by the Pensions Institute at Cass Business School, explored the situation of these stressed schemes. It looked at 'second best' alternatives that could avoid those schemes' eventual fall into the PPF, with the associated costs and impact on member benefits of that action.

The PPF's 'insurance policy' approach to scheme and sponsor solvency leads to the assumption that the employer will be around long enough to support the scheme in fulfilling its obligation to pay members their full benefits. As such, it has a 'benign and low-key role'. It only steps in when the worst happens and the employer becomes insolvent.

But this doesn't reflect a more commonplace scenario – when a scheme is significantly underfunded relative to the sponsor business and the covenant is weak.

As a result, trustees can't rely on the financial support they need from the sponsor. It could be that insolvency is inevitable sooner or later, or that the company's future is viable, but only if the defined benefit deficit is removed from the balance sheet.

According to the report, typically, 'stressed schemes' suffer from the following characteristics:

- The sponsoring employer's covenant is weak. Trustees are not able to rely on the sponsor to fund the members' full benefits over time, due to the mismatch between the length of the recovery plan, and the potentially much shorter lifespan of the sponsor's business.
- The scheme's funding position is weak. The scheme needs more support from the employer, in the form of contributions and guarantees, at a time when the employer's support is being significantly reduced.
- The scheme is subject to 'PPF drift'. This describes a month-by-month increase in the cost of providing PPF compensation.

The most common causes of PPF drift for stressed schemes are the impact of non-statutory pension increases and the increasing number of members who reach normal retirement age, when they qualify for much higher levels of PPF compensation.

This largely unexplored group of schemes represent a risk to the industry.

Their scenarios are not discussed publicly – trustees tend to suffer in silence and as a result there has been little exploration of second best outcomes, in which trustees satisfy their obligations to all of their stakeholders as best they can.

Not exploring alternatives to the either/or outcome of entering the PPF or soldiering on with whatever support the sponsor might be able to provide could mean the insolvency of around 1,000 sponsor businesses. This represents around a sixth of the schemes in the PPF index.

The Pensions Institute's paper explores some alternatives to this scenario, including opportunities for many more schemes to pay less than full benefits – but still more than PPF levels – on a planned and co-ordinated basis.

In order to do that, the paper argues, there needs to be some changes to the industry backdrop to support stressed schemes:

- All stakeholders – the Pensions Regulator, the PPF and the government – need to acknowledge the danger posed by stressed schemes.
- They need to work together to identify outcomes that are second best (i.e. pay more than the PPF to members, but may not pay full benefits).
- Trustees are often, in the words of the report, in a state of 'informed bewilderment' and

TRUSTEES ARE OFTEN IN A STATE OF 'INFORMED BEWILDERMENT' AND NEED PRACTICAL SUPPORT

need practical support. They do not have the skills required to deal with scenarios of corporate and debt restructuring required to handle some negotiations with sponsors, particularly in the light of the regulator's 2014 sustainable growth objective (see box, right).

• Trustees also often need to be better informed, particularly by their sponsor, which many not be candid with them about future corporate plans. They are also often not aware of the rating the regulator has given to their covenant.

The paper also outlines two additional options that could serve as alternatives to the cliff-edge of PPF entry.

• PPF plus bulk purchase annuity buyout (PPF+BPA). Providing the scheme's funding level and sponsor assets allow, trustees can agree a PPF+ BPA buyout of the liabilities with an insurer. This would typically mean reducing member benefits, but still retaining a level above PPF compensation.

• Planned entry to the PPF. If a PPF+BPA approach isn't an option, and where it's clear that the recovery plan is unlikely ever to be met, trustees could agree to a scheme entering the PPF in a planned way, rather than waiting for the cliff edge of company insolvency, particularly if this is ultimately inevitable. ■

THE PENSIONS REGULATOR'S SUSTAINABLE GROWTH OBJECTIVE

This was introduced as part of the 2014 Pensions Act. The Pensions Institute report into stressed schemes argues that this 'sustainable growth' aim is at odds with trustees' longer-standing duties to ensure member benefits are paid in full and to protect the Pension Protection Fund by avoiding the need for PPF compensation whenever possible. The new objective could require trustees to permit the sponsor to keep money in the business, at the expense of supporting the pension scheme. The potential outcomes of this could be worsening funding positions for already stressed schemes – and the loss of money that could have been used to support the scheme.

The Pensions Institute report also argues that the new objective introduces conflicts of interest for trustees. If they prioritise member interests, they will require higher sponsor contributions. A sponsor could then point to the sustainable growth objective as grounds for not providing those contributions. But to put the sponsor's business needs first risks trustees not fulfilling their obligation to protect member benefits.

STATISTICS

c1,000 – the number of private sector defined benefit schemes that are stressed and unlikely to pay member benefits in full

Those schemes represent:

£225bn in liabilities
£180bn in assets
£45bn deficits

15-17% of the Pension Protection Fund Index that these figures represent

[Source: estimates compiled by the Pensions Institute for use in 'The Greatest Good for the Greatest Number']

COMPANIES IN NUMBERS

Our survey results showed that often, what the trustees want doesn't always match what their employers are prepared to offer. Furthermore, pension schemes are often seen to be affecting a company's ability to grow or finance itself. In contrast to trustee perception, very few companies expected to provide full benefits to their members at retirement

DO YOU FEEL OBLIGED TO PUT MORE MONEY IN TO YOUR PENSION SCHEME IN REACTION TO EVENTS SUCH AS THIS YEAR'S BHS SCANDAL?

No (%)

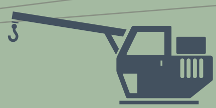
42

IF YOU HAD CASH AVAILABLE, WOULD YOU BUY OUT NOW OR LATER?

NOW 60%

LATER 20%

OTHER 20%



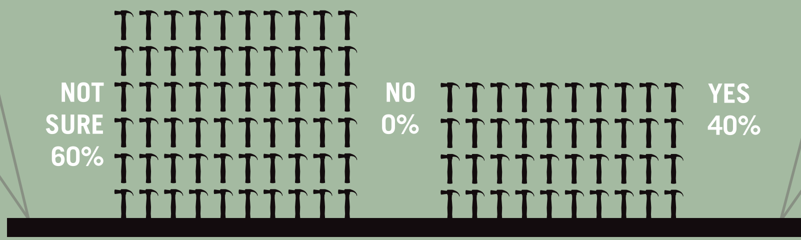
DO YOU FEEL THAT THE EXISTENCE OF A PENSION FUND IS AFFECTING THE COMPANY'S ABILITY TO GROW OR TO FINANCE ITSELF?

NOT AT ALL = **40%**

TO SOME EXTENT = **60%**

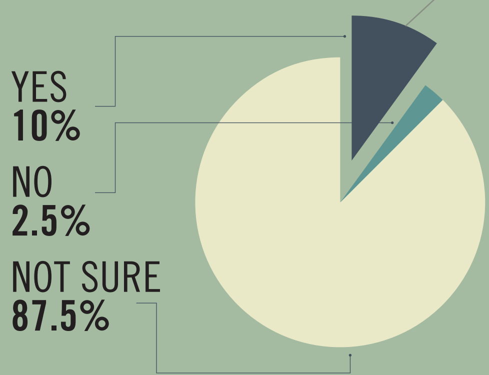
SIGNIFICANTLY = **0%**

DO YOU THINK THE TRUSTEES WOULD ACCEPT THE OFFER IF THERE WERE NO REGULATORY HURDLES IN DOING SO AND IT WAS VIEWED AS A SAFE DECISION FOR THEM TO MAKE?

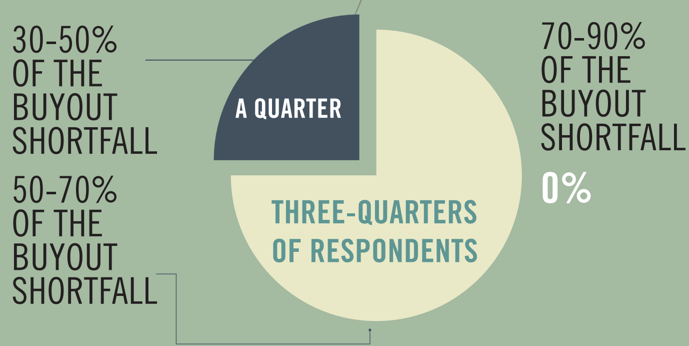


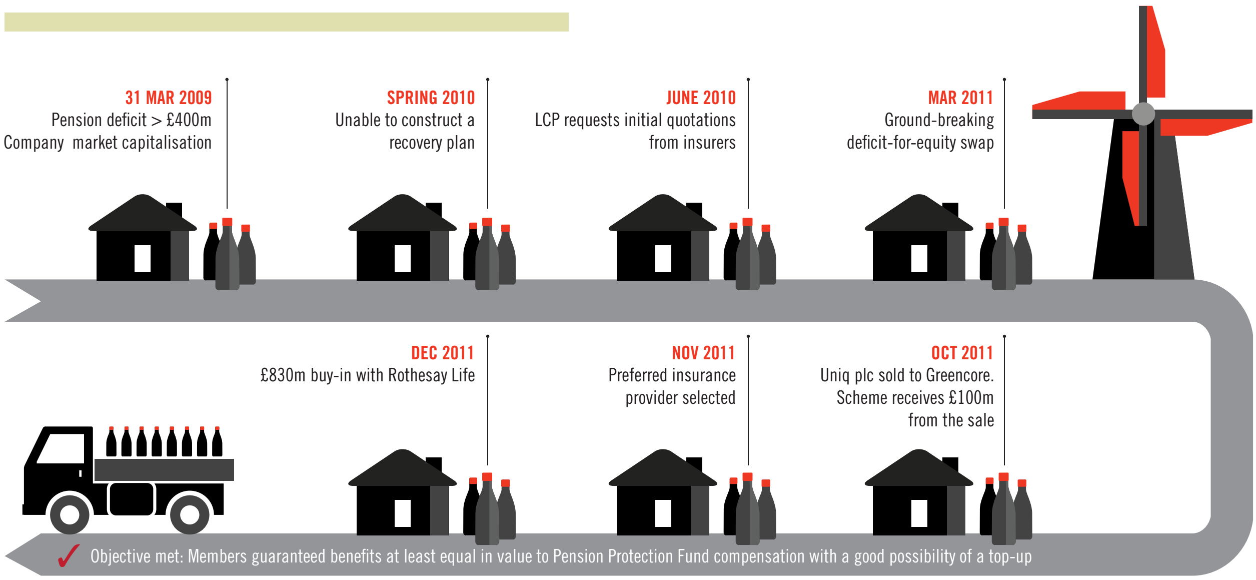
DO YOU EXPECT TO PROVIDE FULL BENEFITS TO YOUR MEMBERS AT RETIREMENT?

IF THERE IS A BUYOUT SHORTFALL, AND THE COMPANY COULD CRYSTALLISE ITS COMMITMENT BY PUTTING UP ONLY SOME OF THAT SHORTFALL (WITHOUT ANY FURTHER PAYMENT), WOULD THAT BE OF INTEREST TO YOU?



IF YES, WHAT PERCENTAGE OF THE BUYOUT SHORTFALL WOULD MAKE THE DISCUSSION WORTH HAVING, FROM THE COMPANY'S PERSPECTIVE?





ALL'S WELL THAT ENDS WELL

A PENSION SCHEME THAT IS FACING DIFFICULTIES CAN SUCCESSFULLY SECURE A BUYOUT DEAL

In December 2011 the trustee of the Uniq plc Pension Scheme secured pension benefits with Rothesay Life in an £830m deal.

In this case study we look at how the transaction brought welcome certainty to the pension scheme's c21,000 members. A timeline is shown above.

RECOGNISING THE STRESSED NATURE OF THE UNIQ SCHEME

The Uniq scheme was a legacy pension arrangement with many issues to resolve.

In 2009, the scheme had a deficit in excess of £400m, yet it was supported by Uniq plc, whose market capitalisation had fallen to below £10m because of the perception of an insurmountable pension problem. The trustee, Uniq plc and the Pensions Regulator recognised that an innovative solution was required for this stressed scheme.

By the spring of 2010, the trustee and Uniq plc were unable to construct a realistic and affordable recovery plan to the satisfaction of the regulator. The trustee de-risked the scheme's investments and began initial discussions with insurers.

The objective was to secure benefits for members at least equal to Pension Protection Fund levels with a regulated insurer, outside the PPF.

THE DEFICIT-FOR-EQUITY SWAP

Under the chairmanship of ITS, the trustee led the pension scheme through a complex restructuring exercise leading to a ground-breaking deficit-for-equity swap in March 2011.

The swap was implemented via a regulated apportionment arrangement – this is a tool used only in exceptional circumstances and with the approval of the Pensions Regulator and the agreement of the PPF.

The deficit-for-equity swap enabled the trustee to take effective control of 90% of Uniq plc's shares in return for giving up its claim on future funding.

In conjunction with Uniq plc's management and the PPF, the trustee then oversaw the sale of the business to Greencore plc. The business continued to trade and jobs were saved.

LCP and Linklaters supported the trustee in discussions with Uniq plc, the Pensions Regulator, the PPF and other parties.

The net outcome for the trustee was an additional £101m paid to the Uniq scheme in November 2011.

SECURING BENEFITS WITH ROTHESAY LIFE

The additional £101m enabled the trustee to meet its objective of securing benefits at least equal to PPF levels with a regulated insurer.

The trustee selected Rothesay Life as its preferred insurer following a competitive selection process. Within a week, the trustee was able to lock into advantageous pricing arising from considerable volatility in bond markets.

Rothesay Life worked closely with ITS, LCP and Linklaters to create a bespoke policy structure that met the trustee's complex requirements surrounding the data and benefit issues that accompany large legacy pension schemes.

The insurance policy guaranteed benefits for all members at least equal to PPF compensation.

The trustee also benefited from significant flexibility should a top-up above PPF levels prove possible. As wind-up is nearly completed, any top-up that becomes payable is expected to be paid in 2017.

SUCCESS THROUGH INNOVATION AND COLLABORATION

ITS encouraged an innovative approach to this complex case. The outcome was positive both for members and for employees:

- The c21,000 members have certainty in retirement
- The members benefit from a policy with a regulated insurer, outside the PPF
- The business continued to trade and jobs were saved.

This outcome was achieved by all parties and their advisers working collaboratively and being willing to test new ground. ■

EXECUTING
AND IMPLEMENTATION

LEGAL VIEW

A buyout is a complicated contract that needs to cover all possible eventualities

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INVESTMENTS

The value and type of asset held in a scheme will affect how a bulk annuity is negotiated

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CASE STUDY

IHG's pension buyout secured discretionary benefits in a deal carried out in record time

PAGE 46

GETTING STARTED

There are a number of complexities involved in completing a buyout. Our survey respondents ranked securing the correct benefits and contract drafting and negotiation with the insurer as the top two

WHAT DO YOU CONSIDER ARE THE TOP TWO KEY COMPLEXITIES INVOLVED IN COMPLETING A BUYOUT/WIND-UP?

(RANKED IN ORDER OF IMPORTANCE – HIGH TO LOW

Ensuring the correct benefits are being secured

Contract drafting and negotiation with the insurer

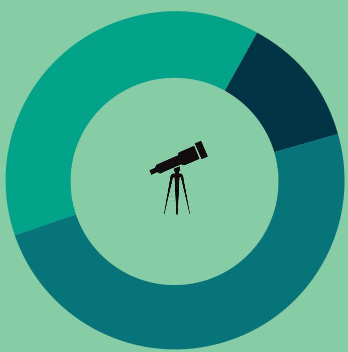
Winding up the scheme (and where relevant, securing trustee discharge)

Obtaining detailed proposals from insurers

Transferring administration to the insurer

Reorganising the assets to be compatible with a transaction

WHEN CONSIDERING WHAT BENEFITS TO SECURE UNDER THE BUYOUT POLICY, ARE YOU MOST LIKELY TO:



Seek to rely on the trustees obtaining a statutory discharge on wind-up
14%

Put in place a company indemnity for additional liabilities that may result from incorrect data
54%

Purchase data risk insurance for an additional cost (typically around 1%) from the buyout insurer (under which the insurer takes on the risk that the benefits turn out to be different in the future)
32%

CHECKING THAT IT ALL ADDS UP

MAKING SURE THE BUYOUT POLICY ACCURATELY MATCHES THE PENSION SCHEME'S LIABILITIES IS THE TOP CHALLENGE

As far as sponsors are concerned, the whole point of buying out their scheme is to make sure they are no longer on the hook for the pension liability. Passing members on to an insurer safely secures their benefits and allows the company to wind up its scheme.

But making sure that the correct benefits are insured, and that there will be no further calls on the employer, is not entirely straightforward. Respondents said the top complexity they faced in decommissioning a scheme was making sure the buyout policy matched the benefits accurately.

Given the complicated nature of many schemes, with accrual often spanning several regulatory regimes and numerous rule changes, this is hardly surprising. Insurers expect to find wrinkles in the data and there are ways employers can make sure they are not required to stump up any extra cash to account for data corrections in future.

The most popular option for doing this identified by respondents was to put in place a company indemnity for additional liabilities. More than half of respondents said this was there preferred way of making sure the correct benefits were covered.

A third of respondents said they would look to complete an all-risk buyout, where they pay an additional premium in return for the insurer agreeing to insure any additional liabilities that are discovered after a transaction.

The least popular option was to rely on the trustees obtaining a statutory discharge on wind-up. Trustees and sponsors are right to be wary of this option.

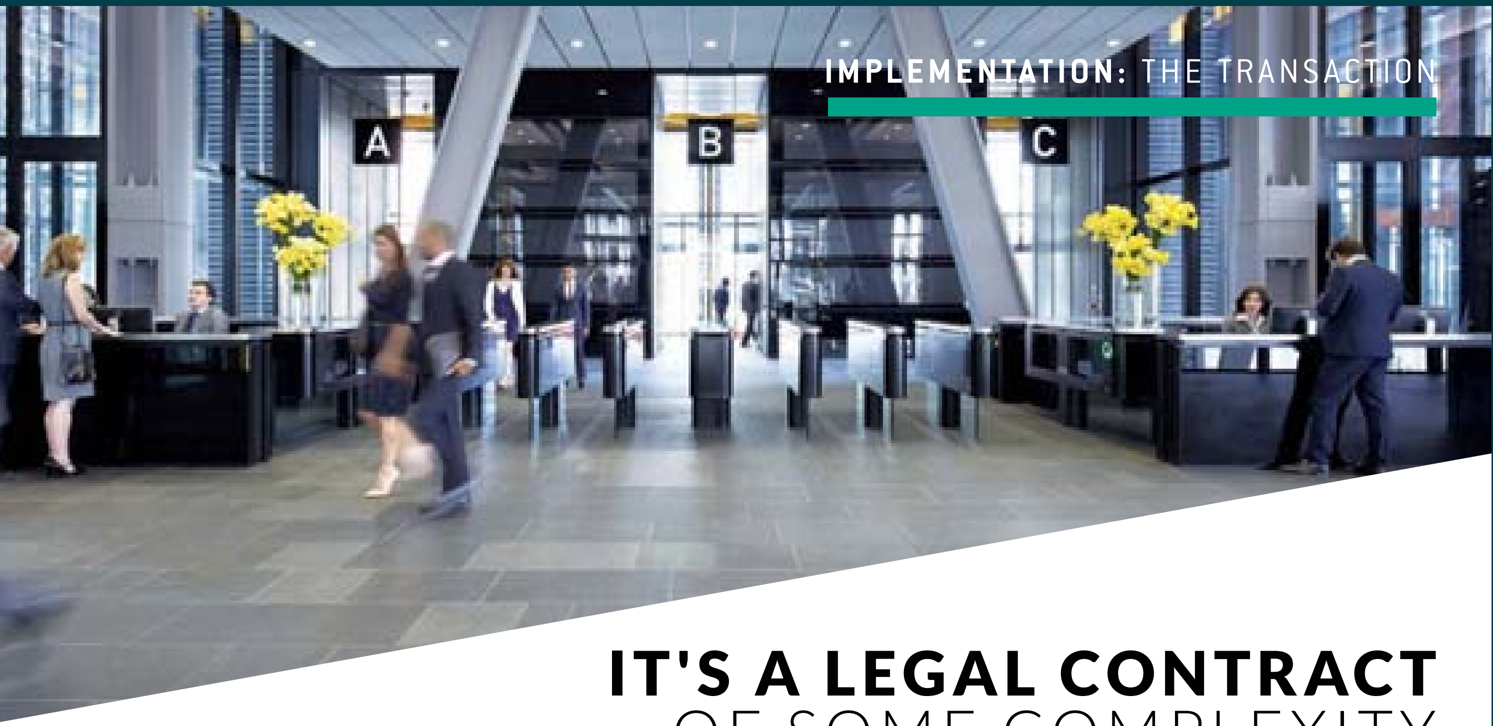
The discharge certifies that trustees have met the procedural requirements for winding up a scheme, but is unlikely to cover them if it turns out they have secured incorrect benefits.

Other complexities identified by respondents include drafting and negotiating contracts and obtaining detailed proposals from insurers. This highlights the importance of good quality advisers.

The next biggest concern is actually winding up the scheme after the members have transferred. Respondents were relatively relaxed about the complexities of transferring administration to the insurer and reorganising their investment portfolio ahead of a transaction.

But employers cannot afford to be complacent. Locking down the residual risk that they may be exposed to after a deal is done is an important part of the process. ■

INSURERS EXPECT TO FIND WRINKLES IN THE DATA



IT'S A LEGAL CONTRACT OF SOME COMPLEXITY

A LEGAL EXPERT TELLS **JENNA GADHAVI** THE TYPE OF ISSUE THAT TRUSTEES NEED TO BE AWARE OF

What are the complexities in executing a buyout over a plain vanilla buy-in?
The obvious, but key difference is that a buy-in transaction results in purchasing an asset that matches the cashflows of a pension scheme, whereas a buyout transaction is designed to discharge the trustees fully from liability and pass that liability to someone else. That forces trustees and employers to confront all of the difficult questions that may be lurking in the pension scheme.

Are there timing considerations that must be allowed for?
Liability management exercises affect the timetable. Writing to members to offer them a pension increase exchange, for example, involves a period of time for them to understand the offer, seek advice and decide what to do.

Solvency II means these exercises almost certainly need to happen ahead of contracting with an insurer, because Solvency II makes it difficult for insurers to competitively price optionality.

Now trustees and employers are more likely to run the liability management exercise, identify the population to be insured, then include only those members as insured persons under the contract.

How important is the buyout contract? What are the key features of robust documentation?
Like any commercial contract, the key provisions must be unambiguous so both parties understand their rights and obligations.

The contract obviously needs to specify the benefits correctly, but time and effort also has to go into understanding key contractual mechanics. When and how is the premium paid? When is any top-up paid? Typically a buyout contract involves payment of an initial estimated premium, followed by a period of data verification. If that verification results in a revised understanding of the liabilities then there can be re-pricing (as opposed to a simple adjustment to reflect a change in data). It is key to understand the circumstances in which there could be a further demand for money. For bigger schemes there will be more scope for tailoring insurers' standard terms.

For schemes coming out of the Pension Protection Fund, what are likely to be the main issues trustees face?
When a scheme comes out of a PPF assessment period because PPF-plus benefits can be secured, the trustees need to ensure that as well as getting the insurance contract right, they deal with all of the issues that have arisen because they have been required to restrict benefits during the assessment period. Some schemes will secure PPF-plus benefits without entering an assessment period. If there is clearly going to be an event that would result in a scheme going into a PPF assessment period, but PPF-plus benefits can be bought, there could be a deliberate structuring so as to avoid an assessment period. In either scenario the key thing of course is that the insurance contract absolutely guarantees PPF-plus benefits and that each member will receive his or her proper share of benefits under the statutory priority order. Careful drafting is required.

How can data-related risks be accommodated in a buyout transaction? Are there particular areas that create complexity?
Some insurers will provide 'data-risk cover', and this can be appropriate for some schemes, but not in every circumstance.

If a scheme is winding up with a deficit, trustees might want to concentrate all their resources on insuring the benefits they know they have, for example. Or trustees could purchase run-off insurance from another insurer, or they could rely on exonerations they might have under their trust deed or an indemnity from the employer if it is still solvent.

Ultimately the courts have the ability to relieve the trustees from personal liability where appropriate. Trustees entering into all-risk cover with an insurer need to understand that this will inevitably result in the insurer doing a high degree of due diligence on the scheme and the insurer may require certain issues to be addressed before going on risk. Importantly, trustees need to assess the need for and value of additional insurance against the backdrop of protections otherwise available to them. ■

DAN NAYLOR
Partner, Travers Smith

WHY THE QUESTION 'WHAT' IS AS IMPORTANT AS 'HOW MUCH'

THE VALUE AND TYPE OF A SCHEME'S ASSETS ARE CRITICAL TO THE SUCCESS OF NEGOTIATING A BULK ANNUITY

SUTHAN RAJAGOPALEN
Principal, financial strategy group
Mercer

Key investment considerations when transitioning into a bulk annuity buyout include:

1. Gaining price transparency
2. How to invest to secure certainty of affordability
3. What to deliver to pay the insurer's premium
4. Investment restructuring and transition
5. Avoiding any trapped surplus

Negotiating the price of a bulk annuity is only half of the journey towards successfully completing a transaction.

The key metric for the sponsor in a buyout will be the gap between the fund's assets and the insurer's premium at completion – which is a fast-moving item.

Sponsors usually have a fixed budget for their shortfall contribution and transactions can fail at the final stages if the assets and premium diverge at the wrong time, pushing up the sponsor's costs to complete a buyout.

So considerable focus is required on the assets that will be used to pay the buyout premium: the other half of the equation. To secure a buyout, it's important to determine how the premium will be paid early in the process, prior to exclusivity being offered to an insurer.

Co-ordination of investment negotiations should, therefore, sit alongside price negotiation and selection discussions to deliver the most effective combined solution, in terms of cost and risk.

The scheme's initial asset portfolio is unlikely to match the behaviour of insurer's price and the relative movements can be large, even on a daily basis. So what can be done to stabilise the economics of a transaction?

To reduce or eliminate this risk, the scheme can negotiate a price tracking mechanism by which changes in the insurer's pricing can be matched by changes in value of an agreed investable asset portfolio.

Benefits of such a price tracking portfolio are that this provides price certainty to the trustees and corporate sponsor alike and can help guide investment decisions around hedging the bulk annuity price. However, part of the full premium will usually be coming from the sponsor after completion and this will typically be held by the sponsor as cash which may not be in the price-tracking portfolio, making it harder for the fund to match.

Once investment risks relative to the price lock/tracking portfolio are identified and the trustees have decided what investments to hold in the closing stages of executing the bulk annuity, the next decision is around what assets to use to pay the premium.

This would involve deciding whether to transition into assets suitable to fund the annuity policy or to plan to liquidate existing holdings and meet the premium through cash. The insurer will want to know what it is going to receive and when, so that it can plan any hedging and investment activities.

The simplest situation is where the scheme has moved to holding the price tracking portfolio, as the insurers will usually accept full in-specie delivery of this portfolio.

Transitioning assets into those the insurer will accept can be used to progressively lock into the selected insurer's price, creating affordability certainty while also potentially managing transition costs.

However, there are some complexities where this is not the case. First, while rate and inflation hedging derivatives can normally be novated to the insurer, there can be difficulties when the collateral terms do not match the insurers'. This can lead to differences in valuations and shortfall in premium.

A second complexity concerns the use of pooled funds. In many cases, tranches of assets can be extracted, although this depends on the willingness and flexibility of the pooled fund investment manager and dealing dates that will need to be incorporated into the transition plan.

Assets transferred out of pooled funds would typically form a pro-rata slice of the fund so that economic characteristics are preserved, but ideally the numbers of holdings are reduced. If the pooled fund can only deliver cash, care will need to be taken with the timing of the risk transfer.

Illiquid assets can present challenges as well. If the insurers will accept them, there may be some debate about their valuations. Where the insurers do not want to own them, then the options with respect to timing and potential realisation values at a sale will need to be considered.

It may be possible to pay some of the premium after a deferral period that enables a sale, but this is likely to incur extra costs that will need to be compared against the lower realisation values from a quicker asset sale.

The final consideration is the risk of a trapped surplus. This can arise if the sponsor pays in additional funds to complete the purchase of the bulk annuity that covers all the liabilities, but then the insurer refunds part of the premium as the result of a data cleanse. Sponsors are rightly keen to avoid trapped surplus as they would normally get spent on augmentations or suffer penal taxation when the sponsor could have paid in less money and avoided the surplus.

The potential for refunds of premium can typically be avoided but this usually involves some form of data risk transfer to the insurer. Alternatively, a small part of the premium can be deferred and then reduced by any refund.

It is also important to consider the period straight after a transaction has been completed to ensure that the all benefit payments can be funded. The trustee will have little or no money left and will need their cash flows to be covered by the insurers.

Trying to transact a bulk annuity without successfully incorporating investment considerations can feel like trying to get on a moving bus with a lot of luggage! ■

IT ALL BEGINS WITH CLEAN, ACCURATE DATA

Many schemes are focusing on the quality of their data as a result of a combination of increasing focus from the regulator and high-profile campaigns from groups such as the Pensions Administration Standards Association (PASA).

Good data always makes sense, and this is especially true for schemes that aspire to buyout and completing a wind-up.

It is not necessary for data to be perfect or even complete, in order to solicit bulk annuity quotes from insurers. It is also possible to execute a bulk annuity – but this is only the first stage in the process.

Most buyout transactions will have two key pricing events

- The calculation of the initial premium based on data used for bulk annuity quotations
- The calculation of a premium adjustment or 'true-up', based on cleansed data

Before individual polices can be issued and a wind-up completed, the data needs to be thoroughly checked for completeness and accuracy. This transitional period (from when a contract is initially signed to when individual policies are issued) can be anything from a few months if planned well to many years if not. This invariably leads to changes to the insured pensions and a resultant adjustment to the original premium.

In addition, the quotation data often has gaps where data is missing and the initial bulk annuity coverage has to be an informed guess that is then subsequently corrected in the run-up to buyout.

Changes to the premium after signing are generally not welcomed by plan sponsors who prefer certainty of costs and want to avoid any trapped surplus from premium refunds.

A MEMBER'S PERSPECTIVE

When an insurance company issues an individual policy to a scheme member they will expect that the policy will spell out clearly (and accurately) the benefits that are payable.

Should they be so inclined, the scheme member, now a policyholder, should be able to accurately calculate the amount of their own increases as they fall due, or confirm what benefit would be payable in the event of their death.

Leaving data 'uncertain' in this regard is not aligned to the principles underlying the Treating Customers Fairly regime.

MISSING DATA

One of the more common examples relates to the level of contingent spouses' pension that are payable. We pick this example with good reason. Where a scheme pays spousal pensions based on pre-commutation benefits, it is not unusual to see administrators who do not have the current spouse's pension immediately available in their data because it's not needed on a day-to-day basis.

While held as a buy-in, a bulk annuity can cover contingent spouses pensions at an agreed percentage of each member's post-commutation pension.

This is unlikely to be good enough for completion of the buyout though, where the trustees will want to secure the actual contingent pensions, leading to a premium adjustment.

If left until after a bulk annuity has been executed, then the data can take time to collect and calculate, leading to delays in the transition process.

SO WHAT CAN BE DONE?

The key is making sure that relevant data is held accurately in the core administration records and importantly, is kept up to date.

In the case of contingent spouses pensions that means increasing them each year at the same time as the normal pension record.

Other areas where benefits might not be reflected in the core data include, but are not limited to:

- Pension Sharing Orders – which have been seen stored in notes fields
- Transferred-In benefits – which have been seen similarly stored
- Underpins held outside of the core data

It makes sense to bring such items out of these non-core fields and into the primary data fields.

It's true that these types of issues are more prevalent in older schemes running on older platforms, but then most defined benefit schemes have a reasonable history behind them . Even if the current platform is robust it's possible that previous ones weren't.

HELPING CERTAINTIES

For trustees and their sponsors who don't like the idea of premium adjustments the original bulk annuity can be structured to have no premium adjustment. However, the data will still need to be collected, calculated, and presented in individual policies.

The alternative is that the insurer issues policies that are light on detail, thus ingraining the weaknesses in historical processing by itself calculating accurate benefits only when they become payable. It is difficult to envisage a situation where this would be acceptable to anyone... in particular the scheme members.

Where there is no premium adjustment the insurer will take the risks of, and cover the cost of, any subsequent data changes that are needed to effect a buyout.

This approach is called all-risks insurance and comes in a variety of forms. It typically covers corrections to benefits for errors that emerge after buyout (but as outlined above can also cover them before) and insurance for missing members who subsequently emerge. This gives the trustees peace of mind after wind-up.

The increased certainty of costs clearly have appeal to the trustees of larger funds and their sponsor, because about 80% of the top 20 buyouts have included an element of all-risks insurance. ■

THE SAYING 'WHAT CAN 'T BE MEASURED CAN'T BE MANAGED' CERTAINLY APPLIES TO PENSION SCHEME BUYOUTS

RUSSELL HIGGS
Head of transitions

HOW TO TIE UP A COMPLEX DEAL IN A SHORT TIME

IHG'S BUYOUT SHOWS DISCRETIONARY BENEFITS CAN BE SECURED WITH INSURERS. JACK JONES REPORTS

It's not uncommon for sponsors to be in a rush to tie up a pension buyout. But the £440m deal secured by trustees of the InterContinental Hotels UK Pension Plan combined impressive speed with some unusual features.

The deal covered approximately 3,000 members and was wrapped up in six weeks. As well as transferring all data risks to Rothesay Life, the transaction secured some of the discretionary benefits members had enjoyed in the past.

DISCRETIONARY BENEFITS

So how did the scheme achieve this?

First, it was in the enviable position of being well funded and well prepared. The trustee board and sponsoring employer began exploring a deal in 2011-12 but decided against transacting as the firm had other priorities for its capital. It completed the buyout with Rothesay Life in August 2013. The scheme had closed to future accrual by this point and was funded on a very conservative basis of gilts minus a half.

ITS director Nita Tinn – one of three professional trustees on the board – says: "We were very well funded and set up a trust fund so that the company could put in some money in case it was needed for the buyout.

"Because we were so well funded, and we didn't need to do this for security reasons because we had a strong sponsor, we were able to negotiate very favourable terms for our members in that we were able to secure some of the discretionary benefits."

As is common in many schemes, pensions in payment increased in line with the Retail Prices Index up to 5%.

When inflation exceeded this cap, the trustees could increase pensions accordingly if the company agreed, and Tinn says IHG had always awarded these additional rises in the past.

"Obviously that was discretionary and would fall away after the buyout," she explains. "But we secured those, so they were not discretionary. The insurer will pay 50% of anything over 5%, so if RPI is at 7% they'll pay increases of 6%."

The trustees took a similar approach to other discretions, such as spouses' benefits. They worked through them line by line, turning them into hard rights where possible.

SIX WEEKS FROM OFFER LETTER TO ANNUITISATION IS UNUSUAL FOR AN ALL-RISK TRANSFER

A SPEEDY TRANSFER

This treatment of discretionary increases makes it even more remarkable that the deal was wrapped up so quickly – six weeks from offer letter to annuitisation, unusual for an all-risk transfer.

Allen & Overy partner Jane Higgins says: "It was a well-run and well-administered scheme but it was not totally ready to buy out – there was an element of uncertainty in the data, as there is in most schemes. So Rothesay had to look at the data and take a view."

It is not uncommon for insurers to take a year or two ensuring the data of the scheme they have taken on is accurate before issuing individual annuities. While this data cleansing is going on, the sponsor is still on the hook for residual data risk. But in this case the sponsor wanted the risk to be transferred faster than this.

So Rothesay hit on the novel idea of using a deed poll to transfer responsibility for paying member benefits from the scheme to the insurer. Higgins explains: "They wrote a document on the day of signing that said 'we are directly insuring the benefits of all members'. That has the same effect as giving them all an individual annuity from a legal perspective."

Although it took a few weeks for the insurer to actually begin paying benefits directly to members, the company had transferred all the risk associated with its scheme.

So what lessons can employers take from IHG's experience? "It's all about timing, being prepared and having a clear strategy with the employer," says Tinn. ■

Rothesay life

TAKING THE RIGHT STEPS TO A SUCCESSFUL CONCLUSION

Ten years on from the development of the bulk annuity market, what do we now know?

Well, first of all, only a small proportion of schemes have actually bought out over those 10 years, but in this latest survey over 50% of schemes are saying that their long-term target is to buy out.

Secondly, we also know that to achieve the long-term target is more complex than it has ever been before.

Record low interest rates are correlated to record deficits. This impact is coupled with a potential capacity crunch for longevity reinsurance brought about by Solvency II and the change in business model of older bulk annuity providers mimicking the models pioneered by new players such as ourselves.

These issues are coupled to the ever-increasing range of liability management exercises. As a result, the range of activities that need to be considered and assessed in order to improve funding takes longer and needs more planning than ever.

What is clear from the experience of those who have bought out already or from the feedback from those that are considering it now is that the appointment of advisers with experience seems to be critical to reaching a successful outcome.

So whether working with your existing advisers or a different team it is never too early to start careful planning and preparation.

This should include a detailed data cleanse, guaranteed minimum pension reconciliation, marital status data gathering and a review of the schemes legal documentation. As well as this, a governance model will need to be established that allows schemes to move quickly when opportunities arise to secure annuities for sections of the liabilities or for the scheme as a whole. In addition, there is a large minority of the schemes of who identify themselves as having a weak covenant.

Taking the steps identified in this report will mean that whatever the outcome the scheme will be in a strong position to de-risk quickly and cost effectively or secure the greatest proportion of members benefits. ■

CAREFUL PREPARATION IS AT THE HEART OF A SUCCESSFUL BUYOUT

SAMMY COOPER-SMITH
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Rothesaylife

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