

Unique needs lead to bespoke solutions

Innovation will be our key theme during 2010 for the defined benefit pensions de-risking market, as trustees seek tailored solutions.

The world of defined benefit pension de-risking has experienced fundamental change in the last three years, but there is plenty more still to come as innovation tops the agenda. First there was the shift from a buyout only environment (to support full scheme wind-ups), to a market where trustees used bulk annuity buy-ins as an insurance policy for schemes with solvent sponsoring employers. 2009 then saw some movement towards a new breed of alternative solutions, especially for larger schemes looking at innovative ways to partially de-risk in a more tailored approach. This included Longevity Swaps, DIY buy-ins and increased Enhanced Transfer Value activity.

For many, this change in focus was driven by both affordability and timing due to the rapidly changing economic climate, coupled with increasingly complex legislative demands on trustees and corporate financial reporting. Scheme funding was hit hard. As was the ability of most sponsors to provide the cash injections required to either stabilise the funding position, or to fund the cost of any de-risking activity with insurers. Consequently, many schemes simply could not afford to implement large scale de-risking solutions, despite an increased desire. As the UK slowly moves out of recession, more schemes may find themselves in a position to entertain de-risking again, but it will be a case of: How much risk do you want to remove? What are you prepared to pay? And when can you transact?

One of the key challenges for trustees will be ensuring any partial de-risking solutions fit with their longer term strategy and do not inhibit the potential for further de-risking in the future. For example there are still some question marks over the effectiveness of Longevity Swaps due to the complexities involved in both setting up and potentially unwinding these in the future to enable full de-risking.

Phased payments

Availability of finances will always be key. It may be that any additional capital injections

from sponsors will need to be staggered, to finely balance the financial recovery of the corporate, while also enhancing pension scheme support. Therefore, providers such as Prudential must help develop tailored de-risking solutions that enable phased funding yet deliver a material level of de-risking from the start. A key example of this may apply to merger and acquisition (M&A) activity. As the economy begins to turn, there is growing speculation of M&A activity across many industries, yet pension fund deficits can prove to be a substantial stumbling block for such transactions. There is scope to develop appropriate pension de-risking solutions that ensure security of pension fund members, but do not damage M&A activity due to affordability. Entering an agreement that secures future pension liabilities in a way that can be off-set via a phased payment structure could help such M&A activity proceed. This approach could aid corporate activity without the burden of an immediate large scale outlay, or the issue of a huge pension deficit sitting on the balance sheet.

Scheme Assets

Another challenge trustees face when de-risking is to hold scheme assets that can be easily traded on the market, or passed to a provider via in-specie transfer. It can be difficult to trade bulk movements in assets without incurring a loss and liquidity can also have an impact. Providers need to deliver ways of taking on a broader range of assets in payment to support schemes, so that transactions can be implemented when the timing is right for the scheme. This could help reduce timescales and costs involved in asset transfer, enabling a more immediate solution.

Predicting Mortality

While each set of trustees understands their own membership, providers such as Prudential have vast experience in assessing mortality due to the volume of pensioner customers we support overall. However, as a result of this

wider experience, mortality assumptions of providers have sometimes been perceived for trustees and corporate sponsors as overly cautious and have therefore provided a barrier to agreeing to transact. This means there is potential to develop 'profit sharing' arrangements, based on actual mortality experience, which would help alleviate any concerns of differences in mortality assumptions used in pricing models.

Investment returns

Providers also need to support trustees in seeking higher yields from their pension scheme assets without exposing the scheme to undue risks. For example, annuities are typically matched via corporate bonds, which offer a degree of security against liabilities but are unlikely to provide a substantial long term return once the appropriate margins have been removed from these yields. For schemes with a younger pensioner population (and potentially a longer mortality term) this could have a serious impact on funding. Such schemes may be able to achieve a higher yield without introducing undue risks or overly complex investment solutions. This could be achieved via bespoke buy-ins that enable a more gradual shift to appropriate asset holdings, allowing the scheme to benefit from potentially higher-yielding investments in the meantime.

There is certainly a lot for providers, trustees, sponsors and advisers to consider. ■

