



With the turbulent global economy, there is assistance at hand for trustees and sponsors navigating their way along the road to derisking, **says Andy Reed**

ESSENTIAL GUIDE

A glance through just about any recent pensions publication will probably leave you thinking that there is only doom and gloom ahead, things have never been worse and there is no obvious way out.

There have been reports of pension deficits doubling, more schemes closing, more than 100 schemes joining the Pension Protection Fund, suggestions that trustees should scrutinise their sponsoring employers' covenant, and counter-suggestions that those same trustees should ease up and leave sponsors be while they get their corporate situation resolved.

Indeed, for some pension schemes, the current economic conditions may well mean that doom and gloom is the very harsh reality – at least in the short term. Yet for many trustees and sponsors, there are various opportunities and steps they can still take towards derisking their scheme liabilities, with varying degrees of risk reduction and associated cost. The fact is, there are now more defined benefit (DB) derisking solutions on offer than ever before.

The key to success is understanding which derisking options are most appropriate (and affordable) for your scheme and ensuring you are well prepared for pursuing the chosen strategy.

Agreeing key aims

Before embarking on derisking strategies, it is vital that pension scheme trustees and

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sponsoring employers agree on their key aims for the scheme. Regardless of the funding position, both parties need to be fully aligned to ensure the most appropriate solutions are implemented effectively and for the right reasons. For example, is there a long-term strategy of gradual derisking, or is there a desire (or even need) to take significant steps that provide an immediate impact? Of course, both parties will want to seek independent advice throughout the process, involving employee benefit consultants, scheme actuaries and lawyers. But collaboration is king.

Identifying the risks

To a greater or lesser degree, each scheme will have unique circumstances relating to the specific liabilities, funding levels and sponsor covenant. This is a complex market, with no single right or wrong answer about how to derisk. Individual scheme analysis is paramount. Once the overall aims have been agreed, trustees need to identify the specific risk hotspots relevant to their scheme. Once this is established, schemes can work with their advisers to assess the solutions available and identify the most appropriate options – and provider – to suit their specific derisking strategy. This may involve any number of solutions, combined to create a fully bespoke routemap.

While there are various risks that affect pension schemes, there are two key areas that derisking strategies aim to address:

- investment risk – in short, the scheme’s ability to afford the cost of liabilities (allowing for contribution rates, inflation, investment returns, scheme assets, etc);

- longevity risk – the increasing complexities of predicting the real cost of an individual within the scheme, particularly with significant improvements in healthcare.

Different solutions can target specific areas of risk within the scheme, so it’s vital to understand the hotspots within each scheme before determining the solution. This is something that financially strong, trusted and experienced providers can help trustees assess. It doesn’t necessarily matter which standard mortality table you use to make assumptions, it’s more important to understand how well your actuarial assumptions truly match the specific membership of your scheme. Various factors can influence scheme-specific risks. For instance, mortality is affected by:

- geographic spread – mortality rates can differ greatly depending on location. Is your membership spread across the UK, or concentrated into a few specific regions? Either way, your mortality assumptions should take this into account;

- socioeconomic – research has proven that lifestyle can be as important as gender when it comes to longevity. For example, skilled workers are more likely to outlive a manual worker of the same age in the same geographic region, yet many schemes do not account for this.

- risk concentration – there could be specific groups of members within your scheme that pose a greater risk, or may skew the mortality model. For example, large portions of pensioners of the same age, or a group of younger executives or skilled staff on higher benefits.

Really understanding your membership and the significant impact this can have on your scheme costs can help identify the right solutions.

DERISKING SOLUTIONS

AIMS AND CONSIDERATIONS

SOLUTION	FOCUS	BENEFITS	RISKS/CONSIDERATIONS
Buyout	All members and associated liabilities	Secures full benefits via a transfer of all liabilities to insurer	Can be expensive - particularly for deferred member benefits. More desirable than entry into the PPF
Partial buyout	Specific selection of members	Similar to full buyout, but only in relation to a specific portion of the scheme	May be used to help phase full buyout in the lead up to wind-up
Pensioner buy-in	Current pensioners	Secures cost of future pension payments for selected members, while trustees continue to manage scheme	More affordable than full buyout, although some risks (such as investments and deferred benefits) remain with the trustees. Can be phased to help spread costs
Annuity vesting buy-in	Future pensioners (current active and deferred members)	Provides a solution specifically relating to members as they approach retirement	Only secures small chunks of liability at a time. Can be implemented in isolation or as a follow-on to a pensioner buy-in.
Enhanced transfers	Deferred members	Reduces number of deferred members in the scheme. Offers members personal choice whether to remain in DB or take enhanced transfer to a DC alternative	Will be more appropriate to some members than others. Requires robust personalised advice process in line with FSAs 'treating customers fairly' principles
Longevity swaps	Matching current pensioners	Locks into the cost of longevity to remove the risk of scheme-specific volatility	As yet not tried or tested in the world of pension schemes. May be complex (and costly) to implement and only likely to be suited to very large schemes

Assessing the solutions

Even assuming other affordable steps have been taken (such as closing the scheme to new entrants and then to future accrual), significant cash injections into the scheme are unlikely in the immediate future. Instead, sponsors will be looking to see a direct correlation between any further money spent supporting the pension fund and the visible reduction in the level of risk remaining.

Derisking solutions can range from hedging investments through to full buyout as part of a scheme wind-up. Most schemes will be looking to implement solutions somewhere in between (with buyout as a possible end game). There are various options available, as outlined in the table to the left.

Agreeing the way forward

Applying a combination of these solutions over time can provide trustees with a routemap that presents a more affordable and manageable way of reducing, and ultimately removing, the risks within their scheme. Current financial markets will make most schemes rethink their investment strategies. The key will be to align such strategies to the wider derisking aims.

For example, bulk annuity deals can be simplified by moving into a portfolio of assets

A word from the sponsor...

that insurers would be willing to hold, thus making it easier to complete an in-specie transfer. While investment strategies help hedge against investment risks, in isolation they do not reduce or remove the liabilities or any associated longevity risk (in most cases, only insurance related solutions can fully achieve this).

However, successful investment strategies can be a good means of affording the security offered by insured solutions, such as buyout or buy-in.

Selecting the right provider

Having agreed on the best approach to solutions available, there is then the equally vital question of who to place business with – another key stage involving input from corporate advisers.

The heightened interest in the DB derisking market has led to a wider range of providers offering solutions, generating a competitive environment that provides a healthy landscape for trustees regarding the range of options available.

However, one of the most important considerations highlighted by the current global economic turmoil is the financial strength and longevity of a provider. While price is clearly important, DB derisking is not simply about the price tag, but also the assurance offered by the promise of the selected provider. Pension provision is a long-term commitment (any contract is likely to be in place for 30 to 40 years), with the livelihood of scheme members at stake – and with it the reputations of trustees and sponsors.

Derisking decisions are vital, and so too is choosing the right partner with the ability to provide that promise for the full duration. Trustees need to think about what they are buying, how long they are buying it for and who they are buying it from. Due diligence should scrutinise the financial strength, security, track record, expertise and flexibility of the provider. There is also the consideration of dealing with a reputable brand that members will trust.

Commencing derisking

Having agreed the aims for the scheme and completed all the analysis of the risks, solutions and provider selection, implementation can be relatively straightforward. However, there are some steps schemes can take to make life easier.

For any scheme looking to derisk, it will be vital to ensure scheme data is thoroughly cleansed. Having accurate data helps the process for any bulk annuity arrangement, such as buy-in or buyout, both in terms of speeding up the transaction and helping to ensure any quotations provided by insurers accurately reflect the real costs to the scheme.

Equally, it can be easier to transact if the scheme is invested in assets that an insurer is happy to accept via in-specie transfers. This can save a lot of time and effort in trying to conduct large-scale disinvestments at a time when the wider investment market may be unwilling to trade into the assets being sold.

Andy Reed is director of defined benefit solutions at Prudential

Background

Prudential is a well-diversified, international retail financial services group with over 21 million customers worldwide. It has significant operations in the UK, Asia and the US and manages in excess of £249bn worldwide (as at December 31, 2008). The company is financially strong, with the credit reserves and capital surplus required to support long-term business such as bulk annuities.

Services

Prudential works together with employers, pension trustees and employee benefit consultants, offering a wide choice of corporate solutions to support defined benefit derisking strategies. Its innovative risk management solutions can be tailored to suit specific scheme requirements, including:

- buyouts;
- pensioner buy-ins;
- annuity vesting buy-ins;
- enhanced transfers;
- defined contribution (DC) pensions; and
- investment solutions (via Prudential M&G).

As one of the first providers of pension buyouts, Prudential has built a strong reputation for trust, backed by an impressive track record for delivering quality solutions.

So far, it has successfully implemented more than 430 bulk annuity solutions, including the first insured pensioner buy-in to exceed £1bn (with Cable & Wireless). It has secured pension liabilities for more than 117,000 pension scheme members, with a combined value in excess of £5.4bn.

Prudential is the UK's number one annuity provider, paying more than £2.1bn each year to provide retirement income to more than 1.5 million people nationwide. This provides its specialist team of mortality researchers with direct access to one of the largest data sets in the industry, helping them to accurately track and predict mortality trends.

The company also provides award-winning DC pension solutions to more than 5,400 UK corporate clients (including 20% of the FTSE 350 companies), supporting around 640,000 members.

Key contacts

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